Finance Committee Presentation on Governmental Accounting Standards Board Statement No. 45

Presented by:
Michael Schionning
Jacqueline Farren

buckconsultants
an ACS company

Finance Committee Presentation Outline

- Results of the analysis by Buck Consultants, LLC
  - Overview of GASB 45 and its requirements
  - Methodology used to calculate GASB 45 costs
  - Initial assessment of the County's GASB 45 costs

- Management Considerations
  - Options available to the County to manage the cost
  - Additional unresolved issues requiring further investigation
  - Recommended direction to County staff

Overview of GASB 45

- Accounting and financial reporting for Postemployment Benefits other than Pensions (OPEB)
  - GASB 45 applies to governmental employers
  - Mandates uniform accrual-based accounting
  - For the County it is effective for the fiscal year beginning July 1, 2007

- Objectives of GASB 45
  - Report OPEB the same way pensions are currently reported
  - Recognize cost of OPEB systematically over employees' years of service

Overview of GASB 45

- OPEB stands for Other Postemployment Benefits
- OPEBs are all benefits other than pension benefits and include medical, prescription drugs, dental, vision, hearing and Medicare Part B or Part D premiums
- OPEBs can also include other postemployment benefits when provided separately from a pension plan
  - Life insurance
  - Long-term care
  - Long-term disability
- For Contra Costa County OPEBs include medical, prescription drug, dental and self-funded long term disability

Overview of GASB 45

- Currently, most governmental employers use a Pay-As-You-Go (PAYGO) method to report OPEB costs
- Financial statements only report the OPEB benefits being paid in the current year as the expense
- Since OPEB is reported in this manner, there has been little or no pre-funding of OPEB benefits

Overview of GASB 45

Why is GASB Requiring this Reporting?

- OPEB benefits are part of the compensation for services rendered by employees
- Benefits are "earned," and obligations accrue or accumulate, during employment
- Entities are not properly accounting for the future benefits that are promised and/or expected by employees
- Analysts will be able to evaluate OPEB obligations in the same way they currently evaluate pension obligations

Overview of GASB 45

- The new standard requires the measurement of two items:
  - The value of premium payments made on behalf of the retiree and his or her covered dependents
  - The value of the "subsidy" that occurs if the retiree rates are lower than the actual cost of the benefits

- The "subsidy" results if an employer:
  - uses the same rates for active and retired employees
  - does not set the retiree rates to be equal to the actual cost of providing coverage

Overview of GASB 45

- The new standard requires the disclosure of two key items:
  - The Unfunded Accrued Actuarial Liability (UAAL).
  - The Annual Required Contribution (ARC)
    - This is made up of the normal cost – the amount that the active employees earn for their service in the year
    - And a not greater that 30 year amortization of the UAAL
- The standard does not require that the ARC be funded
- However, the credit rating agencies will look at how an entity is handling the liability – including whether the liability is being funded – in determining ratings

Overview of GASB 45

- The likely credit implications of GASB 45 include:
  - Lack of funding along with recent rapid health-care cost increases will result in significant OPEB obligations (primarily health care)
  - These obligations may adversely impact credit rating
  - Reporting OPEB could reveal:
    - Funding could strain operation
    - Employers may be unable to fulfill obligation
  - Unfunded liabilities will be considered in rating process

