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CITY OF OAKLAND

AGENDA REPORT

TO: FRED G. BLACKWELL
CITY ADMINISTRATOR

FROM: Osborn K. Solitei

SUBJECT: Response to City Auditor's Pension Audit

DATE: May 7, 2014

City Administrator Approval _____ Date 5/7/14

RECOMMENDATION

Receive the City Auditor's Pension and Audit Report released in April 2014 and Staff's Response and Recommendations in Relation to Oakland's Reported $1.5 Billion Unfunded Pension Liability.

OUTCOME

This report is being presented as an informational item to the City Council.

BACKGROUND/LEGISLATIVE HISTORY

Council member Noel Gallo requested the City Auditor's report on City's unfunded liabilities to be presented to the City Council. Staff was directed to provide responses to the City Auditor's report as well as recommendations. This report provides information related to the City Auditor's report, response from the City Administration, status of the City's unfunded liabilities and measures taken so far to address the unfunded liabilities.

City of Oakland Pension System

The City of Oakland's (the "City") current pension system is the California Public Employees' Retirement System (CalPERS), which includes sworn employees (police and fire) and non-sworn employees (all other employees) and is administered by the State of California (the "State"). Through the CalPERS system, the City provides defined benefits to retirees. A defined benefit is a specified monthly benefit based on the retiree's years of service and final compensation with the City. For most employees, final compensation is determined as an employee's highest paid 12 consecutive months of service. In conjunction with CalPERS, the City also provides eligible retirees and their dependents with Other Post-Employment Benefits (OPEB), which primarily includes health care coverage.

The City also has two "closed" systems, meaning that the systems are closed to new members. These are the Oakland Police and Fire Retirement System (PFRS) and the Oakland Municipal Employees' Retirement System (OMERS). The PFRS and OMERS systems cover employees that were hired prior to July 1976 and September 1970, respectively. Since they are closed to new members, they get very little, if any, employee contributions but pay out to many retirees. City employees hired after 1970/1976 are included in the City's current, CalPERS defined benefit pension plan.

Defined benefit pension plans, in principle, are supposed to be pre-funded and require the employer to set aside money during the employee's career that will later be used to pay for the employee's retirement benefits. The funds that are set aside are invested, with anticipation that the investment will grow in value over time and enable the employer to fund the employee's retirement benefits. Because government agencies provide defined benefits, if the pension investments miss their long-term, target return, the pension system becomes underfunded and must be covered by the City. The combined total unfunded retirement liability for the City's pension systems and for OPEB is just under $1.5 billion per 2012 actuarial valuation.

Scope and Methodology of the Pension Audit

The Office of the City Auditor completed the City's Pension Audit in March 2014. The purpose of this audit was to report the status of Oakland's unfunded pension obligations; Oakland's implemented and planned pension funding strategies; what else Oakland can do to address its pension obligations; and lessons learned from the private sector and other government agencies. To conduct the audit, the Office of the City Auditor interviewed management and staff from the Budget Office, Controller's Office and Treasury Division. The Office also reviewed: historical and most recent actuarial valuations for Oakland's pension systems; CalPERS contracts and relevant policies; relevant state laws, City's financial reports, forecasts and union pension agreements; pension case studies, relevant white papers and identified lessons learned in pension reform from both private and public sectors. Additionally, the Office of the City Auditor benchmarked Oakland's pension obligations and reform progress against other California cities (including San Francisco, San Jose, Berkeley, Sacramento, Los Angeles, Long Beach, and San Diego), and consulted with the City Attorney to understand legal limitations regarding pension reform.

Audit Recommendations

The Audit found that Oakland's pension obligations are growing, but it appears that Oakland's leaders have limited ability to address this significant liability. The Audit also provided a report of actions the City has taken in direct response to its unfunded pension liability. Additionally, the Audit provided a summary of pension reform lessons from private sector employers and other government agencies.

Following the completion of the Pension Audit, the Office of the City Auditor submitted the following recommendations to the City Administration:

1. Convene a Pension Advisory Group to gather, evaluate and organize information for a comprehensive solution to Oakland's unfunded pension liabilities; and
2. Form a coalition of cities to find a common ground to support comprehensive solutions at the state and CalPERS levels.

In summary, pension reform is a complex issue that government agencies are grappling with. Employers are obligated to pay for their growing pension liabilities, which are going to increasingly impact government's ability to provide key services (such as public safety, infrastructure, libraries and parks). While it is important to know why Oakland has unfunded pension liabilities, it is more important that going forward Oakland's leaders, in collaboration with stakeholders, define path to a fair and predictable pension system that provides retirement security for all – new workers, current employees and retirees, without overburdening taxpayers, and while delivering critical City services.

ANALYSIS

The City of Oakland has made significant strides in addressing its unfunded pension liabilities under the legal limitations regarding pension changes. The Administration agrees with the Pension Audit's recommendations that it would take the collaboration of Oakland leaders and different stakeholders to find solutions beyond what the City can do to resolve the matter as a result of these restrictions. However, the comparison of different pension reforms summarized in the Auditor's report is not applicable to the options available to the City of Oakland. Agencies referenced in the Audit are either private or not members of the CalPERS system and, therefore, they are not subject to the same state law and CalPERS policies that govern Oakland's retirement systems.

As noted in the audit, the City has three pension systems and Other Post-Employment Benefits with total unfunded actuarial accrued liability (UAAL) of approximately $1.5 billion. The Police and Fire Retirement System and Oakland Municipal Employees Retirement System are closed systems. CalPERS is for all active employees and has a funded ratio of 77.3% for miscellaneous employees and 79.6% for public safety employees, respectively. The Government Accountability Office (GAO) considers 80% to be a healthy funding level for public pension funds. By this standard, Oakland's CalPERS system is near the acceptable range.

A number of factors impacting pension costs are outside of the City's control, such as the unforeseen financial crisis of 2008 which resulted in significant losses to public pension plans across the state and the country. Still, many of the reforms implemented by CalPERS over the past several years are serving to reduce the City's long-term pension liability while increasing the costs in the short term.

For instance, on February 18, 2014, the CalPERS Board approved new demographic assumptions for the pension system, which marks the third change in factors in the last two years which will result in higher pension costs and ultimately translate into higher contribution rates for the public agencies like Oakland. In addition, CalPERS has lowered the discount rate and is implementing a new smoothing and amortization policy. All these changes impact the long-term funding of the system. However, these changes are intended to protect the beneficiaries and reduce the long-term cost of benefits for all in addition to meeting the pension obligations to current and future public employees.

Although Oakland is limited by State law and CalPERS system constraints regarding what it can do to address its current UAAL, the City has been proactive and taken numerous steps to address its soaring pension costs. Specifically, the City has implemented the following efforts in response to the growing unfunded pension liability concerns:

- **The City increased employee pension contributions.** The City has raised the amount that employees contribute into the CalPERS pension system, thereby alleviating the amount the City has to pay. Specifically, the City implemented the following changes to the employees' pension contributions:

Labor Group	Past Employee Contribution	Current Employee Contribution
Fire	9%	13% (as of 7/1/04)
Police	0%	9% (as of 7/1/11)
Non-sworn	3%	8% (as of 7/1/09)

- **The City has implemented a three-tier pension plan** to address the growing concerns of UAAL in CalPERS and reduce the City's pension costs over time, as shown below:

Tiered Pension Plans

Employee Organization	Tier One (Classic Members)	Tier Two (New Hires in 2012)	Tier Three: AB 340 (January 1, 2013)
Public Safety	Receive 3% at age 50 Pension benefits are based on one year of highest salary	Receive 3% at age 55 Based on the final average salary of 3 years under the Government Code 20037 (hires as of 2/9/12)	Receive 2.7% at age 57 Based on the final average salary of 3 years subject to established cap
Miscellaneous	Receive 2.7% at age 55 Final compensation is based on the twelve (12) highest paid consecutive months.	Receive 2.5% at 55 Based on the highest average annual compensation of the 3 consecutive years (hires as of 6/8/12)	2% at age 62 Based on the final average salary of 3 years subject to established cap

- **The City issued pension obligation bonds.** Unlike other cities, Oakland has a dedicated source of revenue to pay for these pension bonds. The proceeds were used to reduce the UAAL on one of its pension systems (Oakland Police and Fire Retirements System, or PFRS). As a result, PFRS' UAAL was significantly reduced from $426 million to $216 million, and its funded ratio went from 37.5% to 68.2%.

- **The City secured approximately $27 million to pay its pension liabilities through 2022.** Following the dissolution of the Redevelopment Agency, the City has requested paying pension obligations for former Redevelopment Agency employees through the Recognized Obligation Payment Schedule (ROPS) based on employees working on redevelopment projects and programs. On an annual basis, the City estimates receiving $1.2 million from the State until June 30, 2022, which will be used to pay down unfunded pension liabilities.

- **The City secured approximately $14 million to pay unfunded Other Post-Employment Benefits (OPEB) liabilities through 2022.** Following the dissolution of the former Redevelopment Agency, the City has requested paying unfunded OPEB obligations for former Redevelopment Agency employees through the ROPS. On an annual basis, the City estimates receiving $600,000 from the State until June 30, 2022, which will be used to pay OPEB liabilities.

- **The City established a reserve fund to pay unfunded liabilities.** City Council approved appropriations of $10 million in FY 2015-16 and an additional $10 million in FY 2016-17 to be paid into the reserve.

- **The City set aside additional revenues into this reserve.** On June 27, 2013, City Council adopted the FY 2013-15 Policy Budget, Resolution No. 84466 C.M.S., which set aside 10% of the projected excess General Purpose Fund (GPF) Real Estate Transfer Tax ($5.34 mil) revenues in the amount of $534,500. In accordance with the FY 2013-15 Adopted Policy Budget, $534,500 was reserved for unfunded liabilities.

- **Additional changes approved by the CalPERS Board will ensure greater sustainability and soundness of the pension fund in the future.** These include:

Date	CalPERS Adopted Policy Changes
March 2012	Lowered the Discount Rate (from 7.75% to 7.50%)
April 2013	New smoothing and amortization method
February 2014	Increased life expectancy (approximately: males by 2.1 yrs, females by 1.6 years)

❖ **The Administration developed a list of budget strategies aimed at reducing future retirement expenditures**. These strategies include the following:

- Beginning to invest in the California Employer's Retiree Benefit Trust (CEBRT) Fund to fund pension liabilities;
- Migrating to a defined contribution retirement plan;
- Transferring the Oakland Municipal Employees' Retirement Systems (OMERS) liability from the City to a third-party insurance provider via group annuity contracts.

In conclusion, the City recognizes the importance of addressing the unfunded pension liabilities and has taken proactive steps to tackle this issue within the constraints of state laws and the CalPERS system. Similar to other governmental agencies, Oakland has an obligation to pay for its pension liability, which is going to increasingly impact the City's ability to provide key services to the community (such as public safety, infrastructure maintenance, parks and libraries). In addition, unfunded liabilities that have built up over decades cannot be resolved overnight; it will take time to pay them off. To that end, the Administration is looking forward to collaborating with Oakland's leaders and stakeholders to further define the impact the unfunded pension liability has on the City's financial health and to identify comprehensive solutions for the City's pension system that would provide retirement security to employees without overburdening taxpayers.

PUBLIC OUTREACH/INTEREST

This item did not require any additional public outreach other than the required posting on the City's website.

COORDINATION

Staff from the City Administrator's Office, the Controller's Office and the Office of the City Attorney has reviewed this report.

COST SUMMARY/IMPLICATIONS

This report is being presented as an information item to the City Council and contains a general overview of various long-term cost implications for the City's financial position.

SUSTAINABLE OPPORTUNITIES

There is no impact to economic, environmental or social equity opportunities following actions under this report.

For questions regarding this report, please contact Osborn K. Solitei, Director of Finance/Controller, at (510) 238-3809.

