STATE OF CALIFORNIA

PUBLIC EMPLOYEE
POST-EMPLOYMENT BENEFITS COMMISSION

PUBLIC MEETING

Friday, November 2, 2007
10:00 a.m.

Oakland City Hall
Council Chambers
1 Frank Ogawa Plaza
Oakland, California

Reported by: DANIEL P. FELDHAUS, CSR #6949, RDR, CRR

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A P P E A R A N C E S

PUBLIC EMPLOYEE POST-EMPLOYMENT BENEFITS COMMISSION

Commissioners Present

GERRY PARSKY, Commission Chair
Aurora Capital Group

MATTHEW BARGER
Hellman & Friedman LLC

PAUL CAPPITELLI
San Bernardino County Sheriff's Department

JOHN COGAN
Stanford University

CONNIE CONWAY
Tulare County Board of Supervisors

RONALD COTTINGHAM
Peace Officers Research Association of California

TERESA GHILARDUCCI, Ph.D.
Trustee
General Motors Retiree Health Pensions

JIM HARD
President
Service Employees International Union Local 1000

LEONARD LEE LIPPS
California Teachers' Association

DAVE LOW
California School Employees Association

CURT PRINGLE
Mayor, City of Anaheim

ROBERT WALTON
Retired (CalPERS)

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A P P E A R A N C E S

PUBLIC EMPLOYEE POST-RETIREMENT BENEFITS COMMISSION

PEBC Staff Present

ANNE SHEEHAN
Executive Director

JAN BOEL
Staff Director

TOM BRANAN
Policy Director

STEPHANIE DOUGHERTY
Research Director

MARGIE RAMIREZ WALKER
Office Manager

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Public Testimony

MARCIA FRITZ
California Foundation for Fiscal Responsibility

TERRY J. RE
SEIU 1000

EVELYN Y.L. RAMSEY
SEIU 1000/EDD

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A P P E A R A N C E S

Presentations

CLARE MURPHY
Executive Director
San Francisco Employees Retirement System

DAVID CHRISTIANSON
Consultant
Post-Employment Benefits Commission

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Subject Matter Expert

PAUL ANGELO
Actuary

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Table of Contents

Table of Contents

--o0o--

BE IT REMEMBERED that on Friday, November 21, 2007, commencing at the hour of 10:05 a.m., at Oakland City Hall, 1 Frank Ogawa Plaza, Oakland, California, before me, DANIEL P. FELDHAUS, CSR 6949, RDR, CRR, in the state of California, the following proceedings were held:

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(The following proceedings commenced with Dr. Ghilarducci absent from the meeting room.)

CHAIR PARSKY: On behalf of all the commissioners, I want to welcome everyone to our ninth commission hearing. The number is increasing. I guess you lose track a little bit when you're having fun. And we are in our ninth commission hearing. And I want to thank the public for joining us.

Today, we are having the second in a series of three hearings that will focus in on some specific recommendations that the staff has put together for discussion. And we've done this under some specific headings, which we will get into.

The agenda is available in the back of the room. And I certainly want to thank the City of Oakland for letting us use these chambers. It's a little bit august for this group, but that’s okay. I want to thank the City very much for doing that.

First, before we turn to our public comment, I want to repeat what I have said at every hearing. And, once again, I want to remind everyone that we really try very hard to conduct these hearings throughout the state in an effort to both hear from the public and begin a process that I think is inherent in the establishment of this commission, is to begin to inform the public about this very important subject.

But I've said at the beginning of each, that the purpose of this Commission is to identify both the amount of post-employment pension and health-care liabilities; second, to evaluate various approaches that have been used to address this problem; and third, to propose solutions or a plan from our perspective that ought to be considered.

And as we move toward our final report, we are going to try to organize along exactly those lines. And before the Commission members, we're going to circulate between now and the next meeting a table of contents that will reflect this. But you will see that it will be in each of these three categories.

So it will be one category that attempts to identify the amount, a range and amount. Again, that's as much for public information as anything, at least from our perspective, taking into account all the data that we will have received.

Then the second category will be to put forward approaches that have been taken, primarily focused on some case studies that we have had.

And then the third category will be the recommendations that we are making that we have been talking about -- we've talked about at our last hearing in Fresno and that we will be talking about today. And then in our next hearing, we'll do the final set of recommendations.

And the final thing I would like to say from the Commission's standpoint is that, in establishing this Commission -- and, once again, I make this statement at every hearing; but I think it is important -- when the Commission was established in a bipartisan way by the Governor and the legislative leaders, they all made clear that promised benefits that have been made to retirees and those within the public system will be honored. And so this is not a commission coming forward with recommendations to deny those benefits. This is a commission that was established to identify the magnitude, to make sure that we look at approaches, and then came up with some recommendations that, from our perspective, helped honor those promises in a fiscally responsible way.

So with that introduction, before we turn to public comment, any comments any commissioners would like to make?

(No audible response)

CHAIR PARSKY: If not, then we can –- and, Anne, anything from your standpoint?

MS. SHEEHAN: No, you've covered it.

CHAIR PARSKY: Okay. I also want to acknowledge the hard work that our staff has been doing. We will pay appropriate tribute at the end of this process. But Anne and the staff have really done a terrific job at not only preparing an extensive amount of material, but preparing us and me for these hearings.

Okay, let's move to our public comment.

We have three speakers this morning. The first is -- I think it's pronounced "Matcia"?

MS. FRITZ: "Marcia."

CHAIR PARSKY: Pardon me. Marcia? Oh, that's not a "T"?

Oh, Marcia, that's you? I recognize you.

Marcia, would you come forward?

And then Terry Re, and then Evelyn Ramsey.

You should have just said "Marcia."

MS. FRITZ: I should come up here more, it sounds like.

Thank you, Chairman Parsky and Members of this

Commission. My name is Marcia Fritz, and I am vice president of the California Foundation For Fiscal Responsibility.

We're sponsoring a pension reform initiative that incorporates many of the suggestions you've been given, and they've been excellent, by the way. In fact, we're going through a slight revision as a result of some testimony that was just given at the last meeting. It was really, really good input.

Pension options and retiree benefits should be assessed based on three grounds. The first is how they affect incentives. What are you trying to do with your benefits? And number two is how fair they are, both for the payers and those receiving the benefits, and how simple they are to understand.

Today, our veteran cops and firefighters are retiring faster than we can replace them. It's well-known, we're having a labor crunch in trying to hire those people.

Current retiree benefit formulas encourage vital and active workers to go somewhere else and lie down. Many retire on paper and return to work part-time to fill the slots because we can't hire enough people, long before those in the private sector can even think about receiving benefits.

Ask yourself: Is early retirement serving the public good or is it doing more harm?

We now have a teacher assistant in California. We have a favored few who work for the state and local governments and the rest of us who have to work longer.

Actuaries warn that there continues to be an unexpectedly higher number of retirements compared to assumptions. And I've passed around a graph for you to see this trend.

If it becomes permanent, they haven't changed their assumptions yet on these early retirements because they're not sure if they're permanent. But if they do become permanent, our normal costs will increase and our unfunded liabilities will increase a lot.

Our initiative will reverse this trend and provide incentives to work longer.

According to the GAO’s report -- in fact, I believe CalPERS just had a press release on this report today. They talked about some of the positive things I'm going to talk about, a couple of troubling things in this report. They just put it on the Internet last Friday.

But according to the GAO’s report, California is only one of five states whose retirement system boards are off limits to their Legislature; and we are also among just a few that provide benefit formula options which are adopted through the collective bargaining process.

Most other states have formulas. That’s it. They're not collectively bargained. And Wednesday's New York Times article quoted former SEC Chairman Levitt who talked about the pension scandals in California. He was mainly talking about the accounting, the ability to adjust accounting to further agendas.

And, by the way, I sit on the Governmental Accounting Standards Board committee advisory task force; and we are looking right now at tightening those standards because of what happened specifically in California. And that's what the SEC chairman is talking about.

Prop. 162, combined with a broad range of accounting options, handed our retirement system the rope to hang themselves. And an initiative is needed to cut this rope.

Our initiative's two formulas for miscellaneous workers replace dozens of current options. The formula for new workers covered by Social Security is very, very similar to the federal retirement system we have today. The formulas cannot be collectively bargained and increases need to be voter-approved. The benefits are very, very simple to understand.

Chairman Parsky, I agree with you that local control and flexibility is essential. We are pro-labor.

By encouraging employees to work longer, our initiative will save $500 billion over the next 30 years in defined-benefit costs and reduce also the OPEB costs because you have a fewer number of years that people are retired until they're covered by Medicare.

The Legislative Analyst states that this savings will be offset by other additional compensation.

And, Chairman Parsky, it's that "other compensation" that gives the local agencies the control and flexibility that you know is so vital. They'll have more funds for prefunding their OPEB, they'll be able to contribute to a DC plan if they choose, they can provide performance bonuses, they can provide signing bonuses, or whatever else they need to suit their individual needs.

Our initiative increases local control. Over 80 percent of the police and firefighters today now have a 3 percent/50 benefit. Over half of the miscellaneous workers have received benefit increases since 2000.

There are many cities that are now going through their second round of increases. They're going from 2.7 up to 3 percent. It's going to eventually, because of collective bargaining, ramp up to the highest common denominator.

Politicals make union contributions and lobby for increases. In the private sector, we call these payments "bribes” and “kickbacks."

The options that were granted in SB 400 and AB 616 look an awful lot like mandates to me.

Dr. Ghilarducci mentioned that 70 percent of workers who have defined benefit plans don't even know they have them. And I'm not surprised. They can't even figure out what their benefits are without having a consultant.

Last Tuesday, Sacramento's police chief announced he will retire soon after he received a 21,000-dollar exceptional performance benefit. And he's going to retire in a couple months. That was on top of a merit increase that he got back in June.

The City Manager said this latest raise actually only cost $8,000 because he's going to retire kind of midstream. And even the chief himself says that little bump, that performance bonus will have very little effect on his pension. But if he continues like many to draw a paycheck and use up his sick leave and his vacation pay, that $21,000 combined with COLA increases will give him an extra $840,000 over his lifetime if he lives a normal retirement.

Our initiative simplifies pension roles so both managers and employees knew what their benefit is. It's the same, no matter where you go in the state, no matter who you work with, you're going to get the same formula.

And, Mr. Cogan, you say you like the data to back up remarks -- where are you?

Right there.

In this actuarial -- and I know Ron Seeling is in the audience, and I want to compliment him because his reports are getting better and better, and you guys are experts now, and you should be able to go through this. But in this valuation, it says that a 30-year CHP veteran last year, 30 years, made about on average, about $102,000 salary.

To calculate that pension, you add back 8 percent the state picks up for that employee -- that's considered compensation to him -- and then you multiply the total by 90 percent. So you would expect his average retirement, the average retirement for the CHP officers to be about 100,000. But instead, in the report, it's only $68,000.

We offer benefits that provide 100 percent of replacement income. But the officers, at least the CHP officers are choosing to retire when they're eligible, not necessarily when they hit the maximum. A big pension at an early age is not an incentive to work longer.

Favor the facts in front of you, and please consider our initiative and support it. And give control back to the local agencies.

Thank you.

CHAIR PARSKY: Thank you very much.

Next, Terry “Ree.”

MS. RE: “Ray.”

CHAIR PARSKY: “Ray.” I've mispronounced two. We only have one left, so we'll see how well I do. But, at any rate, John Cogan's name was mispronounced, too. So that’s okay.

MS. RE: Thank you for giving me the opportunity to speak.

My name is Terry Re. I'm a state employee. I work for the State Compensation Insurance Fund. I started with the State of California when I was 21. Now, 35 years later, I'm looking forward to retirement. And my retirement benefits were negotiated with collective bargaining, which is very important to me.

Imagine the horror I feel when I hear that pension or health benefits may be compromised. These are benefits that I and all state workers counted on after working many, many years for the State of California.

Excuse me, but working for the State of California is not going to make me rich. In the private economy, I could be making over $30,000 more a year working as an insurance claims adjuster. Unfortunately, I would not have the job security, health benefits, or a guaranteed pension, which is why I’ve stayed with my state job.

My husband and I rely on my benefits, as we both have serious health issues. I had surgery for cancer this year. My husband has had multiple heart attacks. And so I cannot risk losing my health benefits by working in the private industry, since it's so variable there.

And also, as I age, I'm less employable for private industry.

Also, my husband's employer does not have a pension program, so I would be the sole source of income, plus Social Security, for the both of us.

Many state employees looking toward retirement have the same issues as I have.

As you know, the housing costs in California are rising. Many current state employees and retirees struggle with basic housing costs now.

We really don't make very much money, state employees. And that's why we work for the state, because we need the health benefits and the pensions. And that's what's happening with the new people.

You know, our regular state employee salaries are not going up substantially. In the last five years, we got a 7.5 percent raise. That's really awful -- or maybe more. Not much more.

Just think of the costs in five or ten years. The prospect of not having a good pension or health benefits is frightening. Surely, after the state employees have devoted so many years to the great state of California, the great state of California can reward its employees.

Thank you for letting me speak.

CHAIR PARSKY: Thank you.

Evelyn Ramsey.

MS. RAMSEY: Good morning, Commissioners. Thank you for giving me the opportunity to talk to you.

My name is Evelyn Ramsey. I work for the State of California, the Employment Development Department. I've worked for 37 years. I began many, many years ago when my hair was black, and I worked for the Department so long that it's turned gray now. But I've enjoyed every minute of it.

I have been a job steward for the past 25 years, and began in the Richmond EDD office. And I am currently employed now in the Oakland EDD office.

Pensions are the company’s way of telling the workers that they've done good service for many years. It's something that I feel as though we are entitled to because we work very hard.

I have a long commute. And when I get to work, I deal with people that have many problems, and some of them can be kind of tough to deal with. But I've managed that now for 37 years.

Now, in the future, workers should not feel worried about how they support themselves and their families in their old and less productive years. I want my daughter to have the same benefits that I have in my old age.

Currently, I do get Social Security. And I'm looking forward to the 2.5 percent per year of government service when I do decide to retire.

A good pension program provides income, medical and dental plans, life and death insurance policies, and other benefits for retirees, their dependents, and their spouses. A good pension plan can be a positive effect on the quality of the workforce, because conscientious and stable workers will accept lower pay for a good benefit package.

My son, who tried to do private practice previously, was not successful in it. But he had hoped -- or he hopes now to get a job where he can find a good benefit package. So it's very important to the younger worker to feel secure on their jobs.

When employees grow older, their strength wanes, and technology changes, and it's difficult to maneuver, because I have some difficulty myself. I may not look like it, but I do have cancer. I was diagnosed in 2004.

And I'm working on a job now where they let me work according to the way I feel. I may work two days a week or I may come in and work a full five. But I do continue to work; and I'm looking forward to the pension plan when I do decide to retire.

To be honest, I'm a little bit afraid of retirement because I just don't know if I'm going to have enough money when I do leave.

Those who don't have good pension programs, in effect will rely on welfare and government-subsidized programs. And I think that that's a very important thing for you to look at, because many people, especially black people, have not worked on jobs where they have pension programs. And so they have to rely on the welfare programs. Some of them may even fall back into homelessness or deal with real economic problems and health problems that they can't even afford to take care of.

They may even have to rely on their younger relatives, children to support them.

Without adequate pension programs, the elderly will lose their independence. I like to rely on myself. I don't like to rely on government subsidy programs, and I don't like to ask my kids to help me. I want to be self-sufficient. And I think most old people are that way.

Therefore, will you please consider having employers and civil service provide outstanding pension plans in the future for the workers who have devoted their young and productive years to the civil service, or to whatever program they may work for?

Thank you, Commissioners, for listening to me.

CHAIR PARSKY: Thank you very much.

Dave?

MR. LOW: I have a couple questions for this speaker.

First of all, congratulations for your long and dedicated service and thank you for your work.

MS. RAMSEY: Oh, thank you.

MR. LOW: And the previous speaker talked about a pension proposal that they're putting forward.

You're saying you receive 2.5 percent per year of service and with Social Security.

My understanding is, a new employee under this new plan would receive a 1 percent per year of service. So if somebody is working in your same position --

MS. RAMSEY: There's quite a difference.

MR. LOW: -- it's a 60 percent cut.

What kind of impact would that have on your decision, or your ability to retire having a 1 percent per year versus 2.5 percent?

MS. RAMSEY: Well, I would say it's a difference of more than half.

MR. LOW: 60 percent, yes, cut.

MS. RAMSEY: Yes, and that is a big cut.

MR. LOW: And I'm sorry to hear about your cancer.

MS. RAMSEY: Well, I'm working on that. I've got -- well, this is a big thing to me. The doctors keep lengthening my span of life.

MR. LOW: That's good.

MS. RAMSEY: It went from six years to 18 years. And I was told that if I obey all their rules, it could go as long as 30 years. So I'm batting 100 now.

MR. LOW: Well, that’s fantastic.

CHAIR PARSKY: We hope it's a lot longer.

MR. LOW: Yes, right. And my understanding of this initiative that's being put forward, if you didn't work to the full retirement Social Security age, which would be age 67, then you would not be entitled to receive health care in your retirement. I would imagine that would have a pretty devastating impact on you.

MS. RAMSEY: Yes, I believe with the state, we have to work at least 20, 25 years before we're vested to get the full coverage for health benefits.

MR. LOW: Right. And under this initiative, even if you worked 37 years, like someone like yourself, if you didn't reach full-time retirement age, you would lose your retiree health-care benefits?

MS. RAMSEY: Yes, I would think so.

MR. LOW: Thank you.

MS. RAMSEY: Thank you. And you all have a good day now.

CHAIR PARSKY: Thank you very much.

Okay, that completes our public comment period.

We now are going to move into a discussion of each of the categories of recommendations under our second concept.

And just to remind everyone, that second concept that we discussed and agreed would define the framework for these recommendations is on the agenda, but it says -- the concept is, "The costs of promised benefits should be fully identified, known, and paid for within the working career of those receiving the benefit. The process for funding those benefits should be clear, easily understood, and actuarially sound." That's the concept.

Now, within that, we're going to discuss today four categories of recommendations, all of which I think we made available yesterday. We're working hard to try to do things a little bit in advance. And I apologize for last time, but it was the vagaries of my working with the staff.

So you've had I think a chance to see these in advance, which I hope will help our discussion.

So within that concept, the first general category is: *Prefunding OPEB Obligations*.

And I will ask the staff to kind of walk through -- we're not using the word "finding" anymore; we're just introducing the recommendations with sentences. And then we're going to move to discuss four basic recommendations under this category.

So, Tom, why don't you walk everybody through what's on the table, and then we can proceed ahead.

MR. BRANAN: Mr. Chairman, Commissioners. Yes, we gave up on “findings.” My personal favorite of “revelations” was also rejected, so we're not using anything.

CHAIR PARSKY: This is just your “musings”; that's okay?

MR. BRANAN: Yes, yes, "musings" might describe it.

Two of the things that you need to know before we get into the prefunding, are the two principal ways for funding benefits. And that, as you see, is pay-as-you-go, or verbal shorthand, "pay-go." And in that situation, the employer pays the immediate costs for the benefits of current retirees, as well as for survivors of employees and beneficiaries out of the direct budget allocations. The second point is that this approach constitutes an intergenerational cost shift. And third, historically, most public agencies which have provided retiree health care have used the pay-as-you-go approach.

The second approach that we'll be discussing is prefunding. The first point there is that the employer and/or the current employees contribute now to pay the anticipated future costs of promised benefits.

In the short-term, this is more expensive than pay-as-you-go. Over the long-term, the ability to earn investment income and avoid accrued liabilities reduces costs.

While it does not constitute legal vesting, we wanted to emphasize that a practical effect of prefunding is that promised OPEB benefits are more likely to be delivered since the money is there to fund them. And you've heard testimony in earlier hearings about promised benefits or expected benefits that were not prefunded, and in a financial crunch, they also were not paid.

And finally in addition, prefunding is a way to avoid intergenerational cost shift.

Now, we divided each of these topics into pension, things that apply to pensions, and those that apply to OPEB.

Under pensions, California's public retirement plans have been prefunded since their inception, which for many, it was more than 70 years ago. OPEB, the decision to prefund cannot be made in a vacuum, and we recognize that. In general, prefunding will have to compete with other fiscal and budgetary needs of the agency.

Now, we did have one agency that testified before you, some time ago, which when they found they needed to prefund to the amount of $6 million, found that they had an extra $6 million, and they prefunded. But in most cases, our public agencies are not in that situation.

Although the state faces --

CHAIR PARSKY: We don't think so, but we're not quite sure whether or not --

MR. BRANAN: As far as our research has determined, there's probably maybe one other such agency out there.

Although the state faces budget challenges in the next year, prefunding is part of a prudent fiscal approach to paying for retiree health care over the long-term.

Prefunding of the State's OPEB liabilities has been endorsed by both the State Controller and the Office of the Legislative Analyst.

As has been seen in testimony, benefits which have not been funded may be dropped by the employer in difficult economic times. Setting aside the funds can help to reduce the chance of benefits being reduced in the future.

Another funding approach that has been discussed is OPEB bonds. And the points to be made there are, an employer can issue OPEB bonds to create a source of funds for prefunding.

And you've heard testimony from at least one or two agencies that use this as their initial step. So they were funding their unfunded OPEB liability, and then either eliminated OPEB benefits in the future or decided on a way to fund them in the future. But the bond was their initial step for prefunding -- or for funding.

Unlike pension obligation bonds, future health-care costs are difficult to project; and the liability amount used for an OPEB bond is much less reliable. That's primarily due to the unpredictability of medical inflation.

OPEB bonds are basically an arbitrage strategy in which the employer believes that a return on investment funds is greater than the cost of debt.

Even if an employer's OPEB liability is reduced or eliminated sooner than expected, the debt cost to the bond will continue. So, in effect, an estimated OPEB liability has been converted into a fixed debt.

The federal government has not clarified its reimbursement position on OPEB bonds. And you heard testimony on this at the last hearing in Fresno. So that remains a question mark.

And based on the State's recent experience with a proposed pension bond, it should be assumed that an OPEB bond would have to be passed by a majority of the voters. That, of course, is an OPEB bond for the State.

Which brings us to our first recommendations. Prefunding, because it addresses both accumulated and future costs, should be a preferred strategy for all public agencies.

CHAIR PARSKY: Let's just pause on each one of these one at a time, and we'll go around and ask for comments from each of the commissioners, and then we'll see if we can't achieve a common view.

Paul, why don't you start us off, on this Recommendation 1?

MR. CAPPITELLI: I think it's a good recommendation. The only concern I have is whether or not we say that this is the preferred strategy or whether we should say that it is probably one of the most viable strategies.

That would be my only statement.

CHAIR PARSKY: So just to clarify, the concept you are worried about is how strong we make the words. That the underlying recommendation you would --

MR. CAPPITELLI: That's correct. The overall recommendation I think is sound. It would be just the way we worded it.

