

AGENDA
ASSEMBLY BUDGET SUBCOMMITTEE NO. 4
ON STATE ADMINISTRATION

Assemblymember Rudy Bermudez, Chair

TUESDAY, APRIL 18, 2006, 1:30 PM
STATE CAPITOL, ROOM 447

CONSENT CALENDAR		
ITEM	DESCRIPTION	
0150	CONTRIBUTIONS TO LEGISLATORS' RETIREMENT FUND	
0390	JUDGES' RETIREMENT SYSTEM CONTRIBUTIONS	
0840	STATE CONTROLLER	
ISSUE 5	CONSENT BUDGET CHANGE PROPOSALS	10
0890	SECRETARY OF STATE	
ISSUE 5	FORENSIC LEAK ASSESSMENT	15
ISSUE 6	RECORDS PROCESSING BACKLOG	15
1880	STATE PERSONNEL BOARD	
ISSUE 3	STATE EMPLOYEE MEDIATION PROGRAM	17
ISSUE 4	ONLINE STAFFING	17
ISSUE 5	ADMINISTRATIVE SERVICES DIVISION	17
8320	PUBLIC EMPLOYMENT RELATIONS BOARD	
8380	DEPARTMENT OF PERSONNEL ADMINISTRATION	
ISSUE 8	LEGAL REIMBURSEMENT AUTHORITY	30

ITEMS TO BE HEARD		
ITEM	DESCRIPTION	PAGE
0840	STATE CONTROLLER	
ISSUE 1	UNCLAIMED PROPERTY PROGRAM	4
ISSUE 2	AUTOMATED TRAVEL EXPENSE REIMBURSEMENT SYSTEM	6
ISSUE 3	OVERALL SYSTEMS MODERNIZATION PLAN NEEDED	7
ISSUE 4	OTHER POST-EMPLOYMENT BENEFITS REPORTING (GASB 45)	8

0890	SECRETARY OF STATE	
ISSUE 1	HELP AMERICA VOTE ACT	11
ISSUE 2	SPECIAL ELECTION COSTS	12
ISSUE 3	NOTARY PUBLIC SECTION OF THE BUSINESS PROGRAMS DIVISION	13
ISSUE 4	ONLINE DISCLOSURE	14
1880	STATE PERSONNEL BOARD	
ISSUE 1	JOINT WEBSITE WITH THE DEPARTMENT OF PERSONNEL ADMINISTRATION	16
ISSUE 2	STATE EXAMINATION AND CERTIFICATION REPLACEMENT PROJECT	16
1920	CALIFORNIA STATE TEACHERS RETIREMENT SYSTEM (STRS)	
ISSUE 1	UNFUNDED LIABILITIES	18
8260	CALIFORNIA ARTS COUNCIL	
ISSUE 1	LOCAL ASSISTANCE FUNDING	20
8380	DEPARTMENT OF PERSONNEL ADMINISTRATION	
ISSUE 1	EMPLOYEE CLASSIFICATION REFORM	21
ISSUE 2	LEGAL OFFICE STAFFING	23
ISSUE 3	ENROLLEE FUNDED VISION CARE PROGRAM (PER AB 2242)	24
ISSUE 4	WORKFORCE PLANNING POSITION	25
ISSUE 5	DEFERRED COMPENSATION FUND – SAVINGS PLUS PLAN	26
ISSUE 6	JOINT WEBSITE WITH THE STATE PERSONNEL BOARD	27
ISSUE 7	CA DEPARTMENT OF FORESTRY AND FIRE PROTECTION	28
9800	AUGMENTATION FOR EMPLOYEE COMPENSATION	
ISSUE 1	EMPLOYEE COMPENSATION – BARGAINING UNIT MOUS	31
ISSUE 2	FINANCE LETTER – DOF TRANSFER AUTHORITY	33
ISSUE 3	PLATA LAWSUIT	34
9650	HEALTH AND DENTAL BENEFITS FOR ANNUITANTS	
ISSUE 1	GASB 45	37
ISSUE 2	MEDICARE PART D PROVIDES ONLY LIMITED SAVINGS	41
1900	CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM (PERS)	
ISSUE 1	ASSET SMOOTHING	42
ISSUE 2	FINANCE LETTER - MEDICARE PART D POSITIONS	44
ISSUE 3	FINANCE LETTER - ASSISTING CONTRACTING AGENCIES TO COMPLY WITH GASB 45	45
ISSUE 4	DIVERSITY OF INVESTMENT	46
0860	STATE BOARD OF EQUALIZATION	47
1730	FRANCHISE TAX BOARD	
ISSUE 1	AUDITOR RECRUITMENT AND RETENTION	47

ITEMS TO BE HEARD

ITEM 0840 STATE CONTROLLER

The State Controller is the Chief Financial Officer of the State, elected by the people. The Controller's primary objectives are to: (1) provide sound fiscal control over both receipts and disbursements of public funds; (2) report periodically on the financial operations and conditions of both state and local governments; (3) make certain that money due to the State is collected through fair, equitable, and effective tax administration; (4) provide fiscal guidance to local governments; (5) administer the Unclaimed Property and Property Tax Postponement Programs; and (6) participate in tax policy and administration as an *ex-officio* member of the State Board of Equalization and the Franchise Tax Board.

As shown below, the Governor's budget proposes total expenditures of \$154.8 million (\$95.9 million General Fund) for the State Controller's Office (SCO) in 2006-07, an increase of \$27.8 million (21.9 percent) over the current year. Most of the increase is from the General Fund. Proposed staffing is 1,142 personnel-years (PYs), an increase of 28 PYs. These increases primarily reflect scheduled increases to develop the 21st Century Project (the state's new human resources and payroll data system).

State Controller's Office

Program	Actual 2004-05	Estimated 2005-06	Proposed 2006-07
Accounting and Reporting	\$11,974	\$15,355	\$13,751
Audits	22,284	24,229	24,065
Personnel/Payroll Services	25,925	32,116	58,963
Information Systems	13,992	14,516	15,087
Collections	15,527	16,056	16,573
Disbursements and Support	34,179	36,579	37,883
Distributed to Other Programs	-9,714	-10,061	-10,061
Loan Repayment Programs	-3,193	-1,842	-1,477
Total Expenditures (All Programs)	\$110,974	\$126,948	\$154,784

Issues to Be Discussed At Subsequent Hearings

21st Century Project. Adjustments to the continuing implementation of the 21st Century Project will be proposed in a Department of Finance (DOF) Letter shortly.

State Mandated Local Programs. The Controller processes and audits claims by local governments for reimbursement of state-mandated local costs. Budget issues (including proposed Budget Bill language) related to mandates will be taken up on April 25th along with the Commission on State Mandates.

ISSUE 1: UNCLAIMED PROPERTY PROGRAM

Property (such as bank accounts, stocks and safe deposit box contents) that is held in dormant accounts and go unclaimed must be transferred by financial institutions to the State Controller's Unclaimed Property (UCP) Program. The holders of the accounts or property must first attempt contact the owners of the dormant accounts at their last known address. If this is not successful, the holders must transfer the property to the UCP Program according to statutory procedures and deadlines. The UCP Program then forwards the names and Social Security numbers of the property owners to the Franchise Tax Board (FTB), and the FTB attempts to match these against its taxpayer files. If a match produces a more recent address for the property owner, then the UCP Program sends a notice to that address. Unclaimed property is sold, and the General Fund receives the proceeds. However, anyone who can establish ownership at a later time remains entitled to receive payment. The Governor's Budget estimates that the UCP Program will produce \$325 million of General Fund revenue in 2005-06.

January Budget Request

The Governor's Budget proposes \$554,000 from the General Fund for 7.2 PYs of staff to handle increased workload for the unclaimed property program, including attempting to notify owners of unclaimed property, auctioning contents of abandoned safe deposit boxes, and operational support. The new positions would handle existing ongoing workload that currently is handled by employees the SCO has redirected from other functions.

