Development of Los Angeles County Cafeteria Plan Design Strategies to Reduce Retirement Costs

Prepared for Los Angeles County Citizens Economy and Efficiency Commission

July 1993

Produced by W F Corroon

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Dear Mr. Staniforth:

Enclosed please find the Development of Los Angeles County Cafeteria Plan Design Strategies to Reduce Retirement Costs.

We are hopeful that this report will prove useful and help the Commission to develop its recommendations for the Board of Supervisors.

Sincerely,

Drew A. James, F.S.A.
Executive Vice President and Actuary

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Enclosures

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1 INTRODUCTION

1.1 BACKGROUND, PURPOSE, METHODOLOGY AND TERMINOLOGY

Background

The County of Los Angeles sponsors four plans which qualify under Section 125 of the Internal Revenue Code of 1986. Plans which qualify under this Code Section allow employees the ability to exchange nontaxable employee benefits for additional take-home pay, and vice versa. According to legal opinions rendered by the Los Angeles County Counsel's office, independent counsel retained by the Los Angeles Citizens Economy and Efficiency Commission and the fiduciary counsel to LACERA, the full cash options available under these flexible benefit or "cafeteria" plans are to be included as earnings for the purpose of calculating an employee's County retirement benefit regardless of whether or not the employee actually elects to take this cash in lieu of benefits. This resulted in higher County retirement costs.

Purpose

At its meeting held November 17, 1992, the Los Angeles County Board of Supervisors "requested the Citizens' Economy and Efficiency Commission, with the assistance of their independent legal counsel, and compensation expertise to:

a) Examine the viability of measures to cap or reduce the County's liability to the pension system by freezing or reducing the cash available option in cafeteria style benefit plans as recommended in the Corroon Study, and any other alternatives that may serve this purpose; and

b) Examine the County's cafeteria style benefit plans and recommend improvements to enhance equity, and reduce County cost without reducing employees' ability to obtain adequate benefits, or reduce the County's ability to attract and retain qualified personnel."

By this action, the Board of Supervisors made clear its objective to reduce retirement costs associated with the Cafeteria Plans.

Methodology

To accomplish Purpose (a) we proceeded to further develop and evaluate each of the recommendations made in our September 1992 Comparability Analysis in order to:

- determine how they will impact employees' retirement benefits and the associated cost of those benefits;
- determine how they will impact the County's cafeteria plan design;

- determine whether there are any legal impediments to their implementation; and
- adopt, modify or reject them.

Purpose (b) was included to evaluate the cafeteria plan design changes necessary to implement these recommendations. These plan design changes were evaluated by:

1. Comparing the County's cafeteria plans, as modified, to a survey group of plans offered by comparable employers. This was necessary to determine the possible impact on the County's ability to attract and retain qualified employees; and
2. Determining the effect on a sample group of County employees' abilities to purchase a package of benefits under the affected County cafeteria plans, as modified.

Prior to the report sections dealing with these analyses, we have included a "Concepts" section which:

1. explains key issues that will serve as an introduction to the matters addressed by the report; and
2. describes the County's cafeteria plan program, how it operates and how it is funded.

In an attempt to keep the report as concise as possible, the main body of the report focuses on the evaluations, and supporting documentation is provided in the appendices.

Terminology

A number of technical terms are used throughout this report. A Glossary has been provided in Appendix A to define these terms.

Caveat on County Cost Impact

An actuarial evaluation of the retirement benefit cost savings which would result from implementing these recommendations is beyond the scope of this study; however, we have attempted to estimate the potential impact to provide the Commission an idea of the general magnitude of the impact. These estimates are very rough and not appropriate for use outside the context of this report.

1.2 CONCEPTS

This section sets forth the basic concepts that are used throughout the report.

Key Issues

The primary issue which led to this report is the establishment of a proper level of pensionable earnings. This issue was first dealt with in W F Corroon's September 1992 report. The issue came before the Citizens Economy and Efficiency Commission because of the financial impact that the inclusion in Pensionable Earnings of various elements of the County's compensation and benefits package was having on the cost of the County's retirement system. The controversial elements were:

1. Available Cash Options under the County's cafeteria plans;
2. Transportation allowances; and
3. Special salary deferral elections which allowed employees to defer compensation until the years just preceding retirement, significantly increasing the employees' retirement benefits.

On September 29, 1992 the Board of Supervisors eliminated the transportation allowance program. About that same time the Board of Trustees of the Los Angeles County Employees' Retirement Association, responding to the need to develop a specific policy on the third element, acted to include deferred salary into pensionable earnings in the year the salary is earned rather than received. These two actions effectively reduced or eliminated elements (2) and (3) on pensionable earnings.

The continued concern over the impact of element (1) created the need for an additional effort to deal with it.

In making this effort, there are two classes of employees which must be dealt with separately:

1. ***Existing Employees*** – County Counsel and the Commissions' independent legal counsel have concluded that existing employees' are vested in their right to have Available Cash Options included in Pensionable Earnings. Thus, the only means of effectively dealing with this is to reduce or maintain the present level of Available Cash Options under the County's Cafeteria Plans. W F Corroon's September 1992 report presented recommendations to accomplish this.

2. ***Future Employees*** – In its report to the Board of Supervisors, the Commission urged the Board to direct the County Chief Administrative Officer (CAO) to seek legislation which will allow the Board to determine whether or not to include Available Cash Options in Pensionable Earnings for new hires. On November 17, 1992, the Board of Supervisors adopted this recommendation. A bill (AB 1659) has been introduced in the State Legislature which, if it becomes law, would provide the Board the legal basis to make this determination. The impact of eliminating Available Cash Options as pensionable earnings for new hires is evaluated in Section 3.5 of this report.

The implementation of these recommendations raised a series of issues of their own:

a. Are such actions legal?

b. How will the implementation of these actions change the overall design of the County's cafeteria plans and the benefits of employees?

c. Will the cafeteria plan design changes impact the County's ability to attract and retain qualified employees?

Each of these issues will be addressed in the course of evaluating each recommendation.

1.3 DESCRIPTION OF LOS ANGELES COUNTY CAFETERIA PLANS

The County of Los Angeles currently sponsors the following four cafeteria plans for its employees

Nonrepresented Employees

- *MegaFlex*, for nonrepresented (generally management) employees hired or newly eligible after January 1, 1992 and nonrepresented employees covered by the Flexible Benefit Plan before January 1, 1992 who elected to be covered (covers approximately 4,800, or 6% of all employees);
- the *Flexible Benefit Plan*, for employees who were nonrepresented before January 1, 1992 and did not elect MegaFlex (covers approximately 4,200, or 6% of all employees);

Represented Employees

- *Choices*, for employees represented by the Coalition of County Unions ("Coalition") (covers approximately 30,000, or 39% of all employees); and
- *Options*, for members of SEIU Local 660 and Nurses Units 311 and 312 (covers approximately 38,000, or 49% of all employees).

The benefit options available under these plans are identified in Table 1.

TABLE 1

All County Cafeteria Plans	Additional Options Under MegaFlex Only
Medical	Short Term Disability (STD)
Dental	Long Term Disability (LTD)
Group Life Insurance	Elective Annual Leave
Accidental Death and Dismemberment (ADD)	Survivor Income (Plan E only)
Health Care Spending Account (HCA)	
Dependent Care Spending Account (DCA)	

All of the plans offer employees the option of taking cash instead of benefits. Following is a summary of the Available Cash Options under these plans:

- **MegaFlex and Flesible Benefits Plan** — All benefits *except* medical benefits may be waived in exchange for cash under MegaFlex and the Flexible Benefit Plan. In rare cases, medical benefits may also be waived.
- **Choices** — All benefits may be waived under Choices; however, the maximum cash payout is *limited* to the County contribution for single employee medical coverage.
- **Options** — Same as Choices, however, the amount of the Available Cash Option is *lower* under Options. Under the current SEIU bargaining agreement, Options will provide the *same* Available Cash Option as Choices as of July 1, 1994.

To the extent cash is available under these plans, the amount of this Available Cash Option constitutes Pensionable Earnings under the Los Angeles County Employees' Retirement Association whether the employee actually elects to take cash or not. As a result, retirement benefits are determined by including the full Available Cash Option in final pay.

Table 2 on the following page summarizes, by plan, the categories of employees covered, the County's Cafeteria Plan Contribution, the cash payable to the employee and a description of the effect of the Available Cash Option on Pensionable Earnings.

(**Note**: As indicated on Table 2, effective July 1, 1994 the negotiated County contribution under the Options Plan will be the same as that under the Choices Plan. For purposes of our analyses, the Choices County contribution is used for the Options Plan to reflect this long-term result. The short-term impact of having a lower cash option under Options is insignificant in the context of our analyses.)

TABLE 2

SUMMARY OF CAFETERIA PLAN CONTRIBUTION, AVAILABLE CASH OPTIONS AND PENSIONABLE EARNINGS IMPACT

Plan Employees Covered	1993 County Cafeteria Plan Contribution	1993 Benefits Not Available as Cash	1993 Cash Payable to Employee	1993 Pensionable Earnings
MegaFlex All new nonrepresented hired after 1/1/92, and all 1/1/92 nonrepresented employees so electing.	Years of Service / Percentage of Pay 0 - 4 — 14.5% 5 - 9 — 17.0% 10+ — 17.0%* Plan E — 17.0%* (See Note 1) *+.4%/year of service if 10 or more years as of 1/1/91, not to exceed 19% (See Note 2) Minimum: $524/month)	Medical (employee only) (See Note 3)	Difference between County contribution and cost of benefits elected.	Available Cash Option (14.5% to 19% of pay, $524/month minimum).
Flexible Benefit Plan All nonrepresented employees as of 1/1/92 not electing MegaFlex.	10% of pay (no service element) Minimum: $422/month			10% of pay, $422/month minimum
Choices Represented employees of the Coalition.	Depends on Medical coverage option selected (See Note 4) Medical Coverage / Monthly Contribution None — $244.00 ee only — $244.00 ee + 1 — $396.00 ee + 2 or more — $442.00	None		$244/month
Options (See Note 5) Represented employees of SEIU Local 660 and Nurses Units 311/312.	Depends on Medical coverage option selected (See Note 4) Medical Coverage / Monthly Contribution None — $115.00 ee only — $194.03 ee + 1 — $360.26 ee + 2 or more — $413.54			$115/month

Note 1: Higher contributions is provided to Retirement Plan E members with less than five years of service to allow purchase of disability and survivor benefits not provided through Plan E.

Note 2: Service-related vacation and sick leave benefits were folded into MegaFlex, which is the reason why the County contribution contains the service element.

Note 3: Election can be waived under certain narrow conditions.

Note 4: Notation – None = no medical coverage / ee only = employee only / ee + 1 = employee plus one dependent / ee + 2 or more = employee plus two or more dependents.

Note 5: Effective 7/1/94 the negotiated County contribution to Options will be the same as under the Choices Plan.

1.4 EXECUTIVE SUMMARY OF RESULTS

This brief summary provides an overview of the key conclusions and recommendations in this report.

Control of Future Increases in Available Cash Options

In order to avoid future increases in County retirement costs, action must be taken to eliminate future increases in Available Cash Options under all of the cafeteria plans. Section 3.2.1 provides a mechanism to accomplish this goal.

Freeze or Reduce Available Cash Options Under MegaFlex and the Flexible Benefit Plan

In order for County retirement costs to be reduced, not only must future increases in Available Cash Options be eliminated, but they must be reduced as a percentage of employees' pay. Section 3.2.2 provides two mechanisms to accomplish this. The first mechanism imposes a freeze on the dollar amount of Available Cash Option; the second actually reduces the dollar amount.

Exclude Cafeteria Plan Available Cash Options from Pensionable Earnings for New Hires

A bill (AB 1659) has been introduced in the State Legislature which, if it becomes law, would allow the Board of Supervisors the power to eliminate the inclusion of Available Cash Options in Pensionable Earnings for new hires. Two actions are needed in connection with this bill.

1. It needs to be amended to allow existing employees to voluntarily elect to be covered under its provisions. The reason for this amendment is explained in Section 3.5.
2. The lobbying efforts on the bill need to be stepped-up. Each new employee hired before this bill becomes law carries an additional retirement cost.

Eliminate the Selling of Annual Leave Benefits

By establishing an Elective Annual Leave program outside of MegaFlex, a substantial and immediate reduction can be made in the County's Cafeteria Plan Contribution. This translates into immediate reductions in County retirement costs. This is described in Section 3.7.

Evaluation of Executive Compensation and Benefit Issues

The Commission will require some specific data from the Chief Administrative Officer to properly evaluate the bases upon which various County employee compensation and benefits plan design decisions have been made. Section 3.6 discusses this issue.

Recommendations with Potential Legal Barriers

Two of the recommendations in our September 1992 report raise legal issues which could prevent their implementation. They are:

1. Offset of Retiree Medical Benefits; and
2. Addition of 401(k) Option to MegaFlex and the Flexible Benefit Plan

If the legal concerns could be overcome, the first of these two recommendations would be a very valuable tool to deal with the retirement cost issue. For this reason, we believe the Commission should discuss this recommendation with counsel to decide whether it should be abandoned or research further. With respect to the second, federal law precludes its implementation in a way which would achieve the desired result, thus we recommend that it be abandoned.

The report's recommendations are used as building blocks for three alternative strategies that are presented in Section 4.

2 Methods of Reducing Pensionable Earnings

2.1 REVIEW OF THE SEPTEMBER 1992 REPORT RECOMMENDATIONS

In this section, we review the recommendations of W F Corroon's 1992 Retirement Comparability Analysis. (**Note**: Some of these recommendations have been modified slightly for clarity of presentation.)

RECOMMENDATION #1 – Freezing or Reducing Cafeteria Plan Available Cash Options

a. We suggest that future increases in the Available Cash Options under Choices and Options and the Minimum County Cafeteria Plan Contributions under MegaFlex and the Flexible Benefit Plan be carefully considered, controlled, or possibly eliminated, unless there are compelling reasons not to do so.

b. We suggest that the Available Cash Option under MegaFlex and the Flexible Benefit Plan be reduced by one or both of the methods set out below to the lowest level consistent with acceptable cafeteria plan design and prior commitments to employees.

   i. Freeze the MegaFlex and Flexible Benefit Plan Available Cash Option at its present dollar level for each employee. Any increase in County contributions to these plans would be provided in the form of benefits rather than cash options.

   ii. Offset future pay increases granted to employees in MegaFlex and the Flexible Benefit Plan against the Available Cash Option. The rationale for using the offset is to avoid reducing the present take-home pay available to employees.

c. To lessen the impact of the reduction of the cash option on employees, expand MegaFlex and the Flexible Benefit Plan to include 401(k) as a benefit option.

RECOMMENDATION #2 – Retiree Medical Benefits

The County should explore the feasibility of offsetting County retiree health insurance contributions by the retirement benefit increases resulting from the inclusion of the cafeteria plan Available Cash Options as Pensionable Earnings.

RECOMMENDATION #3 – Treatment for New Hires

Exclude cafeteria plan Available Cash Options and transportation allowances from Pensionable Earnings for new hires.

RECOMMENDATION #4 – Salary Deferral Arrangements

Either include all future special salary deferral arrangements in pensionable earnings on an as-earned basis or discontinue such salary deferral arrangements.

RECOMMENDATION #5 – Evaluation of Executive Compensation and Benefits Issues

The evaluation of executive compensation and benefits issues as they relate to public and private sector employees was beyond the scope of our September 1992 study. The Commission may want to recommend that this issue be studied further.

Recommendations #3 and #4 have been adopted (see Concepts Section), although the elimination of cafeteria plan Available Cash Options for new hires has not yet been implemented.

2.2 ADDITIONAL RECOMMENDATION TO BE CONSIDERED

Subsequent to issuing our September 1992 Comparability Study, we developed an additional recommendation which we present here (the numbering of this recommendation continues from Section 2.1).

RECOMMENDATION #6 – Elective Leave Benefits Under MegaFlex

We recommend that the County consider eliminating an employee's ability to sell annual leave (time-off) under MegaFlex and provide MegaFlex participants with a similar Annual Elective Leave program outside of the cafeteria plan. At the end of each calendar year, MegaFlex participants would be required to cash out the total unused balance of vacation and sick leave days at the end of the year up to:

The prior year's carryover plus the current year's accrual
minus
10 Days

This change would produce a reduction in the County Cafeteria Plan Contribution and a commensurate reduction in Pensionable Earnings. Participants will still be able to buy annual leave days through payroll deduction as part of MegaFlex.

We will address this and the remaining recommendations in Section 3.

3 Evaluation of Recommendations

3.1 Methodology for Evaluation of Recommendations

The purpose of this section is to evaluate the impact of implementing the recommendations described in Section 2. We will generally accomplish this by:

1. Providing an overview of the recommendation;
2. Summarizing the opinion of the Commission's legal counsel regarding the legality of implementing the recommendation. The full legal opinion can be found in Appendix D;
3. Describing how the adoption of the recommendation would impact retirement benefits;
4. Describing how the adoption of the recommendation would impact the design of the County's cafeteria plans. This step will be carried out by:
   a. Comparing the ***modified*** County's cafeteria plans, to a survey group of plans offered by comparable employers. The purpose of this comparison is to determine the possible impact on the County's ability to attract and retain qualified employees. A description of the survey group and the survey data is provided in Appendix B.
   b. Determining the effect on a sample group of County employees' abilities to purchase a package of benefits under the affected County cafeteria plans. A description of the sample employee group is provided in Appendix C; and
5. Drawing conclusions and recommendations from the evaluation.

Recommendations #1c, #2 and #5 do not lend themselves to an analysis of this type, thus they will be evaluated by discussion, summarizing the legal opinion, and arriving at conclusions and recommendations.

Order of the Evaluation

To provide better continuity of discussion, the recommendations will be evaluated in an order different than they were presented in our September 1992 report. The order will be:

Recommendation(s):	Will Be Evaluated in Section:
1a	3.2.1
1b	3.2.2
1c	3.3
2	3.4
3	3.5
5	3.6
6	3.7
Note that Recommendation #4 has already been implemented.	

3.2 RECOMMENDATION #1 – FREEZING OR REDUCING CAFETERIA PLAN AVAILABLE CASH OPTIONS

Overview

There are three components to this recommendation as it was set forth in Section 2.1:

a. Control or possibly eliminate future increases in Available Cash Options under the Options and Choices plans, and in the minimum contribution to MegaFlex and Flexible Benefit Plan;

b. Freeze or reduce the Available Cash Options under the MegaFlex and Flexible Benefit Plans; and

c. Expand MegaFlex and Flexible Benefit Plan to include 401(k) as a benefit option.

Components a. and b. will be addressed in a separate subsection. Component c. will be evaluated in Section 3.3.

Summary of Legal Counsel's Opinion

With respect to a. and b., the Commission's legal counsel has advised that, as long as participants in MegaFlex are allowed to revoke their prior elections in conjunction with any modification to MegaFlex that negatively impacts that plan as compared to the Flexible Benefit Plan arrangement or as compared to any new cafeteria plan, the County is free to freeze or reduce available cash options under MegaFlex. This is also true with respect to the County's ability to freeze or reduce Available Cash Options under the Flexible Benefit Plan subject to the same condition. Any such freezing or reducing of Available Cash Options for Options or Choices would of course also be subject to the collective bargaining process.

There are federal legal restrictions which preclude the implementation of Component c. This will be explained in Subsection 3.3.

3.2.1 Recommendation #1a – Control of Future Increases in Available Cash Options Under the Options and Choices/MegaFlex and Flexible Benefits Plans

Overview

To begin the discussion, it is instructive to examine the increases that have occurred in Available Cash Options since the inception of the various plans:

TABLE 3

	Available Cash Options Under:				Percentage of Pay Available Cash Options Under:				Minimum Available Cash Options Under:			
	Options		Choices		MegaFlex*		Flexible Benefits Plan		MegaFlex		Flexible Benefits Plan	
Year	$	% Increase	$	% Increase	%	% Increase	%	% Increase	$	% Increase	$	% Increase
1985							5.0%	—			$240	—
1986							5.0	0%			240	0%
1987							5.5	10			264	10
1988							7.0	27			312	18
1989			$128	—			7.0	0			312	0
1990			156	22%			8.0	14			370	19
1991			195	25	14%	—	8.0	0	$370	—	370	0
1992	$100	—	195	0	14	0%	8.0	0	370	0%	370	0
1993	115	15%	244	25	17	21	10.0	25	524	42	442	19
Average Annual Increase		15%		18%		10%		9%		19%		8%

Gray areas indicate years prior to plan's effective date.
*Employees with 5 or more years of service.

The historical rates of increase in these amounts have been heavily influenced by the rate of increase in the County's medical plans. This has occurred because the County establishes these amounts each year so as to provide participants the continued ability to purchase medical benefits with an increasing price tag.

> The annual increase in Available Cash Options translates into an annual increase in Pensionable Earnings, creating a trend whereby pension benefits increase along with medical costs. A continuation of this practice will result in continued accelerated increases in the County's retirement costs.

The most recent increase occurred in January 1993, when the County Cafeteria Plan Contributions to MegaFlex and Flexible Benefit Plan were increased by 3% and 2% of employees' pay, respectively. This resulted in a 21% and 25% increase in Available Cash Options (respectively) over their 1992 amounts. The County's justification for this increase was:

- To avoid disadvantaging nonrepresented employees; and
- To adjust for increases in medical and dental costs.

