

# EXHIBIT A

17

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7 Attorneys for California Public Employees'  
 Retirement System

8  
 9 UNITED STATES BANKRUPTCY COURT  
 10 EASTERN DISTRICT OF CALIFORNIA  
 11 SACRAMENTO DIVISION

12 In re  
 13 CITY OF STOCKTON, CALIFORNIA,  
 14 Debtor.

Case No. 2012-32118  
 DC No. OHS-15  
 Chapter 9

15 **DIRECT TESTIMONY DECLARATION**  
 16 **OF DAVID LAMOUREUX IN SUPPORT**  
 17 **OF CALPERS' RESPONSE TO**  
 18 **FRANKLIN'S OBJECTION TO**  
 19 **CONFIRMATION OF THE CITY OF**  
 20 **STOCKTON'S FIRST AMENDED PLAN**  
 21 **OF ADJUSTMENT**

22 Date: May 12, 2014  
 23 Time: 9:30 a.m.  
 Place: Robert T. Matsui U.S. Courthouse,  
 501 I Street  
 Department C, Fl. 6, Courtroom 35  
 Sacramento, CA 95814  
 Judge: Hon. Christopher M. Klein

24 I, David Lamoureux, declare as follows:

25 1. I am over 18 years of age, and I am authorized to make this declaration in support of  
 26 "CalPERS' Response to Franklin's Objection to Confirmation of the City of Stockton's First  
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1 Amended Plan of Adjustment.” I have personal knowledge of the matters set forth in this  
2 declaration.

3 **I. Background**

4 2. I hold the position of Deputy Chief Actuary at CalPERS. In this position, among  
5 other things, I manage the Actuarial Office of CalPERS. As the Deputy Chief Actuary, I am  
6 responsible for the overall operation of the Actuarial Office including actuarial and public policy  
7 matters and legislative issues. I also work closely with the CalPERS Board of Administration,  
8 CalPERS Executive Staff and participating employers on actuarial and funding issues.

9 3. I earned a Bachelors degree in Actuarial Science from Concordia University, Montreal  
10 in 1995.

11 4. I have worked in the actuarial profession since 1994. I became an associate of the  
12 Society of Actuaries in 1996 and a fellow of the Society of Actuaries in 2002. I worked for a number  
13 of employers as an actuary before being employed by CalPERS as an associate pension actuary in  
14 1999. Since that time, I have held the positions of senior pension actuary beginning in 2003, and  
15 supervising pension actuary from 2006 until 2010, when I was promoted to my current position.

16 5. I am a Fellow of the Society of Actuaries (F.S.A.) and a Member of the American  
17 Academy of Actuaries (M.A.A.A.).

18 6. The role of a pension actuary is to determine how much money must be contributed to  
19 a pension plan each year in order to properly fund the benefits promised to employees that will  
20 become due in the future. This is done through analysis of the financial consequence of risk.  
21 Actuaries use mathematics, statistics, and financial theory to study uncertain future events,  
22 particularly those of concern to insurance and pension programs. For example, pension actuaries  
23 analyze probabilities related to the demographics of pension plan members (*e.g.*, the likelihood of  
24 retirement, disability and death) and economic factors that may affect the value of benefits or the  
25 value of assets held in a pension plan’s trust (*e.g.*, investment return rate, inflation rate and rate of  
26 salary increases). Pension actuaries determine the value of pension benefits and devise strategies for  
27 funding the cost of the benefits that ensure benefits are properly funded and maintain inter-  
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1 generational equity (*i.e.*, achieve equity across generations of taxpayers, by funding the employees’  
2 benefits while they are rendering service, so that the cost of the benefits is incurred by the taxpayers  
3 receiving services from those employees).

## 4 **II. What is CalPERS?**

5 7. CalPERS is a statutorily created arm of the state of California that functions as a third  
6 party administrator for the pension system for California public employees, which includes  
7 approximately 2,600 separate plans. The California Legislature established CalPERS in 1932, in the  
8 midst of the Great Depression, to provide retirement benefits to California State employees.  
9 Beginning in 1939, public “agencies” (including municipalities like Stockton) were allowed to elect  
10 to participate in CalPERS. Ex. 1, Vested Rights of CalPERS Members (July 2011) at 2 (“CalPERS  
11 Profile”). CalPERS administers the State’s pension plan and healthcare services for almost 1.7  
12 million California public employees, retirees, and their families. Ex. 2, CalPERS Office of Public  
13 Affairs, *Facts at a Glance* (April 2014).

