

City of San José

Some Retirement Cost Projections Were
Unsupported Although Rising Retirement Costs
Have Led to Reduced City Services

August 2012 Report 2012-106



Independent NONPARTISAN
TRANSPARENT Accountability

The first five copies of each California State Auditor report are free. Additional copies are \$3 each, payable by check or money order. You can obtain reports by contacting the Bureau of State Audits at the following address:

California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814
916.445.0255 or TTY 916.445.0033

OR

This report is also available on the World Wide Web <http://www.auditor.ca.gov>

The California State Auditor is pleased to announce the availability of an on-line subscription service. For information on how to subscribe, please contact the Information Technology Unit at 916.445.0255, ext. 456, or visit our Web site at www.auditor.ca.gov.

Alternate format reports available upon request.

Permission is granted to reproduce reports.

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

Elaine M. Howle
State Auditor
Doug Cordiner
Chief Deputy

CALIFORNIA STATE AUDITOR

Bureau of State Audits

555 Capitol Mall, Suite 300

Sacramento, CA 95814

916.445.0255

916.327.0019 fax

www.auditor.ca.gov

August 21, 2012

2012-106

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

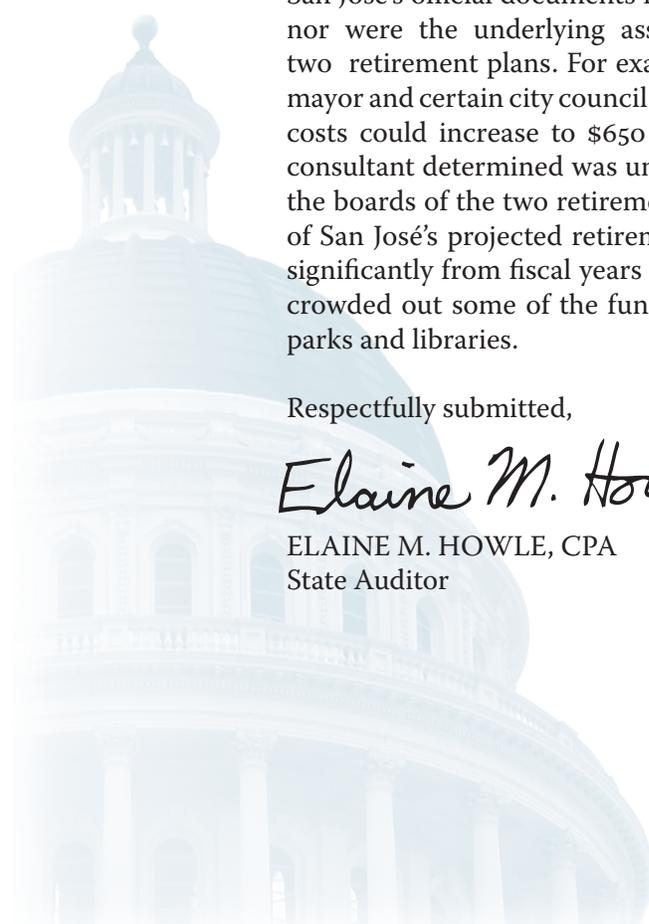
As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the City of San José's (San José) operating budget and current and future retirement obligations.

This report concludes that during fiscal years 2009-10 through 2011-12, San José experienced financial challenges as its budgeted revenues declined and retirement costs—consisting of pension and postemployment health benefits—increased. Although we believe that San José's financial challenges are real, we found that some of the retirement cost projections reported in San José's official documents in 2011 were not supported by accepted actuarial methodologies, nor were the underlying assumptions vetted and approved by the boards of San José's two retirement plans. For example, in supporting the need to reduce retirement benefits, the mayor and certain city council members referred to a projection that the city's annual retirement costs could increase to \$650 million by fiscal year 2015-16, a projection that our actuarial consultant determined was unsupported and likely overstated when assumptions approved by the boards of the two retirement plans are considered. Although we have concerns with some of San José's projected retirement costs for future years, its actual retirement costs increased significantly from fiscal years 2009-10 through 2011-12. These increased costs appear to have crowded out some of the funding previously available for non-public safety services, such as parks and libraries.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor



Blank page inserted for reproduction purposes only.

Contents

| | |
|--|----|
| Summary | 1 |
| Introduction | 3 |
| Audit Results | |
| Some of the City of San José's Projected Retirement Costs Were Unsupported | 15 |
| San José's Retirement Costs Have Been Increasing Dramatically | 20 |
| Increasing Retirement Costs Have Created Budgetary Challenges for San José | 29 |
| Recommendations | 33 |
| Response to the Audit | |
| City of San José | 35 |
| California State Auditor's Comments on the Response From the City of San José | 39 |

Blank page inserted for reproduction purposes only.

Summary

Results in Brief

During fiscal years 2009–10 through 2011–12, the City of San José (San José), the State's third most populous city, experienced financial challenges as its budgeted revenues declined and retirement costs—consisting of pension and postemployment health benefits—increased. Although we believe that San José's financial challenges are real, we found that some of the retirement cost projections reported in the city's official documents in 2011 were not supported by accepted actuarial methodologies, nor were the underlying assumptions vetted and approved by the boards of administration of the city's two retirement plans—the Federated City Employees' Retirement System (federated plan) and the Police and Fire Department Retirement Plan (police and fire plan).

For example, San José used one inadequately supported projection that its annual contributions toward retirement costs would increase to \$400.7 million by fiscal year 2015–16 in three bond statement documents that disclosed its financial condition to potential creditors. In addition, in supporting the need to reduce retirement benefits, the mayor and certain city council members referred to a projection that the city's annual retirement costs could increase to \$650 million by fiscal year 2015–16, a projection that our actuarial consultant determined was unsupported and likely overstated, when assumptions approved by the boards of the two retirement plans are considered. Using the most recent assumptions approved by the two boards, the boards' actuary projected that the city's fiscal year 2015–16 retirement contribution would be \$320.1 million, which is less than half of the unsupported \$650 million projection. Further, in June 2012, city voters approved a measure that, if it survives pending legal challenges, would authorize reduced future pension benefits for current city employees who do not increase their retirement contributions. The measure also requires San José to adopt new retirement plans for new city employees, and it limits the benefits that can be offered under the plans. Reporting multiple retirement cost projections in a short period may have caused confusion among the city's stakeholders attempting to make informed decisions. For instance, it is unclear which retirement cost projection the voters relied on, if any, when they voted for these changes.

Although we have concerns with some of San José's projected retirement costs for future years, the city's actual retirement costs increased significantly from fiscal years 2009–10 through 2011–12. For example, during this period, San José's annual pension costs doubled, driven in part by investment losses experienced by its two retirement plans. Moreover, primarily because of differences

Audit Highlights . . .

Our audit of the City of San José's retirement costs highlighted the following:

- » *Some of the retirement cost projections reported in the city's official documents in 2011 were not supported by accepted actuarial methodologies.*
 - *Three bond statement documents that disclosed its financial condition to potential creditors used an inadequately supported projection that its annual contributions toward retirement costs would increase to \$400.7 million by fiscal year 2015–16.*
 - *A projection that the city's annual retirement costs could increase to \$650 million by fiscal year 2015–16 was unsupported and likely overstated.*
 - *The actuary for the boards of the two retirement plans projected that the city's fiscal year 2015–16 retirement contribution would be \$320.1 million.*
- » *The city's actual retirement costs increased significantly from fiscal years 2009–10 through 2011–12, causing annual pension costs to double.*
- » *Costs related to postemployment health benefits for retirees enrolled in both plans rose by approximately 66 percent over the last four fiscal years.*
- » *As a result of the significant growth in costs related to police and fire retirement benefits from fiscal years 2009–10 through 2011–12, budgeted general fund public safety expenditures increased, even though the average number of actual filled full-time equivalent positions in this area declined by 382.*

in the way the two retirement plans spread their actuarial losses over time, annual pension costs associated with the police and fire plan increased significantly more than the costs of the federated plan. Further, the city's actuarially determined costs related to postemployment health benefits for retirees enrolled in both plans rose by approximately 66 percent over the last four fiscal years.

As of fiscal year 2010–11, San José's unfunded obligations for both plans' pension and postemployment health benefits were \$1.5 billion and \$2 billion, respectively.

These rising retirement costs and declining budgeted revenues have created budgetary challenges for San José. For example, as a result of the significant growth in costs related to police and fire retirement benefits from fiscal years 2009–10 through 2011–12, budgeted general fund public safety expenditures increased, even though the average number of filled full-time equivalent positions in this area declined by 382. Thus, San José may be providing reduced services at an increased cost. Moreover, these increased costs appear to have crowded out some of the funding previously available for services other than public safety, such as parks and libraries.

Recommendations

To ensure that stakeholders receive consistent and reliable information, San José should report the official retirement cost projections that were developed using the assumptions approved by the two retirement plan boards (boards). If San José does not use the official retirement cost projections, it should develop projections that are supported by accepted actuarial methodologies, report this information in the correct context, and disclose significant assumptions that differ from those in the boards' retirement cost projections.

Agency Comments

Although San José agreed with our recommendation, it disagreed with how we characterized some of our conclusions.

Introduction

Background

With a population of almost 1 million, the City of San José (San José) is the third most populous city in the State, based on the California Department of Finance’s January 2012 population estimates. San José provides a range of municipal services, including police and fire protection, sanitation services, environmental management, maintenance of streets and infrastructure, and administration of the library, recreational, and cultural facilities.

San José is a charter city that operates under a council-manager form of government. The mayor and city council are responsible for adopting and establishing policies in the form of ordinances, motions, and resolutions. The city council consists of the mayor and 10 council members, each of whom represents a city district. The mayor and city council members are elected to four-year terms and are limited to two consecutive terms. Under San José’s charter, the city has a city manager who is appointed by the city council, serves as the city’s chief administrative officer, and generally directs and supervises the administration of all city departments, offices, and agencies.

For budgetary purposes, San José groups its operations into four functional areas, as described in the text box. For fiscal year 2011–12, the city adopted a budget of approximately \$2.8 billion, including a total general fund budget of approximately \$906 million. That budget includes funding for approximately 5,400 budgeted full-time equivalent positions.

City of San José’s Functional Areas for Budgetary Purposes

Capital maintenance departments: Provide for the construction and maintenance of the City of San José’s (San José) infrastructure by the transportation and public works departments.

Community services departments: Provide for programs that affect citizens on a daily basis, such as airport and environmental services; parks; libraries; and planning, building, and code enforcement.

General government departments: Provide for the overall management and administrative function of San José, including human resources, finance, information technology, city manager, mayor, city council, city auditor, and city clerk.

Public safety departments: Provide for the safety of the public through crime and fire prevention and suppression efforts of the police and fire departments.

Sources: City of San José’s adopted budgets for fiscal years 2009–10 through 2011–12.

San José’s Retirement Plans

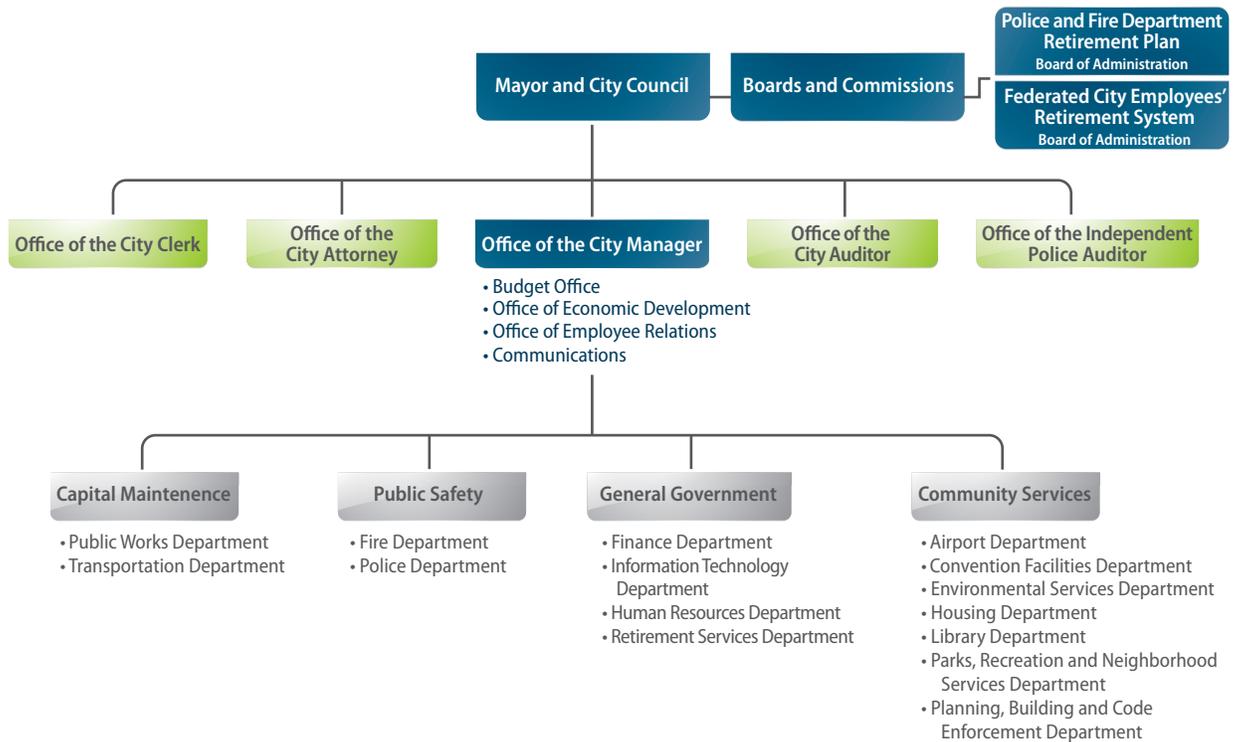
The boards of administration (boards) of the Federated City Employees’ Retirement System (federated plan) and of the Police and Fire Department Retirement Plan (police and fire plan) administer the city’s two retirement plans. Full-time employees who work for the city are generally covered under one of these plans. The mayor and city council members do not participate in the city’s retirement plans; instead, they are eligible to participate in the California Public Employees’ Retirement System. In addition, San José’s part-time employees are generally not eligible to

participate in the city's retirement plans. As of May 2012, a total of 4,805 city employees were participating in either the federated plan or the police and fire plan.