We will evaluate the following cafeteria plan pricing strategy that will terminate this costly practice while keeping medical and dental benefits affordable.

> Rather than increase the County Cafeteria Plan Contribution, freeze or reduce the cost of purchasing medical and dental benefits under the various Cafeteria Plans.

Example

An example might be helpful. Suppose the cost to the County of providing family medical coverage increases from $383 to $420 per month, or an additional $37. If the County elects not to pass this increase along to employees, it has two options:

- **Current** — increase the County Cafeteria Plan Contribution by $37 per month and increase the employee's cost for medical coverage under the Cafeteria Plan by $37; or
- **Recommendation #1a** — keep the County Cafeteria Plan Contribution and the employee's cost for medical coverage constant by having the County subsidize the additional $37 per month.

The financial impact to the employee and the County is the same in either case, but the second approach results in the employee's Pensionable Earnings being $37 per month lower than the current practice, which results in lower retirement costs because the Available Cash Option does not increase.

Impact of Recommendation #1a on Retirement Benefits

By subsidizing the price of medical and dental benefits under the cafeteria plans, the County avoids increasing Pensionable Earnings and medical costs increases while retaining employees' benefit purchasing power.

In order to illustrate the impact of this recommendation on employees' retirement benefits in the future, we have prepared Table 4 on the following pages. This table compares the projected monthly retirement benefits due to the Available Cash Option under the County's Miscellaneous Member Retirement Plan D if:

- **Current** — the County Cafeteria Plan Contribution (and the Available Cash Option) increases with health care inflation; versus
- **Recommendation #1a** — maintaining a static County Cafeteria Plan Contribution and holding down the employee's cost for medical and dental coverage.

Based on Table 3, the current scenario assumes that the percentage of pay Available Cash Options increase with one-half health care inflation, and the minimum and dollar amount Available Cash Options increase with full health care inflation.

Table 4 also assumes salary levels in each employee job classification will increase 5% per year, and that health care inflation grades down from 10% to 7% per year over a 15-year period.

A few important points must be remembered when reviewing the results in Table 4:

1. They are expressed in 1993 dollars. The actual amounts will be higher due to inflation;
2. The benefits at various times of retirement (1993, 5 years, 10 years, etc.) are for similarly situated sample employees retiring at each of those points in time. That is, all will have 30 years of service, retire at age 62, and have similar salary histories (in 1993 dollars) when they retire at these points in time.

Table 4 shows that this recommendation significantly suppresses the amount of the additional retirement benefits that employees will receive in the future from having Available Cash Options included in Pensionable Earnings. It must be remembered that such a result be expected since we are dampening the future effect that the Available Cash Options will have on pension benefits. This is directly in line with the purpose of this report, as set forth on page 2.

Cost Impact

The effect on represented employees is evident from Table 4. This has a significant impact on the County's retirement cost, since approximately 88% of its employees are represented. We estimate that the annual cost savings could be between $16 million and $18 million.

TABLE 4 — RECOMMENDATION #1a

	Impact of Adopting Recommendation 1a on Projected Future Retirement Benefits (Expressed in 1993 Dollars)									
	Choices & Options Plans (Represented)		Flexible Benefits Plan (Nonrepresented)				MegaFlex (Nonrepresented)			
Assuming Retirement at Age 62 in:	Secretary I	Property Agent II	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
1993										
Available Cash Option:										
• Current	$244	$244	$294	$470	$637	$980	$376	$903	$1,187	$1,769
• Recommendation 1a	$244	$244	$294	$470	$637	$980	$376	$903	$1,187	$1,769
Projected Retirement Benefit Due to Available Cash Option:										
• Current	$146	$146	$176	$281	$381	$586	$225	$540	$710	$1,058
• Recommendation 1a	$146	$146	$176	$281	$381	$586	$225	$540	$710	$1,058
5 Years										
Available Cash Option:										
• Current	$308	$308	$371	$602	$816	$1,252	$474	$1,155	$1,517	$2,260
• Recommendation 1a	$191	$191	$230	$502	$669	$1,012	$391	$935	$1,219	$1,801
Projected Retirement Benefit Due to Available Cash Option:										
• Current	$168	$168	$202	$328	$443	$682	$259	$628	$825	$1,230
• Recommendation 1a	$114	$114	$138	$283	$378	$574	$220	$530	$692	$1,024
10 Years										
Available Cash Option:										
• Current	$371	$371	$447	$758	$1,024	$1,568	$582	$1,447	$1,898	$2,823
• Recommendation 1a	$150	$150	$208	$527	$695	$1,037	$416	$960	$1,244	$1,826
Projected Retirement Benefit Due to Available Cash Option:										
• Current	$204	$204	$246	$414	$559	$857	$318	$790	$1,037	$1,543
• Recommendation 1a	$89	$89	$116	$298	$393	$589	$215	$545	$707	$1,039

TABLE 4 — RECOMMENDATION #1a
(continued)

	Impact of Adopting Recommendation 1a on Projected Future Retirement Benefits (Expressed in 1993 Dollars)									
	Choices & Options Plans (Represented)		Flexible Benefits Plan (Nonrepresented)				MegaFlex (Nonrepresented)			
Assuming Retirement at Age 62 in:	Secretary I	Property Agent II	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
15 Years										
Available Cash Option:										
• Current	$427	$427	$515	$937	$1,261	$1,923	$722	$1,755	$2,324	$3,450
• Recommendation 1a	$117	$117	$227	$547	$714	$1,056	$436	$980	$1,264	$1,846
Projected Retirement Benefit Due to Available Cash Option:										
• Current	$237	$237	$286	$514	$690	$1,055	$396	$973	$1,275	$1,893
• Recommendation 1a	$70	$70	$128	$310	$405	$600	$247	$557	$718	$1,051
20 Years										
Available Cash Option:										
• Current	$470	$470	$566	$1,136	$1,520	$2,306	$881	$2,131	$2,784	$4,120
• Recommendation 1a	$92	$92	$243	$563	$730	$1,072	$452	$995	$1,279	$1,861
Projected Retirement Benefit Due to Available Cash Option:										
• Current	$263	$263	$317	$625	$836	$1,270	$484	$1,173	$1,533	$2,270
• Recommendation 1a	$55	$55	$137	$320	$414	$610	$256	$566	$727	$1,059

Impact of Recommendation #1a on County's Cafeteria Plan Costs

This recommendation does not reduce the County's cafeteria plan cost for employees who purchase medical and dental benefits, but will reduce the County's Cafeteria plan costs for employees who waive those benefits. This is because, by subsidizing the employee's cost of medical and dental benefits, those who waive these benefits pass up receiving any subsidy.

Comparison With Employer Cafeteria Plan Survey Data

Information on methods of pricing benefit options, (i.e., the amount employees must pay to buy benefits under a cafeteria plan) was available from the published survey. Of the 282 employers with cafeteria plans comparable to those of the County, 46% subsidized their medical pricing and 42% subsidized their dental pricing. Thus, adoption of this recommendation would not impose a cafeteria plan design feature that lies outside of the mainstream.

Impact of Recommendation #1a on County Employees' Benefit Purchasing Power Under the Cafeteria Plans

This recommendation, by design, retains employees' benefit purchasing power in the face of a frozen County Contribution by holding down the amount employees are charged for medical and dental benefits. However, by holding down future increases in the County Contribution, the Available Cash Option will also be held down. This is evident from Table 4. This reduction in the Available Cash Option produces the desired reduction in the County's retirement costs.

The County might argue that this future reduction in the real value of the Available Cash Option will reduce their ability to attract and retain qualified personnel over time. This argument is not supported by our survey of other employer cafeteria plans. This survey indicates (see Table 8) that the Available Cash Options under the County's plans are significantly higher than the norm.

Conclusion

This recommendation is critically important to containing the County's retirement costs since it impacts the represented employees, the largest component of the County's payroll. We have examined the LACERA's June 30, 1992 actuarial report and observed that the System's actuary is <u>not</u> projecting increases in Pensionable Earnings due to increases in the County's medical costs. Thus, the adoption of this recommendation would eliminate a sizable cost, part of which now is not reflected in the County's retirement costs. We estimated this cost impact of implementing this recommendation to be $16 million to $18 million annually.

3.2.2 RECOMMENDATION #1b – FREEZE OR REDUCE AVAILABLE CASH OPTIONS UNDER MEGAFLEX AND THE FLEXIBLE BENEFITS PLANS

Overview

In Section 3.2.1, we presented Recommendation #1a which operates to limit future increases in Available Cash Options. This section goes a step further and would freeze or offset the Available Cash Options for nonrepresented employees. The recommendation presented here applies only to Nonrepresented Employees and is complementary to Recommendation #1a. Both will be combined into a single strategy in Section 4.

Methods of Reducing Available Cash Options

In our view, the Commission can pursue two approaches to freeze or reduce the Available Cash Options:

1. **To Freeze or Reduce the County Cafeteria Plan Contribution for Nonrepresented Employees** – The Commission can recommend that, not only the Available Cash Option be reduced, but the County Cafeteria Plan contribution also be frozen or reduced. This would have the effect of freezing or reducing not only the additional *take-home pay* employees can elect to take, but also their ability to purchase currently available *benefits; or*

2. **To Freeze or Reduce the Available Cash Option, But Maintain Nonrepresented Employees' Greater Ability to Purchase Benefits** – This would have the effect of freezing or reducing only the additional *take-home pay* employees can elect to take, but allow them to continue to purchase currently available *benefits* by maintaining a higher level of "noncashable" purchasing power under the Cafeteria Plan. This alternative shares some similarity with the Options and Choices plan design. For example, in 1993 under the Choices plan, employees can receive a monthly County Cafeteria Plan Contribution of up to $442, but the Available Cash Option is limited to $244 per month. The employee does not get to spend the $198 difference in benefits if he or she chooses the cash — the difference is forfeited.

The difference between these two approaches is a difference in philosophy relating to the desired level of benefit purchasing power under the Cafeteria Plans. The first approach can only be pursued if the Commission is willing to take the position that the pensionable earnings problem is part of a broader problem; that is, that County employees have too rich a benefit package. Thus, in solving the pensionable earnings problem the broader problem should be properly addressed by reducing the amount the County contributes towards <u>all</u> employee benefits, not just pension benefits. Other than citing pure budgetary necessity, the establishment of an objective basis for taking this position is beyond the scope of this study. For this reason, Recommendation #1b was established along the lines of the second approach. If the Commission sees the necessity to establish an analytic basis for taking the first approach, the scope of the Recommendation #5 Study should be set to include a survey of all employee benefits offered by comparable employers, not just cafeteria plan benefits.

Another issue which could arise modifying the County Cafeteria Plans is the removal of distinctions between the Flexible Benefit Plan and MegaFlex. Since employees in MegaFlex have made an irrevocable election to participate in MegaFlex rather than the Flexible Benefit Plan, current distinctions between the two plans modifying only MegaFlex changes the conditions upon which that irrevocable election was made. There are two ways to deal with this issue:

- Reopen the choice between MegaFlex and the Flexible Benefit Plan at the next open enrollment; or
- Modify the Flexible Benefit Plan in the same way as MegaFlex.

Both approaches are used in the context of the various recommendations evaluated in this report.

Recommendation #1bi – Freezing Available Cash Options

This recommendation would restrict the MegaFlex Available Cash Option in 1994 to the amount the employee was entitled to in 1993 based on the employee's pay rate as of December 31, 1993. This amount could never fall below some target level of Available Cash Option ("Alternative Available Cash Option Target") which would either be a percentage of pay or a dollar amount. This target will be extensively discussed later in this section.

Example

A nonrepresented employee hired December 31, 1990, covered under Retirement Plan D and the MegaFlex plan is earning $4,000 per month as of December 31, 1993. This employee's 1993 County Cafeteria Plan Contribution is 14.5% of pay, or $580.

Under this proposal, the employee's Available Cash Option under the MegaFlex plan would be frozen at 14.5% X $4,000, or $580/month for all future years, subject to the chosen Alternative Available Cash Option Target. If a Target of 10% of pay was selected, the $580 would remain frozen until 10% of the employee's pay exceeded $580. Thus, if the employee's pay were eventually to increase from $4,000/month to $6,000/month, the Available Cash Option would increase to $600/month.

Recommendation #1bii – Reduce Available Cash Options

This approach would go beyond just freezing the Available Cash Option by actually <u>reducing</u> the cash option by offsetting future pay increases against the frozen amount. This would be accomplished by reducing the Available Cash Option as determined under the "freeze" approach by the amount of pay increase received by the employee between the last pay period in 1993 and the last pay period before the calendar year under consideration. This approach prevents potential hardship to the employee by not reducing any employee's current take home pay.

Example

Assume the same employee in the previous example earning $4,000 per month during December 1993 earns $4,200 per month in December 1994. Under this approach, the 1995 Available Cash Option for this employee would be $380 which is calculated as: $580/month (14.5% x $4,000), minus the pay increase of $200/month ($4,200 - $4,000), subject to the chosen alternative Available Cash Option Target. If a Target of 10% of pay was selected, the Available Cash Option would be $420/month (10% x $4,200/month) instead of $380.

Establishing the Available Cash Option Target

Before proceeding with the evaluation of this recommendation, we must determine the proper "target" for the Available Cash Options as they are modified. Clearly, the underlying objective is to reduce the County's retirement costs; however, this must be done without sacrificing intelligent cafeteria plan design.

Establishment of Alternative Available Cash Option Targets

Presented here are three Alternative Target levels of Available Cash Options which will be used in conjunction with Recommendation #1b and a discussion of the philosophy behind each target.

Note that these target levels are being expressed as static amounts. The dynamics of how the Available Cash Option changes over time is addressed later in this section. We will bring these together into a cohesive strategy in Section 4.

- *Alternative Target #1* – MegaFlex Available Cash Option is reduced to that of the Flexible Benefit Plan.

  Philosophy Behind Alternative Target #1 – Nonrepresented employees should have significantly higher Available Cash Options than represented employees, a philosophy currently embraced by the County. This alternative has the objective of eliminating a good portion of the distinctions between MegaFlex and the Flexible Benefit Plan insofar as cash options are concerned. If this alternative were adopted, an argument could be made that, once the target has been achieved, all other differences between MegaFlex and the Flexible Benefit Plan should be eliminated since MegaFlex participants would probably have little choice but to buy back all of their time-off benefits.

Once this happens, there is minimal difference between the two plans.

Such a move could be troubling to MegaFlex participants since they have made an irrevocable election to remain in MegaFlex. The County might deal with this issue by:

1. Allowing MegaFlex participants to re-enter the Flexible Benefit Plan at the next open enrollment; and
2. Implementing Recommendation #6 (i.e., an Elective Annual Leave program for MegaFlex participants only).

- *Alternative Target #2* – MegaFlex's and Flexible Benefit Plan's Available Cash Options are reduced to the current minimum County Cafeteria Plan Contributions under the respective plans. Participants are able to spend the difference between the County Cafeteria Plan contribution and the reduced Available Cash Option on additional benefits.

  Philosophy Behind Alternative Target #2 – Nonrepresented and represented employees should have only marginally greater ability to derive additional take-home pay from their cafeteria plans, although nonrepresented employees should have the ability to purchase more benefits under their plans (i.e., additional vacation, health spending accounts, dependent care spending accounts, etc.). In addition, this greater purchasing power should be proportional to the nonrepresented employees' pay. During the transition period there would continue to be differences between MegaFlex and the Flexible Benefit Plan, although as the Available Cash Option is decreased, employees would be forced into buying more benefits or time off.

  Once the Available Cash Option Target is achieved, it might necessarily follow that a single County cafeteria plan would emerge; however, it is more likely that the cafeteria plans for nonrepresented employees would permanently retain a higher level of County Cafeteria Plan Contribution, at least some portion of which is based on the employee's pay. This would allow nonrepresented employees to continue to afford to purchase pay-related benefits, such as life insurance and additional time-off.

- *Alternative Target #3* – This is similar to Target #2 except the following feature would be added: *Participants who actually choose to receive the Available Cash Option in cash, forfeit the difference between the County Cafeteria Plan Contribution and the reduced Available Cash Option.*

  Philosophy Behind Alternative Target #3 – The philosophy of Alternative Target #2 applies here as well, with the added tenet that nonrepresented employees who opt for the full Available Cash Option should forfeit their right to purchase additional benefits with the balance of the County Cafeteria Plan Contribution in excess of the Available Cash Option. Practically, this would operate similar to the Options and Choices plans; that is, nonrepresented employees would once again be allowed to waive medical coverage. If they do, their County Cafeteria Plan Contribution would be equal to the reduced Available Cash Option.

Note that Alternative Target #3 has the same impact on retirement benefits and costs as Alternative Target #2 (since Pensionable Earnings are the same under both alternatives), but will produce a reduction in the cost of the cafeteria plan as a result of the forfeiture element. Under Alternative Target #3 this reduction is produced for each nonrepresented employee who opts to receive the Available Cash Option as additional take-home pay.

Before proceeding with the evaluation of the retirement benefit impact of these Alternative Targets, we will focus on their cafeteria plan design implications. We will first look at the currently Available Cash Options under the various County Cafeteria Plans, and then compare these and the Alternative Available Cash Option Targets against a group of other comparable employers.

1993 Available Cash Options

Table 5 illustrates the Available Cash Options under the various county cafeteria plans for the sample employees described in Appendix B.

TABLE 5

	Available Cash Options					
MegaFlex*:	Secretary I	Property Agent II	Senior Secretary III	DP Manager I	DP Manager III	Auditor Controller
• Less than 5 years of service			$376	$749	$991	$1,487
• 5 or more years of service**			$376	$903	$1,187	$1,769
• 10 or more years of service as of 1/1/91			$419	$1,027	$1,344	$1,994
Flexible Benefit Plan*			$294	$470	$637	$980
Choices		$244				
Options***	$244					

Gray areas indicate not applicable.

* Note that the Available Cash Options for MegaFlex and the Flexible Benefit Plan assume no medical plan waiver, that is, the employee does not qualify to waive the minimum level of medical benefits under these plans. The minimum cost medical benefit is $148 per month. The only employees who qualify for this waiver are those who have employee (not dependent) coverage under another employer's plan (or Medicare) and Superior Court Judges. Only about 379 MegaFlex currently qualify, thus we have chosen to focus on the great majority.

** The following bullet applies to employees with 10+ years of service as of 1/1/91.

*** Same as Choices (see Note 5 on Table 2)

Because the County Cafeteria Plan Contributions to MegaFlex and the Flexible Benefit Plan (thus, the Available Cash Options) are determined as a *percentage of pay*, higher-paid employees have a much larger potential increase in take home pay than employees covered by the Choices and Options plan. We can demonstrate this by comparing the additional take-home pay results when each sample employee chooses the following "common" package of benefits.

TABLE 6

Common Package of Benefits	
Medical Plan (employee plus 2 dependents)	Kaiser
Dental Plan	Safeguard
Life Insurance Benefits (for employee age 40)	1 times annual salary
Accidental Death & Dismemberment	$200,000 (Employee Only)
Long-Term Disability Benefit	60% of salary
Long-Term Disability Health Insurance	75% of total cost
Vacation (in addition to 8 days for sick leave)	3 weeks
Short-Term Disability	60% of salary (7-day waiting period)

This "common" package was chosen because it provides adequate coverages and benefits for the typical employee.

Following is the take-home pay that the sample employees will receive after purchasing the common package of benefits listed above:

TABLE 7

Additional Take-Home Pay After Purchasing Common Package of Benefits

	Secretary I	Property Agent II	Senior Secretary III	D P Manager I	D P Manager III	Auditor Controller
MegaFlex*			($60)	$274	$457	$832
Flexible Benefit Plan			$37	$209	$374	$712
Choices		$31				
Options**	$33					

Gray areas indicate not applicable.
* Employee with 5 or more years of service.
** Same as Choices (see Note 5 on Table 2)

Amounts in parenthesis indicate that the employee needs to have this amount deducted from his or her pay in order to buy the common package of benefits.

It is clear from the MegaFlex and Flexible Benefit Plan results in Table 7 that higher-paid employees can purchase an adequate package of benefits and still have money left to supplement their paycheck. The lower paid employees in MegaFlex need to go out-of-pocket to purchase these benefits.

The County recognizes that the practice of providing employees a county cafeteria plan contribution as a percentage of pay results in an increase in total compensation for some employees. The County believes that, from a total compensation pay policy perspective, the MegaFlex and Flexible Benefit Plan contribution arrangement is a cost-effective aid in recruiting and retaining a high caliber of nonrepresented employees. We presently have no basis upon which to argue against this position. In fact, the purpose of Recommendation #5 is to obtain the data necessary to support or refute this position. This issue will be addressed further in Section 3.6.

Comparison of Alternative Available Cash Option Targets Against Employer Survey Groups

As part of this study, W F Corroon surveyed a group of comparable employers' cafeteria plans to serve as a benchmark for evaluating the various cafeteria plan changes presented in this report. A detailed description of the survey group and data can be found in Appendix B. Table 8 provides the survey group comparison for the Alternative Available Cash Option Targets for the sample group of employees described in Appendix C.