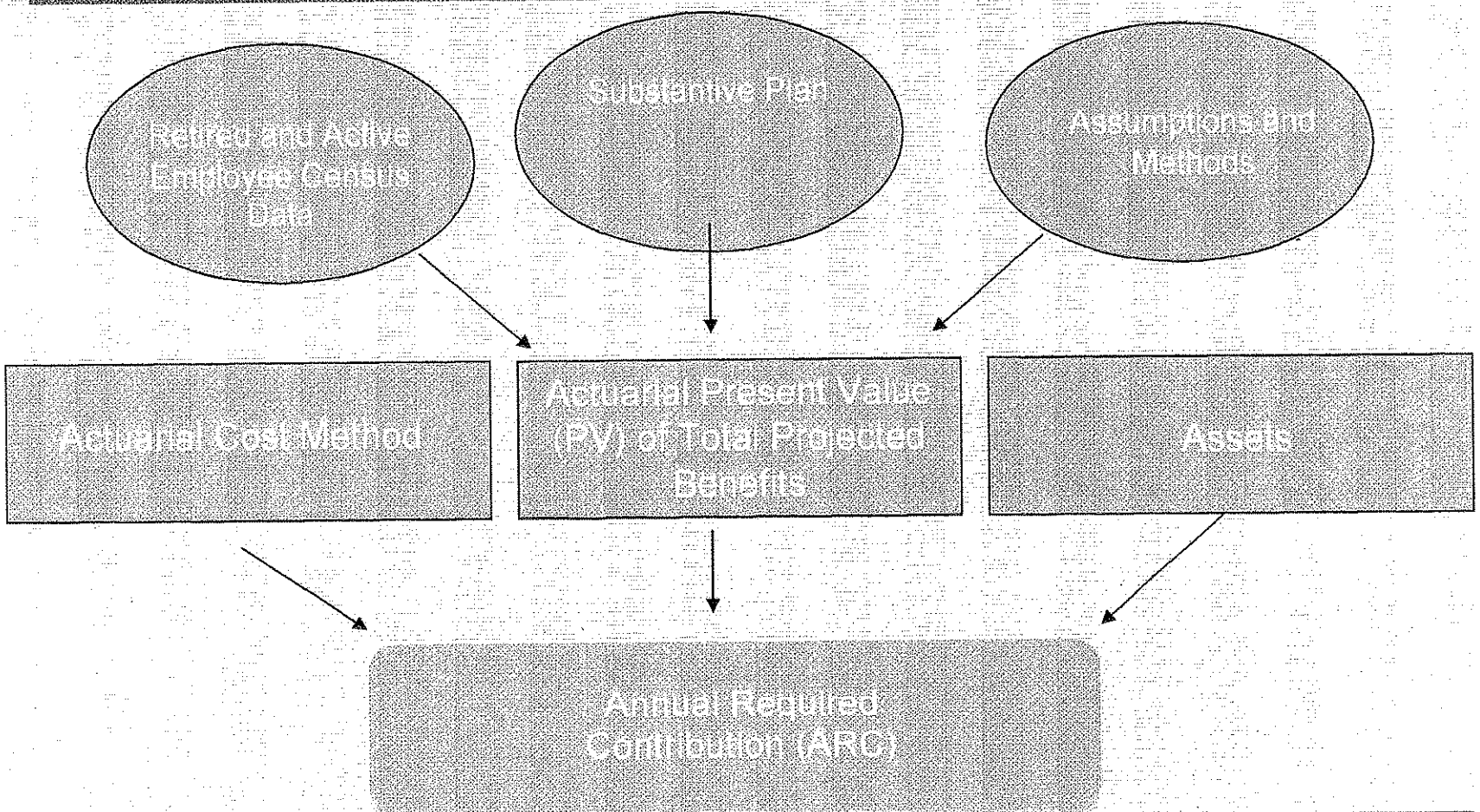
Methodology Used to Calculate GASB 45 Costs

- The measurement of the liability can broadly be determined by:
  - Projecting employer cash outflows for benefits
  - Discounting projected benefits to the current date (or the Present Value (PV))
  - Allocating the PV of projected benefits to periods using an acceptable actuarial cost method
- This measurement includes the use of demographic and economic assumptions (including the healthcare cost trend rate)

Methodology Used to Calculate GASB 45 Costs

- Substantive Plan – The plan as understood by the employer and plan members
- Need to consider:
  - Eligibility, underlying benefits and cost sharing arrangements
  - Historical patterns of changes
  - Written documents and communications to participants
- Other plan features
  - Caps on Employer's share of benefits
  - Potential implicit rate subsidies
  - Medicare Part B or Part D premium reimbursement

Methodology Used to Calculate GASB 45 Costs



Methodology Used to Calculate GASB 45 Costs

INPUT

- Census Data
- Demographic Assumptions
- Participation & Dependent Coverage Assumptions

- Base year per capita costs
- Trend and Aging Assumptions

- Substantive plan

Projected Covered Population X Projected Per Capita Costs = *Total Projected Benefits* - Projected Retiree Contributions = *Projected Employer Provided Benefits*

OUTPUT

Methodology Used to Calculate GASB 45 Costs

Total PV of Benefits is discounted value of projected benefit payments

Year	Projected Employer Provided Benefits	Total Present Value of Benefits
2007	$3,000,000	
2008	$3,300,000	
2009	$3,600,000	
2010	$3,900,000	
2011	$4,300,000	

Discount Rate

Methodology Used to Calculate GASB 45 Costs

- Discount rate – Expected long-term investment yield on investments expected to be used to finance payment of benefits. Investments could include:
  - Plan assets — for a funded plan (where assets are accumulated in a trust)
  - Employer assets — for an unfunded plan
  - A combination of plan and employer assets — for a partially funded plan

