OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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DROP Cost Neutrality Study

OVERVIEW

The Deferred Retirement Option Plan (DROP) is a voluntary program for City employees who were hired before July 1, 2005. DROP became effective April 1, 1997. City employees who are eligible to retire and were hired before July 1, 2005 are eligible to participate in DROP. Such employees can continue to work in DROP for up to a five year period, and are considered active employees.

A DROP participant's pension is set upon entry into the program, and such an employee does not accrue further service credits after entering DROP. Additionally, pension contributions will cease for both the DROP participant and the City.

The San Diego City Employees' Retirement System (SDCERS) accounts for each employee's "DROP Participation Account." Deposits to the participation account include the participant's monthly pension payment, contributions of 3.05% of pensionable salary from the participant and 3.05% in matching contributions from the City, as well as interest income. Meanwhile, the DROP participant continues to work as an active employee, earning salary and receiving other benefits of active employment, such as flexible benefits and SPSP, in the case of General Members.

A DROP cost neutrality study is fundamental in determining compliance with San Diego Municipal Code section 24.1401, in which it is stated that "DROP is intended to be cost neutral." Cost neutrality is not defined in the Municipal Code. Conducting a cost neutrality study is consistent with the "Kroll Report" recommendation that the City retain its own independent actuary.[1] The DROP cost neutrality study, which will be presented to City Council on March 7, 2011, has been prepared by the firm of Buck Consultants.

[1] On August 8, 2006, the firms of Kroll and Willkie, Farr & Gallagher issued a report entitled Report of the Audit Committee of the City of San Diego (typically referred to as the "Kroll Report"). The Kroll Report

FISCAL/POLICY DISCUSSION

Background of the DROP Cost Neutrality Study
DROP has been actuarially studied a number of times over the years since its establishment (as shown in Buck Consultants PowerPoint presentation to Council). Such studies have not comprehensively included both the costs to the City's pension system and other City costs. Rather, these previous studies only considered the impact to the pension system (based on Buck Consultants review of the published conclusions). Additionally, these former studies did not develop DROP participation assumptions based on analysis of a comparable system.

As part of the study which will be presented to Council on March 7, 2011, Buck Consultants isolated DROP's effect on retirement behavior by analyzing the County of San Diego retirement system. An historical analysis of retirement patterns was used to develop retirement pattern assumptions. Most other pension assumptions in Buck's analysis are based on the assumptions contained in actuarial valuation of the City's pension system as of June 30, 2009. The methodology and assumptions used by Buck are outlined in the PowerPoint presentation attached to the March 7, 2010 Council agenda (Item S-400).

The DROP cost neutrality study is the result of a joint City-Labor effort. The work for the study was started under an actuarial services agreement, which became effective February 9, 2010. The actuarial services agreement was broad-based, encompassing more than the DROP study, which was originally estimated at $50,000.

After extensive discussions regarding the scope of the DROP cost neutrality study among the COO, the IBA and City labor unions, all parties agreed that the scope needed to be expanded to include an historical analysis, including an in-depth examination of changes in retirement behaviors due to DROP. Moreover, in addition to evaluating pension system costs, Buck comprehensively examined other DROP-related costs, including payroll, medical, and other fringe benefits. (Workers' compensation costs do not appear to be included in the analysis.) The resulting DROP cost neutrality analysis compares the present value of future benefits with and without DROP, and it is prospective in nature.

The increases in the scope of the DROP study resulted in an increased cost estimate of $250,000; and the final cost for Buck's work is approximately $300,000. The City labor unions were asked to contribute funding for the DROP cost neutrality study, but to-date they have not agreed to do so.

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recommended a Remediation Plan designed to achieve the following four principal compliance objectives: enhanced accountability; greater transparency; increased fiscal responsibility; and independent oversight.

Study Outcome

Per Buck's PowerPoint presentation, "the DROP of the City of San Diego will be considered cost neutral if the present value of the City's share of costs for all compensation and benefit programs with DROP included is within 2% of the present value of what those costs would be in the absence of DROP."

Due to the long-term nature of the costs associated with DROP, the joint City-Labor study group agreed to utilize a present value methodology to examine the compensation costs related to DROP. A cost neutrality tolerance level of 2% was recommended by Buck Consultants; and the joint City-Labor study group considered and agreed to this tolerance level. The main reason for incorporating a 2% tolerance is that the cost neutrality analysis is based on many assumptions and methods that could have a range of reasonableness.

The cost difference between the City benefits structure with and without DROP is based on a snapshot of the City benefits structure, and includes assumptions such as those related to salary inflation and interest earnings. Changes in the City benefits structure could result in DROP being more or less costly.