CHAIR PARSKY: Okay, Lee?

MR. LIPPS: My thoughts were very much similar to Paul's. It could be a preferred strategy for some public agencies. It may not be possible for all public agencies, first and foremost.

The other observation I would have is that although the recommendations are listed in order, number 1, 2, 3, 4, and 5, I'm not sure that I would agree that that's some type of priority order, that that's the priority order that they should go into.

CHAIR PARSKY: They weren't meant to suggest priority. And so the numbering of them we certainly can think about it a little bit more. It wasn't meant to be the priority.

MR. HARD: Yes, I agree with the previous two speakers on the wording because as we go down, we'll see that we're looking at particular circumstances of different governmental entities.

And then I do have a concern about the order, too, because normally, I think that whatever comes first is what other people perceive as perhaps most important. So I have a concern about the order also.

CHAIR PARSKY: John?

MR. COGAN: Thank you, Gerry.

To me, this is the most important recommendation that we will consider. It does seem to me from the testimony -- is that better? -- from the testimony that we've heard so far, the arguments in favor of this are pretty clear. Prefunding would allow us to have greater benefits to retirees at a lower cost to the taxpayer. Prefunding would, by putting dollars behind the promises, give these promised benefits greater security, and it would reduce the liabilities that we impose on future workers.

It's not a new idea. It's worked in pensions, and it should work in health care. And so I'm very much in favor of a strong recommendation for prefunding.

I hear from Jim, Lee, and Paul, that there might be some grounds in some local governments where there might be reasons for not going with prefunding; but I'd like to hear more in terms of specifics. What would those conditions be that would lead us to conclude that it's not a good idea for a community, a city to begin the process of prefunding.

CHAIR PARSKY: Okay, we'll come back on that subject.

Dave?

MR. LOW: I think both points are legitimate. And I do believe that the recommendation is a little inconsistent with some of the later recommendations saying that it should be a preferred strategy; and then number 3, to jump ahead a little bit, it doesn't really make the same sort of consistent statement. So I think that there's some inconsistency there.

I think that prefunding is a good strategy and it deserves a serious look. But I do believe that there should be some level of flexibility in decision-making, and it ought to be justified.

Just on background, too, I just want to note that on one of the backgrounds where you say that the pension funds have all been prefunded since the inception, I was told that CalSTRS actually didn't start prefunding the pension until 1972. So not all were -- and that's a good example, that even starting late, they were still able to reach a level of very high funding status. So we might want to just correct the background.

(Dr. Ghilarducci entered the meeting room.)

CHAIR PARSKY: Tom, did you have a comment?

MR. BRANAN: I think that's true, that actually STRS started out by a grant of benefits to all teachers, I think of $500 apiece, and nothing to pay for that past liability.

I would point out that STRS was not able to, with such a late start, they were not able to invest their way into the position they're in now. It took several interventions by the Legislature with infusions of cash to get them to where they are.

MR. LOW: Sure, I'm not making a judgment. I'm just -- it's sort of just a technical.

MR. BRANAN: Good.

MR. LOW: And there are some other systems that I think are still -- I think LRS is still pay-as-you-go.

MR. BRANAN: Well, that's true, LRS and JRS, those are the legislative and judges retirement system. They're usually not held up as examples of pension policy. But you're correct.

CHAIR PARSKY: I think it's more of a factual comment than it is a comment about policy.

MR. BRANAN: Good.

CHAIR PARSKY: Okay. Yes?

MR. COTTINGHAM: I think as a method of staying ahead of the game, I concur with most everybody here that prefunding is the way to go. I guess what's left is to determine how strong it's going to be recommended.

Like, as Lee says, there's some entities out there, governmental agencies, cities and counties, that may have some difficulty. And I think that would be dependent on whether or not they're able to make -- whether it's the ARC that they're trying to cover or a supplemental payment, and have the ability to do that.

But I think what we've also learned is that even if you're not paying your ARC and you're covering your supplemental payment, you're still going to be meeting your pension obligations. And also in this last year, we have seen CalPERS pass legislation to help their members and actually other members now get into a prefunding mode with them and letting them to invest in the pool to give benefit to everybody also.

CHAIR PARSKY: Bob?

MR. WALTON: Just a point of clarification. The Legislative Retirement System is properly funded, and I think it's been fully funded for a number of years, and that's why it's a not required a contribution. It's a closed system, virtually, with some limited exceptions. But there is a Judges Retirement System, JRS-1, that is a pay-as-you-go, always has been, probably always will be.

As far as recommendation, I strongly support this recommendation, only with one clarification, and it doesn't necessarily need to be a recommendation. I understood in the background material that when we talk about prefunding, we're doing so under a sound actuarial policy. It's not willy-nilly, pay whatever you can, whenever you can. It's under strong actuarial policies and practices that prefunding should be addressed.

But I strongly support this.

CHAIR PARSKY: Connie?

MS. CONWAY: And I would agree. And I don't even mind it being Recommendation Number 1. And because I sit here and I look at us as a commission, charged with making recommendations, and I worry that if we don't make -- I mean, I like the way the statement is, the way it is because there's always exceptions. And I don't want to start nit-picking and saying “except for” or “but” or “only.” So I personally really am okay with this as is.

CHAIR PARSKY: Matt?

MR. BARGER: I also have -- I thought John was actually very eloquent on the why's and wherefore's that I would echo. But I would echo that it should be our number-one recommendation. I would prefer the strongest possible. I view it as, if it is, as a preferred strategy is not, you know, overly strong. And certainly there's room for people in different situations to come to different conclusions. But as a recommendation, I think it would certainly be the minimum, I would think, that we would want to give.

And the other point I think, it's a little vague, actually, on what does that mean because there's two parts to this. There's one, avoiding sort of pay-as-you-go going forward, what's the sort of normal cost. And then there's the second question of what do you do when you accumulated liability, you know, over what period of time do you need to actually attempt to amortize that.

And my recommendation on that probably would be over the lifetime of the current workers, so that there's sort of -- it just sort of leaves out the question of over what period do you attempt to amortize the existing liability. So I think that's the important part of it and a certain hole, actually, in the statement at best.

CHAIR PARSKY: I do think that -- I'd like to come back on the question of exceptions to this. But I do think that the other three recommendations are meant to be somewhat linked in terms of the strength of the message to the first. And I would see it in that context. Because if you just lead with the first recommendation all by itself and didn't get into what you're specifically recommending to be done at the state level, then it -- so I do think there is a nexus there.

But before we move off of this, I think it would be helpful for those of you that -- Teresa, nice to see you. I didn't see you there.

DR. GHILARDUCCI: Nice to see you.

CHAIR PARSKY: Do you have any comments on this recommendation before we move to -- do you have a few clarifications?

DR. GHILARDUCCI: No, the fact that you said the other three were linked to it helps clarify with Bob, and that is about what does “prefunding” mean.

CHAIR PARSKY: But I would like to hear if there are specific exceptions or reasons why an authority wouldn't want to prefund, so that maybe we can work to strengthen the statement but still take into account some level of flexibility. So maybe Lee or Paul could make those comments.

MR. LIPPS: Let me take a stab at that.

CHAIR PARSKY: Okay.

MR. LIPPS: Because I think the statement "wouldn't want to prefund" is very, very different than the statement "couldn't prefund." And a lot of the "couldn't" there has to do with the adequacy of the current funding levels.

I could start, for example, with education, the field that I know best. And if we're talking about K-12 education and the funding levels that we currently have in the state, which are, by any standard, low by national standards, national averages, particularly when you start taking a look at per-capita income and all the rest of that, it is very, very low.

We've just finished having a number of studies that came out of Stanford, 24 different research studies, and the pretty overwhelming conclusion was that we are greatly underfunded, particularly when we measure the funding against providing what's called an “adequate and equitable education” for all our students, particularly students of the greatest need.

Having said that, if we were to put forth the recommendation that said that you had to do this funding, you had to be given this prefunding, and we take away from the current educational programs' funding, which is already inadequate, further lower the types of services and programs that we are offering to our children, I think you could make a pretty good, solid case that that in itself would be a form of intergenerational cost-shifting. Because it will be future generations that have to pay for the educational inadequacies that children will get today, in the same way that if I was a county supervisor, for example, and I had to begin prefunding retiree benefits, which, as was stated in several places, could be much more expensive in the short-term but eventually, there's some long-term gain. But it's this year's budget that I'm creating a shortfall in.

And we have created in this state incentives, at least for school districts and other agencies, to engage in deferred maintenance, meaning, take care of your property now to avoid really extensive long-term fixes 15, 20 years down the road, another intergenerational cost-shift.

Well, if I'm a county supervisor, and I now have to begin prefunding the retiree benefits to lessen the impact on my budgets on 25 or 30 years in the future, then I may have to neglect some of the routine maintenance that I would be doing now to keep things in relatively good shape to avoid more costly fixes later.

So I think those are two examples where it could not be done based on the current funding levels.

Now, should it be done? In an ideal world, if there was plenty of money? Sure. But I would also like to clarify one other point, because I think Tom made the statement and, John, you made the statement that prefunding would reduce the cost of the benefit.

I don't believe that that's the case. It may reduce the cost -- and it's not quibbling, but it may reduce the cost of the impact of retiree benefits on a future budget. But the actual cost of the benefit, given the current state of things, is going to continue to increase exponentially.

Prefunding doesn't do anything to reduce the actual cost of -- and I'm thinking specifically now of retiree benefits -- the actual costs on a per-person basis of what that benefit is.

There are some health-care reforms out there, SB 840 that would do that. But this doesn't speak to that.

CHAIR PARSKY: Before we come back around, any other examples that anyone would like to bring forward of exceptions to maybe a stronger statement than this?

A comment, John, that you might have on those exceptions?

MR. COGAN: Well, I think Lee made a very good point, especially in the context of education, where, in effect, you could trade off one investment for another. And so I think your point is very, very well made.

It also suggests, I think, a solution. And the solution is that we avoid making recommendations to the state or to localities about where the funding source comes from. That is, we not try to mandate that the funding source for health-care benefits for educators come from the education budget. We leave that as an open question and let each locality, let the state decide on the funding source and not have it come from education, and thereby avoid this problem that I think is a legitimate one that Lee has raised. That would be my solution to the problem, is basically let's not require that the funding come from education, so there's no necessary reduction in education spending, the way I think about it.

And as far, by the way, to the cost of the taxpayer -- my point was the cost to the taxpayer.

What we have now in the pension world is three-quarters of the benefits paid to current pensioners comes from returns on investments as opposed to taxpayer-financed contributions. And it would be very nice if 20 years from now or 30 years from now, we had the same situation with health-care benefits for retirees. So that's pretty well what I was driving at.

CHAIR PARSKY: All right, just to follow on that. How would people feel about strengthening the statement, but making it clear that we are not dictating or even recommending the source of this funding so that the statement would be stronger? And again, this is not meant to edit statements, you're going to have plenty of opportunity to do that. But make a stronger statement that it should be the preferred strategy; but, rather, that it should be -- or that prefunding should be adapted for all agencies, but indicate that we're not indicating the source of that funding, giving flexibility to the educational community that if they couldn't derive this funding from their own source -- in other words, they were making priority choices -- that they would seek it elsewhere or not, or have to be an exception.

Bob?

MR. WALTON: I certainly support that, Mr. Chairman. I think this Commission really can't get into source of funding. It’s really not our task and our responsibility to do so. And I think using the words “preferred strategy” is the right recommendation.

MR. WALTON: I think it is clearly the preferred strategy, both short-term and long-term, as well as reduce costs eventually. But the funding issue is left to the legislative bodies, whether it's the state level or local level, and it's up to them to address that. That's what they're elected to do and that should be their task.

CHAIR PARSKY: But just to follow on, Bob, what I was suggesting was, to make the words a little -- again, not to edit it, but just to make the words a little stronger than "preferred strategy," but couple it with the sourcing. If that runs counter to people's views, please express them.

MR. WALTON: I don't have any problem. I'm not sure what could be a stronger word other than "preferred," but --

CHAIR PARSKY: Well, just eliminating the words "preferred strategy" and just say "It should be the policy of all public agencies."

MR. WALTON: Again, I think it's very important that we make a recommendation that that is the preferred, or just the policy of the local government to prefund the benefit.

CHAIR PARSKY: Any other comments?

Matt?

MR. BARGER: I mean, I would be on board with that. And I think actually what Lee was touching on is a little bit of the crux of the issue that makes it delicate, which is, how do you do this right now, at the same time we're generating these costs that should be accounted for and recognizing by deferring them, we're not making things better, in my opinion. You know, we're making them worse, probably. Just making bigger problems to deal with. And I think it's important to go on record and say, "This is the right way to approach this," even if it's not crystal clear how anybody's going to deal with this next year. But, clearly, this is what we'll need to figure out how to deal with over the next few years.

CHAIR PARSKY: We're going to talk a little bit about how we think the State ought to deal with it. But you're right, it's not an attempt to tell all local authorities how to deal with it or where the funding should come from.

Dave, did you have something?

MR. LOW: Yes, I have a certain level of discomfort in terms of the way it's being termed, because

I don't think -- if you say it's the preferred policy or it's the recommended policy, I think that it does cross over into the area where you are telling them to make a choice in terms of where they make their expenditures.

I think that I'm more comfortable with addressing it as a policy issue, to say, you know, "We think that this is the optimal way to handle this issue. And sort of all things being equal, this is the best policy for these reasons," and laying out those reasons. I'm a lot more comfortable with that than saying, "It should be every agency's policy to do things this way." I think that connotes a different sort of thing. And I think we ought to sort of bullet the statements instead of number them; and that way, they have sort of an equal footing.

But I would prefer to make a policy statement about the policy reasons why prefunding is an optimal way to handle this as opposed to addressing it as a recommendation that this be the policy of local boards or the State.

MR. BRANAN: Mr. Chair?

CHAIR PARSKY: Oh, yes, out in the audience.

MR. BRANAN: I think I can offer something that will allay some of the concern about the order that they're in and the number.

You have to remember, this is just one set of all the recommendations that will be put before you. When they show up in the final report, this number 1 will not be number 1, and maybe they won't be numbered at all, as Mr. Low was suggesting. But this is just a piece of what the Commission will produce.

MR. PRINGLE: Mr. Chairman?

CHAIR PARSKY: I just want to ask, Curt, I don't know whether you're up to speed on this section here --

MR. PRINGLE: Yes.

CHAIR PARSKY: But I'm sure you have views, so I'd like to hear it.

MR. PRINGLE: No, no. I think I feel comfortable with the language being as bold as possible, obviously. But I also respect the fact that there's a way to massage it a bit so that we demonstrate why it is that it's a positive or preferred policy or should be a policy. I think articulating that a little more in depth would probably strengthen that recommendation and certainly not water it down.

CHAIR PARSKY: Okay, Paul?

MR. CAPPITELLI: You know, as I read through this, perhaps if we took what is now number 3 and made it the very first statement, and then make number 2 to follow, and then number 4 becomes the third, and then this becomes what kind of cleans it all up, it might flow a little bit better. And maybe that's where we're hung up on. Because as I read through, if you make a statement about local public employers identifying prefunding options and then go on to say, “And the State should do this,” and then go on to say that, “any employer considering this,” and then in the final tag line could be, “prefunding because it addresses this should be a preferred strategy.” I think it kind of flows a little bit better.

CHAIR PARSKY: Okay.

Yes?

MR. HARD: Yes, I would endorse what Lee said about these are choices that governmental entities need to make. These are political choices.

And the thing about intergenerational discrimination, this and other matters has to do within state service right now, there's a question of whether or not there's going to be some kind of reform in California regarding health care. There is a projected budget deficit. So even on this particular issue that happens to be driving the cost of post-retirement benefits, health care itself, the question is how would that be funded.

And putting this forward as what must be done is -- I mean, basically, it cuts out the decision-making of the -- well, it's our recommendation that they make this the number-one priority; whereas in fact this is -- you're correct that it saves the taxpayers money in the future. But, in fact, it doesn't help the inflation rate of medical care.

And as far as the projections go, that I see, this is going to be unsustainable anyway, even with prefunding.

So, you know, you're recommending that these bodies, elected bodies, make this choice versus perhaps trying to address an issue which would reduce the taxpayers' bill for the uninsured, reduce premium payers' bills for their own insurance.

So whereas I do think that it's a preferred strategy, it does have to be taken into context of the governmental entities and the tax base that you're talking about.

And I don't really understand how this question of where the funds –- particularly where the funds will come from, under what governmental agency you're talking about is any kind of solution to actually paying for these things.

MR. BRANAN: Mr. Chairman?

MR. HARD: There's only a certain set of –- there’s only a finite amount of revenue each year.

MR. BRANAN: Correct.

MR. HARD: So I don't get it. Maybe it's my naiveté, I certainly accept that. How that's a solution to this problem, given the state, of course, of two-thirds majority pass tax increases or how choosing among which program in a finite revenue helps sort this out. I didn't quite understand that.

CHAIR PARSKY: Well, I think just a couple of comments. I think we need to keep in mind the charge of the Commission and what we've been asked to put forward.

And although I think you make a very good point in terms of the need to address the escalating costs of health care, that that's not the charge of this commission.

Our charge is to attempt to put forward recommendations with respect to these liabilities, as to how we think policymakers ought to address them, given the fact they are promises that have been made and that policymakers need to honor those policies.

So what is the best way we think they ought to consider doing this?

And I do think that on this subject of prefunding -- and I have the highest regard for all of our policymakers. However, I do think that it's very important that to some extent we hold them to task on the notion that they have -- they feel that these are promises that are to be made and that this is a high priority for them to honor these promises for public employees, and they continue to say that public employment is something we want to encourage.

Well, if that is the case, then I think it's important that we indicate to them: Fine. Now is the time to start making sure that these promises can be met in a responsible way.

So I do think it's important that we step back a little bit and make sure we kind of draw the line a little bit on what the charge is, recognizing that the points you made I think are very legitimate.

MR. PRINGLE: Mr. Chairman?

CHAIR PARSKY: Curt?

MR. PRINGLE: I guess what -- I apologize for having to step out on a conference call, but I thought we were just talking about Item 1.

CHAIR PARSKY: We are.

MR. PRINGLE: Which is to make a statement that says, "Prefunding is a preferred strategy." And I'm looking forward to discussions on Item 2 and Item 3.

But from my perspective, would this Commission consider saying, "We recommend that the Legislature not make their annual contribution on retirement benefits”? Of course, we wouldn't, because that is a commitment, and we would see that commitment there. Therefore, that is a prefunding strategy. That's a prefunding strategy on retirement.

So just to say that we think the preferred strategy on OPEB benefits should be the preferred strategy isn't necessarily saying, "Wipe away every other obligation or put that as the number-one obligation.” It's just that is the preferred way to address the liability of benefit that is there, just as I don't believe anyone here today would say we should encourage the Legislature to have more flexibility in making their employer match on retirement benefits.

I don't think that improperly harms the legislative process. It just says, "We know that that's an obligation," and there is a preferred strategy there. That preferred strategy there is, in fact, to make sure that we are prefunding that. And I just see these as an equivalent position. And to start out by saying that's a preferred strategy, I think is a strong and important place to start, and then we can always talk about how they should go about addressing that individually, through the legislative process in Item 2, or as local entities in Item 3.

CHAIR PARSKY: I think you've articulated the rationale.

What I was doing, perhaps not as articulately as possible, was to see if the commissioners wanted to strengthen the statement even more, because there were several that said that this was the minimum. So I was kind of pushing a little bit to see if we wanted to make a stronger statement, taking into account exceptions.

Why don't we have a couple more comments on this one? Then I'd like to move to all of them, and then we can come back around.

Lee?

MR. LIPPS: Well, much of, Curt, what you say, and, Gerry, what you say, sounds good in the abstract.

When we strengthen a statement like this, here's the local translation. And I only speak from the world of some thousand school districts, 340,000 teachers, 280,000 classified employees, regardless of their affiliation. At least how it works at our level is that if we strengthen the statement to say: “It should be the policy,” which is stronger than "the preferred policy" --

CHAIR PARSKY: Right.

MR. LIPPS: -- to whatever extent we strengthen it, that will be taken at the local school board and school district administration level as a mandate. And that is how they will approach their employees. It may even be how they approach their budgets because they will almost always insist that they are, you know, fiscally prudent and fiscally responsible, whether they are or not. But that's what they will say.

And I know this for a fact because I've been dealing with this exact, same issue in terms of school boards and school districts saying that they are required to put money -- I mean, the word "required" -- statutorily required to put money away for retiree health benefits since 1994. We had to dig out the GASB and the FASB stuff, and it hadn't even really been formulated yet. It was just a rumor, but we were already hearing that. So that's how it's going to translate in terms of the local school district budget.

You know, if you really wanted to -- I'm sort of thinking off the top of my head here, which is dangerous for me, but I could almost go along with the statement that says that “Prefunding is the ideal strategy for dealing with OPEB benefits if there is additional money provided.”

Now, as soon as that you say, of course, and we're all sitting around here, “Okay, well, that means more taxes." Yes, it does. But anything short of that, at least for a number of public agencies and their budgets, there is no way to go about it without harming the current program for some good period of time.

You know, one of the questions that's been going through my mind -- and I think Matt probably knows the answer to this -- but it is, in order to get to this 75 percent payment, you know, through the return on investment, how many years am I going to need to put away money before there is enough money that would generate 75 percent of what a given year's payment is going to be? Is it 15 years? Is it 18 years? You know, how long before I actually find some kind of a benefit that benefits -- that has a good, positive impact on the local agency budget?

CHAIR PARSKY: I would just suggest you hold those comments until we get to Recommendation 3 and see how that kind of fits into what you're saying, but I think it may.

Two more comments on this, and then I'd like to get through all of these and see if we can then come back.

Matt?

MR. BARGER: Lee touched on something, actually, that I didn't want to let disappear into the ether, which is what does "prefunding" mean.

CHAIR PARSKY: Pardon me?

MR. BARGER: What does "prefunding" mean.

CHAIR PARSKY: Right.

MR. BARGER: Because, again, I think there are -– again, I come back to there's sort of two parts to it. There's sort of recognizing what is the normal cost you're accumulating, which both the pay-as-you-go and what you're going on the hook for, and then there's amortizing the future, you know, the liability you’re building up today.

And I think some sort of statement that says, prefunding means coming up with a plan to deal with a liability over some reasonable period of time and paying the normal cost is what “prefunding” means to me." And I don't want to let people sort of skate on what is it exactly we're saying.

DR. GHILARDUCCI: Gerry, can I add --

CHAIR PARSKY: Teresa, yes? You've been remarkably quiet so far. That's okay.

DR. GHILARDUCCI: I know. Am just thinking.

And my comments may sound like they're from 35,000 feet, because I was at 35,000 feet just an hour ago.

Matt, there's another part of prefunding, which is actually funding past service. So in some cases, that hasn't even been done, promises made now that haven't been funded.