TABLE 8

Currently Available Cash Option	Secretary I	Property Agent II	Senior Secretary III	D P Manager I	D P Manager III	Auditor Controller
	Available Cash Option Targets – Comparison with Employer Survey					
MegaFlex*			$376	$903	$1,187	$1,769
Flexible Benefit Plan			$294	$470	$637	$980
Choices		$244				
Options**	$244					
Alternative Target #1						
MegaFlex*			$376	$470	$637	$980
Flexible Benefit Plan			$294	$470	$637	$980
Choices		$244				
Options**	$244					
Alternatives Targets #2 & #3* **						
MegaFlex*			$376	$376	$376	$376
Flexible Benefit Plan			$294	$294	$294	$294
Choices		$244				
Options**	$244					
Surveyed Employers						
Public - 1	$140	$140	$140	$140	$140	$140
Public - 2	$234	$234	$234	$234	$234	$234
Public - 3	$75	$75	$75	$75	$75	$75
Public - 4			$117	$117	$117	$292
Corp. - 1	$113	$144	$127	$189	$221	$287
Utility - 1	$52	$84	$67	$131	$165	$233

Gray areas indicate not applicable.
* Employees with 5 or more years of service.
** Same as Choices (see Note 5 on Table 2)
***Note that Alternative #3 produces the same Available Cash Option as Alternative #2.

The results of the survey comparison demonstrate that Alternative #1 provides Available Cash Options that exceed those of all other surveyed plans, particularly for the nonrepresented employees in MegaFlex and the Flexible Benefit Plan. The remaining alternatives provide Available Cash Options which are comparable to the survey group, albeit still higher.

Because our employer survey group sponsored a relatively small number of comparable plans, we utilized a published survey (Flexible Compensation Programs and Practices 1993 (1992 Data) - Hewitt Associates, Lincolnshire, IL) to supplement our sample data. More details on this published survey, which contained data from 472 employers, can be found in Appendix B. This survey found that about 85% of the 282 employers with plans comparable to those of the County permit employees to take unused credits as taxable cash. Only 4% of these plans limit the amount that can be taken as cash, and such limits range from \$300 to \$1,200 per year. It should be pointed out that it is extremely unlikely that any of these employers include the Available Cash Option (as opposed to the actual cash taken) in pensionable earnings. If they were required to do so, many more employers would certainly restrict the Available Cash Option. In any event, the Alternative Available Cash Options under all of the Alternative Targets exceed this \$300 to \$1,200 range.

Conclusion on the Establishment of Alternative Available Cash Option Targets

In conclusion, the Alternative Targets are not overly restrictive when compared to our sample employer group nor when compared to the published survey. We can therefore conclude that reductions in the Available Cash Options should not adversely affect the County's ability to attract and retain qualified employees. Therefore, we believe they are appropriate for use in connection with Recommendation #1b. The Commission can choose whichever target it believes is consistent with its own philosophy and retirement cost reduction objectives. Their retirement cost reduction potential will be addressed in the following analysis.

Impact of Recommendation #1b on Retirement Benefits

Having now established a set of Alternative Targets which are feasible from a cafeteria plan design standpoint, we can now evaluate how their use will impact retirement benefits and costs.

Table 9, on the following page, demonstrates the impact that Recommendation #1bi (*freezing* Available Cash Options) would have on the retirement benefits in our typical nonrepresented employee group under MegaFlex and Miscellaneous Member Retirement Plan D. The table provides the impact on the portion of the employees' projected retirement benefit due to the inclusion of the Available Cash Option in Pensionable Earnings. The impact is illustrated applying Alternative Available Cash Option Target #1, and then Targets #2 and #3 (recall the retirement impact is the same for these two Targets). Table 10, following Table 9, provides the same information if the MegaFlex Available Cash Options are *reduced* according to Recommendation #1bii rather than merely being *frozen*. We provide similar projections for the Flexible Benefit Plan in Tables 11 and 12.

Note that these tables assume that Recommendation #1a is implemented in conjunction with this Recommendation #1b. These tables utilize the same assumptions as Table 4 (see page 21).

TABLE 9 — RECOMMENDATION 1bI

Assuming Retirement at Age 62 in:	Impact on Retirement Benefits of Freezing MegaFlex Available Cash Option — Alternative Available Cash Option Target #1				Alternative Available Cash Option Targets #2 and #3			
	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
1993								
Available Cash Option:								
• Current	$376	$903	$1,187	$1,769	$376	$903	$1,187	$1,769
• Recommendation 1bi	$376	$903	$1,187	$1,769	$376	$903	$1,187	$1,769
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$225	$540	$710	$1,058	$225	$540	$710	$1,058
• Recommendation 1bi	$225	$540	$710	$1,058	$225	$540	$710	$1,058
5 Years								
Available Cash Option:								
• Current	$474	$1,155	$1,517	$2,260	$474	$1,155	$1,517	$2,260
• Recommendation 1bi	$295	$708	$930	$1,386	$295	$708	$930	$1,386
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$259	$628	$825	$1,230	$259	$628	$825	$1,230
• Recommendation 1bi	$177	$424	$556	$829	$177	$424	$556	$829
10 Years								
Available Cash Option:								
• Current	$582	$1,447	$1,898	$2,823	$582	$1,447	$1,898	$2,823
• Recommendation 1bi	$231	$554	$729	$1,086	$231	$554	$729	$1,086
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$318	$790	$1,037	$1,543	$318	$790	$1,037	$1,543
• Recommendation 1bi	$138	$332	$436	$650	$138	$332	$436	$650

TABLE 9 — RECOMMENDATION 1bi
(continued)

Assuming Retirement at Age 62 in:	Impact on Retirement Benefits of Freezing MegaFlex Available Cash Option — Alternative Available Cash Option Target #1: Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Alternative Available Cash Option Targets #2 and #3: Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
15 Years								
Available Cash Option:								
• Current	$722	$1,755	$2,324	$3,450	$722	$1,755	$2,324	$3,450
• Recommendation 1bi	$227	$547	$714	$1,056	$181	$434	$571	$851
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$396	$973	$1,275	$1,893	$396	$973	$1,275	$1,893
• Recommendation 1bi	$128	$310	$405	$600	$108	$260	$341	$509
20 Years								
Available Cash Option:								
• Current	$881	$2,131	$2,784	$4,120	$881	$2,131	$2,784	$4,120
• Recommendation 1bi	$243	$563	$730	$1,072	$142	$340	$447	$667
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$484	$1,173	$1,533	$2,270	$484	$340	$1,533	$2,270
• Recommendation 1bi	$137	$320	$414	$610	$85	$204	$267	$399

TABLE 10 — RECOMMENDATION 1bII

	Impact on Retirement Benefits of Reducing MegaFlex Available Cash Option							
	Alternative Available Cash Option Target #1				Alternative Available Cash Option Targets #2 and #3			
Assuming Retirement at Age 62 in:	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
1993								
Available Cash Option:								
• Current	$376	$903	$1,187	$1,769	$376	$903	$1,187	$1,769
• Recommendation 1bii	$376	$903	$1,187	$1,769	$376	$903	$1,187	$1,769
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$225	$540	$710	$1,058	$225	$540	$710	$1,058
• Recommendation 1bii	$225	$540	$710	$1,058	$225	$540	$710	$1,058
5 Years								
Available Cash Option:								
• Current	$474	$1,155	$1,517	$2,260	$474	$1,155	$1,517	$2,260
• Recommendation 1bii	$295	$502	$669	$1,012	$295	$295	$295	$295
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$259	$628	$825	$1,230	$259	$628	$825	$1,230
• Recommendation 1bii	$177	$283	$378	$574	$177	$177	$177	$177
10 Years								
Available Cash Option:								
• Current	$582	$1,447	$1,898	$2,823	$582	$1,447	$1,898	$2,823
• Recommendation 1bii	$231	$527	$695	$1,037	$231	$231	$231	$231
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$318	$790	$1,037	$1,543	$318	$790	$1,037	$1,543
• Recommendation 1bii	$138	$298	$393	$589	$138	$138	$138	$138

TABLE 10 — RECOMMENDATION 1bII
(continued)

	Impact on Retirement Benefits of Reducing MegaFlex Available Cash Option							
	Alternative Available Cash Option Target #1				Alternative Available Cash Option Targets #2 and #3			
Assuming Retirement at Age 62 in:	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
15 Years								
Available Cash Option:								
• Current	$722	$1,755	$2,324	$3,450	$722	$1,755	$2,324	$3,450
• Recommendation 1bii	$227	$547	$714	$1,056	$181	$181	$181	$181
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$396	$973	$1,275	$1,893	$396	$973	$1,275	$1,893
• Recommendation 1bii	$128	$310	$405	$600	$109	$109	$109	$109
20 Years								
Available Cash Option:								
• Current	$881	$2,131	$2,784	$4,120	$881	$2,131	$2,784	$4,120
• Recommendation 1bii	$243	$563	$730	$1,072	$142	$142	$142	$142
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$484	$1,173	$1,533	$2,270	$484	$1,173	$1,533	$2,270
• Recommendation 1bii	$137	$320	$414	$610	$85	$85	$85	$85

TABLE 11 — RECOMMENDATION 1bI

	Impact on Retirement Benefits of Freezing Flexible Benefit Plan Available Cash Option							
	Alternative Available Cash Option Target #1				Alternative Available Cash Option Targets #2 and #3			
Assuming Retirement at Age 62 in:	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
1993								
Available Cash Option:								
• Current	$294	$470	$637	$980	$294	$470	$637	$980
• Recommendation 1bi	$294	$470	$637	$980	$294	$470	$637	$980
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$176	$281	$381	$586	$176	$281	$381	$586
• Recommendation 1bi	$176	$281	$381	$586	$176	$281	$381	$586
5 Years								
Available Cash Option:								
• Current	$371	$602	$816	$1,252	$371	$602	$816	$1,252
• Recommendation 1bi	$230	$502	$669	$1,012	$230	$368	$499	$768
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$202	$328	$443	$682	$202	$328	$443	$682
• Recommendation 1bi	$138	$283	$378	$574	$138	$221	$298	$460
10 Years								
Available Cash Option:								
• Current	$447	$758	$1,024	$1,568	$447	$758	$1,024	$1,568
• Recommendation 1bi	$208	$527	$695	$1,037	$180	$289	$391	$602
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$246	$414	$559	$857	$246	$414	$559	$857
• Recommendation 1bi	$116	$298	$393	$589	$108	$173	$234	$360

TABLE 11 — RECOMMENDATION 1bi
(continued)

	Impact on Retirement Benefits of Freezing Flexible Benefit Plan Available Cash Option							
	Alternative Available Cash Option Target #1				Alternative Available Cash Option Targets #2 and #3			
Assuming Retirement at Age 62 in:	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
15 Years								
Available Cash Option:								
• Current	$515	$937	$1,261	$1,923	$515	$937	$1,261	$1,923
• Recommendation 1bi	$227	$547	$714	$1,056	$141	$226	$306	$471
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$286	$514	$690	$1,055	$286	$514	$690	$1,055
• Recommendation 1bi	$128	$310	$405	$600	$85	$136	$183	$282
20 Years								
Available Cash Option:								
• Current	$566	$1,136	$1,520	$2,306	$566	$1,136	$1,520	$2,306
• Recommendation 1bi	$243	$563	$730	$1,072	$111	$177	$240	$369
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$317	$625	$836	$1,270	$317	$625	$836	$1,270
• Recommendation 1bi	$137	$320	$414	$610	$67	$106	$143	$221

TABLE 12 — RECOMMENDATION 1bII

	Impact on Retirement Benefits of Reducing Flexible Benefit Plan Available Cash Option							
	Alternative Available Cash Option Target #1				Alternative Available Cash Option Targets #2 and #3			
Assuming Retirement at Age 62 in:	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
1993								
Available Cash Option:								
• Current	$294	$470	$637	$980	$294	$470	$637	$980
• Recommendation 1bii	$294	$470	$637	$980	$294	$470	$637	$980
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$176	$281	$381	$586	$176	$281	$381	$586
• Recommendation 1bii	$176	$281	$381	$586	$176	$281	$381	$586
5 Years								
Available Cash Option:								
• Current	$371	$602	$816	$1,252	$371	$602	$816	$1,252
• Recommendation 1bii	$230	$502	$669	$1,012	$230	$230	$230	$230
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$202	$328	$443	$682	$202	$328	$443	$682
• Recommendation 1bii	$138	$283	$378	$574	$138	$138	$138	$138
10 Years								
Available Cash Option:								
• Current	$447	$758	$1,024	$1,568	$447	$758	$1,024	$1,568
• Recommendation 1bii	$208	$527	$695	$1,037	$180	$180	$180	$180
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$246	$414	$559	$857	$246	$414	$559	$857
• Recommendation 1bii	$116	$298	$393	$589	$108	$108	$108	$108

TABLE 12 — RECOMMENDATION 1bII
(continued)

	Impact on Retirement Benefits of Reducing Flexible Benefit Plan Available Cash Option							
	Alternative Available Cash Option Target #1				Alternative Available Cash Option Targets #2 and #3			
Assuming Retirement at Age 62 in:	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
15 Years								
Available Cash Option:								
• Current	$515	$937	$1,261	$1,923	$515	$937	$1,261	$1,923
• Recommendation 1bii	$227	$547	$714	$1,056	$141	$141	$141	$141
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$286	$514	$690	$1,055	$286	$514	$690	$1,055
• Recommendation 1bii	$128	$310	$405	$600	$85	$85	$85	$85
20 Years								
Available Cash Option:								
• Current	$566	$1,136	$1,520	$2,306	$566	$1,136	$1,520	$2,306
• Recommendation 1bii	$243	$563	$730	$1,072	$111	$111	$111	$111
Projected Retirement Benefit Due to Available Cash Option:								
• Current	$317	$625	$836	$1,270	$317	$625	$836	$1,270
• Recommendation 1bii	$137	$320	$414	$610	$67	$67	$67	$67

A distinguishing difference between the respective retirement benefit impacts of the Available Cash Option Freeze versus the Reduction is the time it will take for reductions in retirement benefits (hence, the County's retirement costs) to be realized. The Freeze strategy generally takes between ten and fifteen years to achieve the Alternative Available Cash Option Target #1, and well in excess of twenty years to achieve Alternative Available Cash Option Targets #2 and #3. The Reduction strategy takes less than five years.

In our September 1992 comparability study, we evaluated the "competitiveness" of the County's retirement benefits versus other public and private entities. The results were that the County's retirement benefits for nonrepresented employees generally exceed those of the other entities. Also, we found that the County was unique among those surveyed for including cafeteria plan cash options in Pensionable Earnings. For these reasons, we do not believe the adoption of this recommendation will negatively impact the County's ability to attract and retain qualified employees.

Cost Impact

Table 13 provides the approximate range of County retirement cost reductions resulting from these various strategies when implemented in conjunction with Recommendation #1a.

TABLE 13

	Alternative Available Cash Option Target:	
Available Cash Option:	#1	#2 or #3
Freeze	\$17 million to \$19 million	\$18 million to \$20 million
Reduction	\$18 million to \$20 million	\$19 million to \$21 million

Impact of Recommendation #1b on Cafeteria Plan Design

Earlier in this section, we provided an analysis of the Cafeteria Plan design impact of the various Alternative Available Cash Option Targets. The conclusion was that the Alternative Targets are not overly restrictive when compared to our sample employer group nor when compared to the published survey. Section 3.2.1. dealt with the impact of lowering the real value of Available Cash Options over time. There is no need to repeat that analysis here, since the Freeze and Reduction strategies do not raise any new issues in this regard. We will instead focus here on a comparison of the Cafeteria Plan Design impacts of Alternatives #2 and #3.

To review:

- **Alternative Target #2** – Targets the Available Cash Options at the Minimum County Cafeteria Plan Contribution (presently $524 and $442 per month under MegaFlex and the Flexible Benefit Plan, respectively, if the employee waives medical coverage. If not, these amounts are $148 lower). The County Cafeteria Plan Contribution is not reduced and the excess over the Available Cash Option can be used to purchase noncash benefits.
- **Alternative Target #3** – Has the same Available Cash Option target as #2, but if an employee waives medical coverage, he or she must also waive the excess of the Cafeteria Plan Contribution over the Available Cash Option.

Comparison with Employer Cafeteria Plan Survey Data

Only 4% of the published surveyed plans limit the amount of the employer cafeteria plan contribution that can be taken in cash. However, these employers' pension plans *do not* include the value of the Available Cash Option as Pensionable Earnings. It is almost certain that a greater percentage of employers would limit available cash if they were required to include them in employees' pensions.

In this same survey, 50% of employers have a plan which allocates an employer contribution to the participant based on his or her benefit election. The Choices and Options plans as well as Alternative Target #3 have such a feature.

Note further that Alternative Target #3 would discourage employees from taking the entire Available Cash Options as additional take-home pay by waiving medical coverage. This would protect against the medical benefit anti-selection problem that the County experienced when nonrepresented employees were given greater rights to waive medical coverage. Those that waive medical coverage must also waive a valuable portion of the County Cafeteria Plan Contribution. This should offset any financial effects of anti-selection.

For the above reasons, we believe that implementation of either Alternative Targets #2 or #3 would be reasonable from a design standpoint. From a cost standpoint, Alternative Target #3 provides additional savings to the County, not under the retirement plan, but under the Cafeteria Plans. It is our understanding that some 15% of nonrepresented employees opt to receive the full Available Cash Option as additional take-home pay. This might drop to 5% to 10% in future years when the target is reached.

Cost Impact

If Alternative Target #3 were in place today, it would translate into a County Cafeteria Plan savings of one million to three million dollars per year. Note that these savings will be lower during the transitional years that Recommendation #1b is operating but has not yet brought the Available Cash Option down to the target.

Impact of Recommendation #1b on County Employees' Benefit Purchasing Power

For those employees who utilize the County's Cafeteria Plans to purchase benefits, there is no reduction in their benefit purchasing power, since only the Available Cash Option is reduced, not the County contribution. Only those employees who utilize the Plan to increase take-home pay will be taking a reduction.

Conclusions

Recommendation #1b provides the mechanisms necessary to reduce both the County's retirement benefits and Cafeteria Plan costs.

A wide variety of approaches can be taken depending upon the underlying philosophy that is embraced. The choice of philosophy is a policy decision of:

1. The speed with which the reduction in retirement costs is realized (i.e., Freezing or Reducing the Available Cash Option);
2. Whether or not to allow nonrepresented employees to continue to have a higher potential for increased take-home pay relative to represented employees at the expense of a smaller reduction in retirement costs (i.e., Alternative Target #1 versus Alternative Target #2); and
3. Leveraging the reduction in Available Cash Options to produce reductions in the County's Cafeteria Plan costs as well as retirement costs (i.e., Alternative Target #3).

Regardless of the approach chosen, Recommendation #1a and #1b should be implemented as a package. Section 4 will present alternative strategies incorporating these various approaches.

3.3 Recommendation #1c – Addition of 401(k) Option to MegaFlex and the Flexible Benefits Plan

Overview

If Recommendation #1b is implemented using either Alternative Available Cash Option Target #1 or #2, it would be advantageous to expand the pre-tax benefit options to allow employees to deposit "noncashable" County Cafeteria Plan Contributions into a 401(k) plan. This would retain, as near as possible, the cash nature of the benefit, albeit as deferred retirement savings. It would, at least in spirit, retain some portion of the retirement benefit that would be lost by reducing the Available Cash Option.

In our view, adding this option would have preserved the Pensionable Earnings nature of the amounts eligible for deposit into the 401(k) plan, insofar as those amounts cannot be taken in cash (i.e., the amounts in excess of the Available Cash Option).

Summary of Legal Counsel's Opinion

Federal law requires a cafeteria plan which includes a 401(k) benefit option to also provide an Available Cash Option large enough to allow employees to cash out any amounts that might otherwise be contributed to the 401(k). For this reason, this recommendation will not produce a desirable result.

Conclusion

The recommendation appears to be precluded by legal barriers. We believe the Commission must abandon this recommendation.

3.4 RECOMMENDATION #2 – OFFSET OF RETIREE MEDICAL BENEFITS

Overview

In our 1992 comparability analysis, we addressed the policy issue of what an appropriate pay base should be to measure income replacement for retirement benefit purposes. We believe that the mere existence of a cafeteria plan does not create the need for additional retirement income. The County's cafeteria plans convert employee benefits into their cash equivalent, which the County retirement program in turn converts into additional pension benefits. The direct result is that the retirement benefit now replaces both pay *and* benefits. For this reason, we argued that there may be justification to use the pension benefit increase as an offset against the amounts the County would otherwise contribute for that retiree's medical benefits. The premise is that by basing part of the pension on benefit values, that part of the retiree's pension benefit already pays for a portion of the County's commitment to provide medical benefits for that retiree.

As an example, assume an employee retires at age 62 from Retirement Plan D with 30 years of service. Assume further that the employee has final annual earnings of $30,000 before including the MegaFlex annual cash option and $35,100 after including it. The retiree is entitled to a monthly retirement benefit of $1,835.14 of which $266.65 is due to the inclusion of the MegaFlex Available Cash Option. This employee would be required to contribute towards the cost of retiree health insurance up to the lesser of the cost of the chosen coverage or $266.65 per month. In future years, the $266.65 would be increased with cost-of-living adjustments.

In effect this extends the cafeteria plan concept into the retirement years (albeit without the tax advantages) since the retiree can choose to contribute towards and participate in the County health plan, or to keep the $226.65 per month.

This recommendation would potentially produce County savings totally offsetting pension costs.