Most notably, it has been recognized that decreasing the retiree health benefit, while keeping all other cost components unchanged, would increase the DROP cost differential. This is true because the current flexible benefits costs for active DROP members are less than retiree healthcare costs. Reclassifying DROP participants as retirees, with more expensive retiree premiums, increases the overall costs for those individuals.

Reducing the retiree health benefit to the flexible benefits level would bring the present value differential between the City benefits structure with and without DROP up to the 2% tolerance level. The City is currently negotiating with its labor unions regarding a reduced retiree health benefit. Such a reduced benefit could decrease the Other Post Employment Benefits (OPEB) Unfunded Actuarial Liability and annual OPEB contributions more than the corresponding increase to the DROP cost differential.

The result of the DROP cost neutrality study is that DROP is cost neutral based on the established 2% tolerance level; but it is not cost free. The results of Buck's analysis show that the cost of the City benefits structure with DROP is 1.6% higher than the cost of the City benefits structure without DROP. See the chart on the following page, taken from Buck Consultants' PowerPoint presentation, for details on the comparison of the City benefits structure with and without DROP.

Prospective Present Values[1]	Present Values without DROP[2] (000)	Present Values with DROP[2] (000)	DROP Impact Magnitude (000)	DROP Impact Relative (%)
Pensions	$3,239,521	$3,255,907	$16,387	100.5%
Salary and Wages	4,382,809	4,514,774	131,965	103.0%
Paid Time Off (paid at retirement)	387,070	412,350	25,280	106.5%
Supplemental Pension Savings Plan	163,684	166,338	2,654	101.6%
City's Matching Contribution to DROP	133,676	137,701	4,025	103.0%
Medicare	63,551	65,465	1,914	103.0%
Retiree Health Care Contribution[3]	650,436	616,905	(33,531)	94.8%
Grand Totals	$9,020,746	$9,169,440	$148,694	101.6%

1 ***Impact of DROP on disability insurance, life insurance, ROC, recruitment and training was deemed not material on a prospective basis.***

2 ***Impact Present values for active population as of June 30, 2009.***

3 ***We assumed that DROP does not change the costs of health coverage for active members.***

The only overall savings differential of the seven benefit components in chart above is tied to retiree health. As retiree healthcare is reformed, these savings will be minimized.

The largest cost differential between the City's benefit structure with and without DROP is related to salaries. The salary differential is $132.0 million of the $148.7 million total differential – approximately 90% of the total. Buck has indicated that costs for employees who replace retiring employees are built into the salary analysis. Actual results will depend on actual hiring and promoting practices. It is possible that backfilling positions could negate some or a substantial portion of the cost differential related to salaries. It is important to note that this is a complex analysis, based on many assumptions and methods, and changes in those assumptions and methods could change the results of the analysis.

Future Considerations

Modifications to DROP should be considered to bring DROP toward the goal of being cost free. Ideally, DROP would produce cost savings. Modifications to reduce DROP costs include the following:

- Restricting eligibility for participation, i.e. increasing the age of eligibility for DROP:
    - The City has taken steps to increase the DROP eligibility age for two labor unions: POA and AFSCME, Local 127. The City imposed a DROP eligibility age change, from 50 to 55 for POA, and from 55 to 60 for Local 127. However, this action has not been implemented or enacted in the Municipal Code, as there has not been a Charter section

143.1 vote of employees who are members of the pension system. It was planned that this vote would take place upon completion of the DROP cost neutrality study. SDCERS is currently preparing for a 143.1 vote, which is anticipated to occur at the end of March 2011. If the vote concurs with the imposed eligibility changes, the Municipal Code can be amended via City Council ordinance.

- Requiring employee pension contributions during the DROP period – such contributions would not be contributed to the participants' DROP accounts.
- Reducing or eliminating the 3.05% City contributions to DROP participant accounts.
- Eliminating pension COLA increases during the DROP period.
- Crediting reduced pension payments to DROP accounts (i.e. 90% of the pension benefit, rather than 100%).

CONCLUSION

The result of the DROP cost neutrality study is that DROP is cost neutral based on the established 2% tolerance level; but it is not cost free. The results of Buck's analysis show that the cost of the City benefits structure with DROP is 1.6% higher than the cost of the City benefits structure without DROP. It is important to note that this is a complex analysis, based on many assumptions and methods, and changes in those assumptions and methods could change the results of the analysis.

The IBA supports efforts that bring DROP toward the goal of being cost free. Further, it would be even better if DROP were to produce cost savings for the City, while providing an advantageous benefit for City employees.

The IBA recommends that the City consider obtaining a periodic DROP cost neutrality analysis – within two years if the City implements retiree healthcare reform, and possibly once every five years, thereafter.

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Lisa Byrne
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst