2016 Trends in Labor Relations

League of California Cities

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Long Beach, California

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Speakers

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Agenda

- Local Government Context
- Trends and Emerging Issues
  - Wages
  - Leave
  - Retirement benefits
  - Health benefits
- Strategies for 2016 and beyond

Local Government Context

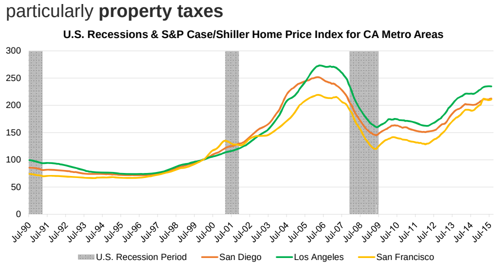
Different Perspectives

- **Labor perspective**
  - Out of recession; Economy is strong
  - Good revenue growth & public support for new revenue measures leaning positive
  - Expectations are high that City will give something
- **Management perspective**
  - Yes, things look better in the short-term; 3-5 years out much more difficult to assess
  - Structural challenges persist; Sense that we didn't really address underlying problems
  - Other unmet needs?
  - Service-level erosion
  - Costs are triggering re-evaluation of service provision models

Home Values Rising

Property Tax Revenues Strong in 2016

- Growth in home prices over the last several years has contributed to robust growth in state and local revenues – particularly **property taxes**



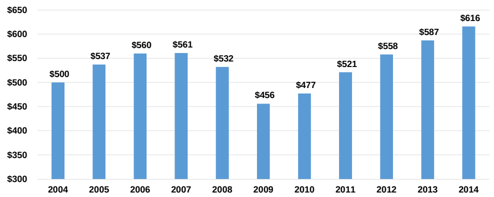
Source: S&P/Case-Shiller Home Price Index, SF & LA Regions

Sales Taxes

Revenues Show Robust Localized Economic Activity

- State and local government sales tax receipts continue to show strength (California data shown in chart)
  - From 2009 (post-recession trough) through 2014 (most recent full-year data), compound average growth rate of **6.2%**

California State & Local Sales Tax Receipts (Millions of $)



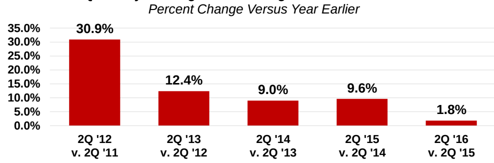
Source: California State Board of Equalization, Table 2. Taxable Sales

Downward Trend in Auto Sales

Substantial Uncertainty in Near-Term

- While the number of new vehicle registrations grew year-over-year in 2016 (1.8%), the rate of growth is significantly less than prior years
  - A slow down in auto sales could have a relatively quick and potentially severe financial impact on sales tax revenues for California cities

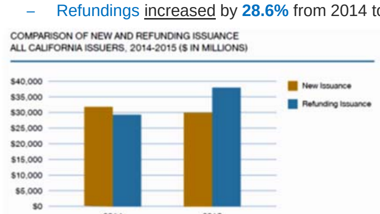
Quarterly New Light Vehicle Registrations in California
Percent Change Versus Year Earlier



Source: California Auto Outlook, August 2016, California New Car Dealers Association

Infrastructure Investment Lags

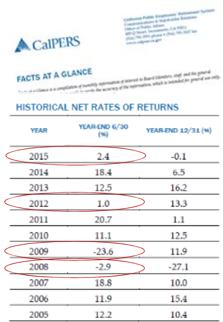
- There's a significant need to upgrade infrastructure throughout the state. However, revenues to support new debt service are scarce and political backing for infrastructure investment appears to be waning despite low interest rate environment
  - **New money** issuances decreased by **6.5%** from 2014 to 2015
  - Refundings increased by **28.6%** from 2014 to 2015



Source: California Debt and Investment Advisory Commission, 2015 Annual Report, June 9, 2016