Initial Assessment of the County's GASB 45 Costs

- As of January 1, 2006, Buck estimates than the Actuarial Liability for the current benefit plan is:
  - $2.57 billion under the assumption that the County continues to fund the OPEB benefits on a PAYGO basis
  - $1.43 billion under the assumption that the County elects to fully fund the Annual Required Cost (ARC) each year

Initial Assessment of the County's GASB 45 Costs

- As of January 1, 2006, Buck estimates than the Annual Required Cost (ARC) for the first year is:
  - $216.33 million under the assumption that the County continues to fund the OPEB benefits on a PAYGO basis
  - $102.70 million under the assumption that the County elects to fully fund the Annual Required Cost (ARC) each year
  - This compares to the expected PAYGO cost of $33.15 million for the first year

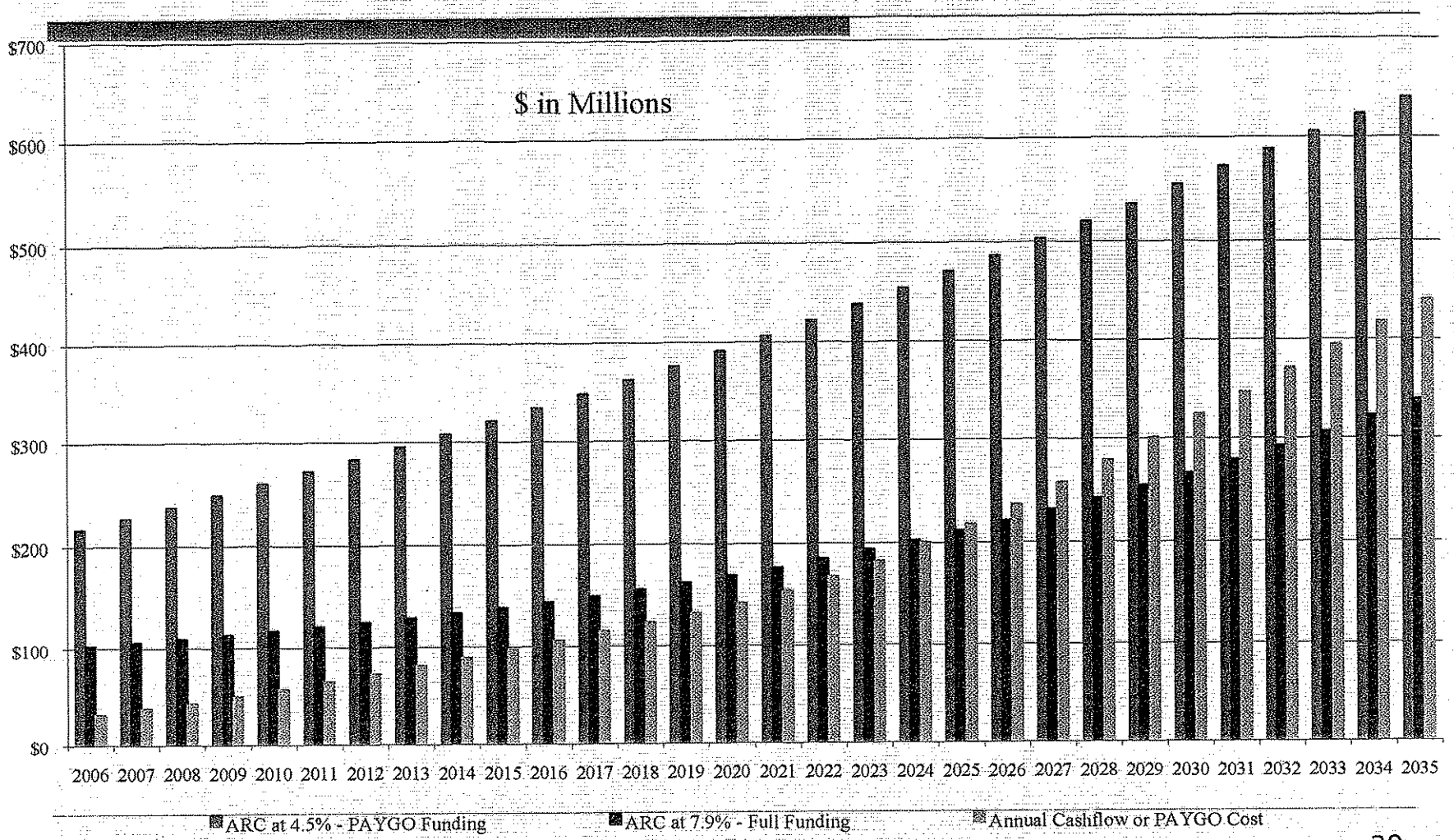
Initial Assessment of the County's GASB 45 Costs