Respectfully submitted,

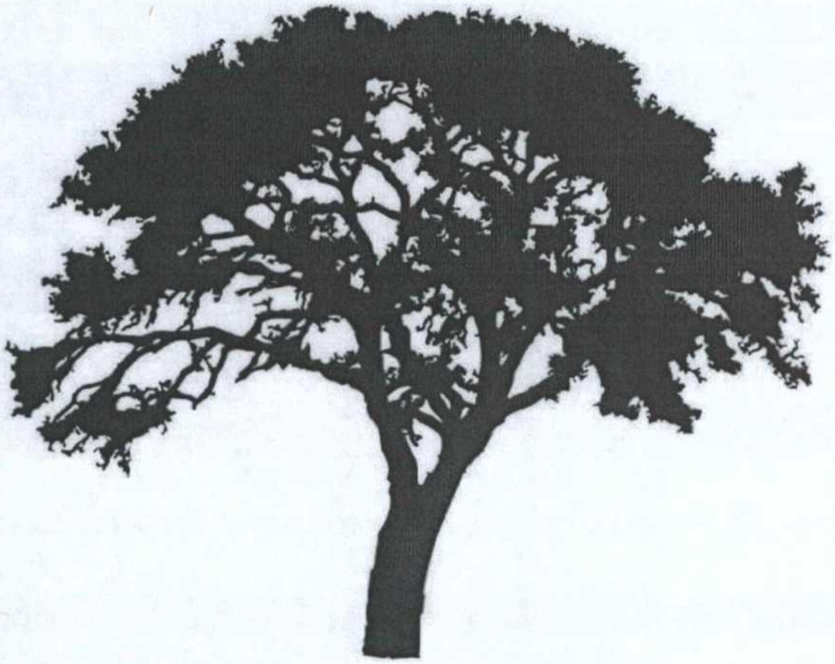
Osborn K. Solitei
Director of Finance/Controller

City of Oakland
Office of the City Auditor

April 20, 2014

Pension Audit

Oakland's $1.5 billion pension obligations will continue to impact its ability to provide key services. Oakland's leaders must address this significant liability now.



City Auditor
Courtney A. Ruby, CPA, CFE

PERFORMANCE AUDIT

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CITY OF OAKLAND

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April 20, 2014

OFFICE OF THE MAYOR
HONORABLE CITY COUNCIL
CITY ADMINISTRATOR
CITIZENS OF OAKLAND
OAKLAND, CALIFORNIA

RE: PENSION AUDIT

Dear Mayor Quan, President Kernighan, Members of the City Council, City Administrator Blackwell, and Oakland Citizens:

With an unfunded pension liability hovering at $1.5 billion, Oakland faces a three pronged challenge of delivering critical City services and meeting the promises made to current and retired employees, without overburdening taxpayers. While formerly viewed as a cash flow issue, we now know pension obligations are a solvency issue. There is simply not enough money coming in to pay for what must go out.

Attached you will find the Pension Audit Report, which provides a clear picture of Oakland's pension situation, the steps Oakland has taken, lessons learned from the private sector and other government agencies, and identifies what else can be done.

Oakland has taken several steps (some on its own accord and some resulting from state reform) to address its pension liability and stabilize its finances. Because California cities are limited by current state law and CalPERS policies, Oakland's ability to address its unfunded pension liability significantly falls short of what is owed. While this is a statewide problem, Oakland is 100 percent accountable to its taxpayers for solving this financial dilemma.

If this problem is not tackled, the results will likely be greater service cuts, staff reductions, and new tax increases. The City has already reduced its workforce by 21 percent - or 720 positions - over the past decade, reduced the number of sworn police officers by 27 percent in the last six years, instituted rolling brown-outs of two fire stations, and implemented significant reductions in services, including street maintenance, code enforcement, planning, cultural arts, and neighborhood improvement programs.

The audit recommends that moving forward, Oakland's leaders, in collaboration with stakeholders, define a path to a fair and predictable pension system: one that provides retirement security for new, current, and future employees, does not overburden taxpayers, and sustains delivery of important City services. Oakland should work in partnership with other cities to begin addressing this at the state level.

There is no prefabricated solution to reforming pensions. It is a complicated issue that most government agencies are grappling with and every agency's solution must address its own unique circumstances. If Oakland does not immediately begin to address the larger issues, it may not be able to meet its future pension obligations without radically changing the manner, means, and breadth of city services.

Respectfully submitted,

Courtney A. Ruby

COURTNEY A. RUBY, CPA, CFE
City Auditor

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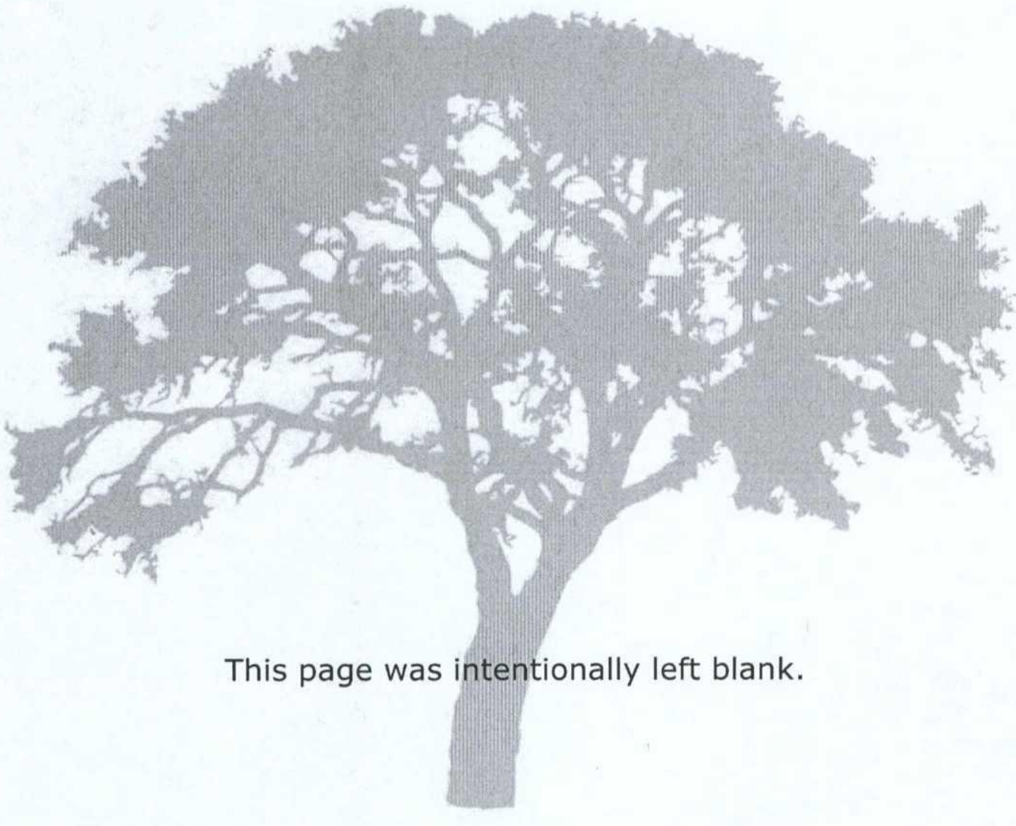

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REPORT SUMMARY
Pension Audit

OVERVIEW

The audit found Oakland's $1.5 billion pension obligations are growing and will increasingly impact its ability to provide key services in the future. While Oakland currently has limited ability to make pension reform changes, Oakland's leaders must become involved in addressing this significant liability now.

Summary

The Office of the City Auditor conducted a performance audit to clearly report the status of Oakland's unfunded pension obligations, Oakland's implemented and planned pension funding strategies, Oakland's options in addressing its pension obligations, and lessons learned from the private sector and other government agencies.

Audit Findings

The findings from the audit are:

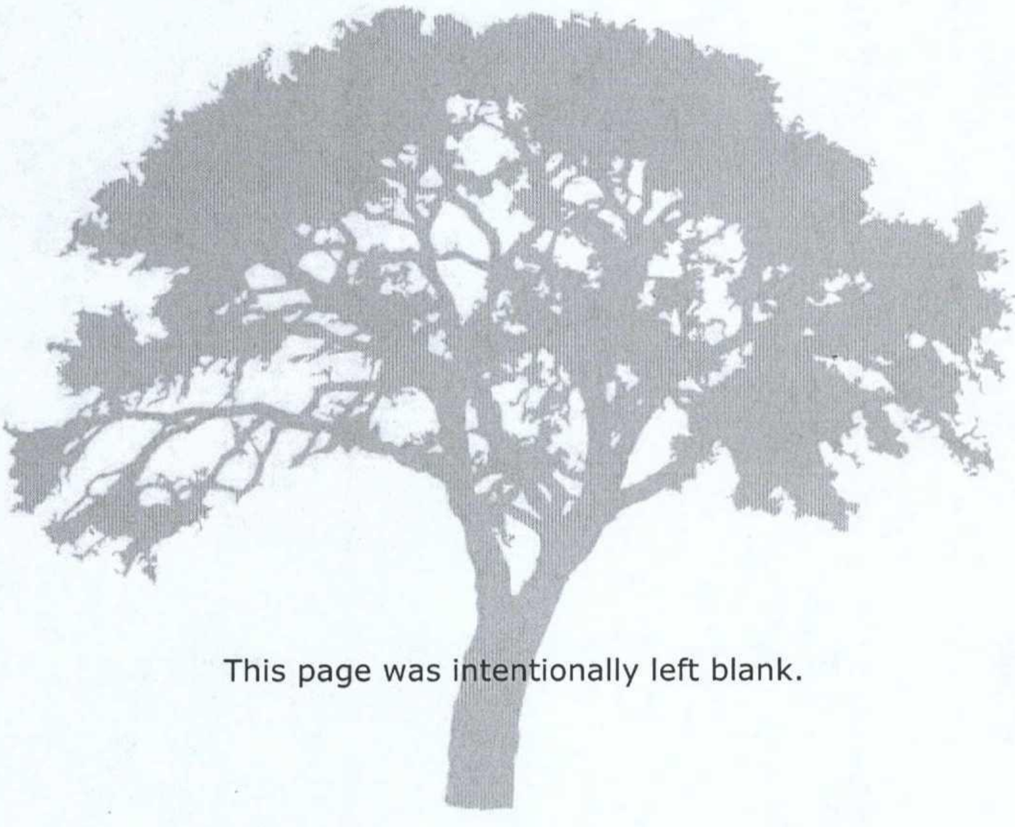
- Oakland's pension obligations are growing but it appears that Oakland's leaders have limited ability to address this significant liability.
- Oakland could benefit from lessons learned from the private sector and other government agencies.

Recommendations

To address the audit's findings, the report recommends that the Administration and the City Council should:

- Convene a Pension Advisory Group to gather, evaluate, and organize information for a comprehensive solution to Oakland's unfunded pension liabilities. This Advisory Group will design a plan to impact pensions on three levels:
    - State/ Federal – what legislative changes, if any, are needed to be proposed so that the municipalities may be in control of their financial futures as related to pensions.
    - CalPERS – does CalPERS serve the needs of all of its member agencies and how does Oakland and other municipalities have a greater impact on CalPERS policies given issues such as Moody's new rating approach.
    - Oakland – what changes may be made now within the restrictions of CalPERS and state law, and which of these changes can be agreed to by all stakeholders.

  This process should be convened publicly and have clearly defined processes for stakeholder input including citizens and employees. The Advisory Group should be comprised of a broad cross section of stakeholders, for example, the City should strongly consider including: academia and pension experts, an independent financial consultant, an independent law firm.
- Form a coalition of cities to find common ground to support comprehensive solutions at the state and CalPERS levels.



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Introduction

Retirement systems were originally designed as an incentive for older workers to retire, preventing stagnation and increasing opportunities for young people to enter the workforce at cheaper salaries. A century later, instead of providing income for only a few remaining years of life, retirement systems have ballooned into significant, decades-long financial obligations for many cities and states.[1] Local governments throughout California have been struggling with growing, unfunded pension and health care liabilities. In a July 17, 2012 letter to the California Senate and Assembly leadership, the mayors of eight of the 11 largest cities in the state noted that escalating pension costs were adversely affecting their budgets, residents, and city employees.[2]

Government agencies made pension promises that far exceed the assets that have been set aside to cover them, and at some point, taxpayers will likely have a large bill to pay to settle those promises.

Governments believed that increasing pension liabilities was a cash flow issue and could be solved accordingly (i.e., we don't have the funds currently but we will have them later; so how do we cover the payment right now). It is not; instead, pension liability is a solvency issue (i.e., how do we make this payment for the long term).[3] Unfunded pension liabilities are growing over time due to a variety of factors, including but not limited to, people living longer,[4] poor market performance, and ballooning healthcare costs.[5] Government agencies made pension promises far exceeding the assets that have been set aside to cover them, and at some point, taxpayers will likely have a large bill to pay to settle those promises.[6]

Most government agencies, including Oakland, provide current and past employees with defined benefit pension plans,[7] where the government guarantees the level of benefits that will be paid.[8] Defined benefit pension plans are, in principle, supposed to be pre-funded and require the employer to set aside money during an employee's career to be used later to pay for the employee's retirement benefits. The money that is set aside is invested by the employer into a mix of equities and bonds; ideally, the investment will grow in value over time and enable the employer to fund the employee's retirement pension. However, if the invested money does not grow as expected, the employer, the City of Oakland, is responsible for covering the difference between what was actually received from the investment and the amount that the employee was promised for retirement. Because most governments have defined benefits, if the pension investments miss their long-term target return, the pension system becomes underfunded and must be covered by the government, and ultimately the taxpayer.[9] The status of cities' and states' unfunded pension liability has grown dramatically over the years, and government agencies will continue to face considerable financial risks from rising pension costs for years to come.[10]

The purpose of this audit is to report the status of Oakland's unfunded pension obligation, steps Oakland has taken regarding its pensions, what else can be done, and lessons learned from the private sector and other government agencies. It is important to know why Oakland has unfunded pension liabilities. However, it is more important that, going forward, Oakland's leaders, in collaboration with stakeholders, define a path to a fair and predictable pension system that provides retirement security for all - new workers, current workers, and retirees. This should be done without overburdening taxpayers, while also delivering critical City services.

