Sacramento County
SCERS
Employees' Retirement System

**ITEM 11**

Executive Staff
Richard Stensrud
Chief Executive Officer
Jeffrey W. States
Chief Investment Officer
John W. Gobel, Sr.
Chief Benefits Officer
Kathryn T. Regalia
Chief Operations Officer

**For Agenda of:**
June 15, 2006

June 8, 2006

**TO:** President and Members
Board of Retirement

**FROM:** Richard Stensrud
Chief Executive Officer

**SUBJECT:** Methodology Used to Determine Retiree COLA

As you know, over the last couple of years, questions have arisen regarding retiree cost-of-living adjustments (COLAs). The questions fall into two basic categories: (1) Why are the recent retiree COLAs lower than the COLAs or Consumer Price Index (CPI) changes seen in other areas; and (2) What, if anything, can be done to make the determination of the COLA easier to understand. The purpose of this Memorandum, and the materials attached hereto, is to provide your Board with information on these matters so that your Board can determine whether any changes should be made in the methodology used to determine the annual retiree COLA.

The first two attachments provide an overview of the methodology used to determine the COLA and an explanation of how the COLA effective April 1, 2006 was calculated. Those materials are: (1) A Memorandum dated February 9, 2006 recommending adoption of the COLA as calculated by The Segal Company; and (2) An Important Notice from SCERS' website regarding the COLA effective April 1, 2006. Among other things, those materials note that Section 31870 of the 1937 Act places certain limitations on how the COLA is determined for SCERS retirees that are different from the rules or practices used to determine the annual COLA for active employees. The materials also note that there are limited ways in which the methodology for calculating the COLA can be modified or simplified.

The next two attachments provide information regarding the impact of changing one of the two possible variables in the calculation of the COLA – i.e., shifting from SCERS' long-standing practice of determining the year-to-year change in the CPI by comparing the annual average CPI for the two years, to comparing the year-end CPIs for the years in question. Those materials – an e-mail message to your Board dated May 17, 2006 and a letter from The Segal Company dated May 11, 2006 – explain that there is no material difference in the COLAs generated by the two approaches and any incremental advantage of one method over the other varies and changes based on the period measured. Accordingly, unless your Board believes that changing the method of comparison would make the calculation of the COLA easier to understand, I recommend that your Board continue to utilize the annual average CPI as it 'smoothes' the intra-year volatility in the CPI.

The last set of attachments provide information regarding the impact of changing the other possible variable in the calculation of the COLA – i.e., the particular CPI used in making the year-to-year comparison.

Historically, SCERS has used the U.S. Department of Labor Bureau of Labor Statistics CPI for All Urban Consumers for the San Francisco-Oakland-San Jose area in making the calculation. This is based on the language in Section 31870 which states that the relevant CPI shall be the Bureau of Labor Statistics CPI for All Urban Consumers "... for the area in which the county seat is situated ...." Since the Bureau of Labor Statistics does not determine a CPI specific to the Sacramento area, the logic has been that the appropriate CPI should be the one for the San Francisco-Oakland-San Jose area as it is the nearest and most comparable urban area to Sacramento. Implicit in this rationale is the assumption that the San Francisco-Oakland-San Jose CPI would better reflect cost-of-living in Sacramento than a broader geographic region like the West Region CPI which includes data from all the western states, north to south, starting with Colorado. Further implicit in this rationale is that the cost-of-living in the San Francisco-Oakland-San Jose area – and in Sacramento – would generally run higher than the cost-of-living in the broad West Region.

SCERS' interpretation and application of the language in Section 31870 is the same as that utilized by the other 1937 Act systems. San Diego CERA uses the CPI for the San Diego area. LACERA, San Bernardino CERA, Orange CERS and Santa Barbara CERA utilize the Los Angeles-Anaheim-Riverside CPI. However, so does Kern CERA and Tulare CERA. San Mateo CERA, Alameda CERA, Contra Costa CERA and Marin CERA use the San Francisco-Oakland-San Jose CPI. However, so does San Joaquin CERA, Stanislaus CERA, Merced CERA, Fresno CERA, Sonoma CERA and Mendocino CERA. Only Imperial CERA uses the West Region CPI, which is arguably a better match to the economic setting of Imperial County.