The police and fire plan is administered by a nine-member board composed of two city employees who are members of the police and fire plan, two retired plan members, and five public members. The federated plan is administered by a seven-member board composed of two city employees who are members of the federated plan, one retired plan member, and four public members. The members of each board are appointed by the city council to four-year terms, but one of the public members of each board must first be recommended by the other current board members before being appointed by the city council. The public members of each board must have at least 12 years of experience relevant to the administration of a public retirement plan, such as investment management experience, and may not be current or former city employees or officers and may not be participating or receiving benefits under either plan. Under the state constitution, the boards have fiduciary responsibility for the assets of each plan and the responsibility to administer the plans to assure prompt delivery of benefits and services. The city's municipal code imposes specific duties on each board, which include considering requests for retirement and administering and investing plan funds.

The day-to-day operations of both retirement plans are administered by a city department. Specifically, San José's municipal code requires the director of the city's Department of Retirement Services (Retirement Services) to provide staff services to the retirement boards, to maintain the records of each plan, and to serve as each board's secretary. The director of Retirement Services supervises the investments of each plan's assets; administers retirement benefits; and analyzes, develops, and recommends policy for the boards. Retirement Services also assists the boards in selecting actuaries for their plans. Retirement Services' administrative costs are paid by the retirement funds. Although the director of Retirement Services has various duties in the operations of the two retirement plans, he is appointed by and reports directly to the city manager; and the operating budget of Retirement Services is approved by the city council. Figure 1 shows the organization chart of San José.

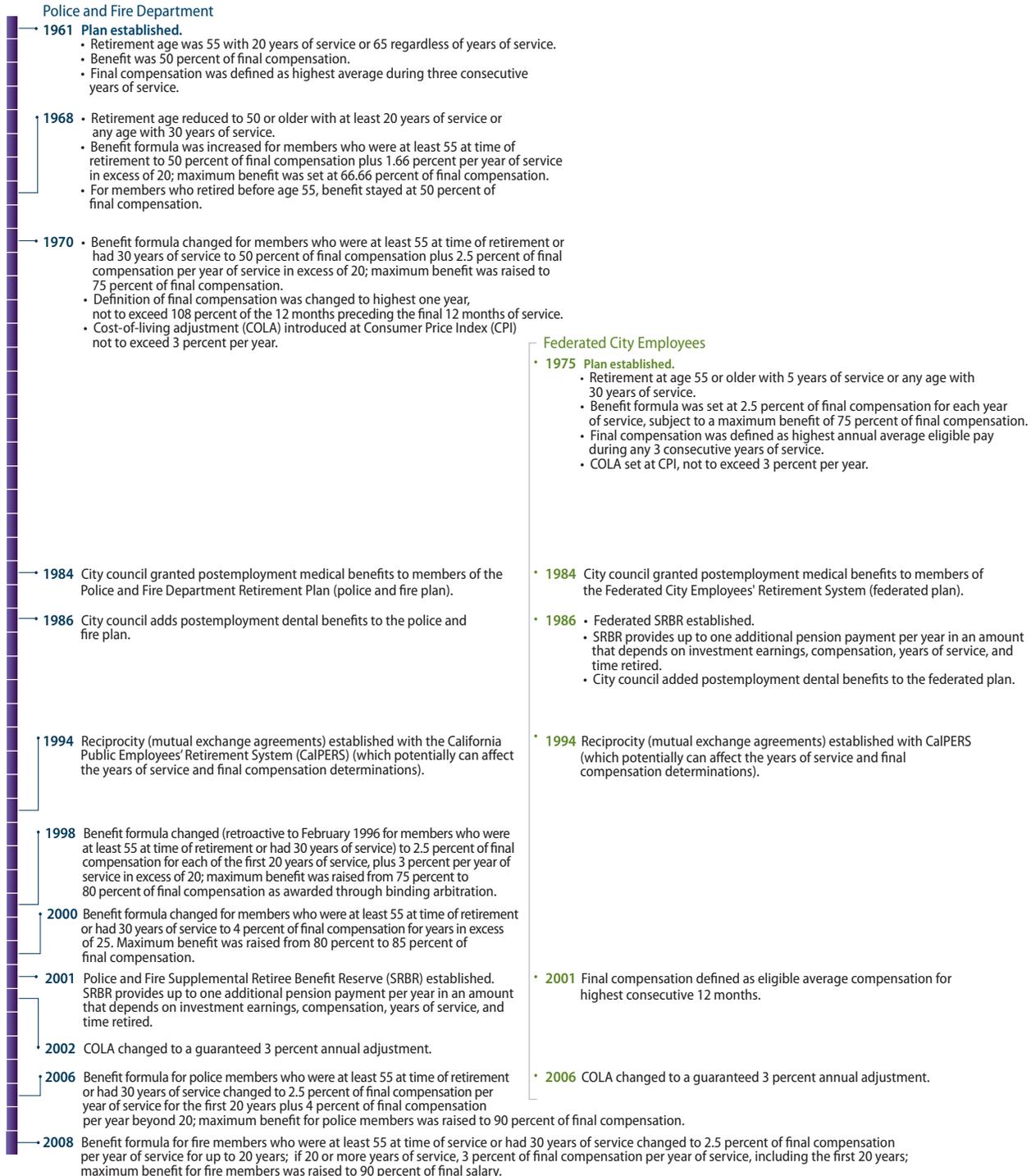
Figure 1
City of San José's Organization Chart



Sources: City of San José's Web site, 2011–12 Adopted Operating Budget; San José Code of Ordinances Title 2 Administration.

The city offers an array of retirement benefits to its employees, including pension and postemployment health benefits for retirees. However, city employees do not participate in the federal Social Security program while employed by the city and do not earn credit for Social Security benefits, since San José opted not to participate in this program. Both pension plans use investment income and employer and employee contributions to provide eligible retirees with a defined-benefit pension based on their age, years of service, and final compensation. Employees covered by the federated plan and the police and fire plan have historically contributed roughly 4 percent and 9 percent, respectively, of their pay to their pension plans, as determined by the boards' actuaries. The plans also provide postemployment health benefits, survivor benefits, and disability benefits to qualified members and their beneficiaries. Figure 2 on the following page shows the history of San José's employee retirement benefits.

Figure 2
History of the City of San José's Retirement Plan Benefits



In June 2012 San José voters passed a measure that will generally authorize limits on pension benefits for new city employees and authorize reduced future benefits for current city employees who do not increase their retirement contributions. Specifically, as shown in Table 1 on the following page, the measure amends the city's charter to require the city council to adopt ordinances to place all new employees into new retirement plans with limits on the benefits.¹ Current retirement ages differ based on years of service, and the minimum retirement ages currently are 50 for public safety employees and 55 for other city employees; there is currently no minimum age requirement in either plan for employees with 30 years of service. The minimum retirement age for new employees under the new plan will increase to 60 with 10 years of service for public safety employees, and 65 with five years of service for other city employees. The accrual² rate for benefits will decrease to 2 percent per year of service, with a cap of 65 percent; currently the rate varies between 2.5 percent and 4 percent per year, depending on the plan and years of service, and is capped at 90 percent of final compensation for public safety employees and 75 percent for other city employees. The final compensation will be redefined from the single highest year to an average of the highest three consecutive years using only base pay. Annual cost-of-living adjustments (COLAs) for retirees would be decreased from 3 percent to 1.5 percent or the percentage increase in the Consumer Price Index, whichever is lower.

Current employees will have two options once the city implements the measure. They may voluntarily opt in to receive reduced retirement benefits. These reduced benefits will include an increase in the minimum retirement age to 57 with 20 years of service for public safety employees and to 62 with five years of service for other city employees. Accrual rates will decrease to 2 percent per year for future years of service, while final compensation and COLA adjustments will be changed as described in the previous paragraph. To keep their current retirement benefits, current employees will experience increases in existing employee retirement contributions in increments of 4 percent of pay per year to a maximum of 16 percent annually; these increases will apply even if the city does not implement the opt-in program. The measure also allows the city council to suspend COLAs for five years during a fiscal and service-level emergency, and it prohibits increases in retirement benefits without voter approval. In addition, the measure requires current and new employees to contribute a minimum of half the cost of postemployment health benefit costs, and modifies the process by which the city will determine disability.

¹ While the measure authorizes San José to adopt either a defined-benefit plan or a hybrid plan for new employees, the limits described in this paragraph would apply to defined-benefit plans for new employees.

² The rate at which pension benefits build up as member service is completed in a defined benefit plan.

Table 1**Comparison of Benefits for the City of San José's Two Retirement Plans, Before and After the Changes Adopted in June 2012****Highlights of Ballot Measure B—Federated City Employees' Retirement System**

| | CURRENT EMPLOYEES (TIER 1) | CURRENT EMPLOYEES' VOLUNTARY ELECTION PROGRAM (VEP) | NEW EMPLOYEES DEFINED BENEFIT PLAN (TIER 2) * |
|----------------------------------|---|--|--|
| Maximum benefit | 75 percent of final compensation | 75 percent of final compensation | 65 percent of final compensation |
| Accrual rate | 2.5 percent per year | 2 percent per year (future years only) | 2 percent per year |
| Retirement age | <ul style="list-style-type: none"> Age 55 with 5 years of service Any age with 30 years of service | <ul style="list-style-type: none"> Age 62 with 5 years of service (phased in over 14 years) 30 years at any age, years to increase by 6 months annually beginning 7/1/17 | Age 65 with 5 years of service |
| Final compensation calculation | Highest 1 year | Average of highest 3 consecutive years | Average of highest 3 consecutive years |
| Cost-of-living adjustment (COLA) | 3 percent | 1.5 percent or Consumer Price Index (CPI), whichever is lower | 1.5 percent or CPI, whichever is lower |
| Cost sharing | Effective June 2013, current employees will gradually increase their retirement contributions up to a maximum of 16 percent of pay in 4 percent annual increments, but will contribute no more than half of the cost to pay the unfunded liability. This is in addition to their current retirement contributions. This will occur if either the VEP is not enacted or the employee does not opt-in to the VEP. | For employees who elect to opt in to the lower level of benefits, the city will continue to contribute 73 percent of the current year cost and will contribute the entire cost to pay the unfunded liability. Employees will continue to contribute 27 percent of the current year cost. | Costs will be shared 50 percent/50 percent between the city and employees. |

Highlights of Ballot Measure B—Police and Fire Department Retirement Plan

| | TIER 1 | CURRENT EMPLOYEES' VEP | TIER 2* |
|--------------------------------|---|--|--|
| Maximum benefit | 85 percent to 90 percent of final compensation | 90 percent of final compensation | 65 percent of final compensation |
| Accrual rate | 2.5 percent to 4 percent depending on years of service | 2 percent per year (future years only) | 2 percent per year |
| Retirement age | <ul style="list-style-type: none"> Age 50 with 25 years of service Age 55 with 20 years of service Any age with 30 years of service | <ul style="list-style-type: none"> Age 57 with 20 years of service (phased in over 14 years) 30 years at any age, years to increase by 6 months annually beginning 7/1/17 | Age 60 with 10 years of service |
| Final compensation calculation | Highest 1 year | Average of highest 3 consecutive years | Average of highest 3 consecutive years |
| COLA | 3 percent | 1.5 percent or CPI, whichever is lower | 1.5 percent or CPI, whichever is lower |
| Cost sharing | Effective June 2013 current employees will gradually increase their retirement contribution up to a maximum of 16 percent of pay in 4 percent annual increments, but will contribute no more than half of the cost to pay the unfunded liability. This is in addition to their current retirement contributions. This will occur if either the VEP is not enacted or the employee does not opt-in to the VEP. | For employees who elect to opt in to the lower level of benefits, the city will continue to contribute 73 percent of the current year cost and will contribute the entire cost to pay the unfunded liability. Employees will continue to contribute 27 percent of the current year cost. | Costs will be shared 50 percent/50 percent between the city and employees. |

MISCELLANEOUS PROVISIONS

- If the City of San José (San José) council declares a fiscal and service-level emergency, it will have the ability to suspend the COLA for up to 5 years.
- Current and new employees contribute a minimum of 50 percent of the cost of postemployment health benefits.
- Bonus pension checks from the Supplemental Retiree Benefit Reserve would be discontinued.
- San José would be prohibited from increasing retirement benefits without voter approval.

