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September 23, 2014

The Honorable Glenda Sanders
Presiding Judge of the Superior Court
700 Civic Center Drive
Santa Ana, CA 92701

The Honorable Glenda Sanders,

Please accept this as the City of San Clemente's official response to the 2013-2014 Orange County Grand Jury report, Orange County City Pension Liabilities; Budget Transparency Critically Needed.

At the time the Grand Jury report was developed, the City had two retirement plans for current City employees: The City of San Clemente Employees' Retirement Plan (CSCERP) for Miscellaneous employees, administered by Great-West Retirement Services, and the Safety Lifeguard Plan of the City of San Clemente for Safety employees, administered through the California Public Employees' Retirement System (CalPERS). All permanent employees meeting required guidelines were covered by CSCERP, except Marine Safety personnel, who participated in the CalPERS plan.

In June 2014, the City changed the administration of the CSCERP plan from Great-West to CalPERS, and service time for all existing full-time employees was transferred to the CalPERS system. The City continues to maintain the Great-West plan in order to administer the pension obligation for existing retirees and prior employees, who were not transferred to the CalPERS plan.

It should be noted that the information and tables provided in the Grand Jury report regarding Unfunded Pension Liabilities by City and Plan (pages 18-19 and pages 22-23) did not include any information about the City of San Clemente's pension plan for miscellaneous employees (CSCERP), which covers the majority of the City's employees. The plan listed for San Clemente in the Grand Jury report is the City's Safety Lifeguard CalPERS plan, which covers only 5 active employees.

Regarding the Findings and Recommendations noted in the report that require a response, the City responds as follows:

FINDINGS

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

The City disagrees with this finding. At the time the Grand Jury report was developed, pension benefits for miscellaneous (non-safety) City employees are provided by the City of San Clemente Employees' Retirement Plan (CSCERP), which covers the majority of full-time City employees. At July 1, 2013, the plan had an unfunded accrued liability (UAL), of \$14,663,936, based on Market Value of Assets (MVA). This represents about 29% of one year of General Fund Revenues and \$227.20 on a per capita

basis. Adding the City's total Miscellaneous UAL with its Public Safety UAL, the total UAL amounts to \$16,023,602, representing 32% of General Fund Revenues, and about \$248.27 on a per capita basis.

The Grand jury report includes tables showing comparable data from ten OC Cities. The City of San Clemente's UAL is much lower than the other City's noted in the data tables, on an absolute dollar value and per capita basis, as well as when analyzed as a percentage of General Fund revenues. For instance, the lowest UAL and per capita amount for the ten cities listed was \$53,110,542 and \$1,214.79, respectively, as compared to San Clemente's \$16,023,062 and \$248.27. Using the metrics noted, the total UAL for the City of San Clemente would not be considered large in comparison to other Orange County cities.

Findings 2: OC cities' unfunded pension 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.

The City partially disagrees with this finding. At the time of the Grand Jury report, the City of San Clemente's retirement plan for miscellaneous employees was not administered through CalPERS; therefore, CalPERS changes in key actuarial assumptions would not have impacted San Clemente's unfunded pension liability over that time period. However, there were changes to the actuarial assumptions for the City of San Clemente's pension plan, and the City's UAAL did increase from 2009 through 2013, partially due to those changes and partially as a result of the 2007-09 economic recession. It should be noted that larger gains in investment returns have been seen in the last two years. These increased gains offset some of the liability increases resulting from the actuarial assumption changes. In addition, while the dollar amount of the unfunded liability has increased, the City's funded ratio grew from 2012 to 2013 (from 68.5% funded to 71.1% funded).

