This is an informational report and no Council action is required.

BACKGROUND

The purpose of this report is to provide the Council with the actuarial study results required by the Governmental Accounting Standards Board’s (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pensions*. In addition, an explanation and potential use of Statement No. 43, *Financial Reporting for Post Employment Benefit Plans Other Than Pension Plans*, is provided.

The basic purpose of GASB 45 is to require that public entities measure and report the long-term costs of non-pension retiree benefits, or Other Postemployment Benefits (OPEB). In the City of Palo Alto’s case, medical coverage is the only OPEB offered to retirees. Therefore, this report refers to “retiree medical liability” rather than to OPEB liability.

Since these benefits are a form of employee compensation, GASB 45 states that they should be recognized as an expense as the employee earns them—rather than waiting until the employee retires and his or her medical premiums are paid. An actuarial valuation is required every two years to determine the amount of the liability resulting from the City’s postemployment benefit package (retiree medical liability). Retiree medical liabilities will vary considerably from jurisdiction to jurisdiction based on the benefit levels provided and the agency’s demographics.

Once the retiree medical liability is determined, the City must decide how best to manage it, taking into account multiple factors such as: the size of the liability; the resources available to fund it; the impact on the City’s budget of pre-funding the benefits; legal issues involved in changing any benefits to reduce the liability; whether to establish a trust fund; the need to continue offering competitive benefit packages to attract and retain qualified staff; and the potential impact of a funding plan on bond ratings. At a minimum, rating agencies will look for a well-thought-out plan for addressing the long-term liability under the new rules. Although GASB
45 requires that public entities account for—but not necessarily prepay—the unfunded liability, the financial community will expect jurisdictions to proactively address the liability via some form of funding plan.

GASB 45 replaces the pay-as-you-go method which most governments currently use with accrual accounting (recognizing an expense when it is earned). Rather than simply paying for its current retirees’ medical premiums, the City must also recognize in its financial statements the “earned” cost of current employees’ future retiree medical premiums. If the City were not to recognize these earned costs, as the number of retirees increases (particularly as the “baby boomer” generation leaves the work force), the City would eventually face a huge cash outlay to meet its medical premium obligations. GASB 45 forces jurisdictions to recognize these obligations early through actuarial studies and their recommended annual set-asides, Annual Required Contribution (ARC), so as to avoid the need for huge cash outlays in the future.

**DISCUSSION**

As required by GASB 45, the City contracted with Milliman, Inc. to perform an actuarial valuation to determine the City’s retiree medical liability and how much the City should be setting aside each year to fund that liability. The valuation was completed in April 2006, with a valuation date of July 1, 2005. In addition to determining the unfunded liability (what the City’s employees have earned in retiree medical benefits to-date), the actuarial valuation determines what the City should be setting aside each year.

The actuarial valuation’s assumptions and methods comply with GASB 45, yet as Milliman states in its report, “actual costs will vary from those presented in the valuation to the extent that actual experience differs from that projected by the actuarial assumption.” Any actuarial valuation must be understood as the “best estimate at the time.” Renewing the valuation every two years addresses the fact that real experience invariably differs from projections.

When comparing different actuarial valuations, one must examine the assumptions used for each valuation. For example, every valuation assumes a specific interest rate, based on the expected rate of return on investments set aside to pay for the benefit. The interest rate is used in calculating a single “present value” dollar amount for all future payments and has a significant effect on the valuation result. A higher interest rate results in a lower accrued liability; a lower interest rate yields a higher liability. When staff compared the results of the Milliman study with the results of the Aon study of 2001, using the same interest rate of 6 percent (which is close to the average interest on City investments over the last ten years), the unfunded liability provided by Milliman Inc. was $106.6 million, and the unfunded liability provided by Aon was $93.5 million. Given the identical interest rate assumption, the difference between the two valuations must be explained by other assumptions used in the analyses.

In deriving its assumptions, Milliman relied on data provided by staff with respect to budgeting processes and actual employee turnover information, and on data provided by CalPERS regarding demographic information from all of its agencies. Updated information on mortality, disability and termination rates contributed to the increased unfunded liability of the Milliman study. Milliman also projected higher health care cost increases for 2006-2016 than did Aon as a result of recent experiences.
With the unfunded liability at $106.6 million, the recommended annual set-aside is $10.0 million. Currently, the City pays approximately $3.2 million per year in retiree medical premiums. Once the City implements GASB 45 in fiscal year 2007-08, if it sets aside any less than $10.0 million per year—an additional $6.8 million per year—the difference between what it funds and $10 million will appear on the City’s financial statements.