Sources: San José City Charter, Article XV-A (added by Measure B, June 5, 2012), San José's Mayor's Office, revised recommended ballot measure, 2010–11 Comprehensive Annual Financial Report (CAFR) for San José's Federated City Employees' Retirement System, and 2010–11 CAFR for San José's Police and Fire Department Retirement Plan.

Note: This table is a summary and does not include survivorship and disability benefits.

* While Measure B authorized either defined benefit plans or hybrid plans, the provisions shown are Measure B's requirements for defined benefit plans.

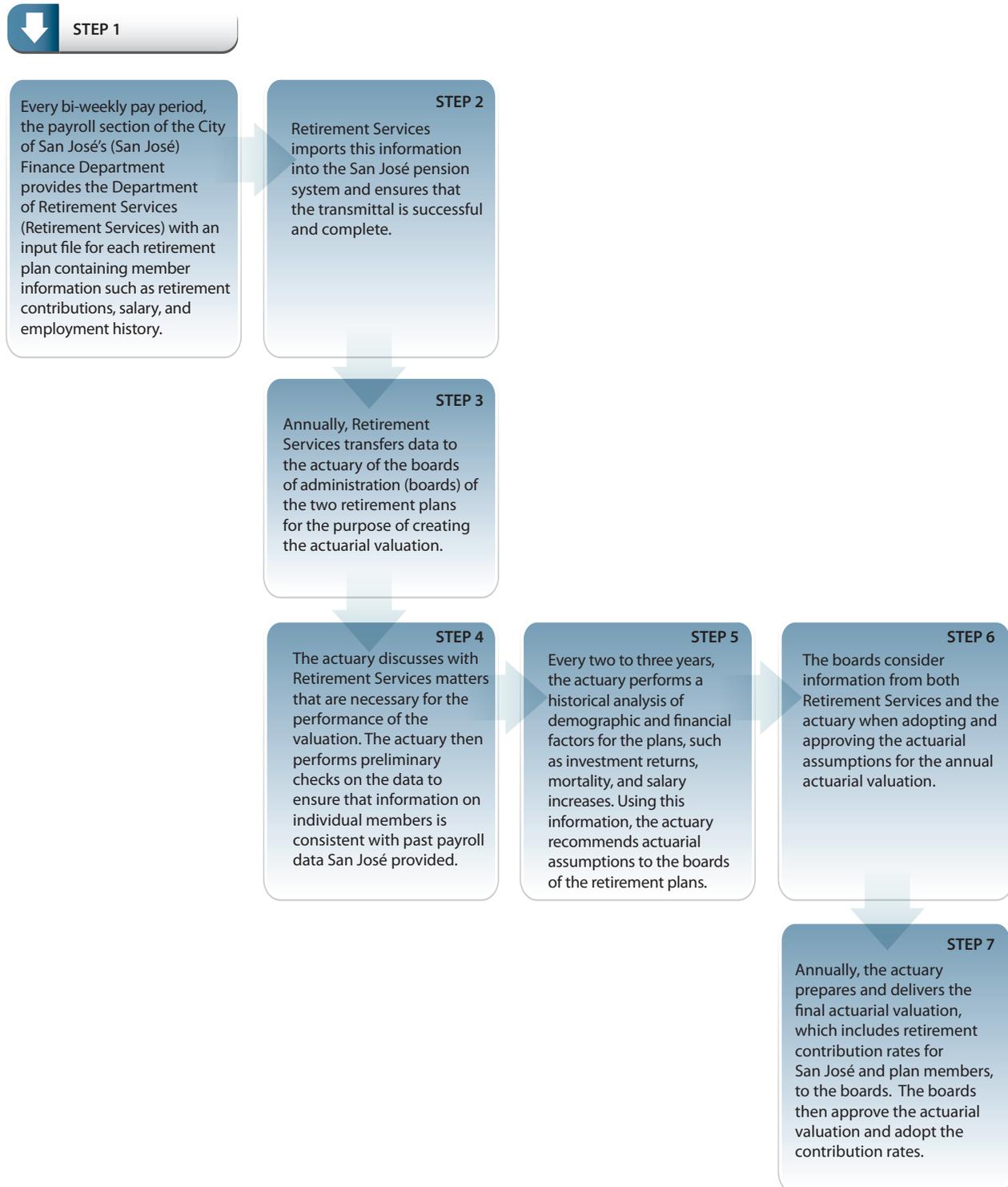
According to the city attorney, many of the provisions of the measure will require adoption of city ordinances to become effective. He also stated that San José plans to adopt an ordinance to establish a new tier with limited benefits for new non-public safety employees in August 2012. Public safety employees have the right to binding arbitration and thus the city expects to adopt limited benefits for new public safety employees no earlier than January 2013. Finally, pending Internal Revenue Service approval and the outcome of several legal challenges to the measure, San José is planning on implementing the pension changes shown in Table 1 for current employees by June 2013.

San José's Process for Calculating Its Official Retirement Costs

San José's municipal code requires an actuarial valuation of its retirement assets and liabilities every five years. According to the city's audited financial statements, it had been the policy of the two boards to obtain actuarial valuations every two years; however, the boards opted to have a valuation completed annually beginning June 30, 2010. The boards' actuary is required to include an analysis of the mortality, service, and compensation experience of members and persons receiving benefits and an actuarial valuation of the assets and liabilities of the plans. The boards use the valuations to determine the retirement contribution rates of their respective plan members and the city.

Figure 3 on the following page illustrates the process the boards use to determine those retirement contribution rates. As shown in the figure, the process begins with the city providing Retirement Services with payroll data, which are then forwarded to the boards' actuary. Our actuarial consultant determined that the valuation process, including the collection and review of data used by the boards' actuary, appears sound and does not vary from generally accepted actuarial standards. Further, our actuarial consultant found that the interaction of the city, the boards, and the boards' actuary appear appropriate for their roles in the production of the valuations. The actuary uses these data to analyze demographic and economic information and then forwards the results of its analysis to the boards so that they can determine which actuarial assumptions to adopt for their respective retirement plans.

Figure 3
Flow Chart for Actuarial Valuation Process



Sources: Interviews with Retirement Services' staff, contracts between the boards of the Federated City Employees' Retirement System (federated) and of the Police and Fire Department Retirement Plan (police and fire) and actuary, federated and police and fire boards' meeting minutes and agendas, and San José's City Auditor Report #09-10 *Audit of Pensionable Earnings and Time Reporting*.

For the city, there are no statutorily required minimum contributions to fund either the pension or postemployment health benefit plans. However, the Governmental Accounting Standards Board sets standards for the manner in which U.S. state and local governments should account for pension and postemployment health benefits in their financial statements. The *annual required contribution* is the amount the city reports in its financial statements as the cost for those benefits. San José has had a long-standing practice of making cash contributions to its pension plans in an amount equal to the full annual required contribution. The city and employees have also been making contributions towards funding postemployment health benefits for active employees and retirees, however, at a level less than the full annual required contribution.

To determine San José's annual required contribution, the boards' actuary first calculates the present value of all benefits the plans are expected to pay for current and former employees. The portion of this amount attributable to past years of service is the *accrued liability*. The actuary then compares this monetary obligation to the plans' assets in order to arrive at the *unfunded actuarial accrued liability*, the amount of the accrued liability that exceeds the plans' assets. Although the city could pay the unfunded actuarial accrued liability associated with the two plans in one year, the liability is generally spread, or amortized, over a longer period, such as 15 to 30 years, thus smoothing the year-to-year volatility. The annual required contribution is made up of the sum of this amortization payment and the value of the benefits that will be earned in the current year, known as the *normal cost*.

Each year a plan will incur gains or losses when the actual experience of the plan differs from the actuarial assumptions. These gains or losses arise from such items as salary increases, terminations, retirements, and investment returns. To the extent that the actual experience differs from the actuarial assumptions, it will add to or subtract from the unfunded liability; over time, these gains and losses are expected to offset each other. Periodically, the boards' actuary will review the experience and may make adjustments to its expectations. When this occurs, the boards and their actuary will agree to change some of the assumptions used in calculating the liabilities to better reflect expected experience. Changes in plan assumptions, such as the assumed rate of return on investment used to calculate liabilities, will also change the unfunded liabilities. All else being equal, a higher assumed return on investment will decrease liabilities while a lower assumed investment return will increase liabilities.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) directed the California State Auditor to perform an audit of San José's operating budget and current and future pension obligations. The audit analysis that the audit committee approved contained nine objectives. Table 2 lists these objectives and methods we used to address them.

Table 2
Methods of Addressing Audit Objectives

| AUDIT OBJECTIVE | METHODS |
|---|---|
| 1 Review and evaluate the laws, rules, and regulations significant to the audit objectives. | Obtained and reviewed relevant laws, regulations and ordinances, and worked with our legal counsel as necessary to apply the criteria to the remaining audit objectives. In addition, we obtained necessary background information for the report. |
| 2 Identify the City of San José's (San José) operating budget, including revenues and expenditures for fiscal years 2009–10 through 2011–12. | Obtained and reviewed operating budget documents for fiscal years 2009–10 through 2011–12. |
| 3 For fiscal years 2009–10 through 2011–12, identify San José's required and actual pension contributions, as well as employees' actual contributions. | <ul style="list-style-type: none"> • Obtained the comprehensive annual financial reports (CAFRs) for the city and its two retirement plans, and verified that the CAFRs were independently audited by a licensed public accounting firm. • Analyzed trends in the city's required and actual pension and other postemployment health benefit contributions, actual employee contributions, and unfunded actuarial accrued liabilities. Our actuarial consultant also reviewed actuarial valuations to gain an understanding of the reasons for significant changes in these areas during the period under review. In addition, our actuarial consultant validated that adequate documentation in these areas existed to support actuarial assumptions used in calculating actual contributions. |
| 4 Identify the source of the pension cost projections and the amounts San José is reporting as its official projections for its pension contribution obligation for fiscal years 2011–12 through 2015–16. Determine whether these projections included all relevant factors and were established using actuarial industry standards and guidelines. | <ul style="list-style-type: none"> • Interviewed San José staff and retirement board chairs to identify the projections that were based on the actuarial assumptions approved by the retirement boards, and obtained San José's retirement cost projections for fiscal years 2012–13 through 2016–17. • Our actuarial consultant reviewed underlying valuation reports and experience studies, and interviewed the boards' actuary and city staff to determine if the factors and assumptions and the resulting retirement cost projections used by the city are congruent with actuarial standards and guidelines. |
| 5 Identify the sources of any other pension cost projections and the amounts San José officials have reported in various correspondence and media outlets as the city's pension contribution obligation for future fiscal years. Determine the reasons for the difference between these different pension contribution amounts and the amounts identified in audit objective 4 above. | <ul style="list-style-type: none"> • Researched retirement cost projections published by San José and media outlets, including the amounts specified in the audit request, and agreed on an inventory of these projections. • Interviewed chairs of the two retirement boards, the director of the Department of Retirement Services (Retirement Services), and other city officials to obtain the rationale, support, and source of these projections, as well as how they were used by the city. • Determined the reasons for the differences among the different projections. Our actuarial consultant determined whether these projections were adequately documented and prepared in accordance with actuarial standards. |

| AUDIT OBJECTIVE | METHODS |
|--|---|
| <p>6 Determine whether San José and the retirement plan boards followed applicable laws, rules, and regulations related to their involvement in actuarial reviews and when reporting San José's projected pension liabilities.</p> | <ul style="list-style-type: none"> • Reviewed the actuary's contracts with the two retirement boards, and interviewed Retirement Services staff and the chairs of both boards to determine the boards' process for approving actuarial assumptions. We determined and characterized the nature of the relationship between the boards, the city, and the boards' current actuary, which includes the flow of information from the city to the boards' actuary. • Our actuarial consultant determined whether the valuation process, including the collection and review of data used by the boards' actuary appear sound and comply with generally accepted actuarial standards. Further, our actuarial consultant determined whether the interaction of the city, the boards, and the boards' actuary were appropriate for their roles in the production of the valuation. • Our legal counsel reviewed relevant city and state laws, including the Political Reform Act and relevant city policies. Our legal counsel also reviewed pending litigation and complaints related to the city's retirement projections. We decided not to report on matters where there was pending litigation or complaints. • We found that the boards' current contracted actuary billed the police and fire board for 1.5 hours of work performed on July 29, August 1, and August 10, 2011, by a former city employee who currently works for the actuary; this work may have related to a project he worked on while previously employed by the city. This is a potential violation of San José's revolving door ordinance. Although the city granted a waiver of its revolving door ordinance to the former employee, it was granted on August 23, 2011, which was after the billing for the work. Therefore, we referred the matter mentioned above to the city attorney for further investigation. |
| <p>7 Determine the major factors that contributed to San José's need to reduce its expenditures for fiscal years 2009–10 through 2011–12. Determine whether these factors were reasonable and if San José had sufficient evidence to support the reductions.</p> | <ul style="list-style-type: none"> • Obtained and reviewed relevant budget documents and CAFRs, and interviewed the city budget director to obtain information on factors taken into consideration when preparing the budget. • Identified the functional areas where San José significantly reduced budgetary expenditures. Obtained San José's explanation for the factors that caused it to reduce expenditures and compared these factors to budgetary support, and information in San José's CAFRs. • Evaluated the relationships between budgeted revenues, budgeted expenditures, average actual filled full-time equivalent positions (FTE positions), and retirement costs. |
| <p>8 For fiscal years 2009–10 through 2011–12, determine the number of positions eliminated as well as the operational areas from which they were eliminated.</p> | <p>Analyzed the reductions in the number of FTE positions by functional area.</p> |
| <p>9 Review and assess any other issues that are significant to San José's operating budget and its current and future pension obligations.</p> | <p>Reviewed and summarized San José's June 5, 2012, ballot measure on pension benefits (Measure B), that the city's voters approved.</p> |

Source: California State Auditor's analysis of the Joint Legislative Audit Committee audit request number 2012-106 and the analysis of information and documentation identified in the table column titled *Methods*.