The January budget request has the following three components:

- 2.6 permanent positions for increased workload associated with the mailing of Franchise Tax Board (FTB) notices to owners of unclaimed property. The rate of FTB matches has doubled recently because the UCP Program has worked through a backlog of old accounts—"fresher" accounts are more likely to have matching taxpayer files.
- 2.1 permanent positions for workload associated with the auctions of safe deposit box contents.
- 2.5 permanent positions for operational support to the Unclaimed Property Program (UCP) management.

The SCO has explained that if the unclaimed property workload positions for FTB notices and auctions are not approved service delivery and unclaimed property auctions would be degraded. Unclaimed property auction revenues would decrease from \$1.6 million to \$1 million annually by 2007, based on reduced capacity to operate online auctions.

Recent Finance Letter Requests

In a letter dated March 30, DOF requested amendments to the budget to add the following additional General Fund augmentations to the UCP Program:

Unclaimed Property System Replacement--\$1.6 million and 5 positions. This request for \$1,573,000 and 5.0 one-year limited-term positions would replace the existing Unclaimed Property information system and supporting applications and spreadsheets with a commercial-

off-the-shelf system. The implementation period is 18 months. The project is expected to generate resource savings of \$261,000 and 1.6 PYs in 2007-08, which will increase to \$1,174,000 and 15.4 PYs in 2010-11 and thereafter. This project will require net funding of \$536,000 General Fund and 2.5 one-year limited-term positions in 2007-08, which reflects the anticipated savings of \$261,000 in 2007-08.

Unclaimed Property Program Auditors--\$1.4 million and 15 positions. This request is for \$1,441,000 and 15.0 two-year limited-term positions to increase audits of unclaimed property holders in California to ensure they are complying with Unclaimed Property law. The SCO estimates that the increase in audit staffing will result in \$7.5 million in additional unclaimed property receipts in 2006-07 and \$15.0 million in 2007-08 and annually thereafter.

Unclaimed Property Program Workload--\$620,000 and 7.5 positions. This request is for \$620,000 and 7.5 two-year limited-term positions to eliminate the backlog of notices related to security claims which is required to be sent to apparent owners of unclaimed property under Section 1531(d) of the Code of Civil Procedure. The SCO estimates that working down this backlog will increase payments to owners of unclaimed property \$8.2 million annually in 2006-07 and 2007-08. This will reduce General Fund revenues by an equal amount, but some of this revenue loss would occur over time in any case as owners are notified and make claims. After the backlog is eliminated, payments to owners should return to lower levels.

COMMENTS

1. **Limited-Term Positions.** Although LAO generally believes that these requests are justified and recommends approval, LAO does have concerns with the number of limited-term positions requested. In some cases, these positions are for workload that is anticipated to be ongoing at some level, and in other cases they are for working down temporary backlogs. LAO points out that recruitment and retention may be difficult, and that contracting might be a more effective alternative for the temporary workload.
2. **Auditor Recruitment and Retention.** Like the tax agencies, SCO reports that it has approximately a 10-percent vacancy rate for auditors, but indicates that current salary rates pose a challenge in recruiting and retaining audit staff. The SCO should identify steps that it is taking to address this problem.

ISSUE 2: AUTOMATED TRAVEL EXPENSE REIMBURSEMENT SYSTEM

The SCO is currently implementing, maintaining, and rolling out the California Automated Travel Expense Reimbursement System (CalATERS), a computer system that automates the previously manual process of reimbursing state employees for travel costs. The benefits of using CalATERS include allowing state employees to submit travel claims easily, improved accuracy through automation, and centralized audits of travel rules and departmental policies. The CalATERS program began in July 2000 and has now been implemented in dozens of departments, affecting more than half of state employees. Within the SCO (where all travel claims must eventually go), efficiencies have occurred, primarily in claims audits and processing workloads. CalATERS has allowed the SCO auditors to conduct more audits, rather than reduce audit staffing. The SCO has recognized the benefits of automated claims by devoting their best travel claims auditors to those claims flagged by the system.

According to the SCO, however, even though CalATERS has rolled out with over half of departments, approximately 80 percent of travel claims still are submitted by paper.

COMMENTS

1. How much potential is there for reducing paper filing below 80 percent? What does the SCO plan to do to increase use of CalATERS and reduce paper filing?
2. Is there any way to capture savings from CalATERS that occur due to reduced administrative costs or more effective control over and auditing of travel claims?

ISSUE 3: OVERALL SYSTEMS MODERNIZATION PLAN NEEDED

The SCO operates a large number of automated systems to provide services to the state (primarily through fiscal and human resource management systems), local governments (through fiscal and reporting systems), and citizens (through the unclaimed property system). Many of these systems are beyond their useful technical life, lack the functionality of modern systems, and are increasingly difficult to maintain and support. To address this problem, the SCO is pursuing a number of projects to replace and modernize its information systems--some, like the 21st Century Project, very large, and some much more modest. In carrying out this program of modernization, the SCO indicates that it is generally following recommendations outlined in a 2002 report by Gartner Consulting.

The Gartner report was developed during a severe state budget crisis. At that time the SCO's most ambitious upgrade, now the 21st Century Project, had just been cancelled due to excessive cost. Acknowledging these fiscal constraints, the Gartner Report provided a five to seven year plan for the SCO to use for modernizing the SCO's technology infrastructure. The central recommendation was that SCO should "incrementally modernize its existing systems and then exploit that modernization for direct business gain." The Gartner report did not, however, provide a priority listing for the replacement of specific systems. Furthermore, the SCO has departed somewhat from the strategy in the Gartner report by reinstating the 21st Century Project, which is much more than an incremental modernization.

An overall priority plan and roadmap for replacing the legacy systems would appear to be needed at this point. This type of plan would enable the SCO to inventory, prioritize, and identify systems that might appropriately be consolidated based on the interaction of the processes they support. To propose replacement without this underlying analysis may overlook the possibility of an enterprise-wide approach enabled by current technology.

Furthermore, the SCO should make its plan and timetables known to those served by its systems (primarily state agencies and local governments). This would help those parties to better coordinate their own information systems planning with that of the SCO.

COMMENTS

Staff understands that the Legislative Analyst's Office has requested a priority plan from the SCO for modernizing its information systems and that the SCO has recently provided its plan to LAO. The SCO and LAO should report to the subcommittee on the content of that plan and the implications of the plan for future budget needs.

ISSUE 4: OTHER POST-EMPLOYMENT BENEFITS REPORTING (GASB 45)

The Governor's Budget requests \$252,000 (special, non-governmental, and bond funds) and one position (two-year limited-term) for increased workload to remain Generally Accepted Accounting Principles (GAAP) adopted by the Governmental Accounting Standards Board (GASB). Specifically this augmentation will enable the SCO to compile an estimate of the state's liability for future post-employment benefits of current state workers and retirees, other than retirement benefits themselves. The primary state liability of this type is for Health and Dental Benefits for Annuitants (Item 9650 funds the current costs of this program). GASBE Statement 45 requires the states to estimate and disclose this liability beginning in 2006-07.

Finance Letter Request. A letter dated March 30th, requests an additional augmentation of \$87,000 (from bond funds and special funds) for one position due to other ongoing increased workload associated with the preparation of various financial reports required by GAAP.

Note: Please see Item 9650 in this agenda for further discussion of the GASBE 45 requirement and retiree health care costs.

COMMENTS

The LAO has recommended funding this proposal as an important step in better quantifying public employee pension costs that would enable the Legislature to better understand the magnitude of the state's unfunded liabilities.

The Controller's estimate of liability for retiree health benefits will require the use of the same types of actuarial methodologies and assumptions used by CalPERS to estimate retirement benefit liabilities (employee age distribution and year of anticipated retirement, for example). For consistency, these methodologies and assumptions generally should be the same, except where there is a specific reason to differ (more recent information, for example).

Because the state now funds only the current cost of retiree health benefits, GASB 45 requires the use of a short-term interest rate (such as the Pooled Money Investment Account—PMIA-earnings rate, or about 4% now) to "discount" future costs. If, on the other hand, the state were fully funding these liabilities (similar to retirement contributions), future costs could be discounted assuming at the earnings rate of a long-term investment fund (such as the CalPERS rate of return of about 8 percent). The present value of the state's liability using the higher investment discount rate will be substantially lower than the liability calculated using the lower short-term rate. Accordingly, it would be useful for the Legislature and the Administration to have a second estimate calculated using the long-term investment rate in order to evaluate the potential costs and benefits of moving toward pre-funding retiree health benefits, as recommended by the LAO.