Summary of Legal Counsel's Opinion

Although this point has not been fully researched, a preliminary analysis would indicate that it is highly unlikely that the County could reduce contributions that it is already currently obligated to make to provide retiree medical benefits by the amount of increased pension benefits due to the Cash Available Option being treated as pensionable compensation.

Conclusion

The recommendation appears to be precluded by legal barriers. We believe the Commission should discuss this recommendation further with counsel and decide whether to abandon it or whether there is any merit to pursuing the legal issues further.

3.5 RECOMMENDATION #3 – EXCLUDE CAFETERIA PLAN AVAILABLE CASH OPTIONS FROM PENSIONABLE EARNINGS FOR NEW HIRES

Overview

Recommendation #3 is to exclude pensionable earnings for employees hired after the date such change is enacted. Practically, this will be achieved by amending State law.

Possible Application to Current Employees

Based upon previously issued legal opinions, this law could not be retroactively applied to employees hired before its effective date unless individual employees elect to have it apply in exchange for some other comparable benefit. This might be done as follows:

- Implement the Available Cash Option reductions described in Section 3.2 only for those employees hired prior to the effective date of the amended State law;
- Establish a new cafeteria plan "tier" that would retain the current high levels of cafeteria plan Available Cash Options for employees hired after the effective date of the amended State law; and
- Give employees hired prior to the effective date of the amended State law the option to join the new Cafeteria Plan Tier in exchange for waiving their right to continue to have the Available Cash Option included in Pensionable Earnings.

If all employees elected to join this proposed new Cafeteria Plan tier, the impact of the Cafeteria Plans on the County's Retirement costs would be eliminated forever. Realistically, it would not be in the financial best interest for those employees nearing retirement to choose this option since it provides them much lower value than the added retirement benefits.

Summary of Legal Counsel's Opinion

There is no prohibition on modifying the definition of pensionable compensation for new hires.

Impact of Recommendation on Retirement Benefits

Table 14 on the following page, illustrates the impact that the removal of Available Cash Options from Pensionable Earnings would have on reducing the retirement benefits of our typical employee group (assuming they are hired subsequent to the new law and elect coverage under Retirement D). This table utilizes the same assumptions (age 62 retirement after 30 years of service in Miscellaneous Member Plan D) as Table 4 (page 21).

The impact of this recommendation is to reduce retirement benefits for post-new law employees and any pre-new law employees who might elect into a new tier Cafeteria Plan. In our September 1992 comparability study, we evaluated the "competitiveness" of the County's retirement benefits versus other public and private entities. The results were that the County's retirement benefits for nonrepresented employees generally exceed those of the other entities. Also, we found that the County was unique among those surveyed for including cafeteria plan cash options in pensionable earnings. For these reasons, we do not believe the adoption of this recommendation will negatively impact the County's ability to attract and retain qualified employees.

TABLE 14 — RECOMMENDATION #3

	Retirement Benefit Impact of Removing Available Cash Options from Pensionable Earnings (Expressed in 1993 Dollars)									
	Choices Plan (Represented)		Flexible Benefits Plan (Nonrepresented)				MegaFlex (Nonrepresented)			
	Secretary I	Property Agent II	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
Before Law Change:										
Monthly Earnings	$2,230	$3,844	$2,984	$6,183	$7,854	$11,275	$2,984	$6,183	$7,854	$11,275
Pensionable Earnings	$2,558	$4,168	$3,358	$6,653	$8,491	$12,255	$3,440	$7,086	$9,041	$13,044
Projected Retirement Benefit	$1,530	$2,492	$2,008	$3,978	$5,078	$7,328	$2,057	$4,237	$5,407	$7,800
After Law Change:										
Monthly Earnings	$2,230	$3,844	$2,984	$6,183	$7,854	$11,275	$2,984	$6,183	$7,854	$11,275
Pensionable Earnings	$2,314	$3,924	$3,064	$6,183	$7,854	$11,275	$3,064	$6,183	$7,854	$11,275
Projected Retirement Benefit	$1,384	$2,347	$1,832	$3,697	$4,697	$6,742	$1,832	$3,697	$4,697	$6,742

Impact of Recommendation on Cafeteria Plan Design

As discussed in the Overview, here are two possible directions that might be taken in establishing cash options for post-new law employees:

1. To maintain cash options at their current (high) levels under a new Cafeteria Plan Tier; or
2. To reduce cash options to the Alternative Target immediately.

The first direction will not impact new employees' Cafeteria Plan benefits whatsoever. The second will impact affordability in the same capacity as discussed in Section 3.2. For this reason, there is no need to carry out further analysis of the Cafeteria Plan impact.

It might be considered most equitable to pursue direction number 1 to compensate post-new employees for the relatively lower pension benefits they will receive by not having Available Cash Options included in Pensionable Earnings. This also allows for the creation of the incentive for pre-new law employees to opt into the new Tier.

Conclusion

We are aware that LACERA is sponsoring a bill (AB 1659) to accomplish the law changes described above. Following is a description of the bill from the April 1993 edition of the Public Retirement Journal.

> AB 1659 as introduced, would add a new definition section to 37 Act Law that would be operative upon adoption of the county board of supervisors. The new section would provide as follows: "Section 31461.1 Notwithstanding Chapter 45 of the Statutes of 1992, "compensation," as defined by Section 31460, and "compensation earnable," as defined by Section 31461, shall not include cafeteria or flexible benefit plan contributions or transportation, security or similar allowances, and shall only include deferred salary or deferred merit increases at the time such amounts are earned, rather than when they are paid."
>
> The section would be effective if adopted by the county board of supervisors and concurred on by the board of retirement.
>
> The new definitions would only apply to employees hired after the adoption of the section.

Note that AB 1659 does not contain a provision to allow employees hired prior to its effective date to elect to be covered under its provisions.

Recommendation

We recommend that the Commission:

1. Recommend to the County that the provision be incorporated into AB 1659 prior to its passage allowing pre-new law employees the right to elect to be covered under this law; and
2. Stress that lobbying efforts on the Bill be stepped-up to accelerate its passage. County retirement costs grow each day that the exclusion of Available Cash Options from Pensionable Earnings is delayed.

3.6 RECOMMENDATION #5 – EVALUATION OF EXECUTIVE COMPENSATION AND BENEFITS ISSUES

Discussion

A suggestion that the County carry out a study of executive benefit and compensation was included in our September 1992 report. This suggestion was adopted by the Commission and included as Recommendation #2 in its November 4, 1992 report to the Board of Supervisors. The CAO's office issued the following brief response to the recommendation at the November 1992 Board of Supervisors meeting:

> "The County already has in place an effective process for developing and adopting compensation and benefit programs including a well-managed and -funded retirement system."

As discussed in Section 3.2.2 of this report, the CAO's office has established a compensation and benefits philosophy which it has followed in designing its pay package. The elements of that philosophy which are relevant to the issues addressed in this report are:

- The MegaFlex and Flexible Benefit Plan contribution arrangement is a cost-effective aid in recruiting and retaining a high caliber of nonrepresented employees.
- Providing significant cash options through the County's cafeteria plans is a cost-effective means of increasing an employee's take-home pay during his or her working years.

The Commission will need additional data before it can properly evaluate the reasonableness of these elements of the County's current total compensation and benefits philosophy.

Conclusion

We believe the Commission should ask the CAO's office for a quantitative demonstration that its total compensation and benefits philosophy is founded on fiscally-sound principles.

3.7 Recommendation #6 – Eliminate the Selling of Annual Leave Benefits from MegaFlex

Overview

Recommendation #6 is to have the Board of Supervisors modify MegaFlex to eliminate employees' ability to sell annual leave (time-off) benefits under MegaFlex, and provide MegaFlex participants with a similar Elective Annual Leave program outside of the Cafeteria Plan.

Flexible Benefit Plan participants receive the following vacation allowances:

Length of Service	Number of Vacation Days
1 to 4 years	10
5 to 9 years	15
10 years	16
11 years	17
12 years	18
13 years	19
14 years or more	20

MegaFlex provides a basic "paid time off" benefit of ten days which replaces both vacation and eight days of full-pay sick leave. To compensate for this replacement, the County contribution to MegaFlex is greater. For employees with less than five years of service, the additional County contribution is 3.2% of pay (0.4% per day x 8 full-pay sick leave days). The 0.4% is the proportion of one day's pay to one year's pay. For employees with five through nine years of service, the additional contribution is 5.2% (3.2% for Full-Pay Sick Leave + 0.4% per day x 5 vacation days). For employees with ten or more years of service as of January 1, 1991, the additional contribution equals 0.4% for each year of service in excess of ten, up to a maximum of 2.0% (0.4% per day x 5 vacation days). Those who achieve ten years of service after January 1, 1991, receive no additional County contribution for any years in excess of ten. Table 16 on the following page, summarizes the additional County contribution for MegaFlex participants for foregone full-pay sick leave and vacation time.

TABLE 15

Length of Service	MegaFlex Participants with: Ten or More Years of Service as of January 1, 1991	MegaFlex Participants with: Less Than Ten Years of Service as of January 1, 1991
1 to 4 years	N/A	3.2%
5 to 9 years	N/A	5.2%
10 years	5.6%	5.2%
11 years	6.0%	5.2%
12 years	6.4%	5.2%
13 years	6.8%	5.2%
14 years	7.2%	5.2%

Since these additional County contributions are part of the Available Cash Option, they result in a corresponding increase in Pensionable Earnings, regardless of whether the participant elects to take these amounts in cash or to use them to buy back the time-off benefits.

This recommendation would remove Elective Annual Leave from the MegaFlex Plan and credit MegaFlex participants with the equivalent vacation and sick leave time outside of the plan. At the end of each calendar year, MegaFlex participants would be required to cash out the total unused balance vacation and sick leave days at the end of the year up to:

The prior year's carryover plus the current year's accrual
minus
10 Days

This would allow employees to carry over no more than 10 days of time-off from one year to the next. Such a program limits the County's unfunded liability for accumulated time-off benefits by requiring employees to either take their vacation time or to take it in cash.

MegaFlex participants would still be able to buy additional time-off through employee salary reduction contributions within the MegaFlex plan.

Summary of Legal Counsel's Opinion

As long as the Board of Retirement makes or has made a determination that the ability to cash out leave days outside of a cafeteria plan does not constitute pensionable compensation, this proposal would obviously result in a reduction in the amount of pensionable compensation being paid to participants in MegaFlex.

Impact on Retirement Benefits

The following Table 16 illustrates the impact that removing Elective Annual Leave benefits from MegaFlex would have on reducing the portion of the retirement benefit due to the Available Cash Option for our typical employee group under Miscellaneous Member Retirement Plan D.

TABLE 16 — RECOMMENDATION #6

Retirement Benefit Impact of Removing Elective Annual Leave from MegaFlex				
	Senior Secretary III	DP Manager I	DP Manager III	Auditor/ Controller
Current MegaFlex Plan:				
Monthly Earnings	$2,984	$6,183	$7,854	$11,275
Available Cash Option*	$376	$903	$1,187	$1,769
Projected Retirement Benefits Due to Available Cash Option*	$225	$540	$710	$1,058
After Removing Elective Annual Leave				
Monthly Earnings	$2,984	$6,183	$7,854	$11,275
Available Cash Option*	$376	$582	$779	$1,182
Projected Retirement Benefits Due to Available Cash Option **	$225	$348	$466	$707

* Assuming employee not eligible for medical waiver.

** Assuming retirement at age 62 after 30 years of service.

The table demonstrates that the implementation of this recommendation could be used to take a substantial first-step to bring the Available Cash Option under MegaFlex to either one of the Alternative Targets introduced in Section 3.2. Recommendations #1a and #1b would then be used to complete the task.

Cost Impact

We estimate that applying this recommendation alone could result in a reduction of one million to two million dollars per year in the County's retirement costs.

Impact of Recommendations on Cafeteria Plan Design

Typically, employers include vacation time under a cafeteria plan to allow employees the ability to sell vacation time and buy other benefits on a pre-tax basis. An employer can produce cost-savings in this fashion by setting costs of cafeteria plan benefit options at a level where employees must sell vacation time in order to afford a full package of benefits. We asked a representative of the Los Angeles County Chief Administrative Office to provide us the rationale for including vacation in MegaFlex and were informed that their objective was to:

- Increase employee productivity; and
- Improve the flexibility of the program.

The first point was to be achieved by having employees sell vacation and spend more time on the job. We further inquired as to whether there was any data to support the contention that productivity increased as a result of this program. We were informed that the increased productivity was expected to result from less employee absenteeism.

We believe that the County's objectives can be achieved through an Annual Elective Leave program established outside of the MegaFlex plan and thus, eliminate the associated pension costs. Following are the advantages and disadvantages of this approach:

Advantages:

1. Reduces Pensionable Earnings since payouts for accrued vacation or sick leave are not includable as earnable compensation under the 1937 County Retirement Act.
2. Eliminates the "use-it-or-lose-it" rule, thus employees can be assured that no time-off will be forfeited from this separate program at year end.
3. Gives employees the opportunity throughout the year to decide whether or not to use the accrued time-off or to receive excess time-off as cash at year end rather than having to make an irrevocable decision before the year begins.
4. Limits the liability that the County must book for accumulated time-off that is carried over from year to year by employees.

Disadvantages:

1. Removes a key distinction between MegaFlex and the Flexible Benefit Plan. This could be overcome by allowing MegaFlex participants to re-enter the Flexible Benefit Plan at the next open enrollment.

2. Precludes employees from directly trading time-off for other benefits on a pre-tax basis. This is more an inconvenience than a disadvantage, since before the beginning of each year, employees can choose to reduce their salary to buy pre-tax benefits for the next year. By the time they make this election, they know fairly well what their payout will be from this program for the current year. They can thus arrange their payroll deduction election for buying benefits under MegaFlex to approximately equal the amount of payout they expect to receive.

3. Removes employees' ability to carry over more than 10 days of time-off. Note that this is the mirror image of advantage #4. Whether or not it is a disadvantage depends upon the point of view.

Comparison with Employer Cafeteria Plan Survey Data

From our survey of comparable employee's cafeteria plans, two provide vacation time "trading" as a benefit option. In the published survey, 26% of cafeteria plans provide some flexibility of time-off benefits within the plan. Of that group:

- 40% allowed both buying and selling of vacation
- 35% allowed vacation buying only
- 19% allowed vacation selling only
- 6% combined time-off benefits (sick leave, vacation, personal time, etc.) for purposes of trading

The MegaFlex plan would become part of the 35% group rather than the 40% group by this change; not a significant difference.

Impact of Recommendation #6 on County Employees' Benefit Purchasing Power

Employee's benefit purchasing power will not be significantly affected by implementing this recommendation. Disadvantage #2 (selling time-off in exchange for other benefits) presents more of a logistical problem than a purchasing power problem. The employee must predict the amount of the Elective Annual Leave payout and set payroll deductions at that amount. On the other hand, advantages #2 and #3 could be presented to employees as offsetting these disadvantages.

Conclusion

Removing the value of time-off benefits from the County Cafeteria Plan Contribution can produce rapid reductions in Pensionable Earnings, and, in turn, County retirement costs for MegaFlex participants. There are both positive and negative impacts on MegaFlex participants, thus it will probably be necessary to reopen employee elections between MegaFlex and the Flexible Benefit Plan. This will allow employees who made an irrevocable MegaFlex election to reconsider whether MegaFlex, as modified with the new Elective Annual Leave program, is still attractive to them.

4 ALTERNATIVE STRATEGIES

4.1 ALTERNATIVE STRATEGIES

Overview

In order to assist the Commission in its mission, we have constructed three alternative strategies that could be used to reduce the County's retirement costs using our recommendation as building blocks. We categorize these three strategies as:

- **Aggressive Strategy** – Produces the most dramatic reductions in costs over the shortest period of time.
- **Moderate Strategy** – Produces gradual cost reductions by introducing cafeteria plan changes that take place over a more extended time period.
- **Conservative Strategy** – Focuses only on those changes that will prevent future retirement cost increases rather than cost reductions.

Each of these strategies are described in this Section.

Aggressive Strategy

The Aggressive Strategy is implemented as follows:

Recommendation #3

The County steps up lobbying efforts for the passage of an amended version of AB 1659 to assure that Available Cash Options under the County's cafeteria plans can be excluded from Pensionable Earnings for all new employees. The amended version of AB 1659 should allow existing employees the right to have the new law apply to them on a voluntary basis.

All new nonrepresented employees hired prior to the passage of AB 1659 will enter MegaFlex with an Available Cash Option equal to the Minimum Cafeteria Plan Contribution (currently $542 if eligible to waive medical benefits, otherwise $376). This will also be true of employees who move from a represented to a nonrepresented classification.

Upon passage of AB 1659, a new cafeteria plan will be established with provisions identical to that of the 1993 MegaFlex plan, including the current high levels of Available Cash Options. Employees subject to AB 1659 will become members of this new cafeteria plan. Existing employees will be given the option (at the next open enrollment) to become subject to the provisions of AB 1659 (i.e., have their Pensionable Earnings exclude the value of the Cafeteria Plan Available Cash Option) in exchange for joining the new cafeteria plan.

The following changes to MegaFlex and the Flexible Benefit Plan should be made effective January 1, 1994:

Recommendation #6

- <u>*MegaFlex*</u> – The right to sell annual leave will be removed from the plan and replaced with a comparable, but different program, outside of MegaFlex. An election to re-join the Flexible Benefit Plan will be available during the upcoming open enrollment.

Recommendation #1a

- <u>*MegaFlex and the Flexible Benefit Plan*</u> – Beginning in 1994, the County Cafeteria Plan Contribution for the year would be comprised of two components:

  1. A dollar amount equal to the Minimum County Cafeteria Plan Contribution for the year in question, plus
  2. A percentage of an employee's pay calculated as any excess of:
     (a) The 1993 County Cafeteria Plan Contribution for the employee (as a percentage of pay); over
     (b) The 1993 Minimum County Cafeteria Plan Contribution as a percentage of the employee's annual pay rate as of December 31, 1993.

This percentage will not be increased in future years. For MegaFlex participants, the 1993 County Cafeteria Plan Contribution used in this determination will be net of the 1993 portion attributable to Elective Annual Leave.

The Minimum County Cafeteria Plan Contribution will be held constant for all future years. The County will subsidize the cost of medical and dental plan options to retain or reduce employees' purchasing power of these benefits, as appropriate.

At the expiration of the current collective bargaining agreements, the County will negotiate for a freeze in the current County Cafeteria Plan Contributions and retention of an agreed upon level of medical and dental benefit purchasing power under the Choices and Options plans. This purchasing power level is to be retained through pricing of the benefits under these cafeteria plans. If this strategy is unsuccessful, the County must include, as a bargaining item, the impact on retirement costs of increasing the negotiated County Cafeteria Plan Contribution.

Recommendation #1bii (Alternative Target #3)

An employee's Available Cash Options in 1994 will be equal to the lesser of:

1. The dollar amount of Available Cash Option to which he/she was entitled in 1993; or
2. The amount that results from application of the percentage of pay that was used in determining his/her County Cafeteria Plan Contribution for 1993.

However, in no event will the amount be less than the Minimum County Cafeteria Plan Contribution. For MegaFlex participants the 1993 Available Cash Option and County Cafeteria Plan Contribution percentage used in this determination will be net of the 1993 portion attributable to Elective Annual Leave.

In future years (1995 and later), the Available Cash Option for the year will equal:

1. The 1994 dollar amount, <u>less</u>
2. Any excess of:
   (a) The employee's annual pay rate as of the last day of the year immediately preceding the year in question; over
   (b) The employee's annual pay rate as of December 31, 1993,

but not less than the Minimum County Cafeteria Plan Contribution for the year, nor greater than the Available Cash Option for the immediately preceding year.

Beginning in 1996, MegaFlex and the Flexible Benefit Plan participants will again become eligible to waive medical coverage if they can provide evidence of other coverage either as an employee or dependent. If medical coverage is waived by the participant in any year, the affected participant will receive the full Available Cash Option as take-home pay, but he or she will not be entitled to any additional County Cafeteria Plan Contribution for such year.

Cost Impact

We estimate that the Aggressive Strategy will reduce County retirement costs by approximately $20 million to $23 million per year. This does not include the cost reductions which result from implementing recommendation #3 for new members or existing members. In addition to the retirement savings, the County will save one million to three million dollars per year in Cafeteria Plan savings beginning in 1993 and later.

Moderate Strategy

The Moderate Strategy differs from the Accelerated Strategy only by:

Forego Recommendation #6

- Maintaining the Elective Annual Leave benefit within MegaFlex; and

Recommendation #1bii (Alternative Target #2)

- Eliminating the 1996 change allowing MegaFlex and the Flexible Benefit Plan participants to waive medical coverage.

Cost Impact

We estimate that this strategy will reduce County retirement costs by approximately \$19 million to \$21 million per year. There will be no savings in Cafeteria Plan costs.

Conservative Strategy

This strategy back-peddles further from the Moderate Strategy by substituting the following MegaFlex and the Flexible Benefit Plan changes for those described in the Accelerated Strategy.

Recommendation #1bi

- *MegaFlex and the Flexible Benefit Plan* – An employee's Available Cash Option in 1994 and later will be equal to the dollar amount of Available Cash Option to which he or she was entitled in 1993.

The appropriate Alternative Available Cash Option Target would be determined in future years, as deemed appropriate under evolving circumstances.

Cost Impact

We estimate that this strategy will reduce County retirement costs by approximately \$18 million to \$20 million per year.

