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To: Mendocino County Board of Supervisors and Community Members:

Ref: County Debt: **General Areas of Concern and Recommendations That Warrant In Depth Investigation**

On January 28, 2010, our committee reviewing County debt issues released summary findings. In that communication, we stated we would be submitting a more detailed report to the Board of Supervisors. Wendy Pollitz and Antonio Andrade have move ahead with providing this detailed report.

General Overall Recommendations

In our summary findings, we recommended that a Committee be formed to further investigate the County Debt. We would note that at least in the area of employee benefits, past efforts to address this situation have not resulted in the fixes proposed. It is important to develop a plan going forward. However, it is perhaps more important to first get a comprehensive understanding about what lead to this rapidly increasing debt so when a proposal is made, it ensures that the same problems are not recreated in the future.

Let us expand on the committee we are recommending. In order for this to be a successful process, and one that the public can endorse, we recommend that the committee be specifically charged to investigate very specifically defined issues, report their finds on these issues, and come up with proposals that address both the short term and long term issues, and of critical importance, that the proposals include check points along the way that identify emerging issues that are proactively addressed before they snowball.

We do note that this may likely involve funds be expended to perform the necessary evaluation tasks. We would also encourage the Board to look to the State to see if they provide a program audit function we could request as part of their oversight function.

With that in mind, this report will be divided into 4 sections: 1) Overall Debt; 2) Pension Plan Obligations; 3) Retiree Health Care Benefits; and 4) Audit Issues. Each section will provide a brief background followed by a short discussion and ending with some suggestions and possible decision points. But most importantly, ours is not a comprehensive list of issues requiring investigation. We did not have the time or support staff to be able to identify all areas that need addressing.

Overall Debt

A) **Background:** Overall debt consists of Funded and unfunded debt obligations of the County. The most recent review of the Long Term Debt balances prepared by the State of California is as of June 30, 2007. It lists these debts County by County and we accept those figures. There are, two things are important to note here: First, the State's review is limited to various bonds and loans and does not included unfunded debts or obligation; Second, this most recent analysis was prepared prior to the 2008-early 2009 financial meltdown we are still in the midst of.

B) **Discussion:** Along with employee benefits issues, we note there has been a fair amount of controversy over the Teeter plan, especially how it is being funded and where the funds are coming from.

C) **Suggestions or Recommendations (to be agreed upon)**
   a. The public be provided with a concise and easy-to-understand explanation of the overall County debt as well as the specific elements of that debt. We recommend that these explanations be posted on the County website and updated as new figures emerge. Furthermore, if addition bonds are to be floated, in particular those bonds that do not require a vote of the people, that this anticipated action be post well in advance of Board action.

Pension Plan Obligations

A) Background: The Pension plan is again underfunded by 10s of millions of dollars There are a number of factors we found that are like contributors to the current underfunding:
   a. Market conditions have been poor over the last 10 years.
   b. In 1997, the County issued pension plan bonds to cover a shortfall in it's pension plan obligations
      i. Although done without voter approval, issuing these bonds were within the purview of the County to do so
   c. In 2002, the County again issued pension plan bond to essentially cover pension plan obligations;
      i. Taking on this debt and issuing these bonds we to eliminate the underfunded pension plan.
   d. In early 2000 the County BOS accepted the Slaven study which increased salaries for County employees and consequently County Pension Plan obligations
   e. The county also increased the pension plan benefits for Safety personnel and therefore County Pension Plan obligations
   f. Over the last few years, the County has substantially increased employment costs and pension plan obligations.
      i. Do note that due to actions by the BOS, employment costs have decreased over the last year in order to meet budget shortfalls.

B) **Discussion.** It is essential to determine the root causes of pension plan a. underfunding. Do note that recent stock market losses has increased pension plan underfunding
   a. It is important to note that due to performance questions, the County has retained a new investment management team.

b. In the case of issuing the pension plan bonds, does not appear that the County strictly adhered their stated policy requiring an in depth analysis of why there were pension plan shortfall. Aside from putting together a debt obligation repayment plan, no actuarial studies were ordered to see what the long term impacts of assuming this debt would be;
c. In the case of salary increases, it does not appear that the County strictly adhered to its policy which requires an in depth analysis of why there what the impacts of these salary increases would be on the County's pension plan shortfalls.
d. Over the last number years the County Retirement plan has not met its investment target return
e. Excess earnings and plan shortfalls:
    i. Under resolution 98-147, when the County pension plan investments has exceeded its 8% target return, the County has authorized the retirement Board to allocate "excess earnings" towards retirement health Care benefit obligations
    ii. However, the County did not how to fund plan shortfalls in those years where the plan did not meet its targeted return.
    iii. The single parameter for allocating these earnings was that these excess earnings were not to exceed 1% of plan assets. .
    iv. Underfunding of the plan creates County debt that must be addressed. Pension Plan Administrator Jim Anderson says that somewhere between 60% to 70% of pension benefits are met through investment return. If excess earnings from one year are not kept in the plan to first shortfalls when the plan does not meet it's target , the plan will fail to meet the pension plan's goal of full funding. Excess earnings are not in fact 'excess' when viewed against the overall funding of the plan. If bonds have been used to fund the pension plan, then excess earnings are partially the result of bond proceeds yet their gain is being used to fund retiree benefits
f. The underfunding of the County's pension plan needs to be determined.