Pension Costs Continue to Escalate

- Pension costs continue to rise driven by…
  - …lingering effects of market downturn
  - …investment volatility in current asset allocation (2.4% return in FY15; **0.61% return in FY2016**)
  - …actuarial methodology changes
  - …mortality improvements
  - …risk mitigation policy that will reduce (slowly!) the discount rate from 7.5% to 6.5%


CalPERS

FACTS AT A GLANCE

HISTORICAL NET RATES OF RETURNS

YEAR	YEAR-END 6/30 (%)	YEAR-END 12/31 (%)
2015	2.4	-0.1
2014	18.4	6.5
2013	12.5	16.2
2012	1.0	13.3
2011	20.7	1.1
2010	11.1	12.5
2009	-23.6	11.9
2008	-2.9	-27.1
2007	18.8	10.0
2006	11.9	15.4
2005	12.2	10.4

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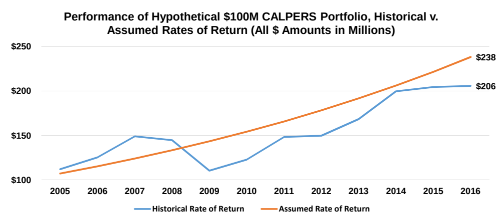
Volatility in CALPERS Rate of Return

- Over the last 10 years, growth in CALPERS investments has not achieved the actuarial expectation of 7.5%
- Volatility has a significant effect on CALPERS funding level and employer pension costs



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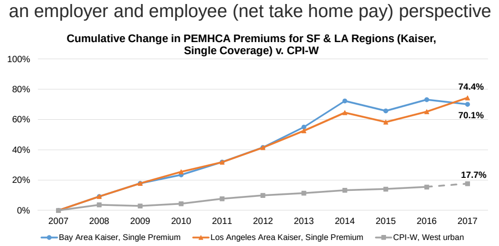
Healthcare Costs on the Rise

- Monthly healthcare premiums continue to rise at rates that outpace general measures of inflation and state and local government revenues. Need to look at affordability from both an employer and employee (net take home pay) perspective



Source: Historical PEMHCA Premiums, Kaiser HMO for Single Coverage; US BLS, Consumer Prices (2.5% Forecast Increase for 2017)

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Other-Post Employment Benefit Trends

- Similar to the Statements 67 & 68 for pensions, GASB Statement's 74 & 75 will change the way that public employers report OPEB liabilities in their financial statements
- Public employers continue to struggle with pre-funding retiree healthcare costs, and many have large unfunded liabilities
- CalPERS agencies seek to establish new tiers, moving new hires to PEMHCA minimum ($125/month in 2016)

Most legal battles concerning vesting of retiree health benefits have been fought. While need to look at vesting on case-by-case basis, in general, retiree health is not likely a vested benefit for PEMHCA participating agencies

Public Employee Labor Trends in 2016

Wages
What are Unions seeking?

- Increased pressure from labor unions for cost-of-living increases that outpace general measures of inflation
  - Similar to pre-recessionary period when hefty wage increases were more common though certainly not mainstream (2.0% to 4.0% range)
  - Attempting to "make up" for wage cuts/stagnation during recession
- Labor unions are also seeking longer-term contracts (3 or more years)
  - How do we incorporate into our long-range financial forecast to assess affordability and sustainability?
  - How certain are we that revenue/expense assumptions will be achieved?

Wage Trend Summary

- In general, public agencies in the highest-performing economic areas are targeting wage increases in the 2.0% - 4.0% range, though there are regional variations (Central Valley and Central Coast, for example) where more moderated wage growth is still the norm
- Inflation expectations remains low for duration of 2016 and are forecast to be moderate in 2017 and 2018…

Inflation Forecast (National)

