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A Guide to Pension Reform Under AB 340 and AB 197

A Public Law GroupTM White Paper

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1. INTRODUCTION

On September 12, 2012, the Governor signed into law a pension reform bill, AB 340 – as amended by trailer bill AB 197 – that will make substantial changes to pension benefits for public employees who become members of a retirement system on or after January 1, 2013, as well as some changes that affect current members.

AB 340 enacts the California Public Employees’ Pension Reform Act of 2013 (PEPRA), which mandates changes to pension benefits and contributions for all public employee pension systems in California (with a few exceptions noted below). Since public employers are covered by a myriad of retirement laws, AB 340 both adds a new Act to the Government Code and amends existing sections of the State Teachers’ Retirement Law (STRS), the Public Employees Retirement Law (PERL), and the County Employees Retirement Law of 1937 (1937 Act).

PEPRA was enacted with a stated goal: to create a more sustainable pension system by reducing employer pension liability and increasing employee contributions toward their pension benefits. PEPRA only accomplishes this goal in the distant future – since the majority of the changes apply only to employees who become retirement system members on or after January 1, 2013. For those public employers still struggling with significant unfunded liabilities for current members, AB 340 does little to address the more immediate needs for a reduction in pension liability, and in some areas actually increases liabilities for most agencies modestly. And most of the Act’s provisions that do provide an opportunity to reduce an employer’s share of an unfunded liability can be realized only by agreement with employee organizations. Because current costs are so heavily driven by unfunded liabilities and the Act does little to help with current employees, the future savings due to the legislation will do little to drive down normal cost or unfunded liability in the next decade.

In this white paper, we provide a summary of the most important provisions of AB 340 and the changes it makes to existing law. The bill’s sometimes vague and often convoluted language leaves many unanswered questions about how this pension reform measure will operate in practice. We attempt to address the likely resolution of some of these questions, while leaving others to be resolved through further legislation or litigation.

2. WHO IS COVERED?

PEPRA applies to almost “all state and local public retirement systems and to their participating employers.”¹ The only retirement systems not affected in any way are the University of California Retirement System and independent retirement systems governed by local charter. Technically, all charter cities and counties are also potentially excluded, but charter entities that contract with CalPERS for all or some of their employees’ retirement benefits are subject to

¹ New Gov’t Code § 7522.02(a)(1).

PEPRA to the extent of those contracts,² and charter counties with a 1937 Act retirement system are subject to the 1937 Act amendments.³

3. PROVISIONS AFFECTING NEW MEMBERS

Most of AB 340's provisions take effect on January 1, 2013, and apply only to new members. A "new member" is an employee who first becomes a member of any public retirement system on or after January 1, 2013 and (1) was not a member of any other public retirement system prior to that date; (2) was previously a member of another public retirement system not subject to reciprocity with the new system; or (3) began employment with a new employer in the same retirement system after a break in service of more than six months.⁴ The six-month condition does not apply to employees who move from one State agency to another, or from one school employer to another.⁵ For purposes of this paper, "current member"⁶ means any employee who does not meet the statutory definition of "new member."

One of the hallmarks of this pension reform is to reduce the overall amount of pension available to new members upon retirement through new formulae, anti-spiking provisions, and limitations on pensionable compensation. Required employee contributions to the normal cost further ensure sufficient funding for future pensions. AB 340 thus mandates five substantial changes for new members:

- A. New retirement formulae with increased retirement age and reduced benefit factors;
- B. Cap on pensionable compensation;
- C. Three-year averaging to determine final compensation;
- D. New definition of "pensionable compensation"; and
- E. Employee cost-sharing of at least 50% of the normal cost to fund the benefit.

A. New Retirement Formulae

To receive the maximum available pension under the new formulae, new members will be required to work a few years longer and will receive an overall lower pension once they do retire.

For new *miscellaneous members*, a 2% at 62 formula will apply, with a maximum benefit factor of 2.5% at age 67.⁷ Currently a majority of PERS agencies have 2% at 55 for their

² New Gov't Code § 7522.02(a)(2).

