City of Woodland

# REPORT TO MAYOR AND CITY COUNCIL

AGENDA ITEM

TO: THE HONORABLE MAYOR AND CITY COUNCIL

DATE: February 26, 2008

SUBJECT: GASB 45 Update – Other Post Employment Benefits (OPEB)

**Report in Brief**

The City Council has received various updates on the implementation of new standards concerning how public agencies account for non-pension benefits for retired employees, collectively known as Other Post Employment Benefits (OPEB). Since 2004, staff has completed several actions in response to Council direction to control the growth in the City's OPEB liability and meet the new standards that require agencies to pre-fund their obligation. In addition, the report presented to the City Council on December 11, 2007 that proposed the Guiding Principles for the FY 2009 Budget and 10-Year Financial Plan stated that meeting the City's OPEB obligation would be factored into the 2008-09 budget and 2008-09 – 2017-18 10 Year Plan.

This report provides the Council with further updates on OPEB, including a discussion of the Governor's OPEB Commission report and presents options for developing a funding plan to meet this liability. Staff believes that the establishment of an irrevocable trust fund to pre-fund retiree health benefits is the best solution to meeting this liability. CalPERS has been active in developing funding solutions for OPEB, and recently created a Trust Fund Program for retiree health benefits which allows public employers to pre-fund their future OPEB costs. A CalPERS representative will attend the February 26, 2008 Council workshop to provide an overview of their new program and the benefits of pre-funding. There are other financial institutions that provide similar programs. In addition, employee compensation options should also be explored that could further reduce the City's future retiree health liability.

Staff recommends that the City Council approve the following actions regarding the City's OPEB obligation:

- Develop a funding plan that includes the establishment of an irrevocable trust fund program as described herein;
- Seek proposals from qualified financial management organizations in order to implement an irrevocable trust fund program; and
- Create a task force composed of labor and management representatives to further study compensation options that could further reduce the City's OPEB obligation.

**Background**

In 2004, the Governmental Accounting Standards Board (GASB) issued Statements No. 43 and 45, relating to Other Post-Employment Benefits (primarily relates to retiree healthcare benefits). These statements require governmental agencies that provide retiree healthcare benefits to recognize the cost of such benefits in a manner similar to defined benefit pension.

Like the City of Woodland, most governmental agencies account for retiree healthcare benefits on a cash basis, meaning that the expense recognized and reported on financial statements is limited to the annual cash outlay for retiree healthcare premiums. GASB 45 changes the accounting standard from a cash to an accrual basis. The accrual basis of accounting requires employers to recognize and report the value of retiree healthcare benefits earned (based on actuarial standards) by both retirees and active employees during the employee's working lifetime.

While the City has yet to develop a funding plan, the City Council has had numerous discussions with staff on this issue and directed the completion of several actions to address the future OPEB obligation. These actions include:

- In 2005, the City retained an actuary to calculate the City's OPEB liability and estimate the City's annual accrued expense. Based on the 2005 data, the City's OPEB liability was estimated at $49 million. The $49 million liability is comprised of $18.2 million of accrued (earned) benefits on existing retirees, $15.3 million for accrued benefits on active employees, and $15.6 million for estimated future benefits of active employees. Assuming a 30-year amortization of this liability, the City's annual OPEB expense is estimated at $4.3 million.

- In 2006, the City Council directed staff to reduce the continued growth of the City's OPEB liability through the updating of all labor agreements. In the previous round of MOU negotiations, the City included a requirement for all contracts to expire on June 30, 2006 to allow various changes in retiree health care to address GASB 45. The most significant change was to modify OPEB benefits on employees hired after July 1, 2006. The City's existing program was kept intact for current retirees and those employees hired prior to July 1, 2006. The existing program was not made available to new employees hired after July 1, 2006; new employees were subject to mandatory enrollment in a defined contribution plan.

  Under the defined contribution plan, the City pays the minimum PERS medical benefit, which is supplemented by contributions to a Retirement Health Savings Plan or "RHSP" (similar to deferred compensation). The difference in costs between the defined benefit vs. defined contribution plan represents a significant savings to the City.