Staff suggests adding the following Budget Bill Language in Item 0840-001-0001 to address the two comments above:

As part of its workplan for preparing the estimate of the state's liability for post-employment benefits prepared to comply with GASBE Statement 45, the Controller shall also prepare (a) an identification and explanation of any significant differences in actuarial assumptions or methodology from any relevant similar types of assumptions or

methodology used by CalPERS to estimate pension state obligations, and (b) an information calculation of the state's liability for post-employment benefits using an appropriate long-term investment rate of return.

ISSUE 5: CONSENT BUDGET CHANGE PROPOSALS

No issues have been raised regarding the following budget change proposals, which are proposed for consent:

- **Apportionments Payment System.** The Governor's budget proposes \$766,000 (special funds) for the third year of this project to replace the existing aging system that distributes apportionments of various revenues to local entities. Ongoing annual maintenance costs are projected at \$62,000.
- **Bank Reconciliation System Replacement.** The Governor's budget proposes \$710,000 (\$308,000 General Fund) to replace the SCO's existing system for issuing and tracking warrants for the state. The SCO indicates that the current system is obsolete and technicians trained to operate it are becoming increasingly scarce.

ITEM 0890 SECRETARY OF STATE

The Secretary of State (SOS), a constitutional office, is the chief election officer of the State and is responsible for the administration and enforcement of election laws and campaign disclosure requirements. The Office also has statutory responsibility for managing the filing of financial statements and corporate-related documents for the public record. In addition, the Office is responsible for the appointment of public notaries, enforcement of notary laws and preservation of documents and records having historical significance (official state archives). All documents filed are a matter of public record and historical importance. They are available through prescribed procedures for public review and certification as to authenticity.

The Governor's budget proposes total expenditures of \$77 million primarily funded through General Fund monies and the Secretary of State's Business Fees Fund which is primarily funded by fees collected for filing and/or receiving copies of documents on file with the Secretary of State.

ISSUE 1: HELP AMERICA VOTE ACT (HAVA)**COMMENTS**

The Department of Finance is currently reviewing a revised spending plan for HAVA and will be releasing it very soon. HAVA will be scheduled for a hearing once the revised spending plan has been reviewed.

ISSUE 2: SPECIAL ELECTION COSTS

The Governor's budget proposes to fully fund the Secretary of State and reimburse counties for the costs incurred administering the November 2005 Special Election (\$54 million). The Secretary of State is allocated \$9 million and the counties are proposed to receive \$45 million.

COMMENTS

Within the legislature, there are discussions currently taking place regarding the financing of the special election and needs for current elections. SB 306 (Ackerman) was introduced to allocate \$9 million to the Secretary of State in order to cover the cost to the Secretary of State for running the special election. These funds are needed now in order to facilitate the June primary election. This bill does not include funding for the counties. SB 306 was signed by Governor Schwarzenegger on April 10th.

New estimates suggest that \$45 million may be more reimbursement than the counties need.

ISSUE 3: NOTARY PUBLIC SECTION OF THE BUSINESS PROGRAMS DIVISION

The Governor's budget proposes \$3.1 million in Business Fees Fund and 28.5 positions to address the increasing workload in the Notary Public Section of the Business Programs Division. This includes moving 12 positions from limited-term to permanent and adds 7 new 2-year limited positions. The Public Notary Section is responsible for all issues relating to public notaries, certifications, notary seals, enforcing laws related to the Child Support Enforcement Program, and investigating violations of notary law.

COMMENTS

The Governor's budget assumes continued large growth in the number of applicants and individuals tested to become Notaries Public. Additionally, there is an assumed increase in collection of Business Fees Fund based on the increase in applicants. There is some question as to the continued growth in applicants following the decrease in activity in the real estate market.

The committee may wish to observe continued growth in applications, and associated growth in Business Fees Fund revenue which could allow the committee to review the need for additional funding at that time.

ISSUE 4: ONLINE DISCLOSURE

The Online Disclosure Act of 1997 (SB 49, Chapter 866, Statutes of 1997) required that certain campaign and lobbying reports be filed online with the Secretary of State starting in January of 2000. Online Disclosure filing would not be required if the committee or lobbyist had raised/spent less than \$100,000. This amount was lowered to \$50,000 starting July 1, 2000.

While some versions of the bill included a requirement that software for compliance with the new requirements be available for \$99 or less, the final version left the cost up to the free market. Shortly after the 2000 elections, the cost of these systems started to become an issue, raising calls for a free filing system. In 2001, AB 696 (Chapter 917) passed and required the Secretary of State to provide a method for filers to submit their required filings free of charge by Dec. 31, 2002.

The Secretary of State initially estimated a cost of \$1.2 million to develop two types of free filing systems, plus ongoing costs, but the legislature decided to simply go with one system. AB 696 in 2001 appropriated the Secretary of State \$600,000 to complete that system by Dec. 31, 2002.

Currently, only some forms are available online.

The Secretary of State's Task Force on Online Disclosure has met seven times during the last year to discuss progress on this issue. However, the Task Force has not yet been able to agree upon final report language, and not Final Report has been issued.

COMMENTS

Over 3 years after the initial deadline, the online disclosure system is still not completed. Without a complete online disclosure system, it is impossible for the legislature to improve and expand upon and develop the online disclosure system. There have been discussions in the legislature regarding changes to who is required to file and how often, but it is difficult to adopt such changes without a system for lobbyists and committees to utilize and comply with such changes.

ISSUE 5: FORENSIC LEAK ASSESSMENT – CONSENT ITEM

The Governor's budget proposes one time funding of \$625,000 from the Business Fees Fund (BFF) to conduct a forensic leak assessment and replace the security monitoring system at the Secretary of State and State archives Building Complex. A forensic leak assessment includes a building inspection to determine location of any existing leaks. The Secretary of State claims these undertakings are needed to protect the health and safety of employees, the public, state property, and state-owned historical documents and artifacts from mold, mildew, damage, theft and unauthorized access.

ISSUE 6: RECORDS PROCESSING BACKLOG – CONSENT ITEM

The Secretary of State's budget includes \$295,000 (General Fund) for one Archivist II position, and an interagency agreement with CSUS Hornet Foundation to utilize at least 12 specialized Graduate Students, to address the backlog of archival records, and to establish a continuing processing program to prevent future backlogs.

ITEM 1880 STATE PERSONNEL BOARD

The State Personnel Board (SPB) is responsible for the oversight of the state's civil service system. SPB ensures that the civil service system is free from political patronage and the employment decisions are based on merit. The Board provides services to state departments in the areas of recruitment, selection, and classification.

The Board consists of five members that are appointed for a ten-year period.

The Governor's budget proposes total expenditures of \$19 million funded primarily through reimbursements from other departments.

ISSUE 1: JOINT WEBSITE WITH THE DEPARTMENT OF PERSONNEL ADMINISTRATION

See Department of Personnel Administration (Item 8380 Issue 6).

ISSUE 2: STATE EXAMINATION AND CERTIFICATION REPLACEMENT PROJECT

In a finance letter dated March, 30 2006, the State Personnel Board (SPB) requested 2 positions (1 permanent and 1 limited term) and \$2,482,300 from the General Fund in order to replace the State's Exam and Certification system.

The SPB currently provides an automated examination system to subscribing departments and issues certification lists of individual's eligible to be hired into specific classifications with in State departments. The examination process determines which applicants are qualified for specific classifications. The certification process refines the eligible list based on job specific categories.

The Current Examination and Certification system was built over 30 years ago and has been updated sporadically to comply with legal requirements.

The SPB contends that this new system will provide easy access, rapid turnaround, make examinations more automated, and perform pre-screening of applicants so the neither their time, nor state staff time, are wasted on applicants that cannot meet the minimum qualifications.

