LOS ALTOS HILLS
CALIFORNIA

FILED
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DAVID H. YAMASAKI
Chief Executive Officer/Clerk,
Superior Court of CA County of Santa Clara
BY D ALDYCKI DEPUTY

August 26, 2010

The Honorable Jamie Jacobs-May
Presiding Judge
Santa Clara County Superior Court
191 North First Street
San Jose, CA 95113

Re: 2009-2010 Santa Clara County Civil Grand Jury Final Report - *Cities Must Rein In Unsustainable Employee Costs*

Dear Judge Jacobs-May,

Attached please find the requested response to the subject report as filed with the Clerk of the Court on May 26, 2010. The report confirms that many of the Town's current practices are indeed best practices for sustainable employee costs.

Town management considers the current employee compensation package sufficient to remain competitive in employee recruitment and retention. While opportunities for cost savings have been identified, it is important to note that other agencies in the County are moving their salaries and benefits closer to those that the Town has maintained for over a decade. Therefore, the Town must carefully evaluate the impact of any reductions to its compensation package on the recruitment and retention of quality employees.

As a result of the report, Town management will make the following recommendations immediate to the City Council for implementation in the current fiscal year, 2010-11:

1. **Modify the salary schedule to reduce salary increases between steps.** The Town's current five step salary schedule provides a 5.0% merit increase between steps. An employee hired at the entry level salary step could progress to top step within five years of employment with the Town. In response to the report's Recommendation #3, management will recommend that the City Council decrease the percentage increase between merit steps from 5.0% to 2.5%. This change would result in an employee reaching top step after eight years of employment. Implementation is anticipated by the December 2010.

2. **Establish a two-tier employee pension system.** The Town has maintained the 2% @ 55 CalPERS pension benefit based on an employee's final three years of compensation. It is important to note that the Town's pension benefits have been the most conservative in the County. Nonetheless, neighboring public agencies have recently instituted a second tier of pension benefits for new hires by moving to the 2% at 60 CalPERS pension benefit. A move

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to the lower pension benefit is estimated to save approximately 1.75% of eligible payroll. Eligible payroll will only include payroll for those employees hired after the effective date. Management will recommend a second tier of pension benefits for new hires and implementation is anticipated by June 2011.

3. **Create a $700,000 Pension Contingency Reserve.** The Town's history of fiscally responsible personnel policies can be enhanced by establishing a pension contingency reserve fund to protect against unanticipated spikes in pension costs. The Town fully funded its direct unfunded pension liability (CalPERS Side Fund) as of June 30, 2010. CalPERS' investment return for the twelve months ended June 30, 2009, however, has taken a large toll on the assets available to offset liabilities. The Town's share of the unfunded liabilities cannot be reasonably estimated at this time. As such, management will recommend a pension contingency reserve policy that reserves $700,000, or roughly five times the Town's annual pension contribution in 2010-11. The reserve will be funded annually as part of the operating budget beginning in 2010-11 and funded over the next five to ten years.

The report identifies additional opportunities for the Town to reduce employee costs. The Town's current compensation practices as outlined in response to Recommendation #1, however, does not appear to threaten the Town's fiscal strength. Changes beyond those already recommended are premature and could put the Town at a competitive disadvantage for employee recruitment and retention. Management therefore recommends that these options be held in reserve until either A) other agencies in the region transition to more sustainable compensation practices or B) the Town experiences a structural change in its revenue stream which results in a structural operating deficit. If the need arises to reduce employee costs in order to close an operating budget deficit, the following may be viable options:

- **Reduce the Town's cafeteria plan contribution**. The Town currently provides a generous cafeteria plan contribution that allows employees to purchase medical insurance with no out-of-pocket premium cost. If the Town's cafeteria plan contribution were reduced to 90% of the average medical premium, the Town would save approximately $28,000 annually from both active employees and eligible retirees receiving the retiree medical reimbursement benefit.
- **Share pension costs with employees.** The Town currently pays the employee's share of the pension benefit which is 7% of eligible payroll. For each 1% picked up by the employee, the Town would realize an annual savings of approximately $17,000.

On behalf of the Town, I thank the Santa Clara Civil Grand Jury for providing a comprehensive review of public employee compensation costs. The report confirms that many of the Town's current practices are indeed best practices for sustainable employee costs. I remain committed to recommending fiscally responsible policies and practices that maintain the Town's balanced budget and maintain the Town's competitiveness in the labor market.

