



August 23, 2010

The Honorable James J. McBride  
Presiding Judge  
Superior Court of California, County of San Francisco  
400 McAllister Street  
San Francisco, CA 94102

Dear Judge McBride:

The following is in response to the 2009-2010 Civil Grand Jury report, "Pension Tsunami: The Billion Dollar Bubble."

As you know, San Francisco has been at the forefront both in providing universal access to health care and managing our retirement obligations in a partnership with workers. I'm proud to have worked together with city workers to pass Proposition D, which increased employee pension contributions and protected the security of our retirement system. San Francisco has led the way in insuring basic health access is a right, while working in collaboration with all of the stakeholders to address the real cost challenges associated with our health and retirement systems. Efforts to turn back the clock on health care are shortsighted and will end up costing us all more in the long run.

Increased pension costs are a very real concern as we plan for the future financial health of our city. Like other local and state pension systems across the country, San Francisco's pension system has been impacted by the economic downturn. Over the past several years, my administration has worked actively with city departments, labor organizations, and a wide range of stakeholders to develop and implement initiatives to address projected growth in the cost of pensions and other employee benefits. In June of 2010, the voters of San Francisco overwhelmingly passed Proposition D, which changed the way the City calculates retirement benefits, increased the employee pension contribution amount for new safety employees, and required that any savings realized from reduced employer contributions to the San Francisco Employees' Retirement System (SFERS) be used to pay for future benefit liabilities.

Since Proposition D, the City has continued to pursue pension and benefits reform. These efforts are important to control cost increases that, if left unaddressed, could have a very real impact on the City's long-term ability to support important programs and provide critical services. The continuing dedication of my office, the SFERS staff and the Department of Human Resources (DHR) underscores our belief in the importance of pension reform to our city's future.

The Civil Grand Jury findings and recommendations on Proposition H warrant a brief discussion. Proposition H, approved by voters in 2002, requires the City and the safety employee unions to meet and confer when the City's retirement contribution rate exceeds zero percent, in order to implement a cost-sharing arrangement. The Civil Grand Jury asserts that the City has not complied with portions of the

City Charter established by Proposition H. However, the City has met with the Police and Fire unions and these meetings have resulted in significant reductions to the cost impact of employer contributions to our General Fund. Furthermore, as DHR explains in its response, these reductions have also almost completely covered the increased costs under Proposition H.

As our negotiations with the public safety unions have demonstrated, we must work collaboratively with labor to address this issue. When labor contracts come up for renewal, the City will continue to consider the impact these contracts will have on any future pension obligations.

**The Mayor's Office response to the Civil Grand Jury's findings is as follows:**

**Finding A1:** San Francisco's Defined Benefit Plan retirement benefits are financially unsustainable without significant cutbacks in jobs and city services.

**Response:** Disagree. San Francisco's Defined Benefit Plan is one of the most soundly funded and managed public retirement systems in the United States; the system itself is sustainable, despite the impact of the severe economic downturn. The City has faced economic downturns before, and, as it has in the past, our system will recover and remain financially sound.

**Finding A2:** For current employees and retirees, pension benefits are guaranteed by City Charter and protected by Federal and State constitutional provisions prohibiting impairment of contract.

**Response:** Agree.

**Finding B1:** The City's pension and health benefit costs are expected to increase from approximately \$400 million for the current Fiscal Year to nearly \$1 billion in five years, a billion-dollar bubble that the City cannot realistically afford.

Current pension rules are producing an ever-increasing employer contribution rate, from 0% in 2004, to 9.49% in 2010 and to 30% by 2015. This will impact the General Fund, and could make it very difficult for the City to sustain funding for police and fire, public health, human services, cultural and artistic programs. It will disproportionately affect the poor and the needy, and tax the middle class.

**Response:** Partially Disagree. Although the City's pensions and health benefit costs are expected to increase significantly over the next several years, the City is working to reduce the impact that these increases will have on important programs and critical services. As the Controller and the SFERS state in their respective responses, the 30% employer contribution rate referenced by the Civil Grand Jury is a projection provided by the SFERS' actuary based on a worst-case scenario where the SFERS Trust would earn only 4.5% on investments for the period covering Fiscal Year 2009-2010 through Fiscal Year 2013-14 rather than its assumed 7.75% return. In fact, the SFERS Trust earned over 12% investment returns for Fiscal Year 2009-2010, well in excess of the worst-case scenario assumed in the SFERS projection. Please see the Controller's response and the SFERS' response.