The City of San Clemente's UAAL and funded ratio over the past several years is noted in the table below:

Actuarial Valuation Date	Actuarial Accrued Liability (AAL)	Actuarial Value of Assets (AVA)	Unfunded AAL (UAAL)	Funded Ratio
7/1/2013	\$58,124,474	\$41,346,698	(\$16,777,776)	71.10%
7/1/2012	\$52,775,327	\$36,170,712	(\$16,604,615)	68.50%
7/1/2011	\$46,678,961	\$32,284,398	(\$14,394,563)	69.20%
7/1/2009	\$35,704,653	\$25,911,607	(\$9,793,046)	72.60%

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

The City partially disagrees with this finding. It is agreed that downward revisions of expected investment returns as well as using more realistic mortality assumptions will increase the amount computed as unfunded liabilities. It is agreed that this is a risk to the City of San Clemente as it would likely mean increases to the City's required pension contributions in coming years. CalPERS, the City's new pension plan administrator as of June 2014, provides notification in advance of potential changes and, in some cases, "smooths" the changes over time, spreading the impact over a longer period. In addition, the City mitigates this risk by including the projected fiscal impact of proposed upcoming actuarial changes in its long-term financial forecast, allowing for advance budget planning for the impact of such changes.

However, in terms of risk, it is the City's stance that NOT changing actuarial assumptions when warranted would be more risky to the City in the long run. If actuarial corrections were warranted and not made, then the City would continue to fund its pension plan with outdated and/or inaccurate actuarial assumptions, resulting in underfunding its pension obligation, effectively postponing current obligations to the future. It is prudent to ensure that actuarial assumptions are realistically based, so that the computed Annual Required Contribution (ARC) and the related pension rate ideally provides for adequate funding to pay future promised benefits without further increasing the UAAL balance in the future.

Findings 4: Locating city budget information on a city web site is not always straightforward and prior year budgets are sometimes not posted by a city.

The City disagrees with this finding. The City of San Clemente's Adopted Budget document is available on the City's website and can be easily located in a number of ways. In addition, Adopted Budget documents for the last five years are also included, and can be easily located, on the City's website, www.San-Clemente.org.

Findings 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.

The City disagrees with this finding. The City of San Clemente's annual Adopted Budget includes projections for Total General Fund Operating Revenues and Expenditures for the current year and for four years into the future (see page 39 of the City's FY 2015 Annual Budget). In addition, most of the graphs, charts and tables in the document include prior year data (showing both the adjusted budget and projected amounts) as well as data of the actual results from two years prior.

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

The City partially disagrees with this finding. While the City of San Clemente's annual Adopted Budget does not include the requested information in a footnote, it does include detailed narrative for these items. In the FY 2015 Adopted Budget, the City Manager's Transmittal Letter (pages 15-21) includes summary detail on assumptions and risks and includes explanations of significant cost adjustments. More detailed information on these items is found in the Financial Overview section (pages 29-40). Revenue assumptions are also detailed in the budget document (pages 62-64 and Pages 88-92).

Findings 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.

The City partially disagrees with this finding. Page 37 of the FY 2015 Adopted Budget document provides information on the City's Reserve contributions for the coming year, including Fund Balance reserves. Trend data for the General Fund's Fund Balance reserves is shown on Page 78-79 of the budget document. In addition to the Budget document, the City annually prepares a Long-Term Financial Plan (LTFP) document which provides a much more detailed (14 page long) Reserve Analysis. That document is presented, discussed and reviewed at an open public meeting each year, and the document is easily accessible on the City's website for the current year as well as for several previous years. Please refer to www.San-Clemente.org, to locate the City of San Clemente's LTFP.

Findings 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 to five years.

The City partially disagrees with the finding. The City agrees that increases to the ARC are imposed externally by CalPERS and due to the most recent smoothing policy changes by the CalPERS Board, rates used to calculate the ARC will “ramp up” up to five years when there are changes to smoothing policies, assumptions or investment losses; however, the City does not necessarily agree that these changes are unpredictable. CalPERS notifies agencies when policy changes or assumption changes are planned to be proposed and what kind of effect agencies should anticipate from these changes. As an example, the new mortality assumptions that were approved earlier this year, were communicated to agencies about a year before they were brought to the Board for discussion and the actual changes to rates will not occur for another two years. As for the smoothing changes, these were also communicated almost a year in advance and the Chief Actuary put on several presentations on the topic leading up to the CalPERS Board meetings and sought feedback from agencies on the various alternatives. Unpredictable is unforeseen and sudden. The process of changing mortality assumptions and smoothing policies was not sudden. It is also well known that CalPERS reviews actuarial assumptions every few years and agencies are aware of this when forecasting their budgets.