GASB 43 and the Trust Fund Option

GASB 43 outlines the potential impacts of creating an irrevocable trust for retiree medical premiums. Although it does not require that a trust be created, there are significant advantages to doing so. First, establishing a trust and contributing to it annually would allow assets to be invested in higher-yielding portfolios than the City’s. This would raise the interest rate used to calculate the present value of the unfunded liability and reduce the required annual set-aside. Secondly, as the trust assets grow, a larger share of the required retiree medical resources would come from investment income. Third, any funds placed in the trust would reduce the amount of the unfunded liability, and therefore the City’s annual required set-aside would again be reduced. Lastly, establishing a trust-based funding plan would demonstrate to rating agencies evidence of a “well-thought-out” plan to address the retiree medical liability. The City would avoid a potential bond rating downgrade with resulting higher borrowing rates and cash outlays.

As of June 30, 2005, the City had a balance of $18.2 million in the Retiree Health Benefits Internal Service Fund. If this fund balance were transferred to a newly established irrevocable trust, the unfunded liability would be recalculated using a 7 percent interest rate, dropping it from $106.6 million to $92.1 million. Next, the $18.2 million in the trust would be subtracted from the unfunded liability, which would then drop to $73.9 million; $32.7 million (31 percent) lower than the original unfunded liability. In turn, the annual set-aside would drop from $10 million to $8.1 million. Therefore, given the scenario outlined above, the City stands to save $1.9 million per year by establishing an irrevocable trust.

Of the $18.2 million in the Retiree Health Benefits Internal Service Fund, $13.3 million came from the General Fund; $4.7 million came from Enterprise Funds, and $0.2 million from Internal Service Funds. The unfunded liability for Enterprise Funds (using a 7 percent interest rate) is $24.3 million. If the Enterprise Funds were to contribute to the trust the remaining $19.6 million of its unfunded liability, the balance in the trust would jump to $37.8 million. It should be noted that the Enterprise Funds have only contributed the pay-as-you-go amounts for retired General Fund administrative support staff who had done Enterprise Fund work; they have not contributed the rest of the earned benefits for those retirees and current employees working on their behalf. Therefore, staff will calculate the amount of unpaid past allocated costs for future adjustments.

There are several types of trusts the City may pursue, including a 501(C)(9) or Voluntary Employees’ Beneficiary Association (VEBA) trust, a 115 trust or special purpose government trust, among others. In addition, the California Employees Retirement System (CalPERS) and California Public Agency Retirement System (CalPARS) are exploring the feasibility of managing a trust. Staff will continue to research all the trust options and make recommendations in early FY 2006-07.
Additional Options for Reducing the Liability

The process of undergoing two actuarial valuations brought to light two points: one, the City’s retiree medical benefit is generous compared to those of many other California cities; and two, this benefit will become increasingly costly, perhaps unaffordable, in the future. To diminish future costs, additional steps must be taken to modify current medical plan options. The City has taken a first step in changing vesting requirements for retiree medical benefits for newer hires.

As of 2005, all bargaining units except Palo Alto Police Officers Association (PAPOA) have adopted a two-tiered structure. The current agreement with PAPOA expires on June 30, 2007, and staff will negotiate for a two-tiered plan at that time. For management employees, IAFF and Chiefs members hired on or after January 1, 2004, and SEIU employees hired on or after January 1, 2005, the City pays for 50 percent of medical benefits after 10 years of service, with the City’s portion increasing by 5 percent for each additional year of service up to 20 years. Each actuarial valuation includes only current employees – not future hires. Therefore, the two-tier structure will limit increased additional liability resulting from employees entering the employee pool in the future, yet will do virtually nothing to reduce the current unfunded liability.

Another area of concern is the high cost of the PersCare health care option currently available to a limited number of SEIU employees and to all future retirees. Staff is addressing health care costs in negotiations with the labor groups as contracts expire.

Conclusion

Staff has determined the liability for retiree medical benefits and the amount the City must set aside each year to fund this liability. Staff concludes that establishing a trust is the most beneficial immediate course of action. Staff is also developing strategies to further reduce the liability and will return to Finance Committee in early fiscal year 2006-07 with options and recommendations both for establishing a trust and for reducing the liability.

RESOURCE IMPACT

This is an informational report, for Council’s information with no immediate impact upon City resources beyond what is discussed above.

POLICY IMPLICATIONS

There are no policy implications beyond what is discussed above.

ENVIRONMENTAL REVIEW

The action recommended is not a project for the purposes of the California Environmental Quality Act.
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ATTACHMENTS

Attachment A: Milliman, Actuarial Report