The last set of attached materials show that the economic assumptions behind SCERS' use of the San Francisco-Oakland-San Jose CPI rather than the broad West Region CPI have been valid and that for the last twenty years use of the San Francisco-Oakland-San Jose CPI has been more beneficial to SCERS retirees than if the West Region CPI had been used.

The first table shows the year-by-year annual COLA that would have been produced under the two CPIs over the last twenty years. These COLA numbers are absolute actual COLA numbers and do not reflect what a retiree would have received under his/her respective tier COLA cap (but recall that any COLA in excess of the cap is 'banked' for future use). As with the analysis of shifting from comparing the annual average CPIs to comparing the year-end CPIs, the difference between the two indices is not enormous, and the method that produces the higher COLA varies depending on the period being measured. However, over the full twenty year period, the cumulative COLA from the San Francisco-Oakland-San Jose area CPI was larger than the cumulative COLA that would have been produced by the West Region CPI.

The second table shows the actual absolute COLA numbers for the period rounded to the nearest one-half percent as required by Section 31870. It shows that as the COLA would have actually been determined, there were more 'winning' years than 'losing' years under the San Francisco-Oakland-San Jose CPI. In addition, the cumulative advantage of the San Francisco-Oakland-San Jose CPI increased slightly.

The last attachment shows the year-by-year data in graph form.

In sum, while SCERS retirees might rightfully point out that they would have done better in the last few years under the West Region CPI, it should also be noted that SCERS retirees did substantially better from 1997 through 2001 under the San Francisco-Oakland-San Jose CPI. The data also clearly illustrates that totally apart from the policy issues raised by such a practice, it is as problematic to try to 'CPI-time' as it is to 'market-time.' Accordingly, unless your Board believes that the economic assumptions implicit in the use of the San Francisco-Oakland-San Jose CPI are no longer valid, then I recommend that your Board continue to utilize that index.

A final note in this regard: While a comparison of the nation-wide, all-city CPI to the San Francisco-Oakland-San Jose and West Region CPIs for the last three years shows that the COLA would have been higher under the nation-wide index than the other two indices, over the twenty year period the cumulative COLA under the nation-wide index was lower than both the San Francisco-Oakland-San Jose CPI and the West Region CPI.

I hope this information is helpful. I will be happy to answer any questions you might have.

Respectfully,

Richard Stensrud
Chief Executive Officer

Attachments

Sacramento County
SCERS
Employees' Retirement System

Executive Staff
Richard Stensrud
Chief Executive Officer
Jeffrey W. States
Chief Investment Officer
John W. Gobel, Sr.
Chief Benefits Officer
Kathryn T. Regalia
Chief Operations Officer

**For Agenda of:**
February 16, 2006

February 9, 2006

**TO:** President and Members
Board of Retirement

**FROM:** Richard Stensrud
Chief Executive Officer

**SUBJECT:** April 1, 2006 Retirement Allowance COLA

## Recommendation:

Adopt the cost-of-living adjustments (COLA), effective April 1, 2006, for SCERS retirement allowance payments as determined by and set forth in the attached materials from The Segal Company.

## Background:

Under Section 31870 of the County Employees' Retirement Law (1937 Act), each year the SCERS Board must determine the appropriate COLA for SCERS retirement benefits and implement that COLA on April 1st. Pursuant to the law, the appropriate COLA is based on the annual change in the U.S. Department of Labor, Bureau of Labor Statistics Consumer Price Index (CPI) for the San Francisco-Oakland-San Jose area. The law requires that this change be rounded to the nearest one-half percent. The actual COLA that a person receives is dependent upon the individual's tier and date of retirement, and includes consideration of whether the individual has any accumulated carry-over in his/her 'COLA Bank.'

## Discussion:

As stated in the correspondence from The Segal Company, comparison of the past two annual average CPIs for the relevant region shows an increase of 1.96%, resulting in a base COLA of 2% when rounded to the nearest one-half percent. The actual COLAs by tier and retirement date are set forth in the materials attached to the actuary's letter.