But we are talking here as if there's some kind of technical, correct way to fund a promise made in the future. And I think I actually agree with Jim, that actually we're really talking about a set of priorities, because we're not talking about here prefunding the obligation to provide fire services in Anaheim. We're not going to endow the sheriff's department or endow other kinds of investments. There's something about retiree health that's kind of special here that requires recognizing that there is a liability in the future, like all other government services, and that we want to do something about it.

Making that decision means that we are actually elevating that expense. We are actually saying that this promise is whole, it's important, and putting money behind it I think cements the promise to future retirees, and would only make people feel more secure, because it would secure that promise. So that's a perspective I'm coming from.

It seems going to language that's even stronger than this does not make any sense because it then implies that a good official, somebody who wants to do good government, has to find that source and not fund the fire department. And that is not what we want to say.

CHAIR PARSKY: And I think consistent with that, and I think the reason the staff has put forward the language that's here is that, again, if you look at it in the context of the next recommendation, it's a very specific request, vis-à-vis the State to begin a process that, at least from a priority standpoint, the State can afford, but they have to establish the priority.

So I think, to some extent, we've circled back around to the language of the recommendation, in one sense, recognizing that we may need to build in what Matt was saying and what Dave was saying, and introducing it, to make sure that it's understood what prefunding is about.

Okay, yes, did you want to make one comment?

MR. COTTINGHAM: Yes, I did.

I think one of the things we do have to consider is, I'm still on board with the statement and making it a strong statement, is that as to what Lee was saying, I think anything we come out with, no matter how strong it is or not, some entities -- maybe most of them -- are going to look upon it as a mandate, because it's coming out of this Commission, and that is our charge.

Also in respect to what Jim has said about there is a great unknown there in health care, more the charge is to find the extent of unfunded liabilities. And that's a very hard mark to hit with what is occurring in that industry, and something we may not be able to pinpoint unless we decide that we are going to come out. And, again, it's off the statement, with some type of recommendation for what could be done for controls in that area.

But I think that getting back to this statement, I think Commissioner Low and Commissioner Pringle laid it out very well, is that besides this statement, that there should be some bullet points that explain why prefunding is important and what prefunding can do to assist you in going forward with your OPEB obligation.

CHAIR PARSKY: Okay, let's move on.

That's real clear now, right, Tom?

MR. BRANAN: Absolutely, Mr. Chairman.

Oh, I did want --

CHAIR PARSKY: One second.

Connie?

MS. CONWAY: I just had a quick side conversation, is that -- I'm not trying to muck up this OPEB liabilities, but technically, I don't believe that my plan has any, because we don't offer them. So what do you do in that case? I mean, prefunding -- I guess it doesn't hurt the plan that I currently work with, to say you should prefund it.

CHAIR PARSKY: No.

MS. CONWAY: I suppose if you're going to do it, we don't offer it.

CHAIR PARSKY: Well, presumably, unless you have the liability kind of floating above there without offering it, you wouldn't have to address it.

MS. CONWAY: So, I mean, this conversation assumes that all plans offer OPEBs?

CHAIR PARSKY: Not necessarily. It is --

MS. CONWAY: I mean, when we have conversation, I think everybody -- I sit here thinking, yeah, I'm talking about this, but -- okay.

CHAIR PARSKY: Tom?

MR. BRANAN: Mr. Chairman, after listening to all of the comments, it seems to me that Commissioner Cappitelli's suggestion might solve some of these if we put Number 1 following what is now Number 3, you go through a whole series of conditions that are being recognized in those previous -- what would be the previous recommendations, and you end up with something of a policy statement in what is now Number 1.

And I'd like to know if that is something that might satisfy the commissioners.

CHAIR PARSKY: I think coupled with an introduction that explains the benefits of prefunding, then maybe that would satisfy everyone here.

Okay, let's move to Recommendation 2 and see if we can move toward something that may be more specific.

MR. BRANAN: We're on a roll now.

Number 2, "The State of California should establish prefunding as a current budget priority and begin prefunding its OPEB liabilities. For the coming year, the State should set aside a minimum of $500 million and up to $1 billion, if possible, to begin its prefunding. The specifics of this commitment should be negotiated between the Governor and the Legislature."

And if I might just add something that came up earlier, or pertinent to that, staff very much is aware that funding these benefits is a political decision. That's why this language is in, but the Governor and the Legislature will decide it. But we are looking at the charge in the Governor's proclamation, and that is finding what we think, and the Commission agrees, are good alternatives for dealing with this problem.

So we're not ignoring the fact that there are political decisions to be made, but we are setting out what we think should be thrown into that political mix.

CHAIR PARSKY: Okay, let's go around.

Let's start on Matt's end this time.

MR. BARGER: Good.

I actually agree wholeheartedly with the first sentence and would cross out the rest of it, personally. I don't see why it is in our purview to be setting aside the specific compromises that the Legislature might decide to do as opposed to fulfilling our primary recommendation, which is to fully fund these things. So I would be on board for the first sentence and not the rest of it.

CHAIR PARSKY: You would eliminate the acknowledgements of the Governor and the Legislature?

MR. BARGER: Actually -- excuse me -– I would get rid of the second sentence, not the third sentence.

CHAIR PARSKY: Yes, I took it that way.

Connie?

MS. CONWAY: I guess the skeptic in me is saying, yes, that's a great statement.

CHAIR PARSKY: Good.

MS. CONWAY: Is that going to happen?

CHAIR PARSKY: Well --

MS. CONWAY: But we're recommending that?

CHAIR PARSKY: Right. Just step back and say the role -- again, the role of this Commission is not to make any decision.

MS. CONWAY: It's to give good advice.

CHAIR PARSKY: It’s to give advice and to come forward with the best approach that we think ought to be considered.

MS. CONWAY: Then I believe that is a good statement.

CHAIR PARSKY: Bob?

MR. WALTON: One question before I reply.

Tom, how is this consistent or inconsistent, the specifics that you contain in this recommendation, with what the Director of Finance suggested at a previous hearing? I don’t believe it was -- it was different than this one.

MR. BRANAN: I don't think they're inconsistent.

He did not, as I recall, commit himself to an amount. But he did say what he was looking at was beginning prefunding. I think where he got more specific was the cutoff line where he would begin prefunding. It wasn't even going to be new hires, but, say, next week, current and future would begin to be prefunded. But I don't think this is inconsistent with Finance.

CHAIR PARSKY: Since our executive director wears a second hat, we'll ask her to take off the executive director hat and put on her other hat.

MS. SHEEHAN: Yes. Let me share with you, as most of you know, we have asked the actuary to do some additional runs for us. And one of those is to do a run for the director of the Department of Finance. That would separate accumulated liability from future, both new employees, as well as service -- new service for current employees. So as Tom said, it's not inconsistent.

We should have that run back probably in the next two to three weeks. So it will give us some ideas of, okay, what they said in their original report in terms of who began to do full prefunding, as opposed to sort of separating out past service from the future.

And I think for the reasons that, you know, Mike was looking at various –– Mike Genest, Director of Finance, was looking at various alternatives in terms of coming up with various suggestions in his role as the Governor's Finance director.

CHAIR PARSKY: Okay.

MR. WALTON: All right, now to respond.

I, to some extent, agree with Matt. I think we could limit this recommendation to just the first sentence. But if we are going to make specifics -- and I'm not opposed to making specifics -- I would prefer, in lieu of these dollar figures, to something along the line that the State should at least, at a minimum, pay the normal cost, plus interest, plus some amount to pay down the unfunded liability as a definition of starting prefunding. In other words, the basic step the State should make is to at least stop the bleeding as far as the increased unfunded liability goes. In other words, start paying the normal cost, start paying the interest on the unfunded, and then start paying some amount to pay down the unfunded liability.

MR. COTTINGHAM: Okay. I think, as I recall, Director Genest gave three or four options in his statement. But I don't think this is inconsistent with what we're supposed to do as the charge of the Commission.

The only thing I am asking is that I think the figure that Mr. Genest quoted as to what it would take was a bit higher than the $1 billion.

MS. SHEEHAN: Well, I think what Mike had testified on -- and we talked about some of what would be the normal costs, plus beginning to pay down in terms of -- I think it's 1.3 or so, in addition to what we are paying the pay-as-you-go, so it takes us up to about 3.6.

But Mike did give you some various scenarios. One would be just future service of future employees. He was doing various scenarios, looking at what the costs of each of those would be.

So you are right, Mr. Cottingham, he provided various scenarios.

But if we were to do the full funding and begin to prefund fully, if I recall correctly, 2.6, 2.7 billion, if we were to take -- you know, you have to add that to what the current pay-as-you-go cost is.

MR. COTTINGHAM: Okay, and I concur with leaving an amount in there as a target. Because I think if you leave that open, then the Legislature will be on their own to determine what level of funding. And then who knows what could happen?

CHAIR PARSKY: Dave?

MR. LOW: I think -- first of all, I don't know what's magical about 500 million or a billion. I'm curious as to how you come up with that figure as a target, because I don't know that that's the appropriate target or not, and so -- but beyond that, I think when you set any target -- I mean, a billion, for example, it begins to beg that same question that Lee Lipps had raised specifically for schools or local agencies for the state. Because now you're saying you need to prioritize the budget so a billion dollars doesn't get spent someplace else. So that means we're cutting welfare recipients or pay to the elderly or whatever, it's going to be a budget situation where the UC and K-12 and everybody else is fighting over that same budgetary amount.

I think that's a place where I'm not sure that I'm comfortable going in terms of inserting myself into that process. I feel a lot more comfortable with Number 2 and Number 3 and having the State go through a reasonable process of identifying their options and determining what the preferred strategy is, as opposed to dictating that strategy.

CHAIR PARSKY: Just one comment on that. I do think -- recognizing that everyone here may have other interests in other priorities; but, again, I would urge everyone to think about the charge of the Commission. And I think unless we feel that this priority that we're talking about shouldn't be at the top of the list, from our standpoint, then the more we water it down, the less opportunity there will be for the policymakers to treat this seriously.

So I mean, again, it's the choice of the Commission. But I think before the Commission came into existence, to some extent, we saw on this prefunding issue what happens in the normal legislative process. And that is nothing, on the prefunding notion.

So if this is -- and, again, it's a choice of everyone around this table -- but if prefunding is an important policy and it is an important message to give, at least at this level, we are making a statement that says, "Yes, you should -- the specifics and how you negotiate it out and how you work it out are left to you as policymakers. But from our standpoint, it's important that this begin, and this begin in a meaningful way, that the dollar numbers, I think, were in there to demonstrate meaningfulness."

John?

MR. COGAN: I support what Matt and Bob especially said about this recommendation. In fact, I'd go a little bit further. I'd take out everything, as they would, beyond the first sentence. And I'd make the first sentence a simple declarative: "The State of California should begin prefunding its OPEB liabilities." And then in an explanatory statement, I would go where Bob is going: Not only should we begin to fund the additional liabilities as they are promised, but we should also begin to pay down the existing debt. And that's what we mean by "prefunding."

So I would be very, very strong on this when it comes to the State.

CHAIR PARSKY: Curt?

MR. PRINGLE: Well, I want to make sure I'm reading this right.

CHAIR PARSKY: Take them one sentence at a time.

MR. PRINGLE: Well, but it's the second bullet point on page 3 at the back of the information, that says, "Under its current pay-go approach, it is estimated the State will pay $1.36 billion for health care for its retired employees in fiscal year '07-08. It will accrue an additional $2.23 billion unfunded liability for the future cost of health benefits earned during fiscal year '07-08, bringing the total cost of these benefits to $3.59 billion."

Am I reading that, under this recommendation, we are saying, yes, pay the $1.36 billion, which is a current pay-go, but only addressing $500 million to a billion dollars of the increasing $2.23 billion liability in this approach in the paydown context? So not covering what we are adding to the burden in fiscal year '07-08, not covering that, but, in fact, allowing that obligation to grow larger; right? Is that what I see?

CHAIR PARSKY: Well, it was an attempt to start.

MR. PRINGLE: Right.

CHAIR PARSKY: It was not an attempt to fully prefund because I think we tried to appreciate the budgetary constraints in that process.

MR. PRINGLE: And I guess from our perspective as a commission, to say it is okay to allow each fiscal year to add more to the burden and, therefore, exacerbate the problem, we're not even making the recommendation in this, that we should at least pay all of our obligation in this current fiscal year. We're basically saying we should allow it to grow in this fiscal year.

And for me, what I'd like to see this say, Mr. Chairman, is make a policy statement. I don't necessarily care what the money is, but that the State needs to ensure that the liability that is incurred in each year is paid for, and there needs to be a plan of action to reduce the amount of unfunded liability.

Because I would like to see on the next one, the local government one, too, if they don't come up with a payment schedule, at least they create a plan to address that.

And I would like to charge the Governor and the Legislature to work on a plan to address that prepayment.

And, you know, we can say "put $500 million in this pot or a billion dollars in this pot, or $2.3 billion in this pot," but that's a one-time action that's responding to our recommendation.

I would like this to be a recommendation that says, "and to create a plan of payment to address that," or "a plan of action."

And, you know, if the Legislature in future budget years have a positive budget flow, which there has been, you know, one or two of those in the last 20 years, or a difficult budget year, at least they've created a plan of which they say, "We're not going to be able to fulfill our plan this year," but they have a plan.

And I just don't necessarily know if I like just saying all we want to recommend is they'll throw a billion dollars in the pot this year, but never really be forced to address a long-term strategy to reduce that overall obligation. And I think in this recommendation, we could do that and be a little more aggressive than that.

CHAIR PARSKY: Well, I'll let Tom comment a little bit. But I do think it's important to separate out the concept of prefunding to deal with future obligations; to create, in effect, a reserve, the earnings of which and the reserve are intended to deal with future obligations, which at this stage is not happening; and the obligations that are currently in the budget, to deal with the current obligations or not.

And so I think -- I think what Mike was saying was, there was 2.6 billion -- repeat again what was provided.

MS. SHEEHAN: Yes, the 1.3 is the ongoing pay-as-you-go. And then if we were to fully fund --

CHAIR PARSKY: Could you speak into the mike a little bit, Anne?

MS. SHEEHAN: If you were to fully fund, you know, the whole cost, the accrued, you know, on a 30-year amortization, it would go up to about 3.6, if you put the two together.

I think what Mike was trying to do is separate out the accrued liability to stop the bleeding going forward --

CHAIR PARSKY: Right.

MS. SHEEHAN: -- is what his idea was.

And so one of them was new employees going forward or --

CHAIR PARSKY: Current.

MS. SHEEHAN: -- new service for current employees. There are various ways to sort of break that out. And I think that is what he is struggling with, as to how we could, in his words, stop the bleeding going forward.

CHAIR PARSKY: John?

MR. COGAN: As I recall, I had some objections to this.

CHAIR PARSKY: You did, you did. Stay with your interpretation of this.

MR. COGAN: I'm worried about the track that we're going on here. I mean, it seems to me that the Genest recommendation amounts to this Commission coming out after highlighting the size of the State liabilities for health care, and then coming out with a recommendation that the State should do nothing about the $47 billion health-care liability. That's kind of silly, and I think we'd embarrass ourselves if we did that. That's why I was so strong in my concerns about it.

And so I'm not sure I think it's a good road to go down here to tell the state that it should only prevent increases in this liability. I think we need to go further.

CHAIR PARSKY: And consistent with that, though, you think a reference to specific amounts are not appropriate?

MR. COGAN: It's a bad idea. I think it’s a bad idea, yes.

CHAIR PARSKY: Okay.

Bob?

MR. WALTON: Yes, going back.

I think the words, Mr. Chairman, you used, and Mr. Pringle suggested, of recommending that each employer address it, have a plan and -- the words you used -- should begin and have, in a meaningful way pay for this obligation, without putting dollar amounts. Because I think some of the concerns -- once you put a dollar amount out there, it becomes a target. Whether it's the right target or not, no one will care. And they think, "Well, if we put this which in, that's okay." Well, it may not be.

And I think each employer should address this, that it has to do with their budget priorities and everything else. That's just a natural course of action that every political body has to address. But, again, I think this Commission's task is to charge employers to: You've got to recognize this and you've got to have a plan to address it.

CHAIR PARSKY: I think -- oh, sorry.

We're going around this way. I'm sorry.

MR. HARD: Yes, I don't agree with Number 2 because I don't see -- first of all, it's inconsistent with Number 3. And I'm not sure why the State of California, as an entity, doesn't consider these issues in Number 3 rather than it's simply supposed to start funding. And both the Department of Finance and, of course, the Legislative Analyst’s office have endorsed prefunding, but not necessarily immediate or full prefunding.

And if you went to the $2.59 billion, that's a 90 percent increase in, you know, that particular line-item cost.

And I don't know why this Commission would put that, or $500 million or a billion as specific as the budget priority, even though I think I agree with Curt and others and Bob about that this is about fixing this problem estimate but, you know, we've looked into a whole lot of historical information, health care, the cost, prefunding of annuities and all that. And so we're looking at these things broadly.

And it seems to me that the third statement makes a lot more sense for including the State of California at the front of that, and local public employers should identify the prefunding options; because I think people said that the Legislature and the Governor are going to have to figure this out.

So I object to this, the way this Number 2 is written, because it's inconsistent with 3. It doesn't say the rest of this -- the stuff they should go into.

I think it's helpful to have, you know, those pieces of the analysis laid out for the State also.

CHAIR PARSKY: Well, again, I think if we moved away from a specific recommendation on an amount, then I think what people ought to think about is, you know, kind of consistent with what John was saying, that if, in the other part of our report, we identify at least a range of obligations, of liabilities that exist that are of the magnitude that we've been hearing, and then not come forward with a statement that directs, or at least recommends to the policymakers that this is a significant issue that should not be postponed, that something should start now, I think that we will be hard-pressed to have carried out our function.

It's not that -- I think people are saying that the specifics are something that -- in terms of whether it should be 500 million and how it should be done. But the concept of having a plan, I think that concept is an important one to deal with this. I think we ought to think carefully about not really coming forward in a strong way about urging the State to begin now.

Lee?

MR. LIPPS: Excuse me. So we are going to have the local entities -- cities, counties, everything -- figure it out in terms of Number 2 to identify prefunding options and determine the strategy as appropriate, but not the State of California.

CHAIR PARSKY: Well, no --

MR. HARD: I think we are all –- I think it would be absurd for us not to propose something serious about all these government entities, including the State of California. But I don't understand the difference here, given that each entity has different politics, different tax bases and all that.

So I'm not objecting to prefunding, because I think that's the thing to do in the ideal. And I think the State should do that, too.

But I don't get this, and I don't agree with it.

CHAIR PARSKY: Well, maybe I can help you a little bit here.

The concept of -- that maybe was elaborated a little bit more on Number 3, and let's hold on discussing 3. Maybe it should be incorporated into 2 as well. It's not that we're trying to tell the specifics of how; it's more that we're trying to direct them to do something now with respect to this concept. And maybe that could assuage some of your concerns because it would apply both at the state level and the local level.

Lee?

Don't comment on Recommendation 3 yet. We're getting to it.

MR. LIPPS: Originally, I was going to ask Tom for just a couple of points of clarification.

CHAIR PARSKY: Go right ahead.

MR. LIPPS: And after this last discussion, basically those were -- now, I'm really confused.

Tom, is Number 2 only intended -- it was my assumption -- let me put it this way: That Number 2 was intended to apply to the State of California for its retirees from its systems that were entitled to OPEB benefits?

MR. BRANAN: That was our intention while we were doing it.

MR. LIPPS: So this wouldn't apply -- it's not intended, at least initially, to apply to giving some sort of direction to local entities? We're just talking about basically that $1.36 million that's a pay-go -- that those employees alone, not the other --

MR. BRANAN: We see local agencies under Number 3.

MR. LIPPS: Under Number 3? Okay, that's --

MR. BRANAN: That's correct.

MR. LIPPS: I just wanted to clarify that.

Okay, so I'm not sure where the local entities came into this; but suddenly, I got confused at the end of this last exchange.

CHAIR PARSKY: It was just meant, I think –- it was meant to indicate that we were suggesting to the local entities that they take into account a number of factors in doing certain things. We seem to be a little bit more rigid in our approach to the State. And all I was saying is, we can massage the third sentence of Recommendation 2, to acknowledge that there are some things that need to be taken into account that we'll leave to the policymakers, without -- or at the same time, making a very strong statement about that it should happen now.

MR. LIPPS: Okay.

With a couple of caveats -- and I'm going to ask Matt to grip the arms of his chair -- I'm going to agree entirely with Matt and his amendment.

CHAIR PARSKY: Really?

MR. LIPPS: If it's just simply -- yes, I am. Yes, I am.

If it's just simply said -- but I need to get some caveats -- if it just simply said that, “The State of California should establish prefunding, and the specifics of this commitment should be negotiated between the Governor and the Legislature,” I can agree with that.

I don't think specific dollar amounts should be put in there, and I don't think that it should be any stronger than that.

The caveats that I would raise at this point is that we center to -- and, again, it's sort of the world that a lot of us in this room live in, is that -- let me back up.

One of the things I recall Mr. Genest saying about beginning prefunding, was that this would be a good thing to do given the current state of the budget with the 6 to 8 billion deficit, I don't think we can start it right away.

If the decision is made to begin prefunding, the State has to take the money, get the money somewhere else.

Typically, as Dave mentioned, some of the places they take it are out of social services; but the other places that they take money from are away from counties by not funding or shifting money in counties; or Curt's two favorite numbers -- or one favorite number -- Proposition 98. The pressure to suspend Proposition 98, should we have to -- should the state decide -- pardon me?

MR. PRINGLE: How did I get in your discussion?

MR. LIPPS: Well, it looked like you were falling asleep there.

MR. PRINGLE: I am.

MR. LIPPS: The temptation or the pressure to suspend Proposition 98 would become fairly strong, and it has been in the past, and it has been suspended twice in the past. But if Proposition 98 gets suspended as a result of implementation of particularly these specific dollar amounts in the amount of a billion, it has the same effect as reducing or requiring local education agencies also to begin prefunding to the detriment of its educational program.

CHAIR PARSKY: Teresa?

DR. GHILARDUCCI: Tom or Gerry, I'd like to know your motives for treating the State and the local agencies differently? You know, what was the point there? Is it because we, as a commission, have a special role to say something to the Governor and to the Legislature, and we just feel politically we are a little more removed from the other entities? Or is it because we've made a judgment that the State can afford it and the other entities can't? I would like to know what's in that motive.

And then also there must be some good sense in the actual number. Did you say, "Look, a good principle, because we have that principle in pensions, is that we fund the ongoing normal cost"? And that makes sense. If we're making a promise today on a going-forward basis, we should at least pay for that promise, well, that's a principle. But you haven't asked that the Legislature fund the full normal cost.

Did you have it? And was that a political decision, that somehow asking for the full normal cost funding is just too much?

So I'd like to know -- before I throw it out, I'd like to know if there were good reasons for having it. What were some of the hidden motives?