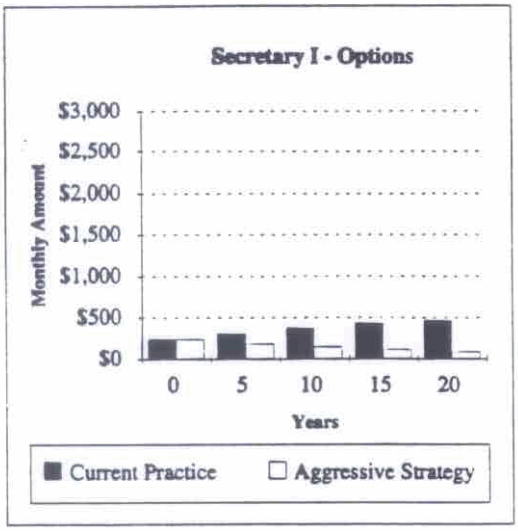
Comment

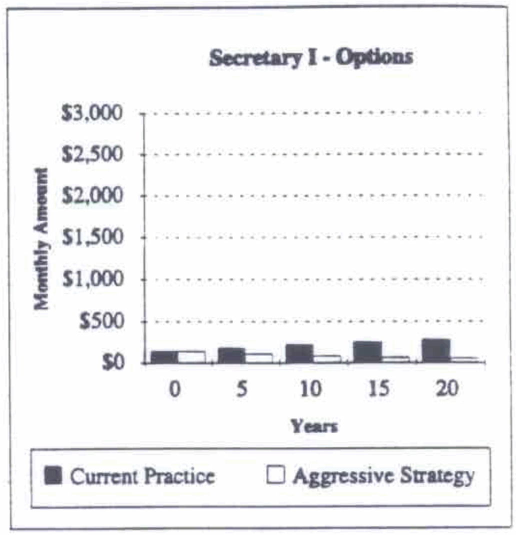
There are many other strategies that could be developed using the recommendations as building blocks. The Commission may want to center its efforts on the development of the general policy which will be used in achieving the objective of reducing retirement costs.