Please note that determination of the COLA is not based on a comparison of the December 2004 CPI to the December 2005 CPI, but rather, the COLA is based on a comparison of the average annual CPI for the years in question. Also, please note that determination of the COLA is not based on simple subtraction of the average annual CPI for 2004 from the average annual CPI for 2005, but rather, the COLA is based on the ratio of the two average annual CPIs. This allows for determination of the percentage change from the preceding year as opposed to a percentage change from the original 'base' period used in determining the average annual CPI (the base period is 1982-1984). Put another way, via the ratio, 2004 becomes the base year for measuring the cost-of-living increase.

This methodology – which SCERS has consistently utilized in determining the COLA – can sometimes result in confusion for people who mistakenly think the COLA is determined through a December to December comparison or by simple subtraction. Confusion can also result if there is a difference between the retirement allowance COLA and the salary COLA for active employees. Accordingly, as was done last year, an explanation of how the retirement allowance COLA is determined has been put on the SCERS website, and can be reached via the 'Important Notices' link. A copy of the SCERS website explanatory information is attached to this Memorandum. Also attached is a copy of the Department of Labor, Bureau of Labor Statistics web page that shows graphically and in table form the annual average CPI numbers for the last five years, along with the one-year percentage change in the annual average CPI for those years. This document is accessible via a link in the SCERS website COLA explanation page. The notice that is sent to payees with the April payment informing them of the COLA encourages people to refer to the SCERS website if they have questions. Hopefully these materials will help SCERS members understand how the retirement allowance COLA was determined and why the salary COLA for active employees might be different.

Please let me know if you have any questions.

Respectfully,

Richard Stensrud,
Chief Executive Officer

SCERS Employees' Retirement System

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# IMPORTANT NOTICES

## Information About The Retiree COLA

### Inquire about the availability of documents in alternate formats.

The retiree cost-of-living adjustment (COLA) is governed by Section 31870 of the County Employees ' Retirement Law of 1937 (1937 Act). Under that section, the SCERS Board must determine the appropriate COLA for SCERS retirement benefits and implement that COLA on April 1st each year. Pursuant to the law, the COLA is based on the annual change in the U.S. Department of Labor, Bureau of Labor Statistics Consumer Price Index (CPI) for All Urban Consumers for the San Francisco-Oakland-San Jose area. The law requires that this change be rounded to the nearest one-half percent.

SCERS' actuary performs the calculation of the cost-of-living increase. In making this calculation, the actuary compares the **average annual CPI** for the calendar year just ended with the average annual CPI for the preceding calendar year, and **not** the **end-of-year CPI** for the two years. Thus, to determine the COLA effective April 1, 2006 , the actuary compared the average annual CPI for 2004 and 2005 , not the December 2004 CPI compared to the December 2005 CPI. The average annual CPI is often slightly different than the year-end CPI, but over time the two measures produce virtually identical results.

Determination of the COLA is not based on simple subtraction of the average annual CPI for 2004 from the average annual CPI for 2005 . Instead, the COLA is based on the ratio of the two average annual CPIs. This is done because the actual CPI number is a measure of how much consumer prices have changed relative to a designated 'base period' (the current base period is 1982-1984). In order to measure the amount of change from year to year, as opposed to the amount of change from the base period, the actuary must use the ratio of the two average annual CPI numbers. Put another way, via the ratio, 2004 becomes the base year for measuring the increase in the cost-of-living in 2005 .

The U.S. Department of Labor statistics on cost-of-living for the San Francisco-Oakland-San Jose area can be found here PDF. The chart on that page shows that the average annual CPI for 2004 was 198.8 and the average annual CPI for 2005 was 202.7. The ratio of these two annual average CPIs shows an increase of 1.0196% from 2004 to 2005 . This results in a base COLA of 2% when rounded to the nearest one-half percent, as required by the law.

The actual COLA that a person receives is dependent upon the individual's tier and date of retirement, and includes consideration of whether the individual has any accumulated carry-over in his/her 'COLA Bank.' A person accumulates a balance in his/her COLA Bank if the actual cost-of-living increase for a year is greater than the maximum annual COLA authorized for the person's tier by the 1937 Act. For example, the maximum annual COLA for a Tier 3 Miscellaneous member is 2%. If the actual cost-of-living increase for the year was 3%, the Tier 3 member would get a 2% COLA and accumulate 1% in his/her COLA Bank. The balance in the COLA Bank would then be applied the next time the actual cost-of-living increase for the year was less than the annual maximum COLA. Accordingly, if the actual cost-of-living increase the next year was 1%, SCERS would add the 1% balance in the COLA Bank to the 1% COLA for the year, resulting in a total COLA of 2%. The balance in the COLA Bank would be reduced to zero.