COMMENTS

The LAO advises that this project is separate from DPA's budget requests for consultants to study changes to the state classification system. SPB also point out that the current Examination and Certification system is not capable of implementing large scale changes in data and functionality in an automated fashion, resulting in significant staff time to do so manually. They claim that these changes are necessary to implement any future changes to the rest of the civil service system. SPB points out that these changes, however, are necessary whether or not such additional changes are made to other parts of the system.

ISSUE 3: STATE EMPLOYEE MEDIATION PROGRAM – CONSENT ITEM

Adds one position and \$102,000 (reimbursement) to accommodate a significant increase in mediation referrals and allow redirection of administrative functions.

ISSUE 4: ON-LINE STAFFING – CONSENT ITEM

Request for two positions and \$191,000 (reimbursement) to provide the assistance needed with the on-line system. SPB states that many State Departments, Agencies, Boards, and Commissions utilize this on-line system and depend upon SPB to provide technical assistance for that use.

ISSUE 5: ADMINISTRATIVE SERVICES DIVISION – CONSENT ITEM

Request for one position and \$102,000 (reimbursement) for the Administrative Service Division. The Administrative Service Division has had a reduction in staff in recent years, with no reduction in workload.

ITEM 1920 CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM (STRS)

The State Teachers' Retirement System (STRS) provides retirement related benefits and services to 735,000 active and retired educators in public schools from kindergarten through the community college level. The system provides three types of benefits: 1) service retirement benefits determined on the basis of member's age, years of service, and final compensation 2) survivor benefits and 3) disability benefits.

The STRS board has twelve members; four ex-officio members including the Superintendent of Public Instruction, State Treasurer, State Controller, and the Director of Finance; three public members; one retiree of STRS; one member that is either a school board member or community college trustee; and three representatives elected by STRS members.

The main objectives of STRS include: the maintenance of a financially sound retirement system, the maintenance of efficient administrative operations, continuous improvement of the delivery of benefits products and services to STRS members, and the development and improvement of the benefits and products to STRS members.

The State contribution is proposed at \$1 billion in the Governor's budget. The total expenditure is budgeted at \$7.8 billion coming primarily from the Teachers' Retirement Fund.

ISSUE 1: UNFUNDED LIABILITIES

STRS currently estimates it has an unfunded liability of \$20.3 billion, representing a funding ratio of 86 percent as of June 30, 2005. For comparison, CalPERS on June 30, 2004 (2005 data will be available May, 2006) was 87.3 percent funded, and the average US pension fund was 83 percent funded.

The board conducted a survey of options for addressing this unfunded liability. Based on the responses of the board members and member organizations, staff developed four strategic packages to address the unfunded actuarial obligation. Most of the strategy components will need to be enacted by legislation.

Staff identified four separate strategies to address the unfunded actuarial obligation. Generally, these strategies can be described as:

- Including all of the funding options for which 60 percent of the responding Board members either recommended or strongly recommended adoption of the option.
- Including all funding options which affect benefits, except the 2 percent annual adjustment made to monthly benefits.
- Reducing the unfunded actuarial obligation by increasing contribution rates for members, employers and the State without reducing benefits.
- Spreading the burden on all stakeholders.
- Staff will be evaluating the impact of each scenario on contribution rates and members and report its findings to the Board at their June Board meeting.

COMMENTS

Varying methods will have different cost implications to the state General Fund. Most solutions will require legislative review and action. These funding options will likely be studied by all parties (administration, legislators, LAO, etc.) many of whom may offer counter proposals. As such, it may take some time before these options are flushed out and ready for legislative review.

ITEM 8260 CALIFORNIA ARTS COUNCIL

The California Arts Council was established in January 1976 to encourage artistic awareness, participation, and expression; to help independent local groups develop their own arts programs; to promote the employment of artists and those skilled in crafts in both the public and private sector; to provide for the exhibition of art works in public buildings throughout California; and to enlist the aid of all state agencies in the task of ensuring the fullest expression of our artistic potential.

The Council recognizes that the arts are essential for the cultural, educational, social and economic development of California. The Council seeks to further its mandates and services to the public through the development of partnerships with the public and private sectors and by providing support to the state's non-profit arts and cultural community, which are broad-based and extended across the state from its largest metropolitan areas to its most rural areas.

The Governor's budget proposes total expenditures of \$5.1 million (\$1.1 million General Fund), an increase of \$1.8 million over the 2005-2006 budget. Funding comes primarily from the Graphic Design License Plate Fund, General Fund, and Federal Trust Fund.

ISSUE 1: LOCAL ASSISTANCE FUNDING

The Governor's budget proposes to use an additional \$1.8 million in funds from the Graphic Design License Plate Account for local assistance programs administered and funded by the California Arts Council. Local assistance grants were eliminated after 2002-2003. The additional funding is available to reinstate those grants because SB 1213 (Chapter 393, Statutes of 2004) increased the cost of the Art License Plate, funding the Graphic Design License Plate Account.

COMMENTS

In 2000-2001, the Arts Council was funded at more than \$20 million for programs and local grants. Their funding has been decreased ever since.

ITEM 8380 DEPARTMENT OF PERSONNEL ADMINISTRATION

The Department of Personnel Administration is the Governor's chief personnel policy advisor. The Department represents the Governor as the "employer" in all matters concerning State employer-employee relations. The Department handles issues related to salaries, benefits, positions classification, and training. Many of these duties are also shared with the State Personnel Board. For rank and file employees, these matters are determined through the collective bargaining process and for excluded employees, through a meet and confer process. The Department also administers the state employee deferred compensation programs.

The Governor's budget proposes total expenditures of \$91 million, with funding primarily from the General Fund (\$34 million) and the Flexelect Benefit Fund (\$27 million).

ISSUE 1: EMPLOYEE CLASSIFICATION REFORM

The Governor's budget proposes an additional \$1 million in General Funds for the purpose of beginning to reform the state employee classifications and determine appropriate testing instruments for the revised state classification structure. This process will be a joint effort between the State Personnel Board and the Department of Personnel Administration.

The funds will be used to hire consultants, assess the current systems, provide recommendations for maintenance or change, and develop a comprehensive strategy and business plan for implementation of reform.

BACKGROUND

The State Classification system has changed limitedly since the creation of the California civil service system. The California Performance Review (CPR) SO47 stated that "The State's classification plan contains too many classifications, is inflexible, and is too cumbersome for today's HR needs." The Little Hoover Commission stated "The State examination and selection process should be adaptable to the needs of individual departments and specific positions, while more effectively allowing for merit-based decisions."

LAO

The large number of classifications, many of which apply to a small number of employees, do limit managerial flexibility and can lead to disputes between employees and departments according to the LAO. There are also other factors affecting the efficiency and effectiveness of our state hiring practices such as overlapping authority of DPA and State Personnel Board.

Rather than conduct a piecemeal study of specific components of the system, the LAO recommends the administration provide a comprehensive proposal for reforms to all state classifications, as well as the rest of the state civil service system.

COMMENTS

With over 4,500 separate job classifications, many groups have called for some sort of reforms to the classification system. However, other key factors must be done in coordination with this reclassification process, such as changing the civil service testing system. If we complete a reclassification effort and reduce the number of classifications we have, that will only make things worse under our current system of testing applicants. Our current testing system doesn't allow you to look at specific skill sets an employer may be looking for, so with fewer classifications, it would be come even more difficult for an employer to pick qualified applicants from the pool. Both the State Personnel Board and DPA recognize these concerns.

The State Personnel Board has requested funding to replace the existing State Examination and Certification system. Prior to the completion of those changes, it may be premature to make changes in the classification system without an examination and certification system that can handle those changes.

A proposal for the complete reform of the civil service system, including a description of the proposed new system, time it will take to complete (including phases if necessary), and the cost and resources necessary to complete each phase, may be beneficial to the committee.

ISSUE 2: LEGAL OFFICE STAFFING

The Governor's budget proposes an additional 6 positions and \$852,000 in reimbursement authority to meet the current workload demands of the Department of Personnel Administration's legal office. Demand is increased due to a rise in litigation relating to collective bargaining issues and legal actions regarding state employees.