³ AB 340, §§ 28-33.

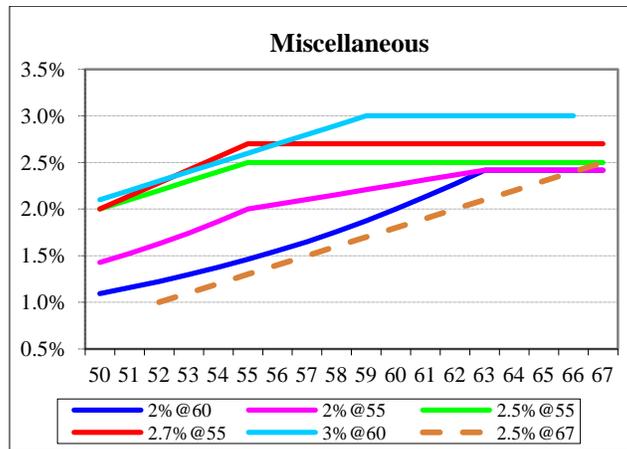
⁴ New Gov't Code § 7522.04(f).

⁵ *Ibid.*

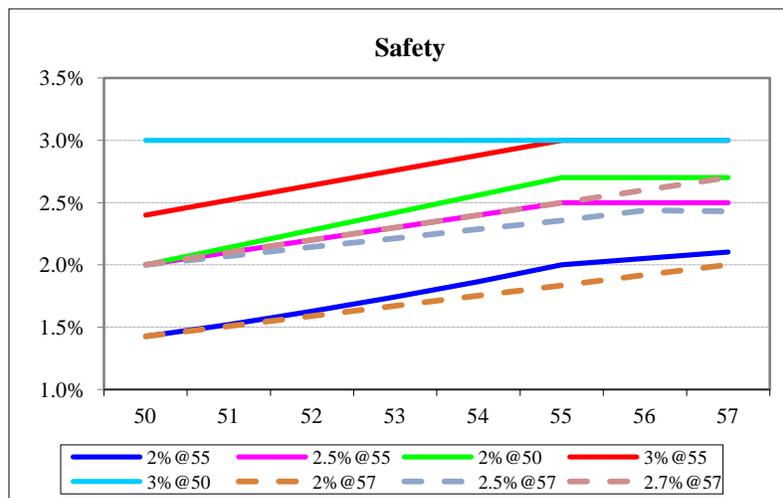
⁶ In CalPERS lingo, these are "classic" members.

⁷ New Gov't Code § 7522.20.

miscellaneous employees, with members reaching the maximum benefit factor of 2.418% at age 63. The following graph compares the new formula to the previously available formulas:



For new *safety members*, the legislation provides for three possible formulas: 1.426% at 50, with a maximum benefit factor of 2% at age 57 (Basic); 2% at 50, increasing to 2.5% at 57 (Option 1); or 2% at 50, increasing to 2.7% at 57 (Option 2).⁸ The default formula will be the formula which is lower than, but closest to, the current benefit formula at age 55.⁹ Since most public agencies have adopted a 3% at 50 or 3% at 55 formula, the default formula for over 90% of public employers will be the highest of the formulas, Option 2. The following graph compares this formula to the previously available formulas:



After January 1, 2013, agencies can bargain for a lower safety formula, but implementation of a lower formula can only be attained through mutual consent.¹⁰ Ironically, this takes away a

⁸ New Gov't Code § 7522.25.

⁹ New Gov't Code § 7522.25(e).

¹⁰ New Gov't Code § 7522.25(f).

management prerogative that existed before AB 340 – the right to unilaterally implement a second-tier formula after exhaustion of impasse procedures.

PEPRA provides no leeway regarding these new retirement formulae; they *must* be used for new members of any retirement system that offers a defined benefit plan.¹¹ Thus, effective January 1, 2013, second-tier retirement will be implemented by operation of state law for most public employers; those that already have two tiers will now have a third. As for existing optional benefits under an employer's CalPERS contract, they will apply to new members unless prohibited by AB 340.