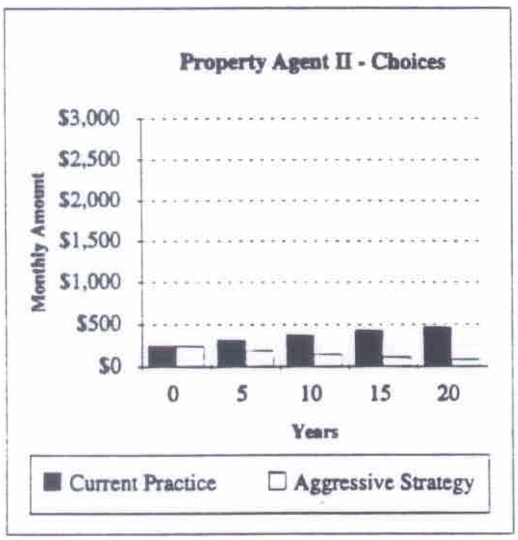
AGGRESSIVE STRATEGY

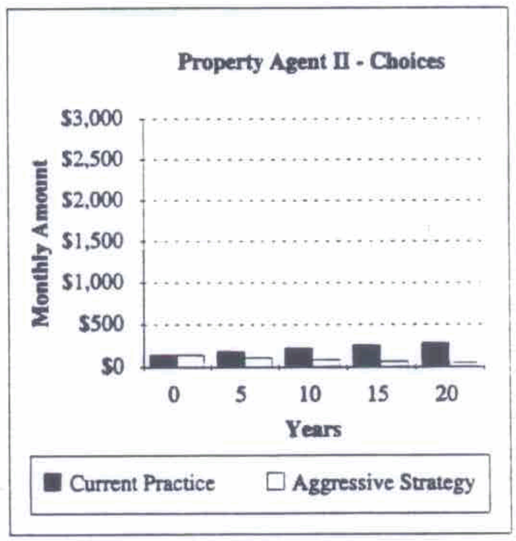
Available Cash Option

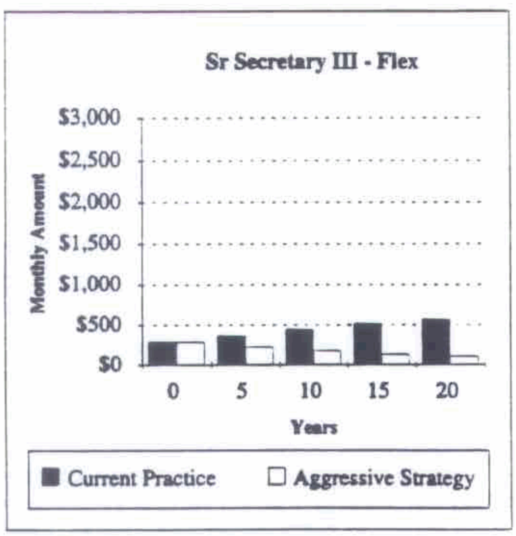
Retirement Benefit

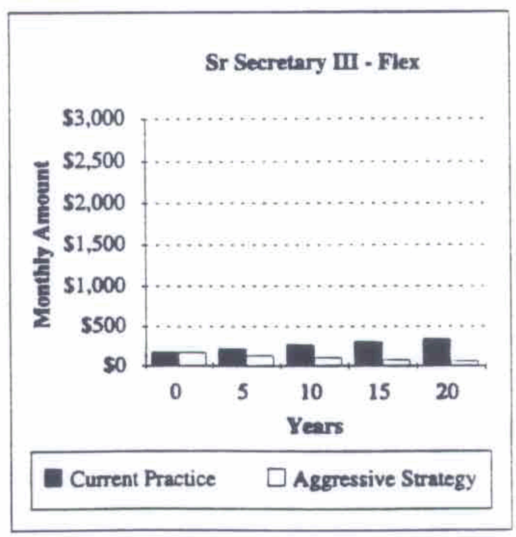






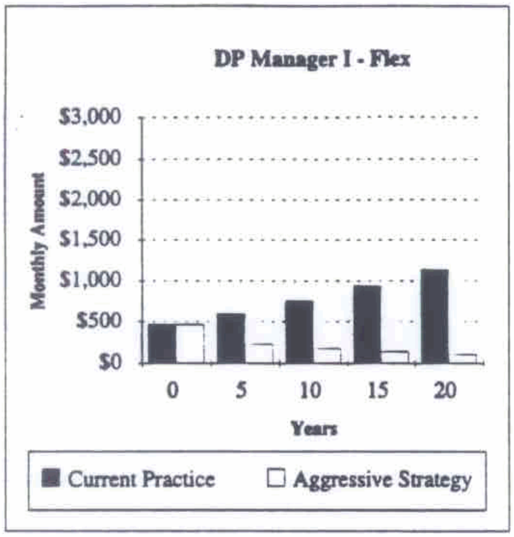


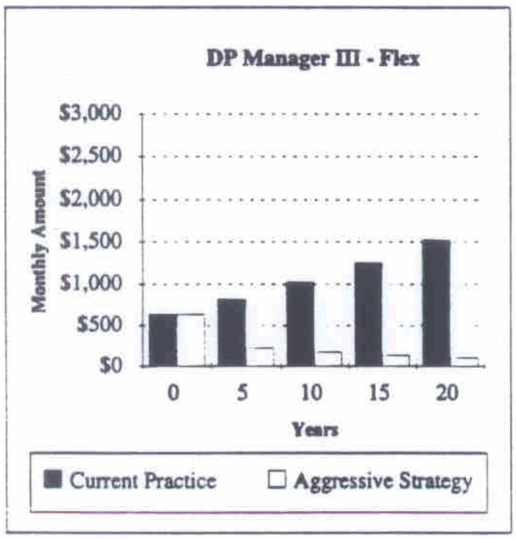


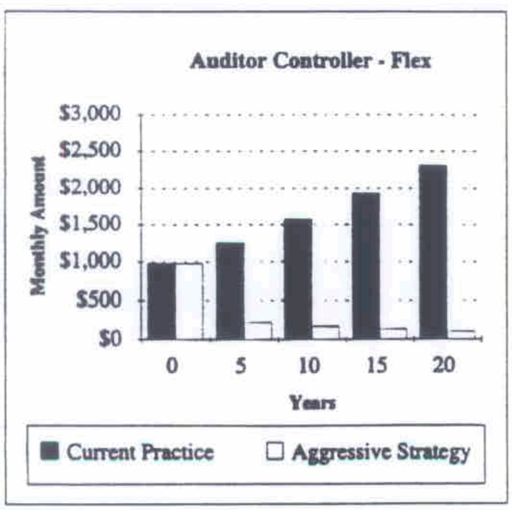


AGGRESSIVE STRATEGY

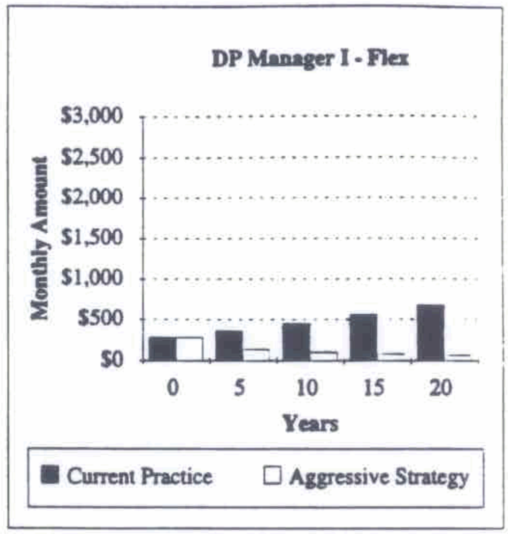
Available Cash Option

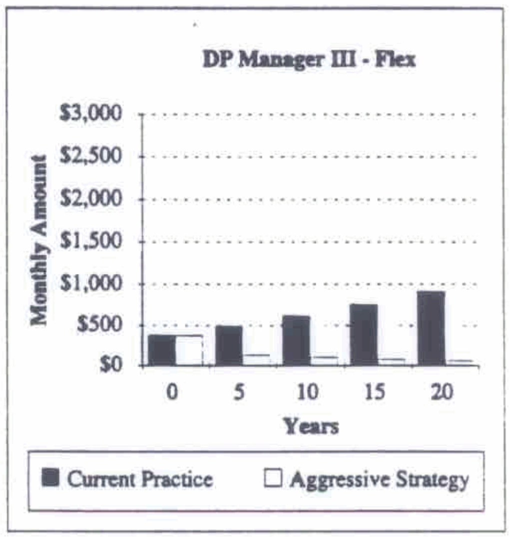


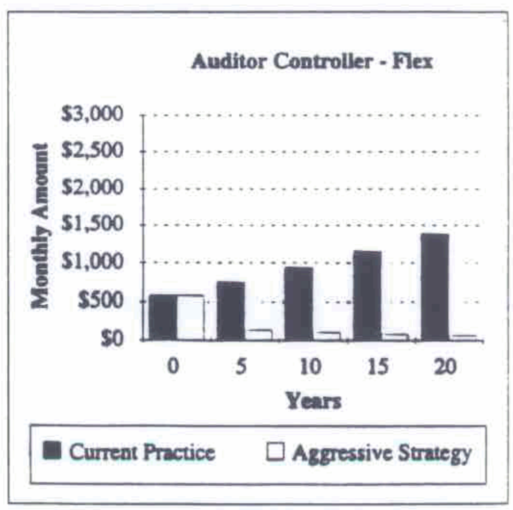




Retirement Benefit



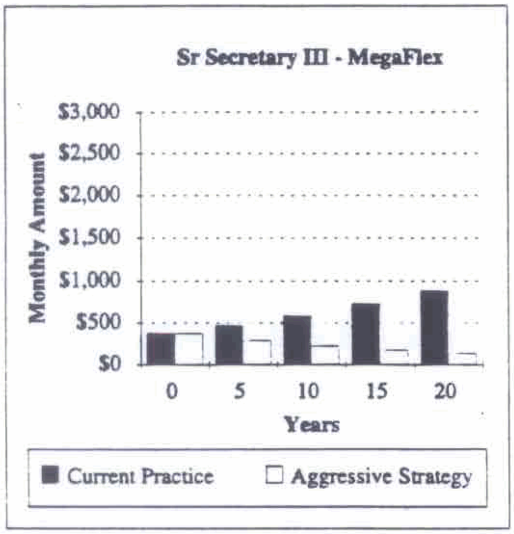


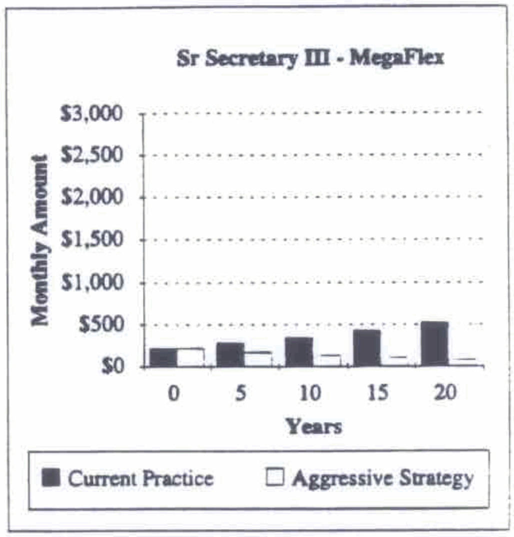


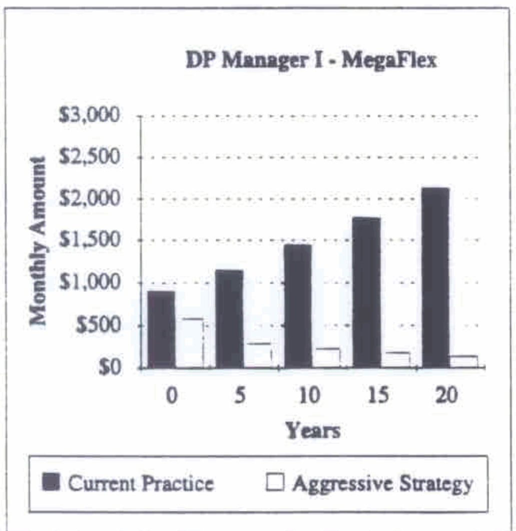
AGGRESSIVE STRATEGY

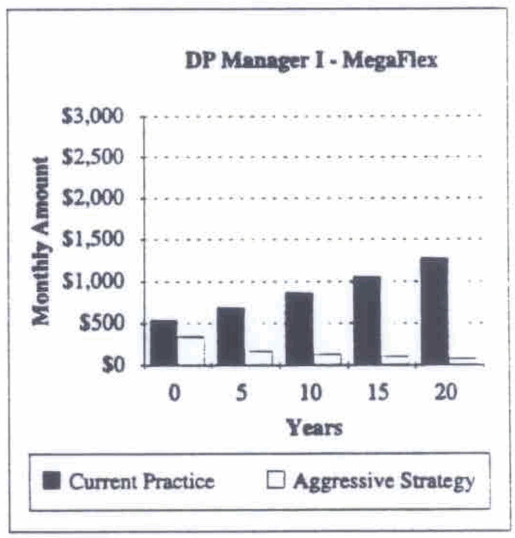
Available Cash Option

Retirement Benefit



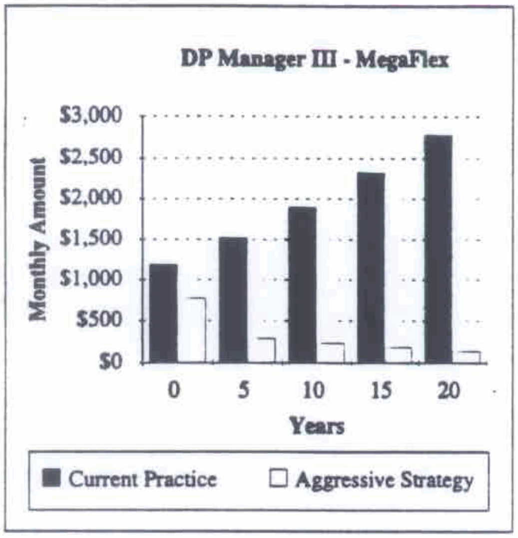


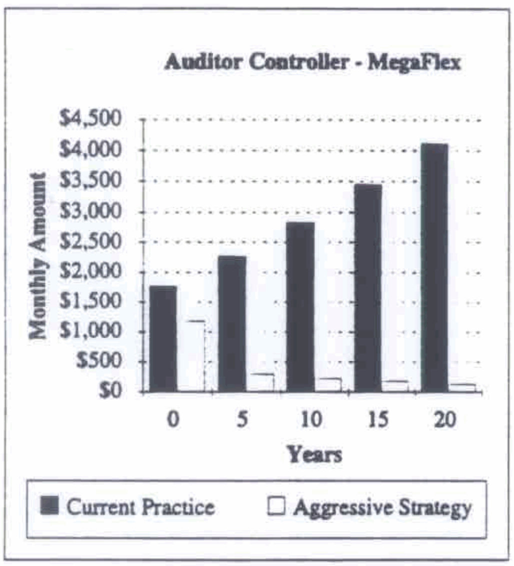




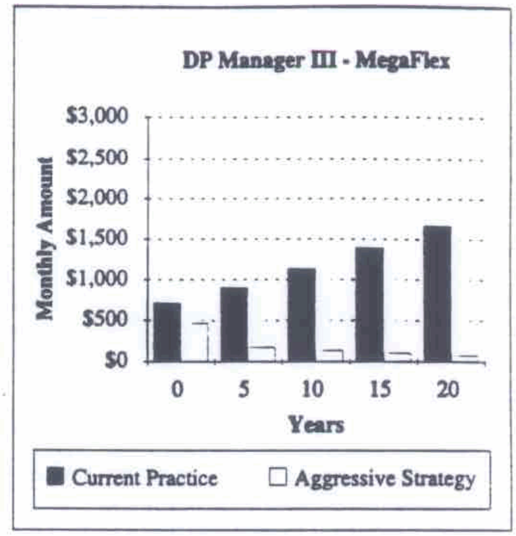
AGGRESSIVE STRATEGY

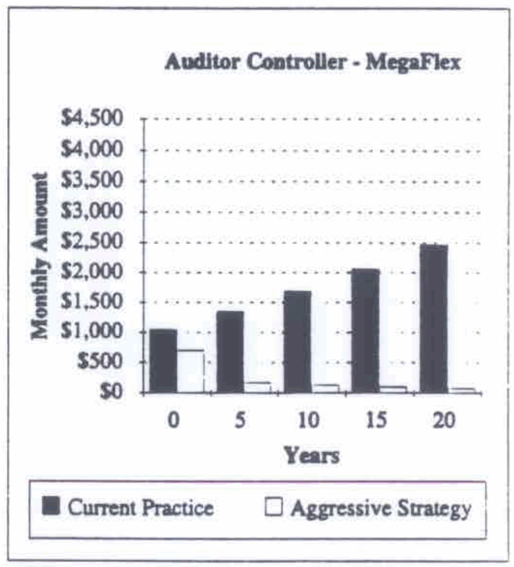
Available Cash Option





Retirement Benefit

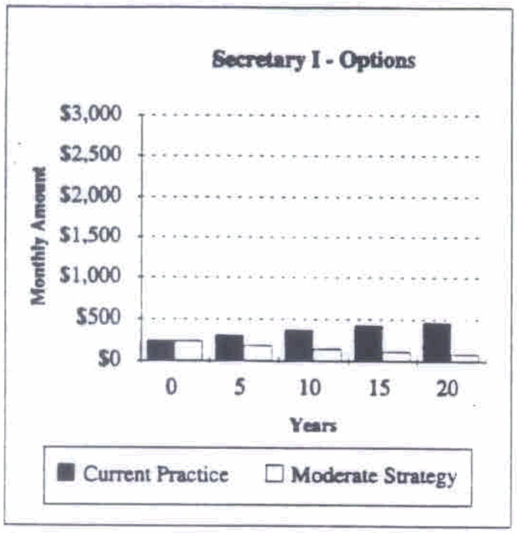


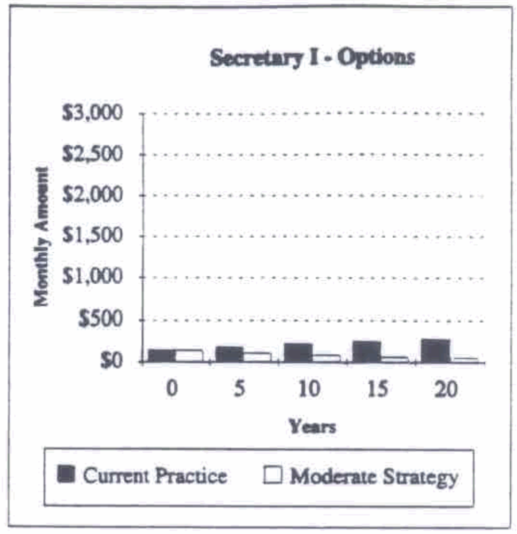


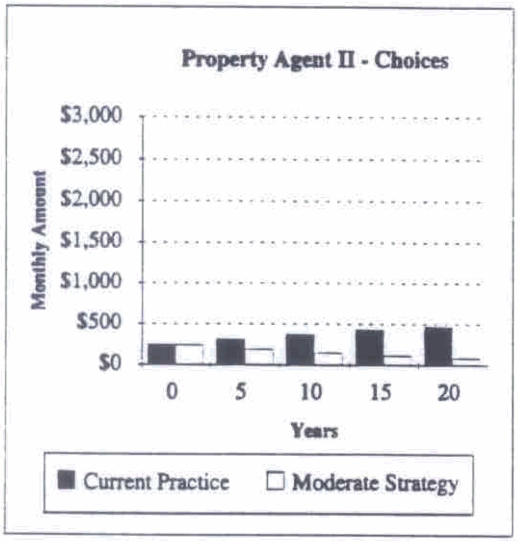
MODERATE STRATEGY

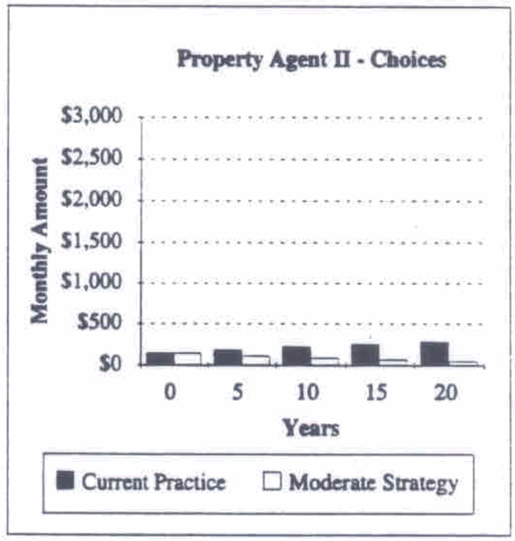
Available Cash Option

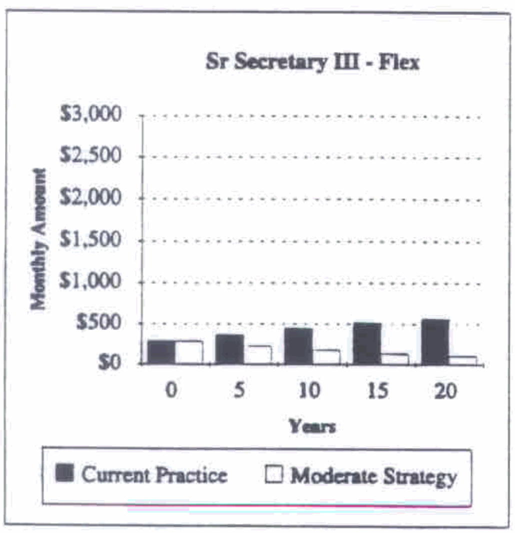
Retirement Benefit

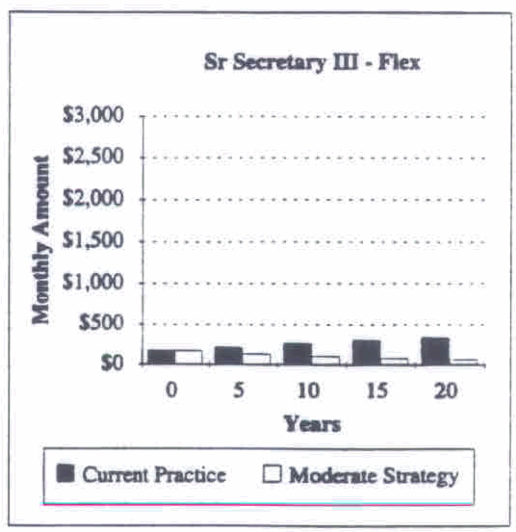






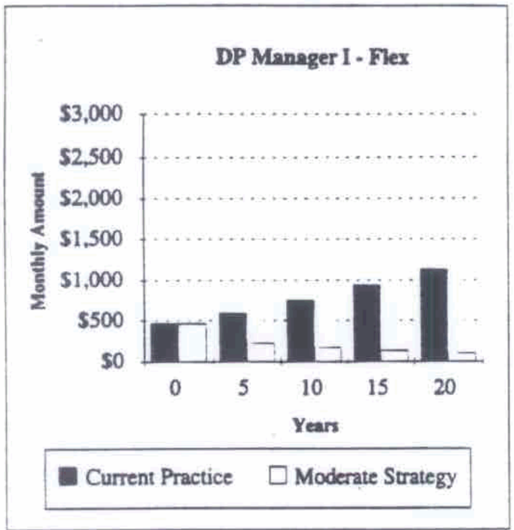


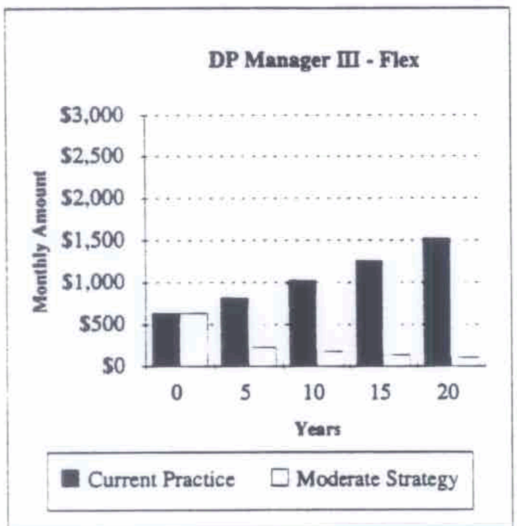


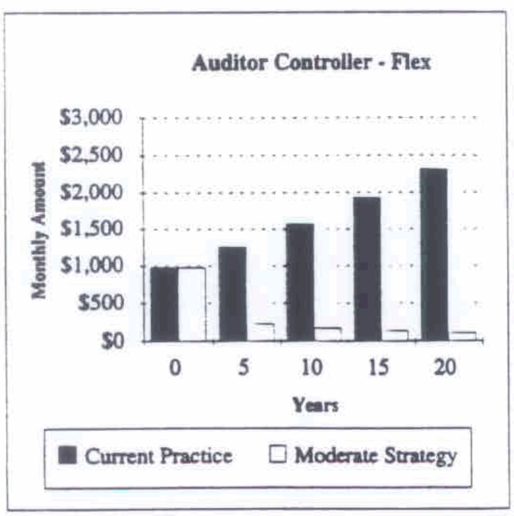


MODERATE STRATEGY

Available Cash Option







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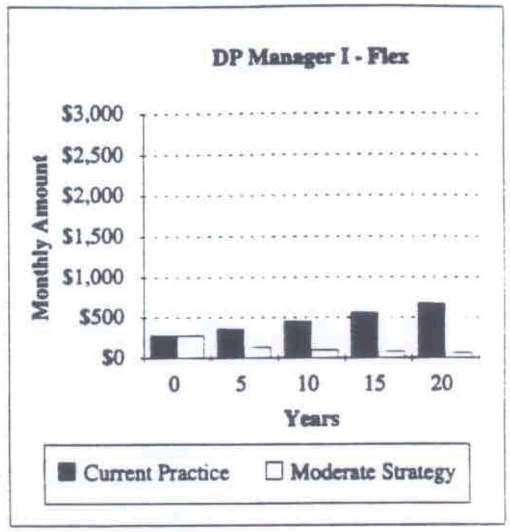

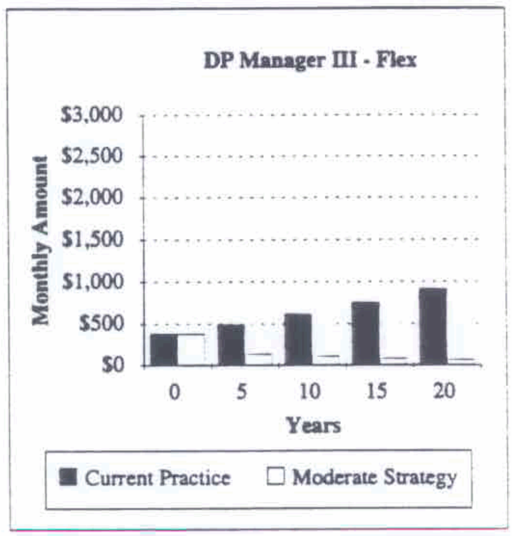

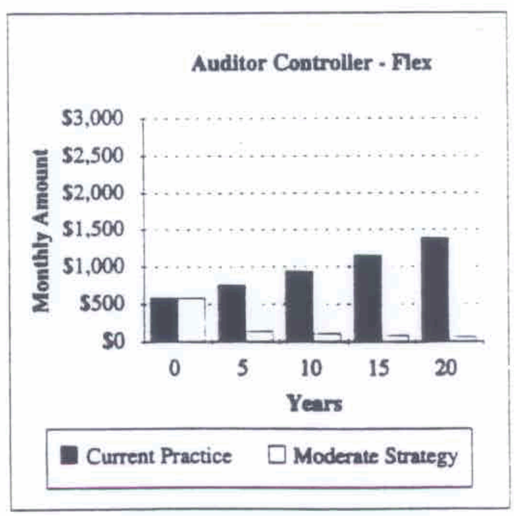

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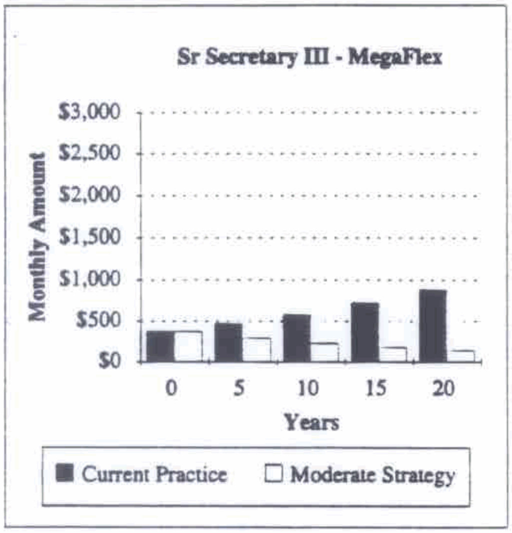

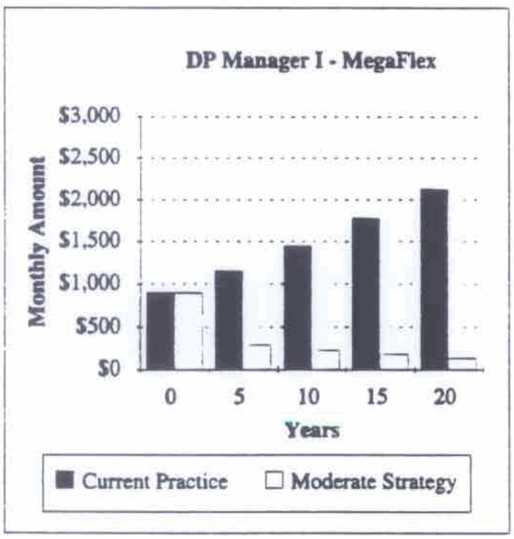

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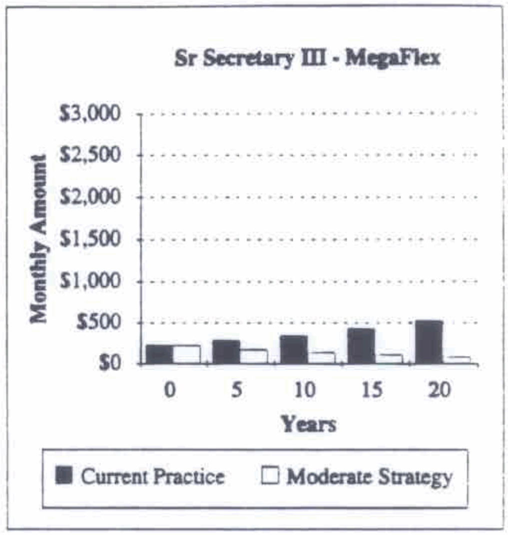
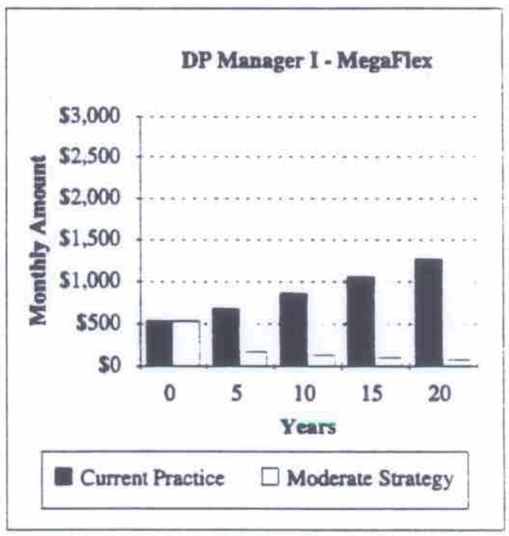
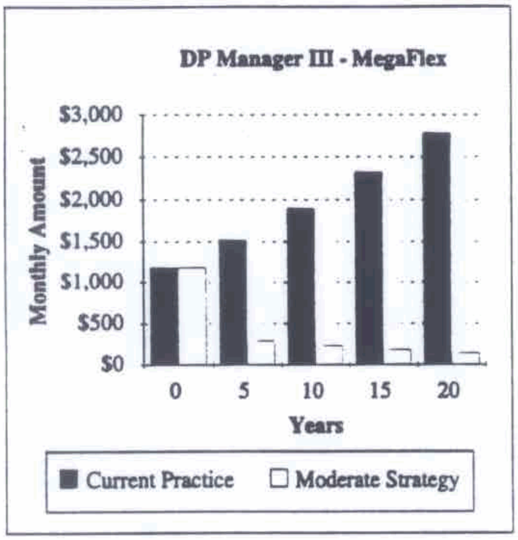
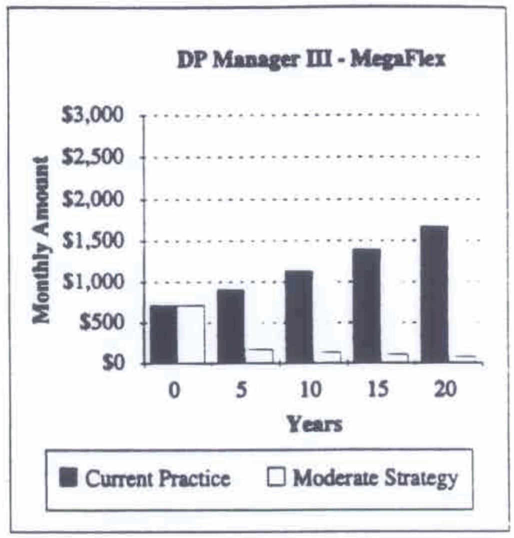


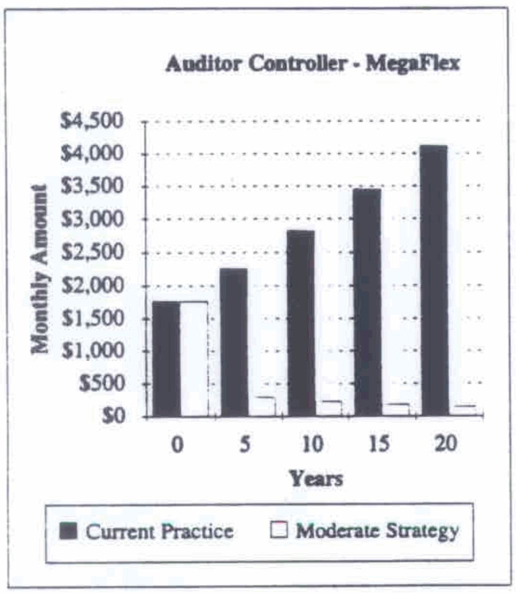


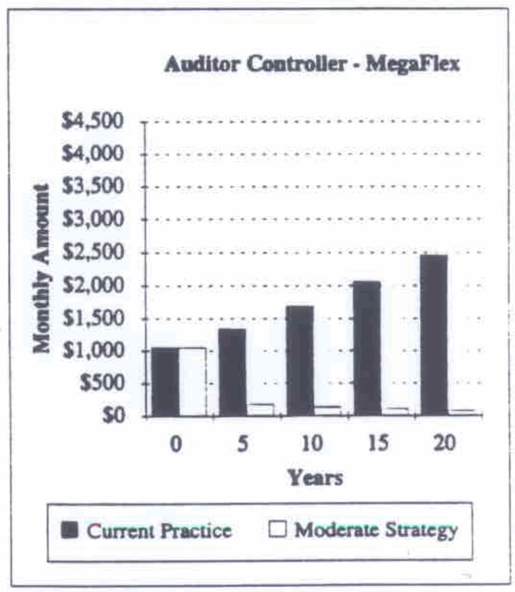
MODERATE STRATEGY

Available Cash Option | **Retirement Benefit**



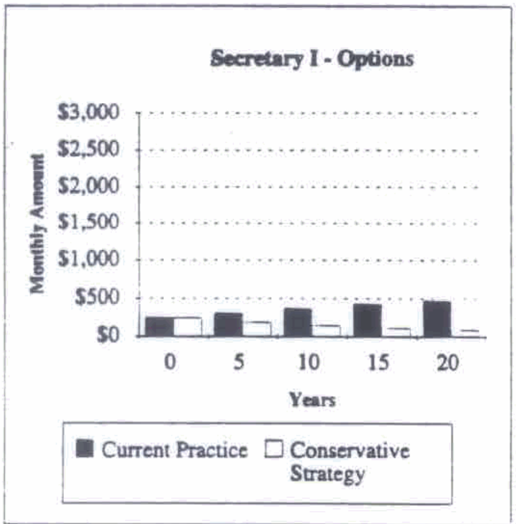


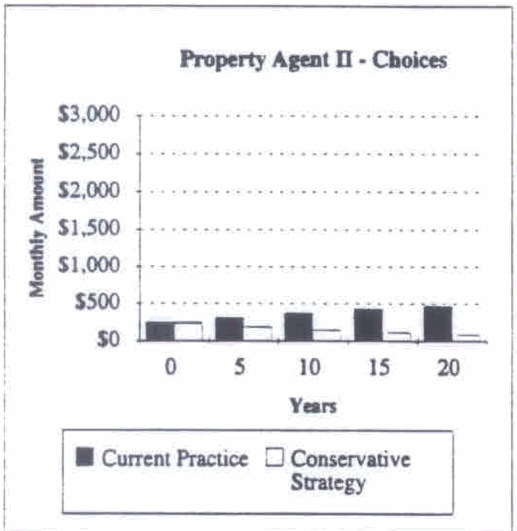


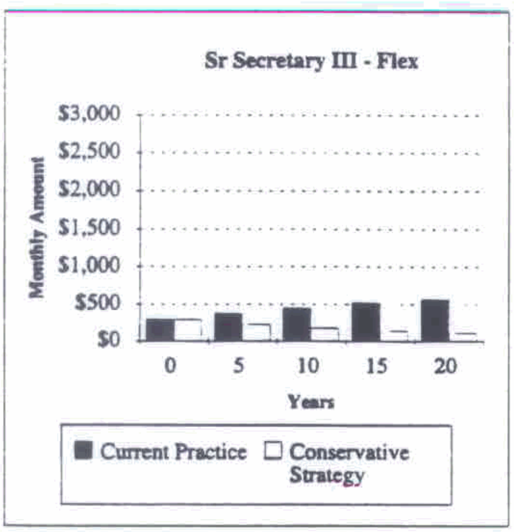


CONSERVATIVE STRATEGY

Available Cash Option







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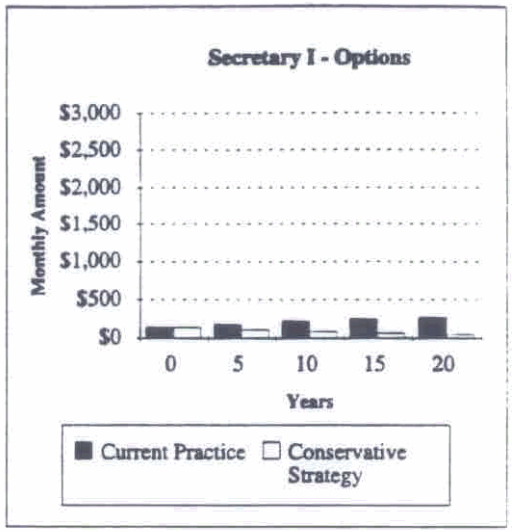
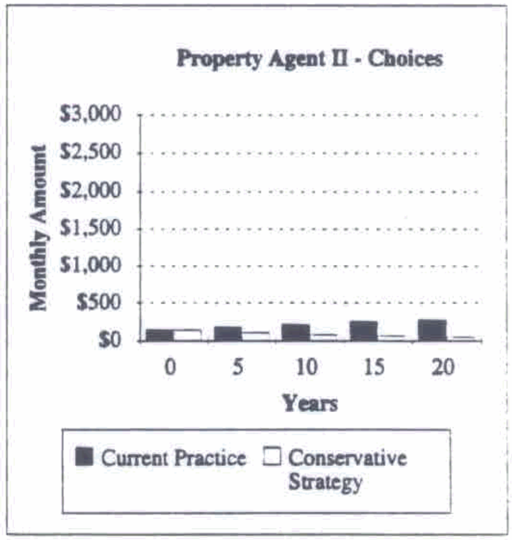
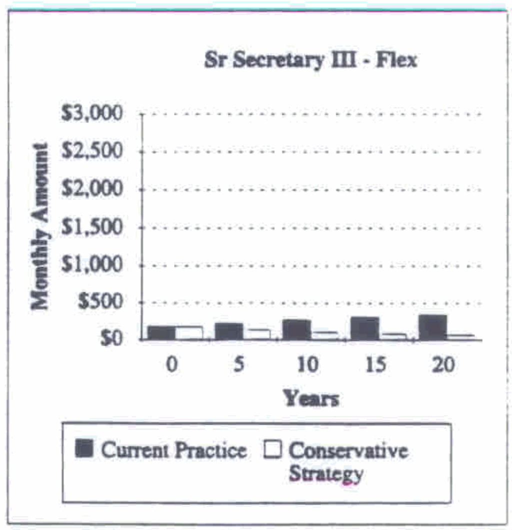
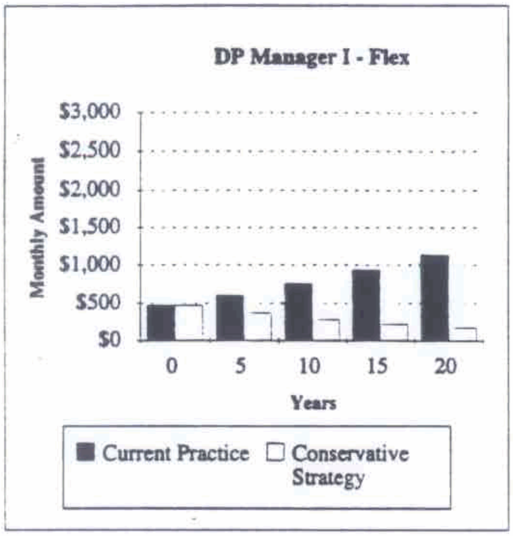