Since 2000-2001, the Legal Division has dropped from 51 permanent staff positions to 39 while litigation workload has increased by 66% over the same time period. DPA is also dealing with several federal lawsuits against the Department of Corrections and Rehabilitation (CDCR), most notably *Coleman v. Schwarzenegger*, *Plata v. Schwarzenegger*, and *Madrid v. Woodford*. These cases demand much time from the Legal Division's staff.

COMMENTS

It should also be noted that should DPA be unable to meet the necessary demands of state agencies and departments, some outsourcing may be necessary to accommodate the workload. This will most likely result in overall increased costs to the state.

ISSUE 3: ENROLLEE FUNDED VISION CARE PROGRAM (PER AB 2242)

The Governor's budget proposes one new position and \$82,000 in reimbursement authority for the purpose of creating an enrollee funded vision care program for state retirees. Currently, retirees are eligible for both health care and dental care funded by the state. This vision plan would be a stand-alone pool, separate from the active employees' plan. There would be no cost to the state to administer this program.

COMMENTS

According to DPA, since 1988 there have been numerous legislative bills attempting to provide a vision benefit to State annuitants. In 1990, PERS was authorized to establish a vision benefit for State annuitants, but no funding was approved.

ISSUE 4: WORKFORCE PLANNING POSITION

DPA requests an augmentation of \$140,000 ongoing funds for 1.0 exempt positions to act as the "State Workforce Planning Administrator" to coordinate and manage the provision of workforce and succession planning consultation and training service for State departments. This position will help departments prepare for the large number of retiring state employees and how to prepare for their departure.

The California Performance Review and the Little Hoover Commission have both cited the potential upcoming challenges the state will face due to record numbers of retiring state employees.

The position proposed will identify existing resources to provide to departments with guidance and training. Individual departments will be responsible for undertaking the actual efforts needed.

LAO

Recommends rejecting this proposal and suggests that "hiring a single individual to provide consulting and assistance services to departments would be an ineffective response to this issue." They recommend a more comprehensive approach to deal with the issue.

COMMENTS

This position seems to be focused on coordinating existing resources and responding to the media regarding state workforce planning efforts. The actual development of plans and implementation will still fall on the individual department level using existing resources.

ISSUE 5: DEFERRED COMPENSATION FUND - SAVINGS PLUS PROGRAM

DPA requests an augmentation for spending authority of the Deferred Compensation Fund of \$1.7 million in 2006/2007. They propose this amount to grow to \$3.2 million on 2010/2011 to fund the third-party administrator costs for providing recordkeeping and trustee services to the State's 457 and 401(k) Defined Contribution Plans and the Part-time Seasonal and Temporary (PST) Retirement Program.

DPA entered into a 5 year contract for these services in January of 2006. This new contract includes an increase in services including education and outreach, a dedicated processing team, and specialized investment fund administration. This increase in services corresponds with an increase in the cost per participant to the program. Cost to the participating individuals will remain the same.

This increase does not have an affect on the General Fund as funding comes from reimbursements received from the program's investment providers and monthly administrative fees assessed against the participant's accounts.

ISSUE 6: JOINT WEBSITE WITH THE STATE PERSONNEL BOARD

DPA Requests a one time General Fund augmentation of \$200,000 for 2006-2007 and an ongoing augmentation of \$100,000 for 2007/2008 and thereafter. This funding will be split evenly between DPA and the State Personnel Board (SPB). (\$100,000 to each department in 2006-2007, and \$50,000 ongoing costs for each department.) This funding will be used to implement and maintain a Human Resources Internet Portal Service Center.

Currently, California's personnel management system is split between the SPB and DPA. The functions and information provided on the two separate websites are not coordinated, even though each organization has overlapping and related responsibilities. The websites currently duplicate some issues, and poorly coordinate others.

A coordinated site would allow a user who goes to either site (www.spb.ca.gov or www.dpa.ca.gov) to be directed to one main site. That site would have links that lead to pages controlled and maintained by the entity that currently operates those pages.

LAO

LAO points out that the DPA reports .5 staff positions and \$50,000 devoted to management of its website. The SPB reports 2.5 positions and over \$260,000 in resources devoted to its website.

SPB and DPA point out, in response, that a large majority of that budgeted money is already allocated to existing IT needs. Combined with the loss of staff over the last few years, they feel it would be difficult to absorb new workload within existing resources.

LAO also point out that "required planning documents" were not submitted on time. State IT projects require a Feasibility Study Report (FSR) to be completed to address any issues that may come up. This was not completed prior to submittal of the BCP.

COMMENTS

The proposal requests ongoing funds to complete tasks that could be completed by existing staff in the departments who will still be responsible for all but the front "portal" page. With 3.0 staff and over \$300,000 in resources available, it may be possible for existing staff to make improvements on their own.

ISSUE 7: CA DEPARTMENT OF FORESTRY AND FIRE PROTECTION (CDF)

The employee compensation costs for CDFFP are increasing significantly, largely driven by increases in the compensation rate for “planned overtime” pursuant to a 2001 MOU with CDFFP firefighters (Unit 8). Planned overtime is the portion of the firefighters’ *regularly* scheduled workweek for which they receive compensation at overtime rates. The number of hours in a firefighter’s workweek is determined by state contract. Federal law requires that firefighters be paid at overtime rates for the portion of a workweek that exceeds 53 hours.

Currently, the scheduled workweek for most state-funded CDFFP firefighters exceeds 53 hours only during the fire season. While the length of the fire season varies across the state, it is generally for a period of six to seven months (May-November) in Northern California and nine to ten months (April-November) in Southern California. During the fire season, firefighters normally work three 24-hour shifts in a week, for a total of 72 hours. Of this total, 19 hours are therefore considered planned overtime. During the non-fire season, firefighters do not currently accrue planned overtime because they generally work a 53-hour week consisting mostly of day shifts. During this time, when wild land fire activity is low, firefighters prepare equipment for the next fire season, take vacation time, conduct fire prevention activities, and perform work on a reimbursement basis for those activities considered local government responsibilities.

The budget proposes an augmentation of \$38.7 million (\$34.3 million General Fund, \$4.4 million reimbursements) for increases in employee compensation costs due to contractual increases in planned overtime costs. This is the result of a provision in the 2001 Unit 8 MOU that provides that beginning the last day of the agreement (June 30, 2006), firefighters will earn planned overtime year round, instead of only during the fire season as is the current practice.

COMMENTS

These costs, and the CDF budget, are heard in Budget Sub-Committee 3. These items are on their agenda for their hearing tomorrow, April 19th. The committee may address the issue by asking for report language that identifies the additional fire prevention efforts that result specifically from the expansion of the non-fire season workweek to 72 hours.

LAO

The LAO recommends trailer bill language stating:

It is the policy of the state for the Department of Personnel Administration to consider the cost-effectiveness of any Unit 8 memorandum of understanding (MOU) with an effective date on or after July 1, 2006. It is the intent of the Legislature that the department, in conjunction with the California Department of Forestry and Fire Protection, analyze the costs and benefits of proposed staffing patterns and compare those with the costs and benefits of alternative staffing patterns. Alternatives to be considered should include both proposals which reduce the need for planned overtime and proposals which eliminate the need for planned overtime. A report of the department’s analysis and its findings, along with a report on the outcome of the negotiations using the analysis, shall be submitted to the Legislature upon the submission of the Unit 8 MOU for legislative approval.

The following trailer bill language was developed from LAO and department recommendations:

It is the intent of the Legislature that the Department of Personnel Administration, in conjunction with the California Department of Forestry and Fire Protection, analyze the costs and benefits of proposed staffing patterns and compare those with the costs and benefits of alternative staffing patterns as part of its negotiations over the term of a new Unit 8 MOU with an effective date on or after July 1, 2006. Alternatives to be considered should include proposals which reduce or eliminate the need for planned overtime and the impacts on additional staffing required under such alternative work schedules. A report of the department's analysis and its findings, along with a report on the outcome of the negotiations using the analysis, shall be submitted to the Legislature upon the submission of the Unit 8 MOU for legislative approval.