CHAIR PARSKY: Tom, why don't you start with your motives, and then I'll go into my motives?

MR. BRANAN: Let's see, I think there was a first question there.

DR. GHILARDUCCI: Yes, why the asymmetric treatment?

MR. BRANAN: Okay. That was intentional. This Commission was established by the Governor and the Legislature. We feel that, given that, that this Commission can, if not mandate, then strongly recommend that the State do something.

Traditionally in this state, that is often not the case with local governments, especially in the area of benefits. So there was a conscious decision to do that.

And then getting to the question of the number, first, I'd like to say why there is a number at all. And that comes from the experience, as the Chairman has pointed out, some of our elected officials in Sacramento do not take the long-term view. And these kinds of things, if left general, can just be pushed off and pushed off.

A case in point was last year, which probably nobody then thought was a good budget year, but compared to now begins to look like it. The Legislative Analyst said about a possible surplus, that some of the surplus should be put against the State's unfunded health-care liability, and nothing was done.

So we did intentionally take a large number, with the idea of putting it out there and putting some dollars into the mix in Sacramento.

As to why the particular numbers were chosen, with hindsight, we probably should have used the full $1.23 billion --

CHAIR PARSKY: Right.

MR. BRANAN: -- that was in the GRS report. We are guilty of rounding.

CHAIR PARSKY: Tom has expressed my motives.

DR. GHILARDUCCI: Okay. You've answered my question.

CHAIR PARSKY: Paul?

MR. CAPPITELLI: The only thing I would add is I, too, I'm a little uncomfortable with specific numbers in this recommendation.

But I think that we know, because we've been here listening to testimony, we know the genesis of where this recommendation comes from and how we came to conclude that it should be a certain dollar amount.

Maybe there needs to be some wording in here towards the end that talks about not only the Governor and the Legislature, but with specific recommendations from the Department of Finance. Because I know that's somewhat assumed but, really, that's where derive our estimates from; and then let that be something that can be determined later.

But I concur that this should be a pretty strong statement because this is a big price tag, and that's one of the main reasons why we're here. So I don't think we should water it down.

CHAIR PARSKY: Curt?

MR. PRINGLE: I was just asking, when you said $1.23 billion, isn't it $2.23 billion?

MR. BRANAN: Well, the State is paying and it's going to pay $1.36 billion for its existing. That's pay-as-you-go.

MR. PRINGLE: That's pay-as-you-go? Right.

MR. BRANAN: And then if you take -- no, you're right --

DR. GHILARDUCCI: What's the normal -- the normal cost is 2.3?

CHAIR PARSKY: I think it’s 2.3.

MR. PRINGLE: So just state that, Tom, what you're reading right there.

MR. BRANAN: “Under its current pay-go approach, it's estimated the State will pay $1.36 billion for health care for its retired employees in fiscal year '07-08. It will also accrue an additional $2.23 billion unfunded liability for the future cost of health benefits earned during '07-08, bringing the total cost of those benefits to $3.59 billion.”

MR. PRINGLE: So we're not talking about the $1.36 billion, we're talking about towards the $2.23 and infinity and beyond. In other words, to the $47 billion of the total unfunded obligation. That's what we're referencing in the $500 million range; right?

CHAIR PARSKY: Well, and I think that was the reason for my comment. It wasn't clear enough. But this was supposed to be additive –

DR. GHILARDUCCI: Right.

CHAIR PARSKY: -- to what the 1.3 was, which is assumed to be included.

MR. PRINGLE: Therefore, I would –- I mean --

MR. BRANAN: If I could clarify.

CHAIR PARSKY: I'm sorry, Tom?

MR. BRANAN: I do need to clarify. The $3.59 billion is if the State continued on pay-as-you-go.

DR. GHILARDUCCI: Right.

MR. PRINGLE: Well, if we continued on pay-as-you-go and the State chose to pay its full obligation for the '07-08 year, that $2.23 billion would otherwise not be paid. I mean, for example, this year, we only paid that first component, right, the $1.36 billion.

MR. BRANAN: Correct.

MR. PRINGLE: We did not pay the --

DR. GHILARDUCCI: Normal cost.

MR. PRINGLE: -- the normal cost, the additional obligation that's being accrued in this year for obligations; right?

DR. GHILARDUCCI: And you want to say you want to do that?

MR. BRANAN: Yes. And according to the GRS report, if the State began prefunding this coming budget year, the payment this year would go from $1.36 billion to $2.59 billion, but there would be no accrued unfunded liability.

MR. PRINGLE: And, Mr. Chairman, if we're going -- I would like to see us state boldly why we are doing certain things. And if one of the things we're stating boldly in this recommendation is the State should not allow future budget years to accumulate obligation, therefore, we recommend that they pay that full obligation this year, and if they don't, explain why, give them an out. Say, that the State Legislature and the Governor have chosen not to because of limitations on fiscal issues. But at least forcing that in this discussion, that this is what we are recommending, the full amount of that obligation, the normal costs be paid. And if it's not, and the Governor and the Legislature shall negotiate how to do it; and if they can't, they --

CHAIR PARSKY: Should explain.

MR. PRINGLE: -- should explain why.

Additionally, though, Mr. Chairman, I do think that I really do hear, and I totally support the fact that we should force the State to take the same action as the local governments, and state under 3, when we get there, that the State and local governments should be required to make this plan of payment, or at least plan or prepare for it. So I'd like to see if there's any interest in taking those recommendations.

CHAIR PARSKY: John?

MR. COGAN: Curt, I have a question.

Forgetting the numbers, putting the numbers aside for the moment, are you saying that your view is that the Commission should make a recommendation to the State that it fund the additional liabilities, and only the additional liabilities that will be accrued each year? Or that it should also begin paying down the liability that's been accrued to date, the $47 billion?

MR. PRINGLE: My hope was not to put myself in front of you as Mike Genest did. And, in fact --

CHAIR PARSKY: Well, you are.

MR. PRINGLE: -- on Recommendation 2, state we should stop the bleeding.

CHAIR PARSKY: Right.

MR. PRINGLE: And on Recommendation 3, state, the State and will local government should prepare a plan to address and pay that complete unfunded liability.

And that's not us writing that recommendation, it's forcing the Legislature and the Governor to figure that out; but, in fact, recommending that we should not be adding to that obligation and the State should not be adding to that obligation.

“Stopping the bleeding” is a good reference, I think.

MR. COGAN: Yes, yes.

And I would just say, I prefer us to go farther, if we could. That is, the State -- the goal of fiscal policy for the State should be to also begin to reduce the unfunded liability that's been accrued to date.

DR. GHILARDUCCI: Let me just clarify, John. That would mean that this number would be the normal cost, plus some number that represents an amortization of past liability.

And do we even want to say how long that amortization period should be? I mean, I thought that's what we were hearing.

MR. BRANAN: Mr. Chairman, I think there's a misconception here. The amounts that we're talking about do amortize existing liability. That is part of the GRS recommendation.

MR. COGAN: Tom, I'm not sure that this is what the paragraph says, though. That's why I said, let's put numbers aside for the moment, and the Commission should think about the policy.

CHAIR PARSKY: The policy.

MR. COGAN: Right, as opposed to the specific numbers.

CHAIR PARSKY: And so why don't you articulate what the intent was of the recommendation, then we can change the words around between now and the final report.

MR. BRANAN: Well, the intent of the recommendation, if we could have everything that we want to, was that the state --

CHAIR PARSKY: Let's just start there.

MR. BRANAN: We will start there -- that the State begin prefunding in compliance with what I think was Scenario Number 3 in the GRS actuarial report.

The first scenario was pay-as-you-go, the second one was about 50 percent prefunding, and the last scenario where these numbers were generated is full prefunding, and that does include the existing liability.

CHAIR PARSKY: So, again, then you have to change the language of the recommendation to reflect that, if that's what your choice is.

Because it's not that the language wouldn't support that, it's just not detailed enough to incorporate that.

Bob?

MR. WALTON: Thank you. I think I agree with John. I like the words in the recommendation rather than the numbers, referring to the GRS report.

And I think about -- I hate to get back to discussing the order of these, but I do think it would make some sense, actually, that in Recommendation 3, start with that, and include the State and local employers should do all these things.

Furthermore, the State specifically should do more. And I think the State should be called out separately. One, it's the biggest kid on the block. It's probably equal to all the local employers combined, the liability. At least that was preliminary numbers that would suggest that. And we know more about it. We have the report. We have specifics about the State. We don't have that for every local employer, so I don't think we're in a position to make specific recommendations about every local employer.

But I think that order, including the State and local government should identify, should have a plan, et cetera, et cetera. And, further, the State should do these specific actions. That, I think, makes sense to me.

CHAIR PARSKY: That sounds like a positive recommendation.

Matt?

MR. BARGER: Then it will be Lee's turn to hold onto his chair. He may topple over backwards at this point.

The only disconnect I see in all this is, in some sense, there is a sense of a mandate, is too strong of a word, but a recommendation that all these local districts -- counties, et cetera -- put aside money that they currently are not putting aside, even though they should be, they're generating costs and being sort of totally quiet on the fact of where exactly is that supposed to come from. And that, I think, gets back a little bit to, I think, Bob's point about, you know, the State is the big boy in this and should be setting an example, and also should be conscious of what it is that we're saying in terms of the implications for cities and counties and school districts and all the rest of it. I mean, it's something they have to be conscious of. They can't just sort of float above and think only about the State.

So I don't know quite how to put that into --

CHAIR PARSKY: Well, maybe -- let me suggest we move to Recommendation 3, because we may be able to pull it back together.

Why don't we move to Recommendation 3, and eliminate the word "local" as the first word of the recommendation, and then proceed ahead with it?

MR. BRANAN: Number 3, "Public employers should identify prefunding options and determine if such a strategy is appropriate, given their plan design, available assets, and anticipated future liabilities. If a public employer does not establish a prefunding strategy, it should clearly identify an alternative approach to address its OPEB liabilities."

CHAIR PARSKY: And let's consider that to be Recommendation 1. And not that the order there is necessarily meaningful.

Let's comment about that in light of -- and we may want to incorporate the word "plan," or some -- to satisfy it. And again, this is not an attempt to -- I think we will be walking into unpleasant waters if we water down this whole approach to prefunding.

So I think clear consensus of the Commission, is that this is certainly at the heart of what we want to recommend. And it's consistent, I think, with what everyone wants.

So this is not an attempt to do that, and we want to be careful about how it would be interpreted.

But the sense out of the discussion on the first two recommendations is that we should acknowledge the fact that plans need to be developed, and we may want to say "be developed to deal with the existing obligations that have been created and the unfunded liabilities." But I was just taking a sense of what everyone was saying.

Why don't we comment on Recommendation 3 in that context? Not changing what one may say based on what we heard or what it may say based on what we heard.

So let's start around.

Paul?

MR. CAPPITELLI: Yes, as with the recommended changes that you suggested and with what Tom inserted when he read it, I think that works for me. I think it's a good segue into everything else and it really just kind of sets the groundwork.

CHAIR PARSKY: Lee?

Are we losing Tom?

MS. BOEL: He’ll be back. Tom said he'll come back.

CHAIR PARSKY: You've driven Tom out of here?

MS. BOEL: He’ll be back. He needs to make a quick stop.

CHAIR PARSKY: Okay, I'm sorry, keep going.

Stephanie will help out.

MR. LIPPS: I concur with this recommendation as amended.

CHAIR PARSKY: Okay.

MR. LIPPS: Just changing the word "local" to "public employers."

CHAIR PARSKY: In two spots.

MR. LIPPS: In two spots, and the rest of it unchanged, I don't have any problem with it.

CHAIR PARSKY: Yes, Jim?

MR. HARD: It makes sense to me.

CHAIR PARSKY: Curt?

MR. PRINGLE: Well, I would just -- I actually think it would be good to state -- to start off, “The State and local government employers should," and articulate that we are focusing on both.

Also, do we really want to use the word "option" in the first line? “The State and local government employers should identify a prefunding strategy, a prefunding plan," as opposed to just letting them off the hook and kind of vetting through a variety of options of which they have not identified with their specific option, maybe? Allow them to come up with something that -- you know, we're not saying you can never change it, you can't modify it, but at least come up with a plan that fits your government and your entity?

I feel then, at least, we're asking them to do something, and to consider all those other elements of that, but at least be able to say, "Okay, this is how we want to approach our obligation." And if they wish to change it later, they can. But they at least will be forced to contemplate what their strategy is.

CHAIR PARSKY: Lee, does that affect your support of the recommendation?

MR. LIPPS: Yes, because what the language says is that "The public employers should identify prefunding options."

CHAIR PARSKY: Options.

MR. LIPPS: So they're being told to do something.

If you wanted to prefund -- let's not get into the state of pre-decision-making. Take all the options you have for prefunding. Parcel tax, diverting money out of the general fund, an OPEB bond -- whatever other options, and take a look at them all, and see if you can find one that works for you. Then it says, "If you choose not to prefund," then you have to take another affirmative action, and that is to say, "The public agency then has to clearly identify an alternate approach to addressing its OPEB liabilities."

So I see them being told to do very specific things, identifying a series of options, as many as they're creative enough to come up with, deciding whether or not one of them will work for them short-term.

MR. PRINGLE: Well, wait a minute. That's the one part I don't see it requiring. And, you know, all I would like to do -- if we want to identify prefunding options, determine a preferred strategy, and see if such strategy is appropriate. In other words, just at some point in time pinpoint one strategy, not explore all options. So, I mean, I think we are saying the same thing. Let's look at every option, but then settle on something as a preferred option, and then go through the rest of that.

MR. LIPPS: See if it's -- well, I think those are all intertwined.

MR. PRINGLE: I guess I just want to make sure you come up with some preferred option or strategy for your entity, and then vet it through the rest of that recommendation.

CHAIR PARSKY: We'll work on the language.

John?

MR. COGAN: I like the idea of 3 as it's written, with the modifications that have been proposed.

CHAIR PARSKY: Dave?

MR. LOW: I agree.

CHAIR PARSKY: You’re okay?

Bob?

MR. WALTON: Same. Agreed.

CHAIR PARSKY: Connie?

MS. CONWAY: Yes.

CHAIR PARSKY: Matt?

MR. BARGER: One other thing I would add is I think for anybody who's getting a rating, it's something you have to do regardless over the next few years, anyhow. So this is something that's going to happen because I think that's part of the testimony of what the rating agencies are looking for.

MR. COGAN: You have a lot more confidence in the rating agencies.

MR. WALTON: We don't want to go there.

CHAIR PARSKY: Okay, let's move to Recommendation number 4.

MR. BRANAN: Number 4, "Any employer considering the use of OPEB bonds should fully understand the potential problems they bring, such as shifting costs to future generations, converting future estimated OPEB liabilities into fixed indebtedness and the uncertainty concerning continued federal cost-sharing for debt service on such a bond."

CHAIR PARSKY: I would just add one thing before we open the discussion. After the word "understand," I would suggest we consider "and make public," the words "and make public," so that the public is aware of all this. But that's just an editing comment.

Let's start -- Matt?

MR. BARGER: I tend to walk into this with a fair degree of skepticism about OPEB bonds. And my first question would be why we're even commenting on them at all. So my first question is, do we need this recommendation at all?

CHAIR PARSKY: That may be the consensus here. However, I think there is some concern about that this solution, which is a solution policymakers may instinctively go to, isn't fiscally responsible, let's put it this way, or is not as fiscally responsible as prefunding. So it's an acknowledgment that this is a direction that policymakers may take because they feel that this is a way around having to make current priority choices.

MR. BARGER: Well, I mean, if that were the case, I would probably lengthen it and, you know, include the factors we identify. So that statement alone, I have a problem with.

CHAIR PARSKY: Well, we can come back around to how much meat we should put on it, or whether we should have it.

For one, I have watched policymakers using the bonding approach as a solution to really dealing with fiscal prudence on budgeting. And so that's the reason it was at least out here for discussion.

MR. BRANAN: Mr. Chairman, to expand on that; we felt we had to discuss it because it is out there, it's being discussed among public agencies as an option. And, in fact, two such agencies have addressed this Commission. So we didn't think it was something that could be ignored.

CHAIR PARSKY: Connie?

MS. CONWAY: Well, from a local perspective, probably I think it's language that local governments would agree with and would want there, I'd kind of like to make public; and with the caveat, though -- I'm kind of wordy -- that because every agency that I know that's really in trouble, you keep hearing about the ones that are on the verge of -- on this, they're all bonded and they're doing even -- I mean, they're doing so much, that that's why they're in trouble.

CHAIR PARSKY: Bob?

MR. WALTON: I see this a little bit differently. I think this recommendation is entirely negative. And I think there could be agencies out there that feel that OPEB bonds are the right way to start or not fully prefund their OPEB liability. And I think that's their choice.

And I think we should address the issue because it is out there. And I think the words "fully understand and make public" is good; but I think it shouldn't be entirely negative. There are reasons -- good reasons -- why OPEB bonds are the appropriate vehicle.

The interest arbitrage issue, the cost-efficiency, possibly. The emphasis on the negative is fine with me, but I think it ought to be at least somewhat balanced.

CHAIR PARSKY: Okay.

MR. COTTINGHAM: I actually concur with Mr. Walton that said -- I mean, I think what we've heard in testimony is that OPEB bonds can be a very dangerous way to go for an entity, but it is their own decision. And I think as long as we throw the proper cautionary statements in there, we aren't saying they can't do it, but we're saying that if it is a direction they're going to go, they should be fully aware of the downside.

CHAIR PARSKY: Exactly.

Dave?

MR. LOW: Yes, I would agree with that. And I do think it's important, because I can tell you that as soon as GASB began taking effect, those organizations that were selling OPEB bonds began to market them very aggressively. So they go into the school superintendent’s office and say, "This is the way you need to do this." So I think it's important for this Commission to address issues. Because if we ignore it, then what we do is leave those people sort of at the -- you know, without information. And I think it's important that we make a recommendation. I think it's important that we balance it.

My personal bias is that, for them, they're not very effective, and I think that we should articulate those reasons why we think that they have problems.

CHAIR PARSKY: John?

MR. COGAN: I share Matt and Dave's skepticism about these OPEB bonds. Yet Bob makes a very good point. I mean, there are circumstances under which an OPEB bond can be a good thing. And so maybe something like, you know, inserting as a parenthetical to begin this recommendation something like, "While OPEB bonds can be an appropriate vehicle, any employer considering the use of OPEB bonds should fully understand the potential limitations of the problems they bring," boom, and then we go into those limitations and problems.

It does seem to me that when I think of the dangers, one of the biggest dangers I see in these OPEB bonds is that they enable politicians to stand up and say we're funding our health-care retiree benefits or our retiree benefits when all they're doing is shifting the liabilities around, so that they appear somewhere else on the budget; and so they mask what they're really doing. And that, to me, is dangerous. So I'd like to have a little discussion somehow in this of that sort of fundamental problem that we see not only in governments, but we see in private industry.

CHAIR PARSKY: Yes, Curt?

MR. PRINGLE: I'm okay. {}

CHAIR PARSKY: You're okay?

Lee?

MR. LIPPS: I sort of want to agree with John, in that, you know, the --

CHAIR PARSKY: Be careful in “sort of agreeing with John.” Be careful now.

MR. LIPPS: No, I understand.

If we wanted to say that OPEB bonds under certain circumstances -- or OPEB bonds might be an appropriate vehicle if you wish to risk the fiscal health of your public agency on arbitrage and the current stability --

CHAIR PARSKY: That's good, we like that.

MR. LIPPS: -- and the current stability of the market.

CHAIR PARSKY: That's good.

MR. LIPPS: Originally, I thought that Number 4 was superfluous to what was contained in Number 3. I see that as an option that can be considered.

But Matthew, once again, persuades me, and along with what Dave said. As soon as the rumors about GASB 45 and what it's going to entail might contain, there were a number of firms that began aggressively marketing bonds; and some districts that either went ahead and began purchasing bonds or are currently considering to do so because it is an easy way out for them.

And I've got to tell you, I like the idea of making it public, but I've never heard a school district business official that couldn't present all the good reasons for doing something, even though there were nothing but bad reasons, whether it was to engage in certificates of participation or bonds or what have you.

So I like it with the amendment of "make public." I don't think it's still strong enough, but I can go with the current language and "make public."

CHAIR PARSKY: Teresa?

DR. GHILARDUCCI: Yes, this made me smile because I thought why don't we just say we don't like them? Because we're going to shift costs -- we're going to eat our children and do all sorts of bad things.

It is important for this language to be here. You might remember that we were even marketed to, that we had people who wanted to sell those things come to us. And so it is important -- I would like to hear what the language would be balancing, to recognize that they're -- we didn't get any testimony about when they were a good idea, but there probably is circumstances where they are. I'd like to see that language.

But I also want to point out that when we say that the reasons for doing them should be made public, we're actually implying that we have some idea about how those reasons should be reported. So when we say we want the officials to make public that they're shifting the burden to future generations, that's kind of empty. We're not saying how we want that to be reported.

So we might want to explore -- I mean, Professor Shoven's testimony, to see if he had any recommendations, how we actually quantify or make public the risks rather than just kind of an empty but negative statement, that we're shifting it to future generations.

CHAIR PARSKY: Okay, yes, Paul.

MR. CAPPITELLI: The only thing I would add is, I think we demonstrate our bias if we use the word "problems." I think that word might be replaced by the word "risk" or "risks" or something of that nature. But

I think if we use the word "problems," right away that somehow suggests that a big, red flag from this group.

DR. GHILARDUCCI: We want to do that? Yes.

MR. CAPPITELLI: Well, I think we need to -- in deference to those entities that feel that this is a viable way, we don't want to throw them into a tailspin with their policymakers, et cetera. We want to make a statement. And our statement, I believe, should be if you're going to do this, you need to know that these are the risks associated with that.

But if we word it in such a way that it comes across that we're saying, "Don't do it," then I think we run the risk for those entities that have already done it, that they go into this, you know, with consternation; and I don't think that's really what we want to try to create with this recommendation.

CHAIR PARSKY: Again, I think the motivation behind this was not to mandate that it shouldn't be done; and so I think an introductory clause along the lines of what John suggested seems appropriate; but, rather, that if it's a policy chosen, that the public ought to understand -- in shorthand, we'd have to elaborate on that, that it doesn't solve the problem. The amount of benefit that you get from the potential arbitrage, which people may argue may not be real at all. The arbitrage may not exist. That's a small benefit, if you will, to addressing the underlying problem, which is how you're going to make sure that these obligations in the future can be met.

Bob?

MR. WALTON: I like the term "risk" rather than "problem," but I like the wording that John used, although it's not necessarily equally balanced.

Putting in wording that, "While it may be appropriate in a limited number or certain circumstances, there are risks and here's what they are," I think that's fine.

CHAIR PARSKY: Okay, with that, I think that the staff is very clear on how we will come out with these recommendations unnumbered, and we'll just have to go to work on them and come back to this group.

Okay, let's move -- do you have any other clarifications you'd like?

