CITY of NAPA

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August 7, 2008

FILED
AUG 11 2008
Clerk of the Napa Superior Court
By: Deputy

The Honorable Francisca Tisher
The Honorable Raymond A. Guadagni
Presiding Judges 2007/2008
Superior Court of the State of California
825 Brown Street
Napa, CA 94559

Dear Judges Tisher and Guadagni:

The City of Napa has received and reviewed the Findings and Recommendations of the 2007-2008 Grand Jury Final Report on Retirement Benefits for County of Napa and City of Napa Employees. This correspondence represents the collective response from the required respondents as called out in the Grand Jury Report. The City Council unanimously approved the responses, as included herein, in open public session on August 5, 2008.

The City's staff and Council wish to recognize the effort put into the report by the Grand Jury members. The report represents a serious effort to addresses significant public policy issues in a thoughtful and comprehensive manner. The work required to collect the information and develop an understanding of very complex and technical issues like this is a daunting task.

We took the Grand Jury's recommendations seriously and dedicated many staff hours in order to formulate responses. We hope that the observations, updates and corrections provided herein will be accepted, as intended, to be an attempt to contribute information leading to a better and more complete public awareness of the City's Pension and Benefit funding status and a different perspective of related policy questions. We hope that the Grand Jury will find this information helpful and that they will consider contacting us if they need clarifications regarding the attached response.

Respectfully submitted:

Mike Parness
City Manager

enclosure

Received
Napa Superior Court
AUG 11 2008
Court Executive Office

CITY OF NAPA CITY COUNCIL
AGENDA REPORT

Admin II Calendar
Agenda Item No. 14C
Date: August 5, 2008

To:	Honorable Mayor and Members of City Council
From:	Mike Parness, City Manager by MTW
Prepared by:	Carole Wilson, Finance Director, 257-9510 Mike Parness, City Manager, 257-9501 Michael Barrett, City Attorney, 257-9516
Subject:	Response to 2007-2008 Napa County Grand Jury Final Report on Retirement Benefits for County of Napa and City of Napa Employees

ISSUE STATEMENT:

Approve the City response to the 2007-2008 Napa Grand Jury Report

DISCUSSION:

The 2007-2008 Napa County Grand Jury Final Report on "Retirement Benefits for County of Napa and City of Napa Employees" was submitted to the City on or around June 2, 2008. The Grand Jury requested responses from the Mayor and City Council, and the Finance Director. Generally, responses from the City Council are due within 90 days, and responses from all other City officials are due within 60 days, after the Grand Jury Report was submitted to the City. This agenda report represents a consolidation of the required responses from all responding City Officials. If Council concurs with these draft responses, they will be sent to the Grand Jury as representative of all individuals required to respond for each section of the report pertinent to the City of Napa.

The issue of Employee retirement benefits and the relationship to fiscal viability is complex and at times confusing. While the Grand Jury was diligent in their efforts and spent considerable time and attention to their research, it is important that we begin this response by providing some updated information and in some cases corrections to information contained in the Report that are not accurate, current or complete.

Labor Costs: The Grand Jury stated that the *City of Napa and Napa County respectively, pay 80% and 54% of their annual budgets for wages and benefits (Summary Section pg 1, para. 4).*

The City of Napa's General Fund approved Budget for 2007-2008 was approximately $60 million. Expenditures for labor were projected to be 80% of General Fund spending. When identifying the County's labor costs the Grand Jury compared labor costs to an All Funds Budget which resulted in labor representing 54% of the total spending plan. If the City were to use the same approach, our percentage of labor costs within our All Funds Budget of $172 million would be 33%.

Budget Balancing: The Grand Jury Report identifies a City funding gap reported in our Budget document of $3.9 million for 2007-2008 and $3.7 million for 2008-2009. Labor costs were identified as the as the key component of the funding gap. The report goes on to identify examples of planned program cuts and service reductions because of this gap (Summary Section, pg. 1, para. 4).

There is no question that labor costs have been growing in recent years and they represent a larger percentage of our operating budget. This trend has led to Council direction to find ways to work with employees to contain this cost and allow diversion of new revenue to support expanding program needs. It should be noted however, that the funding gaps reported in the Budget document and subsequently adjusted in November, were also based on fully funding new needed reserve programs, restoring reserve funds utilized in prior years, providing for numerous unfunded needs and restoring staff and resources to priority programs that had been reduced in prior years.

In addition, the Grand Jury did not recognize the major Budget amendments which took place in November of 2007 which largely reversed most of the budget cuts they identified and also restored 29 needed staff positions.