ISSUE 8: LEGAL REIMBURSEMENT AUTHORITY – CONSENT ITEM

Request for an increase in reimbursement authority of \$1,345,000 for 2006-2007 and ongoing for the Legal Division. This increase is based on a rate increase for Attorney services and for Paralegal services.

ITEM 9800 AUGMENTATION FOR EMPLOYEE COMPENSATION

This budget includes funding for state civil service and related employee compensation for changes in the cost of new agreements with employee bargaining units and other costs that don't fit in an individual department's budget. Employee compensation funding is based upon approved Memoranda of Understanding for represented employees that are ratified by the Legislature. Compensation for excluded employees is determined by the Department of Personnel Administration or other authorized entities.

The Governor's budget proposes total expenditures of \$382 million and includes \$67 million (General Fund) to address the *Plata* Lawsuit. Funding comes primarily from the General Fund and other unallocated Special Funds.

ISSUE 1: EMPLOYEE COMPENSATION – BARGAINING UNIT MOU'S

The Governor's budget proposes funding in accordance with the MOUs signed with 5 collective bargaining units. The budget does not, however, include funding for the 18 bargaining units whose agreements have, or will expire in the next year. The Department of Personnel Administration was augmented in the 2005-2006 budget to fund comprehensive employee compensation surveys. These surveys, when completed, will be used by the administration to guide its negotiations with the remaining bargaining units.

LAO

While it is typical of recent practice to exclude funding for possible new MOUs, LAO points out that up to 90% of state employee's may have expired contracts in 2006-2007. Any new agreements reached are likely to increase, not decrease costs. Each one percent increase in salary for the 18 bargaining units whose contracts will expire before the end of the 06-07 year, could cost \$120 million (\$65 million General Fund).

The LAO also notes that even without new MOUs signed, health costs for the state will continue to increase. If a new agreement is not reached, the old agreement carries forward, and two-thirds of current MOUs require the state to pay a specific percentage of average health plan premium costs for employees and their dependents. This means that if state health plan premiums rise in 2007 (as expected), the amount the state must contribute will increase as well. This could translate into increases of up to \$120 million (\$40 million General Fund). This is in addition to any increases approved for salary increases.

COMMENTS

Despite the potential for the costs estimated by the LAO, the administration excludes these costs for possible future MOUs in order to preserve the confidentiality of their negotiating strategy with the bargaining units. Legislation enacting new MOUs can include first-year funding for new salary costs, so this is not critical for inclusion in the 9800 budget. It is important however to note that with 18 units bargaining for contracts, and costs in excess of \$120 million for each 1% salary increase, the costs could be substantial and use up significant reserves.

The impending health costs may need to be addressed separately from the other issues in the bargaining unit contracts. The health care costs will be incurred regardless of new MOUs. If health care premiums go up (as expected), unless a new MOU is signed with a decrease in state contribution (not expected), the state will need to cover those costs. Without funding budgeted for this purpose, departments will have to absorb those costs in their regular budget as unallocated reductions.

ISSUE 2: FINANCE LETTER – DOF TRANSFER AUTHORITY

In a finance letter received March 30th 2006, the Administration requested "transfer authority between the Special Funds appropriation and the Non-Governmental (NGO) Cost Funds appropriation." As employee bargaining units develop MOUs with the Department of Personnel Administration, money is placed in 9800 as a place holder for when those negotiated increases will need to be paid. The actual split between Special Fund costs and NGO costs is always a best estimate at the time of budgeting.

"This action would not permit increasing the overall amount appropriated for employee compensation but would allow the Department of Finance" to make changes within the approved amounts to make the split between the fund types match the actual department requests.

The language provided states:

"9800-001-0494 and 9800-001-0988, Provision 3:

Notwithstanding any other provision of law, upon approval of the Department of Finance, expenditure authority may be transferred between Items 9800-001-0494 and 9800-001-0988 as necessary to fund costs for approved memoranda of understanding or, for employees excluded from collective bargaining in accordance with salary and benefit schedules established by the Department of Personnel Administration."

COMMENTS

This does not expose the General Fund to any additional risk. The DOF does its best to estimate the necessary split for these costs, but because requests are made through the year by departments for these funds, it is very difficult to determine the exact split between the funds.

ISSUE 3: PLATA LAWSUIT

In April 2001, the Prison Law Office filed a class action lawsuit titled *Plata v. Davis* challenging the State's ability to provide adequate medical care to prison inmates.

Compliance with the terms and conditions of the settlement agreement is dependent upon the phased implementation of the Inmate Medical Services Program Policies by the Department of Corrections and Rehabilitation to meet the minimum level of care necessary to fulfill the department's obligation. The benefits of the proposed changes include: more timely and comprehensive assessment of inmate needs as they enter CDC; improved access to medical services; the implementation of a comprehensive chronic care program using standardized data collection forms and guidelines consistent with National Commission on Correctional Health Care panels where at each visit, an assessment will be made on how well the inmate is doing as compared with established standards; staffing of emergency rooms by registered nurses 24 hours a day, seven days a week and a 30 day follow-up assessment by the primary care physician whenever a referral of an inmate to a specialist has been made.

The Administration is requesting funding of \$67 million (\$56 million General Fund) to increase the pay of State-employed doctors and nurses in accordance with the court order to immediately increase compensation for several classes of prison medical personnel.

COMMENTS

To date estimates show that required costs under the court order total only \$21 million. The additional \$47 million the Governor's budget includes is for salary increases for doctors and nurses in "other departments with job classifications similar to those of prison staff covered by the Plata case order."

LAO suggests that these salary adjustments should be discussed at the bargaining table. "The State should not voluntarily offer pay raises not required by the court order without considering the whole range of compensation and workplace issues."

They also point out that at the bargaining table, the administration could more effectively use data from the comprehensive employee compensation survey to be released in April, according to information provided to a Senate budget subcommittee.

The LAO recommended funding only \$21 million of court-ordered pay increases in its *Analysis of the 2006-07 Budget Bill*. Pay increases for other employees would also be funded in the line item for Augmentation for Employee Compensation, if they are approved through the regular collective bargaining process, according to LAO.

Since publication of the LAO's *Analysis*, the administration has begun to provide additional recruitment and retention (R&R) pay differentials for several clinical classifications at Department of Mental Health (DMH) state hospitals and psychiatric programs, following notification to the Legislature. The administration cited heightened recruitment and retention challenges at DMH caused in part by the higher pay offered at CDCR under the *Plata* court order for employees in similar classifications. The estimated cost for four months of the R&R differentials at DMH is \$12.2 million.

COMMENTS

The LAO and DOF should be prepared to discuss why the additional salary adjustments should or should not be handled at the bargaining table along with a rationale for the need for this funding. Can the Department of Corrections and Rehabilitation (CDCR) hire 600 new people in a matter of months? Has this had an effect on the number of vacancies in CDCR?

Additionally, with new cost estimates coming in, new staff to direct these changes, and the potential for additional court mandated costs, all parties involved should be prepared to discuss the expected direction for these funds.

ITEM 9650 HEALTH AND DENTAL BENEFITS FOR ANNUITANTS

This program, administered by the California Public Employees Retirement System (CalPERS), funds health and dental benefits for retired state employees and their dependents. The program began in 1962, with an employer contribution of \$5.00 per month toward the cost of a basic health plan. Since then, major medical plans, Medicare, and plans supplementing Medicare have been developed. Dental care was added in 1982. The 2005-06 employer contribution for health premiums maintains the average 100/90 percent contribution formula established in Government Code Section 22871. Under this formula, the state averages the premiums of the four largest health benefit plans in order to calculate the maximum amount the state will contribute toward the retiree's health benefits. The state also contributes 90 percent of this average for the health benefits of each of the retiree's dependents. The retiree is responsible for paying all health benefit plan costs that exceed the average of the four largest benefit plans. The 2005-06 monthly contribution maximums are \$394 for a single enrollee, \$738 for an enrollee and one dependent, and \$933 for an enrollee and two or more dependents. Dental care premiums vary by plan and number of dependents. Retirees who are enrolled in Medicare, and whose health plan premium is less than the maximum state contribution may apply the difference towards their Medicare Part B premium.