MR. BRANAN: Oh, no, it's all crystal clear.

But we do have a problem with --

CHAIR PARSKY: I'm sorry.

MR. BRANAN: -- our tax attorney, who is going to help you with the various tax proposals, has to be in San Francisco by 1:30. And I was wondering if we might -- we would need to take them up next. I was wondering if we might look at, are there some of the proposals to which there is no opposition?

CHAIR PARSKY: Okay.

I just want to ask our reporter, are you okay or would you like a break?

THE COURT REPORTER: I'm fine. Thanks.

CHAIR PARSKY: All right. Let's see about that subject.

The recommendations in the tax area, which have been circulated -- where's our tax advisor?

MR. BRANAN: There he is.

CHAIR PARSKY: The tax recommendations -- let's just focus on Recommendations 1 through 6. There are six recommendations that involve basically communications to the IRS.

Is that right, Tom?

MR. BRANAN: That's correct.

CHAIR PARSKY: These are communications to the IRS with respect to Recommendations 1, 2, and 3 and 5 and 6. We'll come back to 4.

Let's take them one at a time and just see if there's any objection or concerns about them.

And, obviously, the commissioners will have an opportunity to consider these at more length, but just to see if we have any questions of our tax expert.

So Recommendation 1, which has to do with investment assets used to fund retirement health benefits, it's an urging of the IRS -- and I don't have to read it all.

Any thoughts or any questions for the moment? And we'll have an opportunity to come back. Any questions of our tax advisor on that?

(No response)

CHAIR PARSKY: Any comments our tax advisor would like to make on that, given his time constraints?

MR. BLUM: First, I appreciate very much your taking us out of order.

CHAIR PARSKY: That's okay.

MR. BLUM: Second, I do think that there are two fundamental principles here with all of these recommendations.

One of them is that the Revenue Service, in administering sound federal tax policy, should not interfere with sound retiree health and pension policy. And a number of the things that they are doing, in fact, do interfere with very sound policy that the state and local agencies with collective bargaining are doing or are engaged in.

And the other principle is that, again, to the extent that it is in accordance with sound federal tax policy, that the Revenue Service should facilitate tax compliance by retirement systems. That's the last recommendation, Recommendation Number 6.

Those are the fundamental principles that these are all based on.

CHAIR PARSKY: And those principles we would want in this section of the report to be stated as an introduction --

MR. BLUM: Yes.

CHAIR PARSKY: -- and then move.

And you would see -- and maybe we want to include this, too -- a specific letter -- or communication, if you will -- in writing to come from this commission, directed to the IRS in the areas you've identified?

MR. BLUM: Exactly, correct.

CHAIR PARSKY: We'll want to make sure we craft that and let all the commissioners see the exact language of it as well.

Yes, John?

MR. COGAN: I think the recommendation makes a lot of sense. But I'm wondering, what would the IRS say? What's their reason why they won't allow now combining of funds?

MR. BLUM: Well, there's history here, and the history starts from at least four decades ago, when there was a narrow view of how the rules ought to work; and there were not financial instruments, and there was not a need to commingle monies.

And so when you start with history, and you start with history with things that are far apart, and then you slowly start to bring them together, there's some inertia. And what we've seen over the last, roughly, ten years is that there's been some change. And there's only change, usually, when people ask for it. And right now, no one has really pushed and asked for it.

MR. COGAN: Great. Thanks.

CHAIR PARSKY: Okay, any other questions on Recommendation 1?

Yes, sorry, Matt?

MR. BARGER: I just have a -- maybe I do like editing, I don't know.

I have an issue with having each one of these be a separate recommendation. It just seems like we're coming up with all these recommendations that many of them are very technical, and it counterbalances sort of the bigger ones we've been talking about to some extent. And I'm wondering whether or not, assuming we come to the conclusion that these are all technical, that there isn’t some sort of recommendation that we have a letter incorporating these sorts of issues, you know, appendixed or something, but not --

CHAIR PARSKY: I think that's probably a valid comment, that I think in the body of the recommendations that come, it ought to be broader, but then have in the appendix a series or maybe group them as a letter that includes the technical recommendations.

Would you say, as a matter of effectiveness, that putting together a series of recommendations in one letter waters down the ability to get any one of them accepted?

MR. BLUM: No. I think you put them all together in one letter.

CHAIR PARSKY: That's probably right then.

I think that as the report gets developed, we're going to want to include in this federal tax issue area something that is broad in terms of a recommendation, commensurate with the other kinds of recommendations, but include a reference to the fact that there's going to be a letter containing the technical aspects of these recommendations. Something like that I think is a very good idea.

Does that seem okay?

Okay. Just so we make sure that there's no further comment on Number 2.

Bob, any comments on Number 2?

MR. BLUM: Well, I think --

CHAIR PARSKY: We have a question here and then we'll come back.

MR. WALTON: Was staff going to present it first?

CHAIR PARSKY: I'm sorry, go ahead.

Do you want to just mention Number 2?

MR. BLUM: Well, personally, I think Number 2 is really critical, because it interferes with substantial collective bargaining that has gone on all up and down the state.

MR. WALTON: My only question is that the statement implies that employer-provided health benefits that are not collectively bargained aren't tax-free; is that correct?

MR. BLUM: That is correct. That's the way the statute reads now. To change that would require a change in the statute. There is a special rule for collectively bargained programs now. And if the Commission wants to recommend to the Congress that there be a change in the statute, that's a different level of recommendation.

These recommendations were designed for the Revenue Service in the context of what it can do administratively. It's much easier to have accepted.

MR. WALTON: Well, it's my understanding, there's many small public employers in California that don't have collectively bargained benefits?

MR. BLUM: I'm not opposed to expanding the recommendation.

MR. WALTON: Okay. I just wanted to make sure of what you were stating.

MR. BLUM: Certainly.

MR. WALTON: Because it doesn't say it here, but you can assume the converse by its inference.

MR. BLUM: That's right.

CHAIR PARSKY: Bob, you're suggesting that we urge the same tax treatment for non-collectively bargained benefits?

MR. WALTON: Well, if, in fact, that's the case -- I could wrong -- but it’s my understanding, there are employers in California, public employers, that aren't subject to collective bargaining. That's my understanding.

CHAIR PARSKY: But the question is, what's the tax treatment?

MR. WALTON: And from what Mr. Blum says, those are taxable. I don't think they're being treated that way today.

MR. BLUM: The Revenue Service --

MR. WALTON: That's the Revenue Service's interpretation.

MR. BLUM: The Revenue Service takes the position that if they're not fully insured and if there is a vesting schedule, that for the highly compensated, that a part or all of the benefits are taxable. That's the Revenue Service position. And, frankly, that position is supported by the statute.

MR. WALTON: So the trigger is whether or not they're fully insured --

MR. BLUM: That's correct.

MR. WALTON: -- as opposed to whether or not they're collectively bargained?

MR. BLUM: It's both collectively bargaining and fully insured. But there is an exception in the statute for collectively bargained programs. And the Revenue Service is not interpreting that in a manner which is consistent across the board. So they have interpreted "collectively bargained programs" in the health and welfare area, and particularly the retiree area, retiree health area, much more harshly than elsewhere. And that's just inappropriate from my perspective.

MR. WALTON: I understand.

CHAIR PARSKY: Dave?

MR. LOW: My understanding is to address Mr. Walton's issue would require statutory change, which would make it consistent with the collectively bargained. And then the IRS opinion would then apply to both, if we were to already have done the statutory change. But if we don’t do the statutory change, then getting an IRS opinion on this issue is irrelevant because it's not the same statute.

MR. BLUM: That is correct.

CHAIR PARSKY: But the recommendation here would be, without the need for statutory change to, in effect, urge the IRS to move away from the position they seem to be taking.

MR. BLUM: That's right. At least deal with the collectively bargained situation.

If the Commission wants to recommend to the Congress the statute be changed, terrific.

CHAIR PARSKY: John?

MR. COGAN: Does the State of California, the Franchise Tax Board, have the same interpretation as the IRS does now? Or --

MR. BLUM: The Revenue and Taxation Code follows the Internal Revenue Code in this area.

MR. COGAN: Now, there's no necessary reason then that we shouldn't have a separate recommendation for the State?

CHAIR PARSKY: Well, they would follow it, naturally, if there was a change at the federal level?

MR. BLUM: Yes, yes.

MR. COGAN: But if the federal government doesn't do anything, and if you think it's a good policy, we should at least have it stay low.

MR. BLUM: In this situation, the Franchise Tax Board effectively just goes along with whatever the Revenue Service does.

MR. COGAN: And they're not statutorily required to go along, or they are?

MR. BLUM: No, they are statutorily required.

MR. COGAN: Required?

MR. BLUM: Right. It actually incorporates the Internal Revenue Code.

MR. PRINGLE: They're statutorily by the state.

MR. BLUM: That's what I'm getting at.

MR. PRINGLE: They're not federal statutes.

MR. COGAN: Right, that's what I'm getting at. If they're statutorily required by the State, it seems to me you get this good reputation that the federal government should implement it; and if the federal government doesn't implement it, it seems to me that we should recommend that the State do so, quite independent of what the federal government does.

I mean, it's nice that the federal government should do something. But if we think it's a good idea for the federal government to change something, we also think it's a good idea for the state to do something even if the federal government didn't, I guess that's my point.

MR. BLUM: I think it works a little differently. If the Feds change, the state changes automatically.

MR. COGAN: I got that.

MR. BLUM: If the Feds don't change, I think it's highly unlikely the State will change.

MR. COGAN: Well, that's asking for a projection about what could happen.

MR. BLUM: Right.

MR. COGAN: It's kind of what should the Commission's preference be, I'm thinking. Yes.

CHAIR PARSKY: Well, it certainly wouldn't be objectionable from your standpoint to have a letter go to the Franchise Tax Board.

MR. BLUM: Correct.

CHAIR PARSKY: Then we should include that.

MR. PRINGLE: But also it all depends upon the hierarchy of this idea. If we want the State to change, we are recommending the State Legislature take action on a variety of other recommendations in our report. So if we want to address this -- I mean, the Franchise Tax Board will respond to state legislation. So we don't necessarily need to have -- and they probably won't drift away from the IRS independently. So if the Feds don't do it, then I think you have to address it by statutory action on the State side.

CHAIR PARSKY: I don't think there would be any objection to including addressing the State as well.

Okay, Recommendation 3.

Any comments, Bob, on this one?

MR. BLUM: Well, recommendations, this is something that's in the process. I actually talked with them last week about it, and they're still working on this. This is still the goal. I think that this is something that could significantly adversely affect public employees, members of retirement systems. It would increase the cost of providing for their own pension benefits, making redeposits or purchasing additional service credit. And I find no basis in the law for the Revenue Service doing this. They just don't like it. It's just an institutional thing. They don't like it.

Well, okay, that's not the law.

CHAIR PARSKY: Any objections here?

MR. COGAN: Can we just get a little bit of background, to give a little color to this issue?

MR. BLUM: Sure, sure. How much color do you want?

CHAIR PARSKY: Just enough so John says it's enough.

MR. BLUM: This is a very special provision for public employees only. It was enacted in ERISA in 1974. In 1974, when ERISA was enacted, someone came to the Congress and said, "Well, you know, you're changing all the rules on employee contributions to pension plans, and you're making them after tax. But look what happens in the public sector. In the public sector, what happens is, they're mandated, members have to put money into retirement systems, and employers,” quote, "’pick up,’" close quote, “these contributions. They should be treated as pretaxed.”

Now, I can tell you that there was substantial confusion at the congressional level as to what that meant and whether it should have happened or should have been enacted. And what happened politically was, there was a special provision put in the Revenue Code to except from taxation, pickup member contributions, because otherwise ERISA would not have passed. It would have been blocked at the congressional level. So it was put into the statute.

I can tell you this because I was in the room when we wrote this thing.

And everybody said, "Well, what is this?"

And we all said, "We don't know, but we're going to write it in, anyway, because we have to, to have the legislation passed."

Since that time, the Revenue Service has interpreted it. And there are, what, since 1974, many years of interpretation. And since, roughly, the early nineties, in hundreds of rulings, the Revenue Service has said that using this section of the Revenue Code, individuals who redeposit -- if you understand what that term means -- redeposit their contributions into a retirement system or who purchase service credit from a retirement system can do it on a pre-tax basis.

In the last three or four years there are people who are in critical positions of the Revenue Service, middle management positions, who have said, "We don't like this." And so they've got a project to cut this out.

And, you know, I've been talking with them about this. And, yes, this project is rolling forward. So I say, "Wait a minute, the law hasn't changed, the statute hasn't changed. This is inappropriate."

MR. COGAN: A very good explanation. Thanks.

This is a good recommendation.

CHAIR PARSKY: We like addressing those middle-level government employees, right.

MR. COGAN: I always wanted to meet somebody who was involved in drafting ERISA law.

MR. BLUM: That's me.

CHAIR PARSKY: And it's still alive and kicking.

MR. BLUM: Right, right. And I could tell you more war stories someday, but not now.

CHAIR PARSKY: Okay, Number 4, comments, Bob?

MR. BLUM: So Number 4 is a product of confusion among three agencies: The Revenue Service, the Department of Labor, and the Pension Benefit Guarantee Corporation, which insures benefits for private-sector employers. They have found that they don't agree on what constitutes a public agency. And this is actually quite important for the regulation from really being excluded from regulation, and from being excluded, on the tax side, from a number of provisions in the Revenue Code that really don't work for public-sector retirement systems.

So for the past couple of years, we've

discovered, really by chance, that these agencies have been talking to each other to try and develop a uniform definition of "public agency."

They don't understand how public agencies work. They really don't. And, roughly, a year ago they were in a position which would have treated as not public agencies fire districts, police districts, water districts, transportation districts -- you can go on and on. It was absolutely bizarre.

They have, as far as I can tell, moved off of that. But what's really gone on is they are trying to figure this out without talking to people in the public sector. And that seems to me to be quite inappropriate.

They will eventually come out with proposed regulations. But once proposed regulations are in stone, they're published in the Federal Register, it is much harder to get them changed to a position of reality than if you can get in to talk to people at the outset before they're published.

In this situation where there is so much at stake for so many smaller public agencies, and to a large extent, that's what we're talking about, it strikes me that that's an inappropriate way of administering the Tax Code. So this is a suggestion they open that process.

CHAIR PARSKY: My only question on this one, I think -- I certainly understand the process of getting into the IRS a strong letter dealing with the other issues. This is in kind of a different category, it seems to me --

MR. BLUM: Yes, that's correct.

CHAIR PARSKY: -- in terms of the effectiveness the Commission can have. I mean, to some extent, I think that the IRS will be put on notice in these other areas.

Here, do you think this could be as effective coming from the Commission?

MR. BRANAN: Could the Commission be one of several?

MR. BLUM: Well, Tom just asked whether the Commission could be one of several. I think the short answer is yes, the Commission should be one of several. And I actually think the Commission could have substantial impact here just opening up that process.

CHAIR PARSKY: Okay.

DR. GHILARDUCCI: May I ask a question?

CHAIR PARSKY: Yes, Teresa?

DR. GHILARDUCCI: What is the PBGC's role in this? Are they trying to define public entities as private entities and requiring premiums for their defined benefit participants? I just don't understand what's at stake.

MR. BLUM: The short answer is yes.

DR. GHILARDUCCI: Really?

MR. BLUM: Sure. If you're on this side of the line and if you’re private sector, you've got to pay the premium.

DR. GHILARDUCCI: Can you give us -- so this is public utilities, special districts? Can you give us an example?

MR. BLUM: Well, what I said was a year ago -- and I was talking with the person who was deeply involved with the group that was developing these regulations, and what I was told -- and I’ll just repeat -- police districts, fire districts, transportation districts, water districts, many, many districts would have been treated not as public entities.

DR. GHILARDUCCI: Oh, but their defined benefit plans would be insured by the PBGC?

MR. BLUM: If you pay the premiums.

DR. GHILARDUCCI: Well, that could be a benefit.

MR. BLUM: Maybe it would and maybe it wouldn't.

DR. GHILARDUCCI: But this is a way for the PBGC to get more premiums?

MR. BLUM: This would be a way for the PBGC to get more premiums.

CHAIR PARSKY: I guess one follow-on question is, do you think this communication would be as effective going -- directed to the PBGC, and maybe the Labor Department, and not necessarily the IRS at this stage?

MR. BLUM: It's a three-agency group.

I think in this situation, that it would be as effective if it went just to the Revenue Service. But if you wanted to add to the PBGC and the Department of Labor, it certainly is not going to hurt, not at all.

CHAIR PARSKY: Okay, well, maybe we want to think -- I just wasn't quite sure where the IRS and the other agencies kind of fit into the process.

And given the mandate of the Commission, where we could be the most effective, I think that's what you may want to think a little bit about on that subject.

Matt?

MR. BARGER: Yes, I think I was headed off maybe in the same direction as you are, but I just wanted to be clear. I can see Number 1 as having a nexus to what we're doing --

CHAIR PARSKY: Right.

MR. BARGER: -- and sort of wander down into 4. It sounds like something that, in a vacuum, I would probably would agree with, but I'm not quite sure what it has to do with this.

CHAIR PARSKY: Or it may be said another way, which of these three entities do you think will carry our recommendation with a stronger obligation, as opposed to in this interagency mess that is going on here?

MR. BLUM: Let's put it this way: The Revenue Service is always the strongest agency among the three.

CHAIR PARSKY: Yes, but I meant a communication from us.

MR. BLUM: I think that the letter you send should be sent to the Commissioner. And I think that if, in fact, you can get the attention of the Commissioner, that really is the issue, that this would be of value sending to the Revenue Service.

CHAIR PARSKY: Number 5?

MR. BLUM: Number 5 looks like it is just focused on domestic partners, and it is not. Number 5 is focused on all of the retirees who receive health care from a public retirement health-care program in California. Because in California, domestic partners must be treated in the same manner as spouses. And the Revenue Service has recently come out with a rule that says, "If health-care benefits are provided to anyone other than a spouse or what's called a tax dependent, a child for whom you are responsible for paying the upbringing costs, if you will, if it's paid to anybody -- anybody, one person within the program, other than a spouse or a tax dependent, then everybody who is covered by that program has taxable health benefits.

Now, the reasons why they did this, you can argue with whether that's sound or not. But that says -- and we have been told this in writing -- that says that if a domestic partner who is not a tax dependent, which is mostly the case -- if a domestic partner who is not a tax dependent receives retiree health-care benefits, that the retiree health-care benefits of all of the people who are in that program are taxable.

Now, the Revenue Service understands that that is truly off the wall, if you will, and so they -- pardon me -- they've worked on this, again, at what's called the "middle-manager level." And they said, "Well, okay, if, in fact, that health care has been paid for as a tax matter, so it comes out, quote, after tax, then that's not a problem. Then people are not taxed. Everybody is not taxed.

The standard way of doing this until recently has been when the domestic partner benefit is paid, it's reported as taxable income and someone pays tax on it, and that's not a problem.

They've said, "No, no, no, that does not work.

What you have to do instead for retirees -- it works for active retirees. It does not work for retiree health care." They say that as the individual employee earns the retiree health-care benefit, you must impute income to that person every year during that person's employment.

And we've said, "Wait a minute, as a practical matter, that just does not work. It's very difficult to figure it what it is. There's all kinds of opportunity for game-playing, there's too much uncertainty going on. How in the world do you do this?" And they kind of say, shrug, “You figure it out.”

It's extremely bad social policy. So put that aside. It's extremely bad tax policy, and it raises extraordinary risk for all kinds of people who are retired in this state. It is not something that is necessary, and it is certainly something that the Revenue Service could change on. And there is good, sound, technical reasons for them to change. But this is one that I think is, again, very important for this Commission.

CHAIR PARSKY: Just to clarify, is the recommendation to not impose the tax, or to impose the tax when the payment is made?

MR. BLUM: The latter, the latter.

I think it would be inappropriate to say, "Not impose the tax." That's what the Tax Code says.

CHAIR PARSKY: Any comments here?

MR. PRINGLE: Thank you, Mr. Chairman.

So I need to probably hear it one more time exactly what is being suggested. And in this case, the individual employee and his or her domestic partner, there would be an obligation to pay the tax on the benefit at the time it's being used; is that how that works?

MR. BLUM: Let me give you an example.

MR. PRINGLE: Yes.

MR. BLUM: So suppose that the retiree health-care benefit for the domestic partner is 400 bucks a month, $4,800 a year. Currently, the way most employers and health plans treat this is when that premium is paid, when the $400 every month is paid for the domestic partner, that's treated as taxable. So the person gets to age 60, retires, the premium is paid, 4,800 bucks for the next year, that's treated as taxable. And that's fine, and people have accepted that.

But now let's assume that we have someone who is age 25, who has a domestic partner and is earning retiree health-care benefits under the program of the public agency. The Revenue Service says, "Okay, you're

25. You have a domestic partner. You will be earning -- you are earning retiree health-care benefits which will be paid to you at some age when you retire, let's take 55, the earliest age usually at retirement, that's 30 years. What we want the agency to figure out is what the value of that will be in 30 years, and we want that agency then to impute to you income.”

Now, there's a couple actuaries out in the audience, one of them I actually talked with about this, "How in the world do you do this?" The actuary would have to figure out some very complex formulas. And ultimately what would go into the W-2 for that 25-year-old is some additional income. Now, that person -- first of all, that's a wild guess.

Second of all, that person may or may not ever have a domestic partner at the time of retirement. You don't pay tax on that at the age of 25. That's the Revenue Service position.

MR. PRINGLE: But at this moment in time, are those calculations being made?

MR. BLUM: We're starting to do them, yes.

MR. PRINGLE: Has this ever been an issue pursued by the IRS?

MR. BLUM: Yes. That's how we got into it.

MR. PRINGLE: In the state of California, it's been an issue pursued by the IRS?

MR. BLUM: Yes.

MR. PRINGLE: And, therefore, has it ever been resolved, in terms of an individual taxpayer's position?

MR. BLUM: No. Well, not to my knowledge, no. It comes to the agency. The agency which is administering the program has got to file W-2's and has got to really be concerned about the taxation or the non-taxation of the benefits for all of its employees.

An agency really should not be taking the risk that all of its employees and all of its retirees could be taxed on this.

MR. PRINGLE: I guess the only issue -- it does sound very absurd what is being sought.

But I guess my question is, where are we in this process? I believe many of these domestic-partner benefits were allowed in the state of California in about -- in 2000. Therefore, if you're suggesting that only recently, that the IRS has come to any point of discussion or challenge on this, and the IRS has yet to formally resolve what they will do with that taxpayer -- they may have sought a certain action but, in fact, we don't know what that outcome is, is this the thing where -- is this something where we need to be involved at this point in time?

I mean, if it is, if this is the law, it's been fully responded to, I think it's worth talking about. But if this isn't, if this is still something in limbo, being pursued through the legal processes, I don't know if it's been resolved on that point for us to be putting it as a highlighted item within our report.