Because of accumulated balances in their COLA Banks, Tier 1 members (both Safety and Miscellaneous) who retired prior to March 31, 1981 received a COLA of 4% effective April 1, 2006.

The determination of the retirement benefit COLA is separate and apart from the determination of any salary cost-of-living increase for active employees. The retirement benefit COLA is determined by the SCERS Board, while a salary adjustment for active employees is determined by the Board of Supervisors. In addition, determination of the salary adjustment for active employees is not controlled by the 1937 Act and thus can be based on different cost-of-living benchmarks, which can result in a larger salary adjustment than the retirement benefit COLA.

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## Stensrud. Richard

**From:** Stensrud. Richard

**Sent:** Wednesday, May 17, 2006 3:50 PM

**To:** 'Bill Cox'; 'Bill Johnson'; 'Dave Irish'; 'James Diepenbrock'; 'John Kelly'; 'Keith Devore'; 'Nancy Wolford-Landers'; 'Robert Woods'; 'Ron Suter'; 'Steve Soto'; 'Winston Hickox'

**Cc:** Regalia. Kathy; Gobel. John; Likarich. Suzanne; States. Jeff; Craig. Florence; Bach. Michele

**Subject:** Segal Analysis of Possible CPI Change for Retiree COLA

**Attachments:** Segal Letter Regarding CPI Used to Set COLA 5-17-06.pdf

You will recall that at a recent Board Meeting there was discussion regarding what, if anything, could be done to make the determination of the retiree COLA easier to understand. I explained at that time that unfortunately our options for computing the COLA are very limited and do not simplify the calculation very much. Specifically, the 1937 Act states that the COLA is to be determined based on "... the percentage of annual increase or decrease in the cost of living as of January 1st of each year as shown by the then current Bureau of Labor Statistics (BLS) Consumer Price Index (CPI) for All Urban Consumers for the area in which the county seat is situated ... ." Accordingly, we are required to use the BLS All Urban Consumers Index, rather than some other index, and the relevant 'area' has to be the Bay Area and not an area of regional or national scope. And, as we have previously explained, to determine the percentage change from one year to the next, the calculation requires use of a ratio and not simple subtraction.

It appears that the only variable is whether we compare the annual average CPIs or the year-end CPIs. As you will recall, the long-standing SCERS practice has been to compare the annual average CPI in a year to the annual average CPI of the following year to determine the percentage change over the period. The annual average CPI 'smooths' CPI volatility over the year and is beneficial to the retiree if the CPI is declining later in the year. By contrast, the year-end CPI places less emphasis on what has happened during the year but can be beneficial to the retiree if the year ends on a high inflation note. You may further recall, however, that I reported that the actuary had advised me that he believed the two methods yielded virtually the same total COLA over time.

At your request, I asked Segal to provide us with an analysis of the outcome under the two methods. I also asked them to advise us if changing from the annual average to the year-end method would result in any transition adjustment or change in the actuarial COLA assumption. Attached for your review and consideration is Segal's response.

As you will see, Segal analyzed the annual COLA that would have been applied under the two methods and how the base benefit would have changed over two time periods – first, for a retiree who retired ten years ago and then for a retiree who retired twenty years ago. In both cases, the retiree's starting base benefit was $24,000.

For the ten year retiree, the annual average CPI method produced $247.36 more in total benefits than the year-end method. Please note that this difference is relative to total benefit payments to the retiree of more than $279,000 during the period.

Interestingly, for the twenty year retiree, the year-end CPI method was more advantageous. Specifically, it produced $559.53 more in total benefits over the period. Again, however, please note that this difference is relative to more than $675,000 in total benefits paid to the retiree in the period.

Based on this data, I think it is fair to say that (1) the choice of CPI method does not make a material difference in the COLA received; and (2) any incremental advantage of one method over the other varies based on the period measured. Segal's conclusions that changing the method would not cause a transition adjustment or change the actuarial COLA assumption are consistent with this view.

