## Agenda Item 5

August 19, 2014

**ITEM NAME:** Proposed Regulations for Reportable Compensation under PEPRA

**PROGRAM:** Customer Account Services

**ITEM TYPE:** Action

**RECOMMENDATION**
Staff recommends the Pension and Health Benefits Committee (PHBC) approve the regulation defining pensionable compensation for submission to the Office of Administrative Law (OAL). The regulation will be added to Chapter 2 of Division 1 of Title 2 of the California Code of Regulations (CCR) as Section 579.7.

**EXECUTIVE SUMMARY**
Since the passage of AB340, the California Public Employees Retirement System (CalPERS) has introduced a series of regulations to aide in the interpretation and administration of the Public Employees' Pension Reform Act (PEPRA) of 2013. The draft regulation was released for public comment in May 2014. As anticipated, CalPERS received dozens of comments, both in support and opposition to the draft regulation. The largest number of comments were related to one pay type: temporary upgrade pay. The comments submitted did not bring us any closer to a consensus or raise any new arguments; therefore staff is recommending maintaining the original draft language for adoption to be submitted to OAL for its final review and addition to the CCR.

This regulation, when finalized, is intended to clarify CalPERS interpretation of what is considered pensionable compensation for "new" members (generally those hired on or after January 1, 2013). This will provide uniform compliance amongst all participating employers.

**STRATEGIC PLAN**
This agenda item supports Goal A, Improve long-term pension and health benefit sustainability by ensuring high quality, accessible and affordable health benefits.

**BACKGROUND**
At the April 2014 CalPERS Board of Administration meeting, the Board approved the proposed regulatory action defining pensionable compensation. Subsequently, the Notice of Proposed Regulatory Action was filed with OAL which initiated the 45-day written comment period where interested parties could submit public comments relevant to the proposed regulatory action.

The written comment period ended July 14, 2014. A total of 36 comments were received, 32 within the comment period. Most of the comments were related to temporary upgrade pay.

In addition, numerous comments requested a public hearing. The public hearing was appropriately noticed for today, August 19, 2014, at 9:30a.m., to allow any interested parties to present testimony and comments regarding the proposed regulatory action. The PHBC and CalPERS staff are not required to respond to public comments during the hearing; however, all comments must ultimately receive a written response from CalPERS as part of the final rulemaking file.

Temporary Upgrade Pay

As discussed in the April 2014 meeting, temporary upgrade pay was originally considered an “Ad-Hoc” type payment and excluded from the pensionable compensation regulation. After further review, and discussion with many stakeholders, CalPERS staff determined it more appropriately represented the normal monthly rate of pay for services rendered and should be included.

Temporary upgrade pay for “classic members” (generally those first hired before January 1, 2013) is defined as compensation to employees who are required by their employer or governing board or body to work in an upgraded position/classification of limited duration.

Employers most commonly use this pay item under two circumstances. When an employee leaves their position unexpectedly employers often move the next ranking employee into that position until a new permanent employee is hired to permanently fill the vacancy. During that time an agency typically initiates a formal recruitment. The other common situation is when an employee leaves their position for a short duration, such as medical leave, and employers move a lower ranking employee into that position until the employee returns.

In both situations the employee entering into the temporary position must give up their previous duties and completely work in the upgraded position. We can often see where they’ve placed another employee into their position as a temporary backfill.

Staff would then evaluate this pay item to determine if it appropriately meets the following four reporting components required by law:

- Required: Cannot be a volunteer assignment. This would make it open to manipulation.
- Work in upgraded position: Cannot be for taking on duties in addition to theirs. This would be viewed as overtime.

- Limited Duration: individualize by employer. Often more than one year is not considered temporary or limited.
- Must be contained in a labor agreement: All pay items must list the conditions for payment including a description and eligibility requirements. This ensures transparency.

Labor agreement documents are a major part of the review to determine if the pay item should be reportable and used toward a retirement calculation. Two examples of temporary upgrade pay being used appropriately in conjunction with language in a labor agreement are as follows:

Differential 99 criteria (in part)
- When an employee is assigned out-of-class work for two (2) consecutive work weeks or more, he/she shall receive the rate of pay he/she would have received…if appointed to the higher classification.
- Compensation for out-of class work shall not exceed one year.

Differential 100 criteria (in part)
- If a department head or designee requires an employee to work in a higher classification for more than two consecutive weeks, the employee shall receive the rate of pay…the employee would have received if appointed to the higher class for the entire duration of the assignment.
- No employee may be compensated for more than one (1) year of out-of-class work for any single approved out-of-class assignment.