Respectfully submitted,

Carl Cahill

Carl Cahill
City Manager

Date: August 26, 2010
To: The Honorable Jamie Jacobs-May, Presiding Judge
From: Carl Cahill, Town of Los Altos Hills City Manager
Re: Requested response to the 2009-2010 Santa Clara County Civil Grand Jury Final Report: **Cities Must Rein In Unsustainable Employee Costs**

Finding # 1 – *The costs of total compensation for employees have grown substantially in the past decade and now threaten the cities' fiscal stability.*

Response: Agree.

Recommendation # 1 – *All of the cities in the County need to implement measures that will control employee costs. As a starting point, each city should determine the percentage of savings required from the total compensation package to reach budget stability, and provide choices of wages and benefits in collective bargaining sessions for the unions to achieve that percentage goal.*

Response: Implemented. The Town's fiscally responsible policies regarding personnel costs have positioned the Town well during this economically challenging time. In particular, attention has been paid to the following components of employee compensation:

i. Salaries – The Town has exercised prudence with employee salaries. According to the 2009 Bay Area News Group's survey of public employee salaries, over 75% of public agencies in the Bay Area provide higher salaries to employees in comparable job classifications. Beginning in 2008, the Town suspended Cost of Living Adjustments in recognition of uncertain economic conditions. Also in 2008, the Town eliminated automatic departmental budget adjustments for merit (also called step) increases. Merit increases are controlled by the City Manager utilizing a merit increase contingency fund. All other salary increases are governed by the following two policies:

1. When an across-the-board salary increase is made, the change is a Cost-Of-Living-Adjustments (COLA) which is tied to the US Bureau of Labor Statistics Consumer Price Index Urban Wage Earners and Clerical Workers for the San Francisco-Oakland-San Jose region.

2. Where deemed appropriate by either the City Council or City Manager, a comparable agency salary survey may be conducted for a specific job classification to ensure that the Town's salary is competitive with the City of Los Altos and the Towns of Atherton and Woodside. Since 2008, salary surveys have been conducted for three classifications – City Manager, City Clerk, and Maintenance Superintendent.

ii. Pension – The Town has also exercised prudence with pension benefits. In the past decade, while many agencies provided their employees with more generous retirement benefits, the Town maintained the "2% at 55" CalPERS pension formula. Further, the Town maintained the provision that calculates pension benefits based on the average of the employee's final three years' compensation; whereas the regional standard appears to be calculated on the single highest year's compensation. In June 2010, the Town funded its direct unfunded pension liability (referred to as the CalPERS Side Fund). Additionally, management will recommend creating a second tier of retirement benefits for new hires by Jun 2011. Further, management will recommend the creation of Pension Contingency Reserve equal to five times the annual pension cost or $700,000 to protect against unforeseen changes in pension costs. The Town's fiscal condition is strengthened by past restraint on pension benefit enhancements and proactive policies to address unfunded pension liabilities.

iii. Retiree Medical – The Town has exercised prudence and proactive financial planning for unfunded retiree medical liabilities. In 2007, the Town implemented GASB Statement No. 45 regarding retiree medical liabilities ahead of schedule. In accordance with GASB standards, the Town is fully funding its annual required contribution for retiree medical liabilities. The Town also created a two tier retiree medical program for new hires effective October 2007. Under the old program, an eligible retiree is entitled to a retiree medical reimbursement benefit that is tied to the cafeteria plan contribution for active employees and is valued up to $17,000 in 2010. Employees hired by the Town after October 2007 are entitled to a retiree medical benefit valued at $1,300 in 2010. The Town's fiscal condition is strengthened by proactive measures to fund retiree medical liabilities and create a two-tier retiree medical benefit.

iv. Headcount – The Town has not grown its workforce over the past decade despite substantially expanding services offered to the Town's residents. To accomplish this, the Town has identified opportunities to enter into contractual arrangements with private industry and other public agencies for specialized services and to augment internal staff capacity. Additionally, the Town has executed a number of personnel reorganizations to align the Town's budgetary resources with the changing needs of the community.

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Finding # 2 – *Salary and wage increases do not reflect changes in economic conditions; e.g. even with minimal inflation, yearly COLAs are granted with little bearing on the actual increase in cost of living or market conditions.*

Response: Agree.