With no material difference in the benefits received under the two methods, the question becomes whether your Board believes that changing the method would make the COLA any easier to understand and whether there is any value in changing the method based on that reason. In that regard, I would note that Segal reports that to the best of their recollection no 1937 Act client has ever changed methods.

I look forward to your thoughts.

Thanks.

Richard

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MAY 15 2006
SCERS

May 11, 2006

Mr. Richard Stensrud
Chief Executive Officer
Sacramento County Employees' Retirement System
980 9th Street, Suite 1800
Sacramento, CA 95814

**Re: Sacramento County Employees' Retirement System**
**CPI Basis for Annual Retiree COLA Adjustments**

Dear Richard:

We understand that the SCERS Board is considering a modification to the Consumer Price Index (CPI) basis currently used to determine annual retiree COLA adjustments. Currently the Board measures the change in an annual CPI measure from year to year as opposed to a December to December change. We have some 1937 Act clients who use the annual index method and some who use the December index method, so presumably the choice is subject to Board policy.

This letter addresses only the benefit and actuarial impacts of using one basis versus the other, and the numerical considerations of changing bases. It does not address any of the legal implications of making a change. Your legal counsel should examine that perspective.

**Benefit Impact**

To determine the benefit impact of using one basis versus the other, we compared the annual COLA benefits of a theoretical member who retired with a $24,000 annual basic benefit either 10 or 20 years ago as provided in Attachment A. In some years it was the annual index method that gave a higher benefit and in some years it was the December index method. The biggest difference in any year's annual benefit (for the 20-year retiree) was about $625, but the great majority of years exhibited a difference of under $200.

If the retiree retired 10 years ago, the annual index method would have yielded a slightly higher total cash benefit paid over that 10-year period of about $247. If the retiree retired 20 years ago, the December index method would have yielded a slightly higher total cash benefit paid over that 20 year period of about $560. Our conclusion is that the two methods are numerically equivalent as to their long-term benefit impacts.

**Transition Year**

If the Board were to decide to change to the December index basis for the April 1, 2007 COLA increase, that increase would be based entirely on the increase from the December 2005 index to the December 2006 index. There should be no transition adjustment.

**Actuarial Valuation Impact**

The COLA assumption in the actuarial valuation would be unchanged if this policy change were to occur. As a result, there should be no impact on contribution rates.

Please let us know if you have any questions or require additional information.

Sincerely,

Andy Yeung

Andy Yeung, ASA, MAAA
Associate Actuary

DZJ/dvb

cc: Kathryn T. Regalia, CPA

## Attachment A – Comparison of Cash Benefits Paid Under Annual Index and December Index Methods

### Tier 1 Member Who Retired 10 Years Ago

| | Benefit Paid Using | | |
|---|---|---|---|
| Year Beginning April 1 | Annual CPI Method<br>(1) | December CPI Method<br>(2) | (1) - (2) |
| 1996 | $24,000.00 | $24,000.00 | $0.00 |
| 1997 | $24,840.00 | $24,960.00 | ($120.00) |
| 1998 | $25,585.20 | $25,708.80 | ($123.60) |
| 1999 | $26,608.61 | $26,737.15 | ($128.54) |
| 2000 | $27,672.95 | $27,806.64 | ($133.69) |
| 2001 | $28,779.87 | $28,918.91 | ($139.04) |
| 2002 | $29,787.17 | $29,641.88 | $145.29 |
| 2003 | $30,382.91 | $29,938.30 | $444.61 |
| 2004 | $30,686.74 | $30,537.07 | $149.67 |
| 2005 | $31,300.47 | $31,147.81 | $152.66 |
| Total | $279,643.92 | $279,396.56 | $247.36 |