Reference to Vallejo: The Grand Jury report states that in order to avoid replicating the bankruptcy in Vallejo, the City must address our costly pension and post employment benefits (Summary Section, pg 2, para 1).

While unsustainable labor agreements were the most visible element of the Vallejo financial collapse, there are several other factors which contributed to the bankruptcy filing including:

- Inconsistent fiscal management and discipline
    - Ongoing General Fund subsidies for other funds
    - Reliance on non-recurring revenues to sustain operations
- Inconsistent political and administrative leadership (e.g., seven City Managers in four years)
- Lack of economic development and a poorly performing local economy

The conditions which resulted in the Vallejo bankruptcy simply don't exist in Napa. Strong fiscal policies have been adopted in Napa to regulate spending and provide controls to keep a balanced operating budget and assure that adequate reserves are in place. Reserve programs have been fully funded in Napa to cover operating shortfalls which may occur as well as providing a secure source of funds in the case of emergencies. Much stronger controls over labor costs and management decisions are in place in Napa which provides more stability and control over operating costs. And the City administration and City Council are actively engaged in ongoing review and control of our fiscal position. Napa's local economy is thriving with private investment at an all time high and implementation of established economic development goals continue.

While Vallejo's experience should serve as a wake-up call to all government entities, to suggest that Napa is heading in the same direction as Vallejo is an unreasonable conclusion which could unnecessarily alarm our residents and leave an impression that cannot be supported by the facts.

Pensions: The Grand Jury stated that the City has an unfunded pension liability of $49,314,000. The City is funded at 79% of its total obligation between miscellaneous employees and safety employees. Ideally, pensions should be funded at 70% to 80% (Discussion Section, pg 7, para 3)

According to the City's June, 2007 audited Financial Statement our unfunded CalPERS liability is $31.6 million. The medical retiree unfunded liability (Other Post Employment Benefits, or "OPEB") estimates range from $12.7 million to $18 million for a *total* unfunded liability including medical retiree and pension liability of $44.3 million to $49.6 million. The Grand Jury's prior observation and recommendation that the City must "more rapidly reduce" our unfunded pension obligation is in conflict with the observation that the City has funded the pension program consistent with the levels deemed the "ideal range" by PERS.

FINDINGS

The following are the Grand Jury findings and recommendations along with proposed City responses. The responses contained in this report are provided as required and in accordance with section 933c of the California Penal Code.

The 2007-2008 Grand Jury finds that:

2. **The City of Napa:**
   a. **Retirement benefit for its employees (with limited exceptions) is a defined-benefit plan.**

   RESPONSE: The City agrees with this finding.

   b. **Plan for its non-safety employees and the Mayor and council members is a "2.7% at 55" plan.**

   RESPONSE: The City agrees with agrees with this finding.

   c. **The plan for its safety employees is at "3% at 55" plan.**

   RESPONSE: The City disagrees with this finding. The retirement plan for safety employees is "3% at 50".

   d. **Vesting period for the City of Napa employees is 5 years and for the Mayor and Council members 8 years.**

RESPONSE: The City agrees in part with this finding. The vesting periods for retiree medical benefits are determined by bargaining group. The vesting ranges from 5 years for Police, Fire, and Police Mid Management; 8 years for Council Members, 10 years for the Administrative, Management, Professional, Executive, and Fire Mid Management groups, and 15 years for all other employees.

e. **Current annual cost to provide medical benefits to retired employees is $1,400,000, a more than six-fold increase from $227,240 in 2002.**

RESPONSE: The City disagrees with this finding. In Fiscal Year 2001-02, the 'pay as you go' cost for retiree medical was $227,240. In Fiscal Year 2006-07, the 'pay as you go' cost for retiree medical was $615,080, approximately 2.7 times the original cost. The $1.4 million is the annual required contribution to fund both the 'pay as you go' annual cost plus funding for the accrued liability for future medical retiree costs.

f. **Estimates it will spend approximately $44,000,000 over the next six years to fund pension benefits, assuming a flat salary increase of 5%.**

RESPONSE: The City agrees with this finding and offers updated information. The City provided the estimated CalPERS pension cost of $44 million based on the January 2007 Long Term Financial Plan. The plan was updated in June 2008 with revisions including the 29 new positions restored during Fiscal Year 2007-08 and allowed for two new positions per year in order to address increasing service demands. These revisions increased the six year CalPERS pension cost estimate to $49 million.