Background

Historical Events Shaping Today's Pension Systems

The status of governments' current pension situations is the aftermath of a number of significant economic events and laws. Below is a high-level overview of key events and laws impacting government pensions. The below paragraphs only discuss impacts as they relate to pensions and not the reasons why the laws were enacted or other impacts and benefits that may have occurred.

In 1978, Proposition 13 was enacted in California which cut the property tax rate, capped the annual increase in assessed value, and required a two-thirds super majority in the legislature for any tax hike. The overall result was that California had less revenue available. There were also a number of initiatives that required funds to be used for specific purposes, limiting availability of funds to be spent elsewhere. Additionally, it is now more difficult for policymakers to raise taxes to increase revenues.[11]

In the mid to late 1990's, during the dot-com boom, tax dollars flowed into state and local governments and pension funds were earning record high returns. Pension promises were made under the illusion that the stock market returns of the dot-com boom were the new normal. This resulted in California passing Senate Bill (SB) 400 in 1999. SB 400 brought dramatic pension changes to the state, including:[12]

- Lowering the minimum retirement age from 55 to 50 for most sworn employees and from 60 to 55 for non-sworn employees.[13]
- Eliminating a reduced benefit package thus allowing all employees to enjoy more generous benefits.
- Making retroactive benefit increases to retirees of as much as 50 percent for workers whose decades-long contributions were based on a lower expected benefit.
- Making the increased benefits available to local government workers covered by California Public Employee Retirement System (CalPERS[i]).[14]

Lowering the retirement age and retroactive benefit increases meant higher benefit amounts for more years, making the cost of California's pensions among the highest in the nation.

Lowering the retirement age and retroactive benefit increases meant higher benefit amounts for more years, making the cost of California's pensions among the highest in the nation.[15] In 2003 and 2004, Oakland followed the state's example (SB 400) and similarly lowered the City's retirement age for its employees and raised the level of pension benefits provided.

[i] CalPERS administers health and retirement benefits on behalf of the City of Oakland.

In 2008-09, the stock market collapse and housing bust exposed the structural vulnerabilities of California's public pension systems and the political decisions that led to a growing retirement obligation for state and local governments.[16] The stock market collapse and housing bust affected governments' revenue,[17] resulting in less revenue to allocate among critical services and other costs, such as pension obligations. California was hit hard.[18] According to the Center for Retirement Research at Boston College, California had higher foreclosure and unemployment rates than most other states, and between 2007 and 2010, local government revenue in California grew by only 3 percent compared to 9 percent for the rest of the nation.[19] In 2009, CalPERS reported losing approximately 24 percent of participants' pension money in the stock market crash.

Another factor in play is that pension costs are swelling as baby boomers reach retirement.[20] When retirees outnumber current employees, the base of people paying into the pension system is fewer than the number of people collecting from the system.[21] This imbalance requires government agencies, and thus taxpayers, to cover the difference.[22]

Objectives & Methodology

Objectives

The objectives of this audit are to clearly report:

- The status of Oakland's unfunded pension obligations.
- Oakland's implemented and planned pension funding strategies.
- What else Oakland can do to address its pension obligations.
- Lessons learned from the private sector and other government agencies.

Methodology

To conduct this audit, the Office:

- Interviewed management and staff from the Budget Office, Controller's Office, and the Treasury Department.
- Reviewed historical and most recent actuarial valuations for Oakland's pension systems.
- Reviewed CalPERS contracts and relevant policies.
- Reviewed relevant state laws.
- Reviewed the City's comprehensive annual financial reports, budgets and financial forecasts, City Council resolutions, relevant staff reports, and union pension agreements.
- Reviewed pension case studies, relevant whitepapers, and identified lessons learned in pension reform from both the private and public sectors.
- Benchmarked Oakland's pension obligations and reform progress against other California cities, including San Francisco, San Jose, Berkeley, Sacramento, San Diego, Los Angeles, and Long Beach.
- Consulted with the City Attorney to understand legal limitations regarding pension reform.

The Office conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS), except for independence. The Office participates in the benefit program being audited and the City Charter requires the City Auditor to serve on the board of the Oakland Municipal Employees' Retirement System (OMERS). Being a voting member of this board creates a management participation threat to independence and a self-review threat. However, OMERS is a closed pension system and, as of July 1, 2012, the system only covers 28 retirees and beneficiaries, less than 1 percent of the individuals in all of Oakland's pension systems. OMERS board members also do not receive any compensation. The following safeguards were designed by the Office to mitigate these threats and to help ensure that the facts and findings presented in this audit are fair and impartial: 1) The scope and objectives of the audit were established to ensure that there would not be a threat of self-review. As such, the audit focused on the City's active pension system, CalPERS rather than OMERS; also, the Office did not review any decisions made by the OMERS board of administration. 2) The source of all pension/financial data included in the audit report was provided by the Administration and was cross-compared with the City's independently audited financial statements and independently prepared actuarial reports. 3) The Administration was provided with multiple opportunities to review and provide feedback on the accuracy of the report's findings and conclusions. 4) The Office engaged a well-qualified auditor to perform independent fact checking of the report findings and conclusions.

Beyond the above disclaimer, GAGAS requires that the Office plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the audit's findings and conclusions based on the audit's objectives. The Office believes that the evidence obtained provides a reasonable basis for the audit's findings and conclusions based on the audit objectives.

AUDIT RESULTS

FINDING 1

Oakland's pension obligations are growing but it appears that Oakland's leaders have limited ability to address this significant liability.

Summary

The City has three pension systems, one current and two closed systems. The City owes money to two of the three systems. Additionally, Oakland is obligated to provide retiree health benefits known as Other Post-Employment Benefits (OPEB). Oakland's total unfunded liability is approximately $1.5 billion. Oakland has made efforts to address this outstanding balance, but is faced with significant legal limitations regarding pension reform. Despite current limitations, a growing $1.5 billion unfunded pension liability is a serious issue that requires comprehensive strategies by Oakland's leaders and stakeholders.

This chapter will provide an overview of: 1) Oakland's pension systems and obligations, 2) the steps Oakland has taken regarding its pension systems, and 3) legal limitations to changing Oakland's current pension benefits.

Section 1.1

Overview of Oakland's Pension Systems and Obligations

The City's current pension system is the California Public Employees' Retirement System (CalPERS), which includes sworn employees (police and fire) and non-sworn employees (all other employees) and is administered by the state. Through the CalPERS system, the City provides defined benefits to retirees; a defined benefit is a specified monthly benefit based on the retiree's years of service and final compensation with the City. For most employees, final compensation is determined as an employee's highest paid 12 consecutive months of service. In conjunction with CalPERS, the City also provides eligible retirees and their dependents with OPEB, which includes health coverage. The City's two closed systems are the Oakland Police and Fire Retirement System (PFRS) and the Oakland Municipal Employees' Retirement System (OMERS). The PFRS and OMERS systems cover employees that were hired prior to July 1976 and September 1970, respectively, and are closed to new members. This means that they get very little, if any, employee contributions but pay out to many retirees. City employees hired after 1970/1976 are included in the City's current, CalPERS defined benefit pension plan.

Oakland has a $1.5 billion unfunded pension and healthcare liability.

As can be seen in Exhibit 1, the City has payment obligations to two of its three pension systems and to OPEB. The combined total unfunded retirement liability is just under $1.5 billion per 2012 actuarial valuation.[ii]

[ii] Starting in FY 2014-15, Governmental Accounting Standards Board (GASB) 68 will require the City to record its unfunded pension liability based on market value and potentially use a blended discount rate. The new standards are related to accounting and financial reporting and do not apply to the City's contribution rates to pensions. However, these changes will likely increase the volatility of the City's reported funded ratio for its pension systems.

Exhibit 1: Oakland's Retirement Obligations per June/July 2012 Actuarial Valuation

Retirement Obligation	Assets [A]	Liabilities [B]	Unfunded Liabilities	Funded Ratio
CalPERS (California Public Employees' Retirement System)			**$742,168,699**	
– Sworn	$1,080,138,724	$1,398,098,675	$317,959,951	77.30%
– Non Sworn	$1,655,997,001	$2,080,205,749	$424,208,748	79.6%
OPEB (Other Post-Employment Benefits)	$0	$553,530,074	$553,530,074	0% [C]
PFRS (Oakland Police and Fire Retirement System) [D]	$437,219,000	$640,908,000	$203,689,000[E]	68.2%
OMERS (Oakland Municipal Employees' Retirement System)	$4,448,000	$3,630,000	($818,000) [F]	122.5%
Total			**$1,498,569,773**	

Source: The most recent actuarial valuation reports for Oakland's pension systems.

[A] *Actuarial Value of Assets: The Actuarial Value of Assets used for funding purposes is obtained through an asset smoothing technique where investment gains and losses are partially recognized in the year they are incurred, with the remainder recognized in subsequent years.*

[B] *Entry Age Normal Accrued Liability or Actuarial Accrued Liability: The total dollars needed as of the valuation date to fund all benefits earned in the past for current members and retirees.*

[C] *The City funds OPEB pay-as-you-go with no current money set aside for future liabilities.*

[D] *Projected PFRS valuation shows impact of the pension obligation bond that the City issued in 2012 to reduce the PFRS unfunded liability from $426.8 million to $216.8 million. The City used the bond revenue to make five years of advanced payments on its obligation to PFRS. Required payments to PFRS will not re-commence until fiscal year 2017-18. The general purpose fund portion of the PFRS payment beginning in FY 2017-18 is estimated to be $24.2 million. The City also makes annual payments to pay back the obligation bond; these payments span from 2013 through 2026.*

[E] *In 2012, in response to a lawsuit, the Alameda County Superior Court sustained that the City had overpaid $3.83 million annually in benefits to PFRS members from 2008 to 2012 and that this money could be recovered by the City. In early 2014, the First District Court of Appeals in San Francisco overturned most of that ruling. The outcome of any future appeal is unknown and thus the potential impact to PFRS outstanding unfunded liability is also unknown.*

[F] *OMERS funding is currently greater than its obligations. However, this may fluctuate depending on the actual rate of return and assumptions used.*

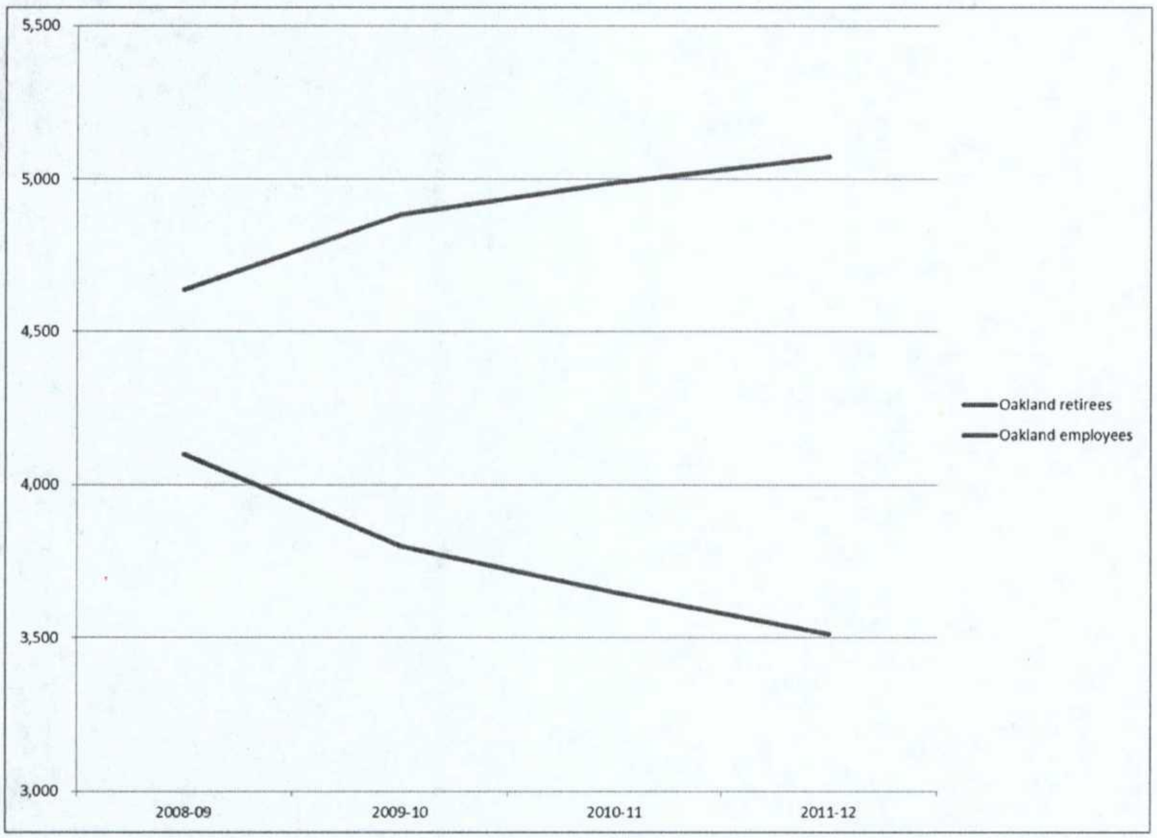
Two terms used in discussing pension systems are unfunded liability and the funded ratio. Unfunded liability is pension debt. It is the amount the City owes to pay for benefits earned by current employees and retirees. The funded ratio is the amount the City has set aside to pay for its pension debt compared to the total pension debt. Although the City has a $1.5 billion unfunded retirement liability, the City meets its annual payment obligations to its pension systems (called Annual Required Contributions or ARC). Pension payments are determined by pension actuaries based on numerous factors. Actuaries establish ARC payments to cover total pension obligations including both the amount due for current employees, as well as the unfunded pension liability for retirees.