Assessment of Data Reliability

In performing this audit, we relied upon an electronic data file extracted from the information system listed in Table 3. The U.S. Government Accountability Office, whose standards we follow, requires us to assess the sufficiency and appropriateness of computer-processed information. The table below shows the results of this analysis.

Table 3
Methods to Assess Data Reliability

| INFORMATION SYSTEM | PURPOSES | METHODS AND RESULTS | CONCLUSION |
|---|---|--|---|
| City of San José's (San José) PeopleSoft human resources information system (human resources data). Data as of May 2012. | <ul style="list-style-type: none"> To identify San José's average actual number of filled full-time equivalent positions (FTE positions) and employees by functional area from July 2009 through May 2012.* To identify the number of San José employees and those who participated in the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan as of May 2012. | <p>We performed data-set verification procedures and electronic testing of key data elements and did not identify any issues.</p> <p>We did not perform accuracy and completeness testing of San José's human resources data because it is used as corroborating evidence and is not the sole support for any finding, recommendation, or conclusion. Further, this audit is most likely a one-time review of a local entity and therefore did not warrant the same level of resource investment as a state agency whose system produces data that may be used during numerous future audit engagements.</p> | <p>Undetermined reliability for the purposes of this audit.</p> <p>Nevertheless, we present these data, as they represent the best available data source of this information.</p> |

Sources: California State Auditor's analysis of various documents, interviews, and data obtained from San José's human resources data.

* As shown in Figure 8 on page 32, the number of FTE positions calculated is the average for the period.

Audit Results

Some of the City of San José's Projected Retirement Costs Were Unsupported

In 2011 the City of San José (San José) reported multiple projections of its future contributions towards the costs of its retirement plans, some of which were based on assumptions that had not been approved by the boards of administration (boards) of its two independent retirement plans and that were not supported by documentation required by accepted actuarial standards. San José released these retirement cost projections to various stakeholders and used these estimates for purposes such as budgetary forecasting and to disclose its projected contributions toward its retirement costs in official bond statements.

In January 2011 city administrators made a public presentation on retirement reform to the city council, which included projections that estimated that the city's annual contributions toward retirement costs would increase to \$400.7 million by fiscal year 2015–16. This same projection was also referenced in disclosures contained in the official bond statements of San José's Financing Authority issued in March 2011, and in San José's official bond statements issued in March and July 2011. As shown in Table 4 on the following page, this projection also appeared in several documents that were used to communicate city officials' concerns over rising retirement costs. For example, San José's mayor mentioned this figure in his State of the City address in February 2011 and in his March 2011 budget message for fiscal year 2011–12.

However, the two boards' actuary had not prepared this projection nor had the boards approved the underlying assumptions associated with it. Further, the projection was not adequately supported. Rather, a staff actuary employed by the Department of Retirement Services (Retirement Services) developed this projection and provided it to the city manager's budget office for budgetary forecasting purposes. According to the director of Retirement Services, the staff actuary developed the projection using an actuarial model that had been verified against models used by the boards' current and former outside actuaries based on payroll data as of June 30, 2010. He also indicated that this projection considered the impact of layoffs that occurred in July 2010 and an assumption of across-the-board salary reductions. However, in support of this projection, San José officials were only able to provide us with spreadsheets that our actuarial consultant determined were not appropriate documentation of the assumptions, data, and methodology and that did not include any information as to how this projection should be used. Without such evidence, our actuarial consultant could not be assured that San José calculated and used this projection appropriately. Although this projection was not adequately documented, a subsequent July 2011 projection yielded similar results, as we discuss later.

Table 4
Cost Projections Related to the City of San José's Pension and Postemployment Health Benefits
Fiscal Years 2011–12 Through 2016–17
(In Millions)

| | JANUARY 2011 | FEBRUARY 2011 | JUNE 2011 | JULY 2011 | FEBRUARY 2012 | |
|--|--|--|--|---|--|---------|
| Fiscal Year | 2011–12 | \$256.2 | NA | NA | \$262.8 | NA |
| | 2012–13 | 310.5 | NA | NA | 323.4 | \$251.2 |
| | 2013–14 | 360.2 | NA | NA | 380.4 | 298.8 |
| | 2014–15 | 388.9 | NA | NA | 416.1 | 319.0 |
| | 2015–16 | 400.7 | \$650.0 | \$575.0 | 431.5 | 320.1 |
| | 2016–17 | NA | NA | NA | NA | 325.0 |
| Source of projection | Department of Retirement Services (Retirement Services) staff actuary | Director of Retirement Services | Retirement Services' staff actuary | The retirement boards' external actuary | The retirement boards' external actuary | |
| Did retirement boards approve actuarial assumptions used to calculate these projections? | No | No | No | No | Yes | |
| Meets actuarial standards? | No—the City of San José (San José) was unable to provide appropriate documentation of the assumptions, data, or methodology used to calculate these projections. | No—San José was unable to provide support for this projection. | No—San José was unable to provide appropriate documentation of the assumptions, data, or methodology used to calculate this projection. | Yes | Yes | |
| Primary purpose | Budgetary forecasting. | The mayor used this estimate to call attention to rising retirement costs. | Internal retirement cost projection. | To provide an independent review of the January 2011 projection that was previously prepared by Retirement Services' staff actuary. | Budgetary projections based on the June 30, 2011, actuarial valuations. | |
| Documents that included these projections | <ul style="list-style-type: none"> • 2011-12 City Manager's Budget Request & 2012–2016 Five-year Forecast and Revenue Projections for the General Fund and Capital Improvement Program issued in February 2011 • Mayor's February 2011 State of the City address • February 2011 public budget study session • Mayor's March 2011 budget message for fiscal year 2011–12 • May 2011 public retirement reform city council budget study session • City manager's May 2011 Fiscal Reform Plan • Official bond statements issued in March 2011 and July 2011 | <ul style="list-style-type: none"> • Mayor's April 2011 press release • Mayor's May 2011 press release • May 2011 fiscal reform memo signed by the mayor, vice-mayor, and two council members • Mayor's June 2011 budget message for fiscal year 2011–12 • August 2011 Stanford Institute for Economic Policy Research public meeting • News media outlets | June 2011 e-mail from the director of Retirement Services to a staff actuary that entered the public domain when it was obtained by an NBC Bay Area news outlet. We did not find any official documents that included this figure. | <ul style="list-style-type: none"> • August 2011 Stanford Institute for Economic Policy Research public meeting • October 2011 labor negotiations update presentation to the city council • November 2011 Fiscal and Service-Level Emergency Report • Official bond statement issued in December 2011 | <ul style="list-style-type: none"> • 2012–13 City Manager's Budget Request & 2013–2017 Five-year Forecast and Revenue Projections for the General Fund and Capital Improvement Program issued in February 2012 • Mayor's March 2012 budget message for fiscal year 2012–13 • March 2012 city council session on future retirement costs | |

Sources: San José's actuarial reports, official bond statements, budget documents, press releases, meeting minutes, and news media outlets.

NA = Not Applicable.

In February 2011 the mayor, the director of Retirement Services, the staff actuary of Retirement Services, the city manager, and a deputy city manager attended a city council budget study session. During the meeting, a city council member asked a variety of questions regarding retirement costs. At one point in the meeting, the director of Retirement Services stated:

“The benefits are going to be whatever the benefits are, but in order to fund them and accurately project for them, to actually project forward how much it’s all going to cost, we need to fix all of these things inside the valuations that we already know about, and we’re nowhere near fixing those. If you fixed all of that, you’re looking at probably another \$250 million above your \$400 million. So the \$400 [million] is really just a basic starting point that recognizes the losses that have occurred and doesn’t really fix anything going forward.”

In the months following the director of Retirement Services’ comment that retirement costs could increase by \$250 million above the original \$400.7 million projection, to call attention to rising retirement costs the mayor’s office reported in official city documents, in press releases, during a public presentation, and to news outlets that the city’s annual retirement costs could reach \$650 million. For example, this figure appeared in a May 2011 fiscal reform memo signed by the mayor, vice mayor, and two council members, and in the mayor’s June 2011 budget message for fiscal year 2011–12. When we asked the director of Retirement Services where the \$650 million projection came from, he stated that it was just an estimate “off the top of his head” that he provided in response to a question during the February 2011 budget study session. He also told us that after he became aware that the mayor was using this figure in public communications, he had his staff actuary verbally inform the mayor’s office that this was not an official projection and that there was no documented support for this estimate. On February 9, 2012, the city manager wrote a letter to the mayor and city council to respond to information in an NBC Bay Area news story that aired the day before about San José’s retirement cost estimates. In the letter, the city manager clarified that the \$650 million annual retirement cost figure was simply an estimate and was never intended to be used as a formal projection.

According to the director of Retirement Services, San José’s former director of the Finance Department (finance) began to question the reliability of the \$400.7 million cost projection after the mayor reported that the city’s annual retirement contributions could reach \$650 million. However, according to the current acting director of finance, this was part of the city’s normal process of ensuring that a factual discussion of the city’s two retirement plans is included in official bond statements. In June 2011 the

To call attention to rising retirement costs the mayor’s office reported in official city documents, in press releases, during a public presentation, and to news outlets that the city’s annual retirement costs could reach \$650 million.

director of Retirement Services emailed the staff actuary to ask for a copy of the spreadsheet that calculated the \$400.7 projection. In the email, the director of Retirement Services noted that the spreadsheet indicated that “with fixing demographics and other issues,” the city’s annual retirement contributions could reach \$575 million; he went on to state that the city’s finance staff challenged the \$400.7 million projection after they heard that there was no backup for the \$650 million figure. The \$575 million annual retirement cost projection that the director of Retirement Services mentioned became public when a media outlet obtained the email.

The director of Retirement Services explained to us that the \$575 million projection was one of many calculated by the staff actuary before and after the mayor reported the \$650 million figure to news outlets. He added that the \$575 million projection represents one scenario of how high the city’s retirement contributions could be if the actuarial assumptions were more conservative and were based on recent actual experience. However, in support of this projection, San José officials again were only able to provide us with spreadsheets that our actuarial consultant determined were not appropriate documentation of the assumptions, data, and methodology used to calculate this projection. Without such evidence, our actuarial consultant could not be assured that this projection had been calculated appropriately. The director of Retirement Services asserted that the \$575 million figure was not used in any official city documents, and we did not find any official city documents that included this figure.

On June 30, 2011, Retirement Services requested that the external actuary shared by the two boards perform an independent review of the previously mentioned \$400.7 million projection prepared by the staff actuary of Retirement Services, and instructed the boards’ actuary to use the specific rules or assumptions that were used to calculate this amount. According to this actuary, Retirement Services was requesting the boards’ actuary to check the math in the \$400.7 million projection to see if it would arrive at the same amount. The boards’ actuary concluded that the specified assumptions, including assumed net investment rates of return for the Police and Fire Department Retirement Plan (police and fire plan) and the Federated City Employees’ Retirement System (federated plan) of 7.5 percent and 7.75 percent, respectively, were reasonable. In July 2011 the boards’ actuary completed this exercise and projected that the city’s contribution towards its employees’ retirement costs would reach \$431.5 million in fiscal year 2015–16, a figure relatively close to the initial \$400.7 million estimate. Our actuarial consultant determined that the \$431.5 million projection was calculated in accordance with generally accepted actuarial standards. However, it is important to note that even though plan assets were used to pay for this projection the two boards did not request it nor did they approve the assumptions used in its development. The use of retirement plan assets to pay for this projection is the subject of a current lawsuit filed by retirement plan members.

In July 2011 the boards’ actuary completed this exercise and projected that the city’s contribution towards its employees’ retirement costs would reach \$431.5 million in fiscal year 2015–16.

Although the \$431.5 million retirement cost projection was relatively close to the \$400.7 million retirement cost projection, the data San José provided to the boards' actuary did not include information on pay cuts and reductions in the workforce that occurred in fiscal year 2010–11. According to the director of Retirement Services, these data were not available until after the boards' actuary completed the projection. The city subsequently used the \$431.5 million projection in various documents, including an official bond statement issued in December 2011 and its November 2011 *Fiscal and Service Level Emergency Report*. The stated purpose of this report was to address projected budget shortfalls, primarily caused by rising retirement costs, by declaring a fiscal emergency that the city asserted would allow it to modify its pension benefits in accordance with its charter. To call attention to these rising retirement costs, San José referred to the \$431.5 million retirement cost projection for fiscal year 2015–16 in the report. However, San José indicated in this report and the official bond statement that this estimate may show some improvement, considering the pay cuts and reductions in the workforce that occurred in fiscal year 2010–11.

In addition, on December 1, 2011, the mayor and several council members recommended that the city council defer their consideration of declaring a fiscal and service level emergency until after the boards' actuary updated its retirement cost projections. On December 6, 2011, the city council voted to defer such consideration to an undetermined date. On that same day, the city council voted to place a retirement reform measure on the June 5, 2012, ballot.

Finally, in February 2012, the boards' actuary produced an updated five-year retirement cost projection based on its recently completed June 30, 2011, valuations. This projection reflected the most recent assumptions approved by the boards, such as a 7.5 percent assumed investment rate of return for both the police and fire and federated pension plans. The projection also factors in the salary and staff reductions that occurred during fiscal year 2010–11, which reduced payroll costs by approximately 24 percent. The boards' actuary estimated that the city's annual contribution towards its employees' retirement costs would be \$320.1 million by fiscal year 2015–16. Our actuarial consultant determined that this projection was calculated in accordance with generally accepted actuarial standards. Although still a significant number, the February 2012 projection of the city's future contributions towards retirement costs was significantly lower than all of the previously discussed projections as shown in Table 4 on page 16. For example, the projection by the boards' actuary of the city's fiscal year 2015–16 retirement contribution of \$320.1 million was less than half of the \$650 million estimate for the same period that the mayor had used to draw attention to rising retirement costs.

On December 1, 2011, the mayor and several council members recommended that the city council defer their consideration of declaring a fiscal and service level emergency until after the boards' actuary updated its retirement cost projections.

Reporting multiple retirement cost projections in a short period may have caused confusion among the city's stakeholders attempting to make informed decisions. For instance, as we indicated in the Introduction, in June 2012 the city's voters approved significant changes to its pension plans. However, it is unclear which retirement cost projection the voters relied on, if any, when they voted for these changes.

San José's Retirement Costs Have Been Increasing Dramatically

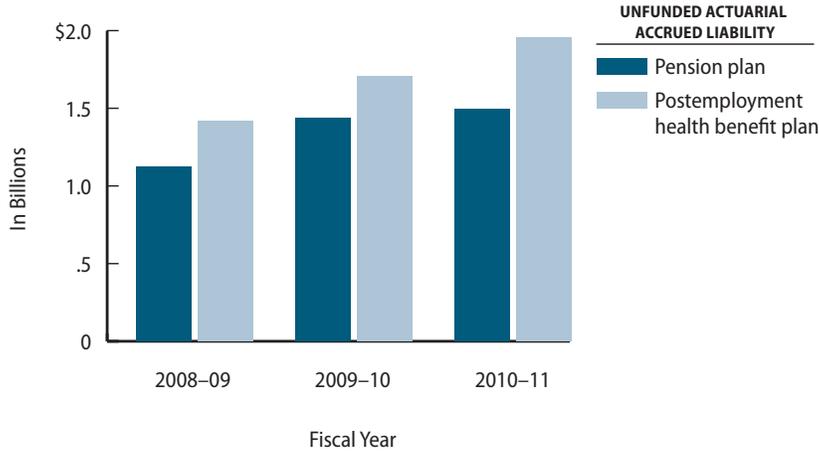
Since fiscal year 2006–07 San José's retirement contributions have been increasing. Over the same period, the funded status of the retirement plans has deteriorated, despite the increased contributions. Unfunded retirement obligations result when the value of the plans' assets are not large enough to cover the value of projected pension and postemployment health benefits. Economic losses in retirement plan assets, such as the \$1 billion two year investment loss San José experienced in fiscal years 2007–08 and 2008–09, contribute to the growth of unfunded retirement obligations, as can changes in benefits and assumptions and differences between actuarial assumptions and actual results.

As shown in Figure 4, San José's cumulative unfunded liability for its pension plans increased from \$1.12 billion in fiscal year 2008–09 to \$1.49 billion in fiscal year 2010–11, an increase of 33 percent. Similarly, its cumulative unfunded liability for postemployment health benefits increased from \$1.42 billion in fiscal year 2008–09 to \$1.95 billion in fiscal year 2010–11, an increase of 38 percent. At June 30, 2011, the combined \$3.4 billion in unfunded retirement liabilities represents more than 8.2 times the city's eligible annual payroll.

There are many reasons why the \$3.4 billion unfunded liability exists. According to our actuarial consultant, benefit accruals, changes in assumptions and methods used to calculate liabilities, and benefit improvements can increase liabilities over the years. At the same time, unless assets increase at the same pace—via contributions or investment returns—a shortfall will result. During the period of our review, major factors contributing to the increase in unfunded liabilities included investment losses and assumption changes made by the retirement boards to better reflect future expected experience. For example, for fiscal years 2007–08 through 2010–11, investment performance on pension assets, on average, was significantly below the assumed returns. In apparent response to this, the retirement boards reduced their assumptions of future investment returns, which contributed to the increase in the city's unfunded liabilities.

At June 30, 2011, the combined \$3.4 billion in unfunded retirement liabilities represents more than 8.2 times the city's eligible annual payroll.

Figure 4
Unfunded Actuarial Accrued Liability for the City of San José’s Pension and Postemployment Health Benefit Plans
Fiscal Years 2008–09 through 2010–11



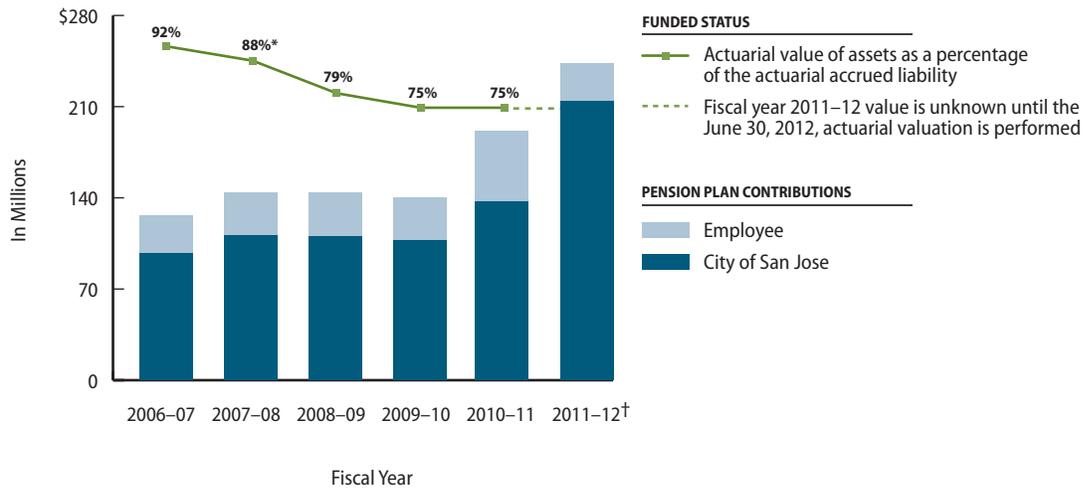
Sources: City of San José’s comprehensive annual financial reports and actuarial valuations.
Note: Includes Federated City Employees’ Retirement System and Police and Fire Department Retirement Plan.

The City’s Costs for Pension Benefits Have Increased Significantly

San José’s cumulative unfunded liability for its pensions alone (excluding postemployment health benefits) increased from \$1.12 billion in fiscal year 2008–09 to \$1.49 billion in fiscal year 2010–11. In fiscal year 2010–11, the city’s pension plans had accumulated liabilities of \$6 billion, but they had only \$4.5 billion in assets. The resulting \$1.5 billion unfunded liability equates to a funding status of 75 percent, as shown in Figure 5 on the following page. As a basis for comparison, the *Pew Center on the States Issue Brief* on public sector retirement benefit funding released in June 2012, for fiscal year 2009–10, noted that the State had a funding status of 78 percent for its pensions. As mentioned in the Introduction, financial reporting standards require the disclosure of actuarially determined annual required contributions. For the years that we reviewed, fiscal years 2006–07 through 2010–11, San José contributed the full amount of these costs to its pension plans. Although these contributions were relatively level through fiscal year 2009–10, San José has experienced significant contribution increases since then. Specifically, its pension contributions doubled from \$107 million in fiscal year 2009–10 to an estimated \$214 million in fiscal year 2011–12. Employee pension contributions increased from \$33 million in fiscal year 2009–10 to \$54 million in fiscal year 2010–11 but then declined to an estimated \$29 million in fiscal year 2011–12, likely due to lower payroll costs stemming

from wage reductions and position eliminations. However, as shown in Figure 5, increased contributions in the aggregate have not been enough to improve the funded status of the plans.

Figure 5
Contributions and Funding Status for the City of San José’s Pension Plans
Fiscal years 2006–07 Through 2011–12



Sources: City of San José’s (San José) comprehensive annual financial reports, actuarial valuations, and certain estimates provided by San José’s Department of Retirement Services.

Note: Includes Federated City Employees’ Retirement System and Police and Fire Department Retirement plans.

* An actuarial valuation was not performed as of June 30, 2008; consequently, our actuarial consultant estimated the funded status for fiscal year 2007–08 using the June 30, 2007 and June 30, 2009 valuations.

† San José and employee contributions shown for fiscal year 2011–12 are unaudited estimates.

According to our actuarial consultant, funded status is a measure of a plan’s status at a single point in time, so this ratio should be reviewed over time. Funded status may vary from one year to the next because of external events such as the overall economy. Higher funded ratios are to be expected following periods of strong economic growth and strong investment returns, and lower funded ratios are to be expected after years of poor investment returns such as the recent downturn beginning in fiscal year 2007–08. According to the Pension Committee of the American Academy of Actuaries, no single level of funding should be identified as a defining line between a “healthy” and an “unhealthy” pension plan. Notwithstanding, for public pension plans only, Fitch Ratings stated in its February 17, 2011 report, *Enhancing the Analysis of U.S. State and Local Government Pension Obligations*, that it generally considers a funded ratio of 70 percent or above to be adequate and less than 60 percent to be weak, while noting that the funded ratio is one of many factors that it considers when it analyzes pension obligations.

Two significant factors contributed to the decline in the funded status of the San José retirement plans. First was the significant two year investment losses the plans suffered in fiscal years 2007–08 and 2008–09; pension plan assets alone lost nearly \$979 million during this period. Second there was also a decrease in the assumed investment return and other changes in assumptions. As explained earlier, experience losses, such as investment losses, arise from differences between assumptions about future performance and the actual experience of a retirement plan.

Because short-term deviations from assumptions are expected, the retirement plans apply two smoothing processes to help reduce year-to-year volatility in contribution rates. According to our actuarial consultant, both are common and are generally accepted actuarial practice. First, rather than using the market value of a fund's assets to determine annual required contributions to a plan, an actuarial value of assets is used, which smoothes investment returns over a five-year period. For example, if a plan experienced a \$500 million investment loss in fiscal year 2008–09, only 20 percent, or \$100 million of that loss, would be reflected in the actuarial value of assets as of June 30, 2009. Each year thereafter, another 20 percent, or \$100 million of the original loss, would be reflected, so that the full \$500 million loss would not be fully reflected in the actuarial value of assets used in the annual required contribution calculation for five years.

Second, any changes in a plan's unfunded liability are amortized, or spread, over an extended period of time (16 years for the police and fire plan and 20 years for the federated plan³). Using the example above, each additional \$100 million in investment loss that is recognized would be converted to a 16- or 20-year payment (similar to a mortgage) and added to each year's annual required contribution. Finally, there is a one-year lag between the date of the actuarial valuation and the time when the resulting annual required contribution is applied. For example, the annual required contribution calculated based on the June 30, 2010 valuation, was not applied until fiscal year 2011–12.

For these reasons, the investment losses that occurred in fiscal year 2008–09 did not affect annual required contributions until fiscal year 2010–11. In addition, their full impact will not be reflected for a few more years. Table 5 on the following page shows the factors that caused San José's costs for the federated and police and fire pension plans to increase from fiscal years 2009–10 through 2011–12.

San José's pension costs for employees covered by its police and fire plan increased much more significantly than did its costs for employees covered by the federated plan, partly because the police

Pension plan assets alone lost nearly \$979 million during this period and there was also a decrease in the assumed investment return and other changes in assumptions.

³ Until fiscal year 2010–11, the federated plan spread gains and losses over 30 years.

and fire plan spreads each annual loss or gain over 16 years compared to 20 years for the federated plan. As a result, experience losses, like the \$979 million investment loss the pension plans recently experienced, have a relatively larger impact on the annual required contribution of the police and fire plan. In addition, the boards' actuary calculates the city's contribution rates for the two pension plans as a percentage of expected payroll. However, as the city's payroll changes from year to year, the amounts of its annual required contributions will also vary. As shown in Table 5, the city's required contributions to the federated plan and the police and fire plan increased by \$8.8 million and \$13.8 million, respectively, because the city's payroll experience was higher than expected, thereby increasing the amount of contributions.

Table 5
Factors That Caused the City of San José's Pension Costs to Increase From Fiscal Year 2009–10 to 2011–12
(In Millions)

| | FEDERATED | POLICE AND FIRE | TOTALS |
|--|---------------|-----------------|----------------|
| City's Pension Costs in Fiscal Year 2009–10 | \$54.6 | \$52.3 | \$106.9 |
| Increases Due to Experience | | | |
| Investment losses | \$12.4 | \$21.8 | \$34.2 |
| Demographic losses* | 2.0 | 4.0 | 6.0 |
| Payroll† | 8.8 | 13.8 | 22.6 |
| Other | 4.2 | 6.9 | 11.1 |
| Subtotals | \$27.4 | \$46.5 | \$73.9 |
| Increases Due to Assumption Changes | | | |
| Lower assumed rate of return and other economic assumption changes | \$1.8 | \$12.1 | \$13.9 |
| Demographics and other‡ | 3.1 | 16.3 | 19.4 |
| Subtotals | \$4.9 | \$28.4 | \$33.3 |
| Total Changes | \$32.3 | \$74.9 | \$107.2 |
| City's Pension Costs in Fiscal Year 2011–12 | \$86.9 | \$127.2 | \$214.1 |

Source: Our actuarial consultant's analysis of underlying actuarial valuations.

* Differences between demographic assumptions and actual experience generate gains or losses that will increase or decrease the City of San José's (San José) annual required contributions. Demographic assumptions include assumptions related to rates of retirement, disability, termination, and mortality.

† The boards' actuary calculates San José's contribution rates for the two pension plans as a percentage of expected payroll. As the city's payroll changes from year to year, the amount of its annual required contribution will also vary.

‡ Changes in demographic assumptions can increase or decrease San José's annual required contributions.

Changes in the assumptions also account for a large portion of the contribution increases for the police and fire plan. A decrease in the assumption regarding the investment rate of return can have a very large impact on the funded status of the plan and the resulting contribution. The investment return assumption for the police and fire plan was lowered from 8 percent to 7.75 percent for the June 30, 2010, actuarial valuation, which increased the amount of the city's required contribution by \$12 million. It was then lowered to 7.5 percent for the June 30, 2011 actuarial valuation for both the federated and police and fire plans. However, because of the lag between the valuations and the time it takes to affect contributions, this latest decrease in the investment return assumption will first affect contributions in fiscal year 2012–13 and is therefore not reflected in Table 5.

San José's required contributions for the police and fire plan also increased by another \$16 million due to other demographic assumption changes made as a result of the analysis of the plan's actual experience by the boards' actuary, according to our actuarial consultant. Among those changes were a slight improvement in mortality assumptions (reflecting the fact that people are expected to live longer, which increases liabilities and annual required contributions), a lowering of the retirement assumption for police to earlier retirement ages, and changes to termination and disability rates.

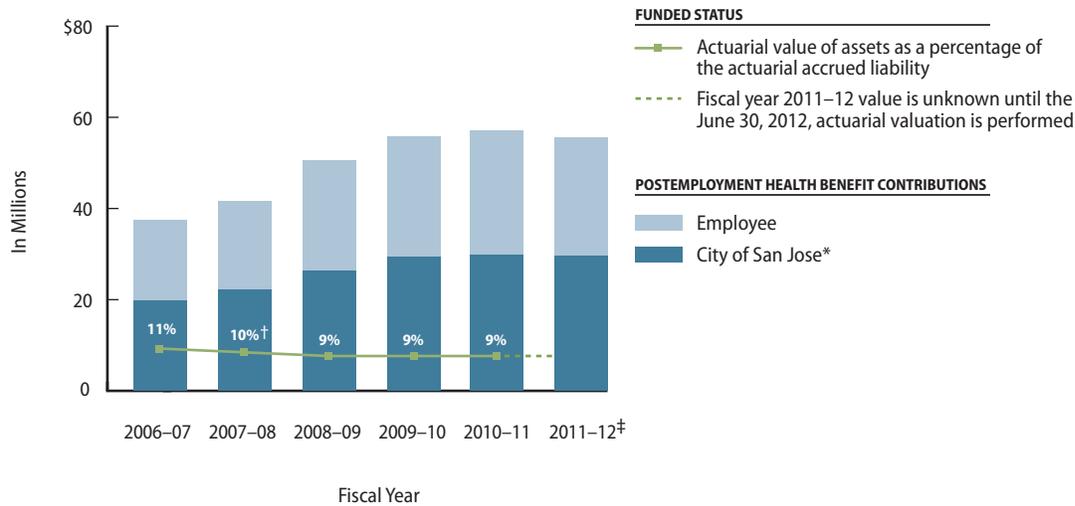
San José's required contributions for the police and fire plan increased by another \$16 million due to other demographic assumption changes made as a result of the analysis of the plan's actual experience by the boards' actuary.

The City's Costs for Postemployment Health Benefits Are Also Increasing Significantly

San José's annual required contributions for its employees' postemployment health benefits have also been rising rapidly. The city's annual required contributions for retirement health benefits increased from \$80 million in fiscal year 2008–09 to an estimated \$133 million in fiscal year 2011–12. However, San José only contributed 33 percent of these postemployment health benefit costs in fiscal year 2008–09, declining to an estimated 22 percent in fiscal year 2011–12. Specifically, the city paid an estimated \$30 million of its annual required contribution of \$133 million, or 22 percent, in fiscal year 2011–12.⁴ The city's annual postemployment health benefit contribution is similar to that of the state. According to the *Pew Center on the States Issue Brief* released in June 2012, for fiscal year 2009–10, the State contributed only 29 percent of the amount necessary to fund retiree health benefits. In part because San José has only partially paid its annual required contributions, the funded status of its postemployment health benefit plans has hovered around only 10 percent for the last five fiscal years, as shown in Figure 6 on the following page.

⁴ This amount does not include any implicit rate subsidy, which refers to the additional cost of including retired employees in the same health insurance plan used by current employees. These costs were unavailable for some of the periods under our review and were excluded to enhance comparability.

Figure 6
Contributions and Funding Status for the City of San José's Postemployment Health Benefit Plans



Sources: City of San José's (San José) comprehensive annual financial reports, actuarial valuations, and certain estimates provided by San José's Department of Retirement Services.

Note: Includes Federated City Employees' Retirement System and Police and Fire Department Retirement Plan.

* The amounts shown do not include any implicit rate subsidy, which refers to the additional cost of including retired employees in the same health insurance plan used by current employees. These costs were unavailable for fiscal years 2006-07 and 2007-08 and were excluded from subsequent years to enhance comparability.

† An actuarial valuation was not performed as of June 30, 2008; consequently, our actuarial consultant estimated the funded status for fiscal year 2007-08 using the June 30, 2007 and June 30, 2009 valuations.

‡ San José and employee contributions shown for fiscal year 2011-12 are unaudited estimates.

Under San José's collective bargaining agreements, city contribution rates to the postemployment health benefit plans were previously capped at a level below the amount needed to fully fund the annual required contributions. However, San José has reached general agreements with various bargaining groups to begin contributing 100 percent of its actuarially determined annual retirement health care costs after a five-year phase-in period subject to certain limitations. This five-year phase-in began in fiscal year 2009-10 for members of the federated retiree health care plan. The phase-in period for the police and fire plan's police members began in fiscal year 2009-10, while the phase-in for fire members began in fiscal year 2011-12.

Increases in annual required contributions for postemployment health benefits are a direct result of the rising unfunded liability. Between June 30, 2009 and June 30, 2011, the unfunded liability related to the city's postemployment health benefits rose from over \$1.4 billion to nearly \$2 billion, an increase of roughly 38 percent. Table 6 illustrates the main factors contributing to this increase. Other than interest on the unfunded liability, several assumption changes contributed heavily to the increase. For the federated plan, assumption changes contributed to a \$198 million increase in the unfunded liability from fiscal years 2008-09 through 2010-11. Of the \$198 million, \$82 million can be attributed to lowering the assumed rate of return, or the discount rate, used to measure the liabilities; and another \$31 million is due to the impact of changes in projected health

care costs. Finally, as a result of the analysis by the boards' actuary of the federated plan's demographic experience, significant changes were made to demographic assumptions, resulting in an increase in the unfunded liability of more than \$85 million. According to our actuarial consultant, key changes to those demographic assumptions included earlier assumed retirement ages for employees with at least 30 years of service, improvements in mortality assumptions reflecting that participants are expected to live longer, higher family coverage percentages, as well as changes to withdrawal and disability rates.

Table 6
Factors That Caused the City of San José's Postemployment Health Benefits Unfunded Actuarial Accrued Liability to Increase From Fiscal Years 2008–09 to 2010–11
(In Millions)

| | FEDERATED | POLICE AND FIRE | TOTALS |
|--|------------------|-----------------|------------------|
| Postemployment Health Benefits Unfunded Liability as of June 30, 2009 | \$710.9 | \$706.0 | \$1,416.9 |
| Expected Changes | | | |
| Deficit payments* | \$(25.5) | \$1.8 | \$(23.7) |
| Interest on unfunded liability† | 101.8 | 106.1 | 207.9 |
| Subtotals | \$76.3 | \$107.9 | \$184.2 |
| Changes Due to Experience | | | |
| Investment losses and (gains) | \$(24.5) | \$2.4 | \$(22.1) |
| Demographic losses‡ | 49.3 | 5.3 | 54.6 |
| Subtotals | \$24.8 | \$7.7 | \$32.5 |
| Changes Due to Assumptions | | | |
| Projected health care costs | \$30.6 | \$(40.3) | \$(9.7) |
| Lower assumed rate of return (i.e., discount rate) | 81.7 | 138.8 | 220.5 |
| Demographics§ | 85.6 | 22.9 | 108.5 |
| Subtotals | \$197.9 | \$121.4 | \$319.3 |
| Total Changes | \$299.0 | \$237.0 | \$536.0 |
| Postemployment Health Benefits Unfunded Liability as of June 30, 2011 | \$1,009.9 | \$943.0 | \$1,952.9 |

Source: Our actuarial consultant's analysis of underlying actuarial valuations.

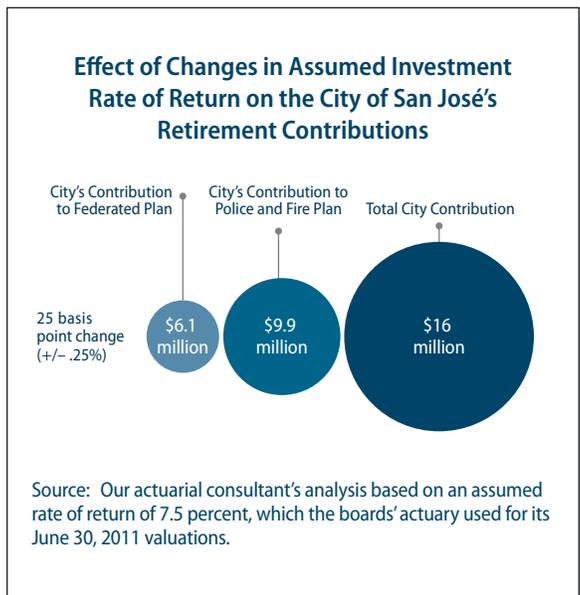
* When the City of San José's (San José) contributions to its postemployment health benefits plans exceed the normal cost, or value of the benefits earned during the year, the excess contributions go towards reducing the deficit (i.e., unfunded liability). However, when the city's contributions are less than the normal cost, the deficit or unfunded liability increases.

† Interest on the unfunded liability represents the change in the unfunded liability due to the passage of time. Interest on the unfunded liability for the period is calculated using the assumed investment rate of return.

‡ Differences between demographic assumptions and actual experience generate gains or losses, which will decrease or increase the unfunded liabilities of San José's postemployment health benefit plans. Demographic assumptions include assumptions related to rates of retirement, disability, termination, and mortality.

§ Changes in demographic assumptions can increase or decrease the unfunded liabilities of San José's postemployment health benefit plans.

For the police and fire plan, assumption changes contributed to \$121 million of the unfunded liability increase. While the change in the assumed rate of return, or discount rate, increased the unfunded liability by nearly \$139 million, this increase was partially offset by lower projected health care costs reducing the unfunded liability by about \$40 million. Finally, changes in other demographic assumptions made to tie assumptions to actual police and fire plan experience, increased the unfunded liability by \$23 million. According to our actuarial consultant, key changes to demographic assumptions included earlier assumed retirement ages for certain employee groups, updated family coverage percentages, as well as changes to withdrawal and disability rates.



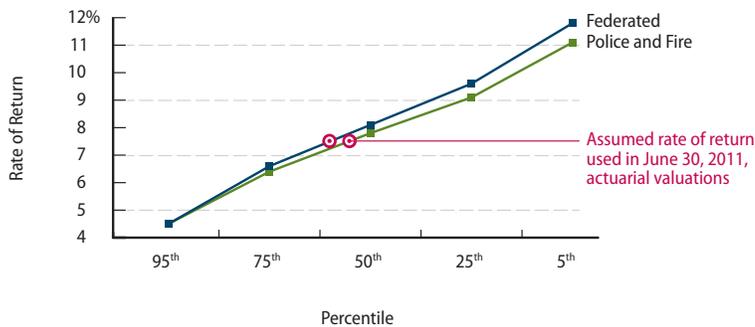
Lower Assumed Rates of Investment Return Decrease Actuarial Losses, However, Overly Conservative Rates Increase Contributions

Of all assumptions used in calculating retirement plan contributions, the assumed rate of return on assets is one of the most impactful and most debated. The experience analysis reports for San José's retirement plans released in 2011 by the boards' actuary provide the estimated effect on contributions of a 0.25 percent change in the assumed rate of investment return. The effect of a 0.25 percent change on city contributions, assuming all other assumptions remain unchanged, is shown in the text box.