3. **OPEB:**

a. **The County of Napa also provides OPEB for its retired employees and elected officials, some for their lifetime.**

RESPONSE: Not applicable to the City of Napa.

b. **The City of Napa also provides OPEB to its retired employees and elected officials, some for their lifetime.**

RESPONSE: The City agrees with this finding.

c. **The cost of OPEB, particularly health insurance has experienced double-digit percentage increases in the past 5 years.**

RESPONSE: The City agrees in part with this finding. Health insurance premiums for those employees who retired or will retire under the contracts in effect in the early 1980s will continue to impact the City's OPEB costs. Health insurance premiums, for the public and private sectors, have routinely experienced double digit percentage increases. However, for the majority of City retirees who left City service after 1984 and future retirees, OPEB benefits are not tied to health insurance costs but are capped at a fixed rate. This cap greatly reduces the growth rate of the retiree medical benefit.

d. **Early retirement of City and County employees, allowed by the pension plans, obligates the City and County to provide OPEB for a longer period of time until a retiree becomes eligible for Medicare at age 65.**

RESPONSE: The City agrees in part with this finding and would like to note that the obligation to provide OPEB can continue beyond the age of 65.

e. **The unfunded OPEB for the County of Napa is between $37 and $51 million and the City $2.8 million.**

RESPONSE: The City disagrees with this finding. The City's unfunded OPEB estimate ranges from $12.7 to $18.0 million.

f. **The County has started reducing its unfunded OPEB liability and intends to be fully funded in 14 years.**

RESPONSE: Not applicable to the City of Napa.

4. **Pensions:**

a. **The costs to both the City and County for pension benefits are rising so rapidly that they can adversely impact the provision of other government services.**

RESPONSE: The City agrees in part with this finding. The rapid increase in CalPERS rates in the early 2000's due to the drastic market decline challenged all local governments to meet pension obligations while maintaining or enhancing services. During the 5 year period prior to the economic downturn government pension costs were non-existent since funding obligations were covered by significant PERS investment returns. These radical swings in funding obligations have been corrected with a 15 year actuarial smoothing model to avoid future volatility to the pension rates governments will need to pay. This will allow stability and provide for better fiscal planning.

Further, excluding Police and Fire, employees retiring from the City receive a fixed medical benefit ranging from $226 a month to $347 a month. Therefore, the City has, to a large extent, insulated itself from the high OPEB costs other entities are experiencing.

b. **The unfunded liability by the County of Napa for pension benefits is $52.5 million.**

RESPONSE: Not applicable to the City of Napa.

c. **The unfunded liability by the City of Napa for pension benefits is $49.3 million.**

RESPONSE: The City agrees with this finding. By way of clarification, the June 2007 audited financial statements reported an unfunded CalPERS liability of $31.6 million. As previously indicated, the medical retiree unfunded liability estimate ranges from $12.7 to $18.0 million for a total of $44.3 million to $49.6 million.

5. **The City needs to budget more funds to more rapidly reduce its unfunded pension liability.**

   RESPONSE: The City partially agrees with this finding. Currently, the City fully funds its' CalPERS annual pension contribution. The City will also establish a trust fund for the retiree medical obligation. The City has fully funded the OPEB contribution for this budget cycle, and intends to fully fund the annual required contribution in the future.

6. **The consequences of the failure to manage these unfunded liabilities can result in tax increases, reduced services and impaired borrowing ability.**

   RESPONSE: The City agrees with this finding. Failure to manage these costs can result in serious consequences. Because the growth rate of benefit costs, particularly pension contributions, increased drastically a few years ago the City Council has established a high priority on identifying ways to contain the growth of labor cost.

   The City has been proactive in managing the medical retiree liability by achieving negotiated contracts with caps on medical retiree benefits for most of its bargaining groups and continues negotiations with the other groups in order to achieve Council's priority of fiscal stability and sustainability while providing competitive compensation in order to attract quality personnel.

7. **GASB 45 government agencies providing retiree health care and other non-pension retirement benefits must disclose the future and accrued cost of those benefits to the public within the next four years.**

   RESPONSE: The City agrees with this finding. The City will be reporting its full cost and liability of retiree benefits in the June 2008 audited financial reports.

8. **Government agencies pay more of their compensation in the form of benefits than in the private business sector.**

RESPONSE: The City agrees with this finding. However, it is important to note that as recently as five years ago, the City was paying much less to fund pensions than the private sector. This was the result of the 'super-funded' status of the CalPERS pension system which generated more investment income than necessary to fully fund retirement costs. When PERS investment income declined following the market collapse it became the responsibility of PERS member agencies to fund the gap required to maintain annual program requirements. This cyclical fluctuation, which has subsequently been addressed, has been the driving force behind the recent uncharacteristic growth of costs of public sector compensation.

