

ATTACHMENT A
THE PROPOSED DECISION

BEFORE THE
BOARD OF ADMINISTRATION
CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATE OF CALIFORNA

In the Matter of the Statement of Issues
Against:

CITY OF SAN CARLOS,

Respondent.

Case No. 2013-0351

OAH No. 2013050653

PROPOSED DECISION

Administrative Law Judge Diane Schneider, State of California, Office of Administrative Hearings, heard this matter on September 24, 2013, in Walnut Creek, California.

Petitioner California Public Employees' Retirement System was represented by Senior Staff Attorney Elizabeth Yelland.

Respondent City of San Carlos (City) was represented by Cepideh Roufougar, Attorney at Law, Jackson Lewis, LLP.

The record was left open for the submission of briefs in lieu of oral closing arguments. The City timely submitted a Closing Brief and a Reply Brief, which were marked for identification, respectively, as Exhibits A and B. CalPERS timely submitted a Closing Brief and a Request for Official Notice, which were marked for identification, respectively, as Exhibits VIII and IX.

The record closed and the matter was submitted for decision on December 23, 2013.

ISSUE

Did CalPERS err when it determined that the City's Inactive Safety Police Plan must be unwound from consolidation with the Active Safety Fire Plan in the "2 percent at 50" risk pool?

CALIFORNIA PUBLIC EMPLOYEES'
RETIREMENT SYSTEM
FILED 20 Feb 2014

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FACTUAL FINDINGS

Procedural background

1. Alan Milligan filed the Statement of Issues in his official capacity as the Chief Actuary in the Actuarial Office of the California Public Employees' Retirement System (CalPERS).

2. Petitioner CalPERS is the government agency responsible for administering the Public Employees' Retirement Law (PERL). The provisions of PERL are set forth in Government Code sections 20000 et seq.¹

3. Respondent City of San Carlos (City) is a public agency that contracts with CalPERS for retirement benefits for its eligible employees.² Insofar as the City is a contracting agency, it must comply with the provisions contained in PERL. (§ 20460 et seq.) Under PERL, the City's employees are generally classified as "safety" or "miscellaneous" members.³ Local safety members include police officers and firefighters.⁴

4. On October 18, 2012, CalPERS notified the City of its decision to remove the City's Inactive Safety Police Plan from the 2 percent at 50 risk pool (Risk Pool #7). The City timely appealed, and this hearing followed.

CalPERS's duties and powers

5. PERL established a retirement system for state employees and participating local public agencies. The retirement system is funded by employee and employer contributions. As a statutorily created entity, CalPERS is authorized to pay benefits only when authorized by statute, and in an amount authorized by statute. (*Hudson v. Posey* (1967) 255 Cal.App.2d 89.)

6. CalPERS was established as a trust solely for the benefits of its members. (§ 20170.) CalPERS's Board of Administration (Board) was established to manage and control CalPERS. (§ 20120.) The Board has exclusive control over the administration of the retirement fund. (§ 20171.) The Board is also the "sole judge of the conditions under which persons may be admitted and continue to receive benefits." (§ 20125.) Section 20160,

¹ All further statutory references are to the Government Code unless otherwise indicated.

² The City initially contracted with the organization that is now CalPERS in September 1943.

³ Section 20371.

⁴ Section 20420.

subdivision (b), often referred to as the mistake statute, requires the Board to “. . . correct all actions taken as a result of errors or omissions of . . . this system.”

Authority of Chief Actuary Alan Milligan

7. Alan Milligan is the Chief Actuary for CalPERS. Board CEO Anne Stausboll delegated to Milligan the authority to take action on all matters that are the responsibility of the CEO. Among other things, CEO Stausboll delegated to Milligan the authority to approve staff determinations on actuarial matters, to ensure that they are consistent with Board policies, methods and assumptions, and to oversee the evaluation, development, and implementation of Board-approved actuarial policies and procedures for each retirement system under the administration of the Board. Milligan’s authority includes the authority to unwind a consolidation of active and inactive participants in a risk pool. He is also authorized to determine if an employer’s participation in a risk pool materially impacts other employers in that risk pool.

Applicable laws, regulations and board resolutions relating to risk pools

8. In order to simplify the menu of benefits available to contracting agencies, stabilize rates and lower costs, CalPERS began the process of creating risk pools in 2002. A pool consists of a collection of employers who group their assets and liabilities together in order to share risks, thereby producing increased financial security and rate stability.

9. The provisions of PERL relating to risk pools are found at sections 20840 and 20841. Section 20840 empowers the Board to “. . . create, combine or eliminate risk pools for local miscellaneous members and local safety members.”

10. Section 20841 requires the Board to establish, “by regulation, the criteria under which contracting agencies shall participate in a risk pool and the criteria under which contracting agencies . . . may participate in a risk pool.”⁵ In determining the criteria, the Board must consider “the expected variability of the employer contribution rate due to demographic events.” (§ 20840, subd. (b).) Section 20841 further provides that where a contracting agency “participates in a risk pool, the assets and liabilities with respect to the affected member classification shall be combined with the risk pool.”

11. The Board’s implementing regulations provide that a contracting agency “with a rate plan of less than 100 active members on any annual actuarial valuation date shall be required to participate in a risk pool.”⁶ The implementing regulations also provide that with respect to new agencies contracting with CalPERS after the creation of risk pools, CalPERS

⁵ Section 20480.

⁶ California Code of Regulations, title 2, section 588 .1.

may determine that participation in a risk pool is unfavorable to other agencies in the pool; in such cases the matter “may be” referred to the Board for hearing. (Cal. Code Regs., tit. 2, § 588.2.)

12. Board resolutions set forth policies of the Board. On June 18, 2003, the Board adopted Resolution No. 03-03-AESD, which created nine separate risk pools. Five of the pools were created for miscellaneous members and four were created for safety members. This Resolution provided:

Safety members that are still subject to a miscellaneous service retirement formula following a reclassification to the safety category will participate in the risk pool applicable to the other members of the same employee category.

Inactive members that are subject to a different service retirement formula than one applicable to the active members of the same employee category will participate in the risk pool applicable to the active members of the same employee category.

13. An inactive plan is one that has no active members. On June 16, 2004, the Board adopted the following revision to the Resolution,⁷ which created an inactive risk pool:

Pool #10—Inactive Plan Pool

- All rate plans determined to be inactive in the June 30, 2003 actuarial valuation (i.e. no active members in the rate plan) shall participate in the Inactive Plan Pool, regardless of the benefit formula applicable to the inactive members of the plan.
- Rate plans moving from an active status to an inactive status will be transferred from their then current pool to the Inactive Plan Pool following a period of at least one year in which they had no active members.

[Original emphasis.]

14. Risk Pool #10, the Inactive Plan Pool, was created to apply to inactive plans. CalPERS’s policy requiring that inactive plans be placed in an inactive pool was created to avoid saddling employers with active members from funding the liabilities of inactive plans, who do not have contributions from an ongoing payroll.

⁷ The Resolution remained the same, with the exception of the addition of Pool #10. As used herein, the term “Resolution” refers to the Resolution as amended on June 16, 2004.

CalPERS's consolidation of City's active and inactive safety members

15. The City provides police and fire protections to its residents. In 2008, the City established the Safety Police Tier 2 Plan. Police officers were enrolled in CalPERS and were considered safety members. Based on the date of hire, police officers earned pension benefits under either a 3 percent at 50 or 3 percent at 55 formula. On October 31, 2010, the City eliminated its police department and "outsourced" its police services to the San Mateo County Sheriff's Office. The City's Police Plan became inactive after it eliminated its Police Department. In its June 2011 actuarial valuation CalPERS moved the inactive police plan to Risk Pool #10, the Inactive Plan Pool.

16. For many years the City did not have its own fire department. Fire protection services were provided pursuant to a contract with another agency. On October 1, 2011, the City established its own fire department. The City's firefighters were enrolled in CalPERS and were considered safety members. The firefighters earned pension benefits under a 2 percent at 50 formula (Risk Pool #7).

17. Rebecca Mendenhall is the Administrative Services Director for the City of San Carlos. Her job encompasses helping administer the City's contract with CalPERS. In the summer of 2011, Mendenhall spoke with David Dubois, CalPERS Senior Pension Actuary, about the possibility of consolidating the City's Inactive Safety Police Plan with its Active Safety Fire Plan, in Risk Pool #7. The City was facing increased costs as a result of the police plan moving to the Inactive Plan Pool. Consolidation of the plans was expected to save the City about \$800,000 in annual contributions.⁸

18. In May 2012 Dubois informed Mendenhall that the City's request to consolidate the inactive police officers with the active firefighters in Risk Pool #7 was approved, effective June 2012. The City made the required payments to CalPERS in connection with the consolidation, in the approximate amount of \$1,100,000. Milligan was not consulted regarding the consolidation.

CalPERS's determination that consolidation was a mistake and must be unwound

19. About four months after the consolidation was permitted, CalPERS staff reviewed the numbers for the June 30, 2011 valuation of Risk Pool #7. CalPERS staff determined that the consolidation increased the contribution rate for all employers in the risk pool by about one-half of one percent. Milligan determined that its consolidation was improper because it violated the Resolution requiring that inactive members be placed in an Inactive Plan Pool. Based upon the analysis provided by his staff, Milligan determined that the consolidation resulted in a material increase in the rates of all employers in Risk Pool #7.

⁸ The savings in annual contributions turned out to be closer to \$500,000.

20. In early October 2012, Dubois called Mendenhall and explained that CalPERS's decision to allow the consolidation would be reversed. In a letter to Mendenhall dated October 18, 2012, Milligan outlined the financial impact of the consolidation on other employers in Risk Pool #7:

[It] would increase the 2013 to 2014 employer contribution rate for all other plans in that pool by about 0.56 percent for the following reasons:

1. Your police plans added about \$5.2 million to the shared pool unfunded liability, but that additional unfunded liability had no police payroll over which its cost could be spread. The rate impact from this cause was 0.45 percent of payroll.
2. Your fire plan had a higher than average normal cost due to its high average entry age. The rate impact from this cause was 0.11 percent of payroll.

21. According to Milligan, as a result of the consolidation the total projected additional contributions required of other employers in Risk Pool #7 was approximately \$375,000 annually or \$18,000,000, over a 30-year period. Milligan determined that the increased cost to other employers was "unacceptable." He concluded that it was "not appropriate to consolidate these two plans and that we had to unwind that consolidation."

22. Milligan gave the City two options for moving forward. The option chosen by the City under protest,⁹ was to unwind the consolidation and keep the Active Safety Fire Plan in Pool #7 and move the Inactive Safety Police Plan to Risk Pool #10.

23. The City objected to CalPERS's action by letter dated November 14, 2012. In additional correspondence to the City, dated February 8, 2013, Milligan explained that the consolidation also violated the Resolution requiring that rate plans moving from an active to an inactive status be transferred to an Inactive Plan Pool. He further explained that the correct action, pursuant to the Resolution, was to move the inactive police plan to the Inactive Plan Pool. Milligan explained that CalPERS erred because it failed to "properly analyze the financial impact on other employers prior to informing the City that it would allow consolidation. CalPERS, he explained, was required to correct this error.

24. At hearing Milligan explained the reasoning underlying the creation of the inactive risk pool:

⁹ CalPERS had also suggested the possibility that the City keep its consolidated plan but remove it from risk pooling. Although the City did not choose this option it is noted that at hearing Milligan stated that the option of removing the City from pooling may not have been available.

So in the run up to the implementation of risk pooling, we identified a concern where if we allowed inactive agencies to continue to be in the risk pool after they ceased . . . all active members, that any unfunded liability due to demographic gains or losses or investment gains or losses, they would be amortized over the active members. And since they had no active members they would not be making any contributions to the unfunded liability nor would they get any benefit from any actuarial gains.

We felt it was appropriate, that [it] would be of grave concern to employers. So we felt the best solution was to create an inactive risk pool in which we would design the liabilities on the basis of the [allocation of] any gains or losses based on their share of the pool's liabilities.

25. Milligan explained that Dubois erred in allowing the consolidation in the instant case because he failed to consider the impact of the consolidation on other employers in the risk pool; and given the magnitude of the impact, Dubois should have brought the issue to Milligan's attention.

26. Dubois recently retired from his position as Senior Pension Actuary. Julian Robinson is currently CalPERS's Senior Pension Actuary assigned to San Mateo County. At hearing, Robinson noted that because Pool #7 is one of CalPERS's smaller pools, with about 69 members, the consolidation has a disproportionately large impact on the pool. While Robinson acknowledged that CalPERS's calculations regarding the financial impact on other employers contained some errors, he explained that assessing the impact of the consolidation involves complex actuarial calculations with a "slew of moving parts."

27. At hearing, Milligan agreed that if the inactive police officers were allowed to remain in Risk Pool #7, other employers in the risk pool would be required to make an additional contribution of .45 percent rather than .56 percent of payroll. The difference, .11 percent, accounts for the normal costs associated with the inclusion of the fire safety members into Risk Pool #7. Milligan explained that the bulk of the increased cost to pool members was based upon the inclusion of inactive police members in the plan, which was approximated at about .45 percent. (Robinson estimated that a .45 percent rather than a .56 percent increase would result in a cost of approximately \$14,400,000, to other employers over a 30-year period, rather than the \$18,000,000 that was originally contemplated.) Milligan determined, and it is found, that the .45 percent increase in costs to other employers, by virtue of the consolidation of the inactive police office into Risk Pool #7, was material.

28. Milligan further explained that under the Resolution, where a plan moves from active to inactive status, it should be transferred from an active to an inactive risk pool.¹⁰ CalPERS has a fiduciary duty to administer retirement plans in the best interests of its members. CalPERS's duty includes minimizing employers' contributions to risk pools, even if it conflicts with the interests of one member of the pool. Milligan determined, and it is found, that if the consolidation were allowed to continue it would significantly increase the contributions of the other employers in Risk Pool #7, thereby violating CalPERS's fiduciary duty to these employers. Milligan's determination is also consistent with the Board's policy that inactive plans be placed in inactive risk pool. Once CalPERS realized it made a mistake that benefitted one agency over a pool of agencies, it had a duty to correct it.

29. Ian Altman is an actuary and co-founder of Altman and Cronin Benefit Consultants in San Francisco. Altman opined that, for several reasons, Milligan's decision was made without sufficient information: He thought that Milligan's letter to the City dated October 18, 2013, failed to meet the standards of the actuarial profession in that it was, at points, unclear and contained errors. He noted some discrepancies in the calculations provided by CalPERS. Altman calculated the annual cost of consolidation to Risk Pool #7 as about \$300,000, not \$375,000. He questioned why, in calculating the impact of the consolidation, Milligan failed to take into account the City's \$1,100,000 contribution to Risk Pool #7. He opined that the City's contribution of \$1,100,000 would have neutralized the \$300,000 annual cost to Risk Pool #7 for about four years. Overall, Altman did not think the increase in costs to the other employers in Risk Pool #7 by virtue of the consolidation was material. Although Altman has impressive educational and professional credentials as well as extensive experience as an actuary, his testimony was insufficient to rebut the evidence submitted by CalPERS, set forth above.

LEGAL CONCLUSIONS

Preliminary matters

1. As the appealing party, the City has the burden to demonstrate that CalPERS erred when it determined that the City's Inactive Safety Police Plan must be unwound from the consolidation. (*See McCoy v. Board of Retirement* (1986) 183 Cal.App.3d 1044, 1051.)

2. CalPERS's request for official notice of Precedential Decision 98-02, *In the Matter of the Appeal of Decreased Level of Retirement Allowance of Harvey H. Henderson* (OAH No. L-1997120520), is granted. CalPERS's request for official notice of the decision

¹⁰ According to Milligan, CalPERS has occasionally allowed consolidation of plans but only where it does not materially impact the other employers' contribution rate to the pool.