CHAIR PARSKY: Well, I think the reason that the staff has put this forward is the potential impact on all retirees. That's the reason.

MR. PRINGLE: But I haven't heard that -- is that presently then what is -- I thought you said that the IRS has changed from that, and is focusing, singularly, on the individuals and those cases as opposed to focusing on the entire plan or the entire pool?

MR. BLUM: They focus on the entire plan. That's how this case is.

CHAIR PARSKY: That's the reason we're here.

MR. BLUM: Yes. What we're talking about is extremely high risk and the possibility that in any circumstance you could have an audit.

But what is actually happening now is that the public agencies are going to the Revenue Service and asking for rulings on their retiree health-care program. Every one of them comes up.

MR. PRINGLE: Therefore, Mr. Chairman, I don't see how then this recommendation addresses what you've suggested. And if it did, then I think that's a much cleaner way of looking at that.

In fact, not talking exactly about when the benefit should be paid or against when it was earned but, in fact, talking about how this issue should not affect the entire pool. However this is resolved, maybe what we should do is have the Commission urge the IRS on the issue relating to taxes being paid on domestic-partner health benefits, that there should not be a tainting of that pool or the entire pool based upon this question, and allow that question to be resolved.

MR. BLUM: That is an extraordinarily rational suggestion, and it's not the way the Revenue Service works, I'm sorry. I apologize. I would love it if that's the way it was.

MR. PRINGLE: Well, that's fine. But I guess I'm just saying, if someone were to read this, this does not address why this is an issue of this body.

I think if we do address that, it's much more comfortable for everybody to say, "Of course, we should address the future impacts to the entire pool." So if you wish to modify this recommendation to express that, and even get to the specific point of when those taxes -- or how that benefit is to be taxed, that's fine with me.

I am just saying, the recommendation probably needs to vet out more precisely why this should be something we would consider.

CHAIR PARSKY: Sure. And I think you started, Tom, by saying that this recommendation was not just to deal with domestic-partner issues but, rather, to all plan issues.

And I think it needs to be recouched in that way, still getting to the technical recommendation that you want to make.

John?

MR. COGAN: Just to make sure I'm clear on this. The IRS taxing the accrual, if you will, has the practical effect of discouraging employers from accruing benefits to its employees; right?

MR. BLUM: That certainly is one possibility.

MR. COGAN: And so if this Commission likes the idea of employers accruing benefits, retiree health-care benefits for their workers, then we should be against the IRS move to tax these benefits as they accrue --

CHAIR PARSKY: Accrue.

MR. COGAN: -- because we are discouraging employers from adopting a policy that we would support, it seems to me. If we're looking for why this might be good policy for us to engage in, to me, that's a good reason.

CHAIR PARSKY: I think that's a good way to introduce the recommendation.

MR. PRINGLE: And, Mr. Chairman, on that point, then is there any similar circumstance, in addition to domestic partners, that this could be compared to? I mean, is there a similar action to “of age” children who are covered on a plan while they're in school, where they have tax liability and file independently? Is there any --

CHAIR PARSKY: Or said another way, are there any other people or categories? I thought you indicated that. But who are they?

MR. BLUM: We have, in fact, just recently discovered with a client, that one of the categories is stepchildren. And stepchildren don't always fit precisely within these rules, and that could cause similar problems.

CHAIR PARSKY: It clearly should encompass then more.

MR. BLUM: Right.

CHAIR PARSKY: The nature of the recommendation, I think that's a correct comment.

I think it should be couched on the accrual issue, and it should be couched in terms of the potential risk to all plan participants, or all retirees as this policy is evolving, and then get to the specific recommendations.

Okay, Number 6?

MR. BLUM: Number 6 comes in the category of facilitation rather than non-interference. Number 6 is -- and it's a situation where right now most large California retirement systems -- not all but most of them -- do not have a letter from the Revenue Service saying, "We have reviewed your program, and we think it's tax-compliant."

Most private-sector systems have such a letter and regularly get them. I can't give you an exact number, but I'd say it's at least 95 percent.

The reason that we have the difference between the public and the private sector is because the private sector grew up differently again. It's historical.

The public sector started with these retirement systems at least 60 or 70 years ago, they started at a time that people thought that they were part of the government agency. In some respects, they actually were. As a constitutional matter, they were exempt from taxation, but they have diverged. We now have Proposition 162. We have retirement systems that are run by independent boards.

We also had a situation in the early seventies where the Revenue Service basically took hands off of the public-sector systems, and then they came back in. So now, we have a number of very large retirement systems that cover hundreds of thousands of people of public employees in California in an uncertain situation.

Yes, we think they're tax-qualified; but we know if we were really to dig -- and occasionally we do -- that there are some potential problems with the tax-qualified status of those plans.

It's not good for the retirement systems, it's not good for the participants, for the employees and the retirees and, frankly, it's not good for the Revenue Service, because the Revenue Service has no real way of dealing with this.

The Revenue Service has a couple of very good, well-established processes for dealing with issues like that with the private sector. They have a very good understanding of how the private sector works.

They have almost no understanding at all of how the public sector works in its retirement systems. And when we talk with them about coming in and getting an approval letter, and coming in and getting some problems fixed, and getting them fixed in a rational way, frankly, they're not capable of dealing with it. They just are not. Not in a way that makes sense.

So the recommendation to the Revenue Service is, take your existing processes, learn more -- obviously, we would help -- learn more about how the public-sector system works, and develop a process that encourages public retirement systems to come in and to work with you to become tax-compliant in a situation that's safe.

It's not very safe right now for public systems to come to the Revenue Service because they don't know what's going to happen. And so it's catch as catch can.

CHAIR PARSKY: Bob?

MR. WALTON: My comments are more specific to all these recommendations. And I was troubled when I first saw the draft because like I think Matt made an earlier comment, that I'm not sure the weight of the report seems to be focused on tax issues, and which is not the charge of this Commission. And I was troubled by how in depth we're getting into tax issues.

But setting that aside, before this Commission takes any action, final action on these recommendations on tax issues, I would at least like to see input from the retirement systems throughout the state -- CalSTRS, PERS, '37 Act representatives, some of the larger city and county systems, because I don't know that they would agree that these are issues. And I want to find that out because I don't want to be asking questions of the IRS that are systems that we supposedly are trying to help, would agree that there are problems.

I know several of these issues PERS has addressed over the years, and may or may not support the context in which they're being asked.

So I would like to direct staff, if the Chair was so inclined, to request input from these various systems on these specific recommendations. And not necessarily public testimony, but at least input.

CHAIR PARSKY: Right.

MR. WALTON: Have them review them, give us their thoughts on whether they're a good idea or not, and how they should be modified.

CHAIR PARSKY: I think that's a good suggestion. I do not think that this report should be dominated by these technical tax issues at all. But I do think that the Commission can play an important role in bringing about positive changes, provided we're doing it without the objection of some of these -- of the public systems.

So on each of these, we'll ask the staff to confer with respective systems. And if there are objections -- well, I think we'll want the staff to report back on how that is to go.

MR. WALTON: Certainly. And let me just clarify. I'm not necessarily opposed to this Commission, where it’s appropriate, to asking these questions.

CHAIR PARSKY: Right.

MR. WALTON: I think we may be in a better position to do that than individual systems, and I support that. But I want to be clear on the issues that we do address.

CHAIR PARSKY: And I think, Bob, your point of view when you came before us was that you really do believe that this Commission, as it is constituted, can have an effect. This is not a technical letter that the IRS -- covering any number of these is not a technical letter that the IRS would just throw in the wastebasket; that's your view?

MR. BLUM: That is correct.

CHAIR PARSKY: We don't need any letters that they'll throw in the wastebasket.

MR. BLUM: That is correct.

Actually two views. One, that you can absolutely have an effect; and second, that it is much safer -- to use a word that I just did a little bit ago -- much safer for the retirement systems of the state of California for you to bring these issues up than for any particular retirement system to bring them up.

CHAIR PARSKY: Well, that, we certainly can find out.

Okay, let's go on.

The staff added three issues. Whenever you add additional issues, that suggests that these were just add-ons.

Was that not your intention?

MR. BRANAN: Well, in a sense, they were add-ons. They came out of testimony from a local government coalition that addressed the Commission in Fresno. They previously had sent the Commission a letter setting out these items, and then they spoke to you about them. They had several which we did not take. We did take these three, and we've simplified them.

CHAIR PARSKY: Well, let's just focus first with Bob here on Number 2.

MR. BRANAN: To be fair, Mr. Chairman, these did not come from Bob.

CHAIR PARSKY: Oh. Well, then maybe what we do on these -- certainly on Number 2 we'd like to -- he doesn't have to comment on it now, but before we come back, I think he ought to review Number 2, since it's a direct clarification or request of the IRS.

Is this something you're familiar with?

MR. BLUM: Yes, I am. And I can talk with you about it if you want.

Generally, there are a limited number of options under the tax rules to have what we would call a "tax-favored" place to plunk some money, a trust. One that many agencies are interested in, I believe that CalPERS uses it, is a trust under section 115 of the Revenue Code.

The value, fundamental value of section 115 is, there is not a lot of regulation. So it is very open.

The lack of value -- the other side of it is, there's not a lot of guidance in terms of what you have to do to, in fact, have a 115 trust that works.

So a number of agencies will then go to the Revenue Service and ask for a specific ruling -- which is fine, it makes a lot of sense. It costs money and time to do that.

It would, in fact, be useful if the Revenue Service were to issue a general rule, being in the context ordinarily of a revenue ruling, that would set out basic concepts and basic parameters that you have to meet in order to come within section 115. I think that that's what that recommendation is.

CHAIR PARSKY: Once again, I think we want to make sure that we understand the point of view of not just the people that put this forward, but across the board here.

1 and 3, Tom, comments about those, at least as I see 1 and 3.

Recommendation 15 and 17.

MR. BRANAN: Yes, on Recommendation 15, this goes to something that you discussed earlier today in terms of OPEB bonds. And currently, when an agency pays pay-as-you-go for retiree health care, the federal government pays its part, whatever that is, of the payroll costs. And I think this is especially important for counties.

No one has been able to get an answer from the IRS about will they continue to pay that share of bond costs. And that is what this would seek, is to try and get a letter from the IRS, a decision --

CHAIR PARSKY: A decision from the IRS or --

MR. BRANAN: No, no, you're right. OMB.

CHAIR PARSKY: This is the august body called OMB.

MR. BRANAN: Yes, that's who it is.

CHAIR PARSKY: Again, I, for one, don't have a basis for knowing can this be effective, can this not be effective.

I think we want to be -- we want to be careful in not putting forward a series of recommendations that don't have the same level of weight.

MR. BRANAN: Well, we included this one because we felt, again, a letter from the Commission would have a lot more weight than a letter from a city or a county, and that was also the feeling of the organizations representing cities and counties.

CHAIR PARSKY: Well, I think with respect to each of these, and this one in particular, if we want to include it, we really should include the reference to who has urged this on the Commission, so we understand that context.

Yes, Curt?

MR. PRINGLE: I just think these are -- there's a difference between us asking the IRS to take a certain action or asking for laws to be changed to effect the interpretation that we don't agree with. I think there's a difference in us just saying, "Hey, give some general tax advice," or you've withheld it, or you haven't made up your mind.

I mean, in all of these, I don't really see that we're specifically seeking something that's been vetted. So I do, in fact, think we dilute whatever weight we may or may not have in getting recommended policies changed, which we make a specifically clear recommendation, to just adding in that, a whole a bunch of requests for technical advice and information.

And I think we kind of miss our charge with some of these.

CHAIR PARSKY: Well, I think staff needs to go back and think about that issue. Because I must say that, as I read these, I thought somewhat the same on these.

So you can come back, Tom, and urge on this Commission, but -- see, if you want. But I would do it in the context of not wanting to water down the other recommendations. And I definitely think that in the tax policy area, we ought to have a recommendation that is couched at the same level, if you will, as the recommendations in the other area, and then incorporate a technical letter which can be referenced, but a technical letter that would go, that would be part of the appendix, if you will, of the report.

Bob?

MR. WALTON: One other quick comment on number 1, where we talk about combining for investment purposes.

I know there's a distinction -- and I want to make sure we make this depending on what goes forward of commingling for investment purposes and co-investing.

I know that's the term that CalPERS uses, where they don't commingle but they co-invest, and there's a difference. And we want to make a distinction on what we're talking about here, because I think you're just talking about commingling funds here.

MR. BRANAN: All right, we'll make that distinction.

CHAIR PARSKY: Okay, with that, we'll take a break for lunch, and then come back.

We have two other issues, and then a briefcase study.

(Midday recess taken from 1:15 p.m. to 1:57 p.m.)

CHAIR PARSKY: We're going a little bit out of order, but the next set of recommendations has to do with mitigation of pension market volatility. And although it's a lofty term, I think we ought to be able to at least move through these efficiently.

So, Tom, why don't you proceed ahead?

There are four recommendations to consider.

MR. BRANAN: Would you like to go to the recommendations without the background?

We can answer questions as they come up.

CHAIR PARSKY: That would be fine.

DR. GHILARDUCCI: If John has enough color, you can. You have to give John enough color, enough background color.

MR. BRANAN: Let me just read the introductory paragraph there:

"Large market swings can and do greatly affect the employer contribution rate in defined benefit retirement plans. In order to stabilize contribution rates, employers should consider implementing any or all of the following recommendations."

And the first recommendation is: “Many retirement systems have smoothing periods for investment losses and gains which are as short as three years. If they consider contribution rate volatility to be a problem, public retirement systems should consider the use of longer smoothing periods to lessen contribution volatility.”

And one example of a system moving to a longer period is CalPERS which recently moved to a 15-year smoothing period.

CHAIR PARSKY: Okay, let's just pause on that.

And when I first was considering this, I thought that was a somewhat watered-down statement, but that's okay. We'll see how everybody reacts.

Paul?

MR. CAPPITELLI: I have no objections to the way it's written. And admittedly, I probably don't know as much in this arena as others so I would defer to those people who know more.

CHAIR PARSKY: Teresa?

DR. GHILARDUCCI: I liked it a lot, but I am so interested in what you --

CHAIR PARSKY: Oh, I was joking.

DR. GHILARDUCCI: Okay, all right.

CHAIR PARSKY: Lee?

MR. LIPPS: Generally, I would be in favor of a smoothing period longer than three years. I don't know what the magic number is. 15 strikes me as a little bit long, notwithstanding the experience in CalPERS. But, again, I have no real clue if we're going to have something -– and I think there's a place for them -- as to what would be an appropriate length of time.

And, again, notwithstanding the fact that they are smoothing periods, you could have an exceptionally bad run of years, much longer than what your standard smoothing period is, or a good run of years.

CHAIR PARSKY: The language, of course, was intended to use it as an example, not as a directive.

Jim?

MR. HARD: Yes, I'm fine with the language. And if we don't want to be direct, maybe we just delete the last sentence.

CHAIR PARSKY: Curt?

MR. PRINGLE: Well, I wish you weren't kidding, because I think it does sound kind of watered down, and it’s --

CHAIR PARSKY: I said that for you, you know.

MR. PRINGLE: Okay, well, thanks. I'm the only one that really appreciates it.

But I don't know if 15 years is the best; but, I mean, is there -- prior to five years ago, were there smoothing periods for any of the retirement systems?

MR. BRANAN: Were there smoothing periods? Yes, there were.

MR. PRINGLE: And was there a smoothing period for CalPERS?

MR. BRANAN: I think five years ago, were they at three?

MR. ANGELO: Effectively three.

MR. BRANAN: This is Paul Angelo, sitting next to me, trying to grab the microphone.

Paul is an actuary that we have brought on board for Commission work.

CHAIR PARSKY: His reputation precedes him.

Paul, nice to have you here.

MR. ANGELO: Thank you, Mr. Chairman.

MR. PRINGLE: The question I have, though, is the reason why we're suggesting smoothing periods is because, in fact, the circumstances that led to some employer -- lack of employer contribution and then the rapid move-up of employer contributions and employee contributions were very challenging and devastating. That's why CalPERS went to a fifteen-year.

But if they were on a three-year before, isn't there something that we would like to state in a more bold fashion that says, "This is a target" or “This is what should be contemplated to advance beyond a three-year, which we view as too short?" I mean, if we're even going to reference this, why don't –- why do we somewhat make on a parity a three-year smoothing period and a 15-year smoothing period, as opposed to make a recommendation of some sort or demonstrate a best practice or demonstrate through the words we use, you know, why we think a longer period is better?

MR. BRANAN: Well, this recommendation and the next one is really dealing more with the volatility of the employer rate so that if you had no smoothing period and you had a great year in the market, then you would have most likely a very large surplus. The next year, you could lose everything with a bad year.

So what these are for is more to smooth out the employer rate.

And at least in PERS, with local agencies, the request for the smoothing procedures came from cities and counties who had been whip-sawed for year after year, and it was very difficult to plan their budgets.

As far as why 15 is in here, as far as I am aware, that's the longest one in practice.

MR. PRINGLE: In the state or in the nation?

MR. ANGELO: I would say in the nation.

MR. PRINGLE: Well, Mr. Chairman, I don't know where anybody else is on this, but I would certainly feel more comfortable if we suggested something longer than three years, or suggested a reason why a longer smoothing period is of value.

For us, in our city, a smoothing period isn't just for the employer, because there's certain employee contributions that are based off of the employer's contribution.

So during those spiking years at CalPERS, yes, our employees received the same benefit the employer received with a very limited contribution; but during those spiking or rapidly increasing contribution years that followed, this is not just an employer issue from my perspective, because my employees went in some cases to a 10 percent contribution increase in a single year, over and above what they had already been making. So the employees also feel some of that, depending upon, you know, what's bargained for them. So I understand what is here. I just wish it was maybe a little more instructive to somebody who is going to read this recommendation.

CHAIR PARSKY: John?

MR. COGAN: I agree with Curt. I'd really like to see a good description of the problem we are addressing by smoothing here so if we can add more, it would certainly help me.

Lee makes a good point. Fifteen years, I don't know if there's any evidence on 15 years. CalPERS' 15-year policy has been in effect for how long?

MR. BRANAN: Two years.

MR. ANGELO: Two years.

MR. COGAN: So I'm not really sure about the efficacy of the policy. That is, I think it's in the right direction, but I'm not sure how effective it's going to be, I'm not sure we have a lot of data on how effective that is in combating the problem.

MR. BRANAN: Well, keep in mind we did not recommend 15.

MR. COGAN: I know.

MR. BRANAN: And the background material does, I think, explain more where this recommendation came from.

CHAIR PARSKY: Well, is at the heart of your request that in explaining what we're trying to address here, we identify the concerns we have over, in particularly robust years, there's an immediate rush to either increase benefits or reduce or eliminate contributions, and that that doesn't adequately prepare the system for the inevitable down-years; right?

MR. COGAN: *(Nodding head.)*

CHAIR PARSKY: And so maybe a way to introduce these recommendations would be to highlight that and maybe take some of the background and put it right up front.

MR. COGAN: And if we're not sure how well the PERS system in 15 years is working, whether it's too long or it’s not long enough, whether it's going to have any effect in dealing with the problem that we describe, it seems to me it would be unwise. I think we can use it as a “for example” in a recommendation, you know. It's just if we put it in a recommendation, even as a "for example," then we are sort of suggesting to localities that, “This is the policy that's worked for them. We're not sure it will work for you,” but we're not even sure it's worked for CalPERS yet. We haven't come to that point. It hasn't been around long enough.

Now I believe that it's going to be effective; but belief and having evidence to support that is two different things.

One thing that you’d said, Tom, that I'd like to comment on just for the rest of my commissioners, it seems to me that when thinking about why we would smooth to remove the volatility, I wouldn't focus so much on the contribution rates. I think it's both benefit levels and contribution rates.

DR. GHILARDUCCI: Yes.

MR. COGAN: You know, when we raise benefits, that's a permanent increase that cannot be undone. When we alter contribution rates, well, we can always go back, and adjust those contribution rates. It is just a lot easier.

So it seems to be that when I look at the historical record and observe the pension bodies and the legislative bodies, town councils, and so forth, raising benefits and cutting contribution rates when the fund has a temporary surplus, I see both, and we should be a little bit more balanced in our discussion as to the nature of the problem.

CHAIR PARSKY: All right, Dave?

MR. LOW: I would agree with Mr. Cogan on the issue of PERS, 15 years, in the respect that we don't know, it's only been two years.

And I know that PERS just went through a very painstaking process of running thousands and thousands of scenarios before selecting the 15-year period. But I also know that even within the PERS board now, there's some question about whether that was the right number, you know, whether possibly it should be a shorter period. So with only two years of experience, I don't think we ought to reference that.

I do support the concept of smoothing. The general concept, I am very supportive of, but I don't think we should specify or even use this as an example.

MR. COTTINGHAM: Again, I concur with the smoothing period; but in your examination of this, I mean, were you not able to find any entity that had been already using a longer smoothing period, and that they had been using 15 years? I know that several years ago, that the system in San Diego County I believe went to 15 years and that would be about five years ago that they started. Wouldn't they have a little better history of it?

MR. BRANAN: I had never heard that they had gone to 15 years; have you?

MR. ANGELO: No. There's -- I think what they went to was a 15-year amortization period for their liability, which is sort of the next step after you smooth the investment return.

Different policies.

MR. COTTINGHAM: Okay, theirs is an amortization.

MR. ANGELO: I believe so.

MR. COTTINGHAM: All right. I think from our perspective, what we are also looking at, as far as liabilities, is trying to level out the contribution rates that employers make. And I think everybody does have basic acknowledge that smoothing is a way to accomplish that.

And I guess the crux of it is, how -- what is the best smoothing period state to keep the rates stable and to, I guess, ameliorate the market fluctuation that would go on with that. So I think it is something that we should do.

I don't know if we need to recommend 15 as set, but I do think we need to recommend smoothing. And, obviously, we're going to get into some of the other aspects of smoothing when you have the good years and the bad years later on.

CHAIR PARSKY: Bob?

MR. WALTON: As I recall, when PERS looked at this issue, first, we must understand it was predicated upon doing some extensive surveying with local employers under PERS. And by far, a significant majority felt rate stabilization was what was most important to them over all the factors. And you have to look behind how the 15 years was developed.

As Dave said, PERS looked at any number of scenarios that would smooth the rate of return. And I think as opposed to using a certain period, like 15 years even as an example, you may want to go back to the underlying objectives. For instance, they're looking for a methodology that would result in an employer rate that would increase or decrease by no more than 2 percent. And I’m picking that number. They had some information that describes that better.

And also PERS –- and we may want to have staff get that from them, just for information -- PERS applied this policy retro. In other words, they went back and said, "If this policy were around 10, 15 years ago, what would the rate have been?,” and compared it to what the rate was. And that really tells you how effective that was or was not over time. And that may be good information.

But I think in the recommendation we may want to, instead of putting years that's most appropriate to minimize rates within a certain corridor, that may be going too far. But certainly, it's not the same for everyone.