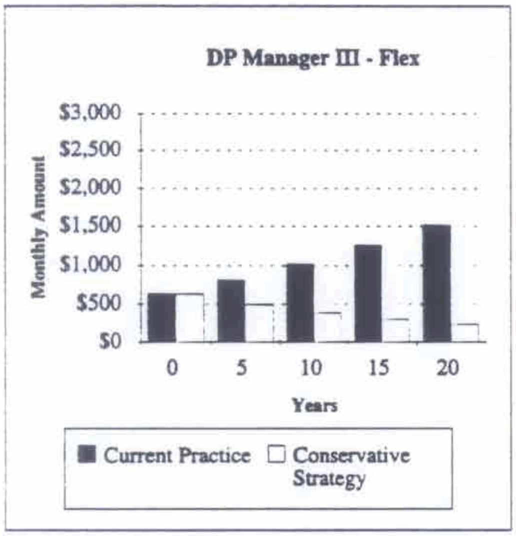


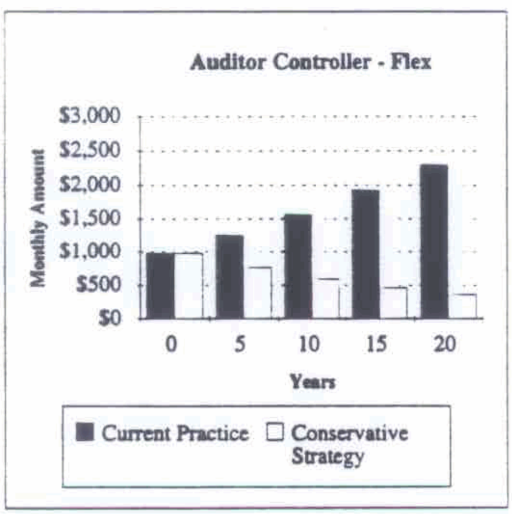


CONSERVATIVE STRATEGY

Available Cash Option







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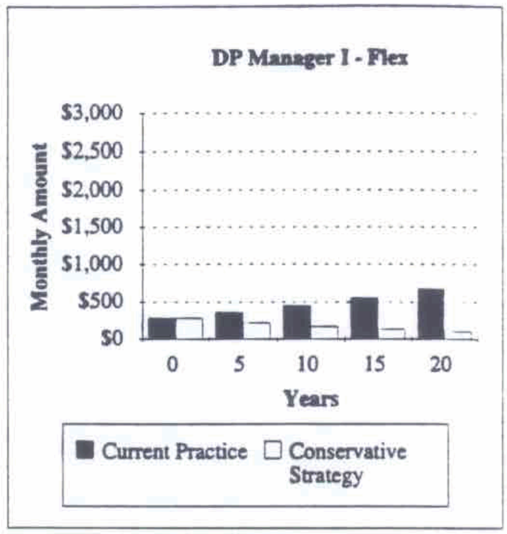
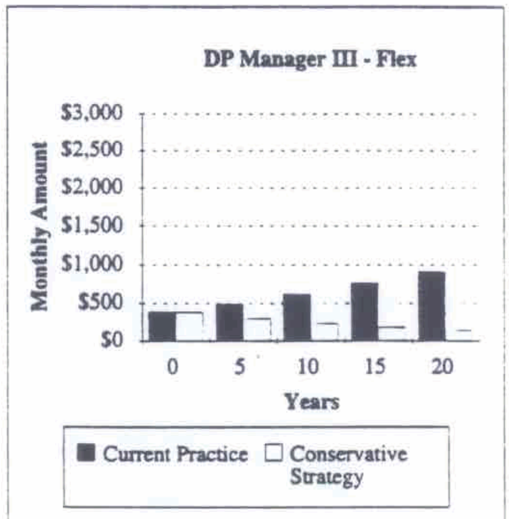
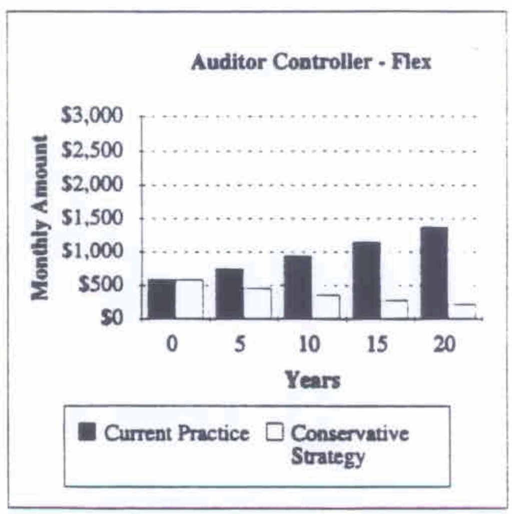
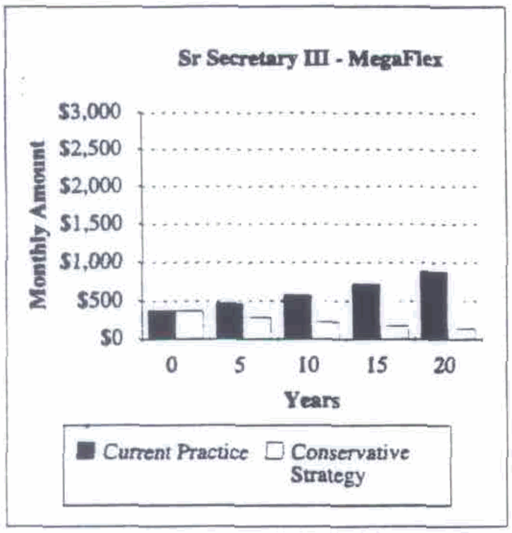


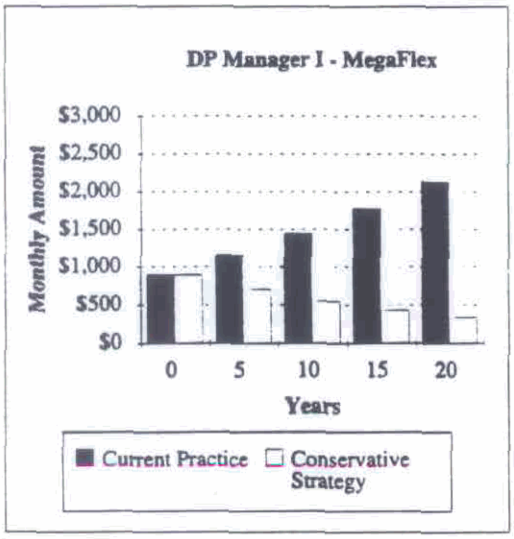




CONSERVATIVE STRATEGY

Available Cash Option





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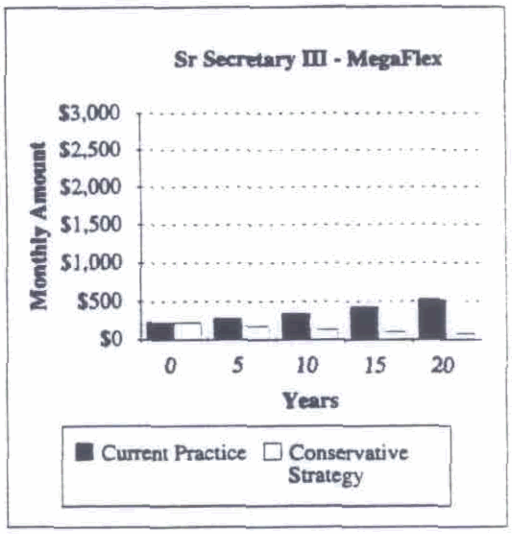
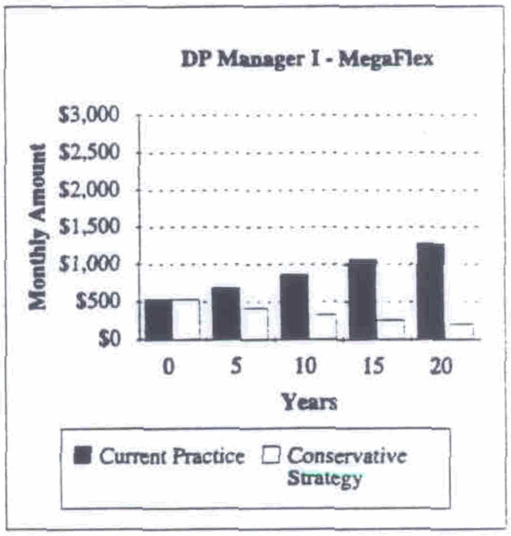
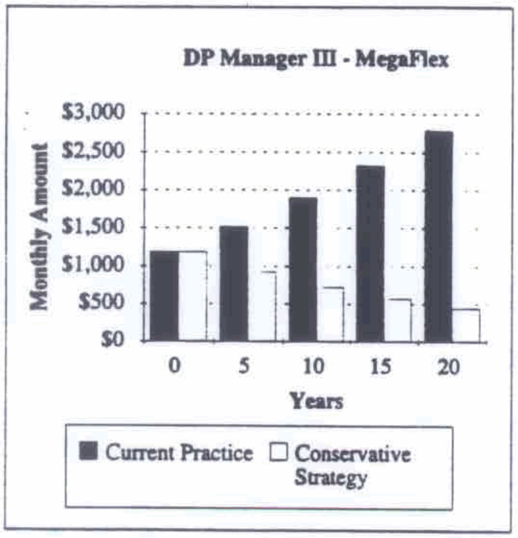
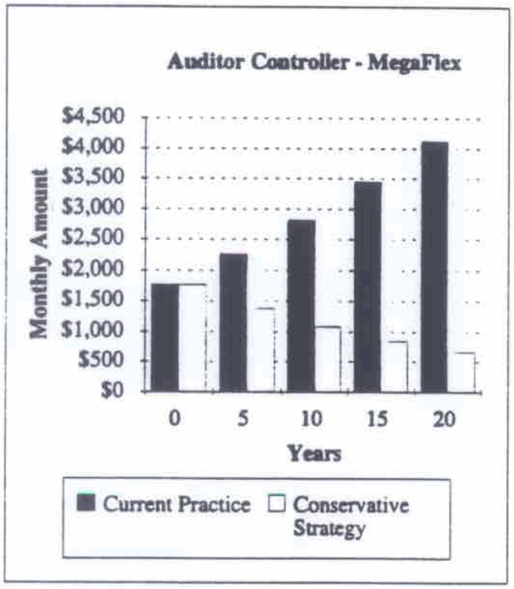




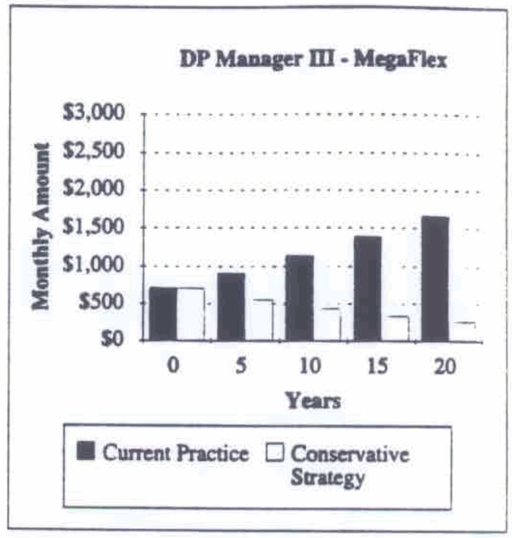
CONSERVATIVE STRATEGY

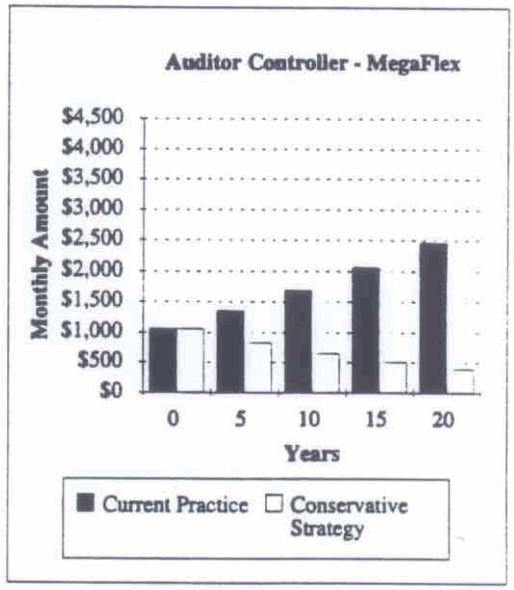
Available Cash Option





Retirement Benefit





5 Appendix

Appendix A — Glossary

Cafeteria Plan This is a plan which allows an employee to choose among a menu of employee benefit options and purchase those that best fit his or her personal and family needs. An employee is also allowed to opt for cash in lieu of benefits. The County of Los Angeles sponsors four cafeteria plans (MegaFlex, Flexible Benefit Plan, Choices and Options) as described in Section 1.3.

County Cafeteria Plan Contributions This is the amount of money that the County provides to each employee to purchase benefits from the cafeteria plan menu. Some (or all) of this money could be taken by the employee in cash. If the cost of the benefits chosen by the employee exceeds the County contribution, the employee pays the balance through a before-tax payroll reduction.

Available Cash Option This is the maximum amount of cash that an employee can choose in lieu of benefits under a cafeteria plan. There are some limitations placed on the available cash options under the County's cafeteria plans. According to County counsel and independent legal sources, the Available Cash Option is Pensionable Earnings under the Los Angeles County Employees' Retirement Association.

Pensionable Earnings This is the amount of an employee's compensation that is used to determine his or her retirement benefit, as well as the amount used to determine contributions to the retirement plan. It is composed of base salary plus any additional compensation considered pensionable according to governing law. In the case of the County's retirement plans, governing law is the 1937 County Retirement Act.

Health Care Spending Account/Dependent Care Spending Account These accounts work similar to bank accounts from which withdrawals can be made to pay for an employee's health and dependent care expenditures, respectively. These accounts are funded with before-tax dollars. If the entire amount is not expended within one year's time, the unused balance is forfeited.

Full-Pay Sick Leave Sick leave during which the employee is paid his or her full salary or wage. Flexible Benefit Plan participants receive 8 days of full-pay sick leave per annum.

Minimum County Cafeteria Plan Contribution

The County Cafeteria Plan Contribution under two of its plans (MegaFlex and Flexible Benefit Plan) are allocated to individual participants as a percentage of their salary; however, there is a minimum dollar contribution below which the County contribution cannot fall. In 1993, the minimum County Cafeteria Plan contribution is $524 under MegaFlex and $442 per month under the Flexible Benefit Plan.

LACERA

The Los Angeles County Employees' Retirement Association, the organization that invests the assets and administers the retirement plans for County employees.

Choices

The County's cafeteria plan for employees represented by the Coalition of County Unions ("Coalition") (covers approximately 29,000 or 39% of employees).

Options

The County's cafeteria plan for Service Employees International Union (SEIU) Local 660 and Nurses Units 311 and 312 (covers approximately 37,000, or 49% of employees).

MegaFlex

The County's cafeteria plan for nonrepresented (generally management) employees hired or newly eligible after January 1, 1992 and nonrepresented employees covered by the Flexible Benefit Plan before January 1, 1992 who elected to be covered (covers approximately 4,800, or 6% of employees).

Flexible Benefit Plan

The County's cafeteria plan for employees who were nonrepresented before January 1, 1992 and did not elect MegaFlex (covers approximately 4,200, or 6% of employees).

Alternative Available Cash Option Target

The ultimate amount of the Available Cash Option (either a dollar amount or a percentage of pay) after it is reduced through the application of the strategies described in Section 3.3.

Appendix B — Survey Sample

Comparability of Current Cafeteria Plans with Those of Other Employers

In order to provide a comparison base against which to evaluate the Los Angeles County Cafeteria Plans, we surveyed 5 of the 10 largest corporations with headquarters in Los Angeles County, 2 California public utilities, and 10 other California public employers. The public employers survey included four of the largest 1937 Act systems, the two largest CalPERS counties, two of the largest city systems, and state employees covered under CalPERS. The survey participants are the same as those used in our 1992 Comparability Analysis and are shown below in Table B-1.

TABLE B-1

Public Employers Listed in the Order of Number of Active Participants	Public Utilities
State of California	Pacific Telesis Group
City and County of San Francisco	Southern California Gas
City of Los Angeles	
Orange County	**Industrial Companies Headquartered in Los Angeles County**
San Diego County	
City of Los Angeles Department of Water and Power	
Riverside County	Occidental Petroleum Corp.
Alameda County	Atlantic Richfield Company
Sacramento County	Rockwell International Corp.
	Litton Industries Inc.
	Avery Dennison Corp.

To provide a consistent basis of comparison, we only considered cafeteria plans that were at least partially funded by employer contributions and had a cash option, as are the Los Angeles County plans.

As shown in Table B-2 below, most of the employers contacted did not have such cafeteria plans.

TABLE B-2

Type of Employer	Number with Employer Funded Cafeteria Plans	Number Without Employer Funded Cafeteria Plans	Total Survey
Public Employer	4	6	10
Private Employer	1	4	5
Public Utility	1	1	2
Total	6	11	17

Because our sample is relatively small, we included as part of our analysis information from a published survey[1] on flexible compensation plans. This survey includes information from 345 out of 472 organizations with cafeteria plans which allow employees to choose among benefit options. Briefly, the published survey included 34 employers located in California. The employers included both manufacturing (30%) and service (70%) employers, from various industries such as hospital/health care, insurance, banking, education, utilities, and finance/real estate. The largest concentration of employers (42%) was among medium sized organizations (1,000 - 4,999 employees). Only 5% of the survey participants had 50,000 or more employees. The size of the organizations ranged from 74 to 352,000 employees.

In our analysis we first compared the range of benefit options offered under the Los Angeles County Plans with those surveyed employers, then we focused on the amount of the Available Cash Option among our sample employees.

Comparison of Benefit Options

In order to evaluate the design similarity of the County's cafeteria plans with those of the surveyed employers, we compared the types of benefits offered under the various plans. Our survey revealed that:

- All the employers with cafeteria plans provided medical and dental coverage
- All but one employer included Health Care Spending Accounts (HCA) and Dependent Care Spending Accounts (DCA)
- All but two employers included life insurance and Accidental Death and Dismemberment (ADD) protection

[1] "Flexible Compensation Programs and Practices 1993 (1992 Data)," Hewitt Associates, Lincolnshire, IL.

A summary of the types of benefits included in the surveyed cafeteria plans and the published survey are shown in Table B-3 below.

TABLE B-3

Comparison of Cafeteria Benefits Options													
	Med	Den	Vis	Life	ADD	ACO	CA	LTD	STD	Vac	LTC	HCA	DCA
MegaFlex	x	x		x	x	x		x	x	x		x	x
Flex Ben	x	x		x	x	x						x	x
Choices	x	x		x	x	y						x	x
Options	x	x		x	x	y						x	x
Public - 1	x	x										x	x
Public - 2	x	x	x										
Public - 3	x	x	x	x	x							x	x
Public - 4													
Private - 1	x	x	x	x	x		x	x		x	x	x	x
Utility - 1	x	x	x	x	x		x			x		x	x
Published Survey*	x	x		x	x	x		x				x	x

Note: MegaFlex provides for survivor income for employees in Plan E.

Med	Medical	LTD	Long Term Disability
Den	Dental	STD	Short Term Disability
Vis	Vision	Vac	Additional Vacation
Life	Group Life Insurance	LTC	Long Term Care
ADD	Accidental Death & Dismemberment	HCA	Health Care Spending Account
CA	Cash Accumulation	DCA	Dependent Care Spending Account
ACO	Available Cash Option (x = unlimited, y = limited)		

*Benefit options indicated are those offered by 50% or more survey participants.

Conclusions from Comparison of Benefit Options

The range of benefit options available under the County's cafeteria plans are fairly typical, with the possible exception of the inclusion of short-term disability coverage and vacation time as options under the MegaFlex plan. According to the Hewitt survey, 16% of employers offer short-term disability coverage as part of their cafeteria plans, and only 26% offer the ability to trade vacation for cash or other benefits.