Retiree Costs Compared with Active Employee Costs. Average state costs for retirees and active employees are similar. However, total average premium costs per active employee are greater, with the employee picking up the difference. A significant portion of retiree health care costs is paid by Medicare, which covers more than 60 percent of retirees.

Health and Dental Benefits for Annuitants

Budgeted Expenditures

(in thousands)

Program	Actual 2004-05	Estimated 2005-06	Proposed 2006-07
Health and Dental Benefits for Annuitants	\$800,676	\$895,197	\$1,019,368
Total Expenditures (All Programs)	\$800,676	\$895,197	\$1,019,368

Budget Estimates 13.8-percent Cost Increase. The budget estimates that spending for Health and Dental Benefits for Annuitants will total \$1 billion in 2006-07—an increase of 13.8 percent from the current-year amount. This estimate will be further refined in June after CalPERS establishes health plan premiums for 2007. Although all of this cost is budgeted from the General Fund, 35 percent of this cost is for retirees from programs funded by special funds or federal funds and the General Fund for these costs (two years in arrears) through the Statewide Cost Allocation Plan--pro-rata assessments on special funds and federal funds for statewide costs.

ISSUE 1: GASB 45

Unlike pension benefits, the state funds Health and Dental Benefits for Annuitants on a "pay-as-you-go" basis, meaning that all contributions are used to pay the costs of current costs of current retirees. No funds are set aside and invested for the future costs of either current or future retirees. In June 2004, the Governmental Accounting Standards Board (GASB) approved in Statement 45, an accounting standard for other (than pensions) post-employment benefits. This new rule states that all government employers must report the unfunded liabilities associated with their other post-employment benefits, such as retiree health and dental benefits, when these benefits are not provided through the pension plan. Because this is currently a pay-as-you-go program in California, the state's unfunded liability is the amount that is required to provide future benefits for all current retirees and to meet the state's obligation to existing employees when they retire. The new reporting requirement must be included in California's 2007-08 financial statements. The State Controller's budget includes funding for preparing this estimate of unfunded liability. Although the state is permitted to fund these benefits on a pay-as-you-go basis, the state will have to report its liability as determined by the actuaries. This could negatively affect the state's financial reports and impact its credit rating if the state does not reduce or manage the unfunded liability.

Given that annual costs are now \$1 billion, and have been increasing rapidly, the state's unfunded liability will be large. The need to recognize this liability presents a challenge, but also several opportunities. Because the state is an ongoing entity, a pay-as-you-go approach can be viable (it's what the state has done for 47 years) unless commitments are made that will require devoting ever-increasing shares of the state budget to these retiree benefits in the future. By annually calculating the unfunded liability for these benefits, compliance with GASB Statement 45 will assist the Legislature in identifying future funding pressures earlier, when corrective actions may still be possible. Furthermore, if the state were to begin making contributions to reduce the unfunded liability, and if those contributions were invested by CalPERS, the earnings could help to mitigate future costs.

LAO Report: *Retiree Health Care: A Growing Cost For Government*

LAO Sees Continued High Rate of Spending Increase. In a recent report, the Legislative Analyst's Office (LAO) examined the impact of GASB 45 and the rapidly growing cost of retiree health and dental benefits for the state. Over the four-year period from 2006-07 to 2010-11, the LAO estimates that the annual state cost of retiree health and dental benefits will increase at an annual rate of 12.5 percent--from \$1 billion to \$1.6 billion. The high rate of growth results from increasing health care costs and from an anticipated increase in the number of retirees as baby boomers begin to retire from state service. For comparison, the state currently pays contributes about \$1.5 billion annually toward the health benefits of active employees.

State Unfunded Liability May Exceed \$70 Billion. Looking at estimates that have been done in some other states, LAO makes an "educated guess" that the state's unfunded liability will be in the range of \$40 billion to \$70 billion or more. In addition, the University of California, local governments, and some school districts have substantial unfunded liabilities for retiree health benefits and, like the state, also face rapidly rising costs. LAO also estimates that to begin fully funding state retiree health and dental benefits (over a 30-year period), the state would have to spend roughly \$6 billion in 2006-07, or \$5 billion more than the \$1 billion budgeted.

LAO Recommendations. The LAO report makes the following recommendations concerning retiree health benefits and efforts to comply with GASB 45:

- **More Disclosure and Planning**

Recommend approving State Controller's request for \$252,000 in 2006-07 to obtain a retiree health actuarial valuation for the state, consistent with GASB 45 (see Issue 4 under the State Controller).

Recommend requiring public entities choosing to obtain valuations to submit them to the State Controller.

Recommend requiring State Controller to report on retiree health benefits, costs, and liabilities statewide.

Recommend requiring school districts to develop plans to address retiree health liabilities.

Recommend requesting UC to propose a plan to address its retiree health liabilities.

Recommend establishing state working group to report to the Legislature on options for funding and reducing costs of retiree health benefits.

- **Funding Retiree Health Benefits**

Recommend beginning to partially pre-fund retiree health benefits after receipt of state's retiree health actuarial valuation, ramping up to an increased level of contributions over several years.

- **Options to Reduce Future Retiree Health Costs**

Extensive options exist to reduce costs for state employees hired in the future.

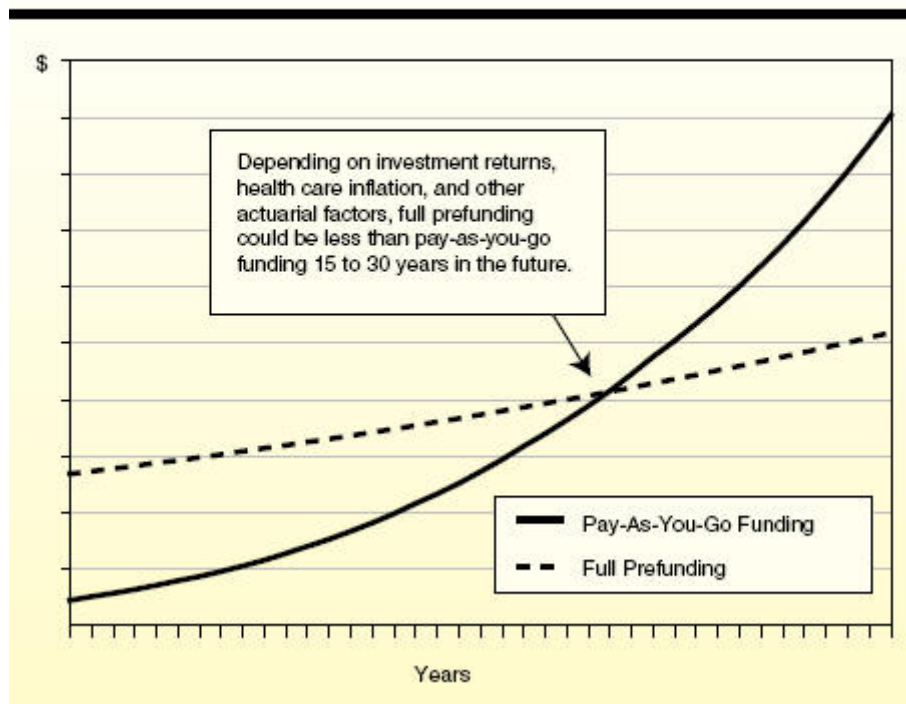
For costs related to current and past employees, options may be limited.

Advantages of Pre-Funding.

Although LAO recognizes that the state's current fiscal condition makes pre-funding difficult, they point out the following advantages of pre-funding retiree health benefits, instead of funding only on a pay-as-you-go basis:

- **More Economical Over Time.** Paying more now can dramatically reduce costs over the long term because investment earnings would supplement state and any employee or retiree contributions for retiree health costs. Figure 9 (from the LAO report) illustrates the long-term benefits of fully pre-funding retiree health benefits by contributing the full annual contributions (normal costs and costs to retire unfunded liabilities) specified by GASB 45.

