City of Sebastopol

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August 1, 2006

Judge Robert Boyd, Presiding Judge
Sonoma County Superior Court
County of Sonoma Hall of Justice
600 Administration Drive
Santa Rosa, CA 95403

Dear Judge Boyd,

RE: Grand Jury Report for Fiscal Year 2005-06

The Grand Jury report has requested us to respond to their recommendations contained in the final report entitled, "The Impact of Yesterday's Promises". This letter serves as our collective response to the Grand Jury request.

The final report, "The Impact of Yesterday's Promises" contained a background statement that determined current accounting standards do not provide for complete information about benefit obligations. Consequently, to comply with these federal standards by showing over-funded or under-funded pension and health care liabilities, we should have a clear and useful picture that should be published. We agree wholeheartedly with this statement and have been taking steps to address this situation in our city.

We also agree with the conclusions stated in the report that describe the experiences in the private sector and the need for public employers to gain control over spiraling health care and pension benefits provided to retirees as soon as possible to avoid unintended financial consequences from unfunded benefits. We believe we are following a responsible course of action in Sebastopol that will avoid the need to "raise taxes, cut other services and lay off workers, if there are not enough assets or reserves to meet the requirements of the new accounting laws." as cited in the Grand Jury report.

Our specific responses to the findings as stated in the report are as follows:

F1 *What the grand jury was able to interpret from the piles of financial information provided, was that health care benefits alone indicated no extreme differences between cities. These health care premiums averaged about 3% of the budgets. The premiums had a broad range of $5,400 to $11,500 per employee per year, taking into consideration* *single versus family coverage and risk factors. Adding all the other contributions : pensions, dental, vision and/or life insurance to the equation, employee benefit costs are close to the normal range of 17 to 20% of the budgets.*

We partially agree with this finding. However, we are aware that some public employers in Sonoma County are paying well in excess of the $11,500 health care premium cost per employee per year stated in the finding. We also are unsure what the Grand Jury term "normal range of 17 to 20% of the budgets" means. From our experience, the cost of employee benefits, as a percentage of total budget are at one of the highest percentages ever due to the recent high increases in PERS retirement costs and health care premium increases.

F2 California Public Employees Retirement System (CalPERS) is the pension plan of choice. During our interviews it became apparent, that actuarial expertise and plan management were highly respected.

We partially agree with this finding. PERS is one of the best, if not the best public employee retirement systems in the country. However, they are only now instituting a method to avoid the extreme peaks and valleys of employer contributions to the retirement system that we have experienced during the past fifteen years. We are also concerned that PERS has offered some retirement plan options to employers that have resulted in significant cost increases in pension plan costs and earlier retirement opportunities for public employees that have contributed to the problem stated in the Grand Jury Conclusion that:

"Figures furnished to the jury by providers indicated that driving up these costs are early retirements without Medicare eligibility. Boomers and the age group between 50 and 65 out-spend health care premiums by 164% and the figure for all retirees out-spending health care premiums is 131%."

The retirement plan options provided to employees were adopted by PERS creating early retirement opportunities that have, among other unintended impacts, contributed to health care premium increases for public employers.

F3 Health care coverage costs have doubled in the past five years and are projected to double again in the next five years. Insurance providers blame this on the costs of new technology.

We partially agree with this finding as we have experienced a doubling of our health care coverage costs. We have no knowledge of future increases other than we expect them to increase. We are also unaware of the statements of insurance providers that the cost of new technology is the cause. We believe utilization and the inflationary cost increases to provide the goods and services are also major contributors to the cost increases.

F4 The State of California, as quoted in the Sacramento Bee, sees the way out of this situation of unsustainable health care promises: "the solution- just quit promising health care for life. That's what the Medicare system is for."

We can neither agree or disagree with this finding. We have not seen the article from the Sacramento Bee as quoted. In regard to the quote itself, we agree that employers should not make promises to employees regarding benefits for which is not pre-funded. The difference in perceived financial security between Social Security (pay as you go) and PERS (83% pre-funded) illustrates the fiscal responsibility of pre-funding retiree benefits.