Appendix C — Sample Employees

Sample Employees

The methodology we used was to select a representative group of "typical" employees" from various distinct classifications within the County. Taken together, these typical employees then comprise a representative cross-section of the employee population. The sample group is the same as used in our September, 1992 Comparability Analysis.

In order to reflect differences in pensionable compensation, the classes were based on cafeteria plan coverage and the other *special* forms of compensation typically received. Within each class, a sample General member job title, representative of the General members of the group, was chosen. Hypothetical employees from these job titles were used for comparisons throughout the report. The classes and associated job titles were:

TABLE C-1

Represented	Job Title	Cafeteria Plan
SEIU Local 660	Secretary I	Options
Coalition	Property Agent II	Choices
Nonrepresented	**Job Title**	**Cafeteria Plan**
Other	Senior Secretary III	MegaFlex/Flexible Benefit Plan
Professionals/Managers	Data Processing Manager I	MegaFlex/Flexible Benefit Plan
Performance Based Pay recipients	Data Processing Manager III	MegaFlex/Flexible Benefit Plan
Senior Management/ Department Heads	Auditor Controller	MegaFlex/Flexible Benefit Plan

Pensionable Earnings Pensionable earnings utilized in our study for each of the job titles are shown in Table C-2.

TABLE C-2

Typical Employee Monthly Pensionable Earnings						
	Represented	Represented	Nonrepresented	Nonrepresented	Nonrepresented	Nonrepresented
	Local 660	Coalition	Other	Professionals & Managers	Performance Based Pay	Dept. Heads/ Senior Mgmt.
Types of Compensation	Secretary I	Property Agent II	Senior Secretary III	DP Manager I	DP Manager III	Auditor Controller
Monthly Base Salary	$2,230	$3,844	$2,984	$6,183	$7,854	$11,275
Shift Differentials	$4	$0	$0	$0	$0	$0
Other Compensation (e.g. Bilingual Pay)	$80	$80	$80	$0	$0	$0
Available Cash Option (1993)	$244	$244	$294	$470	$637	$980
MegaFlex Available Cash Option	N/A	N/A	$376	$903	$1,187	$1,769

Appendix D — Morgan, Lewis & Bockius Legal Opinion

MORGAN, LEWIS & BOCKIUS

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July 15, 1993

Economy and Efficiency Commission
163 Hall of Administration
500 West Temple Street
Los Angeles, California 90012

Re: W F Corroon Report

Dear Commissioners:

Background

This opinion is written in conjunction with the "Development of Los Angeles County Cafeteria Plan Design Strategies to Reduce Retirement Costs" prepared for the Los Angeles County Economy and Efficiency Commission by W F Corroon.

Prior Legal Opinion, Corroon Report and Board Action

Los Angeles County has established four "cafeteria plans" under which eligible employees are given the opportunity to choose among certain benefits such as health, dental, life or disability insurance and the receipt of additional current cash compensation in lieu of such benefits. These four plans are the Flexible Benefit Plan ("Flex"), Megaflex, Choices and Options. Flex, the first of these, was established effective January 1, 1985 for non-represented employees of the County. Effective January 1, 1991, the County adopted Megaflex as an alternative plan to Flex. As discussed further below, Megaflex provides greater County contributions than Flex; however, in order to participate in Megaflex, employees were required to give up a number of benefits to which they otherwise would have been automatically entitled such as certain vacation and sick leave benefits. Choices and Options were established in 1989 and 1992, respectively, and are available to employees represented by various County employee unions.

Commencing in January of 1991, amounts representing both cash elected in lieu of benefits and amounts otherwise receivable in cash but used to purchase benefits under the various cafeteria plans were treated as pensionable compensation for retirement plan purposes. In early 1992, the undersigned was retained as independent legal counsel by the Economy and Efficiency Commission (the "Commission") to render a legal opinion on, among other things, whether cash paid to an employee under a cafeteria plan or cash used under such a plan to purchase benefits for an employee should be treated as pensionable compensation for purposes of the County's retirement program. This legal opinion was issued on July 15, 1992. A number of legal issues considered in that opinion (herein referred to as the "Prior Legal Opinion") are related to areas discussed in this opinion and, as a result, portions of this opinion will incorporate some of the discussion and conclusions reached in the Prior Legal Opinion.

The Prior Legal Opinion concluded that while the California statute defining pensionable compensation ("compensation earnable") was unclear in its application to available cash options under a cafeteria plan, the interpretation by the Board of Retirement that such amounts should be so included and a consideration of various legislative enactments of the State of California supported the finding that cash paid to an employee under a cafeteria plan or cash used under such a program to purchase benefits for an employee were probably correctly determined to be pensionable compensation. Furthermore, the Prior Legal Opinion concluded that, in any event, it was highly likely that the courts would find that current employees were vested in such treatment with the result that such amounts would be treated as part of their pensionable compensation during their terms of employment.

Concurrent with the retention of independent legal counsel, the Commission, at the request of the Board, retained a consultant, W F Corroon, to review the County's cafeteria plans in the light of comparable private and public plans and to make recommendations with respect to the possible modification of such plans and, in particular, modifications that would reduce the expense associated with treating cash options as pensionable compensation. This Corroon report was issued in November of 1992 in conjunction with the Commission's report to the Board of Supervisors entitled the "Los Angeles County Policies and Practices Governing Retirement Eligible Salary & Benefits." The Commission's and Corroon's reports were discussed at the Board's meeting of November 17, 1992 and, at that time, the Board requested that the Commission, with the assistance of its independent legal counsel, "[e]xamine the viability of measures to cap or reduce the County's liability to the pension system by freezing or reducing the cash available option in cafeteria style benefit plans" and to "[e]xamine the County's cafeteria style benefit plans and recommend improvements to enhance equity, and reduce County cost without reducing employees' ability to obtain adequate benefits, or reduce the County's ability to attract and retain qualified personnel." This has resulted in the current Corroon report to which this legal opinion is attached.

Interrelationship between Flex and Megaflex

The Corroon report discusses a number of possible modifications to the design of Megaflex especially with respect to the amount of cash in lieu of benefits to be made available to participants in the plan.[1] These proposals raise the obvious legal question as to the extent to which the County can implement such modifications without illegally impinging on the rights of current participants in Megaflex. In considering this question, the interrelationship between the operation of Flex and Megaflex is an important part of the analysis.

As indicated above, Flex was effective January 1, 1985 and was the first cafeteria plan under which County employees had a choice between various benefit options or cash in lieu thereof. As with all the other County cafeteria plans, the plan has been designed from its inception to meet the requirements of Section 125 of the Internal Revenue Code and, hence, to result in any election of benefits by participants being treated as pre-tax for the electing employees even though the employees had the option of receiving cash in lieu of such benefits.

Megaflex was effective January 1, 1991 and is similar to Flex in most respects. However, generally speaking, for those employees who participate in Megaflex, certain other benefits that would have automatically accrued to such employees (and which continue to be automatically accrued for participants in Flex) were eliminated. These lost benefits primarily involved additional sick leave and vacation days that would otherwise have accrued automatically. In exchange for the loss of such benefits, the County increased the amount of contribution to be made to Megaflex participants as compared to that being made for participants in Flex. This increased contribution was calculated

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1/ The report focuses on Megaflex in this respect because the cash available under that program (which in turn gives rise to pensionable compensation) is significantly greater than that available under Flex. In addition, although Choices and Options also involve cash options (although to a much lesser extent), the fact that these plans are subject to the collective bargaining process eliminates the ability of the County to unilaterally make changes in the design of the programs.

in a manner so as to be clearly related to the sick leave and vacation day benefits that were no longer automatically available to Megaflex participants.[2] This increased contribution could be either used to purchase the lost days, expended to purchase other benefits or taken in cash.

All non-represented employees were given an option for 1991 to either participate in Flex or the new Megaflex program. All previously accrued vacation and sick leave was retained for employees electing to participate in Megaflex. Thus, from the outset, a decision to participate in Megaflex rather than Flex was (and has continued to be) simply a voluntary decision on the part of an employee as to which benefit program was of more value to him or her. A similar decision was presented to the employees for the 1992 year. However, commencing with the 1992 year, employees in effect were required to make an irrevocable decision as to whether to participate in Megaflex or Flex for 1992 and future years of employment. In addition, all new hires of the County and those newly eligible for the non-represented employees' cafeteria plans on or after January 1, 1992 were automatically covered by Megaflex rather than Flex. As with the prior election, the election made for the 1992 and subsequent years as between the two programs was entirely voluntary on the part of each employee with such a choice simply being one of trading off certain benefits available under one program for other benefits of roughly equivalent economic value under the other program. In this connection, the election materials supplied to the employees provided worksheets by which each employee could determine which program was better for him or her.

In none of the communication materials that we have reviewed is there any representation that Megaflex or Flex benefits would be maintained at certain levels or that the amount of benefit available as cash would be maintained at any particular level. We have requested any additional communication materials that might contain statements to that effect, but have been supplied with nothing of this nature.

Legal Opinion

The Corroon report discusses a number of options that the Board might consider in redesigning Megaflex and Flex. As indicated, a number of these involve a reduction in benefits available under these programs including a reduction in the

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[2] Memorandum from Chief Administrative Office to the Economy and Efficiency Commission dated April 30, 1993, page 4.

amount of cash (and hence pensionable compensation) that might be available as an option under Megaflex. In our opinion, these proposals involve three principal legal issues - (1) whether the employees currently participating in the cafeteria plans are vested in certain levels of benefits under those plans or in any current particular benefit provided under such plans such as the amount of benefit that can be received in cash, (2) even if not vested, whether the County is estopped from making certain changes in the benefit plans because of irrevocable elections made by participants in the plans and (3) whether a reduction in any cash option is impermissible because it has an indirect effect on the amount of pensionable compensation received by plan participants and, hence, undermines their vested pension rights.

Vesting

As discussed at length in the Prior Legal Opinion (pages 24-33), the concept of vesting in public sector pension plans has been developed and firmly embedded in California law through a long line of cases starting with Kern v. Long Beach, 29 Cal.2d 848 (1947). In Kern, it was decided that a public employee's pension constitutes an element of compensation, that a vested contractual right to pension benefits accrues upon acceptance of employment and that such a pension right may not be destroyed once vested without impairing a contractual obligation of the employing public entity. Because of this well-established judicial authority and the probable unavailability of any of the recognized exceptions to this doctrine, the Prior Legal Opinion concluded that current employees are very probably vested in the treatment of flexible benefits as pensionable compensation.

It is important to note, however, that the vesting concept to the extent that it precludes even prospective reductions in benefit levels has been developed in the context of pension plans. There is no comparable general doctrine of vesting applicable to fringe benefit programs such as a cafeteria plan. Presumably, this is because of the nature of a pension plan under which benefits are usually calculated with reference to a participant's service. Under these circumstances, the courts have prohibited the reduction of pension benefits where the accruing of such service has already commenced. A fringe benefit plan, on the other hand, may be viewed more as an element of current compensation which, as discussed below, the courts have freely allowed to be reduced prospectively by a public entity employer.

There are a few cases involving the application of a vesting concept to non-pension benefits. However, these cases have involved situations in which the affected employee or employees had already rendered all or part of the service necessary to meet the threshold requirements for the benefit and then the public entity had taken action eliminating the benefit in question.

California League of City Employee Associations v. Palos Verdes Library District, 87 Cal.App.3d, 135 (1978) is typical of these cases. The benefits eliminated by the District were (1) a longevity salary increase equal to 2% of base pay awarded at the end of the 9th, 12th, 15th and 18th years of service; (2) a 5th week of vacation for full time professional employees after ten years of continuous service and (3) a four-month, fully paid sabbatical for librarians at the end of each six years of full time service. These benefits were eliminated unilaterally by the district as to all employees who had not yet completed the specific conditions precedent to qualify for the benefits. In striking down this action, the court stated: "To the librarian who has worked five and one-half years toward the right to take a sabbatical at the end of six years, or the long term employee who has been working toward entitlement to five weeks of vacation after ten years of service, it would be grossly unfair to allow defendant to eliminate such benefits and reap the rewards of such long-time service without payment of an important element of compensation for such service." Id. at 140. Similar results were reached in Youngman v. Nevada Irrigation District, 70 Cal.2d 240 (1969) and Ivens v. Simon, 212 Cal.App.2d 177 (1963) where the public entity eliminated annual step wage increases after the service had been rendered by the employee to qualify for the increase. Likewise, in the recent case of Thorning v. Hollister School District, 11 Cal.App.4th 1598 (1992), it was held that a school district could not discontinue post-retirement health benefits under circumstances where former board members had already retired having been promised such benefits and, hence, again had already completely rendered the service that had been necessary to qualify for the benefit.

It would be a giant leap from the results reached in these cases to assert that a government employee is vested in certain levels of benefits in a fringe benefit plan so that such levels, once established, cannot be reduced during the remainder of the employee's employment. Rather, such programs, basically involving the payment of current compensation, would seem to fall clearly within the general rule expressed in the leading case of Butterworth v. Boyd, 12 Cal.2d 140 (1938) on the power of a public entity to adjust such compensation (in this case allowing the introduction of a mandatory employee contribution as a part of a health care plan). As stated in Butterworth and restated in a number of other California cases decided since: "It is well settled that public employees have no vested right in any particular measure of compensation or benefits, and that these may be modified or reduced by the proper statutory authority." Id. at 150. Applying these principles in Opinion 84-505, 67 Ag. Gen.Opin. 510 (1984), the Attorney General's office opined that while it was not permissible for a school district to eliminate health benefits coverage for board members who had already left office having met the qualification for such benefits or to discontinue such benefits during specific terms of office of a board member who in effect had contracted for the benefits during such term, the district could legally eliminate such benefits for future terms of existing board members.

In conclusion, it is our opinion that the courts have not restricted a public entity's ability to prospectively reduce or otherwise modify benefits provided pursuant to a non-pension benefit plan except in a few cases where such action would be fundamentally unfair to employees who had already accrued service in exchange for receiving the benefit in question.[3] Accordingly, in our opinion, the modifications discussed in the Corroon report involving either prospective reduction of the benefits provided pursuant to a cafeteria plan or the available cash options under such a plan would not be legally impermissible on the basis that they impinge on any vested rights of plan participants not to ever have any such modification made during the entire terms of their employment.

Estoppel

Even if certain benefits in the County's cafeteria plans are not vested for future service merely because of the previous establishment of those benefits by the County, the question still remains as to whether the County has, by its actions with respect to the plans, estopped itself from proceeding with certain options set forth in the Corroon report. This is particularly

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[3] It is recognized that there is a service component in Megaflex (but not the other cafeteria plans) under which a participant receives a somewhat higher County contribution after achievement of a minimum number of years of service. However, this plan design feature, which does not pertain to meeting the threshold requirements for qualifying for benefits under the plan, would not, in our judgment, place this situation in the same category as those involved in Palos Verdes Library District and the other cases discussed above where the modification had a fundamentally unfair retroactive effect.

true with respect to Megaflex for which it has been asserted that no modifications in the amount of the available cash option are possible because of certain irrevocable elections previously made by current participants in this plan pursuant to which they gave up other benefits that they could otherwise have received, e.g., vacation and sick leave days.

As described above in the discussion of the interrelationship between Megaflex and Flex, it would appear that during their participation in Megaflex thus far, the participants have not in fact given up any benefits as a result of such decision but have merely exchanged certain available benefits for others. Thus, for example, while certain vacation and sick leave benefits that would have otherwise accrued during such time were not available, the participants in Megaflex have received an additional County contribution under Megaflex with which such benefits or their equivalent could have been purchased if they so chose.

Under these circumstances, we do not believe that the County is estopped from making prospective changes to Megaflex including reduction of the available cash option solely because of the past elections made by Megaflex participants. Furthermore, as stated above, we have been supplied with no communication materials under which the County has otherwise restricted its ability to amend the plan. Our conclusion in this regard would be different if it were proposed to hold the Megaflex participants to their elections under circumstances where only the Megaflex benefits were reduced and the participants were not given an opportunity to revoke their prior elections so as to be able to participate in Flex or any other cafeteria arrangement made available as an alternative to Megaflex. However, in recognition of this, the Corroon report does not suggest any course of action that would have this result.

Indirect Effect on Pensionable Compensation

Although, under the above analysis, modifications reducing available cash options in the cafeteria plans would be acceptable in themselves, the question remains as to whether they would be permissible when their effect would also be to reduce pensionable compensation payable to an employee participating in the plan. In other words, if an employee is vested in his or her right to have a cash option treated as pensionable compensation, would a reduction in the amount of that cash option constitute an indirect undermining of that vested interest?

There is very little judicial authority on this question. However, it is doubtful that a court would find it impermissible for a public entity ever to reduce an item of pensionable compensation even in circumstances where it would violate the vesting doctrine for the same entity to recharacterize that compensation as non-pensionable. If carried to its logical conclusion, such an approach would even prohibit a public entity from reducing the salary of an employee because this would also have the effect of reducing the employee's pensionable compensation. Indeed, the couple of cases that have considered this point have allowed legitimate exercise of the public employer's authority even where an indirect effect of such action has been to reduce an employee's pension.

An example of this is Miller v. State, 18 Cal.3d 808 (1977). In Miller, the plaintiff claimed that his vested pension rights had been impaired because during his employment the mandatory retirement age was lowered from age 70 to age 67, thus in effect reducing his ability to earn a greater pension. The California Supreme Court rejected such claim because the change in mandatory retirement age was clearly within the power of the legislature. As for the indirect effect on the plaintiff's pension, the court stated as follows:

> "It avails plaintiff nothing that he failed to work until age 70 because the Legislature forced him to retire at age 67. Although he was entitled to earn increased pension benefits so long as he remained in state employment, as we explained above, plaintiff had no vested contractual right to continue working for any specified period of time. In short, his membership in PERS did not confer on him the right to remain in state employment beyond age 67 and he had no constitutionally protected right to continue in his position until age 70 in order to receive a larger retirement allowance."

Even more to the point is the recent important case of Claypool v. Wilson, 4 Cal.App.4th 646 (1992) (petition for review denied by California Supreme Court on June 18, 1992; cert. petition denied by U.S. Supreme Court at 113 S. Ct. 812 (1992)). One of the issues involved in that case was whether employees' vested pension rights were impaired under circumstances where a new COLA provision was not comparable to a prior COLA provision applicable to the employees in question, and where the legislature had provided for a discontinuance of the employee contributions necessary to fund such prior COLA. Thus, the court was squarely presented with the question of whether the legislature's exercise of its authority to discontinue the employee contributions in question impaired other employees' vested pension rights because this action eliminated the source of the necessary funding to provide the vested benefit and, hence, indirectly affected that benefit. As phrased by the court, "[t]he appropriate question is whether there is a vested contract right under the former supplemental Cola statutes to continued contributions by new employees which is impaired by a statute which places new employees in a noncontributory pension program." Id. at 669. The court found that the legislature could validly adopt such amendment to the retirement system even though the effect was to erase the benefits to members with vested rights in the former COLA.

In explaining the basis for its decision, the Claypool court held that a public entity could not be constrained from taking an otherwise lawful action simply because of the indirect impact on pension benefits. Although this action in Claypool involved modification of another aspect of the pension system itself, it would appear that the same principle could equally apply to the situation at hand where an otherwise lawful modification of the cafeteria plans has a similar effect. For this reason and for the reasons discussed above, it is our opinion that a modification to the cafeteria plans involving a reduction in the available cash option would not be unlawful because of its indirect effect on the amount of pensionable compensation received by participants in those plans.

Other Matters

Proposal to amend current State law to exclude available cash options from pensionable compensation for employees hired after the date such change is enacted - As discussed in the Prior Legal Opinion (pgs. 24-33), the courts have held that an employee's benefit in a public pension plan is vested once employment commences. There is no prohibition whatsoever on the modification of a pension plan for service to be rendered by new hires as long as such modification is put in place prior to the date of hire. Accordingly, the enactment of any such State law would not violate the constitutional prohibition on the modification of pension benefits. Furthermore, there would appear to be no prohibition that would prevent an existing employee from voluntarily waiving the right to continue to have available cash options included in pensionable compensation in exchange for the right to participate in any new cafeteria plan established pursuant to the enactment of any such State law.

Proposal to eliminate the ability of employees to sell annual leave benefits under Megaflex and to provide Megaflex participants with a similar elective annual leave program outside of the cafeteria plan - As long as the Board of Retirement makes or has made a determination that the ability to cash out leave days does not constitute pensionable compensation ("compensation earnable"), this should result in a reduction in the amount of pensionable compensation currently being paid to participants in Megaflex.

Proposal to use the increase in pensionable compensation to offset the County's contribution to provide retiree medical benefits - Because there has been no indication that the Board of Supervisors would consider such an approach from a policy standpoint, this proposal has not been exhaustively researched at this point. However, in our judgment, it is highly unlikely that the County could partially discharge an existing contractual obligation by offsetting it by another obligation, i.e., the increase in pension benefits due to the cash available option being treated as pensionable compensation. Furthermore, if this proposal were to be pursued, it would be necessary to determine whether any such course of action would result in a violation of the County's legal obligation to contribute specified amounts for retiree medical benefits at the time such obligation was undertaken.

Sincerely,

Frank H. Smith, Jr.