14 8. The CalPERS Board is governed by the California Constitution and statutes, such as  
15 Cal. Const., art. XVI, § 17 subdiv. (b), which mandates that the CalPERS Board ensure the rights of  
16 CalPERS members and retirees to their full earned benefits. In 1992, California voters approved  
17 Proposition 162, which gave the CalPERS Board exclusive authority over the administration and  
18 investment of pension funds. In enacting Proposition 162, the electorate amended article XVI,  
19 section 17 of the California Constitution, to read in part as follows:

20 Notwithstanding any other provisions of law or this Constitution to the  
21 contrary, the retirement board of a public pension or retirement system shall  
22 have plenary authority and fiduciary responsibility for investment of moneys  
23 and administration of the system, subject to . . . the following: [¶] . . . The  
24 retirement board shall . . . have sole and exclusive responsibility to administer  
the system in a manner that will assure prompt delivery of benefits and related  
services to the participants and their beneficiaries.

25 Ex. 3, (relevant portions of official ballot pamphlet (Nov. 3, 1992)). Proposition 162 amended the  
26 California Constitution to provide that the CalPERS Board has “the sole and exclusive power to  
27 provide for actuarial services in order to assure the competency of the assets” of the system. Cal.  
28 Const., art. XVI, § 17, subdiv. (e). The intent behind the measure was to protect public pension funds

1 by vesting the authority to direct actuarial determinations solely with the CalPERS Board. Ex. 3 at  
2 36 (relevant portions of official ballot pamphlet (Nov. 3, 1992)). By granting the CalPERS Board  
3 sole authority to administer the system, Proposition 162 prevented the legislative and executive  
4 branches from “raiding” pension funds to balance the State budget. *Id.* at 38.

5 9. The CalPERS Board is governed by the California Public Employees Retirement Law  
6 (the “PERL”), which imposes statutory obligations on the Board and employers such as the City of  
7 Stockton. Under the PERL, Stockton has certain obligations to CalPERS, and CalPERS in turn has  
8 obligations to the City of Stockton’s current and former employees to provide retirement benefits in  
9 accordance with the provisions of PERL. These statutory obligations are not directly affected by the  
10 acceptance, rejection or modifications of the City’s collective bargaining agreements.

11 10. For public employees serving municipalities in California, the legislature created a  
12 three-party structure under which CalPERS provides retirement benefits. First, each municipality  
13 elects a “contract” with CalPERS that triggers the applicability of statutes including the PERL and  
14 other laws, regulations and policies governing the provision of pension benefits through CalPERS.  
15 Second, each public servant has an employment contract with the municipality that includes pension  
16 benefits. Finally, CalPERS has a constitutionally defined responsibility to provide pension benefits  
17 to its members and retirees and to protect these benefits.

18 11. Less than one hundred agencies have terminated their relationship with CalPERS in  
19 the more than eighty years of the existence of the system. Virtually all of these terminating agencies  
20 are very small local districts or agencies and most employers have terminated because they are  
21 winding up their operations and ceasing business. No employer the size of the City of Stockton has  
22 ever terminated its relationship with CalPERS. CalPERS administers a terminated agency pool for  
23 agencies that terminate their relationship with CalPERS. As of June 30, 2012, there were 90 agencies  
24 that had terminated their contract with CalPERS for which CalPERS continues to administer benefits  
25 through the terminated agency pool. As of June 30, 2012, the terminated agency pool held about  
26 \$178 million in assets and \$89 million in pension obligations. These pension obligations covered 740  
27 members and/or beneficiaries currently receiving a benefit and 349 members that have not yet retired  
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1 but are entitled to a deferred retirement benefit. By comparison, the termination liability for the  
2 Stockton plans alone would affect approximately 2,518 members that have not yet retired but are  
3 entitled to a deferred retirement benefit and 2,075 members and/or beneficiaries currently receiving a  
4 benefit, and would result in termination obligations exceeding \$2.6 billion for both plans while the  
5 assets as of June 30, 2012 totaled about \$1 billion.