	2016 Avg	2017 Avg	2018 Avg	2016 – 2020 5-Yr Avg	2016 – 2025 10-Yr Avg
Inflation Forecast (%)	1.6%	2.3%	2.3%	2.1%	2.15%

Source: Third Quarter 2016 Survey of Professional Forecasters, August 12, 2016

Market Drift for Firefighters
San Jose–San Francisco–Oakland CSA

	Contract Term	FY2015-16	FY2016-17	FY2017-18	FY2018-19
San Francisco	7/1/07 - 6/30/18	1.00% (7/1/15)	2.00% (7/1/16)	2.00% (7/1/17)	TBD
Vacaville	7/1/15 - 6/30/18	2.15% (9/1/15)	1.50% - 4.00% (1/1/17)*	1.50% - 4.00% (1/1/18)	TBD
Tracy	7/1/15 - 6/30/18	2.00% (1/1/16)	3.00% (7/1/16)	4.00% (7/1/17)	TBD
Manteca	7/1/15 - 6/30/19	2.50% (1/1/16)	2.00% (1/1/17)	2.00% (1/1/18)	2.00% (7/1/18)
Palo Alto	7/1/15 - 6/30/19	2.50% + 5.00% market adjustment (4/11/16)	2.50% + 8.00% market adjustment (6/30/16)	2.50% (6/30/17) + 2.50%** (12/31/17)	TBD
Santa Cruz	9/26/15 - 9/20/19	0.00%	0.00%	0.00%	1.85% (7/14/18)
Gilroy	7/1/16 - 6/30/18	2.00% (7/1/15)	3.00% (7/1/16)	3.00% (7/1/17)	TBD

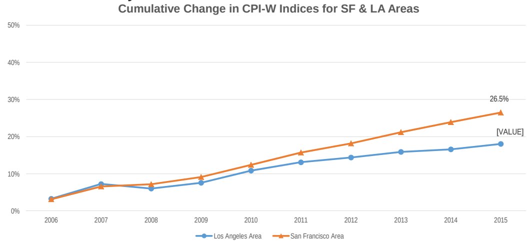
Notes:
* Adjustment dependent on city revenue increases.
** Adjustment dependent on results of compensation survey.

Market Drift for Firefighters
Los Angeles–Long Beach CSA

	Contract Term	FY2015-16	FY2016-17	FY2017-18	FY2018-19
Anaheim	7/1/15 - 6/29/17	4.00% (11/23/15)	2.00% (6/17/16)	4.00% (6/16/17)	TBD
Glendale	9/1/15 - 6/30/18	3.50% (7/1/15)	0.00%	3.50% (7/1/17)	TBD
Ontario	7/1/14 - 6/30/18	5.00% (7/12/15)	5.50% (7/10/16)	4.00% (7/9/17)	TBD
Corona	7/1/07 - 6/30/17	3.00% (7/1/15)	4.00% (7/1/16)	TBD	TBD
Fullerton	7/1/15 - 6/30/17	5.00% (7/4/15)	4.00% (7/2/16)	TBD	TBD
Orange	7/1/15 - 6/30/17	3.00% (11/1/15)	3.00% (8/9/16)	TBD	TBD
Newport Beach	7/1/15 - 12/31/18	2.75% (7/1/15) + 2.75% (1/1/16)	2.75% (1/1/17)	2.75% (1/1/18)	TBD
Hemet	7/1/15 - 6/30/18	0.00%	0.00%	0.00%	TBD
Redlands	7/1/15 - 6/30/17	3.00% (7/1/15)	3.00% (7/1/16)	TBD	TBD

CPI-W for SF and LA Regions
10-Year Look-Back

- Since recession, San Francisco metro area has outpaced Los Angeles in cost of living for urban wage earners, significantly so since recovery



Source: BLS Not Seasonally Adjusted CPI, Urban Wage Earners and Clerical Workers, Base 1982-84=100

Market Drift Different for Different Jobs

- Recruitment and retention problems can cause wage increases much larger than inflation
- Keep in mind different demand patterns for different labor markets. In Modesto:
  - Firefighter hiring
    - 2015: 232 applicants screened, hired 0; 524 lateral applicants, hired 8 (1.53%)
  - Police hiring
    - 2015: 2,200 applicants screened, 39 hired (1.77%); 240 lateral applicants, 3 hired (1.25%)
    - 2016 (YTD) 1221 applicants screened, 19 hired (1.56%); 162 lateral applicants, hired 1 (0.62%)

