September 3, 2014

Honorable Glenda Sanders
Presiding Judge of the Superior Court of California
700 Civic Center Drive West
Santa Anna, CA 92701

RE: Orange County City Pension Liabilities

Dear Judge Sanders:

The City Council has authorized me to submit the City of Laguna Beach's response to the June 18, 2014, report of the Orange County Grand Jury regarding Orange County City Pension Liabilities. In accordance with California Penal Code Sections 933 and 933.05, the City's response addresses the Orange County Grand Jury Report findings and recommendations pertaining to the City of Laguna Beach.

Response to Findings:

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

Response: The City of Laguna Beach partially agrees with the finding. It is important to note that comparing the unfunded liability between Orange County cities on a per capita basis can be misleading. For example, the City of Laguna Beach has a significant amount of year-round tourism and frequently services over 100,000 visitors per day. Using a per capita statistic for the City Laguna Beach does not represent the populous served. These visitors, while helping to pay for city services, including the unfunded pension liabilities, through revenues such as sales tax and hotel tax, have a significant impact on the level of staffing required for police, fire, lifeguard and public works services.

Another challenge is that cities that contract with other public agencies for municipal services, such as police and fire, may not capture their future pension liabilities in their budgets. This presents difficulties comparing pension liabilities between cities in Orange County.

Finally, it should also be noted that the City of Laguna Beach has been proactive in addressing the City's pension plan (CalPERS) unfunded liability. In 2010, the City approved the payoff of a $10 million pension liability to CalPERS, this was a payoff of the City's Side Fund which represents the unfunded liability for past service credit of

safety employees. Additionally, in 2013, the Laguna Beach City Council and employee associations agreed to higher contributions by employees to their retirement ranging from 8%-12%. In May 2014, the Laguna Beach City Council approved a financial plan to start paying CalPERS an additional $1 million towards the miscellaneous plan unfunded liability with a goal to increase the amount to $1.4 million annually next year, FY 2015-16. These additional payments will shorten the payoff period of the unfunded liability by four years and save the City roughly $12 million over the next 30 years. Next year, when CalPERS gives agencies the ability to make payments toward their individual pooled plan unfunded liabilities, the City Council will consider additional strategies to address the safety plans unfunded liability.

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

Response: The City of Laguna Beach agrees with the finding. However, it is also possible that the liabilities could decrease in the future due to improved investment returns.

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

Response: The City of Laguna Beach partially agrees with the finding. In any pension plan there are numerous assumptions used to calculate the pension contribution. Those include assumptions for investment returns, mortality rates, demographics, and pay levels. These actuarial assumptions are very complex and can change significantly to adjust for actual events. The CalPERS Board has the sole and exclusive power to provide for the actuarial services in order to assure the competency of the CalPERS system. The Board also has the sole and exclusive duty to make actuarial determinations. It should also be noted that unexpected improvements in actual data compared to actuarial assumptions, such as improved investments returns, can reduce future liabilities.

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

Response: The City of Laguna Beach disagrees with the finding. The City of Laguna Beach budget for the current year and seven prior years is available on the City's website. The budget information can also be found by performing a keyword search using the search word "budget" in the search box located on the City website homepage.

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

Response: The City of Laguna Beach disagrees with the finding. The City of Laguna budget includes, by line item detail, one-year of prior year revenue and expenditures data and projected revenues and expenditures for the upcoming two years. Significant events that are likely to impact revenues and expenditures beyond the two-year period are discussed in the budget transmittal letter. In addition, the City also models future revenues and expenditures for three to five years into the future.

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

Response: The City of Laguna Beach disagrees with the finding. The City of Laguna Beach budget includes a transmittal letter that articulates not only the key revenue assumptions and expenditure changes expected over the upcoming two years, but also the City's key revenue and expenditure challenges over the long-term.

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

Response: The City of Laguna Beach disagrees with the finding. The City's budget transmittal letter and accompanying city-wide summary schedules describe significant changes in revenues, expenditures, reserves and trends for the various city funds. These budget summary schedules also note that the City's maintains a Disaster Contingency Fund equal to roughly 6% of operating expenditures and a General Fund reserve of 20% of operating expenditures. This level of reserve is intended to provide the City with sufficient working capital and margin of financial safety to address unforeseen, one-time expenditure emergencies like fires, floods, earthquakes, landslides, sewage spills, or economic downturns.