- If the County elects to fully fund the ARC, then the net OPEB obligation – or the liability that is shown on the balance sheet – is $0
- If the County elects to continue to only fund the PAYGO costs, then the difference between the ARC and the PAYGO cost is reflected as the net OPEB obligation
- This would be $216.33 million less the $33.15 million PAYGO cost or $183.18 million
- This OPEB obligation would continue to increase over time until it is equal to the actuarial liability

Initial Assessment of the County's GASB 45 Costs

- The chart on the next page provides a 30-year projection of:
  - The ARC under the assumption that the ARC is fully funded each year
  - The ARC under the assumption that the PAYGO cost is funded each year
  - The expected PAYGO costs for each year

Initial Assessment of the County's GASB 45 Costs



Management Considerations

Options Available to the County

- Option 1 - Continue to fund the PAYGO costs
- Option 2 – Modify the existing OPEB plan
- Option 3 - Pre-fund all or portion of liability
- Option 4 - A combination of the above options

Option 1: Continue PAYGO Funding

- Under this option the County would leave the current OPEB plan unchanged
- It would not fund the ARC above the required PAYGO funding
- Essentially, this Option is keeping the status quo

Option 1: Continue PAYGO Funding

- Pros:
  - Minimizes short-term budget impact
  - No change from current process

Option 1: Continue PAYGO Funding

- Cons:
  - Large long-term budget impact as the costs continue to grow
  - Net OPEB obligation continues to grow on balance sheet and will reach a level consistent with the $2.57 billion actuarial liability
  - Estimate that in 5 to 6 years, the County's total liabilities will exceed total assets
  - Risk of credit rating downgrade

Option 2: Modify the Existing OPEB Program

- Under this option, the County would look at changes in the existing OPEB programs. Although the County has not initiated any analysis on any options, the changes could include:
  - Changing the eligibility requirements for the benefit
  - Changing the coverage amounts (deductibles, copays, coinsurance, etc.)
  - Changing the amount the County contributes towards coverage
  - Unblending the active and retiree rates

Option 2: Modify the Existing OPEB Program

- Pros:
  - Reduced liability and PAYGO costs
  - Produce an ARC that may be within the County's ability to fund

Option 2: Modify the Existing OPEB Program

- Cons:
  - May affect competitiveness with other employers
  - A portion of the employees are covered under CalPERS, where the County has little or no control on program design

Option 3: Pre-funding in an Irrevocable Trust

- Under this option the County would pre-fund some portion of the ARC up to the full amount through a Trust
- By pre-funding the obligation through an irrevocable trust or equivalent arrangement, the County can use a higher discount rate – which by itself lowers the liability and ARC
- The investment earnings will help reduce the long term cost commitment from the County general fund for the OPEB benefits

Option 3: Pre-funding in an Irrevocable Trust

- Pros:
  - Reduces liability by allowing higher discount rate assumption (higher assumption only applies to the portion pre-funded)
  - Reduces risk of credit rating downgrade
  - Reduces budget volatility by establishing funding plan not tied to annual premium cost increases

Option 3: Pre-funding in an Irrevocable Trust

- Cons:
  - Full pre-funding is likely not affordable
  - Uncertainty as to whether the State/Federal Government will reimburse pre-funded amounts
  - Risk that pre-funding will be unnecessary if liability is reduced by unforeseen events such as major assumption changes or nationalized health care
  - Risk of investment losses in the trust fund

Option 4 – A Combination of Options

- The county may wish to consider a combination of approaches to manage its OPEB liability, which may include:
  - Modifications to the current OPEB plan
  - Partial pre-funding through an irrevocable trust or equivalent arrangement

Additional Unresolved Issues Requiring Further Investigation

- Research competitive level of current OPEB benefits
- Research State and Federal positions on reimbursement of OPEB expenses
- Identify steps to establish a trust for accumulating pre-funding assets
- Identify options for managing investment of trust assets

Recommended Direction to County Staff

- Prepare an analysis of liability reductions that could be produced through changes to healthcare benefits and present in closed session

- Prepare an analysis of the cost associated with funding varying levels of the liability and make recommendations concerning the portion of the liability that should be pre-funded and present at a future meeting of the Finance Committee

Recommended Direction to County Staff

- Investigate unresolved questions concerning State/Fed cost reimbursement, establishment of an irrevocable trust for pre-funding assets, and investment options for pre-funding assets and report back at a future meeting of the Finance Committee
- Work with California State Association of Counties (CSAC) and other public sector partners to gather data and develop statewide strategies for managing this issue