Compensation Studies

- Most compensation studies are unsophisticated and easily misinterpreted
  - Need to inquire as to the value of studies, squarely address purpose of study, and seek clarity on how agency will use the results
  - Studies don’t paint complete picture of compensation and often ignore “value” of pension and Other Post-Employment Benefits (OPEB) despite the high cost of these benefits to employers
- Market disparities in compensation studies result largely from selection of comparable agencies
  - Unions typically advocate for inclusion of known high payers in a market study…and management responds with low payers

Compensation Studies

– Rational Compensation Study Criteria
  - Analyze rational labor market criteria and re-evaluate competitors on a regular basis
    - ➢ [Examples]
  - Total Compensation rather than wages
    - ➢ Benefits must be costed and valued
    - ➢ Consideration for time off
    - ➢ Must incorporate "value" of pension and OPEB (generally through Normal Cost analysis for DB plans and direct contribution for DC plans)
    - ➢ Cost sharing for PERS

– Consideration of other factors
  - Economic capacity of the employer
  - Retention and recruitment as factors
  - Higher wages must come from creating greater value for which employers will pay, whether this is in the public or private sectors

Classification Studies

- Classification studies tend to describe what agencies are already doing
  – For example, a classification study might tell an agency that 1 of 3 supervisors in a department is acting more like a deputy director of said department
- That said, classification studies fail to answer:
  – **What should an agency do?**
  – **What is the optimal organizational structure from a service-level perspective?**
  – **Financial perspective?**
- Organizational audits often provide a clearer starting point for analysis

Employee Pension Contributions

- Many public agencies continue to seek additional employee pension cost sharing through:
  – Elimination/reduction of EPMC for "Classic" members
  – Requiring employees to contribute toward Employer Rate
- **Must consider changes in employee pension contributions in context of wage increases shown on previous slides**
  – Some agencies are "buying" pension concessions with equivalent wage increases…essentially "swapping" any savings from pension for salary

1% for 1% Pension Contribution Swap

- **Hypothetical:** Assume an agency is proposing a 3% across-the-board wage increase for its Police unit whose "Classic" members currently pay 9.0% toward their pension. In an effort to enrich the retirement benefits of those unit members nearing retirement, the Police unit proposes to pay 12.0% toward their pension (an additional 3.0%) and asks for an offsetting 3.0% wage increase, for a total wage increase of 6.0% offset by "Classic" employees paying an additional 3.0% toward their pension.

Is this a good idea?

1% for 1% Pension Contribution Swap

- **No! Not a good deal from an affordability viewpoint!**
- Must consider the following:
  - Salary linked "roll-up" costs and overtime increases
  - Savings from 3% employee pension contribution only applies to "Classic" members (probably about 2/3rd of unit) while 3% wage increase applies to all bargaining unit members (including PEPRA tier)
  - Any wage increase above CalPERS' actuarial assumption, will lead to an increase in unfunded liabilities
    - Rough estimate: A 1% wage increase above the actuarial assumption would add about 0.25% to 0.40% to the Employer Pension Rate. Therefore, if "swap" is being considered, management should seek 0.6% to 0.75% wage increase for each 1% giveback on pension, and this is before roll-up costs/overtime is considered!

Pension Reform: MAPE v MCERA (CA Ct App)

- Facts: Post-PEPRA, MCERA adopted rules eliminating some forms of pensionable compensation on a prospective basis. Unions sued on behalf of members asserting a vested right.
- Analysis
  - "a public pension system is subject to the implied qualification that the governing body may make reasonable modifications and changes before the pension becomes payable and that until that time the employee does not have a right to any fixed or definite benefits but only to a substantial or reasonable pension." (Miller v. State of California (1977) 18 Cal.3d 808.)
  - Courts have long held that pension modification "must be" accompanied by a corresponding benefit.
  - MCERA court concludes that the Supreme Court has only held that pension modification must be reasonable and "should be" accompanied by a corresponding benefit.
  - In this case, a prospective change in benefits was reasonable