6 12. Of the more than 1500 public agencies that contract for pension services with  
7 CalPERS, none of them (other than the bankrupt City of San Bernardino) were delinquent by an  
8 amount in excess of \$150,000 as of March 31, 2013.

### 9 **III. Pension Funding in California**

10 13. The basic premise of a defined benefit pension plan is to defer compensation received  
11 during employees' peak earning years to their lowest earning years. The amounts of such deferred  
12 payments are determined based on actuarial assumptions and calculations, and the risk is pooled  
13 among the participants in the plan. For a homogeneous population, predictions for larger groups are  
14 more accurate than for smaller groups. Accordingly, as a pool is made smaller and smaller, the  
15 volatility of the cost per member increases because the risk is pooled among a smaller group.

16 14. The sources of funds used to provide the pension benefits are employee contributions,  
17 employer contributions and investment income. Employee contributions are set by statute and vary  
18 by benefit level. Under pension reform enacted by the California legislature in 2011, new employees  
19 must pay half of the "Normal Cost," which is the annual cost of service accrual for the upcoming  
20 fiscal year for active employees in the absence of any unfunded or overfunded liability to be  
21 amortized. Normal Cost is expressed as a percentage of the employer's covered payroll.

22 15. A city's contribution obligations to CalPERS are determined on an actuarial basis,  
23 taking into account investment returns, mortality rates, projected retirement pattern, projected  
24 compensation and other factors. All actuarial calculations are based on a number of assumptions  
25 about the future such as demographic assumptions including the percentage of employees that will  
26 terminate, die, become disabled and retire each future year and economic assumptions including  
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1 future salary increases for each active employee and future investment returns. The key role of the  
2 actuary is to spread this cost over time in a manageable way.

3 16. Investment income is based on actual performance but must be estimated in order to  
4 determine future employer contributions. Investment returns are obviously dependent on global  
5 financial circumstances and vary from year to year. The historical average annual return for  
6 CalPERS investments over the past 30 years is 9.5%. Ex. 4, (Depicting CalPERS' historical returns  
7 from fiscal year 1983-84 to fiscal year 2012-13). Presently CalPERS employs an estimated expected  
8 return rate of 7.5% in order to determine contributions, but as can be seen from the historical data,  
9 actual returns may vary significantly from that estimate. Assumptions about the investment  
10 return/discount rate are not based on investment targets or benchmarks but are instead driven by asset  
11 allocations. As asset allocations change, investment return assumptions are revised. The current  
12 investment return assumption is 7.5%, which is a combination of 2.75% for inflation and a real rate  
13 of return of 4.75% (net of investment and administration expenses).

14 17. The benefits under CalPERS are pre-funded. Instead of allocating money at or near  
15 the time that benefits become due, a pre-funded plan relies on an orderly schedule of contributions  
16 well in advance of benefit requirements. The willingness and ability of the sponsor of a defined  
17 benefit pension plan to maintain an orderly schedule is a major factor in the benefit security for  
18 retirees and in the maintenance of an actuarially sound plan.

19 18. The funded status is determined each year by comparing the assets in the plan to the  
20 liabilities of the plan. The assets are impacted by the contributions received and investment returns  
21 on those contributions while the liabilities are impacted by the benefits earned by its employees,  
22 which is based on an employee's years of service and age of retirement. If the City does not timely  
23 make its required payments, the actuarial soundness of the fund may be negatively impacted. The  
24 actuarial calculations are premised on the fact that contributions will be made when required and  
25 invested when made.

26 19. When contributions are delayed beyond the required date, the plan falls out of  
27 actuarial balance and actuarial soundness is put in jeopardy. By not making timely contributions, the  
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1 asset base is not being increased as projected while at the same time, the liabilities are continuing to  
2 increase as employees continue to earn service credit.

3 20. An employer's contribution requirement is annually calculated and is expressed as a  
4 percentage of payroll. This may change due to presently considered modifications by the CalPERS  
5 Board. The employer's contribution amounts are due and payable following each pay period.  
6 Contributions are due by the 15th day following the last day in the pay period to which they relate.  
7 However, payroll and contribution information are due by the 30th day following the last day in the  
8 pay period to which they relate. Given this lag between the two dates, once CalPERS receives the  
9 payroll and contribution information, if there is any discrepancy between the amount paid and the  
10 payroll and contribution information supplied by the employer, later periodic payment amounts are  
11 adjusted to account for discrepancies.