As for charter entities, PEPRA appears to restrict their ability to modify pension benefits through charter amendments. Under PEPRA, a public employer may not adopt a new defined benefit formula unless it is the same as those set out in PEPRA, or it is certified by the retirement system's chief actuary and governing board, and approved by the Legislature.¹² This language suggests that a charter city or county that currently contracts with CalPERS cannot break away and establish its own independent retirement system without legislative approval, unless the system provides the exact same benefits as CalPERS does under PEPRA. The language is broad enough to be read as prohibiting *any* change to a benefit formula by a charter-established retirement system that results in a greater benefit than the PEPRA formulas, unless the Legislature has approved the change. This could restrict such systems' ability to modify second tier benefit formulas that provide a greater benefit than PEPRA. Either reading significantly infringes on charter entities' constitutional home rule authority, as well as on the voters' initiative power.

B. Cap on Pensionable Compensation

For new members subject to Social Security, final compensation used to calculate a new member's pension benefit cannot exceed 100% of compensation subject to Social Security taxation, which for 2012 earnings is \$110,100.¹³ For those new members not participating in Social Security, final compensation cannot exceed 120% of that amount, currently \$132,120.¹⁴ The retirement system must adjust the amount annually based on the Consumer Price Index for All Urban Consumers, but the Legislature reserves the right to modify the amount prospectively.¹⁵

This cap cannot be exceeded by providing a supplemental defined benefit plan for any new member.¹⁶ And while an employer may contribute to a defined contribution plan for new

¹¹ New Gov't Code §§ 7522.20(a), 7522.25(a).

¹² New Gov't Code § 7522.02(d)&(e).

¹³ New Gov't Code § 7522.10(c)(1).

¹⁴ New Gov't Code § 7522.10(c)(2).

¹⁵ New Gov't Code § 7522.10(d).

¹⁶ New Gov't Code § 7522.18.

members whose final compensation is over the cap, those contributions are also restricted: the employer's contribution "shall not, when combined with the employer's contribution to the employee's retirement benefits below the compensation limit, exceed the employer's contribution level, as a percentage of pay, required to fund the retirement benefits of employees with income below the compensation limits".¹⁷ In other words, the contribution to a defined compensation plan must be equal to or less than the defined benefit contribution as a percentage of salary. As an example, assume the employer contributes 10% of salary to the defined benefit plan for employees under the cap. For an employee with \$250,000 salary, an employer could contribute \$11,000 to the defined benefit plan (10% x \$110,000 under the cap), and \$14,000 to the defined contribution plan (10% x \$140,000 above the cap).¹⁸ This limitation is significant and may lead to recruitment and retention issues in management positions and areas where there historically is strong competition with the private sector for quality candidates.

C. Three-year Averaging for Final Compensation

To limit the possibility for pension spiking through final-year salary increases, final compensation for calculating the pension benefit is determined by averaging highest annual compensation over a consecutive 36-month period.¹⁹ Currently, a minority of local agencies use a 3-year average, while most use highest compensation over a 12-month period.

D. Exclusions from Pensionable Compensation

Currently, pensionable compensation consists of the employee's base pay rate plus "special compensation" contained in a collective bargaining agreement approved by the employer's governing body. PEPR and the concurrent 1937 Act amendments significantly reduce the types of "special compensation" that count toward the retirement benefit.

Pursuant to AB 340, only the new member's regular, recurring base pay may be used to calculate the pension benefit.²⁰ Uniform allowances and certain one-time pays that are currently part of final compensation will now be excluded.²¹ Also excluded from the calculation is any "compensation paid to increase a member's retirement benefit," as determined by the retirement board (i.e., anything which arguably "spikes" compensation).²²

The 1937 Act amendments are similar, except that pensionable compensation includes payments for up to 12 months of leave "earned and payable" during the period used to calculate the

¹⁷ New Gov't Code § 7522.10(g).