F5 *Reserve funding will be mandatory for all employing entities offering benefits for life. This is nothing new to pension providers, however, it will be new for health care, dental care, life insurance or any other promises for life. A mismatch between assets and liabilities has to be addressed. Full disclosure will provide this information.*

We partially agree with this finding except for the first sentence that "Reserve funding will be mandatory for all employing entities offering benefits for life." GASB #45- "*Accounting and Financial Reporting by Employers for Post Employment Benefits other than Pensions*" requires states, local governments and public entities to adopt accrual basis of accounting for post employment benefits, instead of the pay-as-you-go basis most employers currently use. GASB #45 covers all non-pension post employment benefits. It also requires that an actuarial valuation be conducted at least every other year and the entire accrued liability be amortized over a period not longer than 30 years. The annual expense of a public entity will include only that year's amortized portion of the unfunded liability. As long as a public entity makes a full contribution (equal to its amortized cost) to a qualified trust, it does not have to place a liability on its statement of net assets. This will not require an employer to fully fund the liability at the outset in a reserve fund, but over the course of the identified 30 year or less amortized period.

F6 *Both current employees and retired employees will benefit from the security of knowing that what they expect and have been promised is not dependent on the whims of the future.*

We fully agree with this finding.

Our responses to the Grand Jury Recommendations are as follows:

R1 *The grand jury recommends that Supervisors, Council members and financial officers should verify that health or other lifetime benefits promises are secured properly and in compliance with reserve funding standards.*

The Recommendation has not yet been fully implemented, but will by fiscal year 2007-08 We have already created a reserve fund for our retiree medical unfunded liabilities and estimate that it covers approximately 20% of our liability. We have a financial reserve policy which will result in this coverage increasing in the future. We annually appropriate the necessary funding for the current year liability without impacting our operations or creating the necessity to borrow funds as in other jurisdictions.

We assume that "secured properly" and reserve funding standards" means being in compliance with the recently issued GASB #45- Accounting and Financial Reporting by Employers for Post

Employment Benefits other than Pensions. This new accounting rule requires states, local governments and public entities to adopt accrual basis of accounting for post employment benefits, instead of the pay-as-you-go basis most employers currently use. GASB #45 covers all non-pension post employment benefits. It also requires that an actuarial valuation be conducted at least every other year and the entire accrued liability be amortized over a period not longer than 30 years. The annual expense of a public entity will include only that year's amortized portion of the unfunded liability. As long as a public entity makes a full contribution (equal to its amortized cost) to a qualified trust, it does not have to place a liability on its statement of net assets. The City of Sebastopol has instructed it's independent outside audit firm of Terry E. Krieg, CPA to bring the City of Sebastopol into compliance with the requirements of GASB #45.

R2 The grand jury recommends that the Board of Supervisors and/or City Councils enlist actuarial expertise to audit this asset/obligation disclosure.

This recommendation has been implemented.

R3 The grand jury recommends that the advice of an expert should be solicited to consider the fairest most equitable way to offer health care benefits to public employees. This should be disclosed.

This recommendation has been implemented. The City of Sebastopol is one of 18 north coast cities who are members of the Redwood Empire Municipal Insurance Fund (REMIF) which is a joint powers authority that was formed for the express purpose of jointly purchasing insurance products for its employees and each city member. Our current health insurance costs are approximately 25% lower than costs of comparable health insurance plans offered through CalPERS- a statewide insurance pool. Other insurance experts we use are USI associates and the members of CAJPIA (California Association of Joint Powers Insurance Authorities).

R4 The grand jury recommends to build a secure structure for maintenance of employee benefits should not be deferred.

This recommendation has been implemented. All employee benefits for active employees are financially secured through our annual budgeting process which takes into account the numerous needs of the City. The structure for maintaining these benefits are constantly reviewed and adjusted for changing conditions communicated between our benefit plan providers, insurance brokers and plan managers at REMIF. The financial security for employee benefits are given significant consideration when determining employee compensation issues along with city needs for maintaining all the services for police, fire, water, sewer, community development, streets and the support services necessary to operate a full service city.