12 21. An actuarial valuation for each plan of a contracting agency is performed every year to  
13 determine the present value of future benefits (*i.e.*, the total amount of money needed to fully fund  
14 expected benefits for current members for both past and future service), the Normal Cost (which is  
15 the annual cost of one year of service accrual, as discussed above), the accrued liability (which is the  
16 value of benefits earned to date for past service only) and the current funded status (which is the  
17 market value of the assets as a percentage of the accrued liability).

18 22. Every year, the employer contribution rate is adjusted based on the funded status. If  
19 the plan is less than 100% funded, the employer must pay both the Normal Cost and a payment  
20 towards the unfunded accrued liability. If the plan is 100% (or more) funded, the employer must only  
21 pay the Normal Cost.

22 23. To minimize the effect of any short-term market value fluctuations on employer  
23 contribution rates, CalPERS uses an asset smoothing technique where investment gains and losses are  
24 spread or "smoothed" over a period of time. On April 17, 2013, the CalPERS Board approved a  
25 recommendation to change the CalPERS amortization and rate smoothing policies. Ex. 5, Board of  
26 Administration, Public Employees Retirement System, *Resolution - Actuarial Policies - Amortization*  
27 *and Smoothing Policies* (April 17, 2013). Beginning with the June 30, 2013 valuations that set the  
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1 2015-2016 rates, CalPERS will no longer use an actuarial value of assets and will employ an  
2 amortization and smoothing policy that is designed to cover all gains and losses over a fixed 30-year  
3 period with the increases or decreases in the rate spread directly over a 5-year period. The new  
4 amortization and smoothing policy will be used for the first time in the June 30, 2013 actuarial  
5 valuations. These valuations will be performed in the fall of 2014 and will set employer contribution  
6 rates for the fiscal year 2015-2016. The advantage of the new method is that it will create less  
7 volatility in extreme years, quicker movement towards funded status and future contribution  
8 requirement will be more transparent. The unfunded liability component of the employer rates will  
9 increase in the short-term but in the long-term rates will decrease and the plan will be closer to  
10 attaining funded status. Ex. 9 (depicting contribution rates).

11 24. The most recent Annual Valuation Reports prepared by CalPERS' actuaries for the  
12 City of Stockton were issued in October 2013, and provide valuations as of June 30, 2012. Ex. 6,  
13 CalPERS Actuarial Office, *Safety Plan of the City of Stockton Annual Valuation Report as of June*  
14 *30, 2012*, (October 2013) ("Safety Valuation Report"); Ex. 7, CalPERS Actuarial Office,  
15 *Miscellaneous Plan of the City of Stockton Annual Valuation Report as of June 30, 2012*, at 28  
16 (October 2013). In the course of preparing this declaration, I discovered an inaccuracy in the October  
17 Annual Valuation Report for the Miscellaneous Plan only with respect to the statement of the  
18 liabilities of the plan upon termination. I have corrected this inaccuracy and have posted an amended  
19 valuation report on the CalPERS website for the City of Stockton. Copies of the amended valuation  
20 report will be provided to the City and the parties in the bankruptcy case. My references to the  
21 valuation report for the miscellaneous plan in this declaration are to the amended report (the  
22 "Miscellaneous Valuation Report"). These reports:

- 23 a. Set forth the actuarial assets (including actuarial and market valuations) and  
24 accrued liabilities (including the unfunded actuarial liability) of each plan as of  
25 June 30, 2012;
- 26 b. Determine the required Employer Contribution Rate for each plan for the fiscal  
27 year July 1, 2014 – June 30, 2015;

- 1 c. Provide actuarial information as of June 30, 2012, to the CalPERS Board of
- 2 Administration and other interested parties; and
- 3 d. Provide pension information as of June 30, 2012, to be used in financial reports
- 4 subject to Governmental Accounting Standards Board Statement 27 for a
- 5 single employer defined benefit pension plan.

6 25. In the most recent version of the Annual Valuation Reports, the actuarial valuations  
7 provide the following funding and rate information, for fiscal years 2012 and 2013:

- 8 a. The actuarial and market value of the assets;
- 9 b. The current unfunded liability; and
- 10 c. The funded ratio.