**Finding B2:** The Department of Human Resources and SEIU Local 1021 entered into an agreement that Miscellaneous employees would pay their own 7.5% contribution, and, in return, the base wages were increased by 6% effective July 1, 2010.<sup>1</sup> There was no actuarial valuation to estimate the resulting

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<sup>1</sup> This "swap" will occur on July 1, 2011 and not July 1, 2010.

pension liability for the City. This agreement resulted in a substantial increase in pension obligations for the City without voter approval.

**Response:** Partially Disagree. Although the City did not undertake an actuarial valuation to estimate the resulting pension liability, the Civil Grand Jury's statement that the agreement with SEIU resulted in a substantial increase in pension obligations for the City is incorrect. The City's obligation to obtain an actuarial valuation does not arise in a situation such as this where DHR is negotiating wages.

First, as DHR notes in its response, the City agreed to begin paying the employee pension contribution for most unions in 1995 (not in 2002 as indicated in the Civil Grand Jury report), in lieu of providing wage increases. Therefore, if the City had not paid the employee contribution and instead given employee wage increases at that time, there would have been pension cost increases dating back to 1995.

Second, while it is true that SEIU Miscellaneous (non-MTA) employees will receive a base wage increase on July 1, 2011 in exchange for resuming the payment of the employee pension contribution, it will in fact be on a cost-neutral basis to the City. Although it is also true that any increase in pensionable compensation results in a corresponding increase in employer contributions to retirement, the increase is significant only if it occurs at the end of one's career. However, most SEIU employees will continue working for years after the "swap" takes effect.

More importantly, the SFERS pension fund has been funded assuming 4.5% annual wage increases for miscellaneous employees, increases that the City's miscellaneous unions did not receive and are not scheduled to receive, thereby offsetting the impact on pension costs. Please see SFERS' response for more information. Therefore, the increase in benefit liability as of July 1, 2011 as a result of the 6% wage increase is not significant.

See DHR's and SFERS' responses to this finding for additional information and further clarification.

**Finding B3:** 2,384 retirees receive pensions greater than \$75,000.

**Response:** Agree.

**Finding C1:** Proposition H, passed by voters in 2002, requires that if the City's contribution rate to the pension fund exceeds 0% then the City and the Safety employees unions must "meet and confer" to implement a "cost-sharing" arrangement to reduce the cost impact of the employer's contributions on the City's General Fund. The City's contribution rate has exceeded 0% for fiscal 2004-05 to the present.

The City and County of San Francisco is not in compliance with the requirements of the City Charter resulting from the passage of Proposition H. There have been no "meet and confer" sessions to establish a "cost-sharing" arrangement.

The City Attorney has not mandated that the SFERS Board comply with these requirements of the Charter Amendment resulting from Proposition H.

**Response:** Partially Disagree. The first statement and the third statement are correct. However, I disagree with the second statement. The City has worked with its Police and Fire labor organizations to

negotiate provisions in their respective collective bargaining agreements to address Charter obligations regarding cost-sharing, and has set pension contributions for those organizations at the maximum limit allowed by the Charter. Please see DHR's response and the City Attorney's response for more information and further clarification.

**Finding C2:** The unfunded pension liability for Proposition H as of July 1, 2009, was approximately \$276 million, amortized over thirteen years to about \$26 million annually.

**Response:** Agree. According to the SFERS, the annual amortization payment for Fiscal Year 2010-2011 is approximately \$26 million.

**Finding D1:** The soon-to-be retired have been able to increase final pensionable compensation to inflate retirement benefits.

The Jury found instances of nursing supervisors being allowed to have two concurrent jobs and earn pensions on both, sometimes referred to as pension-pyramiding.

**Response:** Partially Disagree. I agree that practices such as "pension spiking" and "pension-pyramiding" undermine the credibility of the pension system and that the City should prevent such practices.

However, while there are some controls on assignments, pay and retirement calculations that minimizes the risk of these practices, DHR recently completed an audit and found that there are indeed a handful of instances in which employees at the Department of Public Health (DPH) have been earning pensionable income on multiple appointments. DHR is working with DPH to implement a mechanism in the system to prohibit these anomalies from occurring in the future.