Leave Benefits

- Traditionally, public administrators don't think of labor "productivity" in the same manner as is done in the private sector. That said, the public sector needs to meet rising expectations for service delivery
- Generous paid leave allocations and carryover provisions (vacation, sick, personal, holidays, management, etc.) are holdovers from a different era
  - Constructive Receipt
- Why leave is important?
  - Leave is a largely hidden cost that is not easily quantified in the context of negotiations

Leave Benefits

- Starting to see agencies reform leave benefits more in line with private sector norms, particularly as it relates to leave "cash outs" and large carryover balances. ***STILL MUCH WORK TO BE DONE!***
  - State and Local Government have 32% more leave days (11 days)

	State & Local Government	Private industry Workers
Median Vacation Days (20 YOS)	22	20
Median Holidays	11	8
Median Sick Leave Days (20 YOS)	12	6
Sub-Total Median Days Leave	45	34
% with Access to Paid Personal Leave	60%	51%

Source: U.S. Bureau of Labor Statistics, Employee Benefits Survey, 2015

FLSA: Flores v. San Gabriel (9th Cir.)

- City of San Gabriel had a "Flexible Benefits Plan" to which the City contributed. Employees had some discretion in benefits and could take cash out of the plan if they did not use it all.
- Analysis:
  - Under the Fair Labor Standards Act (FLSA), employers are required to pay overtime to nonexempt employees at the rate of 1 1/2 times "the regular rate of pay." 29 U.S.C. § 207(e).
  - Except for seven types of payments (known as statutory exclusions), the regular rate must include "all remuneration for employment paid to, or on behalf of, the employee…." 29 C.F.R. § 778.108.
  - Court held that "cash in lieu" did not meet any of the 7 exceptions and must therefore be counted as part of the "regular rate of pay" for calculating overtime.
  - Court also held that San Gabriel's cafeteria plan was not "bona fide" under the regulations, requiring all payments towards plan benefits to be included in the regular rate

Moving into 2017 and beyond

Our Predictions

- We anticipate that:
  - Increasing benefit costs will continue to erode public services
    - Increasing pension costs, in particular, will put downward pressure on wage and other forms of pensionable compensation
  - Higher costs will lead more cities to reconsider their service provision models
  - Changes in PERS Cost sharing
    - Jurisdictions where employees pay less than the full employee share for CalPERS pensions will continue to push for additional employee payments to pension; **public agencies will grow increasingly leery of going above 9% if it means paying employees to pay the agency**
    - Resistance to paying employees to pay pension costs (EPMC swap) will increase, as public sentiment on the issue grows

Our Predictions

- Public agencies that have not already done so will move toward cafeteria plans for two reasons: (1) to reduce retiree medical contributions; and (2) because cafeteria benefits are not PERSable
  - *IRS Regulations under ACA "affordability test" and Flores v. San Gabriel throw a wrench into the traditional thinking regarding healthcare opt out*
  - *IRC restrictions on the use of 125 monies limit options*
- Time off will become more of a focus for city proposals, especially where backfill is required and for cities with large compensated absences liabilities
- Pressure to reign in "overtime abuses" will continue, whether or not overtime saves money
- Three- and four-year deals will continue to proliferate in agencies that have reasonably stable finances

Parting Thoughts

- Management needs to focus on developing clear explanations of the trade-offs inherent in compensation increases
  - How are the city's employment costs growing? How does that compare to revenue growth?
  - What is happening to city services?
- Develop easily accessible tools to use at the bargaining table.
- Negotiators need to know:
  - The cost of all proposals at the table in real time
  - Areas of particular financial concern – e.g. excessive overtime, premiums, other "hidden" costs
  - Leave usage and "cash outs"

Parting Thoughts

- As always, management should seek involvement at the front end of the negotiating process from "Labor Relations" team: HR, Finance, Department Heads, Management
- Learn how to determine and show whether there's a structural deficit – and if so, what are the consequences
- Continue to push for adequate reserves – especially as another recession is inevitable. Remember, reserves are not a significant liability at the table unless they are very large
- A detailed understanding of benefit costs, both now and predicted, is essential