11 And for fiscal years 2013 and 2014, the reports provide projected employer and employee  
12 contribution rates for service credit earned during the applicable periods.

13 26. For any given year, contribution amounts are calculated by adding together two  
14 different elements:

- 15 a. The "Normal Cost," discussed above.
- 16 b. Payment toward any unfunded accrued liability, which is obtained by
- 17 comparing the assets of the plan to the actuarial accrued liability of the plan,
- 18 *i.e.*, the current value of the benefit for all credited past service of current
- 19 members. Unfunded accrued liability is expressed as a lump sum dollar
- 20 amount.

21 27. The unfunded accrued actuarial liability calculation as described in the Annual  
22 Valuation Reports is not a reflection of any amounts that are currently owed by an employer, nor is it  
23 the amount that would need to be paid to fully fund a plan if the plan were to be terminated.  
24 Unfunded accrued actuarial liability as used in the Reports is a figure calculated to establish a  
25 funding target that is used for an ongoing plan that is a component of the actuarial calculation used to  
26 determine the employer contribution rate for the upcoming fiscal year. It is quite volatile and can  
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1 increase or decrease significantly over a relatively short period of time depending on, among other  
2 factors, the state of the economy and the health of the financial markets.

3 28. The annual contribution is borne by both the employer and the employees. The future  
4 benefits for current employees will be assured only if all contributions of both employer and  
5 employee are made timely and in full.

#### 6 **IV. Stockton's Relationship to CalPERS**

7 29. In September 1944, the City of Stockton, through its City Council, elected to  
8 participate in the California State Retirement System, subject to the provisions of the State  
9 Employees' Retirement Act. Exs. 8.1, 8.2 (Stockton/CalPERS Original Contract & All Currently  
10 Applicable Amendments). The City's retirement plan has two subplans with different benefit  
11 formulas—safety employees and miscellaneous employees. Most City employees who are not safety  
12 employees are part of the miscellaneous subplan.

13 30. Under the PERL, a municipality elects to participate in the CalPERS system by  
14 entering into a "contract" with CalPERS in compliance with Chapter 5 of the PERL, Cal. Gov. Code  
15 §§ 20460 to 20593.<sup>1</sup> The PERL specifies in detail the provisions of the contract, the procedure by  
16 which a public agency may elect to participate, and many other terms. Once a city makes this  
17 statutory election, it is bound and controlled by the statutory provisions governing the system and the  
18 decisions of the CalPERS Board. Cal. Gov. Code § 20506 ("Any contract heretofore entered into  
19 shall subject the contracting agency and its employees to all provisions of this part and all  
20 amendments thereto . . ."). The governing statutes require the municipality to timely pay all required  
21 employer contributions. *Id.* §§ 20532, 20831. The PERL also prohibits the contracting agency from  
22 rejecting any contract pursuant to Section 365 of the Code. *Id.* § 20487. The statutory pension  
23 provisions are a fundamental part of the employment relationship, and should be read to require  
24 adequate funds to meet reasonable expectations of the employees. Participating cities cannot alter  
25 their funding obligation to CalPERS.

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26  
27 <sup>1</sup> CalPERS will hand deliver to the Court a courtesy complete copy of the PERL for the convenience  
28 of the Court.

1           31. For this reason, the City's obligations to CalPERS are not limited to those found in the  
2 language of the document labeled a "contract"; rather, the City's obligations are defined primarily by  
3 applicable State law and regulations.

4           32. As noted above, the City has two subplans, a Safety Plan, which covers the City's  
5 safety officers, and a Miscellaneous Plan, which covers all other City employees. As of June 30,  
6 2012, the Safety Plan had 486 active members, 152 transferred members, 101 terminated members,  
7 and 746 retired members and beneficiaries. Ex. 6. The City's contribution rate for the Safety Plan is  
8 34.605% for fiscal year 2013-2014 and 41.385% for fiscal year 2014-2015. Ex. 6. The Safety Plan  
9 was 68.9% funded as of June 30, 2012. Ex. 6.

10           33. For the Miscellaneous plan, as of June 30, 2012, there were 811 active members, 463  
11 transferred members, 505 terminated members, and 1,329 retired members. Ex. 7. The City's  
12 contribution rate for the Miscellaneous Ex. 7. Plan is 17.939% for fiscal year 2013-2014 and  
13 20.090% for fiscal year 2014-2015. Ex. 7. The Miscellaneous Plan was 73.8% funded as of June  
14 30, 2012. Ex. 7.