The SFERS has also successfully defended against all attempts to "spike" pensions illegally through inclusion of non-wage compensation in pension calculations. Please see the SFERS' response, the Controller's response, and the San Francisco Fire Department's response for more details.

**Finding E1:** For current employees and retirees, health benefits are "vested" after 10 years.

Unlike pensions, health benefits for most city workers are not pre-funded, but are paid directly out of the City's General Fund. In 2001, the City expended \$17 million on retiree health care. By 2007, that amount had grown to \$130 million and continues to rise. Mercer Consulting reported on June 30, 2008, that the City's unfunded liability for retiree health benefits was \$4 billion.

**Response:** Partially Disagree. Current employees who were hired prior to January 10, 2009 receive full employer health care coverage after five years of city service. Although retiree health benefits have not been pre-funded, the Controller's Office has been analyzing the City's unfunded retiree health benefit liability and exploring funding options to address this issue.

Furthermore, San Francisco voters approved Proposition B in 2008, which established a Retiree Health Care Trust Fund and created a graduated health benefit vesting schedule for employees hired on or after January 10, 2009. Pursuant to Proposition B, all employees hired on or after January 10, 2009 must

contribute 2% of their salary into the City's Retiree Health Care Trust Fund. The City contributes an additional 1% for each corresponding 2% employee contribution. These contributions offset retiree health liability.

Nevertheless, retiree health benefits have not historically been pre-funded, and the City has a substantial, unfunded retiree health liability. DHR and the City have taken steps, and will continue to take steps, to address this issue. Please see DHR's response to this Finding and Recommendation E1 for additional information.

**Finding F1:** There are seven SFERS board members: three are elected by the members; three are appointed by the Mayor; and the seventh Commissioner comes from the ranks of the Board of Supervisors. One of the three public members has not been appointed for at least six months.

**Response:** Agree. Please note that since the issuance of this report, I have filled the vacancy.

**Finding F2:** Minutes of the SFERS board meetings record attendance of the board members. When the members representing the public are absent, the interest of the public is eroded.

**Response:** Agree. It is important for members of all commissions and boards to attend meetings.

**The Mayor's Office response to the Civil Grand Jury's recommendations is as follows:**

**Recommendation A1:** The San Francisco City Charter should be amended, as follows:

For new employees, the pension multiplier should be set at a level to provide fiscally sound future pensions – fair to employees and taxpayers alike.

For new Miscellaneous employees, the retirement age to receive full benefits should be comparable to that of Social Security and/or private sector recipients, and be fair to employees and taxpayers alike.

The Jury recommends that City officials consider a hybrid retirement plan with components of both Defined Benefit and Defined Contribution, 401(K)-type, in the next negotiated contract in 2012.

No cost-of-living or other increase should be awarded to retirees unless the pension fund is found through a multi-year analysis to be actuarially sound and fully funded.

SFERS and actuaries for the City should research other public and private sector data to determine fair pension benefits and the results should be reported at SFERS board meetings and to the Board of Supervisors to lead a sustainable plan.

**Response:** Recommendation Requires Further Analysis. While we have taken a number of important and significant steps toward pension reform, there is still more that can be done.

In response to the recommendation that the City increase the retirement age for new miscellaneous employees to receive full benefits, I note that the retirement age at which miscellaneous employees receive maximum benefits was recently increased to age 62. This is among the highest in California (the maximum benefit age in a majority of the other jurisdictions is between age 55 and 60).

I do not believe the City should create a hybrid system that combines elements of a Defined Benefit Plan and a Defined Contribution Plan at this time. Defined Contribution Plans carry risks that have led to negative unanticipated consequences for many private sector employees, and it would be imprudent to switch to any new model that has not proven to be dependable over the long run. However, I agree that we should continue to review other models and structures that could be appropriate for the City.

The Civil Grand Jury recommends that no cost-of-living or other increase be awarded unless the pension fund is sound and fully funded. While it is true that cost of living adjustments (COLA) are awarded regardless of the financial stability of the pension fund, the additional supplemental COLA amount of up to 3.5% is only awarded if there are sufficient excess investment earnings. The cost-of-living adjustments provided under the SFERS plans have been approved by city voters. It would be a violation of the Charter for the City or SFERS to withhold payments to retirees and beneficiaries to which they are entitled under the Charter. Nevertheless, I agree that we should further evaluate whether it is beneficial as a matter of policy to award a COLA when the retirement system's investment earnings are flat.

