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

**BACKGROUND**
The purpose of this report is to provide the Finance Committee with an update on the implementation of Governmental Accounting Standards Board’s (GASB) Statements No. 43 and 45, *Financial Reporting for Retiree Medical Benefits*.

GASB 45 has a broader application than GASB 43 and will require the City of Palo Alto to recognize in its financial statements any unfunded, earned retiree medical costs including that for current active employees beginning in fiscal year 2007-08.

Palo Alto has begun taking steps to implement GASB 45. The City had an actuarial study done by Milliman, Inc. as of July 1, 2005, which is required on a biennial basis, to determine the retiree medical liability and how much the City should be setting aside each year to fund that liability. The unfunded liability ranges from $83.1 million to $148.7 million based on the discount rate assumption used which ranges from 4 percent to 7.75 percent. The lower range of the discount rate is based on the rate of return of the City’s current investment portfolio and assumes staff managing the funds internally without a trust. The higher range is based on staff utilizing a trust or depositing funds with California Public Employees Retirement System (CalPERS), with an expected rate of return of 7.75 percent on its pension fund investments.

In response to Council direction, in an effort to control health costs and in preparing for the implementation of *GASB 45*, the City has:

- Developed a two-tiered retiree medical benefit plan, increasing vesting requirements from five to twenty years
- Negotiated a cap for medical benefits in the latest SEIU contract for current employees and future retirees
- Implemented a cap for medical benefits for the management and professional group and is in the process of capping future retiree medical benefits
- Accumulated $26.5 million in the Retiree Health Benefits Internal Service Fund reserve
- Completed an actuarial study to determine its unfunded liability

In fiscal year 1991-92, staff established retiree medical funding of $6.1 million from a PERS reimbursement. Since then, additional contributions have been made towards the reserve from various funds as cash flow permitted. As of June 30, 2006, the accumulated balance was $26.5 million which includes an $8 million contribution in fiscal year 2005-06 by the Enterprise and other funds. The Enterprise and other funds’ cost for current retirees is $1.1 million. In fiscal years 2006-08, staff plans to allocate an additional $1.2 million each year into the reserve to further reduce the outstanding liability.

GASB 43 addresses the financial statement requirements for retiree medical funding held in a trust fund and applies to those funds maintained by the plan sponsor, employer, CalPERS, or another third party. Currently, GASB 43 does not apply to the City as the City does not have a trust fund for retiree medical liabilities. GASB 43 would apply to the City if it establishes a trust or a pre-funding plan through CalPERS.

Historically, the City has used a pay-as-you-go approach to fund retiree health benefits, withdrawing from the Retiree Health Benefits Internal Service Fund. The Retiree Health Benefits Internal Service Fund was funded by the General Fund and Proprietary Funds (Utilities and Internal Service Funds) each year for current year expenditures, approximately $3.3 million in most recent years.

**DISCUSSION:**
Staff is reviewing several options in determining a funding plan for GASB 45, including:

- Continuing the pay-as-you-go approach and booking the unfunded Annual Required Contribution (ARC) on the financial statements.

  Continuing with the pay-as-you-go approach, while the most economical option in the near term on an annual cash basis, would involve the highest degree of risk as it would hinder the City’s credit rating significantly by showing no effort by the City to establish a plan to fund the liability. A well thought-out plan to fund the unfunded liability is what credit agencies will be looking for to maintain the current AAA credit rating the City enjoys. In addition, the cost for the pay-as-you-go approach will continue to rise exponentially from year to year making the budgeting process difficult.

- Issuing debt to fund the liability.

  Issuing debt would be a quick way to fund the liability. As long as debt service requirements were met, the City would not have to report an unfunded liability in its financial statements. On the down side, this method would be expensive and the City would feel the effects of paying the debt service, principal and interest,
for many years to come depending on the life of the debt issued. Currently, the City has very little debt on its financial statements which is a strong and desirable attribute for the City. There are preliminary plans to issue a significant amount of debt for infrastructure needs in the near future which would further increase the City’s debt service requirements and decrease the City’s coverage ratio.

- Setting up and funding an irrevocable trust with the accumulated retiree medical funding balance.

Setting up and funding an irrevocable trust would have many benefits including:

- Significantly decreasing the City’s unfunded liability as these plans are irrevocable and the funds would no longer appear as an asset on the City’s financial statements.
- The reduction of the City’s ARC, which lowers the cash contribution by the City on an annual basis.
- Annual contributions by the City are a set amount every two years per the actuarial study. These contributions would be more predictable, level payments. Per the study completed by Milliman, Inc., at a discount rate of 7.75 percent, the Annual Required Contribution (ARC) would be $6.9 million.
- An increase on the rate of return on invested funds due to additional investment options.

The decision would have to be made as to whether the assets would be managed by internal staff or externally. The benefits with a trust would be the same as many of the benefits recognized with the last option of a pre-funding plan through CalPERS, but there would be significantly more work involved in the set up. Establishing an investment policy with risk tolerance guidelines and investment advisory group are typical steps in this process.

- Participating in a pre-funding plan - operating similarly to the pension plan - by CalPERS.

One of the most significant changes in the industry since staff’s last report has been the development of a new holding account by CalPERS. CalPERS has been working diligently to serve its customers who participate in the CalPERS Health Benefits Program by creating a pre-funding plan that employers can utilize in place of a trust to invest and safeguard their retiree medical set-aside dollars at an anticipated rate of return of 7.75 percent. In addition, CalPERS has developed an Other Post Employment Benefits Assumption Model (retiree medical assumption model) in order to provide the actuarial services required by its Health Benefits Program participants. CalPERS is working on finalizing the processes of this model, and it is anticipated that the program will commence in early 2007.

If the City were to transfer the $26.5 million balance in its Retiree Health Benefits Internal Service Fund to the CalPERS pre-funding plan, it could expect a return on its investment of 7.75 percent which would lower the unfunded liability from
$83.1 million to $56.6 million as well as the ARC that needs to be contributed annually to approximately $6.9 million per the Milliman, Inc. study. The General Fund’s annual share of the citywide ARC totals $4.8 million. Since the Fund provides staff services to other funds, an allocation of $0.8 million reduces the ARC to $4 million. Furthermore, prior year allocations to other funds only included current retiree costs. Staff recalculated the allocation to include prior year retiree medical costs for current employees which totals $3 million. To level the impact to other funds, the cost will be spread over three years at a repayment rate of $1 million per year resulting in a net annual ARC of $3 million for the General Fund. Working with CalPERS would be efficient for the City since CalPERS manages the City’s pension plan and staff would have more confidence in the actuarial figures if they were calculated by CalPERS because it has the City’s data readily available and staff wouldn’t have to convert that data for a separate actuary.

Staff will finalize a review of the options and funding recommendations for all funds and present them to the Finance Committee as part of the budget process.

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: CMR:272:06, June 20, 2006, Results of Actuarial Study for Retiree Medical Benefits – Governmental Accounting Standards Board Statements Numbers 43 & 45