These differentials (serving as a labor agreement) detail that all classes in all departments are eligible. Both indicate the employee is assigned/required to work in the upgraded capacity. It clearly indicates this is intended to be used in their final compensation calculation as it is subject to CalPERS deduction. There is a stated limit of one year set for the item. The language specifically indicates they are to work in a higher classification, not merely take on additional duties.

There are also times where, based on review of documentation, temporary upgrade pay may be disallowed. For example, if it's found that the pay is for employees taking on duties in addition to what is normally required of their own position, or if the employee doesn't work in that upgraded position, CalPERS would view the additional pay as overtime and it would not be considered reportable. Another possible reason may be if documentation leads to the determination it was used as a way to boost the member's compensation in their last 12 months and is viewed as final settlement pay. One more common reason for temporary upgrade pay to be disallowed is if there is no documentation in any labor agreement providing transparency.

**ANALYSIS**

The Notice of Proposed Regulatory Action (Attachment A) was published in the California Regulatory Notice Register 2014, No. Z2014-0519-01, on May 30, 2014 (Attachment B). The 45-day comment period commenced on May 30, 2014, and closed on July 14, 2014. Stakeholders were notified at the onset via a number of different channels. Outreach continued throughout the comment period via email reminders, direct telephone calls and stakeholder events. As mentioned above, 36 comments were received in relation to the draft regulation for pensionable compensation. Over three-fourths of the comments received provided feedback on temporary upgrade pay: about a quarter supporting, three-fourths opposing. A summary of all public comments is provided as Attachment C of this agenda item. The original comments received and staff's response to each comment is included as Attachment D.

The proposed regulation did not require modifications as a result of these public comments, as indicated above. The proposed regulatory action is included as Attachment E for the PHBC's consideration.

Based on the fact that no new information was provided to revisit the original draft regulation, staff is recommending approval of the original draft regulation for submission to OAL for review and adoption with the two non-substantive changes noted below.

1. Added title "Pensionable Compensation"
2. Corrected the Section number from 571.1 to 579.7.

**BUDGET AND FISCAL IMPACTS**

Administrative Costs

CalPERS will incur some costs in order to comply with the PEPRA legislation. Notwithstanding this fact, staff has attempted to identify the fiscal impact associated with implementing the regulation. In general, certain administrative costs will be attributable to the regulation, including education outreach and training, programming costs to the my|CalPERS system, publication costs, and postage.

In some instances, CalPERS-covered employers may also incur certain administrative costs for training or enhancements to their own systems, and costs associated with complying with the regulation; however, staff may be unable to quantify all of the costs incurred by CalPERS-covered employers. As this information must be provided to the OAL and the Department of Finance as part of the regulatory process, staff continues to work on quantifying the above costs and determining whether there may be additional costs to CalPERS and CalPERS-covered employers associated with the regulation.

Benefit Costs

Staff is unable to determine how often temporary upgrade pay is used, but based on what we know about pay items in general staff would not anticipate that including or not including temporary upgrade pay in the final regulations would have any impact on the actuarial contribution rates. If temporary upgrade pay is included it would result in the employer and employee receiving the temporary upgrade pay having to pay their share of the normal cost on the amount of the increased pay. Any long term costs for the employer would depend on whether temporary upgrade pay results in a higher retirement benefit than anticipated. However, as a percentage of payroll any increase is likely to be minimal.

**BENEFITS/RISKS**

Without the adoption of a regulation, there are significant risks. Not all CalPERS-covered employers may interpret the new legislation consistent with CalPERS interpretation, and that could lead to inconsistent application of these new laws. CalPERS may achieve cost savings as a result of decreased litigation and administrative appeals related to the definition of pensionable compensation as employers and members become more aware of what compensation is or isn't reportable to CalPERS.

Also, there are both benefits and risks for members and employers to the inclusion of temporary upgrade pay:

- Benefits:
  - For the member it could result in an increase in their final compensation when used and reported correctly.
  - For the employer it could be used to incentivize employees to agree to work in an upgraded position.
  - For members it could reduce the use of temporary assignments in lieu of filing permanent vacancies.

- Risks:
  - For the member it could result in paying contributions on an item that might never be used in their final compensation calculation. If it is reported in early to mid-career there is a high possibility their salary will eventually surpass the amount of the temporary upgrade pay amount.
  - For the employer it could result in minimal short term costs by requiring normal cost contributions on the temporary upgrade pay differential.

**ATTACHMENTS**
Attachment A – Notice of Proposed Regulatory Action
Attachment B – California Regulatory Notice Register 2014
Attachment C – Summary of Public Comments
Attachment D – Original Comments and Responses
Attachment E – Proposed PEPRA Regulation

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