¹⁸ League of California Cities, *Comparing League Policy and the Conference Committee Report on Public Employee Pensions*, August 30, 2012, Addendum B.

¹⁹ New Gov't Code § 7522.32.

²⁰ New Gov't Code § 7522.34(a).

²¹ New Gov't Code § 7522.34(c).

²² New Gov't Code § 7522.34(c)(1).

employee's final average compensation, as well as termination pay earned and payable during that period.²³ Initially, AB 340 would have made pensionable the maximum amount of leave that could be earned in each 12-month period during the final compensation period regardless of whether it was payable during those 12 months.²⁴ This "loophole" was fixed in the AB 197 trailer bill, which changed the language to "earned and payable," thereby requiring that the employee actually be able to cash out the earned leave during the 12-month period for it to be pensionable.²⁵

E. Employee Cost-Sharing

The central tenet of AB 340's approach to employee contributions is that all public employees contribute at least 50% of the normal cost of their pensions, and that employers not pay *any* of the employees' required share.²⁶ For new members, this standard will be applied effective January 1, 2013 – with exceptions noted below.

Effective January 1, 2013, new members must pay an initial contribution rate that is the greater of "at least" 50% of the normal cost for the new plan, *or* the current contribution rate of similarly situated employees.²⁷

- "Normal cost" is the present value of the increase in retirement benefits attributable to the current year.²⁸
- Although "similarly situated employees" is not defined, likely it means members of the same group or class of employment. Under this definition, new members could pay the same contribution rate as current members, even if it is higher than 50% of the normal cost of the new retirement plans.²⁹

New members may not have to pay the full 50% contribution immediately if, under a memorandum of understanding (MOU) in effect on January 1, 2013, the employee contribution for current members is less than 50% of normal cost.³⁰ But once the MOU expires, new

²³ Gov't Code § 31461(b)(2), as amended by AB 197.

²⁴ Gov't Code § 31461(b)(2), as amended by AB 340.

²⁵ On November 29, 2012, a Contra Costa Superior Court judge enjoined the Contra Costa County Employees Retirement Association from implementing this provision until a lawsuit alleging that the provision impairs vested constitutional rights is resolved.

²⁶ New Gov't Code § 7522.30(a).

²⁷ New Gov't Code § 7522.30(c).

²⁸ New Gov't Code § 7522.04(g).

²⁹ CalPERS has relied on this reading of the provision in estimating savings from cost-sharing under PEPRA. CalPERS, *Actuarial Cost Analysis – California Public Employees' Pension Reform Act of 2013*, August 31, 2012, p. 7.

³⁰ New Gov't Code § 7522.30(f).

members will be required to pay the full 50% contribution, and this requirement cannot be evaded or delayed through further contract extension, amendment, or renewal.³¹

As for how 50% of the normal cost will be calculated, new members must contribute 50% of the “normal cost rate.” Prior to AB 340, CalPERS excluded the statutorily mandated employee contribution from the annual valuation of normal cost it provided to employers. Going forward, any statutorily required employee contribution (for current members) will be included in the CalPERS valuation. For public employers that do not participate in a risk pool, CalPERS will provide a single blended normal cost rate for all retirement tiers. For those who do participate in a risk pool, CalPERS will provide a separate PEPR normal cost valuation.³²

4. COST-SHARING FOR CURRENT MEMBERS

While AB 340 sets a standard that employees pay at least 50% of the normal cost and employers no longer pay *any* of that employee contribution (EPMC), for current members this standard is not a mandate.

First, EPMC has not been eliminated. If an employer currently pays all or part of the EPMC under an MOU now in effect, that payment will continue until the end of the MOU term. More importantly, unlike for new members, nothing in AB 340 precludes an employer from agreeing in a subsequent contract to pay all or part of the EPMC for current members. On the other hand, AB 340 contains no limitation on an employer’s ability to unilaterally impose, after exhausting mandatory impasse procedures, up to the full employee contribution on current members. Thus, AB 340 does not explicitly change the EPMC landscape for current members.