9. **Government entities do not need to provide these high levels of pension benefits to attract and retain employees.**

RESPONSE: The City agrees in part with this finding. The conclusion of the Grand Jury, while understandable is the result of a generalization which fails to recognize differences in the marketplace. It is a mistake to compare the labor pool and market for many private sector jobs with the public sector. The majority of most city budgets are dedicated to public safety personnel costs. These are not employees that can be selected from the market-place and put to work without a huge investment of training, time and resources. Competition for these individuals is extreme given the shrinking labor pool and high retirement rates in recent years. One need only look at the competition underway by all major cities for qualified police officer candidates. Many agencies have been forced to offer considerable bonuses in addition to rich pension and benefit programs to attract qualified and interested police officer candidates. Nonetheless, thousands of public safety jobs remain unfilled.

Perhaps local government entities could attract and retain qualified new employees with reduced pension benefits, if the government labor market was subject to the same benefit caps established by state law. Absent a statewide limit on pension benefits to regulate this issue, competition for quality employees will make significant change for individual local government entities problematic.

10. **Having the Board of Supervisors and the City Council negotiate or approve wages and benefits on behalf of themselves, although legally permissible, is a classic conflict of interest.**

RESPONSE: The City disagrees with this finding. As the Grand Jury suggests, the practice employed by the Council to adjust wages, pension and OPEB benefits for Council members is specifically authorized by State law, and represents the same method used by the majority of public jurisdictions in the state. The State law that authorizes such increases to compensation includes safeguards against potential conflicts of interest. The Council must review and approve any increase in compensation at a public meeting after considering public input, the amount of any annual increase is statutorily capped to not exceed 5 percent per calendar year, the Council is not authorized to approve any automatic future increases in compensation, and most importantly the Council may not approve an increase in compensation that applies to a Councilmember during his or her term in office. In other words, any increase in Council salary does not go into effect until after an election for a new term of Council.

11. **Private sector defined-benefit pensions are a thing of the past, retiree health care is virtually non-existent and wages, on average, are no greater than their public sector counter-parts.**

    RESPONSE: The City partially agrees with this finding. It is true that the trend in the private sector has moved away from defined benefit pension programs and toward a defined contribution programs. The finding that retiree health programs are virtually non-existent and the conclusions that private sector wages are no greater than their public sector counter-parts represents a gross generalization that cannot accurately be applied across the many job categories and compensation plans in place through out the market place.

12. **The average age at which current City of Napa employees retire is 57 years for miscellaneous employees and 52 for safety employees.**

    RESPONSE: The City agrees with this finding.

13. **The average age at which current Napa County employees retire is 62 for miscellaneous employees and 57 for safety employees.**

    RESPONSE: Not applicable to the City of Napa.

14. **A defined-contribution plan allows the plan to define the level of contribution the employer and the employee will make.**

    RESPONSE: The City agrees with this finding.

15. **A defined-contribution plan provides advantages to the employees and reduces the cost of retirement benefits over time.**

    RESPONSE: The City partially agrees with this finding. A defined contribution plan has some advantages; for example, increased portability and more individual control over investments. It also has the potential to reduce costs for the City over time, although just a few years ago the annual costs would have been much higher to cities with defined contribution programs. Certainly the defined contribution approach provides entities with a fixed cost that makes fiscal planning easier and provides increased stability.

    On the other hand, as correctly indicated by the Grand Jury, with the defined contribution plan the risk lies squarely on the shoulders of the employee. Tens of thousands of workers on defined contribution programs lost a significant amount of their retirement savings as a result of the market downturn that also impacted PERS. The public policy implications resulting from people facing retirement age that are forced to keep working or the public implications of having large numbers of people entering retirement that can no longer afford their cost of living based on their new retirement income have yet to be determined.

RECOMMENDATIONS

The 2007-2008 Grand Jury recommends that:

1. **A shift to defined-contribution plans for all new employees of the City and the County be considered as a priority.**

   RESPONSE: This recommendation requires further analysis in conjunction with other methods of containing labor costs. The City has identified containment of our labor cost as a top priority in our work plan. To accomplish this will require complex negotiations with our labor groups and development of programs that will reduce costs without impacting our ability to attract and retain quality employees. Implementation of a defined contribution program for new employees is one of many alternatives that may be considered in this effort. It should be noted that PERS does not provide a defined contribution option for member agencies at this time.