Recommendation # 2 – *Cities should not increase salaries and wages that are not supported by planned revenue increases. Cities should tie COLA increases to clear indicators and retain the ability to adjust or withhold based on current economic data.*

Response: Implemented. The Town's salary adjustment practices, as detailed in the response to Recommendation #1, effectively implement this recommendation.

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Finding # 3 – *Step increases are arbitrary and do not adequately represent an employee's added value to a city. Combined with COLAs, new employees' wages increase quickly and are not necessarily reflective of improved knowledge and skills.*

Response: Disagree. The Town awards step increases exclusively on the basis of an employee's added value to the organization. When cost of living adjustments are made to the Town's salary schedule (no changes since 2008), the purpose of the adjustment is to ensure that the Town's salary schedule remains competitive to attract and retain qualified employees.

Recommendation # 3 – *Cities should negotiate step progressions from the current three and a half years to seven years. Employees should not receive COLA increases while in step progression.*

Response: Not yet implemented. Management will propose modifying the Town's current salary schedule which has a 5% differential between steps to a 2.5% differential between steps. Implementation is anticipated by December 2010, however this is contingent upon City Council approval.

Finding # 4 - *Medical insurance costs for active employees are growing year after year at rates that exceed most cities' revenue growth, while the employee contribution to medical care is minimal.*

Response: Agree.

Recommendation # 4 - *To contain medical costs, cities should consider the following:*

Recommendation # 4.a. - *Split monthly premiums between the city and the employee and increase the employee's share, if already cost splitting, and remove any employee caps.*

Response: Not yet implemented. Management considers enacting some form of medical premium cost sharing a viable option to cut employee costs. At this time, however, the Town's finances are stable and curtailing employee compensation is not recommended. In the event that revenues structurally change and result in a structural operating deficit, this option may be enacted to eliminate the deficit.

Recommendation # 4.b. - *Establish reasonable co-pays for doctors' visits, prescription drugs, and in-patient and out-patient hospital care.*

Response: Implemented. The Town purchases group medical insurance from CalPERS. Over the past several years, CalPERS has initiated a number of cost saving measure related co-pays to help control costs.

Recommendation # 4.c. -*Prohibit an employee from being covered by both city-provided medical benefits and as a dependent of another city employee.*

Response: Implemented. In accordance with California Public Employees' Retirement Law Section 22843, for the purposes of CalPERS medical coverage: "No person may be enrolled as an employee or annuitant and as a family member." The Town interprets this statute to comply with the recommendation.

Recommendation # 4.d. - *Reduce cash-in-lieu payments.*

Response: No Implementation Anticipated. The Town's cash-in-lieu payments result in annual savings of up to $10,812.00 (net of cash-in-lieu payments) per participating employee otherwise eligible for family medical coverage by the Town in 2010. Reductions to the cash-in-lieu amount could have unintended financial consequences by encouraging employee enrollment in the medical benefit.

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Finding # 5 – *Pension formula changes instituted in the past decade, stock market losses, the aging 'baby boomer' work force, and the growing unfunded pension and OPEB liability all contribute to making retiree pension and health care costs the most problematic and unsustainable expenses the cities are facing. The city contribution to pension plans and OPEBs far exceeds the employee contribution.*

Response: Agree.

Recommendation # 5.a. *Cities should:*

Recommendation #5.a.(1) – *Renegotiate and make provisions for increasing the employees' contribution for current pension plans.*

Response: No Implementation Anticipated. Pension costs have two components. First the employer's required contribution fluctuates annually and is based on CalPERS actuarial valuation reports. The second component is the employee's required contribution which is fixed at 7% for the pension benefit provided to Town employees. The Town currently pays both components, however, neither the employee nor employer pay into Social Security. CalPERS regulates the percentage of the employer's required contribution that can be shifted to employees. In 2010-11, the Town's required contribution to CalPERS is 8.475% of eligible payroll.

Recommendation # 5.a.(2) – *Renegotiate to stop paying the employees' contribution amount to pension plans.*

Response: Not yet implemented. Management considers enacting some form of pension cost sharing as a viable option to cut employee costs. At this time, the Town's finances are stable and curtailing employee compensation is not recommended. In the event that revenues structurally change resulting in a structural operating deficit, this option may be enacted to eliminate the deficit. The Town would save approximately $17,000 for each 1% picked up by the employee.