#### 15 **V. Application of Actuarial Concepts to Stockton**

16           34. Stockton's employer contribution rates are relatively high compared with other cities  
17 in part because of the significant reduction in employees by Stockton during the past few years.  
18 When layoffs occur, the contribution amount necessary to fund the unfunded liability remains  
19 basically unchanged as a result of the layoffs. Since contribution requirements are expressed as  
20 percentage of payroll, contribution rates will generally increase after layoffs even if there are no other  
21 changes and even if the amount due to pay off any unfunded liability has not changed.

22           35. Though Stockton's cost as a percentage of payroll has increased recently, almost all  
23 municipal employers have experienced the same effect. These recent increases in contribution rates  
24 that impacted all employers have been in large part the result of the 2008/2009 financial crisis and the  
25 significant losses in the CalPERS investment portfolio for 2008/2009.

26           36. Employer contribution rates are expected to continue to increase over the next 7 years  
27 for most employers at CalPERS as these employers are asked to contribute more toward the amount  
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1 of money needed to fund the unfunded liability that resulted from the 2008/2009 investment losses.  
2 The CalPERS Board determined that, because of the 2008/2009 losses, employers should retire the  
3 unfunded liability on a more accelerated basis. This policy decision has the effect of front loading  
4 the payments necessary to fund benefits such that contributions will increase and be higher than  
5 under the previous approved amortization policies for a period of about 25 years following which the  
6 contribution amounts will begin to decline and be lower than they would have been under the old  
7 amortization policies. Ex. 9 depicts the forecasted trend of contributions amounts over the next  
8 thirty years.

9 37. Stockton's valuation results are similar in volatility to those of other California  
10 municipalities. For all plans, volatility occurs when actuarial assumptions are not met. Volatility  
11 could come in the form of investment returns being higher or lower than expected and also in the  
12 form of members retiring earlier than anticipated, members living longer than assumed or members  
13 receiving larger salary increases than assumed. In any year, contribution requirements are as likely to  
14 either increase or decrease as a result of actual experience being different than assumed. If focusing  
15 on contribution *rates* instead of contribution amounts, hirings and layoffs, which are in the City's  
16 control, are a major driver of contribution rate volatility. Projected rates are based on payroll  
17 increasing at 3% per year. The rates included in the 2010 valuation were based on that assumption  
18 but, because payroll was lower a year later, CalPERS revised the rates upward to reflect the lower  
19 payroll and the higher rates necessary to generate the same amount of contributions toward the  
20 unfunded liability. The following year, the rates again increased to reflect the Board's changes to  
21 amortization. This year, CalPERS will once again revise the projected rates to reflect the change in  
22 actuarial assumptions adopted this February. It is not true that contribution rates constantly increase.  
23 Contribution rates have declined for various reasons over the years and going forward they are as  
24 likely to either increase or decrease from their current projected levels.

## 25 **VI. Termination**

26 38. The PERL allows for voluntary termination by a contracting agency and in certain  
27 circumstances, CalPERS may unilaterally terminate its relationship with a contracting agency. In the  
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1 event of termination, a terminated agency is required to make a payment to CalPERS in an amount  
2 determined by the CalPERS Board (based on actuarial information) to be sufficient to ensure  
3 payment of all vested pension rights of the terminated agency's employees accrued through the  
4 termination date ("Termination Payment"). The Termination Payment goes into the "Terminated  
5 Agency Pool." Once the Termination Payment is made, CalPERS has no further recourse to a  
6 terminating employer. If a terminated agency the size of the City fails to pay the Termination  
7 Payment, benefits may have to be reduced pro rata based on the amount of the Termination Payment  
8 that is not funded. Once the terminated agency's assets and liabilities have been merged into the  
9 Terminated Agency Pool, no further benefit adjustments are permitted under the PERL. As a result,  
10 the pool is subject to actuarial risk.