Second, unlike new members, the employer cannot unilaterally implement provisions requiring members to pay 50% of the normal cost until January 1, 2018. Nor can the employer unilaterally implement provisions that require employees pay 50% if to do so exceeds the contribution caps set forth in the statute. In short, unless *agreed* to through collective bargaining, AB 340 prohibits an increase in employee contribution above the mandatory employee contribution prior to January 1, 2018.³³ After that date, an employer can increase the employee contribution after exhausting mandatory impasse procedures, but for CalPERS members, the employee contribution can be no more than 8% of pay for miscellaneous employees, 12% for police and fire, and 11% for other safety.³⁴ For many employers, these contribution rates may not equal 50% of the normal cost for current plans, and will not mandate an increase for miscellaneous employees with enhanced retirement formulas who already pay 8%.

³¹ *Ibid.*

³² See www.calpers.ca.gov for Frequently Asked Questions on Pension Reform Impacts.

³³ New Gov’t Code § 20516.5(c).

³⁴ New Gov’t Code § 20516.5(b).

The same holds true for agencies in 1937 Act systems. AB 340 amends the Act to place a similar five-year ban on unilateral implementation of employee contribution between the mandatory employee contribution and 50% of normal cost.^[1] After January 1, 2018, the employer can increase the employee contribution after exhausting mandatory impasse procedures.^[2] However, the increase can be no more than 14% above the normal contribution rate for miscellaneous employees, no more than 33% above the normal contribution rate for police and fire, and no more than 37% above the normal contribution rate for other safety.^[3] The “normal contribution rate” is the percentage of pay the employee contributes each pay period, as set annually by the system’s retirement board based on revised actuarial assumptions. To calculate the amount the employer can impose, the employee’s normal contribution rate is multiplied by the applicable percentage. For example, if the normal contribution rate for a miscellaneous employee is 10%, the employer can impose up to an 11.4% contribution rate. (10% Employee Contribution Rate x 14% Maximum Increase = 1.4%; 10% + 1.4% = 11.4%).

Because of these limitations on increased contributions for current members, AB 340 precludes the full savings from a 50/50 normal cost split absent voluntary agreement. Therefore, AB 340 will not provide the short-term cost savings employers hoped to achieve under the Governor’s original proposed pension reform package. Further, AB 340 does nothing to address the staggering unfunded pension liability most public employers face, as it leaves employee contributions toward unfunded liability to the collective bargaining process without the option of unilateral implementation.

5. GENERAL PROVISIONS APPLYING TO ALL MEMBERS

AB 340 enacts other significant changes that affect both current and new members.

A. Revised Rules for Cost-sharing of the Employer’s Cost

Although current members may not be required to pay the full 50% of the normal cost, revisions to Government Code section 20516 will provide much greater flexibility for employers and unions to negotiate cost-sharing of the employer’s contribution for both new and current members. Previously, cost-sharing of the employer’s contribution that was implemented through a CalPERS contract amendment was limited to covering an optional or enhanced benefit, and could not differ by bargaining unit. Those restrictions have been eliminated.

^[1] New Gov’t Code § 31631.5(a)(2).

^[2] *Id.*

^[3] New Gov’t Code § 31631.5(a)(1).

B. Ban on “Airtime” Purchases

PEPRA prohibits the purchase of nonqualified service credit, i.e. “airtime,” after January 1, 2013.³⁵ Technically, airtime purchases are not supposed to result in increased costs to the employer because the employee is required to pay the actuarially-determined present-day value. In reality, airtime purchases have led to higher employer costs because employees can select when they retire, thereby defeating the assumption of average retirement age upon which actuarial calculations are made.

C. Limitations on Post-Retirement Employment

Currently, a retiree cannot work more than 960 hours per year for a public employer in the same retirement system from which the retiree is drawing benefits. PEPRA continues that limitation but adds a 180-day waiting period for employment after retirement, even if the employee retired due to an employer incentive.³⁶ The waiting period does not apply if the retiree is a police officer or firefighter, or if the employer certifies the employee is needed to fill a critically important position and the appointment has been approved by the governing board in a public meeting.³⁷ Although PEPRA prohibits the retiree from working *directly* for the employer as a contractor, it does not appear to prohibit the retiree from working for a private company that contracts with the employer.