A fund that is very mature, has a lot of assets, may have a different number than another fund that is relatively immature and has a small number of assets. There, it doesn't matter as much. And so one shoe doesn't fit all and trying to get behind the underlying reason why you want to smooth, i.e., create great stabilization, is what the focus ought to be.

CHAIR PARSKY: Connie?

MS. CONWAY: I don't know the magic number, whatever that number is, I guess the underlying message is never, ever, ever, take a holiday. So however this Commission decides to say that, is fine with me.

CHAIR PARSKY: Matt?

MR. BARGER: The situations I care about, actually, are a little bit asymmetric, I think, in the sense that I care more about those situations where you don't have enough as opposed to when you have too much. And knowing the upside, when you're above the line, you know, not contributing as much money as you should be, thinking about the long-term or worse, you're on the downside and your numbers are masking the fact that you have less money than you need to fulfill your promises.

And so I look at a problem as actually sort of two problems, not just one. And it may be that the solution on one side is not the same as the solution on the other, to me.

The second point I have is sort of an accurate measurement problem again, which is, I think if you accurately measure liabilities and then think about whether or not you're funded enough or overfunded, you come out with one answer, versus if you use the actuarial method that is being used, you end up with sort of an underestimate of liabilities. And more often than you, quote, should be, you will end up above the line and not contributing enough. And I have sort of a -- that reminds me again about accurate measurement.

And I tend to think that, you know, there ought to be sort of either you start the line evenly when you say there ought to be a symmetric response of five years or 15 years, or whatever it is above whatever the real financial number is, or you ought to have an asymmetric response to the lower actuarial number. In other words, amortize gains over a longer period of losses. You say, yeah, we can just have it bouncing around like a ping-pong ball over year to year, but we can have it reflect what's happening over three years. If we've taken three bad years, you know, we ought to start reflecting that quickly because we're now starting from a lower number.

And the other thing that I think you can't get away from is we sort of think, “Gee, in the long-term, equity is going to outperform any alternative, and we have heavily weighted this pension fund equity.” And I think in the very long-term, statistics would say that's correct. But in the short-term, you can look at Japan and say it's been close to a generation –- I think it’s been 20 years at this point -- where the stock returns have been negative. There's nothing in there that says, you know, equity's always going to magically do exactly what you hope it's going to do. And so getting into a situation where you defer the reality of dealing with a bad situation, it just seems to me -- it is what makes me uncomfortable about the 15 years specifically.

CHAIR PARSKY: Just to follow that, you would -- where does that drive you, though, in terms of policy?

MR. BARGER: I would be very conservative about amortizing gains, and I would be pretty aggressive about amortizing losses. I think there's some degree of smoothing that's appropriate. I understand why and where that comes from.

But if you said, “Gosh, 15 years is the appropriate number for gains,” I'd be sitting here saying, "How about three years for losses." If there was something along those lines. I would be very asymmetric.

CHAIR PARSKY: John?

MR. COGAN: Bob, Paul -- Bob, is there any jurisdiction that you know that does asymmetric smoothing? Smooths the excesses out for a longer period of time than the shortfall? Does anybody --

MR. ANGELO: There are two aspects of how we reduce this volatility. We've been talking about the asset smoothing. That tends to be symmetrical. That is, if you earn more than what you assumed, you smooth, and if you earn less, you smooth. That tends to be symmetrical.

Once you've done that and you look at everything else and see how well funded your plan is, the overall gains and losses, there we are starting to see something asymmetrical; where, for example, the CalPERS policy, we get to this in two recommendations hence, they treat surpluses very differently than they treat underfunding.

So I think on the smoothing, it tends to be because you think you're going to end up around what you assume tends to be symmetrical, but looking at the funded status of the plan overall, we are seeing asymmetry, and that's actually in one of our recommendations coming up.

MR. COGAN: It just underscores the points that Curt made, which is that you really want to have a very strong description of the problem.

CHAIR PARSKY: Right.

DR. GHILARDUCCI: Gerry?

CHAIR PARSKY: Yes, Teresa?

DR. GHILARDUCCI: One of the reasons I said yes, go ahead, it was shorthand for saying that I remember that CalPERS said they treated gains differently than the losses. And so I'd like the example of the CalPERS. Saying just “15 years” doesn't really quite describe the brilliance of their move. I also was very convinced by all the simulations they had done. So even if we didn't have the experience, that that testing seemed to be pretty good.

What I know in the corporate sector is that the firms that have had -- that didn't take a contribution holiday, had the lower amortizations of their gains. So I endorse that.

But the other way that we might be able to kind of build in that asymmetry is to do what Connie said, is to have a strong recommendation for no employer holidays.

I also wanted to point out that we do have a way to make the benefits a little less sticky downward than you suggested. And that's by giving benefits based on the funding of the plan that are easily taken away. And those are those 13 checks or those ad hoc COLA increases. That's the way you actually build in some flexibility with your benefits, too.

And Matt had a good point as well.

CHAIR PARSKY: A comment you have there, Tom?

Maybe on this issue of how we can incorporate in these symmetrical kind of approaches, let's cover the next recommendation and then come back.

MR. BRANAN: Number 6, "Retirement systems which do adopt longer smoothing periods should be prepared to resist pressure to shorten that period when market returns are up."

And that is obviously a problem for human nature being what it is. When returns are up, there's a tendency to want to recognize those returns much more quickly than losses are returned that are recognized. So that's what this recommendation is.

If you're going to adopt it, don't give it up as soon as returns get better.

CHAIR PARSKY: How could you build that into an acknowledgment that things are not -- it shouldn't be totally symmetrical on the notion of how do you treat gains and losses or how you treat the liabilities.

MR. ANGELO: Here again, I think that it's the -- on the smoothing –- on just the smoothing part, I think that symmetry probably is called for. Otherwise, you have this temptation to try to turn the symmetry the wrong way.

But I think when we get to, you know, the overall funding status, that's really where you're going to see recommendations that move toward treating them very differently, treating a surplus much differently than a shortfall.

CHAIR PARSKY: All right, Paul?

MR. CAPPITELLI: The only comment I would have is, to me, this seems like something that's already in existence. I mean, this is something that's already there.

How do we phrase this in a recommendation to where it really has some strong teeth? I mean, because it seems to me if you had already adapted or you were going to adopt a policy of this type, you could make the statement, but there wouldn't be much to preclude you from making those changes when policymakers make those changes when those tides turn around.

And so how do you make this so it’s not -- I hate to use the M-word, “mandate” -- but how do you phrase this so that it has a little more teeth?

CHAIR PARSKY: Teresa, on this?

DR. GHILARDUCCI: No contribution.

CHAIR PARSKY: Okay, Leonard?

Jim?

Curt?

MR. PRINGLE: I'll suggest, as I think both of the -- I mean, this, in fact, is a recommendation, whereas the first one really isn't. So I think we can combine them all into, you know, a harder recommendation. I think that's what Paul is suggesting.

CHAIR PARSKY: Combining 5 and 6 into something stronger?

MR. PRINGLE: Yes. If you say, "This is what are recommended or best practice is, these are the things that should be considered. When you add smoothing, a period should be established, and it's further recommended that smoothing period should be eliminated or reduced on the” ––

CHAIR PARSKY: Change in the market.

MR. PRINGLE: -- “one- or two-year benefit or upside.”

CHAIR PARSKY: John?

MR. COGAN: I like the idea.

I guess I have a more generic concern about this. We have an enormous -- and I'll call it fundamental problem with defined benefits plans. And it's a political problem. When funds get surpluses, we eliminate contributions or we grant large benefit increases; and when the funds fall into trouble, the system has difficulty dealing with the shortfalls. So we end up with a tendency towards underfunding over time, and that's why this commission is here. So I sort of see the problem as a big-time political problem.

What we have here is kind of a technical solution to that big-time problem. And, in fact, it may work. But we need a larger, stronger, generic recommendation, which is: Don't spend temporary surpluses and fix deficits.

And so it just seems to me that we need to couch these in the right frame. These are like technical solutions that may or may not work. We've got a major, major recommendation to make, which is don't grant any increases in benefits unless they're well-justified and don't grant holidays unless they are justified by the funding service.

CHAIR PARSKY: How do people feel about moving these series of recommendations under a broader one -- or, Tom, do you have some comments to make?

MR. BRANAN: I do. In terms of what Commissioner Cogan just said, I should point out that originally, the topics today were to be heard at the same time as the topics for the next hearing. And those deal with some of the concerns that have been raised. Those are going to be funding policies.

CHAIR PARSKY: Yes.

MR. BRANAN: And you can see on -- well, you probably don't have this, but at that hearing, we'll be talking about the actuarial review panel -- actuarial assumptions, timeliness of reporting, funding benefit changes. So I think that's where we'll get more into some of the concerns that have been raised today.

CHAIR PARSKY: Well, but I think the one thing, though, that we want to think about is to place these recommendations in the context of the problem we're trying to address, because it just seems kind of in a vacuum. And you really want to have the larger policy issue that you're trying to address.

And as, I think, John said, this could be a technical but very positive way to address it.

But I think we want to shine a light on policies that may have been adopted in the past that have caused some of the problems of today.

Dave?

MR. LOW: Along that line, do you have an example of an employer or a system that has actually done this as a policy, reduced their smoothing period when their investments were up? I'm not personally aware of a case where this has ever occurred.

CHAIR PARSKY: No. But, Dave, I think separate out a little bit the problem, which I think is a problem of not addressing smoothing at all, but a problem of when times are good and it seems like there's a higher surplus, the tendency has been to increase benefits or to stop contributions. So that's the nature of the problem now, and, therefore, it has created what we're trying to address.

MR. LOW: Right. And I get that, and I get where John's going with that, and I'm actually agreeing.

CHAIR PARSKY: Okay.

MR. LOW: I'm supportive of a broader policy, I'm supportive of a statement that’s sort of a consistent policy that we ought to be recommending.

I have a problem with this recommendation in that context. I just feel it just sticks out like a sore thumb here, and it's not contextual. I think it's more appropriately dealt with on this broader policy statement, and it's more properly dealt with in pension holidays. But it's just a statement that they should resist pressure when -- I'm not aware of that ever occurring. I think we should delete this and go with a broader statement, and then address the pension holidays.

CHAIR PARSKY: Well, I think, to some extent, were you not trying to address what you think could happen if, in fact, smoothing or a longer period was adopted?

MR. BRANAN: Well, yes, it could happen. And what I've been told by some PERS staff is happening within PERS already, now that returns are up and people are looking at this long smoothing period. So that's anecdotal. That may not be the evidence you want, but that was part of the reason to do this.

MR. LOW: I guess my concern is that maybe there is a legitimate discussion that needs to occur, as we talked earlier, is 15 years an appropriate smoothing period.

So by making a statement, maybe we preclude having an intelligent discussion about maybe it should have been 10, maybe it should have been 12, maybe it should have been 15. I think that we should have that discussion. I think that's a legitimate debate. And I don't think we should make sort of this pejorative statement about just smoothing reducing for this -- and color that sort of an argument.

I would prefer to just have a broader statement that addresses what's an appropriate -- you know, how do we evaluate an appropriate smoothing period and how do we deal with sort of the back practices like pension holidays.

CHAIR PARSKY: Yes, Ron?

MR. COTTINGHAM: I'll just concur with Mr. Cogan and Dave Low in what they were saying, and I think Teresa and Lee, because I believe the smoothing period will have to be determined by best practices, probably. But what we need to address is how they deal with the surplus and the potential for pension payment holidays. I think that's what the really crux of this gets to. And I think there's even been some lawsuits in California that have dictated to some systems how they will use their surplus.

CHAIR PARSKY: Bob?

MR. WALTON: Yes, the context of mitigation of pension market volatility, I'll go back to what I said earlier, really what we're trying to achieve is some stability in the employer contribution. That's the objective. And within that context, how do you do that? And this is one of the methods. There's others.

But I think the other issue that John and some others have mentioned is that manipulation of the actual process and data for short-term gain, whether it's done by the retirement system itself or political body or anyone else.

For instance, the amortization of the unfunded liability back in '91, and it's the issue of the state employees having one-year final comp. Well, that was a proposal that was put forward then by the administration. They were looking for short-term budget relief. It had nothing to do with the funding of the retirement system. But in order to achieve that, one of the things they wanted PERS to adopt was a 40-year period of unfunded liability amortization, which was kind of interesting because that actually created a negative liability and actually increased costs.

But setting that aside, that was a quid pro quo that was put into the legislation that PERS adopts 40-year funding for state plans, then state employees will get one-year final comp.

And so to me, there's two issues here: One, how do you stabilize an employer rate –- and I think that's very specific to the task of this Commission –- and, two, how do you limit the political, if you would, manipulation of retirement systems for short-term gain? And when I say "political," I don't mean just -- I mean, for all parties concerned, everyone. That you use it. You shorten, you lengthen, you change interest rates, you do other things -- experience studies. It's not just the market value of investments, in order to have a short-term paper gain for some other purpose.

CHAIR PARSKY: Connie?

MS. CONWAY: Well, I certainly agree with everybody, whatever our best practices or whatever we're saying is a good thing to do. And I would like to keep it that and not be just manipulative.

The idea that it could be manipulated through this type of smoothing or amortization is troublesome to me.

The only other thing that comes to my mind when I look at this when we're saying the exact amount of years, I don't know how we'd ever determine what that perfect number would be. But in 15 years, I was just thinking about the decision-makers on the retirement board that I sit on. In the past six months, we've had more than half of them turn over. So I don't even know, in a 15-year period, who the heck would be there to even remember when we started the smoothing. So that's -- it's just something to think about, too, you know. Elected commissioners come and go.

CHAIR PARSKY: Matt?

MR. BARGER: I'm now -- this is my new role, is calling into question why we're recommending any number of recommendations so far.

I mean, one of the issues is, I wonder whether or not we actually do want to recommend the use of longer smoothing periods, specifically. I mean, I don't know what the average is now, I don't know really exactly what people are doing. So saying they should be longer or not, I don't know.

I do have trouble with having longer smoothing periods when you're underwater. That doesn't bother me so much, if you're over water, fine.

And I think actually Paul makes a good point, I've been lumping together two things. And the thing I'm actually focused on is the situation with the plan as a whole is underfunded or conversely overfunded. Not when you made more than you expected in any one given year. I think the important thing is, where you stand on the real market on the pension plan as a whole. That should be what is driving what your contribution rates are.

So I am just wondering whether or not we've not watered this down to the point of -- or I'm not quite sure what the right recommendation should be, and I'm not quite sure we haven't watered it down to where it's almost sort of Pavlov, so…

CHAIR PARSKY: Well, we want to avoid that, that's for sure.

But what I hear is that I think we should convert this into a much broader, stronger recommendation, with this as an -- this is an approach that attempts to address the broader issue.

And I think the combination of how to stabilize employer contributions, how to avoid the vagaries of adjusting contributions and benefits at various points in the cycle. Something that is much broader on that. If we direct, if you will, the recommendations around, we ought to give that a try and see how the commissioners feel about that.

Does that seem -- have you got that?

MR. BRANAN: Yes, that does. And I think that will tie in with the next recommendations as well.

CHAIR PARSKY: Okay, why don't we go ahead?

MR. BRANAN: Total and even partial employer contribution holidays are disruptive to the employer when ended are not good pension policy and should be used only sparingly when dealing with overfunding.

And that leads to Recommendation 7: "Employers should be permitted to make contributions which are less than the normal cost of their plan only when substantially overfund. Surplus should be used to offset the normal cost only if amortized over a 30-year period."

And this is to get to the problem that has been seen in most California retirement systems during the last decade.

CHAIR PARSKY: You might just go ahead to 8, and then we'll come back on both of those.

MR. BRANAN: 8, "If an employer's pension account is sufficiently overfunded in accordance with Recommendation 7 above, the employer should place a portion of the contribution savings into an OPEB trust."

CHAIR PARSKY: Now, there are some potentially volatile words in this recommendation that may not be fully understandable. But let's see if we can't address it.

I would just say by way of introduction, the University of California offers a perfect example of what not to do. But I just say that from personal experience, that's all.

Paul?

MR. CAPPITELLI: I'm going to defer to my colleagues for the meat of the discussion. Thank you.

CHAIR PARSKY: Okay, Teresa?

DR. GHILARDUCCI: Well, I can imagine that we're going to have some difficulty with the words of what “sufficiently overfunded" means.

CHAIR PARSKY: You can help. Yes.

DR. GHILARDUCCI: And we have to decide what that is.

A 30-year amortization period, I don't know of -- I guess that only occurred in ERISA, when we had to pay for -- no?

Right. I mean, so I'm getting hand signals from Paul, so I think I have the wrong answer.

But it's such a long period of time that it almost is just really sneakily saying we never want it to happen, I mean, that you would -- you know, that if you had that requirement, you would actually never have a surplus over that amount of time.

Paul mentioned that what we're doing here is what Congress did in 1974, is that we're trying to actually decide what the rules are for a well-funded plan in order to, in that case, secure the promises for employees and for shareholders.

So in some ways, we're reproducing that debate for taxpayers. And that's completely appropriate. But we should notice what we're doing here. It is as difficult as the ERISA writers. But let's go on.

CHAIR PARSKY: Lee?

MR. LIPPS: First of all, I'm very much in favor of not having employer or employee contribution rates. If I have a problem with any part of this recommendation, it just refers to -- I said "contribution rates," but holidays, yes.

If I have some concern with all three of these recommendations, it seems to only refer to employer holidays, and it doesn't put the employees in there.

And as John -- or Gerry, as you mentioned, you see it is a very good example of that.

Recommendation Number 8 by itself, again, would seem only to -- mainly to apply to California state employees. It sounds like in CalPERS, and maybe some of the '37 Act counties. Would it also apply to some of them, but not all of them?

MR. COTTINGHAM: *(Nodding head.)*

MR. LIPPS: So it would have limited applicability to a number of other public agencies.

CHAIR PARSKY: Tom, is that so?

MR. BRANAN: Actually, I think it would apply to most public agencies.

What do you see as the limiting element?

MR. LIPPS: Well, if I understand correctly, if the employer's pension account -- again, now, let me just go back to school districts. Our pensions are through CalSTRS. What would be the mechanism for crediting back to an OPEB account some level of overfundedness? How would that work? Because the OPEBs are offered locally, negotiated and offered locally; and not all school districts in this particular case offer retiree health or other benefits for their employees.

MR. BRANAN: Well, I see what you're saying there.

Other than probably the '37 Act, I think this would require a change in the law.

CHAIR PARSKY: Go ahead.

MR. ANGELO: I think one way of looking at this, though, is that it's not necessarily in the same plan. So you'd have a pension plan, even if it's just an independent charter city. And if you get to where you're so overfunded that even with a 30-year amortization your employer contributions drop below the normal cost, well, that's going to free up a certain amount of the employer's budget.

The idea here is, they would have a totally separate OPEB trust. And instead of taking that savings and taking it out of the budget or whatever else, they would use it as contributions to a separate plan. But it wouldn't be moving within -- moving out of one plan to another.

CHAIR PARSKY: Right.

MR. ANGELO: It would be taking this sort of budget relief this surplus can cause, and suggesting that it be used for the OPEB benefit.

CHAIR PARSKY: Leonard?

MR. LIPPS: So in the case of CalSTRS, where the contribution rates are set by the Legislature?

MR. ANGELO: It would be difficult to apply this in that situation. CalSTRS has a fairly -- I can't say unique, but a rare situation where instead of having the contribution redetermined each year based on the actuarial valuation, it is set in statute.

So this would not -- at least as we've thought through thus far, I'm not sure how this would apply to CalSTRS.

MR. LIPPS: Thank you.

CHAIR PARSKY: Jim?

MR. HARD: Yes, I had the same concern about 30 years also then. You did say this would take a legislative action because I don't think there's any trust right now for state employees; right?

(Mr. Cappitelli left the hearing room for the day.)

MR. BRANAN: The model, like the recommendation -– the model is there in the '37 Act where that's one of the standard ways of providing retiree health care, is the employer in good times gets a credit. It doesn't have to pay money into the retirement system. Their contribution is covered by surplus; but then that amount of money or part of it goes into a retiree health-care fund.

CHAIR PARSKY: Curt?

MR. PRINGLE: Yes, I like these two recommendations; they're fine. I would probably maybe contemplate a third one or something else under the holiday discussion; because, in fact, I don't think either one of them really gets to the heart of the holiday.

One says it's okay if you pay a little less, as long as this happens; and the other says it's okay if you pay a little more than your obligation, and you put that over the OPEB trust fund.

I guess what I'd like to see is a call on public agencies to take action on establishing a minimum contribution rate, which they would commit not to go below. And to publicly establish that -- I mean, we're not mandating it, and in some way calling on every public agency to say, "We're not going to go below a certain contribution level." Those dollars then could be put to super-fund their existing retirement, those dollars could be shifted to an OPEB obligation.

But I think there's probably a way that local governments would step up and see the value of declaring publicly, "This is our minimum threshold for contributions." And even allowing them to make that contribution to PERS, over and above what that PERS contribution is expected of them.

And I guess I just feel that there is plenty of local governments that are, or who may want to be responsible. So we should find, in fact, ways in which they can do that and ways in which those that want to be -- you know, publicly declare themselves as funding at a certain level, can do just that, and deposit more into PERS than their rate may necessarily dictate or, in fact, deposit a minimum amount that then would be offset, a portion to go into an OPEB trust.

MR. BRANAN: Just to make clear, Number 7 does address employer holidays, and it has been pointed out earlier, with a 30-year period, there would be very few employer or employee rate holidays.

CHAIR PARSKY: Well, maybe one answer there would be to incorporate in the recommendation what is the introduction, and then lead to something. I mean, I think the one point is that a strong statement, albeit with some condition on it, about holidays is perhaps what Curt is looking for.

MR. PRINGLE: Sure. I certainly -- I mean, I understand what normal costs are. I probably don't understand the implications of over 30 years.

CHAIR PARSKY: Right.

MR. PRINGLE: Therefore, with my limited time in government service, I can't see that as a blazing recommendation against employer contribution holidays. So it would be nice if we clearly state what we're intending.

And if it says that and, in fact, allows employers to even publicly step up and say, "This is what we want to do to ensure that our contribution is not going to go below what we may commit to our employees," I think that's just fine.

CHAIR PARSKY: John?

MR. COGAN: I think Teresa made some terrific points, actually, that I support entirely.

The recommendations are -- I have a lot of sympathy with the direction that you're going. But when you use terms like "substantially overfunded" and "sufficiently overfunded," you kind of render the recommendation empty, in a way. So if what we're really driving at here is employer contributions, to come out and say, and not kind of pussyfoot around.

Second, Teresa also said something that I found intriguing, which is, with these recommendations, it's almost like we're trying to write the rules of the game in the sense of writing legislation, like ERISA. And I guess I'm wondering whether the Commission should be trying to write legislation here. And maybe we shouldn't be.