Recommendation # 5.a.(3) – *Renegotiate to implement a contribution amount for employees to OPEB; this contribution should provide for a reasonable split of costs between a city and the employee for retiree medical and dental benefits.*

Response: No Implementation Anticipated. The Town has effectively controlled retiree medical costs for new hires. Any changes to the Town's cafeteria plan for active employees will result in retiree medical reimbursement savings.

Recommendation # 5.b. *Cities should thoroughly investigate reverting to prior pension formulas that were less costly*

Response: Implemented. Rather than increasing benefits to one of the more generous pension formulas made available to local agencies in the past decade, the Town has maintained the "2% @ 55" CalPERS pension formula.

Recommendation # 5.c. *To provide a meaningful, long-term solution, the cities should negotiate agreements to:*

Recommendation # 5.c.(1) – *Institute a two-tier system for pension and retiree health care for new hires.*

Response: Partially Implemented. The Town instituted a two-tier retiree health care benefit for new hires effective October 2007. The new tier provides a maximum benefit of $105 per month in 2010 for retiree medical. Town management will recommend providing new hires the "2% @ 60" pension benefit. Implementation of the second tier is anticipated by June 30, 2011.

Recommendation #5.c.(2) – *Increase the retirement age from 50 or 55 to 60 or 65.*

Response: No Implementation Anticipated. Aside from the recommended changes outlined in the Town's response to Recommendation 5.c.(1), the Town does not have the authority to control retirement age. California Public Employees' Retirement Law Section 21060 (a) states: "A member shall be retired for service upon his or her written application to the board if he or she has attained age 50 and is credited with five years of state service." Similar to Social Security, early retirement results in a lower pension benefit.

Recommendation # 5.c.(3) – *Calculate pensions on the last three to five years of salary.*

Response: Implemented. The Town's contract with CalPERS currently calculates pension based on the last three years of salary. There is no option known to management that uses the average compensation of the final five years for the purpose of calculating CalPERS pension benefits.

Recommendation # 5.c.(4) – *Replace current post-employment health care plans with health savings plans.*

Response: No Implementation Anticipated. The Town's modification of the post employment health care plan (also referred to as "retiree medical") in October 2007 controls retiree medical to the greatest extent possible.

Finding # 6 – *Public Sector employees are granted a generous number of holidays, personal days, vacation days and sick leave annually. Rules and limits on accrual vary by city and union, but vacation days and sick leave can be accumulated and converted to cash or calculated into pension benefit within those limits.*

Response: Agree.

Recommendation # 6.a. – *Cities should negotiate with the bargaining units to 1) reduce vacation time; 2) reduce the number of holidays and/or personal days. 3) cap sick leave and eliminate the practice of converting accumulated sick leave to cash or adding into their years of service for inclusion in their retirement benefit.*

Response: No Implementation Anticipated. 1) The Town's vacation accrual rates have remained unchanged for over a decade and there is no indication that the Town's fiscal condition would improve by modifying this benefit. 2) The Town provides up to 12 administrative leave days (referred to as personal leave in the report) to 6 employees, 5 of which are senior management. There is no indication that the Town's fiscal condition would benefit by modifying leave accruals or reducing the number of holidays. 3) The Town does not assign a cash value to sick leave and it cannot be cashed out under any circumstances. As per State mandate, Government Code Section 20840(e), the Town is obligated to allow accumulated sick leave to add to an employee's years of service for inclusion in their retirement benefit. This requirement only applies to employees who retire directly from the Town and does not apply to employees who leave the Town and work for another CalPERS agency prior to retirement.

Recommendation # 6.b. –*Cities should negotiate to substitute paid days off for unpaid days instead of imposing furloughs. For example, reduce paid holidays to major holidays only, consistent with private industry; and convert minor holidays to unpaid. Therefore, the public is not impacted by fewer services caused by furloughs, and the city saves the employee cost.*

Response – No Implementation Anticipated. The Town's current fiscal condition does not require the imposition of furloughs. In the event furloughs are necessary, this recommendation will be considered as an option to minimize service impacts to Town residents.

Finding # 7 – *Cities traditionally determine their compensation packages by surveying the wages and benefits of other public sector employees in the same geographic area. There is major resistance to comparing themselves or mirroring trends with the private sector. This has allowed wages and benefits to become artificially high and out of sync with market trends.*

Response: Agree.