The Government Accountability Office (GAO) considers 80 percent to be a healthy funding level for a public pension fund.[23] By this standard, Oakland's CalPERS system is near the accepted range. However, it is important to remember that even though Oakland is close to achieving a "standard" funded ratio for its current pension system, 80 percent funded means that there is still 20 percent that remains unfunded and will likely continue to grow. Also, as can be seen in the Appendix, Oakland's funded ratio is generally lower than the other CalPERS cities that were benchmarked as part of this audit. Beyond CalPERS, Oakland's PFRS system is funded at 68 percent, which is under the GAO accepted range and means that there is still 32 percent unfunded. This unfunded liability will continue to impact the City's current and future budgets and needs to be strategically addressed.

Any time retirees outnumber active members, the ability to properly fund pension benefits requires larger contributions from the City's taxpayers that would otherwise be taxpayer dollars spent on city services.

Like many government agencies, Oakland is faced with tight budgets and has had to offer fewer services and employ fewer individuals. Oakland also has a growing number of retirees. What does this mean for Oakland's pension system? Any time retirees outnumber active members, the ability to properly fund pension benefits requires larger contributions from the City's taxpayers that would otherwise be taxpayer dollars spent on city services.[24] As shown in Exhibit 2 below, as of 2012, Oakland had 3,513 active employees and 5,071 retired employees in its pension systems. The large number of baby boomers reaching retirement compounds the financial implications for the City.[25]

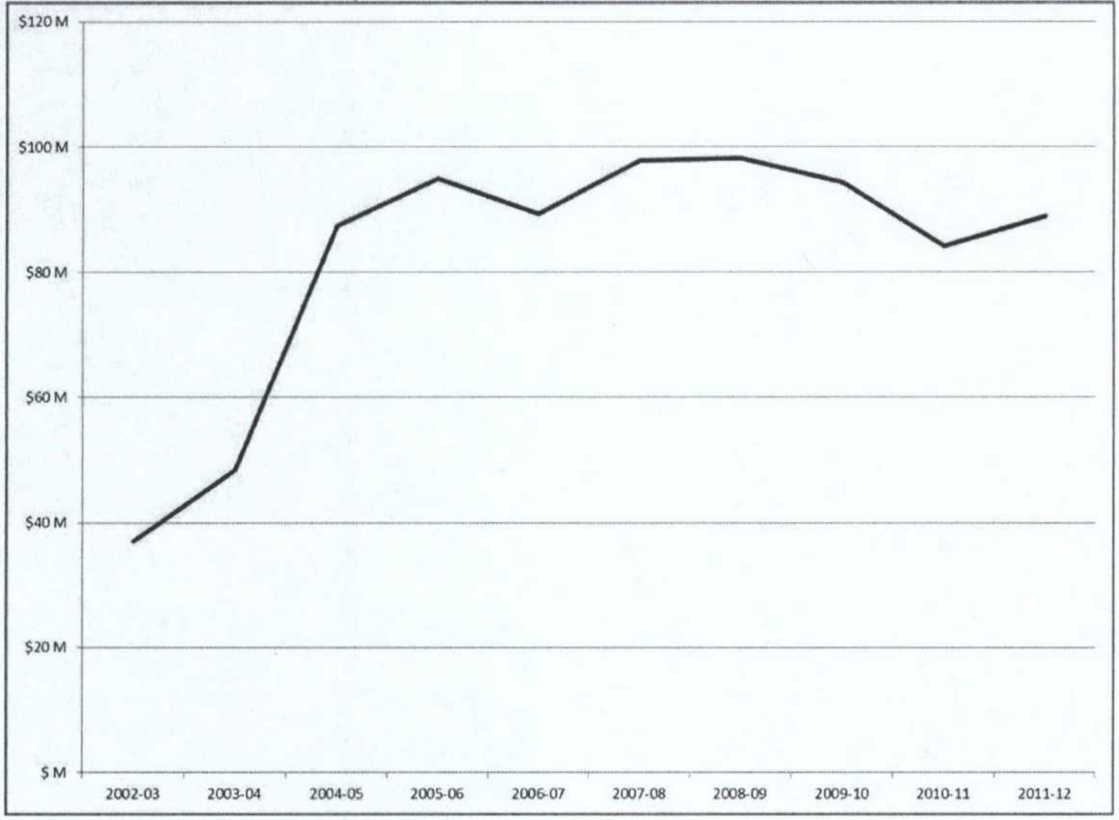
Exhibit 2: Comparison of Oakland's Retirees to Active Employees, 2008 – 2012



Source: Actuarial valuation reports and comprehensive annual financial statements for Oakland's pension systems for 2008-2012.
** Retirees data include beneficiaries.*

As pension obligations grow, the payments needed to maintain a fiscally healthy, sustainable system will also grow. Over the past nine years, Oakland's unfunded liabilities for CalPERS alone have doubled from $363 million in FY 2002-03 to $742 million in FY 2011-12. In turn, Oakland's annual payment to CalPERS increased from $37 million in FY 2002-03 to $89 million in FY 2011-12. See Exhibit 3. According to the Administration, this cost will increase by 21 percent in FY 2013-14 and an additional 8.6 percent increase in FY 2014-15.

Exhibit 3: Growth in the City's ARC Payments to CalPERS, 2002 - 2012 (in millions)



Source: City's comprehensive annual financial statements from FY 2002-2012.

Section 1.2 *Overview of Oakland's Pension Related Actions*

In the last five years, Oakland, like many municipalities, has been operating under a litany of economic woes, including persistently high unemployment, soaring pension and health-care costs, dwindling property values that have robbed cities of revenues, and cutbacks in federal and state assistance that have further limited the revenue available. In response, Oakland has worked to stabilize the City's finances and made numerous difficult decisions and reductions to help navigate this tumultuous time. Some of Oakland's key changes include:

- Reducing the City's workforce by 21 percent over the past ten years, resulting in the elimination of approximately 720 positions.

- Reducing sworn police officers by 27 percent (from 837 to 611) and civilian police staff by 34 percent (from 394 to 261) in the last six years, resulting in the loss of patrol services, reduced investigative resources, and delayed responses to 911 calls.
- Instituting rolling brown-outs of two fire engine companies.
- Implementing significant reductions in other services, including but not limited to, street maintenance, code enforcement, planning, cultural arts, neighborhood improvement programs (including blight removal and illegal dumping response), affordable housing programs, and park services and maintenance.

Oakland's staffing and service cuts do not address the City's unfunded pension liability.

While the above decisions helped balance Oakland's budgets, including covering its current pension ARC payments, these staffing and service cuts do not address Oakland's unfunded pension liability. However, Oakland has also taken several steps to address its pension liability, some on its own initiative and some as the result of state law and CalPERS regulations. Oakland's efforts are on par with the other California cities that the Office examined as part of this audit (see the Appendix for details). The following is an overview of the actions Oakland has taken in direct response to its unfunded pension liability.

Oakland Increased Employee Pension Contributions

As shown in Exhibit 4 below, to help address growing pension costs, the City has raised the amount that employees contribute into the CalPERS pension system. Employee contribution rates are set by statute[iii] and/or collective bargaining agreements.[26] Increasing contribution rates helps alleviate the amount the City has to pay. In order to increase employee contribution rates, the City must obtain agreement of the local unions.

Exhibit 4: CalPERS Employee Pension Contributions by Labor Group

Labor groups	Past Employee Contribution	Current Employee Contribution
Fire	9%	13% (as of 7/1/04)[iv]
Police	0%	9% (as of 7/1/11)
Non-sworn	3%	8% (as of 7/1/09)

Source: Staff reports and interviews on the City's pension systems.

Oakland Added Benefit Tiers and Made Changes Per PEPRA and CalPERS

Oakland added benefit tiers to its pension plan, which allowed the City to change the benefit level provided to future employees. This is done by:

- Decreasing the benefit percentage provided to non-sworn employees when they retire.
- Increasing the age at which the employee can retire thereby reducing the

[iii] Government Code Sections 20678 and 20683 set local sworn member rates and Section 20677 sets rates for local non-sworn members.
[iv] This is in excess of safety members' 9 percent employee contribution per statute.

number of years the City will be paying benefits.

- Changing the salary base on which benefits are calculated by extending the number of years included in the base, which in theory will result in a lower salary base.

In July 2011, the City approved a two-tiered system for all labor unions. The City implemented the two-tiered pension plan for sworn employees on February 9, 2012, and on June 8, 2012, for non-sworn employees. In September 2012, the pension reform bill (Assembly Bill 340) was signed, enacting the California Public Employees' Pension Reform Act of 2013 (PEPRA), which mandates changes to pension benefits and contributions[27] and adds salary caps for almost all state and local public retirement systems in California. Oakland complied with PEPRA and implemented a third tier into its pension plan for all new employees hired on/after January 1, 2013. Exhibit 5 shows the changes that Oakland has recently made to its pension benefits.

Exhibit 5: Summary of Changes to Oakland's CalPERS Pension Benefits

CalPERS Tier	Percentage of Salary Earned	Retirement Age	Final Pay Based On:	Applicable for Employees Hired:
Tier 1	Sworn 3% Non-Sworn 2.7%	Sworn 50 Years Non-Sworn 55 Years	The highest paid twelve (12) consecutive months	Sworn Prior to February 9, 2012 Non-Sworn Prior to June 8, 2012
Tier 2	Sworn 3% Non-Sworn 2.5%	Sworn 55 Years Non-Sworn 55 Years	The highest paid three (3) consecutive years' average	Sworn Between February 9, 2012 and December 31, 2012 Non-Sworn Between June 8, 2012 and December 31, 2012
Tier 3 (per PEPRA)	Sworn 2.7% Non-Sworn 2.0%	Sworn 57 Years Non-Sworn 62 Years	The highest paid three (3) consecutive years' average, subject to established caps	Sworn and Non-Sworn Starting on January 1, 2013

Source: Staff reports, interviews, and City Council resolutions on the City's pension systems.

Exhibit 6 illustrates what a City employee's annual lifetime pension would be in each of the CalPERS tiers. This calculation does not account for an array of actuarial assumptions such as inflation, disability, early retirement, mortality rate, etc.

Exhibit 6: Illustration of CalPERS Tiers

Sworn

$100,000 final pay with 30 years service

Tier 1	Tier 2	Tier 3
Can retire at age **50** **$90,000/ year**	Can retire at age **55** **$90,000/ year**	Can retire at age **57** **$81,000/ year**

Non-Sworn

$100,000 final pay with 30 years service

Tier 1	Tier 2	Tier 3
Can retire at age **55** **$81,000/ year**	Can retire at age **55** **$75,000/ year**	Can retire at age **62** **$60,000/ year**

According to the Stanford Institute for Economic Policy Research, despite the positive elements, PEPRA provides only modest cost savings in the short-term. According to Public Law Group™, PEPRA does little to address the more immediate needs for a reduction in pension liability.