While these actions are significant, the next step is for the City to develop a plan that will meet it currently unfunded future liability. This challenge was acknowledged in the December 11, 2007 staff report proposing the Guiding Principles for the FY 2009 Budget and 10 Year Plan. Among the strategies presented in the report was the City Manager's direction for departments to develop options for further reducing General Fund expenditures by $2 million. The proposed reductions would be utilized to supplement the City's current annual contribution of approximately $1.8 million for OPEB, bringing the total amount close to the $4.3 million previously referenced as the annual contribution to pre-fund the liability. In addition, staff listed the disposal of valuable City property as another option that would utilize "one-time" funds for meeting the future OPEB obligation. Two properties, the Regional Park site and the 128 acre Beamer/Kentucky/County Road 102 site could be valuable under favorable economic conditions. The value of the sites could generate proposals consistent with the Specific or General Plan requirements and Council expectations. The sale of these properties would provide funds that could serve as "seed money" in order to pre-fund the future retiree health liability.

## Discussion

The City of Woodland is not alone in facing this significant financial challenge. As noted in the State of California Public Employee Post-Employment Benefit Commission report dated January 2008, approximately 78% of governmental agencies do not currently pre-fund their OPEB obligations. Because of the significant implications of this new accounting standard, GASB has provided for three phases of implementation. The City is required to implement this new standard in FY 2009.

Until GASB 45 was issued, most governmental agencies didn't fully understand the magnitude of their unfunded OPEB obligations. Given the significance of this financial obligation, many agencies are looking at alternatives to reduce their liability. Below is a recap of what some agencies have and/or are doing to address this issue:

- **State of California Public Employee Post-Employment Benefit Commission:** In December 2006, Governor Schwarzenegger established the Public Employee Post-Employment Benefits Commission (the "Commission") to identify the amount and extent of unfunded liabilities for OPEB statewide, compare and evaluate various approaches for dealing with such liabilities and propose a plan for addressing the OPEB liabilities.

  The Commission's final report was distributed in January 2008. The report, which is very lengthy, includes thirty-four recommendations regarding OPEB funding and financial reporting, discloses results of a state-wide OPEB survey, compiles various public entity case studies and provides technical literature about GASB and actuarial studies.

  While the Commission does not recommend any specific funding methods, they do recommend that public agencies adopt pre-funding as their policy, and noted that pre-funding OPEB is equally important as pre-funding pensions. Secondly, they recommend that each public employer shall identify its OPEB liability, adopt a pre-funding plan and make it public. The Commission recognizes that it may not be financially practical for some agencies to pre-fund OPEB liabilities in the short-term, but recommends that agencies develop a long-term plan to pre-fund and begin doing so as soon as practical.

The executive summary of that report is attached as Exhibit A.

- **CalPERS OPEB Trust Fund:** At the request of their clients, CalPERS has taken an active role in answering questions regarding GASB requirements and funding solutions for OPEB. CalPERS recently created a Trust Fund Program which allows public employers to contract with CalPERS for employee health benefits to pre-fund their future OPEB costs. The pre-funding is supported by the establishment of an irrevocable trust fund that dedicates the funds to the sole purpose of meeting the OPEB obligation and allows investment to occur in a manner that generates a higher return than typical local government investment programs. The higher return will allow pre-funding to be accomplished within a shorter timeframe (20-30 years) than other available means and reduce the City's Annual Required Contribution (ARC).

  A CalPERS representative will attend the February 26, 2008 Council workshop to provide the Council with an overview of their program and explain the benefits of pre-funding OPEB.

- League of Cities / Finance Professional Organizations (CSMFO, CMTA, and GFOA): GASB 45 has been the discussed at numerous conferences. Many agencies are looking at to others (both the state and local levels) for possible solutions or creative alternatives for implementation and management of this significant issue.

  The City of Newport Beach has been the topic of discussion on creative solutions. This city successfully implemented drastic changes to their retiree healthcare benefits. Though a "meet and confer" process which took approximately three years to finalize, the City converted its defined benefit program to a defined contribution program. While not necessarily satisfactory to all, the change provided benefits to both the city and its employees. The plan was unanimously approved by employee associations and implemented three years ago.

  Although the specifics in the Newport Beach Plan may vary from other agencies, some aspects are applicable. More importantly, this plan could provide the framework for developing a funding plan and lead to alternative/creative solutions. Newport Beach retained a team of outside help including labor attorneys, Trustee / Account Custodian / Investment Services, Claims Administrator, Trustee Custodian/ Annuity Provider, and an actuary.

The information described herein suggests that the City should take certain actions to proactively address the future OPEB obligation. These actions include developing a funding plan to meet the future retiree health obligation, soliciting proposals from qualified financial management organizations to establish an irrevocable trust fund program and working with employees to develop compensation alternatives that would further reduce the City's future obligation. The funding plan will likely require a combination of increased annual contributions and "one-time" contributions, perhaps generated by the sale of surplus City property. Establishment of an irrevocable trust fund program will provide the means to meet this obligation sooner through an investment program. Finally, working with employees through a task force composed of management and labor representatives will facilitate the review of compensation alternatives that could further reduce the

City's future OPEB obligation while providing salary and benefits that meets the needs of the workforce.

In the coming months, staff will continue to contact other public agencies facing unfunded OPEB liabilities to learn of different strategies that may have been successful in helping agencies mitigate the impacts of OPEB.

In the fall, staff will retain an actuary to prepare a new actuarial valuation needed to quantify the OPEB liability and obtain necessary actuarial data required for FY09 financial reporting and disclosure purposes.

## Fiscal Impact

Although the GASB does not require governmental agencies to prefund its OPEB obligations, the implementation of these new accounting standards will significantly impact the City's financial statement and reserve fund balances if not fully funded. The attached Exhibit B highlights the impacts that GASB 45 will have on reserve fund balances if the City continues to use only the cash basis for OPEB. Based on the information obtained in the 2005 actuarial report, recording OPEB on the required accrual basis of accounting will deplete the general fund's reserve fund balance by FY11/12.

Equally important is that lack of substantive progress on OPEB financial planning will be viewed negatively by rating agencies; this could ultimately adversely affect the City's credit rating and the City's ability to issue debt.

There are certainly a number of benefits to pre-funding. Pre-funding minimizes future cost impacts through investment in certain securities with higher rates of return. CalPERS noted that investment returns ultimately pay 75% of pension benefits, which minimizes the need for additional cash contributions. These higher investments return assumptions (discount rates) results in a lower present value of the City's future liabilities, and a lower Annual Required Contribution (ARC). As stated previously herein, the City's current ARC is estimated at $4.3 million.

Additionally, any contribution made toward the OPEB liability that is less than the ARC will result in an unfunded liability on the City's financial statements beginning in FY08/09.

## Public Contact

Posting of the City Council Agenda.

## Recommendation for Action

Staff recommends that the City Council approve the following actions regarding the City's OPEB obligation:

- Develop a funding plan that includes the establishment of an irrevocable trust fund program as described herein;
- Seek proposals from qualified financial management organizations in order to implement an irrevocable trust fund program; and
- Create a task force composed of labor and management representatives to further study compensation options that could further reduce the City's OPEB obligation.

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Attachments

# Executive Summary
# A Plan to Address Pension and OPEB Obligations

This report presents a plan to address public pension and retiree health care funding issues across the state of California. The following recommendations are divided into eight groups which together constitute a plan for addressing pension and Other Post-Employment Benefits (OPEB) obligations. For more information on the background and rationale for each recommendation, please see the Recommendations section of this report.

## Group 1
## Identify and Prefund Financial Obligations

### Recommendation 1

Public agencies providing OPEB benefits should adopt prefunding as their policy. As a policy, prefunding OPEB benefits is just as important as prefunding pensions. The ultimate goal of a prefunding policy should be to achieve full funding.

### Recommendation 2

Each public employer shall identify its OPEB liability, adopt a prefunding plan, and make it public. If a public employer does not establish a prefunding plan, it shall clearly identify an alternative approach for addressing its OPEB liabilities and make public its reason for not prefunding.

### Recommendation 3

The State of California shall establish prefunding as both a policy and budget priority, develop and make public a prefunding plan, and begin prefunding its OPEB liabilities.

### Recommendation 4

Any employer considering the use of OPEB bonds should fully understand, and make public, the potential risks they bring. Such risks include: shifting costs to future generations, converting a future estimated OPEB liability into fixed indebtedness, and the uncertainty concerning continued federal cost sharing for debt service on such a bond.