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

Response: The City of Laguna Beach agrees with the finding.

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

Response: The City of Laguna Beach partially agrees with the finding. In the City's budget transmittal letter, the City of Laguna Beach includes a prediction of increases in future annual required pension contributions based on the risk assessment data provided by CalPERS. The budget also includes line item details showing the expected pension contribution for the year by department, by fund, and in total. The required pension contributions are calculated based on the information taken from actual reports provided by CalPERS. However, the City budget does not explicitly show the link between pension contributions and the CalPERS pension system actuarial reports.

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

Response: The City of Laguna Beach partially agrees with the finding. Since the Public Employees' Pension Reform Act (PEPRA) went into effect on January 1, 2013, the City of Laguna Beach has enrolled roughly 8% of current employees in the New (Post-PEPRA) pension plans. Assuming that rate of enrollment continues, City of Laguna Beach employees enrolled in the New pension plans will increase to over 55% in the next ten years.

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

Response: The City of Laguna Beach disagrees with the finding. The City of Laguna Beach Annual Valuation Reports[1] and pension contributions rates[2] for all City pension plans are available at the CalPERS website.

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[1] CalPERS, *Public Agency Actuarial Valuations*, http://www.calpers.ca.gov/index.jsp?bc=/about/forms-pubs/calpers-reports/actuarial-reports/browse-results.xml&strCatId=2&q=laguna-beach-city,
(date accessed 8/25/2014)

[2] CalPERS, Public Agency Employer Contribution Rate Search,
http://www.calpers.ca.gov/index.jsp?bc=/employer/actuarial-gasb/contrib-rates/rates/employer-results.xml&employer_code=4447311817
(dated accessed 8/24/2014)

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

Response: Finding F.12 is not applicable. The City of Laguna Beach does not participate in the OCFA or OCERS pension programs.

Response to Recommendations:

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

City Response: The recommendation has already been implemented. Since 2009, the City of Laguna website has provided the three most recent prior year budgets. Currently, the seven most recent budgets are provided on the City's website, including the FY 2013-14 and FY 2014-15 budget which is a two-year budget. The budgets are easily located and budgets can be found by typing the word "budget" in the City website homepage search box.

Recommendation R.2: Each city's budget information should contain not only this year/next year budget projections, but should show at least five years of projected revenues and expenditures. Projections should be at the same level of detail and use the same line item structure as information in the current budget

City Response: The recommendation will be partially implemented. The City budget already includes line item detail of revenue and expenditures for the upcoming two years. In addition, the City models revenue and expenditures for three to five years into the future and longer for capital improvement funds and special revenue funds. Long-term revenue projections for general purpose funds are not reliable due to external economic factors.

Recommendation R.3: **Each city's budget should show separate line items for predicted employee and predicted employer contributions for the city pension system.**

City Response: The recommendation will be implemented. The City of Laguna Beach budget includes line item detail by department, by fund, and in total of the required City pension contribution for the the upcoming two years. Beginning with the next budget cycle, the City will incorporate separate line items for the predicted employee and predicted employer contributions made by the City to the CalPERS system.

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

City Response: The recommendation has been implemented but will be augmented in the next budget to provide additional information. The City of Laguna Beach budget transmittal letter includes trend data on the use of General Fund reserves and other key funds such as the Capital Improvement Fund, Parking Fund, Sewer Fund and Disaster Contingency Fund.

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

City Response: The recommendation will be implemented. As part of the next budget cycle, the City will incorporate a synopsis of the current pension benefit formulas, retirement rates, the required annual contributions to the CalPERS pension system including trend information, and the risk associated with the CalPERS projections. In addition, the City will include separate expenditures line items for catch-up contributions (payments toward the unfunded liability) and the pension plan normal cost (the annual cost of service for active employees).

Furthermore, in an effort to continue improving transparency related to pension information, the City of Laguna Beach will incorporate into the next budget a separate section dedicated to pensions.

**Recommendation R.7: Each city that has CalPERS as a provider for pensions
should include a provision in their agreements with CalPERS that CalPERS will
post their Annual Valuation Report online.**

City Response: The recommendation has been implemented. The City of Laguna
Beach already includes a link on the City website to the CalPERS webpage displaying
the most recent Annual Valuation Report prepared by CalPERS for all City pension
plans. Furthermore, a second link to to the City pension plan contribution rates is also
provided.

Respectfully submitted,

John Pietig
City Manager

cc: City Council