Over the last two years CalPERS, and subsequently Oakland, has made three changes that impact the long-term funding of the pension system.

- In March 2012, CalPERS lowered the discount rate from 7.75 percent to 7.5 percent.[v]
- In April 2013, CalPERS changed its policies to recognize gains and losses over a shorter period and to use a 30-year fixed amortization period instead of a rolling 30-year period.[vi]
- On February 18, 2014, CalPERS approved a new assumption that takes into account that we now live longer.[vii]

Oakland Issued Pension Obligation Bonds

In 2012, the City issued pension obligation bonds (POBs) to reduce the unfunded liability of one of its pension systems (PFRS). As a result, PFRS' unfunded liability was reduced from $426.8 million to $216.8 million and its funded ratio went from 37.5 percent to 68.2 percent. The amount received from the obligation bonds was used to pre-pay five years of PFRS payments. The Administration's rationale for issuing the pension obligation bonds was to maintain a balanced budget without major reductions to core services funded by the general fund. The City will make two sets of payments: 1) payments to pay back the obligation bonds will be made through 2026, 2) payments to PFRS will re-commence in fiscal year 2017-18, with an estimated general purpose fund share of $24.2 million. However, the City has dedicated a source of revenue to cover the pension obligation bond payments through maturity in 2026.

Oakland Administration's Proposed Strategies to Reduce Long Term Liabilities

In 2012, the Administration prepared and distributed to the City Council a 5-year financial forecast, which among other things included proposed budget strategies to reduce future retirement expenditures. The Administration also issued Agenda

[v] Public employer contribution rates increased by approximately 1-2 percent for non-sworn and 2-3 percent for sworn employees.
[vi] Over time, the proposed methods are designed to improve funding levels and help reduce the overall funding level risk.
[vii] Life expectancy increased by 2.1 year for males and 1.6 years for females.

Reports in December 2013 and January 2014 addressing pensions. The following bullets summarize the City's proposed funding plans from these documents, as well as their status as of January 2014:

- Reserve $10 million in FY 2015-16 and $10 million in FY 2016-17 for unfunded pension and OPEB liabilities, as directed by City Council.
  Status: $20 million will be appropriated in the FY 2015-17 budget cycle.

- Begin investing in the California Employers' Retiree Benefit Trust (CERBT) Fund to fund OPEB liabilities.
  Status: The City Council has allocated a one-time funding of $534,500 for long-term liabilities; it has not yet allocated ongoing funding for long-term liabilities.

- Migrate to defined contribution retirement plan.
  Status: CalPERS is a defined benefit plan. According to the City Attorney the City may not convert to a defined contribution plan. PFRS and OMERS are also defined benefit plans.

- Establish fixed amounts for sworn retirees' medical benefits to make them comparable to civilian retirees.
  Status: This strategy requires unions' support. According to the Administration, the next opportunity to negotiate with the labor unions is when the contracts expire in June 2014 for Fire and June 2015 for Police.

- Transfer the OMERS liability from the City to a third party insurance provider via group annuity contracts.
  Status: According to the Administration, the OMERS Board and its legal counsel are currently exploring this option.

- Pension payments through Recognized Obligation Payment Schedule (ROPS).[viii]
  Status: According to the Administration, the City has received approximately $2.7 million from the State of California and anticipates receiving approximately $660,000 in June 2014 that will be used to pay down unfunded pension liability. The City will receive $1.2 million annually from the State until June 30, 2022.

- OPEB payments through ROPS.
  Status: According to the Administration, the City has received approximately $1.4 million from the State of California and anticipates receiving approximately $330,000 in June 2014, that will be used to pay down OPEB unfunded liability. The City will receive $600,000 annually from the State until June 30, 2022. These payments will be used towards OPEB unfunded liability.

[viii] ROPS is a list of the enforceable obligations of the former Redevelopment Agency, along with estimated payments for those obligations during the ROPS period and the source of funds for those payments.

Section 1.3 *Legal Limitations Regarding Pension Changes*

> ***Because of legal limitations, pension reforms usually only involve changing the benefits of new hires rather than existing employees. However, the savings that will be realized from these changes do not have a significant immediate impact.***

The legal protections granted to employee pensions are a matter of state law. Some state courts have ruled that while benefits already earned must be protected, future benefits can be reduced. Others have ruled that the pension promises made when an employee starts work must be kept for the rest of his/her life.[28] For example, a tentative ruling on the City of San Jose's recent, local pension measure (Measure B) prohibits the City of San Jose from requiring current employees to contribute significantly more towards their pensions. However, the ruling allows San Jose to cut employees' salaries to offset its increasing pension costs.[29] Because of these limitations, the result is that pension reforms usually only involve changing the benefits of new hires rather than existing employees. However, the savings that will be realized from these changes do not have a significant immediate impact.

As part of this audit, our Office consulted with the City Attorney's Office to obtain a greater understanding of what types of pension changes Oakland could make to its current pension system, CalPERS, if any. Exhibit 7 shows six possible pension reform changes and the City Attorney's opinion about whether they are legally possible at this time.

Exhibit 7: Legality of Possible Pension Reform to CalPERS Benefits

	Pension Reform Options	City Attorney's Opinion (January 2014)
1	**Cap pensionable pay** *May the City institute a cap on pensionable pay – for example, for any retirement system that is less than 90 percent funded, can the locality freeze 'pensionable pay'? Actual pay can increase with new labor contracts, but the pay that counts for pension calculations is frozen unless the system is at least 90 percent funded.*	**Not Legal** *The CalPERS plan formulas must be strictly adhered to; only caps that CalPERS establishes are in effect. Accordingly, CalPERS does not allow the City to amend its CalPERS contract to establish caps on pensionable pay. The City cannot establish a different retirement plan to implement this option only for new employees because CalPERS prohibits the City from providing different retirement benefits to members in the same membership classification.*
2	**Cap pension payouts** *May the City cap pension payouts? – cap total annual pension allowance at $80,000, for example, adjusted annually for inflation. For employees with other public-sector pensions, include prior pension in cap calculations. Once employee reaches cap he/she would be enrolled in Social Security.*	**Not Legal** *See answer to option 1, above.*
3	**Cap maximum benefits** *May the City establish a maximum benefit cap? – regardless of formula, 90 percent, for example, is the maximum retirement benefits an employee can earn is 90 percent of salary.*	**Not Legal** *See answer to option 1, above.*
4	**Provide defined contribution plans for new employees** *May the City provide a defined contribution (DC)*	**Not Legal** *See answer to option 1, above.*

	plan for new employees?	
5	**Offer current employees a choice to convert to a defined contribution plan with employer match and match incentives for employees to convert** *May the City offer current employees a choice to convert to a DC plan with employer match or match incentives for employees to convert? Example - employees are placed in more limited pension plans, yet the City has the option to enroll employees in Social Security or establish a 401(k) style defined contribution plan for them or switch to a more moderate defined benefit plan.*	**Not Legal** *See answer to option 1, above.*
6	**Amend CalPERS contract to have members pay a portion of the City's contribution** *May the City amend the CalPERS contract to have members pay a portion of the employer's contribution in addition to the member contribution rate? Cost sharing agreements may be different among bargaining units. Cost sharing for nonrepresented employees would require City Council resolution.*	**Legal** *This can be done if the City reaches agreement with its employees to pay a portion of the employer contribution. This would require a meet and confer in good faith with the respective bargaining units to negotiate agreements. If the parties reach an impasse, the City cannot impose cost sharing above the percentage established by law.*

Source: City Attorney's opinion on possible pension reforms to CalPERS.

Oakland is seriously limited by state law and CalPERS system limitations regarding what it can do to address its current, $1.5 billion unfunded retirement liability.

In summary, the City is seriously limited by state law and CalPERS system limitations regarding what it can do to address its current, $1.5 billion unfunded retirement liability. Without the ability to systemically address significant, growing financial obligations, the City loses control over its ability to plan for and sustain services in the future, which is concerning. Oakland leaders must come together with unions and community leaders to determine viable strategies to reduce Oakland's unfunded pension liabilities while protecting critical City services and offering all employees retirement security.

FINDING 2

Oakland could benefit from lessons learned from the private sector and other government agencies.

Summary

In the previous chapter, the audit identified that Oakland has a $1.5 billion unfunded pension liability. However, due to the current limitations of the CalPERS system and state law, Oakland does not have options to systemically address this growing financial obligation. Despite these limitations, Oakland is still responsible for solving this financial dilemma, otherwise the City will likely continue to face greater service cuts and staff reductions.

The Little Hoover Commission, an independent, bi-partisan, state oversight agency dedicated to investigating state government operations for efficiency, economy, and improved service, noted that the California public sector needs to become involved in the discussion of pension reform, including getting the right to control its own pensions, and thus, its organizational and financial sustainability.

> *The situation is dire, and the menu of proposed changes that include increasing contributions and introducing a second tier of benefits for new employees will not be enough to reduce unfunded liabilities to manageable levels, particularly for county and city pension plans. The only way to manage the growing size of California governments growing liabilities is to address the cost of future, unearned benefits to current employees, which at current levels is unsustainable. Employers in the private sector have the ability and the authority to change future, un-accrued benefits for current employees. California public employers require the ability to do the same, to both protect the integrity of California's public pension systems as well as the broader public good.*[30]

This chapter will discuss the private sector's pension reform, as well as the pension reform of current leaders in the public sector. These two market sectors have taken very different paths to funding employees' retirements. Overall, the private sector reformed its pensions decades ago in order to ensure organizations' health and longevity.[31] Only recently have a few public agencies led the way in following the private sector's example in pension reform; these agencies appear to be proactively addressing their long-term, financial pension obligations.

Section 2.1 *Private Sector's Pension Reform*

Most private companies focus on the bottom-line. As such, the volatility of defined benefit pension plans became a significant issue in the 1980's. Private sector pension reform ensued. Conversely, public employers did not reform their pension plans during that time, and instead, continued to enhance their plans by increasing benefit amounts and lowering the minimum retirement age. This, in turn, increased the costs of their plans. Exhibit 8 shows the key differences between private and public pension plans.[32]

Exhibit 8: Key Differences in Private and Public Pension Plans

Key Difference	Private Sector	Public Sector
Benefit plan used	Defined Contribution Plan Used by the majority of private sector companies. Employer contributions are guaranteed but future retirement **benefits are not guaranteed**.[33]	Defined Benefit Plan Used by the majority of the public sector. Future retirement **benefits are guaranteed**.[34]
Discount rate used[A]	4.9% Average Federal law requires private pension plans to link discount rates to **current, actual yields**.[35]	7.5% CalPERS Government Accounting Standards Board allows public pension plans to link discount rates to **expected rate of return** (which are different than actual yields).[36]
Responsibility for retirement pensions	Employees Defined contribution plan assets are owned and managed by the employee. **Employees are responsible** for their own financial security.[37]	Employers Defined benefit plans depend on the **government agency, and ultimately, the taxpayers** for ensuring guaranteed benefit levels are paid for.[38]
Funding Requirements	100% Funded Legally, defined contribution plans **cannot be underfunded**. Any increase in the plan's benefits must be paid for when the change is made.[39]	80% Funded Goal There is no law requiring a certain level of funding for public pension plans. It appears that **80% funded is a target goal**. In general, increases to the plan's benefits can be made retroactively and do not need to be paid for when implemented.[40]

[A] Measuring the liability of a pension plan requires discounting or adjusting the promised future benefits to today's dollars. The higher the rate used to discount the future benefit, the lower the payment in today's dollars.[41]

Between 1980 and 2008, the trend in the private sector has been to transition from defined benefit plans to defined contribution plans. According to a 2008 Bureau of Labor Statistics report, private sector employee participation in defined benefit plans has dropped from 38 percent participation to 20 percent, while participation in defined contribution plans has increased from 8 percent to 31 percent.[42] According to research, the movement to defined contribution plans over the last 30 years is the result of several factors, including but not limited to:

- Government regulations reduced incentives for employers to maintain their defined benefit plans. This virtually halted new businesses from adopting defined benefit plans.
- Wall Street analysts argued private companies needed to minimize budgetary and legal volatility of defined benefit plans.
- Increasing retiree medical costs put pressure on employers to cut back or drop retiree health benefits.
- Large employers in mature industries were facing a deteriorating ratio between active workers and retirees.
- Workers, especially younger workers, want portable pension plans, as

workers are no longer staying in the same company for their entire careers, and thus, want pension plans that will grow and move with them.[43]

Switching from defined benefit plans to defined contribution plans allowed the private sector employers to guarantee their contributions to employee's pensions rather than guaranteeing the level of pension benefits that will be received for the lifetime of the beneficiary. Furthermore, the private sector uses realistic discount rates based on current yields. Since 2006, private pension plans apply a discount rate that is a blend of long-term corporate bonds, including both upper-medium and high grade securities[ix], ranging from 3.67 percent to 5.63 percent (average 4.9 percent).[44] In general, defined contribution plans cannot have an unfunded liability because the employer is required to make the annual payments. While there are still some long-established, private sector defined benefit plans that have unfunded liabilities, these private sector employers are insured by the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a federal agency created by the Employee Retirement Income Security Act of 1974 to protect private sector defined benefit plans. Basically, if an employer's pension plan does not have sufficient money to pay all benefits owed, the PBGC's insurance program will pay the benefit that had been guaranteed by the pension plan up to the limits set by law.[45]

The result of the private sector's early pension reform is that it is no longer in the dire shape that today's government agencies are in.