Recommendation # 7.a. – *Cities should research competitive hiring practices and alter the approach to determine fair wages and benefits for each city by using public and private sector data.*

Response: Implemented. The Town maintains an open and competitive hiring process to ensure highly skilled candidates are available for consideration. The Town's salary adjustment policies were outlined in response to Recommendation #1.

Recommendation # 7.b. – *Cities should renegotiate salaries and wages using valid market comparisons and not only the current wage index. Cities should utilize more market-oriented compensation practices so that salaries can adjust as competition for labor changes. Cities should reduce entry-level compensation for positions for which there are many qualified applicants.*

Response: Not Yet Implemented. Where data is available to adjust compensation for entry-level positions, the Town will evaluate adjustments to the salary schedule for that subject position as recruitments occur. This approach will be implemented in 2010-11.

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Finding # 8 – *All cities perform certain core function to run smoothly and provide services to their residents. To reduce employee costs and streamline operations, the cities are in various stages of contracting services to private industry or partnering with other cities, special districts, or the County to deliver services.*

Response: Agree

Recommendation # 8.a. – *Cities should explore outsourcing some functions and services to private industry. Cities should discuss the prospect with cities that are successfully doing this to determine best practices and areas for success. Cities should develop contracts with measureable objectives, performance goals, and timelines.*

Response: Implemented. The Town currently contracts with private industry (in whole and in part) for legal services, accounting and payroll services, building inspection and plan check services, professional engineering and planning services, custodial and landscaping services, and sewer line maintenance. Partnering with private industry has the benefit of scalable capacity and reduced exposure to certain long-term liabilities. It is important to note, however, that prevailing wage laws, profit margins, and the oversight necessary to hold private industry accountable can quickly offset cost savings.

Recommendation # 8.b. – *Cities should create partnerships with other cities, special districts and/or the County for services, such as payroll, human resources, animal control, police, and fire.*

Response: Implemented. The Town currently contracts with the County of Santa Clara for law enforcement services. Additionally, the Town contracts with the City of Redwood City for information technology support services, and the City of Palo Alto for animal control services and sewer treatment services.

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Finding # 9 - *Cities can gain operational efficiencies and effectiveness with lower employee costs by making sure they are staffed with the correct numbers of people in the appropriate job classification in all departments and work groups.*

Response: Agree.

Recommendation # 9 - *Cities should analyze the function performed by all job classifications and make adjustments in the work force. Consolidate functions within the same group or a similar group. Reassign appropriate work to lower paid job classifications. Eliminate unnecessary functions.*

Response: Implemented. The Town reviews operations annually to ensure existing staff meet the needs of an ever changing organization. Since 2007, this policy has resulted in the reorganization of nearly 20% of the Town's personnel.

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Finding #10 - *The City of San Jose Auditor identified 88 positions currently being performed by public safety employees that can be performed by civilian employees at lower costs. The safety employees could be moved to positions that require their expertise and training. The auditor estimated this could be accomplished in less than 90 days and save approximately $5 million annually.*

Response: Not applicable to the Town of Los Altos Hills.

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Finding #11 – *In many cities, the contract negotiation process is completed by placing the negotiated collective bargaining agreements on the consent calendar for approval, which is acted on quickly at the start of council meetings by a single motion and vote of the council.*

> **Response: Not applicable to the Town of Los Altos Hills.** The Town does not maintain collective bargaining agreements.

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Finding #12 – *Current contracts were negotiated in good faith by representatives of the cities and the bargaining units; they were approved by the city councils. Promises made to employees were made by elected officials, past and present. Responsibility for formulating and approving solutions to restore the cities' financial stability resides squarely with our elected officials. The economic downturn has placed additional pressure on the situation.*

> **Response: Not applicable to the Town of Los Altos Hills.** The Town does not maintain collective bargaining agreements and therefore does not have contractual obligations that automatically increase employee costs.

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Finding #13 – *Binding arbitration is not open to the public and results in an adversarial process between the city and employee groups. Binding arbitration limits the ability of city leaders to craft solutions that work for the city's budget. The process has resulted in wage and benefit decisions that have been greater than the growth in basic revenue sources.*

Response: Not applicable to the Town of Los Altos Hills.