### Tier 1 Member Who Retired 20 Years Ago

| | Benefit Paid Using | | |
|---|---|---|---|
| Year Beginning April 1 | Annual CPI Method<br>(1) | December CPI Method<br>(2) | (1) - (2) |
| 1986 | $24,000.00 | $24,000.00 | $0.00 |
| 1987 | $24,840.00 | $24,960.00 | ($120.00) |
| 1988 | $25,833.60 | $25,958.40 | ($124.80) |
| 1989 | $26,866.94 | $26,996.74 | ($129.80) |
| 1990 | $27,941.62 | $28,076.61 | ($134.99) |
| 1991 | $29,059.28 | $29,199.67 | ($140.39) |
| 1992 | $30,221.65 | $30,367.66 | ($146.01) |
| 1993 | $31,430.52 | $31,582.37 | ($151.85) |
| 1994 | $32,059.13 | $32,056.11 | $3.02 |
| 1995 | $32,700.31 | $32,697.23 | $3.08 |
| 1996 | $33,517.82 | $33,514.66 | $3.16 |
| 1997 | $34,690.94 | $34,855.25 | ($164.31) |
| 1998 | $35,731.67 | $35,900.91 | ($169.24) |
| 1999 | $37,160.94 | $37,336.95 | ($176.01) |
| 2000 | $38,647.38 | $38,830.43 | ($183.05) |
| 2001 | $40,193.28 | $40,383.65 | ($190.37) |
| 2002 | $41,600.04 | $41,393.24 | $206.80 |
| 2003 | $42,432.04 | $41,807.17 | $624.87 |
| 2004 | $42,856.36 | $42,643.31 | $213.05 |
| 2005 | $43,713.49 | $43,496.18 | $217.31 |
| Total | $675,497.01 | $676,056.54 | ($559.53) |

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|  | 12 Months Percent Change |  |  |
|---|---|---|---|
|  | San Francisco | Western Urban |  |
| Year | Area | Area | Difference |
| 1986 | 3.0 | 2.3 | 0.7 |
| 1987 | 3.4 | 3.4 | - |
| 1988 | 4.4 | 4.1 | 0.3 |
| 1989 | 4.9 | 4.7 | 0.2 |
| 1990 | 4.5 | 5.5 | (1.0) |
| 1991 | 4.4 | 4.4 | - |
| 1992 | 3.3 | 3.4 | (0.1) |
| 1993 | 2.7 | 3.0 | (0.3) |
| 1994 | 1.6 | 2.3 | (0.7) |
| 1995 | 2.0 | 2.6 | (0.6) |
| 1996 | 2.3 | 2.7 | (0.4) |
| 1997 | 3.4 | 2.4 | 1.0 |
| 1998 | 3.2 | 1.9 | 1.3 |
| 1999 | 4.2 | 2.7 | 1.5 |
| 2000 | 4.5 | 3.5 | 1.0 |
| 2001 | 5.4 | 3.7 | 1.7 |
| 2002 | 1.6 | 1.9 | (0.3) |
| 2003 | 1.8 | 2.1 | (0.3) |
| 2004 | 1.2 | 2.3 | (1.1) |
| 2005 | 2.0 | 3.1 | (1.1) |
| Total | 63.8 | 62.0 | 1.8 |

|  | 12 Months Percent Change (After Rounding) |  |  |
|---|---|---|---|
|  | San Francisco | Western Urban |  |
| Year | Area | Area | Difference |
| 1986 | 3.0 | 2.5 | 0.5 |
| 1987 | 3.5 | 3.5 | - |
| 1988 | 4.5 | 4.0 | 0.5 |
| 1989 | 5.0 | 4.5 | 0.5 |
| 1990 | 4.5 | 5.5 | (1.0) |
| 1991 | 4.5 | 4.5 | - |
| 1992 | 3.5 | 3.5 | - |
| 1993 | 2.5 | 3.0 | (0.5) |
| 1994 | 1.5 | 2.5 | (1.0) |
| 1995 | 2.0 | 2.5 | (0.5) |
| 1996 | 2.5 | 2.5 | - |
| 1997 | 3.5 | 2.5 | 1.0 |
| 1998 | 3.0 | 2.0 | 1.0 |
| 1999 | 4.0 | 2.5 | 1.5 |
| 2000 | 4.5 | 3.5 | 1.0 |
| 2001 | 5.5 | 3.5 | 2.0 |
| 2002 | 1.5 | 2.0 | (0.5) |
| 2003 | 2.0 | 2.0 | - |
| 2004 | 1.0 | 2.5 | (1.5) |
| 2005 | 2.0 | 3.0 | (1.0) |
| Total | 64.0 | 62.0 | 2.0 |

## 20 Year Consumer Price Index Change