The result of the private sector's early pension reform is that it is no longer in the dire shape that today's government agencies are in. According to an article in a 2009 Social Security Bulletin, a third of state and local government pension plans were less than 80 percent funded in 2006. This funding ratio decreased to 46 percent with the 2008 stock market crash, which resulted in at least a one trillion dollar loss in the value of assets held by state and local plans.[46] A recent Wall Street Journal article estimates that today's private sector pensions are 96 percent funded, while public sector pensions are 76 percent funded.[47]

In contrast, government agencies are largely still using defined benefit plans, which guarantee the benefit level that will be received by its employees in the future. There is no agency that guarantees assistance for the public sector's pension plans, like the PBGC for the private sector; and since vested benefits are guaranteed by California law,[48] taxpayers are the ones who are ultimately responsible for covering public employees' unfunded pension liabilities. Governments also use a discount rate based on the expected rate of return rather than current yields like the private sector.[49] The discount rate currently used by CalPERS members, including the City of Oakland, is 7.5 percent. In 2012, CalPERS lowered the investment discount rate from 7.75 percent to 7.5 percent.[50] CalPERS' actuaries initially proposed a reduction to 7.25 percent but Board members expressed concern that lowering the rate below 7.5 percent

[ix]Upper-medium and high grade securities is a measure of the quality and safety of a bond, based on the financial condition of the issuer.

would burden local governments already facing financial strain.[51] Even with CalPERS lowering the discount rate to 7.5 percent, this rate is significantly higher than the private sector discount rate average.

The difference between the discount rate used and the actual rate of return gets added to the unfunded pension liability.

What does a difference in the discount rate used mean? Overall, the higher the rate used to discount the future benefits, the lower the payment in today's dollars (thus making today's payments more affordable). However, if there is a difference between the discount rate used and the actual rate of return, this difference gets added to the unfunded pension liability. The seven California cities benchmarked (see the Appendix) use a rate of 7 percent to 8 percent. The actual investment returns over the last 10 years for CalPERS was 6.1 percent.[52] According to the Stanford Institute for Economic Policy Research, relatively small changes in discount rates can result in large changes in the funding ratio and other measures of pension fund condition.[53]

In April of 2013, Moody's Investors Service, a credit ratings agency, issued a new approach to adjusting reported public pension data for credit rating purposes. Moody's new approach uses a high-grade, long-term taxable bond index rate as the discount rate for public pension funds,[54] which would be 4.13 percent for the June 30, 2012 valuation. If CalPERS were to use this approach, the result of applying a 4.13 percent discount rate rather than 7.5 percent would be an additional $1.9 billion added to Oakland's $1.5 billion unfunded pension liability.

Governmental Accounting Standards Board (GASB) issued two standards - GASB 67 for the pension plans such as CalPERS and GASB 68 for the state and local employers such as Oakland - to improve the guidance for accounting and reporting on the pensions. GASB 68, effective for FY 2014-15, requires the City to record unfunded pension liability based on market value and potentially use a blended discount rate. The new standards relate to accounting and financial reporting and do not apply to the City's contribution rates to pensions. According to the Center for Retirement Research at Boston College, with the new standard, the future funded ratio depends heavily on the performance of the stock market and interest rate adjustment[55], which is likely to increase the volatility of the reported funded ratio.

Section 2.2 *Pension Reform by Leaders in the Public Sector*

As of 2012, few public agencies have been able to implement pension reforms that significantly and systemically address growing pension costs.

Between 2009 and 2012, 44 states passed some kind of pension reform,[56] which illustrates that state and local governments can no longer ignore the growing pension crisis. Every year, government officials have to choose between funding taxpayer services such as libraries, police, and street maintenance and funding promised pensions and healthcare costs for their retirees.[57] However, as of 2012, few public agencies have been able to implement pension reforms that significantly and systemically address growing pension costs.

While examples of significant pension reform are not common in the public sector, there have been some leading cities and states that have used the lessons from the private sector to inform significant public pension reform and achieve greater financial stability for future years. The states of Michigan, Rhode Island, and Utah and the California cities of San Diego and San Jose have all led significant pension reform. This section will discuss how these government jurisdictions have pushed the boundaries of public pension reform, including moving from defined benefit plans to defined contribution plans or hybrid plans. However, for the two California cities that have pushed pension reform, it is important to note that neither of these cities were part of the CalPERS system and both cities' reforms have landed in court deliberations about the legality of changing current employees' benefits and moving to defined contribution plans.

Pension Reforms by Michigan, Rhode Island, and Utah

Michigan's pension reform provides a unique example that compares the results of a public group of employees whose plan was reformed and moved to a defined contribution plan 17 years ago, with a group of employees that did not. In 1996, the Michigan State Legislature froze the state employees' defined benefit pension fund for new members and created a defined contribution pension system for future hires. Members already in the defined benefit system were allowed to remain and their benefits have continued to accrue as originally promised, though the workers were given an opportunity to take a buyout of their earned benefits and have those transferred to a defined contribution plan. However, the Michigan State Legislature did not reform the public school employee's (teacher's) pension plan.[58]

An analysis of the system conducted in 2011 by Richard C. Dreyfuss, an actuary and adjunct scholar with the Mackinac Center for Public Policy, concluded that Michigan saved at least $2.4 billion[59] over the first 13 years of the state's reformed plan.[60] In contrast, the teachers' fund, which had not been reformed, experienced two financial crashes that reduced the plan's funded ratio from 97 percent in 2001 to 79 percent in 2009, leaving the teachers' fund responsible for covering the resulting, significant difference. In 2010, the Michigan State Legislature reformed the teachers' fund and created a hybrid pension plan for its new hires similar to the one implemented for the state employees.[61]

The Rhode Island General Assembly, in 2011, passed a major pension-reform bill that suspended cost-of-living adjustments for retirees, increased the retirement age, and introduced a hybrid defined benefit/defined contribution pension plan. This hybrid plan requires employees to contribute 5 percent of their base pay to a defined contribution fund, in addition to the contributions required for the defined benefit fund. The State of Rhode Island contributes 1 percent to the defined contribution fund. Workers will receive retirement benefits that include a defined benefit from the defined benefit fund and earnings from the defined contribution fund. Prior to this 2011 reform, Rhode Island had an unfunded pension liability of $6.8 billion with its pension systems being less than 50 percent funded. After the law passed, the Rhode Island State Treasurer estimated that the reform will save the State $4 billion over the next 24 years.[62]

Utah enacted major pension reform in March 2010 by ending its traditional defined benefit plan for new hires and offering them a choice between a defined contribution plan and a hybrid defined benefit/defined contribution plan, either plan has employer contribution capped at 10 percent of a worker's pay (or 12 percent for public safety employees). If the required contribution is less than 10 percent, the employer must deposit any amount of the 10 percent not needed for the defined benefit portion into the defined contribution portion.[63] If in any given year the hybrid plan has a required contribution of more than 10 percent, the employees, not taxpayers, pay the difference. This requirement makes certain that the hybrid plan is fully funded.[64] Prior to the reform, the 2008 stock market crash caused the Utah pension fund to lose 22 percent of its value, which resulted in a drop from nearly 100 percent funded in 2007 to 70 percent funded by 2009.[65] According to the former Utah State Senator who sponsored the reform, one year's loss equated to a 75 percent increase in pension contributions over 25-year period, or approximately 10 percent of Utah's general fund spending. According to the Wall Street Journal, the reform has benefits for taxpayers and public employees. Workers own their retirement account and can carry it to another job. They also benefit because politicians can no longer take from the pension plan to pay for other government spending. For taxpayers, the reform will eventually slash state pension liabilities in half and taxpayers no longer bear the risk of having to pay higher taxes if the stock market declines. Today Utah's latest actuarial valuation shows that its hybrid plans (for sworn and non-sworn) are above 100 percent funded, as of January 1, 2013.[66]

Pension Reforms by the Cities of San Diego and San Jose

In June 2012, voters in the City of San Diego (San Diego) and the City of San Jose (San Jose) approved reform pension ballot measures by 66 percent and 69 percent, respectively. Both San Diego's and San Jose's pension reforms require that all future benefit increases be ratified by the voters.[67]

San Jose's reformed pension plan places new employees in a lower-cost, defined benefit plan; the City can also contribute to a defined contribution plan as long as the total pension contribution does not exceed 9 percent of an employee's base pay. Although the voters passed reform that affected all employees, the court ruled that no change could be made to current employees' pension benefits. Pension reforms are expected to save the City of San Jose more than $20 million per year.[68]

San Diego's pension reform measure places all new hires, except for sworn police officers, into a defined contribution plan. San Diego's plan directs the City to negotiate with its labor unions and cap all employees' base compensation at fiscal year 2011 levels for six years. San Diego's Independent Budget Analyst estimated that with the six year freeze, San Diego's pension reform would result in net savings to the City of approximately $950 million over 30 years.[69]

The County of Ventura in California and the City of Phoenix in Arizona have similar ballot initiatives for 2014 that closely follow San Diego's pension reform.[70] However, as previously mentioned, neither San Diego nor San Jose are part of the CalPERS system, unlike Oakland, and in both cities, public unions have filed lawsuits against the reforms.[71]

Conclusion

There is no one right way to reform pensions, however, government agencies, including Oakland, must create a plan to make pensions fair and predictable.

There is no one right way to reform pensions. It is a complicated issue that government agencies are grappling with and each agency's solution is going to depend on a variety of factors. However, the situation is clear; government agencies are obligated to pay for their growing pension liabilities, which are going to increasingly impact governments' ability to provide key services (such as safety, street repairs, parks, etc.). Because of this, government agencies, including Oakland, must create a plan to make pensions fair and predictable. Oakland's leaders must become involved now in addressing Oakland's $1.5 billion unfunded pension liability even given the legal limitations that currently hinder the City's ability to address its pensions.

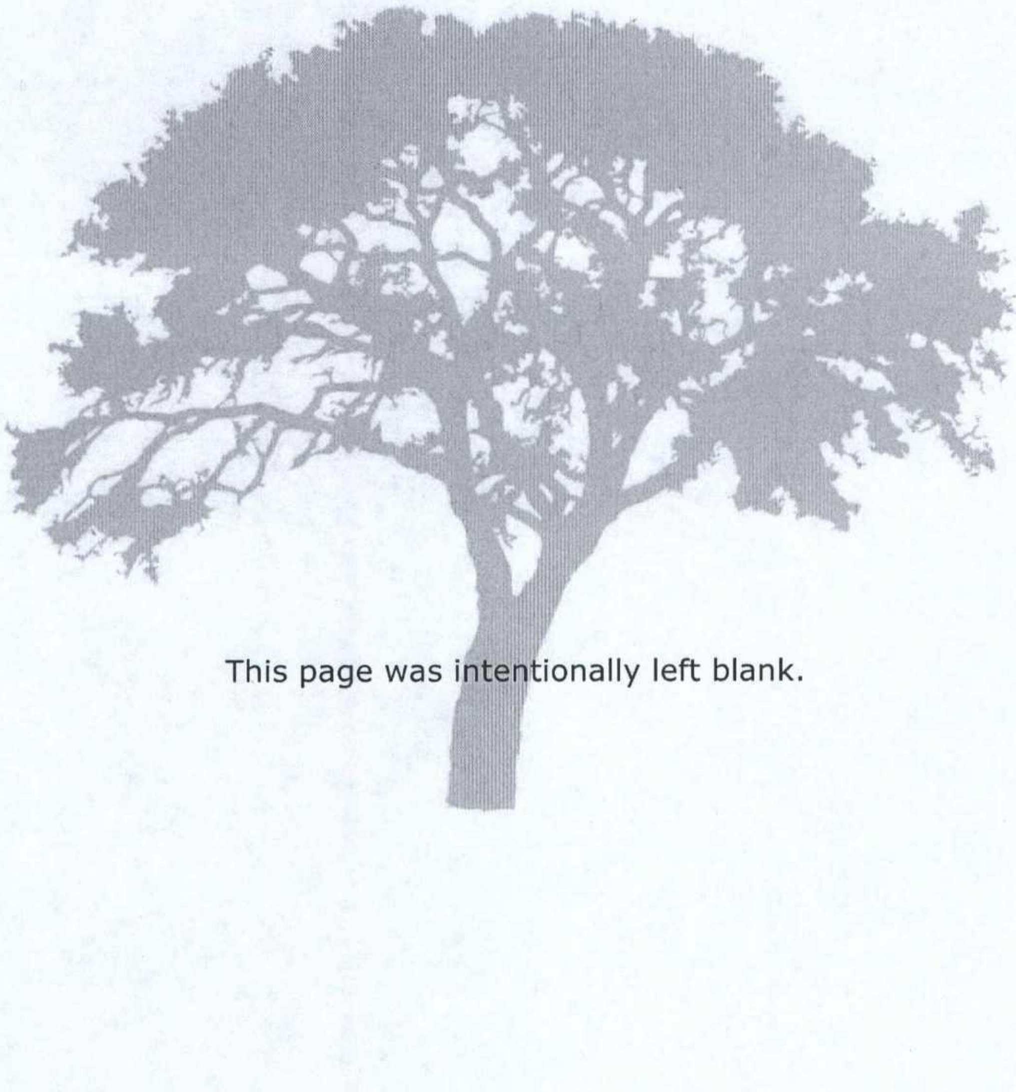
Recommendations

<table>
<tr><td colspan="2">We recommend that the Administration and the City Council:</td></tr>
<tr><td>Recommendation 1</td><td>Convene a Pension Advisory Group to gather, evaluate, and organize information for a comprehensive solution to Oakland's unfunded pension liabilities. This Advisory Group will design a plan to impact pensions on three levels:

• State/Federal— what legislative changes, if any, are needed to be proposed so that the municipalities may be in control of their financial futures as related to pensions.
• CalPERS— does CalPERS serve the needs of all of its member agencies and how do Oakland and other municipalities have a greater impact on CalPERS policies given issues such as Moody's new rating approach.
• Oakland— what changes may be made now within the restrictions of CalPERS and state law, and which of these changes can be agreed to by all stakeholders.

This process should be convened publicly and have clearly defined processes for stakeholder input, including citizens and employees. The Advisory Group should be comprised of a broad cross section of stakeholders, for example, the City should strongly consider including:

• Academia and pension experts.
• An independent financial consultant with no ties to the City to perform analysis on potential reforms as they are recommended by the Advisory Group.
• An independent law firm with no ties to the City to evaluate the legality of potential reforms as they are recommended by the Advisory Group.</td></tr>
<tr><td>Recommendation 2</td><td>Form a coalition of cities to find common ground to support comprehensive solutions at the state and CalPERS levels.</td></tr>
</table>



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APPENDIX

City	Pension Discount Rate	Funded Ratio	Employee Contribution	Employer Contribution FY 2013-14	Lowest Tier
Oakland*	7.50%	Safety 77.3%; Misc 79.6%	Police 9%; Fire 13%; Misc 8% OPEB 0%	Safety 33.35%; Misc 27.295%	Misc 2% @ age 62; Safety 2.7% @ age 57 for new hires
Sacramento*	7.50%	Safety 82%; Misc 82.3%	Existing - Safety 9%, Misc 7%; New hires -Fire: 9%, Police 12%, Misc. 6.75%	Safety 28.675%; Misc 13.645%	Misc 2% @ age 62; Safety 2.7% @ age 57
Berkeley*	7.50%	Police 70.6%; Fire 84.3%; Misc 81.7%	Existing Safety 9% to pension; existing Misc 0% to pension; Safety & Misc new hires (except for 2 unions) pay 50% of normal cost; Police pay additional 1.5% to 3% for FY 2012-14; 0% to OPEB for all employees	Fire: 30.264%; Police 44.324%; Misc 20.1%	Misc 2% @ age 62; Safety 2.7% @ age 57
Long Beach*	7.50%	Safety 94.7%; Misc 88.7%	Safety 9% and Misc 8% to pension; 0% to OPEB	Safety 22.623%; Misc 15.324%	Misc 2% @ age 60; Safety 2% @ age 50
San Jose	Safety 7.25%; Misc 7.5%	Safety 78.8%; Misc 62%	Safety 11%-12% to pension; Police 9.51% to OPEB; Fire 7.35% to OPEB. Misc 6%-7% to pension and 8% to OPEB	Safety Pension 70.55% + Safety OPEB 9.42%; Misc Pension 45.56% + Misc OPEB 11.93%	Safety 2% @ age 60; Misc 2% @ age 65
San Diego	7.50%	68.60%	Safety 11%-19%; Misc 4%-12% to pension depending on entry age and hire date. 0% to OPEB, eliminated for all new hires	Safety 70.63%; Misc 52.27%	No retirement formula in a defined contribution plan
San Francisco	7.58%	82.6%	Safety: 11.5%-13% to pension; Misc 7.5%-12% to pension. 2% to OPEB for hires after 1/10/09 and 1% to OPEB for hires prior to 1/10/09	Police 37.23%; Fire 47.17%; Misc 21.25%	Reduced benefit factor, pensionable pay is base pay only
Los Angeles	7.75%	Safety 83.7%; Misc 69%; Water & Power 78.1%	Safety 9% pension + 2% OPEB = 11% total; most Misc contribute 11% total to pensions (7%) and OPEB (4%)	Safety Pension 34.61% + Safety OPEB 10.73%; Misc pension 20.55% + Misc 5.53% OPEB; Water & Power 47.3% pension	Most Misc new hires 2% @ age 65; Safety: retirement age 50, 40% at 20 years of service, then + 3% for next 5, then + 4% for next 5, then + 5% thereafter

*CalPERS cities. PEPRA changes have not been implemented for all labor unions in some CalPERS cities.

APPENDIX

City	Final Pay	Maximum Benefit Cap	COLA	OPEB and Other Actions	Ballot Initiatives
Oakland*	Highest 3-year avg salary for new hires	90% for safety, no cap for Misc	2%	Allocated one-time funding of $534,500 for long-term liabilities; OPEB and pension payments through ROPS[A]	None
Sacramento*	Highest 3-year avg salary for new hires	90% for safety, no cap for Misc	3%	Eliminates OPEB for new hires for 3 labor groups effective July 2012; City set aside $2M in OPEB trust.	None
Berkeley*	Highest 3-year avg salary for new hires	90% for safety, no cap for Misc	2%	In 2012 City and Police union agreed to a new OPEB plan that places a cap and provides health insurance premium payments to health plan provider. Savings from refinancing and other financial transactions allocated for long-term liabilities.	None
Long Beach*	Highest 3-year avg salary for new hires	90% for safety, no cap for Misc	2%	Allocated one-time funding of $2,455,000 for long-term liabilities.	Did not provide
San Jose	Highest 3-year avg salary	65% of final pay	Indexed to CPI w/ cap 1.5%	City and labor groups negotiated and agreed to make the full ARC over a five (5) year period by increasing the City's contribution and the employee's contribution rate each year.	Measure B passed in June 2012 allows San Jose's workers to keep pension benefits they have earned but requires them to pay more toward their pensions to keep up the same level of benefits. Future benefit increases must be ratified by voters.
San Diego	Avg of the highest 36 months compensation	80% cap for new police hires and cap is reduced by 3% for each year employee retires before age 55	1.7% or 2% depending on retirement date	OPEB DB option is closed to hires on and after 7/1/05. Effective 7/1/09, vesting period for full OPEB is 20 yrs. Retirees b/t 7/1/09 and 4/1/12 had benefit frozen at $8,880 per year. Employees retiring on/after 4/1/12 can choose b/t reduced DB and a DC OPEB plan.	Proposition B passed in June 2012 placed them in a 401(k)-style investment plan. The San Diego plan directs the city to bargain with unions for a six-year freeze on pay used to calculate pensions. It allows current workers to keep pension amounts already earned, only reducing future amounts. Future benefit increases must be ratified by voters.
San Francisco	Highest avg in any 3 consecutive years or avg of 36 consecutive months preceding retirement	90% for safety, 75% for Misc	Max 2% linked to CPI, COLA banking[B]	Prop A on the November 2013 ballot, aims to eliminate a projected $4.4 billion shortfall in the city's retiree health care fund by prohibiting raiding of the fund, setting the city on a path to covering its retiree health care bill fully by 2045.	Prop C passed in Nov 2011 requires city workers to contribute 7.5% of their salaries to the pension fund, a percentage that would rise in bad economic times and fall when the city - and its pension plan - was flush. Prop A, passed in November 2013, aims to eliminate a projected $4.4 billion shortfall in the city's retiree health care fund.
Los Angeles	Safety highest two year salary average; most Misc 3 years	75% for most Misc new hires; 90% cap for safety	Safety 3% max with a COLA Bank[B]; Most Misc 2%	Pre-funds OPEB instead of pay-as-you-go. Eliminate OPEB for dependents.	Measure G- March 2011 established a lower tier for safety employees.

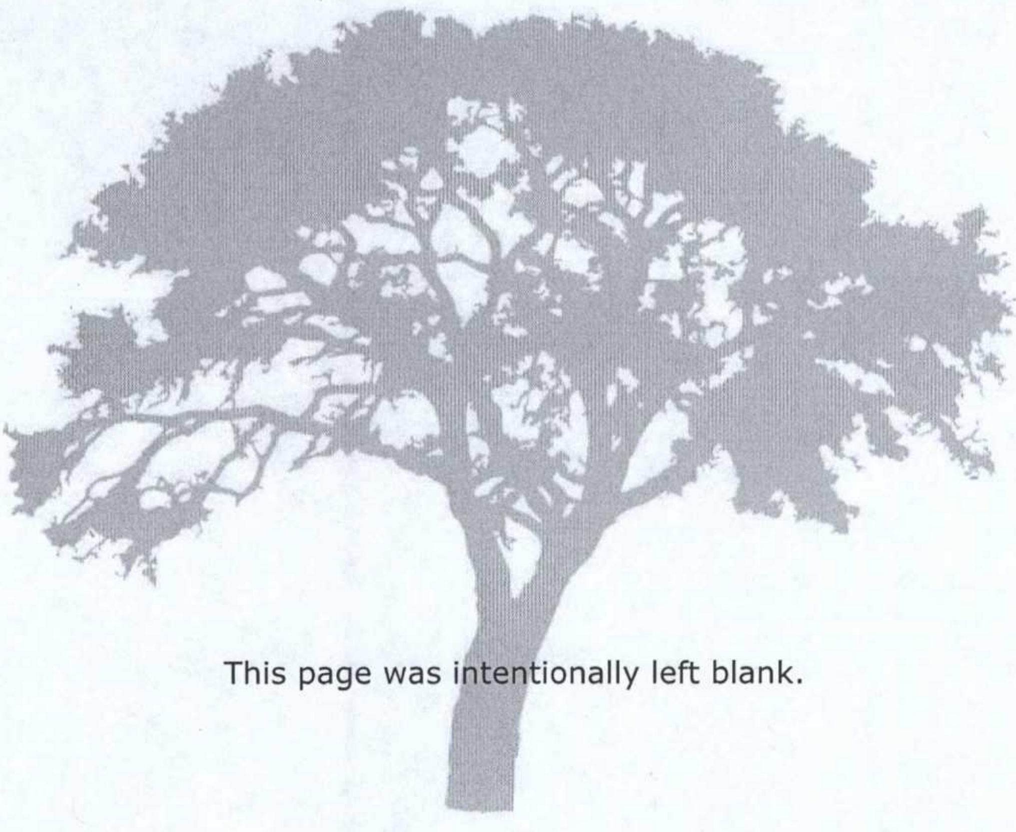
*CalPERS cities. PEPRA changes have not been implemented for all labor unions in some CalPERS cities.

A: ROPS (Recognized Obligation Payment Schedule) is a list of the enforceable obligations of the former Redevelopment Agency, along with estimated payments for those obligations during the ROPS period and the source of funds for those payments.

B: COLA Bank stores any CPI that exceeds the maximum, which is then applied to years in which the CPI change falls below that maximum. For example, if COLA was capped at 3% and CPI was 3%, 5% and 0% over three consecutive years, a member would receive COLAs of 3%, 3% and 2%.