C) **Suggestions or Recommendations**

a. When making decisions about County expenditures that impact the County's Pension Plan, County Decision-makers order a Financial Impact Report(FIR) that includes an actuarial analysis of the financial impacts of that decision on long debt together with a plan that outlines exactly how that debt will be met, and how that dept will impact County services and obligations.
b. Pinpoint the causes for pension plan underfunding so this can be avoided in the future.
    i. Was the initial analysis that lead to determining the bond issue size correct?;
    ii. Analyze the impact of Slaven and safety employee pension benefit increases (if any);
    iii. Analyze the impact of increased employment costs(if any); and

    iv. Analyze if and how investment performance contributed to our underfunded pension benefits;

c. Embark on a plan to ensure that the pension plan is not underfunded.
    i. Review the Excess Earnings decision. Questions to answer:
        1. Although the earning are excess for a single year, are they really excess in terms of the plan;
        2. Bonds were issued to meet pension plan shortfalls. Should pay down of the bonds be a priority?

Retiree Health Care Benefits

A) Background

a. In the early 1980s, employees were promised Health Retirement benefits by the County.
b. In the mid 1980s, the benefit's booklet the County inserted the word "may" when describing the right to health care benefits;
c. Under Resolution 98-147, the County agreed to fund 50% of Retiree Health Care benefits for those within the system at that point and the remainder was to come from "excess earnings"
d. Section IX of the County Retirement Board By-laws state that "Effective September 1, 1998, Retiree Health Insurance Became the Responsibility of the County. Please refer to Board Resolution 98-147"
e. Apparently, the County Union views retiree benefits as a negotiated benefit;
f. It is not clear what the County Administrators bargaining unit's position is regarding their right to retiree health care benefits;
g. It is not clear what the County's position is on their obligation to fund retiree health insurance benefits and if 09-218 was intended to rescind any County obligation for these benefits
h. Under the most recent Aon Report, County Retiree Health Care benefits are determined to be approximately $130 million dollars unfunded.

B) Discussion

There appear to be a lot of confusion on where the County stands in reference their responsibility for retiree health care benefits. Clearly, early employees were promised that benefit. Secondly, there are questions around the funding mechanism for these benefits. If they have an obligation to pay for these benefits, having that payment come from excess pension plan benefits (as currently interpreted) undermines the pension plan's ability to meet its primary responsibility of paying out pension plan benefits to retirees

C) Suggestions or Recommendations

a. Clarify the County's responsibility for paying these benefits;
b. If these are a County responsibility, continue with the current effort to arrive at a plan that meets this responsibility
c. Explore other options for meeting this responsibility.
d. As the retirement board addresses employee benefits, the full scope of the issues needs to be explored.

Audit Issues

A) Background

Initially the audited pension plan distinguished between retiree health care benefits and retiree pension plan benefits. A few years ago, the auditor combined both items when auditing the plan.

B) Discussion.

Please note that many of the areas we are discussing were covered with the auditor of the plan. It was clearly explained to our committee member that the audit performed was based solely on the accuracy of the figures**.** What follows is a discussion of items that we believe need to be covered to get an accurate picture of the situation. This information is usually address in what is often termed a "program Audit."

a. The merging of two independent benefits into a single analysis makes it challenging at best to evaluate the cost of each of the benefits independently.
b. The fact that 'excess earnings' are being diverted for another purpose does not appear to be noted in the annual audit reports of the pension plan.
c. The 'smoothing process' spreads the gains or losses in the plan over a 5 year period. Though the process has its merits, it requires explanation so the lay person can understand how to judge the current status of the plan.
d. It is not clear if plan administrative overhead expenses are deducted from the plan before or after determining if the plan is fully funded or not.
e. It is not clear that the impact of 'excess earnings' withdrawals are ever reconciled with the fact that the overall funding of the plan will not be met even if the targets are met.
f. Smoothing the results based only on whether or not the plan is meeting its target and not incorporating the 'excess earnings' withdrawals results in the decision-maker not getting an accurate sense about how this mathematical calculation compares with the actual funds in the plan. Therefore, when one attempts to smooth the return and includes years when the target was not reached, the smoothing analysis is correct in terms of overall return but totally incorrect in using the smoothed return to evaluate if the plan assets are on target to meet the commitments of the system. In short, leads to a false assurance about the funding requirements of the plan are being met.

g. The origin of the employee census used to determine the funding liability is not clear.

D) Suggestions or Recommendations

a. Perform a program audit on the employee benefits plan;
b. Separate the Pension Plan benefit from the Health Care benefit;
c. Note the fact that excess earnings have been withdrawn from the plan and what impact that has on retirement plan funding;
d. Reconcile the difference between the plan performance pre 'excess earnings' withdrawals and post 'excess earnings' withdrawal with meeting the plan target for the year being audited;
e. Apply the smoothing process to both pre and post excess earnings withdrawals;
f. Note if the total return for the plan year is determined either pre or post administrate expenses being withdrawn; and
g. Confirm the origins of the employee census used for determining the adequacy of plan funding.

Concluding Remarks

The repositories of information and past Board policies are the office of the CEO and the County Auditor/Controller It is essential that these crucial arms of County government function smoothly, efficiently, and provide the BOS with a comprehensive, easily understandable picture of the County debt so they can make prudent decisions on behalf of the citizens of the County.

We undertook this report because we believe the County needs a way forward and wanted to provide some starting points for this analysis.