D. “Equitable” Health Benefit Vesting

Employers who do not participate in PEHMCA establish their own vesting schedules for retiree health benefits, often through collective bargaining.³⁸ Under PEPRA, the health benefit vesting schedule for unrepresented employees cannot be “more advantageous” than the schedule for represented employees.³⁹ Thus, under this new provision, unrepresented employees and elected officials cannot become vested in retiree health benefits sooner than represented employees in a “related retirement membership classification.” PEPRA does not define “related retirement membership classification,” leaving an open question for interpretation. For example, consider an agency that has the following retiree-health vesting schedule:

Represented miscellaneous non-supervisory employees	10 years
Represented miscellaneous supervisory employees	7 years
Unrepresented department heads and elected officials	4 years

³⁵ New Gov’t Code § 7522.46. CalPERS – we think wrongly – believes that eliminating airtime purchases for current members could be an impairment of vested rights. CalPERS, *Preliminary Analysis of the Conference Committee Report*, August 28, 2012, p. 17.

³⁶ New Gov’t Code § 7522.56(d), (f).

³⁷ New Gov’t Code § 7522.56(f)(1), (4).

³⁸ The Public Employees’ Hospital and Medical Care Act provides schedules by which retiree health benefits vest based on years of service. Gov’t Code § 22893.

³⁹ New Gov’t Code § 7522.40.

For the represented employees, the vesting schedule is contained in MOUs, while unrepresented employees and elected officials are covered by resolutions. To whom should the non-represented employees and elected officials be compared? As for unrepresented department heads and elected officials, the above vesting schedule clearly is not compatible with the new law, since it provides a “more advantageous” vesting schedule than for any of the represented employees. CalPERS has taken the position that if an employer has negotiated different vesting schedules for different bargaining units in a “related retirement membership classification,” then vesting for non-represented employees and elected officials “must align with the least advantageous of the groups in related membership classifications, such as State miscellaneous.”⁴⁰ CalPERS cites no authority for this position, and none can be found in the statute itself or in the legislative intent. From our perspective, it is not “more advantageous,” and therefore would be consistent with PEPRA, if a vesting schedule for non-represented employees and elected officials is aligned with that of any bargained-for vesting schedule. But, absent further legislative clarification, CalPERS may not honor that interpretation.

E. No Retroactive Benefit Increases

While there are limited circumstances in which formula or benefit enhancements could be adopted in the future, to the extent they are, only service performed after the date the formula or benefit enhancement becomes operative may be credited at the enhanced level.⁴¹ Note that an increase to a retiree’s annual cost of living adjustment (COLA) does not count as a benefit enhancement under PEPRA.⁴² Thus, for example, a COLA increase from 2% to 5% for all current active employees would be allowed even though it would create a significant liability increase for prior service.

F. Public Safety Industrial Disability Retirement

Currently, public safety members who retire because of industrial disability before their minimum retirement age are limited to collecting the benefit provided for service-connected disability retirement: 50% of final compensation. However, many of those employees have already earned a higher benefit level through years of service. For example, under a 3% at 50 formula, a member who has 25 years of service at age 47 has earned 75% of final compensation for those years with a service retirement. AB 340 allows safety members who retire because of industrial disability before their minimum retirement age to receive their service retirement benefit actuarially reduced to the current age, if that benefit would be greater than the 50% disability allowance.⁴³ This provision increases employer liability for disability benefits because

⁴⁰ CalPERS Circular Letter titled “Implementation of Public Employees’ Pension Reform Act of 2013” (Circular Letter No. 200-055-12), issued December 3, 2012.

⁴¹ New Gov’t Code § 7522.44(a).

⁴² New Gov’t Code § 7522.44(d).