In the Matter of the Statement of Issues against Michael T. Campbell (OAH No. 2012030114) is denied pursuant to Government Code section 11425.60, subdivision (a).¹¹

Contentions on appeal

3. The City argues that CalPERS's action to unwind the consolidation was unjustified for several reasons. First, the City interprets the Resolution to require that the City's safety members, police and firefighters, participate in the same risk pool regardless of whether they are active or inactive members. The City, therefore, asserts that what CalPERS did was correct in the first instance when it allowed the City to consolidate its active and inactive safety members into one risk pool. The City also argues that CalPERS failed to demonstrate that the inclusion of the inactive with the active safety members had a material impact on other agencies in Risk Pool #7. Specifically, the City argues that the increase in the contributions from other employers is not sufficient to warrant excluding the inactive safety members from Risk Pool #7. The City argues that Milligan's determination that the consolidation had an unacceptable material impact on other employers in Risk Pool #7 was arbitrary in that it lacked a factual or legal basis, and instead, was based upon the "will" of Milligan.

4. CalPERS contends that it made a mistake when it consolidated the inactive police officers with the active firefighters in active risk pool because pursuant to its policy, all inactive plans must be placed in the inactive risk pool. Further, because the consolidation increased the amount of contributions required by other employers in Risk Pool #7, allowing the City to maintain the consolidation would violate CalPERS's fiduciary duties to the other employers in the risk pool.

Discussion and determination of Issues

5. The City's contention that Milligan's determination was arbitrary lacks merit. It is within the Board's power to exclusively control and manage the retirement fund, and to determine the conditions under which people may continue to receive benefits.¹² As Chief Actuary for the Board, Milligan is authorized to ensure that the PERL, attendant Board regulations and policies are properly implemented. This authority includes the authority to determine that an employer's participation in a risk pool has an unacceptable material impact on other employers in that pool.

In the instant case Milligan determined that the consolidation initially allowed by PERL should not be permitted. He reasoned that the consolidation contravened the Board's

¹¹ Government Code section 11425.60, subdivision (a) provides that "a decision may not be expressly relied upon as precedent unless it is designated as a precedential decision by the agency."

¹² See citations to PERL set forth in Factual Finding 6.

policy, set forth in its Resolution, of placing members in risk pools based upon their active or inactive status. (Factual Findings 19, 23, 24, 28.) He also determined that the placement of the City's inactive police members in a risk pool with active members had an unacceptable material impact on other employers participating in the active risk pool. (Factual Findings 20, 21, 25, 27, 28.) This determination was within his discretion and was reasonable. Milligan's correction of CalPERS's mistake was required by statute and was proper.

The fact that the evidence suggests that the extent of the impact on the other employers in Risk Pool #7 may be closer to \$14,000,000 over a 30-year period, which is less than the \$18,000,000 originally projected by CalPERS, does not alter the fact that a material impact was established.

6. The City argues that the language contained in the Resolution determines risk pool placement based upon "employee category" and not whether an employee is active or inactive. From this premise, the City concludes that the Resolution required that police officers and firefighters be placed in the same risk pool. This argument is unsupported by the plain language of the Resolution.

7. CalPERS established that its consolidation of the inactive police officers and the active firefighters into Risk Pool #7 was in error because it violated the Board's Resolution and because the consolidation materially impacted the other employers in Risk Pool #7. Against this background it cannot be said that CalPERS's determination to unwind the consolidation of the police and safety members from the active risk pool was improper. CalPERS owes a duty to each of the participants in Risk Pool #7 to minimize employer contributions. If CalPERS allowed the consolidation to stand, it would benefit the City at the expense of the 68 other employers in Risk Pool #7. CalPERS was authorized, and indeed required to, correct its mistake. (§ 20160, subd. (b).) To hold otherwise would abrogate the fiduciary obligations owed by CalPERS to its members. The City's appeal is denied.

8. All contentions made by the parties not specifically addressed herein were considered and are found to be without merit.

ORDER

The City's appeal from CalPERS's determination that the City's Inactive Safety Police Plan must be unwound from consolidation with the Active Safety Fire Plan in the 2 percent at 50 risk pool is denied.

DATED: 2/18/14



DIANE SCHNEIDER
Administrative Law Judge
Office of Administrative Hearings