I, for one, actually don't think we should be writing legislation.

And to the extent that these recommendations and others fall into that kind of category, I would say maybe we should try to avoid them and go to the heart of the issue that we're trying to address, which is the holidays on contributions.

The next question is, if we're going to make recommendations such as these when it comes to pension benefits, what do we say about health benefits? Why are health benefits -- why would the rules of the game be different for health benefits than they would be for pension benefits? And if we don't have the same rules of the road or rules of the game, we should be, as the Commission, explaining why we think there's a difference.

And I know that raises a lot of tough issues, but that's sort of where I come down.

CHAIR PARSKY: Tom?

MR. BRANAN: Yes, I would like your first point, these words "substantially overfunded" or "sufficiently overfunded," certainly "sufficiently" refers back to the definition in 7. And 7 is saying, you cannot have a holiday unless the following happens. And that is, you take your surplus. In essence, you divide it into 30 pieces instead of, as has been done recently, three pieces or five pieces. You apply one-thirtieth of your surplus against your liabilities against your normal costs. And then you can have the holiday if you owe less than your normal costs -- your normal costs before you apply that against it. That ends employer holidays, except in very unusual circumstances. So I would disagree that 7 doesn't say anything.

MR. COGAN: Well, I guess maybe then I should rethink what I said.

I mean, it seems to me that if you want to limit or eliminate employer holidays, let's say it.

DR. GHILARDUCCI: Let's say it.

MR. COGAN: Let's say it straight out.

This I see as one way that we can eliminate employer holidays. There are many other ways that we can do so. And so, again, it's a technical fix for a problem, an endemic problem that we have.

And I'm not saying it's not a bad fix, or I'm not saying it's a good fix, either. I’m just saying, it's one technical fix to a deeper problem. And there may be other fixes.

MR. BRANAN: Well, there are other fixes. And Paul has something technical to add. But before I let him explain it, I want to muddy it a little more.

You could say there will never be another employer holiday; and, in fact, that was something that we discussed in some of your discussions with staff.

The problem with that is, there are times when there's going to be a lot of surplus money in the system.

This goes to that. When you reach a certain level of surplus, then a holiday is warranted.

If you just say there will be no holidays, you're not facing the reality of what is eventually going to happen.

So that's why it's written this way rather than just a blanket declaration, "There should never be a holiday."

CHAIR PARSKY: Well, and I think it is also consistent with the sense of the Commission in this -- my read of the Commission was that there was a clear desire to acknowledge that there are circumstances where a holiday might be appropriate, that people didn't want to have a blanket declaration. But we need to be careful about how we define that.

And once again, I mean, in one sense, you could have subsumed Recommendations 7 and 8 under the introductory statement, and made the introductory statement the recommendation.

MR. BRANAN: We can do that.

CHAIR PARSKY: And 7 and 8 be technical ways in which parties are to consider dealing with the recommendation.

Dave?

MR. LOW: Yes, I haven't seen any testimony coming before the Commission to date that provides us guidance on this 30-year period. So I have difficulty embracing this without seeing anything that has said, "This is an appropriate period to which we should handle this issue.” And so I'm unwilling to accept that until I see more information.

Secondly, this holiday issue, I mean, there's pension holidays -- I define a pension holiday as you're paying zero, and then you could pay normal costs. But you could pay less than normal cost and not go to zero. So I think that's unclear here as well with regard to how you lay this out.

And in addition to the STRS issue, on this OPEB, using excess earnings to fund OPEB, in the schools, there's a thousand school districts in CalPERS in one single pool. They pay one rate. Of those thousand school districts, half of them don't have an OPEB liability at all because they don't provide any retiree health care. So it would be very difficult to handle that within the confines of the way that schools are structured in CalPERS.

CHAIR PARSKY: Ron?

MR. COTTINGHAM: Okay, I concur with a lot of what's been said up here, and that I still think that there should be a minimum payment that employers should make.

I think in viewing past history and the six years that the Richman people like to quote of the six worst years, as far as rates and everything, that was when they came out of a long period of a pension-rate holiday, where I think most of them were paying zero and setting nothing aside. So I think there has to be something that we -- let me say it better -- somehow we have to protect the employer from themselves.

And I'm not sure how allowing them to pay less than normal costs at this point covers the GASB criteria, if that's been factored into this. And we still -- as has been said, we haven't defined what's substantially overfunded or sufficiently overfunded.

I think when Fresno testified, they are at one hundred and twenty-some percent funded, but they are not having a rate holiday, that I recall, they were still paying. But they have used a DROP program very successfully to help fund the retirement system and actually even pay back to the city.

So I don't think there's a rate holiday, but I think they're giving a break back to the city in some other form of remuneration. So I think maybe that's something that could be looked at rather than a rate holiday.

MR. BRANAN: I think that Paul has an answer on your GASB question.

MR. ANGELO: And it actually relates to Commissioner Low's comment as well.

The 30 years that's presented here was actually taken from -- the study was done by CalPERS. And one of the reasons that they -- I believe they ran their model, that they came up with the -- instead of saying that you would always pay normal costs, they describe it as a minimum contribution, the minimum contribution is normal cost minus a 30-year amortization of surplus.

Now, our understanding is the reason they didn't just say “normal cost,” the GASB rules require, when you're setting your annual required contribution, you can't ignore the surplus. You can spread it over as much as 30 years, but you can't ignore it.

So the idea was to have a number that would be consistent with the GASB rules. So that's one of the concerns. So with both the GASB rule and “why 30,” they're both really tied into the analysis that CalPERS did.

MR. COTTINGHAM: And is this something that did -- we look at the picture with the retirement funding and the health-care funding which has a real deficit. I mean, how long is it going to be before we're going to be looking? Because anything that is left over, any surplus should be put towards health care, and I think we recognize that.

So how long are you projecting that it would be before this statement would even be something that somebody could consider?

MR. ANGELO: Well, two very different answers for OPEB versus pensions.

For pensions, we have client systems that are already getting to a 100 percent on a market basis.

Now, with the smoothing, they're still under 100 percent. But that means if they hit their assumption four or five years -- not beat it, just hit it -- they will be moving into surplus within three to five years.

So we have -- because of the recent very strong market -- and, of course, this assumes no big correction -- we could be looking at pensions --

CHAIR PARSKY: Check today.

MR. ANGELO: I know, knock on wood -- we could be moving into looking at pension systems somewhat commonly moving into surplus in the maybe four- to five-, maybe ten-year future. But I would say more like four to five. So it’s not an immediate fix, but I don't think it's remote for a lot of pension systems in California.

MR. COTTINGHAM: And what are you considering as substantially overfunded?

MR. ANGELO: Well, again, for this recommendation, we're using that 30-year test. And that's a hard hurdle to get over. It's pretty close to saying that you just never go below normal costs.

But the idea would be if you go below normal cost because you're so well underfunded, as Tom said, even one-thirtieth of your surplus is enough to reduce your contribution below the normal cost, that amount, that one-thirtieth of your surplus, would then be available under number 8 to provide -- instead of giving budget relief to the employer, actually having him move that into another vehicle, which would be the OPEB trust.

I hope I didn't stretch that sentence out too much.

CHAIR PARSKY: No, no, that's a good sentence.

Bob?

MR. WALTON: I think with the rewording of the recommendations to remove terms like "substantial" or that, and put the actual facts in, what we mean by that;

and PERS used to use the term, and still is, "super-funding." And I know what that means: That means you've got enough money today to pay for normal costs for it.

And so I think you can describe it more distinctly from an actual context and put words in accordance with GASB, in accordance with Generally Accepted Actuarial Principles, things like that, without putting in 30 years or 15 years or something like that.

The other thing, too -- and I think it's important, unless I'm wrong, at least I believe -- that there's tax implications, federal tax implications, that the employer is required to pay more than what's actuarially due. I know there is in the private sector.

MR. ANGELO: Mr. Walton, we think that that's only for the private sector.

MR. WALTON: Okay, but I know that can be an issue.

The final thing is, we shouldn't assume that every employer necessarily has both health and retirement. They don't. And so it's not automatically, "Oh, if you have too much in retirement you put into health," well, there may not be a health plan to put it into; or they may have health and not a retirement, that's a possibility. So it's just something as we're trying to craft these all public agencies.

CHAIR PARSKY: Connie?

MS. CONWAY: Maybe I should retract my very Grinchy statement of "No more holidays, ever, never, in order to” ––

CHAIR PARSKY: You don’t have to if you don’t want to.

MS. CONWAY: -- “in order comply with GASB." God knows, I wouldn’t want to be on the outs of that rule.

And the only other thing I would say is that the -- on number 8, somehow it needs to say, "Should occur at local option if and when they agree to vested OPEB obligations." And I think that's what Bob just said, and I could have not said any of that and just say, "I agree with Dave on everything he said.”

CHAIR PARSKY: Matt?

MR. BARGER: Yes, I find this conversation in some ways sort of Alice-in-Wonderland-like. You're trying to confuse reality, which is the market is volatile, and try and somehow cover up and show it to other people and say, "No, it's not." And so there's a certain little basic problem of how do you reconcile those two things.

And I think what you can't lose track of is actually reporting squarely where you are. And so I still would -- it's interesting what the actuaries do to say, "On a market basis we're here, but we are actually reporting we're over here." I think it's important to keep those two ideas very distinct. And there is sort of a reality and then there is the actuarial thing that you're doing to smooth things.

I actually –- now that I understand where Tom's going with the 30-year thing, I think that actually goes a long ways towards addressing the issue. I mean, I think it's pretty close to the same thing as never having a contribution holiday.

CHAIR PARSKY: It is.

MR. BARGER: And I think it's a suggestion -- I mean, the thought that having a recommendation actually starting up above where it says "total (and even partial)" and have these be "suggested" --

CHAIR PARSKY: "Suggested," exactly.

MR. BARGER: -- "practices." I actually think I would be fine with it.

CHAIR PARSKY: I just want to say, I think your comment is very right about the issue of market volatility. I mean, it's inherent in markets. However, I think that inherent in all of this is a desire to not have for those who are in charge of pension funds react as volatiley as the market may react. And it's not meant to in any way camouflage the fact that markets are very volatile, and I think we need to make sure we make that clear.

MR. BARGER: Yes, we're not addressing actual market volatility.

CHAIR PARSKY: Right.

MR. BARGER: It's absolutely there.

CHAIR PARSKY: We're attempting to address human volatility.

John?

MR. COGAN: One footnote on this point about human volatility, you know, we might be -- it was something we discussed at lunch a little bit, but we might be making things worse by smoothing. If smoothing protects someone from market volatility, then someone would be willing to undertake investments that produce more market volatility.

That is, you've always got to be aware of the law of unintended consequences here. The more smoothing you have, the more likely it is that you would tilt the investors towards more risky investments in the fund, which is not necessarily a good idea.

MR. BARGER: Independent decision.

CHAIR PARSKY: Maybe we'll let Mr. Cogan insert a --

MR. COGAN: A cautionary note.

CHAIR PARSKY: -- a cautionary note on investment strategy. That might be useful in this.

Lee?

MR. LIPPS: But just as a counterpoint to that --

CHAIR PARSKY: Do you want to take more risk in the market? Okay.

MR. LIPPS: No, no, no. But the opposite of what John said may just as well be true.

CHAIR PARSKY: Yes.

MR. LIPPS: That is to say in the absence of smoothing, that that could also encourage investors to take more risk to make up for a previous year's loss, not to mention -- not to mention a change in the rates.

CHAIR PARSKY: Okay, does that help the staff get through that sequence?

MR. BRANAN: Actually, I think it does, yes.

CHAIR PARSKY: Good.

I’m going to make a suggestion since I haven't managed this meeting quite as efficiently as possible.

We have one more set of recommendations, but I think I'm going to suggest that we start the next session with those recommendations because we have one presentation that we've had a very patient presenter waiting. And I'd just like to make sure that she has an opportunity, or they have an opportunity to present. And then we'll come back -- we'll repeat this, Tom, and start the next session with that.

Is that okay with everybody?

Okay, please, this is a San Francisco case study. And those of you in San Francisco that think that you're not part of the state, this is meant to be a direction that says, "Oh, yes, you are."

But please introduce yourself and then we'll listen to your presentation.

MR. CHRISTIANSON: I'm Dave Christianson. I'm a consultant to the Commission.

And next to me on my right is Clare Murphy, a longtime friend of mine, I would like to say, who is the executive director of the San Francisco Employees Retirement System.

CHAIR PARSKY: Speak a little closer to the mike so that we can hear you.

MR. CHRISTIANSON: Sorry about the hoarse voice.

CHAIR PARSKY: That's all right.

MR. CHRISTIANSON: As you know, San Francisco is a charter city and county, and it's unique in the fact that it is a city and county. It’s the only one.

One of the unusual things about San Francisco is that it doesn't have a single retirement system, it actually has three retirement systems. It has its own retirement system for its employees; it has the PERS retirement system for the sheriffs and some institutional police officers; and it has, of course, the teachers’ retirement system for the classified school -- certificated school employees.

One of the unusual things here as well in the state is that it is the only county in which the classified school employees are part of the city retirement system and not part of PERS.

I'm going to be very brief about this. As you probably know, the retirement system is -- San Francisco system is 108 percent funded as of June 30th, 2006. Its benefits are controlled by the charter itself.

And Clare will speak to that process and the success of that process.

MS. MURPHY: Thank you very much for the opportunity to address the Commission.

I was asked to identify some unique aspects of San Francisco. The most, I think, unique aspect of our plan is that the voters, in fact, do define the benefits. They actually receive propositions or charter amendments presented to them, often at each ballot. And this condition has existed since the 1880's, when our plan was first created.

The current structure of the plan exists since a 1932 charter.

I have in my presentation but won't read for you the fact that the city is a home-rule jurisdiction, and the voters hold very dearly their right to make decisions for the jurisdiction, and they have held the pension benefits as part of that set of rights.

The voters have actually considered 114 proposals since 1928. They are careful about when they make a decision to adopt a proposal. 75 of those times they did adopt the proposal; 39 times they rejected it.

Importantly, among those that they have rejected were opportunities brought to them to give away the responsibility for actually determining the benefits.

There are three specific circumstances where different proponent groups with the aid of the Board of Supervisors actually brought a proposal to take the voters' authority and to place it either in a collective bargaining format or in a board of supervisors ordinance-determined environment. And in all cases, those proposals were soundly defeated.

I think that a 70 percent "no" vote on the part of the voters is a "hell, no," and that's what they, the voters, have said when given the opportunity to consider this.

The process of having our benefit changes go before the voters causes there to be a pre-process that causes the legislation to be defined clearly; it causes there to be a required mandated cost analysis, which the retirement system’s actuary is responsible under the law to provide. It sets a period -- and the Controller of the City of San Francisco is able to further amplify on the cost, especially where there are other aspects of the legislation.

The voters' handbook actually includes the cost analysis; and the entire package cost analysis and formal legislation are available to the voters 60 days before the actual consideration at the ballot. And such pension-plan adjustments are the subject of active discussion at voter forums and various other public-policy considerations.

A last item which I did not include in the PowerPoint that I presented is that our plan has a number -- we are governed by a seven-member board. Three of those members are appointed by the mayor. However, the mayor is not able to pick anyone. The mayor is directed by the charter provisions to identify individuals who are experienced in, and I'm quoting, life insurance, actuarial sciences, employee pension planning, investment portfolio management, or a doctor of medicine, which addresses the decisions that our board needs to make regarding disability requirements.

But the composite of our structure and a very able board, who are both very knowledgeable and long-serving, we have three CFAs -- excuse me, two CFAs among the elected members of the retirement board, elected by their counterparts. And the result has been that our plan remains very strongly funded; and our plan changes in a more deliberative fashion because of the public review.

And finally, the voters are the best proxy in a local jurisdiction for the taxpayers, who will ultimately have to actually pay the bill.

And I'd be happy to try to answer questions.

CHAIR PARSKY: Thank you.

Comments from anyone about the –- especially about the appropriateness of a requirement that the voters vote, or that the issues are taken to the voters?

John?

MR. COGAN: Can I ask a question?

CHAIR PARSKY: You may.

MR. COGAN: Addressing your question.

When you compare your ability to recruit public employees to the success that other communities around you have, how do you stack up?

MS. MURPHY: If the question relates to our investment staff, I believe that we have been very able.

It does take effort. I do have to convince a number of parties, including the personnel bureau for the City, to ensure that we have compensation structures that are effective. But I would stack my investment team up against any. And I believe that my operations team, who are responsible for the service to the members and the calculation and accounting for benefits are also top-quality individuals. And they're willing to come and work for an expensive city to live in.

MR. COGAN: Clare, I have another group in mind here.

One of the main reasons we have a pension plan is to help us recruit, attract, and retain talent in our public workforce. And so one of the things that one naturally worries about is that if voters have the ability to vote up or down increases, given their reluctance to pay taxes, you might end up with retirement benefits being too low and that may impair your ability to recruit and retain public employees.

So the question I have: Do you find that when you stack yourself up, compared to other districts, cities, counties, that don't have this requirement of voter approval, do you find that you're able to recruit and retain high quality employees as they are?

MS. MURPHY: I believe that San Francisco is able to.

We do have a balancing. We are a bit below median in terms of general member benefits. We are a little, also, slightly below but very close to the top level of safety benefits.

Our health benefit package, retiree medical package is one of the richest available across the state. And that is a very attractive feature, especially given the fact that a lot of our recruitment is to individuals with great experience, given in part the complexity of what our government does, and the need to recruit specialists in water systems, health programs, and the like, and we have been quite successful in recruiting very excellent individuals to serve in those capacities.

CHAIR PARSKY: Yes, Ron?

MR. COTTINGHAM: Thank you.

One of the things I do know is when it comes to negotiating, that San Francisco PD is one of the entities that everybody likes to have as a comparable if they do that. So I know that they're compensated very well.

You say your medical is one of the richest in the state. But can you tell us what your formulas are for retirement?

MS. MURPHY: Our pension formulas for general members are, they start at age 50 at 1 percent per year, age 60, 2 percent per year, maximum, 75 percent benefit.

For safety members, our benefits begin at age 50 at 2.4 percent per year; and at 55, they are 3 percent per year; 90 percent maximum.

Our health benefits, if that's a part of the question --

MR. COTTINGHAM: Yes.

MS. MURPHY: Our health benefits involve a complex series of subsidies, which are established for the payment by the employer of aspects of the cost of active employee coverage. Retirees are granted the same basic subsidies.

The major subsidy is that the city pays on behalf of its active employees and retirees the average rate paid by the ten largest counties in the state for a single employee.

On top of that, a retiree has 50 percent of the remaining premium paid by the employer. And the first dependent on the retiree receives 50 percent of that premium paid by the employer.

Finally, the survivors of a retiree receive the same benefits which a retiree is entitled to. So the employer continues the medical coverage subsidies to the surviving parties -- spouses, normally, or domestic partners.

MR. COTTINGHAM: Thank you.

CHAIR PARSKY: Bob?

MR. WALTON: Hi, Clare. How are you?

MS. MURPHY: I'm good.

How are you, Robert?

MR. WALTON: You described the pension benefits by voters in the process and how it's worked over the years.

Two questions: First, it just struck me, are the plan changes to the benefit plans subject to voter approval?

MS. MURPHY: The subsidy definitions, our part of the charter as are the structure of the board that governs the Health Service Board, which is an independent body in San Francisco. We have the SFERS board and the Health Services Board.

MR. WALTON: And it's that board that determines co-pays and deductibles and that sort of thing, so that's not subject to any voter approval?

MS. MURPHY: That's correct. The actual

definition in the contract with various health providers is in the hands of the Health Service Board.

MR. WALTON: Secondly, I was struck by the number of times that voters have approved or disapproved changes.

In your recollection, is there anything common about those that are approved versus those that are disapproved? Or is there any similarities or differences?

MS. MURPHY: Given that we're talking about eighty-plus years or almost 80 years, there's a lot of varying factors.

I think important factors are that initiatives have generally not been successful, so that where an item did not go through the legislative process and have the level of exposure and preliminary review, the voters have been less positive.

Clearly, there were periods where the economics of the city and of the country as a whole were not conducive to benefit increases. So the fifties and early sixties did not see much in the way of benefit improvements.

Otherwise, it is really a discrete judgment that the voters make about the actual proposal that's before them.

CHAIR PARSKY: Matt?

MR. BARGER: I have a couple questions. I'll throw all three of them out and let you have at them.

One, I was just curious. Are there other entities, you know, states, cities, counties that you're aware of that have sort of a similar requirement?

The second question I had is, what happened in terms of benefit changes around that period, in ’98, '99, 2000, 2001, when there would have been a super surplus?

And three, can benefits then be taken away as well as added without going through the collective bargaining process?

MS. MURPHY: The answer to the first question is, the other California jurisdiction that I know has now a similar process is the City of San Diego. And this is a new provision that was very recently, I believe last November, enacted by San Diego City.

With respect to what happened to our benefits in the nineties, early 2000's, we did have a significant benefit increase, 2, 3 percent at 55 for safety officers, which occurred in 2002. Really, at the end of that process but during the period where the recognition of the losses had not yet begun to occur.

However, it's important to note that our plan at its peak was approximately 138 percent funded, and never went below 104 percent funded.

So it was still at a period of time, regardless of the value of those funding measures, by all measures, our fund was strongly funded during those periods.

With respect to your last question, can benefits be taken away, a major example of that is 1976, where a leader of the Board of Supervisors determined that our plan had a recurring 17-million-dollar cost increase, which today, for many of our plans, would not seem like a significant number, but at that time, it did aggravate Supervisor Barbagelata. And he moved to create a new tier of benefits for new hires. And starting on November 2nd, 1976, a new lower-level of benefits, approximately 20 percent lower, across all plan types occurred. And it persisted until 2000, when the benefits between the preexisting period and that period were equalized.

So we have orphaned retirees who were retired under that lower benefit structure.

CHAIR PARSKY: And that lower benefit structure was taken to the voters?

MS. MURPHY: It was. And the voters adopted it. It was really like the front page of a newspaper today. It was approximately eight full newspaper-sized pages.

CHAIR PARSKY: Thank you very much. We really appreciate your presentation. Very interesting.

And with that, we'll conclude our session today.

And our next session is in --

MS. SHEEHAN: Sacramento.

CHAIR PARSKY: -- Sacramento on November 13.

We'll see you then.

Thank you.

(Proceedings concluded at 3:22 p.m.)

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REPORTER'S CERTIFICATE

I hereby certify that the foregoing proceedings were duly reported by me at the time and place herein specified;

That the testimony of said witnesses was reported by me, a duly certified shorthand reporter and a disinterested person, and was thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for either or any of the parties to said deposition, nor in any way interested in the outcome of the cause named in said caption.

IN WITNESS WHEREOF, I have hereunto set my hand on the 7th day of November 2007.

DANIEL P. FELDHAUS
California CSR #6949
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Certified Realtime Reporter