GLOSSARY

Annual Required Contribution (ARC)	The ARC is the employer's annual contribution to a defined benefit pension plan. Actuaries establish ARC payments to cover total pension obligations including both the amount due for current employees as well as the amortized unfunded pension liability.
California Public Employees' Retirement System (CalPERS)	CalPERS administers health and retirement benefits on behalf of the City of Oakland.
Cash Flow	Cash flow is the movement of money into or out of a business or government. Cash flow issues occur when a business does not have enough available cash to pay its liabilities.
Contribution Rate	Contribution rate is the percentage of payroll that is used to calculate the employee's annual payment toward retirement.
Defined Benefit Pension Plan	Defined benefit pension plan is a guaranteed pension benefit at retirement based on the number of years of service and final compensation.
Defined Contribution Pension Plan	Defined contribution pension plan is a guaranteed amount deposited yearly into a fund to provide retirement income.
Discount Rate	Discount rate is the interest rate used in analysis to determine the present value of future payments.
Funded Ratio	Funded ratio is a measure of how well funded, or how "on track" a pension plan is. The funded ratio is the amount the City has set aside to pay for its pension debt compared to the total pension debt.
Oakland Municipal Employees' Retirement System (OMERS)	OMERS is a closed pension plan providing benefits to municipal employees hired prior to September 1970.
Other Post-Employment Benefits (OPEB)	OPEB is retirement benefits other than pension, such as health benefits.
Pension Obligation Bonds (POB)	POBs are bonds issued by a government to pay its obligation to the pension fund in which its employees are members. Governments are borrowing money by selling bonds to pay down an unfunded pension liability and using a portion of the proceeds to cover operating budget contributions to the pension systems. The government will then make the annual payments to pay off the debt over as much as 30 years.
Public Employees' Pension Reform Act of 2013 (PEPRA)	PEPRA mandates changes to pension benefits and contributions and adds salary caps for almost all state and local public retirement systems in California.
Police and Fire Retirement System (PFRS)	PFRS is a closed pension plan providing benefits to sworn employees hired prior to July 1976.
Solvency	Solvency is the degree to which the assets of a business or government exceed the liabilities. Solvency issues occur when there are not enough assets, even if sold, to repay the debts.
Unfunded Liability	Unfunded liability is pension debt - it is the amount the City owes to pay for benefits earned by current employees and retirees.



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CITY OF OAKLAND

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Office of the City Administrator

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March 25, 2014

Courtney A. Ruby, City Auditor
City of Oakland, California
1 Frank Ogawa Plaza, 4th Floor
Oakland, CA 94612

RE: Administration's Response to City Auditor's Pension Audit

Dear City Auditor Ruby:

I am pleased to provide you with the Administration's response to the Final Draft Report of the Pension Audit. We welcome fair and impartial performance audits conducted cooperatively to improve the effectiveness and transparency of City government operations.

The Auditor's report confirms many of the challenges the Administration identified in the Five-Year Financial Forecast released last fall and in numerous recent reports to the City Council. **As Governor Brown remarked about rising pension costs when he released his Proposed 2014-15 State Budget, "These liabilities were built up over decades, and likewise, it will take decades to pay them off."**

Over the last three years, the City of Oakland (the "City") has made significant strides in addressing its unfunded pension liabilities under the legal limitations regarding pension changes, as outlined in further detail below. The Administration agrees with the Pension Audit's recommendations that it would take the collaboration of Oakland leaders and different stakeholders to find solutions beyond what the City can do to resolve the matter as a result of these restrictions

However, the Auditor's comparison of the different pension reforms made by other public agencies is not applicable to the reform options available to the City of Oakland since these agencies are either private entities or they are not in the CalPERS system and are not therefore subject to state law and CalPERS policy like the City.

As noted in the audit, the City has three pension systems and Other Post-Employment Benefits (OPEB) with total unfunded actuarial accrued liability (UAAL) of approximately $1.5 billion. The Police and Fire Retirement System (PFRS) and Oakland Municipal Employees Retirement System (OMERS) are closed systems. CalPERS is for all active employees and has a funded ratio of 77.3% for miscellaneous employees and 79.6% for public safety employees, respectively. **The Government Accountability Office (GAO) considers 80% to be a healthy funding level for public pension funds. By this standard, Oakland's CalPERS system is near the acceptable range.**

Oakland, like other cities and states, faces long-term financial burdens with its employee retirement benefits that are growing each year due to various factors. Over the past several years, the City has begun to address its UAAL, but pension reform efforts are constrained by State laws and CalPERS' policy. Developing a viable plan to resolve the City's UAAL will require comprehensive strategies by Oakland's leaders and stakeholders.

A number of factors impacting pension costs are outside of the City's control, such as the unforeseen financial crisis of 2008 which resulted in significant losses to public pension plans across the state and the county. Still, many of the reforms implemented by CalPERS over the past several years are serving to reduce the City's long-term pension liability while increasing the costs in the short term. For instance, on February 18, 2014, the CalPERS Board approved new demographic assumptions for the pension system, which marks the third change in factors in the last two years which will result in higher pension costs and will ultimately translate into higher contribution rates for the public agencies like Oakland. In addition, CalPERS has lowered the discount rate and is implementing a new smoothing and amortization policy. All these changes impact the long-term funding of the system. However, these changes are intended to protect the beneficiaries and reduce the long-term cost of benefits for all in addition to meeting the pension obligations to current and future public employees.

Although the City is limited by State law and CalPERS system constraints regarding what it can do to address its current UAAL, the City has been pro-active and taken numerous steps to address its rising pension costs. Specifically, the City has implemented the following efforts in response to the growing unfunded pension liability concerns:

- **The City increased employee pension contributions.** The City has raised the amount that employees contribute into the CalPERS pension system, thereby alleviating the amount the City has to pay. Specifically, the City implemented the following changes to the employees' pension contributions:

Labor Group	Past Employee Contribution	Current Employee Contribution
Fire	9%	13% (as of 7/1/04)
Police	0%	9% (as of 7/1/11)
Non-sworn	3%	8% (as of 7/1/09)

- **The City has implemented a three-tier pension plan** to address the growing concerns of UAAL in CalPERS and reduce the City's pension costs over time, as shown below:

Tiered Pension Plans			
Employee Organization	**Tier One (Classic Members)**	**Tier Two (New Hires in 2012)**	**Tier Three: AB 340 (January 1, 2013)**
Public Safety	Receive 3% at age 50 Pension benefits are based on one year of highest salary	Receive 3% at age 55 Based on the final average salary of 3 years under the Government Code 20037 (hires as of 2/9/12)	Receive 2.7% at age 57 Based on the final average salary of 3 years subject to established cap

Miscellaneous	Receive 2.7% at age 55 Final compensation is based on the twelve (12) highest paid consecutive months.	Receive 2.5% at 55 Based on the highest average annual compensation of the 3 consecutive years (hires as of 6/8/12)	2% at age 62 Based on the final average salary of 3 years subject to established cap

- **The City issued pension obligation bonds.** Unlike other cities, Oakland has a dedicated source of revenue to pay for these pension bonds. The proceeds were used to reduce the UAAL on one of its pension systems (Oakland Police and Fire Retirements System, or PFRS). As a result, PFRS' UAAL was significantly reduced from $426 million to $216 million, and its funded ratio went from 37.5% to 68.2%.

- **The City secured approximately $27 million to pay its pension liabilities through 2022.** Following the dissolution of the Redevelopment Agency, the City has requested paying pension obligations for former Redevelopment Agency employees through the Recognized Obligation Payment Schedule (ROPS) based on employees working on redevelopment projects and programs. On an annual basis, the City estimates receiving $1.2 million from the State until June 30, 2022, which will be used to pay down unfunded pension liabilities.

- **The City secured approximately $14 million to pay unfunded Other Post-Employment Benefits (OPEB) liabilities through 2022.** Following the dissolution of the former Redevelopment Agency, the City has requested paying unfunded OPEB obligations for former Redevelopment Agency employees through the ROPS. On an annual basis, the City estimates receiving $600,000 from the State until June 30, 2022, which will be used to pay OPEB liabilities.

- **The City established a reserve fund to pay unfunded liabilities.** City Council approved appropriations of $10 million in FY 2015-16 and an additional $10 million in FY 2016-17 to be paid into the reserve.

- **The City set aside additional revenues into this reserve.** On June 27, 2013, City Council adopted the FY 2013-15 Policy Budget, Resolution No. 84466 C.M.S., which set aside 10% of the projected excess General Purpose Fund (GPF) Real Estate Transfer Tax ($5.34 mil) revenues in the amount of $534,500. In accordance with the FY 2013-15 Adopted Policy Budget, $534,500 was reserved for unfunded liabilities.

- **Additional changes approved by the CalPERS Board will ensure greater sustainability and soundness of the pension fund in the future.** These include:

Date	CalPERS Adopted Policy Changes
March 2012	Lowered the Discount Rate (from 7.75% to 7.50%)
April 2013	New smoothing and amortization method
February 2014	Increased life expectancy (approximately: males by 2.1 yrs, females by 1.6 years)

❖ **The Administration developed a list of budget strategies for the City Council's consideration aimed at reducing future retirement expenditures.** These could include the following:

- Begin investing in the California Employer's Retiree Benefit Trust (CEBRT) Fund to fund pension liabilities;
- Migrating to a defined contribution retirement plan;
- Transferring the Oakland Municipal Employees' Retirement Systems (OMERS) liability from the City to a third-party insurance provider via group annuity contracts; and

In conclusion, the City recognizes the importance of addressing this issue and has taken proactive steps to tackle the unfunded pension liability within the constraints of state laws and the CalPERS system. Similar to other governmental agencies, Oakland has an obligation to pay for its pension liability, which is going to increasingly impact the City's ability to provide key services to the community (such as public safety, emergency response, street repairs, parks and libraries). To that end, the Administration is looking forward to collaborating with Oakland's leaders and stakeholders to understand the magnitude of impact the unfunded pension liability has on the City's financial health and to identify comprehensive solutions for the City's pension system that would provide retirement security to employees without overburdening taxpayers and while continuing to provide critical services to its citizens.

Sincerely,

Fred G. Blackwell
City Administrator

Cc: Osborn K. Solitei, Finance Director/Controller

SUMMARY OF ACTIONS NECESSARY TO CLOSE THE REPORT

The "Summary of Actions Necessary to Close the Report" provides our analysis of the City Administration's (Administration) proposed actions to close the report. **The Administration has agreed to implement 100 percent of the recommendations that were provided in the report. The City Council's response will be obtained after they can publicly meet and discuss the recommendations. Once the Office receives the City Council's response, it will publicly post the response.**

Recommendation #1 The Administration and the City Council should convene a Pension Advisory Group to gather, evaluate, and organize information for a comprehensive solution to Oakland's unfunded pension liabilities. This Advisory Group will design a plan to impact pensions on three levels: • State/ Federal - what legislative changes, if any, are needed to be proposed so that the municipalities may be in control of their financial futures as related to pensions. • CalPERS - does CalPERS serve the needs of all of its member agencies and how does Oakland and other municipalities have a greater impact on CalPERS policies given issues such as Moody's new rating approach. • Oakland - what changes may be made now within the restrictions of CalPERS and state law, and which of these changes can be agreed to by all stakeholders. This process should be convened publicly and have clearly defined processes for stakeholder input including citizens and employees. The Advisory Group should be comprised of a broad cross section of stakeholders, for example, the City should strongly consider including: • academia and pension experts • an independent financial consultant with no ties to the City to perform analysis on potential reforms as they are recommended by the Advisory Group • an independent law firm with no ties to the City to evaluate the legality of potential reforms as they are recommended by the Advisory Group	**Resolved** - The Administration agrees with this recommendation and stated that it is collaborating with Oakland leaders and different stakeholders to find solutions beyond what the City can do to address the pension liability. **To close this recommendation, the Administration should provide evidence that a Pension Advisory Group is formed and has designed a plan to impact pensions. This information should be provided to the Office by April 5, 2015.**
Recommendation #2 The Administration and the City Council should form a coalition of cities to find common ground to support comprehensive solutions at the state and CalPERS levels.	**Resolved** - The Administration agrees with this recommendation and stated that it is collaborating with Oakland leaders and different stakeholders to find solutions beyond what the City can do to address the pension liability. **To close this recommendation, the Administration should provide evidence that it has formed a coalition of cities to support pension solutions at the state level. This information should be provided to the Office by April 5, 2015.**

Unresolved status indicates no agreement on the recommendation or the proposed corrective action. Implementation of proposed corrective action is directed in the City Auditor's Analysis and Summary of Actions Necessary to Close the Report.

Partially Resolved status indicates partial agreement on the recommendation or the proposed corrective action. Implementation of the proposed corrective action is clarified in the Analysis and Summary of Actions Necessary to Close the Report.

Resolved status indicates agreement on the recommendation and the proposed corrective action. Implementation of the proposed corrective action forthcoming from the auditee.

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[12] Reason Foundation, Adam B. Summers, "Removing the Unbearable Burden: Pension Reform in San Jose, California," October 2013.

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