Figure 9

Hypothetical Prefunding Scenario

- **Helps Secure the Benefits Expected by Employees.** Pre-funding creates a pool of assets with which to support future benefits that public employees expect to receive. These assets would strengthen the state's ability to provide these benefits over the long term.
- **Contributes to Higher Bond Ratings.** Unfunded pension and retiree health obligations are viewed by bond analysts as similar to debt. For rating agencies and bond investors, more debt can be a negative consideration. While there is no indication that rating agencies will rush to downgrade ratings once GASB 45 reveals large retiree health liabilities, as more states and local governments address retiree health liabilities, rating agencies may compare those governments that have acted with others that have not.

LAO Recommends Partial Pre-funding. In light of the state's ongoing fiscal limitations, LAO recommends that the state begin to partially pre-fund retiree health benefits over the next few years by contributing an additional \$1 billion annually.

COMMENTS

CalPERS indicates that it currently has statutory authority to accept pre-funding contributions from the state for investment. The CalPERS budget includes a Finance Letter request for \$2.9 million to determine the requirements and feasibility of accepting pre-funding contributions from contracting (local) agencies. (Please see Issue 3 in CalPERS.)

Pre-funding would enable the state to use a higher investment rate of return in estimating its unfunded liability for retiree health and dental benefits. This would substantially reduce the calculated unfunded liability. Partial pre-funding would allow this treatment for a portion of the unfunded liability.

ISSUE 2: MEDICARE PART D PROVIDES ONLY LIMITED SAVINGS

The new Medicare Part D Program provides limited coverage of prescription drugs for Medicare enrollees who do not have other drug coverage. In order to reduce the incentive for employers to drop existing drug coverage for retirees and shift costs to Medicare, the federal government provides a subsidy payment based on the drug usage of Medicare enrollees who are covered by employer drug benefits. CalPERS estimates that it will receive \$38 million in 2006-07 from the federal government for these payments. The Kaiser Permanente HMO also will receive subsidy payments on behalf of state retirees enrolled in that plan.

In a Finance Letter request, CalPERS is seeking \$489,000 to compile and track the drug usage information necessary to claim the federal subsidy.

COMMENTS

Drug coverage under state retiree health benefits is more comprehensive than under Medicare Part D.

CalPERS should explain how it will realize savings to the state from the subsidy payments to itself and to Kaiser.

ITEM 1900 CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (PERS)

The California Public Employees' Retirement System (CalPERS) administers retirement and health benefits for more than 1.4 million active employees and retirees of state and local agencies in California. Benefits include retirement, disability, and survivor's retirement benefits, Social Security for State employees, and the development, negotiation, and administration of contracts with health maintenance organizations, group hospitals, and medical insurance plans. In addition, CalPERS administers a long term care program for members and eligible individuals.

CalPERS is governed by a Board of Administration. The California Constitution provides that the Board of Administration has authority over the administration of the retirement system. Therefore, the budget data presented here is for informational purposes only, with the exception of the component of the Health Benefits Program funded from the Public Employees' Contingency Reserve Fund.

The Governor's budget allocates \$1.3 billion from the General Fund and Special Fund contributions totaling \$745,000. The Governor's budget proposes total expenditures of \$12.3 billion with funding coming primarily from the Public Employees' Retirement Fund and the Public Employees' Health Care Fund.

ISSUE 1: ASSET SMOOTHING

After the bull market of the 1990's greatly improved the funding of pension systems, many systems reduced required employer contributions substantially. At about the same time, the state and many local governments increased retirement benefits, which used up surplus assets and increased the annual normal cost of pension funding. When stock markets declined, plans experienced consecutive years of less-than-expected investment returns. This combination led to drastic increases in required employer contribution rates.

CalPERS Rate Stabilization Policy:

Implemented at the April 19th, 2005 Board of Directors meeting, this new plan aims to reduce the fluctuations in required employer contribution rates the state has seen in the past. One of the key aspects to the plan is that it spreads the system's market value asset gains and losses over 15 years, as opposed to the former practice of three years. This will reduce the effects of fluctuations in investment returns on the calculation of unfunded liabilities, which affects the required contribution rates. This is expected to reduce employer rate volatility by 52% in future years.

Based on this new policy, the Governor's budget recognizes a saving of \$251.5 million (\$152.7 General Fund) from the expected state 2005-2006 contribution to CalPERS.

COMMENTS

If this new policy works as expected, this will be very beneficial to the state for planning purposes.

ISSUE 2: FINANCE LETTER – MEDICARE PART D POSITIONS

In a finance letter dated March 30th 2006, CalPERS has requested permanent funding of \$439,000 for 5.5 permanent full time positions and one time funding of \$50,000 for the purpose of implementing the processing of Medicare Part D eligibility files, reconciliation files, and subsidy requests.

CalPERS is also waiting for an opinion for the Office of the Attorney General regarding the distribution of the subsidy (what fund any residuals of the special deposit fund go to), but these positions and their duties are separate from that finding. Regardless of the Attorney General's opinion, CalPERS is required to process the Medicare Part D eligibility files, reconciliation files, and subsidy requests.

COMMENTS

CalPERS estimates they will process subsidy requests for nearly 96,000 Medicare Part D eligible members and will generate approximately \$54 million in subsidies for the benefit of state and contracting agencies. The requested positions are for facilitating this process.

ISSUE 3: FINANCE LETTER – ASSISTING CONTRACTING AGENCIES TO COMPLY WITH GASB 45

CalPERS is requesting one-time expenditure authority of \$2.935 million to assist contracting agencies to comply with GASB 45 financial reporting requirements.

Under this request, CalPERS would assist contracting agencies in meeting their short-term needs by providing the health data necessary to complete the health actuarial valuation necessary to calculate their health benefit liability. CalPERS will also be able to execute a cost study to determine the functional and business requirements necessary to implement a full service model where CalPERS could provide all necessary services to the contracting agencies.

CalPERS augmentation would allow them to bring on 12 business analyst consultants to prepare a detailed cost analysis to determine the functional and business requirements to implement a full service model (including in-house actuarial valuations. This cost study will include:

- Cost analysis for in-house valuations.
- Cost analysis for pre-funding contribution investment options.
- Development of a system interaction model.
- Development of a business interaction model.
- Documentation of all business and technical requirements.

CalPERS points out their successful administration of the pre-funded retirement system as a demonstration that pre-funding is a sensible business approach to reduce future liabilities. Additionally, they point out their impressive growth in net asset value to over \$200 billion as proof of their successful diversified investment strategy and its responsiveness to market developments, making CalPERS a qualified entity to provide such services.

COMMENTS

This could help provide a standard for local agencies and school districts on how to handle GASB 45 compliance issues. Many of those agencies currently utilize CalPERS for existing services, and CalPERS expects many of them to similarly look to CalPERS to provide these new services that will be required under GASB 45 requirements.

This bill has no General Fund effect. If CalPERS is able to provide this full service model, it may save local agencies and school districts money by providing them with an effective investment strategy.

ISSUE 4: DIVERSITY OF INVESTMENT

On June 15th, 2004, CalPERS submitted to the legislature a Commitment to Diversity Report. This report discussed CalPERS existing diversity programs and participation rate levels in CalPERS business activities by ethnic minority firms, women-owned firms, and ethnic minority and women employees, focusing on the management of CalPERS investment assets.

COMMENTS

At the request of the chair, this is an informational issue for CalPERS staff to update the committee on CalPERS status and progress since the 2004 report.

ITEMS 0860 AND 1730 STATE BOARD OF EQUALIZATION AND FRANCHISE TAX BOARD

ISSUE 1: AUDITOR RECRUITMENT AND RETENTION

At earlier hearings, the subcommittee discussed the high vacancy rates for auditors at the tax agencies, recruitment and retention problems that result in the high vacancy rates and the revenue loss to the state resulting from unfilled auditor positions. The subcommittee directed the State Board of Equalization (BOE) and the Franchise Tax Board (FTB) to report back with the following information:

- Plan for increasing salaries to be competitive.
- Plan and strategies for recruitment and retention (in addition to salaries).
- Revenue loss due to excess vacancies.
- Progress in meeting with and working with the relevant bargaining units toward resolving the vacancy problem.