I agree that the City should continue to examine benefits offered to ensure that benefits provided by the City are appropriate and commensurate with other comparable plans. DHR currently conducts this research periodically. The latest survey data is included in the DHR response. Nonetheless, the City pension benefits are consistent with or better than those of many cities and counties. I disagree with the assertion by the Civil Grand Jury that our system is unsustainable and therefore requires these changes.

**Recommendation B1:** The Mayor and the Board of Supervisors should prepare a plan within the next year to fund the projected \$1 billion in pension costs.

**Response:** Agree; Already Implemented. My office, in conjunction with city departments, continues to work to address the projected \$1 billion pension cost. Over the past several years, I have held regular meetings with city departments, labor representatives and other stakeholders to explore and develop options for long-term pension and benefits reforms. These efforts led to Proposition D, approved by voters on the June 2010 ballot, which will limit pension costs.

In addition, two years ago I directed the Controller to undertake the Budget Improvement Project, an effort to examine long-term financial issues and develop reforms to the City's budget process and financial planning. I worked with the Board of Supervisors to turn the results of that process into Proposition A, which was approved by voters in November of 2009. Under Proposition A, the City is now developing two year budgets, financial policies, and a five-year financial plan to address major financial issues including pension and other benefit costs.

In addition to these financial planning efforts, my office continues to work actively with a broad range of stakeholders to develop practical initiatives to address pension costs. I am committed to continuing these efforts and working with the Board of Supervisors to address these issues.

**Recommendation B2:** The Department of Human Resources (DHR) should not enter into agreements with the employee unions which increase the City's future pension obligations without voter approval.

DHR should engage the City's professional Actuary to investigate any increase in pensionable compensation.

**Response:** Disagree; Will Not be Implemented. As part of the collective bargaining process, DHR relies on data furnished by the SFERS and the Controller's Office to evaluate cost increases associated with pensionable compensation. Requiring voter approval of any employee wage increases that would result in an increase in pensions would likely violate both the Charter and State law on collective bargaining.

The Civil Grand Jury recommendation fails to recognize that all increases in pension obligations were voter-approved. Without voter approval, DHR cannot change employee retirement plans. DHR has the responsibility to negotiate wages and benefits with labor organizations in accordance with the Charter, and this responsibility cannot be delegated to the voters. Please see DHR's response and the City Attorney's response for more information and further clarification.

**Recommendation B3:** DHR should compare the retirement benefits in other California cities to determine whether the pension benefits are excessive. The results should be reported to the Mayor and the Board of Supervisors.

**Response:** Agree; Already Implemented. San Francisco's retirement benefits are lower than those of most other cities in California. Please see DHR's response for more information.

**Recommendation C1:** The City Attorney should initiate legal action against the SFERS Board to enforce the requirements of the Charter amendment to "meet and confer" and "cost-sharing" provisions of Proposition H, as stipulated in Charter § A8.595-11(e).

The Jury recommends that the City Attorney and/or his representatives present to the Board of Supervisors and SFERS Board the following documents regarding § A8.595-11(e) of the City Charter:

1. A legal opinion of the charter section.
2. Documentation regarding the dates and times that the City and the Police and Firefighters unions met to confer and to implement a cost-sharing arrangement as required in the section.
3. A legal opinion regarding fiduciary duties of the SFERS Board to comply with it.
4. A legal opinion regarding SFERS duty to revise the Safety employee contribution rate to comply with the Charter section.
5. A legal opinion regarding possible remedies to enforce compliance.

**Response:** Disagree. City Charter §A8.595-11(e) does not require the SFERS to enter into a meet and confer with the City's safety employee unions. Therefore, the City Attorney cannot initiate legal proceedings to require such action. As the City Attorney's response notes, the City has complied with the cost-sharing provisions of Proposition H and the Civil Grand Jury is mistaken about the appropriate role of the SFERS Board in this matter. Please see the City Attorney's response.

**Recommendation C2:** The City and Safety employees should establish an arrangement to share the annual \$26 million cost as required by the City Charter. Please refer to DHR's and the City Attorney's responses.

**Response:** Agree; Already Implemented. Where the City Charter requires the City and its public safety unions to share costs, the City has and will continue to work with the unions as required under the Charter.