Findings 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.

The City agrees with this finding. However, the City of San Clemente does include detailed information about its pension plans and actuarial results in the City’s Comprehensive Annual Financial Report (CAFR). In addition, the City prepared a comprehensive review of pension plans in a Retirement System analysis paper in the City’s 2015 Long Term Financial Plan (LTFP) document.

Findings 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.

The City agrees with this finding.

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

The City disagrees with this finding. CalPERS administers the City’s Safety Lifeguard plan and City of San Clemente’s agency valuations for that plan are located at the following CalPERS website link: <http://www.calpers.ca.gov/index.jsp?bc=/about/forms-pubs/calpers-reports/actuarial-reports/browse-results.xml&strCatId=2&q=san-clemente-city>

Findings 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.

The City agrees with this finding.

RECOMMENDATIONS

Recommendations 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 web site should have a search engine and a single search on the word "budget" should immediately link to the current budget.

This recommendation has already been implemented. At a minimum, the City of San Clemente posts its current and four most recent prior year budgets on the City's website, for a total of five years of available budget information. These budgets are easily located in a variety of ways, including through the Search Engine on the website.

Recommendations 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 for the current budget.

This recommendation has been partially implemented. The City of San Clemente's annual Adopted Budget includes five-year forecasted projections for the General Fund's Total Operating Revenues and Expenditures (see page 39 of the City's FY 2015 Annual Budget). The City will not be implementing the recommendation that the projections in the budget should be at the same level of detail and line item structure as information for the current budget for two reasons. The first reason is that the City annually prepares a Long-Term Financial Plan (LTFP) document which provides a detailed review of the City's five-year Financial Forecast, including background, assumptions, and discussion of key issues. The document also includes the projections at a high level line item detail, rather than at the total level. That document is presented, discussed and reviewed at an open public meeting each year, and the document is easily accessible on the City's website. The second reason is that the budget document is currently over 300 pages long, and adding the detailed information requested to that document would negatively impact the complexity and readability of the document, and does not appear warranted as the City provides the more detailed LTFP document.

Recommendations 3: Each city's budget should show separate line items for predicted employee and predicted employer contributions for the city pension systems.

The recommendation has not yet been implemented, but will be implemented in the City's next budget document (FY 2016). The City plans to add information to its budget document providing detail on each of the City's pension plans, including detailing the budget amounts as between employee and employer share.

Recommendations 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 pension liabilities.

This recommendation is not warranted. Page 37 of the FY 2015 Adopted Budget document provides information on the City's Reserve Contributions for the coming year, including Fund Balance reserves. Trend data for the General Fund's Fund Balance reserves is shown on Page 78-79 of the budget document. In addition to the Budget document, the City annually prepares a Long-Term Financial Plan (LTFP) document which, each year, provides a much more detailed (14 page long) Reserve Analysis.

That document is presented, discussed and reviewed at an open public meeting each year, and the document is easily accessible on the City's website.

In addition, the City's LTFP document for 2014 included a full analysis paper on the City's various retirement systems. The analysis included a discussion of the City's current method of paying off the unfunded liability for the miscellaneous pension's plan (amortized over 20 years) and a recommendation for use of reserves towards a rate stability fund to address possible large future rate increases in the future.