11 39. When determining the Termination Payment, CalPERS is subject to actuarial risks  
12 including longevity risk, investment risk, inflation and wage-growth risk associated with the future  
13 payment of the terminated agency's benefits. Ex. 10, (Dec. 2012 Agenda Item). Unlike in an  
14 ongoing plan, these risks cannot be addressed by adjusting contribution rates in future years. Because  
15 there is no mechanism for receiving additional payments should the actuarial assumptions not be met,  
16 the investments in the Terminated Agency Pool, and the assumptions to determine the Termination  
17 Payment, must be more conservative. To address the longevity risk, the Termination Payment  
18 calculation includes an increase to the liabilities to address mortality fluctuations. To address  
19 investment risk, inflation and wage-growth risk, the CalPERS Board has adopted a policy to  
20 determine the discount rate, inflation assumption and wage growth assumption for termination  
21 calculations. Ex. 11 (CalPERS Circular Letter No. 200-058-11 (August 19, 2011)); Ex. 12 (August  
22 2011 Agenda Item). In addition, the CalPERS Board recently adopted a conservative asset allocation  
23 for the Terminated Agency Pool, providing that assets will be invested in treasury bonds. Ex. 10  
24 (Dec. 2012 Agenda Item).

25 40. A primary driver in determining the amount of the Termination Payment is the setting  
26 of the discount rate, which is a reflection of the asset policy or how the assets are invested. Given the  
27 conservative nature of the investments in the Terminated Agency Pool, the discount rate related to a  
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1 Termination Payment is low when compared with the actuarial rate for the portfolio for ongoing  
2 participating agencies. The cumulative effect of these policies is that a terminated agency's actuarial  
3 liability upon termination is larger than the actuarial liability on an ongoing basis.<sup>2</sup>

4 41. Stockton's Annual Valuation Reports each provide a line item for "unfunded  
5 termination liability," which is an estimate of how much Stockton would owe to CalPERS if its  
6 contracts had been terminated as of *June 30, 2012*. The Miscellaneous Plan lists this unfunded  
7 termination liability at \$575,931,065 and the Safety Plan lists this unfunded termination liability at  
8 \$1,042,390,452, for a total of more than \$1.6 billion. Exs. 6 & 7, Safety Valuation Report at 28 &  
9 Miscellaneous Valuation Report at 28. If a terminated agency fails to pay the Termination Payment,  
10 benefits to employees must be reduced pro rata based on the amount of the Termination Payment that  
11 is not funded.<sup>3</sup> Cal. Gov. Code § 20577. CalPERS may reduce the benefits payable under the  
12 terminated contract only once. *Id.* After the terminated agency's assets and liabilities have been  
13 merged into the Terminated Agency Pool account, the PERL permits no further benefit adjustments.  
14 *Id.* § 20578.

15 42. When a plan is terminated, the PERL imposes a lien in favor of CalPERS "on the  
16 assets of a terminated contracting agency, subject only to a prior lien for wages." Cal. Gov. Code §  
17 20574. Legislative history confirms that this section immediately provides CalPERS with the rights  
18 of a senior secured creditor as a matter of law. The legislature expressly intended to "grant PERS a  
19 lien against the assets of public agencies who have terminated their membership in the system,  
20 usually as a result of agency dissolution and bankruptcy who have unfunded liabilities owed to PERS  
21 for vested employee benefits and have no ability to pay such liabilities." Ex. 13 at 35 (relevant  
22 portions of Legislative History of California Government Code § 20574).

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24 <sup>2</sup> Furthermore, a terminating agency owes CalPERS the costs of collection, including attorneys' fees.  
25 Cal. Gov. Code § 20574.

26 <sup>3</sup> CalPERS may choose to make no reduction or a lesser reduction if the CalPERS Board has made  
27 reasonable efforts to the collect the payment and the CalPERS Board determines that failure to make  
28 a reduction will not impact the actuarial soundness of the Terminated Agency Pool account. Cal.  
Gov. Code § 20577.5.

1           43.     If Stockton chose to terminate its relationship with CalPERS, the City would be faced  
2 with an immediately due and owing massive termination liability secured by a senior lien on all its  
3 assets. The estimated combined unfunded termination liability for both of the City's plans as of  
4 2012, net of the value of assets in the plans, is approximately \$1.6 billion, as more particularly  
5 described in paragraph 41 above.