⁴³ New Gov’t Code § 7522.66.

some safety members can now receive a higher benefit than they would have under prior law. It is, in short, a provision that may increase the frequency of disability retirement. However, because this provision sunsets effective January 1, 2018 (unless renewed by the Legislature), increased employer liability may be limited to the next few years.

G. No Pension Holidays

A public employer's contribution plus the employee's contribution must equal the full normal cost for the plan year.⁴⁴ The system's retirement board may suspend contributions only when: (1) the system is funded by more than 120%; (2) continuing to accrue excess earnings could jeopardize the system's tax-exempt status; *and* (3) receipt of additional contributions would conflict with the retirement board's fiduciary duties.⁴⁵ It is highly unlikely that even one of these conditions, much less all three simultaneously, will occur any time soon. Although most pension systems are now far from full funding, this is a poorly conceived provision. For example, after pension plans are closed, there are strong reasons not to over-contribute as the funds will be locked in the trust until the last plan member dies. While it is true that CalPERS erroneously perpetuated that view that the previously full-funded status of plans would last forever, this provision is overkill.

H. Forfeiture of Pension Benefits for Felony Conviction

Under current law, elected public officials who are convicted of a felony involving bribery, embezzlement, extortion or theft of public money, perjury, or conspiracy to commit such crimes during the course of their official duties forfeit membership in and all rights to benefits attributable to service in the office held when the felony occurred.⁴⁶ Under AB 340, any public employee convicted of any of the following felonies forfeits benefits earned or accrued after the date of commission of the felony:

1. The felonies listed above for public officials;
2. Any felony in connection with official duties, in pursuit of office or appointment, or in connection with obtaining salary or benefits; or
3. Any felony within the scope of official duties and involving a child.⁴⁷

6. CONCLUSION

A product of lengthy negotiation between the Governor and the Legislature, but little public input, the new pension law is poorly drafted, and will undoubtedly lead to significant litigation

⁴⁴ New Gov't Code § 7522.52(a).

⁴⁵ New Gov't Code § 7522.52(b).

⁴⁶ Gov't Code § 1243.

⁴⁷ New Gov't Code § 7522.72.

over the meaning of various provisions. The Governor's Office has suggested there will be "clean up" legislation next year; we should be on the lookout for changes that can be made to clarify and simplify the current language.

To be sure, there are some positive developments in the area of new employee benefits. For the most part, the new tiers are significantly below the benefit amounts currently being negotiated as part of two-tier arrangements around the state. In addition, by eliminating current provisions making cost-sharing of the employer contribution very complex and burdensome, the legislation opens up the possibility of voluntarily bargained agreements for cost-sharing above the mandated employee contributions.

The price of achieving these gains, however, has been considerable. The legislation strongly reflects union hostility toward professional and managerial employees – in particular with respect to caps on pensionable contributions for new employees and the health care vesting provisions. These may undercut the ability of government to recruit top quality talent in the future, particularly if the language limiting supplemental defined contribution plans remains in place.

Perhaps more significant, the legislation gives local governments little, if any, relief in the area of short and mid-term pension costs. Establishing a threshold of 50% of normal cost-sharing (and the corresponding limitations on contribution rates under PERL and the 1937 Act) in 2018 reflects either a misunderstanding or callous indifference to the financial crisis pensions have precipitated. At a minimum, the legislation should have increased the employee contribution by a few percentage points, and not relied upon "half of the normal cost" as its polestar in light of the fact that so much of employer costs are due to unfunded liabilities.

In addition, the legislation does not provide structural reforms in CalPERS governance. The Governor has said he will pursue a constitutional amendment to add greater – and less biased – expertise to the CalPERS Board. Time will tell whether this promise comes to fruition.

Overall, this legislation suggests that the limits of the legislative process have been reached. While increased employee contributions would have been very helpful, in the end, the real challenge is to address the rising cost of future benefits for existing employees. Of course, this raises complex vesting issues; a citizen initiative taking a run at these issues now seems likely.



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