Considering the size of the City's unfunded liability, the size of its Unassigned Fund Balance, and taking into account other projected future costs, the City believes the 20 year amortization period is the most practical and reasonable method to pay down any unfunded liability. Reserves, ongoing pension liabilities and other pension issues are analyzed every few years, as the City's financial position changes or as warranted by other circumstances. It would not be reasonable or prudent for every discussion of reserves to once again address paying down the Unfunded Liability.

Recommendations 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 Annual Required Contributions (ARCs) for these plans and should provide a separate expenditure 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.

The recommendation has not yet been implemented, but will be implemented in the City's next budget document (FY2016). The City plans to add information to its budget document providing detail on each of the City's pension plans, including identifying information about the Annual Valuation Reports, the Annual Required Contribution, and separately indicating what portion is applied as a catch-up contribution towards the liability payment. A discussion of the risks associated with the projections will also be provided.

Recommendations 6: Each city which outsources fire or police services to OCFA and/or OCSD should require them to provide projections of future costs of service out at least five years into the future and require that these projected costs explicitly show the relationship of projected pension costs including amortization of unfunded liabilities. This level of pension cost information should be provided in budgeted expenditures for outsourced services. A discussion of the risks associated with these projections should also be provided by the agencies and incorporated in the city's budgets.

The City of San Clemente contracts with OCSD for Police Services and with OCFA for Fire Services.

OCSD: The Recommendation has already been implemented, as OCSD currently provides projections of future costs of service out at least five years into the future, which explicitly show the relationship of projected pension costs. However, at this time, OCSD is unable to provide a projected cost related to the UAAL beyond the current fiscal year. OCSD has been and continues to work with OCERS and the County to find a method of forecasting that would provide the City with an appropriate and reasonable estimate for this item for planning purposes in the out years.

The City of San Clemente will not be implementing the recommendation to include this level of pension cost information in budgeted expenditures, as these pension costs are not pension expenses for the City. The City does not intend to break out all the individual components of contracted services, as it is believed that it would be confusing to the reader and not accurate, as the City is only responsible for the total contracted cost, not individual pieces of the contract. However, in order to provide as much transparency as possible, and to address the Grand Jury's concern, the City does plan to add an informational section to its next budget document (FY2016) that will provide more information on the

OCSD pension cost projections and any potential impact to the City. A discussion of the risks associated with these projections will also be provided.

OCFA: OCFA does provide a multi-year projection, but does not include details about retirement costs. The City has requested that OCFA provide similar five year information, showing projected pension costs, and will continue to work with the agency to obtain the information.

Similar to OCSD, the City of San Clemente will not be implementing the recommendation to include this level of pension cost information in budgeted expenditures, as these pension costs are not pension expenses for the City as stated. The City does not intend to break out all the individual components of contracted services, as it is believed that it would be confusing to the reader and not accurate, as the City is only responsible for the total contracted cost, not individual pieces of the contract. In addition, the City has a long-term contract with OCFA, with the City's contract cost increases capped at 4.5% per year, regardless of future changes to pension rates. However, in order to provide as much transparency as possible, and to address the Grand Jury's concern, the City does plan to add an informational section to its next budget document (FY2016) that will provide more information on the OCFA projected pension costs and any potential impact to the City. A discussion of the risks associated with these projections will also be provided.

Recommendations 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 Reports online.

This recommendation is not warranted. CalPERS already posts all annual valuation reports online. CalPERS administers the City's Safety Lifeguard plan, and the City of San Clemente's agency valuations for that plan are located at the following CalPERS website link:

<http://www.calpers.ca.gov/index.jsp?bc=/about/forms-pubs/calpers-reports/actuarial-reports/browse-results.xml&strCatId=2&q=san-clemente-city>

The City transitioned to CalPERS for its pension plan for Miscellaneous employees in June of 2014. All future actuarial valuations for the miscellaneous plan will be posted to the CalPERS website as well.

If further information is required regarding this matter, please contact the City's Finance Manager, Judi Vincent, at 949-218-9601.

Sincerely,



Erik Sund
Acting City Manager

C: Mayor and City Council
Orange County Grand Jury