6           44.     I have read the "Reply of Franklin High Yield Tax-Free Income Fund and Franklin  
7 California High Yield Municipal Fund to the CalPERS Brief Regarding Pension Liabilities  
8 (the "Reply"). The Reply argues that a large portion of a termination claim "would not be an allowed  
9 claim because it would exceed the City's actual pension liability." Reply, 9:4-5. That is not correct  
10 because, in a termination situation, the termination claim is the actual unfunded pension liability.  
11 The Reply misapprehends the meaning of actuarial liability and the difference between an ongoing  
12 plan and a terminated plan. In an ongoing plan, adjustments can be made to future contributions as  
13 the actuarial results differ from actuarial assumptions and as assumptions change over time. In a  
14 terminated plan, there are no future contributions and no ability to make adjustments. Consequently,  
15 the actuarial liability for a terminated plan is necessarily greater than the actuarial liability for an  
16 ongoing plan, and the unfunded actuarial liability on termination is the amount that would be needed  
17 to fully fund the plan because there will be no further contributions and would therefore be the  
18 amount of the claim.

19           45.     In a termination, CalPERS would continue benefits without reduction only if the  
20 Board were to find that benefit continuation will not impact the actuarial soundness of the Terminated  
21 Agency Pool. Cal. Gov. Code § 20577.5. As a result, because Stockton could not fund its shortfall  
22 following a hypothetical termination, in the event that Stockton did not fund a material amount of its  
23 contribution obligations, CalPERS would be required to reduce benefits before merging Stockton's  
24 assets into the Terminated Agency Pool.

25           46.     Further, if the City chooses to terminate its relationship with CalPERS, the City could  
26 not enter into a new relationship with CalPERS for at least three years from the date of termination.  
27 *Id.* § 20460. Although the City's existing employees that had benefits accrued as of the termination  
28

1 date in CalPERS would retain their benefits (albeit likely reduced dramatically), they would earn no  
2 additional benefits, and new employees would have no retirement system in which to participate.

### 3 **VII. Portability**

4 47. Generally, benefits accrued by an employee while working for one agency  
5 participating in CalPERS are portable should that employee move to another CalPERS participating  
6 employer. This is also true for employers who enjoy reciprocity with CalPERS. This means that  
7 benefits will continue to accrue uninterrupted when an employee transfers to another employer albeit  
8 under the benefits formulas and other ancillary benefits provided for under employment agreements  
9 for each employer during the time of service for that employer. Each agency will bear responsibility  
10 for payment for the benefits accrued during the service of the employee. For example, for an  
11 employee who works for Stockton for fifteen years and then works for the City of Davis for five  
12 years, the benefits will be funded by Stockton for the fifteen year period and by Davis for the five  
13 year period. If the Stockton plan were to be terminated, the benefits for Stockton employees would  
14 likely be reduced for the period of their service with Stockton if Stockton failed to pay a substantial  
15 portion of its termination liability. For employees that transfer to another employer that was also part  
16 of the CalPERS system, they would continue to accrue benefits that would not be subject to reduction  
17 on account of the termination of the Stockton plans.

### 18 **VIII. Policy Reasons for Enforcing the State's Strict Requirements for Timely Employer** 19 **Contributions**

20 48. CalPERS' principal responsibility is to maintain the integrity of the California Public  
21 Employees' Retirement System. The ability of the sponsor of a defined benefit pension plan to  
22 maintain an orderly and reliable schedule of benefit payments is the principal factor in providing  
23 benefit security for retirees and in the maintenance of an actuarially sound plan. If a City like  
24 Stockton does not timely make its required payments, the actuarial soundness of the fund will be  
25 negatively impacted. The actuarial calculations are premised on the assumption that contributions  
26 will be made when required and invested when made. When contributions are delayed beyond the  
27 required date, the plan falls out of actuarial balance and actuarial soundness is put in jeopardy. By  
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1 not making timely contributions, the asset base is not being increased as projected while at the same  
2 time, the liabilities are continuing to increase as employees continue to earn service credit. No  
3 contracting agency can be allowed to unilaterally determine when and how much it will contribute to  
4 fulfill its obligations to the retirement system. Allowing such a unilateral modification of  
5 contribution obligations threatens the integrity of the retirement systems and the interests of the State  
6 of California in the administration of benefits for its public servants.

7 I declare under penalty of perjury under the laws of the United States of America that  
8 the foregoing is true and correct.

9 Executed at Davis, California on April 23, 2014.

10 By:   
11 David Lamoureux

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