## Group 2
## Limit Contribution Volatility and Use Smoothing Methods Judiciously

### Recommendation 5

Public retirement systems which consider contribution rate volatility to be a problem should consider the use of longer asset smoothing periods to lessen that volatility.

### Recommendation 6

A retirement system which has adopted an asset smoothing method should resist efforts to alter that method for short-term gain, including, but not limited to, contribution rate reductions and benefit increases.

### Recommendation 7

Generally, employer contributions should not fall to zero. An employer should be permitted to have a full or partial contribution holiday only when its retirement plan is substantially overfunded. As used here, "substantially overfunded" means that the existing surplus is used to pay for all or part of the normal cost only after that surplus is amortized over a 30 year period, the longest amortization period allowed by GASB. In particular, employer contributions should fall to zero ("full contribution holiday") only in the rare situation that the surplus is so great that it could be expected to fund a full 30 years of normal costs.

### Recommendation 8

An employer whose pension account is overfunded and who has an OPEB liability should, as its first priority, use that surplus to address its OPEB liability. This should be done either by (1) transferring such surplus directly to OPEB funding in a manner which complies with federal and state law, or (2) using the budgetary savings from any contribution holiday (determined in accordance with Recommendation 7) to make additional contributions to OPEB funding.

## Group 3
## Increase Transparency and Accountability

### Recommendation 9

Legislation should be enacted directing the State Controller's Office to develop a simple and inexpensive procedure to regularly collect and report OPEB data from California public agencies. In order to minimize reporting requirements for public agencies, all the data collected for this report should be contained in the GASB 45 actuarial valuation report periodically required of each public agency and in the agency's GASB 45 footnote. Reporting should be mandatory for those agencies which provide OPEB benefits.

### Recommendation 10

The State Controller's Office should publish the annual report of public pensions, which is required by current law, within 12 months of the receipt of data but in no case longer than 18 months after the end of the fiscal year.

### Recommendation 11

With the exception of school districts and county offices of education, legislation should be enacted to amend Government Code Section 7507 to provide for more clarity in its cost reporting requirements and for clear accountability within a public agency adopting new benefit levels. Specifically, where that section now calls for the determination of "future annual costs", it should be clarified to include "normal cost and any additional accrued liability". Concerning increased accountability, language should be added which requires that the person holding the position with the responsibilities of a chief executive officer within the affected agency acknowledge in writing the actuary's cost determination for the new benefit. School districts and county offices of education shall comply with disclosure requirements pursuant to AB1200 (Chapter 1213, Statutes of 1991) and AB 2756 (Chapter 52, Statutes of 2004).

### Recommendation 12

With the exception of school districts and county offices of education, legislation should be enacted to amend Government Code Section 7507 so that it also applies to the granting or changing of OPEB benefits. As with pension benefits, this statutory change would require that the future costs of the proposed benefit change be determined by an actuary and be made public at least two weeks prior to adoption. School districts and county offices of education shall comply with disclosure requirements pursuant to AB1200 (Chapter 1213, Statutes of 1991) and AB 2756 (Chapter 52, Statutes of 2004).

### Recommendation 13

With the exception of school districts and county offices of education, legislation should be enacted to amend Government Code Section 7507 to require that pension and/or OPEB benefit changes be subject to the public notice requirements found in that section and be presented with an actuary available to answer any questions or to provide additional information, as needed. The presentation and report should be in language easily understood by the layperson, and such information should not be placed on the consent calendar. School districts and county offices of education shall comply with disclosure requirements pursuant to AB1200 (Chapter 1213, Statutes of 1991) and AB 2756 (Chapter 52, Statutes of 2004).

## Group 4
## Improve Plan Design and Communication with Employees

### Recommendation 14

An employer making a contribution to retiree health care should make that contribution proportionate to the number of years of employment and should reward longer careers. This recommendation should be implemented through collective bargaining and should be applied to newly hired employees. The use of proportionate credit to earn the employer contribution for retiree health care should apply only to service retirement.

### Recommendation 15

An employer providing retiree health care should make that benefit dependent upon the employee retiring within a set time after separation from the job.