In regard to financially securing the retiree medical benefit after retirement, the City of Sebastopol has included this goal in its "General Financial Policies" adopted as Council Policy 69 in 2001. Section D "Reserve Policies" includes under the heading "Reserves for Accrued Liabilities" the goal of funding for estimated cost of retirees' medical premium liability. The City has begun funding this reserve requirement and the Financial Statements as independently audited show a funding of $100,000 on page 37. The funding of this reserve will continue to occur on a yearly basis. The City would be able to use our economic reserve if necessary to address any shortfall in our unfunded liability for employee medical after retirement benefits.

In addition, beginning in 2006, not all new employees will be automatically entitled to the medical after retirement benefit plan, but will be offered the option to participate in the city's medical benefit plan for retirees at a 50% cost sharing arrangement, thus reducing future liability growth by a significant percentage.

R5 The grand jury recommends full disclosure of each entities total benefit obligations along with information describing provisions to secure them. We are requesting this information between the end of each entities current fiscal year and December 31, 2006:

We are assuming that the Grand Jury is referring to the costs associated with employee pension and health care costs. **This recommendation has already been implemented.** All of the information that is available to the City in regard to active employees is provided in our annual audit report. For retirees, we can provide the following supplemental information:

- *Number of employees eligible for pension premiums*

The City of Sebastopol currently has 48 full-time employees for whom the City pays 100% of the PERS premium costs. In regard to eligibility for the medical after retirement benefit, 28 of the 48 employees have been employed the minimum of 10 years with Sebastopol to qualify for the benefit.

- *Number of retired employees receiving pension benefits*

We do not maintain a census of former employees who may be receiving a PERS retirement pension that the City has contributed to. Employees may leave their employment with the City prior to their retirement.

The City of Sebastopol does not offer any post-employment pension benefit except for a set contribution for health insurance premiums. The City currently pays contributions for 13 retired employees' health insurances premiums.

- *Financial obligation*

The City's annual financial obligation for PERS costs are contained in our annual audit. For the medical after retirement benefit for retirees, the City of Sebastopol is currently paying $34,745 per year. The annual cost is not affected by increasing health premiums as the City payment is limited to a range of $131.56 to $311.10 per month depending on age and number of dependents. The retiree pays any increases in premium cost.

- *What reserves are in place to insure these pension obligations*

As noted under R4, the City currently has a reserve in place of $100,000 and will be increasing that reserve yearly to fully fund the obligation.

- *Obligation for health care coverage*

In addition to the obligations negotiated with active employees for which the terms and conditions are contained in three separate Memoranda of Understanding, Section 381 of the City of Sebastopol Employee Handbook provides: City will make payments toward health insurance premiums for retirees and dependents, providing the employee has had 10 years of prior employment with City of Sebastopol. The City will pay up to:

single person under age of 65:	$131.56/mo.
single person, over age of 65:	$148.15/mo.
with spouse, both under age 65:	$276.27/mo.
with spouse, one over age 65:	$298.89/mo.
with spouse, both over age 65:	$311.10/mo.

- *Reserve amount in place*

As previously mentioned, the City has created a reserve for the retiree medical plan which currently has a balance of $100,000. We estimate that this amount represents approximately 20 % of the unfunded liability. The city will be conducting an actuarial study to determine the exact amount necessary to fully fund the obligation in compliance with GASB 45.

- *Amount required by federal authorities to secure these health care benefits.*

Actually, GASB #45 issued by the Government Accounting Standards Board does not require any amount to secure these health care benefits, only that the liability be shown on the financial statements. That liability will be determined by actuarial study and that study is required by GASB by June 30, 2008 for large jurisdictions. Smaller jurisdictions such as the City of Sebastopol have until June 30, 2010 to comply.

The City of Sebastopol wishes to thank the grand jury for its work and bringing to light an issue that we have been working toward a resolution during these past 5 years.

Sincerely,

Sarah Glade Gurney
Mayor

David Brennan
City Manager

Ronald C. Puccinelli
Finance Director