As the assumed rate of return is reduced, the amount that San José has to contribute to its retirement plans increases. For example, if the assumed rate of return is decreased from 7.5 to 7.25 percent, the city's annual contributions would increase by a combined \$16 million. However, the sensitivity of contributions to changes in the assumed rate of return is not linear; the farther away from the starting point, the less accurate this projection becomes. As discussed earlier, in February 2012, the boards' actuary projected that San José's annual contribution toward its employees' retirement costs would be \$320.1 million by fiscal year 2015–16, assuming a 7.5 percent investment rate of return. Although a variety of factors can impact the magnitude of a cost projection, the rate of return is a significant driver. For example, according to our actuarial consultant, San José would have to use an investment rate of return assumption of less than 3.5 percent, all other assumptions remaining unchanged, to achieve the \$650 million estimate that the mayor used to draw attention to rising retirement costs.

The appropriate assumption for investment returns is often debated. In addition, the federated and police and fire pension plans are invested differently, so any assumption would need to be plan-specific. Figure 7 shows the estimated probability of achieving different rates of return over the long term based on the plans' actual asset allocations as of June 30, 2011.

Figure 7
Estimated Probability of Achieving Expected Returns Over 30 Years



Source: Our actuarial consultant, based on its expected return estimation tool, and using its capital market assumptions as of the second quarter of 2011 which are appropriate to compare to the City of San José's 2011 valuation cycle; the most recent set of valuations at the time of this review. Results are net of investment fees for a generally passive investment strategy.

As of the June 30, 2011, actuarial valuations, both pension plans use a 7.5 percent assumed rate of return, which our actuarial consultant determined has a probability of being met 55 percent of the time for the police and fire plan and 60 percent of the time for the federated plan. As illustrated in Figure 7, decreasing the assumed rate of return increases the probability of actually achieving the rate. For example, if the federated and police and fire plan boards reduced the assumed rates of return to 6.6 percent, and 6.4 percent, respectively, their probability of achieving those returns would increase to 75 percent over a 30-year period. Although using a lower investment return assumption is a more conservative approach that will reduce occurrences of actuarial losses, overly conservative rates could drive up contributions unnecessarily.

Increasing Retirement Costs Have Created Budgetary Challenges for San José

Rising retirement costs have undoubtedly created budgetary challenges for San José. As we discussed previously, San José's contributions towards its retirement costs rose from \$136 million to an estimated \$244 million from fiscal year 2009–10 to 2011–12,

San José reduced its budgeted salaries for the police and fire departments by \$76 million through a combination of wage reductions and eliminating FTE positions.

a \$108 million increase that was primarily driven by higher costs of retirement benefits in the police and fire plan. During this same period, budgeted public safety expenditures for the city's general fund rose by \$6 million, from \$451 million to \$457 million, despite reductions in the number of average actual filled full-time equivalent positions (FTE positions) for public safety.

From fiscal year 2009–10 to 2011–12 San José reduced its budgeted salaries for the police and fire departments by \$76 million through a combination of wage reductions and eliminating FTE positions. We noted that actual staffing reductions were in line with the budget reductions. Specifically, the city's number of actual filled FTE positions for public safety declined from 2,548 to 2,166⁵. However, during this period, San José's actual retirement cost contributions for the police and fire plan increased by \$76 million. Thus, the savings San José generated by reducing wages and its public safety workforce merely served to offset the increase in its retirement costs. Consequently, San José may be providing reduced public safety services at an overall increased cost to the general fund. As we discussed previously, the city's retirement contributions would be even greater if it made the full actuarially determined annual required contributions for its postemployment health benefits.

Despite net increases in general fund public safety budgeted expenditures as shown in Table 7, San José's overall budgeted expenditures decreased from \$3 billion in fiscal year 2009–10 to \$2.8 billion in fiscal year 2011–12. The city's charter requires it to adopt a balanced budget each fiscal year, aligning expenditures with anticipated revenues and existing fund balances. Because overall budgeted city revenues declined slightly during this period San José had to offset expected expenditure increases in certain areas with decreases in other areas when preparing budgets. As shown in the table, the city reduced budgeted expenditures in all general fund functional areas except public safety. At the same time, San José's number of actual filled FTE positions across all functional areas declined, as shown in Figure 8 on page 32.

San José made its most significant reductions in general fund budgeted expenditures in the functional area of community services, which includes funding for parks and recreation and libraries. It appears that increases in retirement costs related to federated plan benefits, which cover non-public safety employees, contributed to cuts in these areas but not to the extent that police and fire plan retirement costs affected public safety expenditures. For example, although San José's contributions toward federated plan retirement costs increased by more than \$31 million from

⁵ As shown in Figure 8 on page 32, the number of FTE positions calculated is the average for the period.

fiscal years 2009–10 through 2011–12, the city reduced its budgeted non-public safety salaries for all funds by \$77 million during this same time period. It achieved this reduction through a combination of wage cuts and eliminating FTE positions, prompting a decline in its non-public safety FTE positions from 3,590 to 2,784.⁶

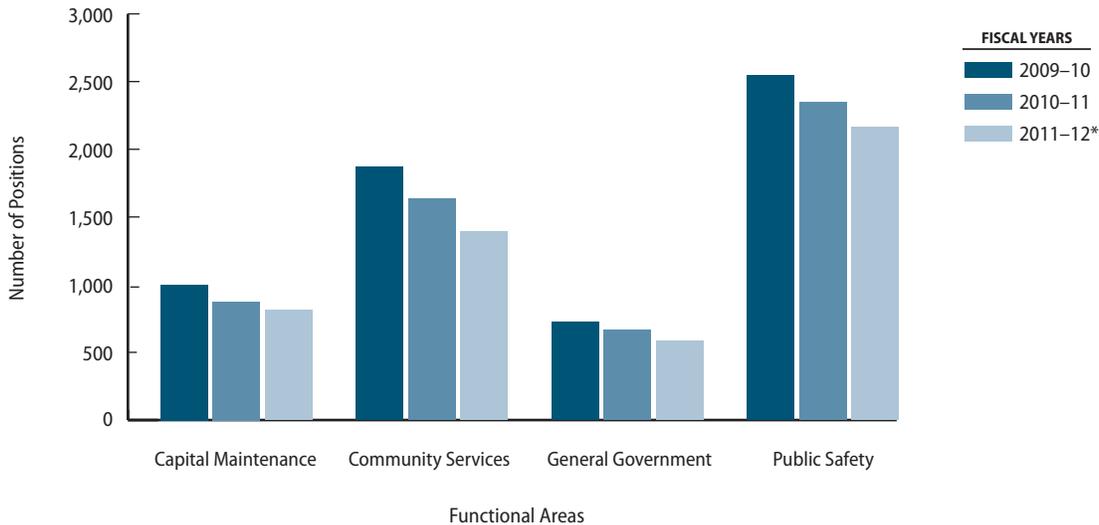
Table 7
The City of San José’s Adopted Operating Budget by Fund Type
Fiscal Years 2008–09 Through 2011–12

| REVENUES AND SOURCES OF FUNDS | 2008–09 | 2009–10 | 2010–11 | 2011–12 |
|--|------------------------|------------------------|------------------------|------------------------|
| City’s General fund | \$1,049,778,030 | \$983,875,351 | \$954,094,629 | \$906,458,009 |
| Enterprise funds | 814,223,161 | 746,740,604 | 728,811,366 | 749,813,418 |
| Trust and agency funds | 2,079,300 | 1,713,788 | 2,089,916 | 2,062,329 |
| Special revenue funds | 836,696,037 | 752,158,446 | 655,534,497 | 659,391,194 |
| Capital improvement program funds | 1,193,672,000 | 1,035,245,995 | 918,494,005 | 1,064,883,461 |
| Subtotals, Revenues and Sources of Funds | 3,896,448,528 | 3,519,734,184 | 3,259,024,413 | 3,382,608,411 |
| Less transfers, loans, and contributions between funds | (618,551,959) | (552,768,986) | (541,285,794) | (538,697,847) |
| Net Totals, Revenues and Sources of Funds | \$3,277,896,569 | \$2,966,965,198 | \$2,717,738,619 | \$2,843,910,564 |
| EXPENDITURES AND USES OF FUNDS | | | | |
| General fund | | | | |
| General government | \$87,620,735 | \$85,065,987 | \$78,446,178 | \$74,067,288 |
| Capital maintenance | 67,681,518 | 64,763,545 | 58,913,105 | 51,008,922 |
| Community services | 126,204,940 | 115,275,423 | 110,078,492 | 96,086,190 |
| Total non-public safety | 281,507,193 | 265,104,955 | 247,437,775 | 221,162,400 |
| Public safety | 439,890,753 | 451,257,380 | 450,831,081 | 456,959,754 |
| Total departmental | 721,397,946 | 716,362,335 | 698,268,856 | 678,122,154 |
| Nondepartmental | 328,380,084 | 267,513,016 | 255,825,773 | 228,335,855 |
| Total General Fund | \$1,049,778,030 | \$983,875,351 | \$954,094,629 | \$906,458,009 |
| Enterprise funds | 814,223,161 | 746,740,604 | 728,811,366 | 749,813,418 |
| Trust and agency funds | 2,079,300 | 1,713,788 | 2,089,916 | 2,062,329 |
| Special revenue funds | 836,696,037 | 752,158,446 | 655,534,497 | 659,391,194 |
| Capital improvement program funds | 1,193,672,000 | 1,035,245,995 | 918,494,005 | 1,064,883,461 |
| Subtotals, Expenditures and Uses of Funds | 3,896,448,528 | 3,519,734,184 | 3,259,024,413 | 3,382,608,411 |
| Less transfers, loans, and contributions between funds | (618,551,959) | (552,768,986) | (541,285,794) | (538,697,847) |
| Net Totals, Expenditures and Uses of Funds | \$3,277,896,569 | \$2,966,965,198 | \$2,717,738,619 | \$2,843,910,564 |

Sources: City of San José’s adopted operating budgets.

⁶ As shown in Figure 8 on page 32, the number of FTE positions calculated is the average for the period.

Figure 8
City of San José's Average Actual Filled Full-Time Equivalent Positions
Fiscal Years 2009–10 Through 2011–12



Source: California State Auditor's analysis of data obtained from the City of San José's PeopleSoft human resources information system (human resources data).

Note: We excluded employees whose human resources data did not include a standard number of hours for which they are expected to work in a week.

* Fiscal year 2011–12 human resources data includes transactions from July 2011 through May 2012.

It appears that increases in police and fire retirement costs have contributed to a decrease in the funds available for non-public safety areas. As San José's budgeted departmental general fund expenditures decreased 5 percent from \$716 million to \$678 million—or \$38 million—from fiscal years 2009–10 through 2011–12, non-public safety general fund budgeted spending decreased 17 percent from \$265 million to \$221 million—or \$44 million, while budgeted public safety spending, which includes the city's contributions towards police and fire retirement costs, increased \$6 million from \$451 million to \$457 million during the same period. Consequently, budgeted public safety spending as a percentage of budgeted general fund departmental expenditures increased from 63 percent to 67 percent while budgeted non-public safety spending as a percentage of budgeted general fund departmental expenditures decreased by 4 percent. We noted San José's actual general fund expenditures⁷ were roughly in line with budgeted general fund expenditures. The city's most significant budgeted general fund reductions in non-public safety have been in the community services area of parks and recreation

⁷ Actual general fund expenditures refer to audited Comprehensive Annual Financial Report (CAFR) figures for fiscal years 2008–09 through 2010–11. Fiscal year 2011–12 CAFR figures were unavailable at the time of this report.

and libraries. For example, the city completed construction of several libraries and community centers. However, according to the city manager's fiscal year 2011–12 adopted budget message, the city delayed the opening of several facilities to defer associated general fund maintenance and operating costs, generating a net cost avoidance of approximately \$6.3 million. In addition to deferred openings, from fiscal year 2009–10 through 2011–12, the city also reduced the general fund budget for parks and recreation and library services by \$20 million through a combination of reducing FTE positions and services.

Recommendations

To ensure that stakeholders receive consistent and reliable information, San José should report the official retirement cost projections that were developed using the assumptions approved by the boards of the two retirement plans. If the city does not use the official retirement cost projections, it should develop projections that are supported by accepted actuarial methodologies, report this information in the correct context, and disclose significant assumptions that differ from those in the boards' retirement cost projections.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Date: August 21, 2012

Staff: Michael Tilden, CPA, Audit Principal
Nicholas Kolitsos, CPA, MBA
Brandon Buress
Tina Kobler
Martin T. Lee

Legal Counsel: Scott A. Baxter, JD

IT Audit Support: Michelle J. Baur, CISA, Audit Principal
Lindsay M. Harris, MBA

Actuarial Consultant: Aon Hewitt

For questions regarding the contents of this report, please contact
Margarita Fernández, Chief of Public Affairs, at 916.445.0255

(Agency comments provided as text only.)