### Recommendation 16

Public sector employers should provide tax-advantaged supplemental savings plans (e.g. 457, 401(k), 403(b), etc.) to their employees on an "opt out" basis. Public employers and their employees should jointly determine the details of any plan offered, including: whether to use a "hard" or "soft" opt out, the minimum contribution amount, and any default investment selection for employee contributions. Employers should also develop an ongoing program to educate employees about their savings options.

### Recommendation 17

Public employers should provide regular explanations to their employees concerning the advantages of their defined benefit (pension and OPEB) plans, the role of compounded interest in their personal savings programs, and the advantage of contributing to savings on a pre-tax basis. Employees who participate in Social Security should be educated that this is a supplemental program only and not a retirement plan. This information should be communicated at regular intervals throughout an employee's career.

### Recommendation 18

Public employers should provide clear explanations to employees concerning current eligibility rules for retiree health care and the terms under which retiree health care is earned. Employers should also clearly explain to their employees the conditions under which health benefits for retirees are to be funded and paid. This information should be communicated at regular intervals throughout an employee's career and through plan documents and collective bargaining agreements.

### Recommendation 19

Public employers should provide timely notification to both active and retired employees when proposing a change in retiree health care benefits. This notification should be provided in a time frame that reasonably allows affected employees and retirees to understand the impact of the benefit change, to review other options available to them, and to comment to the employer on the proposed changes.

### Recommendation 20

CalPERS should periodically inform its contracting agencies about the option of allowing permanent part-time employees access to the PEMHCA health care system. The amount of the employer contribution, if any, should be collectively bargained.

### Recommendation 21

Public employers should evaluate participation in alternate arrangements, including joint power authorities (JPA) and regional health care risk pools, as a means of providing retirees with access to health care coverage.

## Group 5
## Provide Independent Analysis

### Recommendation 22

Legislation should be enacted to create a California actuarial advisory panel at the state level. The purpose of the advisory panel would be to provide the California Legislature, the Governor's office, public retirement systems, public agencies, and other interested parties with impartial and independent information on pensions, OPEB benefits, and best practices.

Such a panel would encourage greater transparency and understanding of actuarial methodology and assumptions used by public retirement systems and would gather and provide information concerning best actuarial practices. Individuals appointed to the advisory panel should have the requisite technical and educational skills to carry out their duties.

### Recommendation 23

All public pension plans should have periodic performance audits performed by an independent auditor.

## Group 6
## Strengthen Governance and Enhance Transparency

### Recommendation 24

A retirement board should not provide incentives for an employer to enhance benefits, and benefit improvements by the employer should not be contingent upon a quid pro quo by the retirement board.

### Recommendation 25

Retirement systems and public agencies should be open and transparent concerning the elements included in final compensation. All public retirement systems in California should have in place safeguards against pension spiking.

### Recommendation 26

Legislation should be enacted which would do the following:

1. Make it a crime to make a fraudulent claim for a retirement or disability benefit or to keep a payment made on the basis of a fraudulent claim;
2. Require that workers' compensation insurers and the Director of EDD provide CalPERS investigators with information they deem necessary when investigating someone concerning the application for, or the receipt of, CalPERS benefits.

### Recommendation 27

The granting of a disability retirement should be based solely on medical information and should not consider personnel, disciplinary, or other ancillary issues.

### Recommendation 28

Boards overseeing pension or OPEB trust funds should evaluate not only reported actuarial liabilities and assets but also the underlying assumptions including discount rates, investment returns, mortality, health care inflation, and whether plans are open or closed systems. Boards should understand the sensitivity to changes in these assumptions, as well as the difference between actuarial values and market values. The authorities responsible for appointing members to public retirement boards should seek out individuals with expertise in the areas of public finance, investments, and public administration. In addition, the trustees of public retirement systems, as well as the trustees of OPEB trusts, should receive continuous training related to the understanding and fulfillment of their fiduciary responsibilities, actuarial methodology and assumptions, and conflict of interest requirements.

### Recommendation 29

Boards which govern pension and/or OPEB trusts should have very strong conflict of interest policies and should adhere to those policies. All trustees should annually attest in writing that they understand and are in compliance with the conflict of interest policy.