2. **The City of Napa and County of Napa each adopt a resolution stating that it will participate in talks regarding health care reform.**

   RESPONSE: The City will not implement this recommendation. The rising cost of health care is an issue affecting all public and private sector entities and individuals. While the City is interested in participating in any discussions that might contribute to a solution we have neither the power nor resources to significantly influence this issue. Adoption of a resolution indicating our commitment to address health care reform would not be a realistic nor fruitful exercise.

   The City has however, made a commitment to work with labor groups to contain the rising public cost of health care programs provided to City employees. These changes cannot lawfully be implemented unilaterally, they are subject to bargaining. Those negotiations are underway and will continue as the term of each current labor agreement expires.

3. **A commission or task force be established to recommend and/or to vote on any wage, pension or OPEB for the BOS or City Council.**

   RESPONSE: The City will not implement this recommendation. As indicated by the Grand Jury Report the practice employed by the Council to adjust their wages, pension benefits or OPEB is neither illegal nor does it fall outside the standard practice employed by the vast majority of public jurisdictions in this State. The State laws that regulate increases to Council compensation already include accountability for the Council's decision, and safeguards against potential conflicts of interest. Any time the City Council increases their pay, pension benefits or OPEB the increase in that compensation, by law does not go into effect for a councilmember until after he/she stands for re-election. All adjustments in compensation must be done formally during a regular City Council meeting in public, the amount of any increase is statutorily capped to not exceed 5 percent per calendar year, and the Council is not authorized to approve any automatic future increases in compensation. This system is designed to place responsibility for decisions on those that have been chosen by the public to represent their interests. To delegate responsibility to a separate task force or commission, that may also be subject to political influence, does not enhance accountability and does not represent progress or good public policy.

4. **Both the City of Napa and Napa County review the time period of the OPEB coverage to determine if it could be reduced, e.g. by adjusting the retirement age percent formulas to reflect a 2.5% at 62 instead of age 55 for miscellaneous employees, or to reflect 3% at 55 instead of age 50 for safety employees, the OPEB liability could be significantly reduced.**

RESPONSE: This recommendation requires further analysis in conjunction with other methods of containing labor costs. As stated previously the City Council has directed that all opportunities to contain labor costs should be studied and implemented where feasible and in the public interest. Rolling back the PERS pension formula as recommended for new employees could reduce pension costs and medical retiree benefit costs in the long run.

From a public policy standpoint, the City Council believes that pension benefits should be designed to provide retiring employees with some assurance that they can maintain their quality of life in retirement. To provide a pension benefit level that exceeds the amount needed to maintain that quality of life is excessive and counter to the public interest. In some cases we believe that condition may exist. The actuarial goal of providing a reduced pension formula for new employee's that will meet but not exceed their standard of living requirements should be the basis for a statewide standard to be adopted by the State Legislature and applied Statewide.

If there is no statewide solution provided, the City will still be interested in studying local remedies to pension formulas that may not be supportable. These changes would only be applicable to new employees as established by the law, and would result in a two tiered pension benefit program that would provide savings over the long term. Assuming a two tiered system for pension benefits could be negotiated with employee groups, and a contract with PERS could be secured to legally establish a two tiered system, there are a number of other factors to consider. As discussed previously the City must retain the ability to attract and retain quality employees. Any individual City reducing pension benefits below the market standard will not be able to attract trained and qualified public sector employees. If we do attract entry level employees we will become a training ground for new recruits that will simply move on when they can qualify for work with agencies offering more competitive benefits. This result is costly and disruptive to operations and speaks to the need for a statewide remedy.

FINANCIAL IMPACTS:

None

CEQA:

The City Manager has determined that the recommended action described in this Agenda Report is not subject to CEQA, pursuant to CEQA Guidelines Section 15060(c).

DOCUMENTS ATTACHED:

None – A copy of the Grand Jury Report is available at the City Clerks office for public review.

RECOMMENDED ACTION:

City staff recommends that the City Council move, second and approve each of the actions set forth below, in the form of the following motion stated as:

Move to:

> Approve the City's response to the findings and recommendations of the Napa County Grand Jury 2007-2008 Final Report on Retirement Benefits for County of Napa and City of Napa Employees (as outlined above, and incorporating any changes made to the responses by the City Council during the meeting), and direct the City Manager to submit the response on behalf of the City Council, the Finance Director and other City officials as required, to the presiding judge of the Superior Court.

CITY MANAGER Mike Parness by [illegible]