August 8, 2012

City of San José
Office of the City Manager
200 East Santa Clara Street
San José, CA 95113

Elaine M. Howle*
California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: City of San José Response to State Audit

Dear Ms. Howle:

The purpose of this letter is to respond to the audit of the City of San José completed by the California State Auditor as requested by the Joint Legislative Audit Committee (JLAC).

We appreciate the State Auditor's confirmation of the serious long-term fiscal challenges that the City faces, especially as they relate to growth in retirement costs. Your audit team clearly recognized that our ongoing budget situation, including actual retirement costs, were the direct cause of the significant layoffs and cost reductions that the City had to make over the past several years to ensure fiscal stability.

Over the past decade, the City of San Jose has addressed General Fund budget shortfalls totaling **\$680 million** and eliminated over **2,000 positions** (all funds), with staffing now at 1988-1989 levels when our population was 20% less than it is now. These reductions have come at a significant price to both our community and to our employees: deep service reductions affecting the residents of our community; employee layoffs and demotions; large reductions in employee total compensation; and an increasing backlog of unmet and deferred infrastructure and maintenance needs.

Over this same ten-year period, our retirement costs have increased from \$73 million annually to \$245 million annually, an overall increase of 236%. These costs currently are approximately 23% of the City's 2012-2013 General Fund Base Budget. These are not projections; these are actual costs that affect our current budget.

The City agrees with the State Audit's recommendation, which is to report official retirement cost projections that are developed using the assumptions approved by the City's two retirement plan boards. The City already does this, and it intends to continue this practice. The retirement cost projections used in our most recent five-year budget forecast were developed by Cheiron, the actuary used by both boards. Cheiron also developed the \$431 million estimate for projected retirement costs in Fiscal Year 2015-2016. In addition, we agree with the State Audit recommendation that if we do not use the official retirement cost projections, the City should develop projections that are supported by accepted actuarial methodologies; report this information in the correct context; and disclose significant assumptions that differ from the boards' retirement cost projections.

* California State Auditor's comments begin on page 39.

Re: City of San Jose Response to State Audit
August 8, 2012
Page 2

As we indicated prior to this audit being authorized by JLAC, extensive resources were already available to provide answers to the questions that the State Auditor was asked to pursue by the Committee. The City's financial situation and pension cost issues have been thoroughly audited and studied by a variety of sources, including independent auditors and actuaries. I have attached our letter to the Joint Legislative Audit Committee dated March 6, 2012, that lists these resources (Attachment A). Given what has already been undertaken to audit and review the City's financial situation, including retirement costs, we found that the information contained in the State Audit was useful as a summary of our current situation. The summary of our current situation is consistent with what the City has already known and shared with our community, the news media, our employees and the Committee.

It is important for all stakeholders to understand that inherent in a defined benefit retirement program is the variability and uncertainty in the costs, both from year-to-year and for projecting into the future. It is important to note that the San José Police and Fire Department Retirement Plan's actuary has advised that because the plan is significantly leveraged, it experiences a much greater volatility in costs compared to other plans. Because of this volatility, it is important that we make regular projections about costs for planning and budgeting. The City is well aware of this caution that projections are subject to change, and they are not guarantees of what the future might hold.

What is unassailable are the dramatic increases that we have experienced. During a City Council budget study session on February 13, 2012, we showed the attached slide (Attachment B) of a projection of retirement costs done in 2001 by William M. Mercer, Inc., the former actuary for both San José retirement boards. This slide shows that the City's retirement costs have become even worse than the "worse case scenario" projected by Mercer more than a decade ago, underscoring both the hazards of relying on long-term projections and the critical importance to update them frequently.

Unlike most California public agencies, the City recognized early that its retirement costs were unsustainable and began the difficult efforts to find fair, practical, and long-term solutions. We take pride in that we are addressing this issue now, before it becomes too late, because of the dire potential consequences for employees, retirees, our community, and our ability to manage our finances. Unfortunately, several California cities have declared bankruptcy recently. Our goal is to avoid that path; rather, the City of San Jose is taking prudent steps to ensure that we will remain fiscally stable, able to provide essential public services and pay for retirement benefits to our employees.

To this end, the City Council unanimously directed the City Manager in March 2011 to develop a Fiscal Reform Plan to achieve \$216 million per year of cost reductions and/or new revenues for the General Fund that will allow us to restore services such as police, fire, libraries, and community centers to the levels of January 1, 2011 and to open the libraries, community centers, and fire stations built or under construction, and the police substation within five years.

In May 2011, the City Council approved the Fiscal Reform Plan that aimed at saving \$216 million in the General Fund over the coming five years and maintaining retirement costs at the Fiscal Year 2010-2011 levels. In addition, Council directed the City Manager to develop a proposed ballot measure regarding pension modification. This measure would: set parameters for a new tier of retirement benefits for new employees; develop a voluntary opt-in program with a lower level of benefits for current employees; provide employee contributions towards the unfunded liability if an employee chooses to remain in

Re: City of San Jose Response to State Audit
 August 8, 2012
 Page 3

the current and more expensive plan; and require the vote of the people to enhance retirement benefits in the future. The ballot measure was developed over the following nine months and became Measure B on the June 5, 2012, ballot. It was passed overwhelmingly by San José voters.

Although the City agrees with the overall State Audit recommendation, there are a few points and clarifications we would like to make about information contained in the report.

- The Audit speculates about what voters did or did not know regarding retirement cost projections when they approved Measure B. However, the audit did not present any campaign material that referenced or used any cost projections, and the report did not cite any evidence about speculative voter confusion. It is important to note that Measure B was not premised on any specific cost projection. ③
- In early 2011, a staff professional actuary in the San José Department of Retirement Services developed a projection of future retirement costs to be used in the City's five year budget forecast. This projected that retirement costs could reach \$400.7 million in Fiscal Year 2015-2016. Although the audit characterizes this projection as "unsupported," the City disagrees and believes this projection was done by a qualified staff actuary. During the normal course of business, the City's professional staff makes financial projections for many purposes, including revenue projections and budgetary planning. The Boards' actuary, Cheiron, later reviewed the figures and estimated the Fiscal Year 2015-2016 costs at \$431 million. Furthermore, the San Jose Police Officers' Association also had its actuary validate the staff's projections independently (Attachment C). ④
- The Audit mentions five different retirement cost "projections" and refers to them as if they are all for the same purpose and had the same official standing. References to the \$650 million and \$575 million "what if" scenarios as "projections," with the same stature as the official projections that the City did use, is a mischaracterization. ⑤
 - In 2011, the City's professional actuary on staff prepared another internal "what if" scenario that estimated that potential retirement cost in FY 2015-16 could reach \$575 million. The City did not use this scenario for either budgetary planning or labor negotiations, and it was never publicly issued. This scenario entered public discussion only after staff internal emails were obtained by news media following a Public Records Act request in February 2012. ⑤
 - Earlier this year a local television news report suggested that the City had based its concerns about growing retirement costs on a "projection" of \$650 million in 2015-16. This scenario was never developed as an official projection; it was only offered during a discussion about how high retirement costs could go at a Council study session in February 2011. Because of the news attention given to this scenario a full year later in February 2012, the City Manager issued a memo to Council that explained that the City Administration never used this verbal scenario for any labor negotiations or budgetary purposes (Attachment D). ⑥
- In addition, the City does not agree with the audit's conclusion that its projections were "likely overstated." The \$400 million budgetary forecast in early 2011 was less than \$431 million reported by an updated actuarial projection made later in 2012. The City's current actuarial projection of \$320 million, approved by the two boards in early 2012, for the first time officially reflected the impacts of the devastating layoffs and salary reductions in June 2010 and June 2011 that combined to reduce overall payroll by **24%**. ⑦

Re: City of San Jose Response to State Audit
August 8, 2012
Page 4

We believe it is important to note that the various projections and scenarios that the State Audit reviewed in its report evolved over a nearly two-year period. For this reason we appreciate the Santa Clara County Grand Jury's recognition of the importance of considering various scenarios in the overall context of the budgetary challenges posed by growing pension costs. In May 2012, the Grand Jury released a report titled "An Analysis of Pension and Other Post Employment Benefits," (http://www.scscourt.org/court_divisions/civil/cgj/2012/pension.pdf). The Grand Jury stated:

⑧

The \$650M per year cost estimate is not a worst case number. Pension experts the Grand Jury interviewed stated that other actuarial assumption changes, within reason and easily justified, would result in ARC costs even higher than \$650M per year. The Grand Jury understands that exploring these actuarial assumptions is justified. They help bring attention to the severity of the Benefits crisis and abate the trend of pushing financial problems to future generations of taxpayers.

Due to the significant cost increases in retirement and the City's diligence in budgetary forecasting and planning, the City of San Jose has been in the forefront of public agencies in addressing the dramatic increases in retirement costs. This year the City of San Jose is actually paying 23% of our General Fund Base Budget to fund retirement benefits and we have been studying and understanding our potential future costs. We are addressing the impact of these costs through an on-going implementation of our Fiscal Reform Plan and the resulting pension modification ballot measure. We cannot afford not to act: without changes the City would continue down the unsustainable path of cutting services and laying off employees to pay for retirement costs.

We appreciate the review of the City's finances and retirement projections and validation of the City's fiscal challenges. We hope that the State and the Joint Legislative Audit Committee can join us in our strong confidence that the City of San Jose is addressing its own fiscal situation appropriately, prudently, and professionally as a model for other agencies in California.

Sincerely,

(Signed by: Debra Figone)

Debra Figone
City Manager

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CITY OF SAN JOSÉ

To provide clarity and perspective, we are commenting on the response to our audit report from the City of San José (San José). The numbers below correspond to the numbers we placed in the margin of San José's response.

We agree that the retirement cost projections that San José used in its most recent five-year budget forecast were developed by the actuary used by the boards of administration (boards) of the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan using assumptions approved by both boards. However, San José has not always done this. For example, as shown in Table 4 on page 16, San José used retirement cost projections developed by its internal staff actuary in January 2011 in its previous five-year forecast (i.e., fiscal years 2011–12 through 2015–16) and various other official documents. As we state on page 15 of our report, this retirement cost projection was inadequately supported and the underlying assumptions were not approved by the boards.

①

San José included in its response four other documents that we have not included in our report. One of these documents ("Attachment A") is a letter that the city manager sent to the chair of the Joint Legislative Audit Committee in March 2012 that contained information regarding San José's finances and retirement costs. The other three documents ("Attachments B-D") were various materials that San José had already provided to us during our audit. These documents can be obtained by contacting the California State Auditor's office.

②

As illustrated in Table 4 on page 16 of our report, San José reported multiple retirement cost projections in the year and a half leading up to the June 2012 election. As we state on page 20, we believe that reporting multiple retirement cost projections in this short period of time may have caused confusion among the city's stakeholders attempting to make informed decisions. As a result, it is unclear which retirement cost projection the voters relied on, if any, when they voted for the measure concerning the city's pension plans.

③

As we state on page 15, the \$400.7 million retirement cost projection for fiscal year 2015–16 that San José's internal staff actuary developed was not adequately supported. Specifically, San José officials were only able to provide us with spreadsheets that our actuarial consultant determined were not appropriate documentation of the assumptions, data, and methodology and that did not include any information as to how this projection should

④

be used. Without such evidence, our actuarial consultant could not be assured that San José calculated and used this projection appropriately. Moreover, we acknowledge that, although this projection was not adequately documented, a July 2011 projection prepared by the boards' actuary yielded similar results.

- ⑤ We did not mischaracterize San José's use of the \$575 million retirement cost projection. We state on pages 17 and 18 of our report that the source of this figure was an email from the director of San José's Department of Retirement Services to a staff actuary. We also include the director's explanation that the \$575 million projection was one scenario of how high the city's retirement contributions could be if the actuarial assumptions were more conservative and were based on recent actual experience. We also acknowledge on page 18 of our report and in Table 4 on page 16, that this projection became public when the director's email was obtained by an NBC Bay Area news outlet, and that we did not find any official city documents that included this figure.
- ⑥ We did not mischaracterize San José's use of the \$650 million retirement cost projection. Further, we disagree with San José's assertion that it only used the \$650 million retirement cost projection during a discussion about how high retirement costs could go at a city council budget study session in February 2011. As we state on page 17, the mayor's office reported in official city documents, in press releases, during a public presentation, and to news outlets that the city's annual retirement costs could reach \$650 million.
- ⑦ San José's response is incorrect in suggesting that we characterized the \$400 million projection as "likely overstated." Instead, as indicated previously in rebuttal point 4, we found that the \$400.7 million retirement cost projection that was developed by San José's internal staff actuary was not adequately supported. However, as we state on page 1 of our report, we do believe that the \$650 million retirement cost projection was unsupported and "likely overstated."
- ⑧ As we indicate in rebuttal point 7 above, we believe that the \$650 million retirement cost projection was unsupported and likely overstated.

cc: Members of the Legislature
Office of the Lieutenant Governor
Little Hoover Commission
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press