### Recommendation 30

Boards overseeing pension and/or OPEB trust funds should meet or exceed the transparency governance requirements they place on companies or on investment managers of plan assets.

### Recommendation 31

Public retirement boards of trustees should establish a separate audit committee, made up of trustees, to oversee and participate in the opening, processing, and closing of the annual audit report to the full board.

## Group 7
## Coordinate with Medicare

### Recommendation 32

Health plan sponsors should identify individuals who are Medicare-eligible and inform them of the need to enroll in Medicare in a timely manner. Employers should provide those individuals with information on penalties which result from delayed enrollment in Medicare.

### Recommendation 33

Employers should provide incentives to individuals to enroll in Medicare and possibly a Medicare supplement plan once they become eligible for Medicare.

## Group 8
## Advocate Federal Tax Law Changes

### Recommendation 34

At the request of numerous local agencies, the Commission agreed to consider several proposed tax changes. Because the Commission can play a unique role in communicating these issues to the IRS, the Commission will write a letter to the IRS recommending the following:

- **Investment of Assets Used to Fund Retiree Health Benefits:** The IRS should modify Revenue Ruling 81-100 to allow the commingling for investment purposes of the funds held to pay public employee OPEB obligations with retirement system funds, subject to appropriate safeguards. Those safeguards should require that OPEB funds must be held in trust solely for the benefit of retirees and beneficiaries and that investments and income must be properly accounted for and allocated.
- **Collectively Bargained Retiree Health Benefits:** The IRS should interpret the law in the same manner for retiree health benefits as it does for pensions, and not tax health benefits which are collectively bargained, even if they are not fully insured. The IRS also should not tax retiree health benefits that provide higher premium subsidies to retirees with longer service, whether or not those benefits are collectively bargained.
- **Saving For Retirement: Redeposits and Service Purchase:** The IRS should not change its current rules concerning pick ups and should not change its rules allowing pre-tax redeposits and the pre-tax purchase of service credit, particularly since there has been no change in the governing law.
- **Definition of "Government Agency" for Retirement Systems:** The IRS, DOL, and PBGC should open their process for defining "government agency" by holding public hearings and inviting government agencies and retirement systems to participate in these sessions to provide critical information before any decisions are made which could adversely affect many public employees.
- **Health Benefits: Retirees, Step Children, Domestic Partners, and All Others Covered by the Retiree Health Plan:** The IRS should not tax the health care benefits provided to everyone covered by a health care plan simply because the plan provides coverage for retirees' step children and domestic partners who are not tax dependents of the retirees.

EXHIBIT B
City of Woodland
GASB 45 OPEB Funding
Depletion of Reserve Fund Balances

| | Fiscal Year 08/09 | | | Fiscal Year 09/10 | | | Fiscal Year 11/12 | | |
|---|---|---|---|---|---|---|---|---|---|
| | General Fund | Enterprise Funds | Total | General Fund | Enterprise Funds | Total | General Fund | Enterprise Funds | Total |
| OPEB Cash Basis | 1,344,000 | 576,000 | 1,920,000 | 1,451,520 | 622,080 | 2,073,600 | 1,567,642 | 671,846 | 2,239,488 |
| OPEB GASB 45 (Accrual)* | 3,010,000 | 1,290,000 | 4,300,000 | 3,010,000 | 1,290,000 | 4,300,000 | 3,010,000 | 1,290,000 | 4,300,000 |
| Beginning Fund Balance | 5,594,000 | 105,907,000 | 111,501,000 | 3,928,000 | 105,193,000 | 109,121,000 | 2,369,520 | 104,525,080 | 106,894,600 |
| Unfunded OPEB (if paid only on cash basis) | (1,666,000) | (714,000) | (2,380,000) | (1,558,480) | (667,920) | (2,226,400) | (1,442,358) | (618,154) | (2,060,512) |
| **Ending Balance**** | 3,928,000 | 105,193,000 | 109,121,000 | 2,369,520 | 104,525,080 | 106,894,600 | **927,162** | 103,906,926 | 104,834,088 |

*Note: The OPEB amounts are obtained from the 2005 actuarial report.
**Note: Ending fund balance assumes the funds will have a balanced budget in each year, with the exception of the GASB 45 OPEB difference.