**Recommendation D1:** San Francisco should take steps to curb abuses from pension spiking by limiting the final pensionable income an employee can claim at retirement and from pension-pyramiding. The Jury suggests the following:

- Use a three-year average to determine pensionable income, similar to Federal rules.
- Limit final pensionable compensation to 120% of the rank pay rate as determined by Civil Service job classification.
- The Controller should perform an independent review of pensions to determine whether the practice of pension spiking is ongoing.
- Disallow employees from drawing pensions from two simultaneous City jobs.
- Pensionable compensation should not include pay for two separate pay types, known as pension-pyramiding.

**Response:**

- Use a three-year average to determine pensionable income, similar to Federal rules.

Agree; Already Partially Implemented. As a reminder, Supervisor Sean Elsbernd and I introduced a Charter amendment to the Board of Supervisors in 2008, which would have required a three-year average to determine pensionable income. The Board of Supervisors voted to reduce that time to two years. The measure, Proposition D on the June 2010 ballot, was passed by an overwhelming majority of the voters (nearly 79%), and it will require a two-year average to avoid spiking in the final year.

- Limit final pensionable compensation to 120% of the rank pay rate as determined by Civil Service job classification.
- The Controller should perform an independent review of pensions to determine whether the practice of pension spiking is ongoing.

Although pensionable income is determined by Charter, I will work with DHR, SFERS, and the Controller's Office to limit final pensionable compensation to the extent possible under the Charter and collective bargaining agreements.

- Disallow employees from drawing pensions from two simultaneous City jobs.
- Pensionable compensation should not include pay for two separate pay types, known as pension-pyramiding.

I agree with the Civil Grand Jury that employees should not draw from two simultaneous city jobs and that pensionable compensation should not include pay for two separate pay types. As stated earlier, my office and DHR are working together to ensure that there are systematic controls in place to eliminate this practice where it exists.

**Recommendation E1:** Department of Human Resources and collective bargaining units should meet and confer to determine a cost-sharing arrangement to pre-fund the \$4 billion unfunded liability for retiree health care obligations.

**Response:** Agree; Already Implemented. The City does have a large unfunded liability for retiree health care obligations. Through past voter-approved propositions, the City has begun to address this

issue by requiring the City and its employees to contribute to the Retiree Health Trust Fund. I will continue to work with the Controller's Office and DHR to address this liability. Please see DHR's response for additional information.

**Recommendation F1:** The Mayor needs to appoint two Commissioners to represent the public's interest.

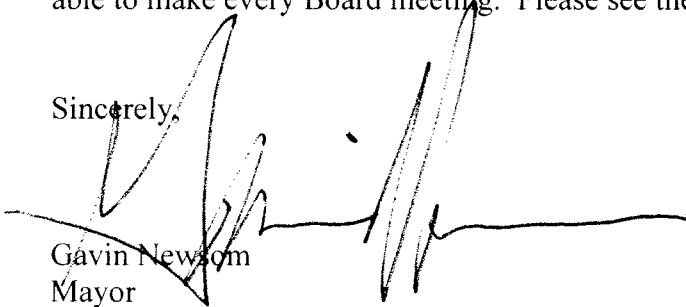
**Response:** Disagree; Will Not be Implemented. I agree that commissioners need to be appointed, and I have already made these appointments. Upon appointment, all commissioners are required to discharge faithfully the duties of the particular commission or board to which they are appointed. In the case of the SFERS, the duty of the commissioners appointed to the SFERS is to represent the interest of the members and their beneficiaries, not only the public at large. All seven SFERS Commissioners share the same fiduciary duty, not just those appointed by the Mayor.

**Recommendation F2:** It is important for the public Commissioners appointed by the Mayor to attend the Board meetings. They should attend regular monthly Board meetings or resign.

**Response:** Agree; Already Implemented. I agree that all Commissioners appointed to the SFERS should attend regular monthly Board meetings. As the SFERS Board states in its response, the Board also has a committee structure that allows its members to discharge its duties even if a member is not able to make every Board meeting. Please see the SFERS' Board response.

Sincerely,

Gavin Newsom  
Mayor

A handwritten signature in black ink, appearing to read 'Gavin Newsom', is written over a horizontal line. The signature is stylized and cursive.