Managing OPEB Liabilities

Public Employees
Other Post Employment Benefits Commission
April 26, 2007

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GASB 43 and 45 Standards

- There are actual benefits to GASB 45
  - Financial transparency
  - Better alignment of the public and private sector accounting
  - Clarity among bargaining group, employees and employers on the true cost of the benefits over time
  - For Municipalities: Full and true knowledge of employee costs (better decisions and more bargaining power)
  - For investors : Full knowledge of a municipality’s long term costs, i.e. over the life of their investment

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GASB 43 and 45 Standards

- There are certainly challenges to GASB 45
  - ►Initially in understanding the statement and its implications
  - ►“Budget shock”
  - ►Liability is based on assumptions with potential for great fluctuation
  - ►Budgets are already strained

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GASB 43 and 45 Standards

- This is such big news because:
  - ►Employers have been funding retiree health benefits like the active health benefits - on a pay-as-you-go (paygo) basis
  - ►But GASB says these are different and the expensing (of this form of deferred compensation) really must occur over the working lifetime of the member

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GASB 43 and 45 Standards

- This is even bigger news because:
  - ►Rating agencies will ask about OPEB, and will work to determine the entity's ability to meet their budget
  - ►Bond ratings and the related cost of capital may be impacted
  - ►Employers, caught unaware of the magnitude of these liabilities, may seek solutions in benefit changes or in funding changes

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GASB 43 and 45 Standards

- Potential budgetary impact
  - ►This will increase the expense associated with providing retiree health care benefits (even if the benefit is a “subsidy-only” benefit)
  - ►Employer’s will need to decide how to balance their budgets, given this increase in expense

GASB 43 and 45 Standards

- How rating agencies assess OPEB
  - They do not downgrade ratings merely because there is an OPEB liability
  - They look to see whether a well thought out plan is in place to manage these liabilities
  - They will look on a year-by-year basis to see the “trajectory” of these expenses and whether the revenue will be there to cover these expenses
    - The ARC displaces other budgetary needs

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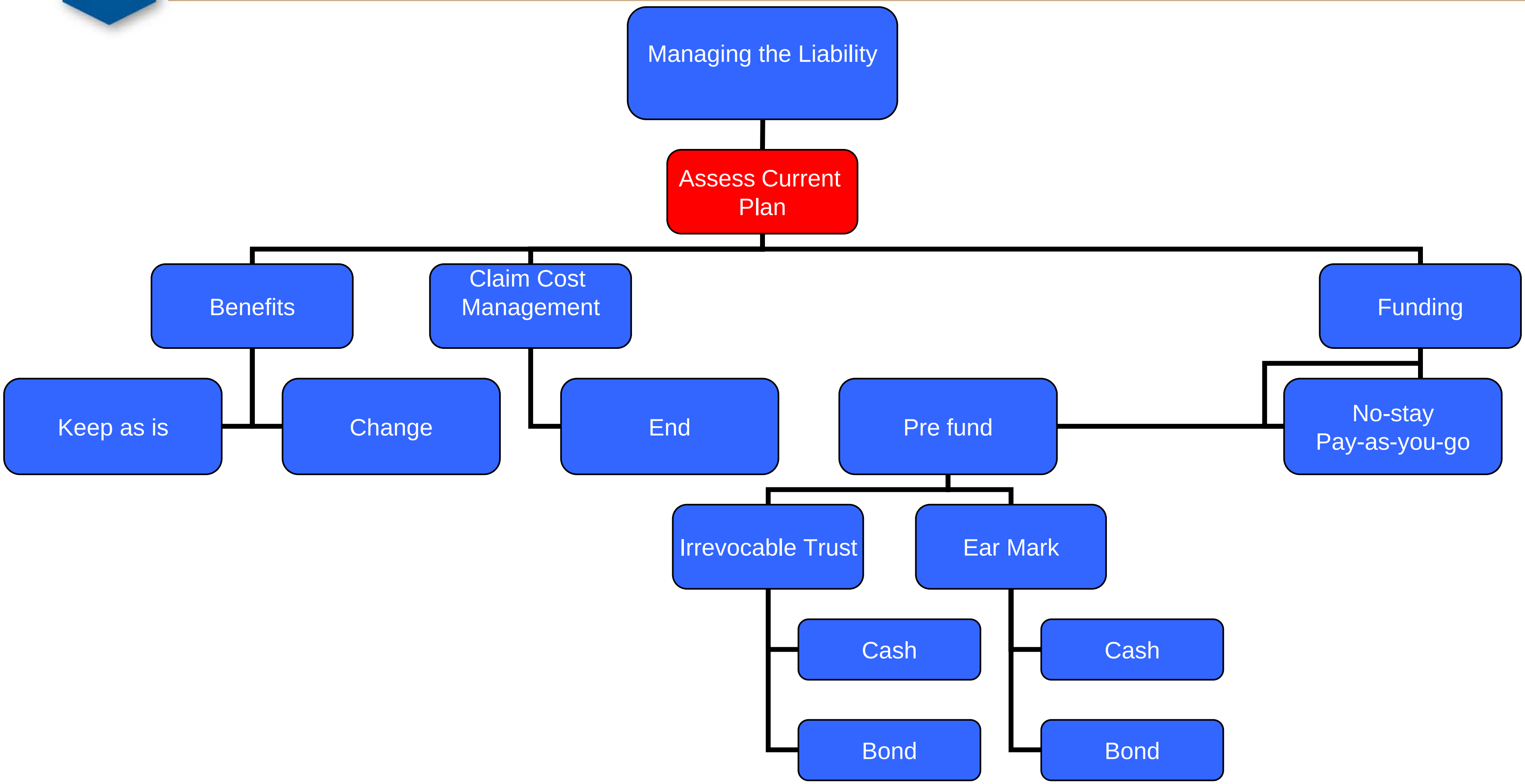
GASB 43 and 45 Standards

- Rating implications
  - Although the total exposure is staggering, it is the annual budget burden that is the key figure
  - OPEB is a “soft” liability
  - Importance of managing the exposure includes limiting future growth in the liability
  - The tactics for management of the liabilities can be as important as the numbers
  - Rating impact will depend on relative liability size, actions taken and impact on financial flexibility

Finance Perspective



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Assess Current Plan

1. Value assets, liabilities, ARC, and NOO consistent with GASB and how plan and trust exist today
2. Estimate general funding encroachment based on current funding policy (the funding policy is generally a pay- as-you go policy from the general or enterprise fund)
3. Look at payroll encroachment
4. Determine impact on work force regarding the balanced budget requirement

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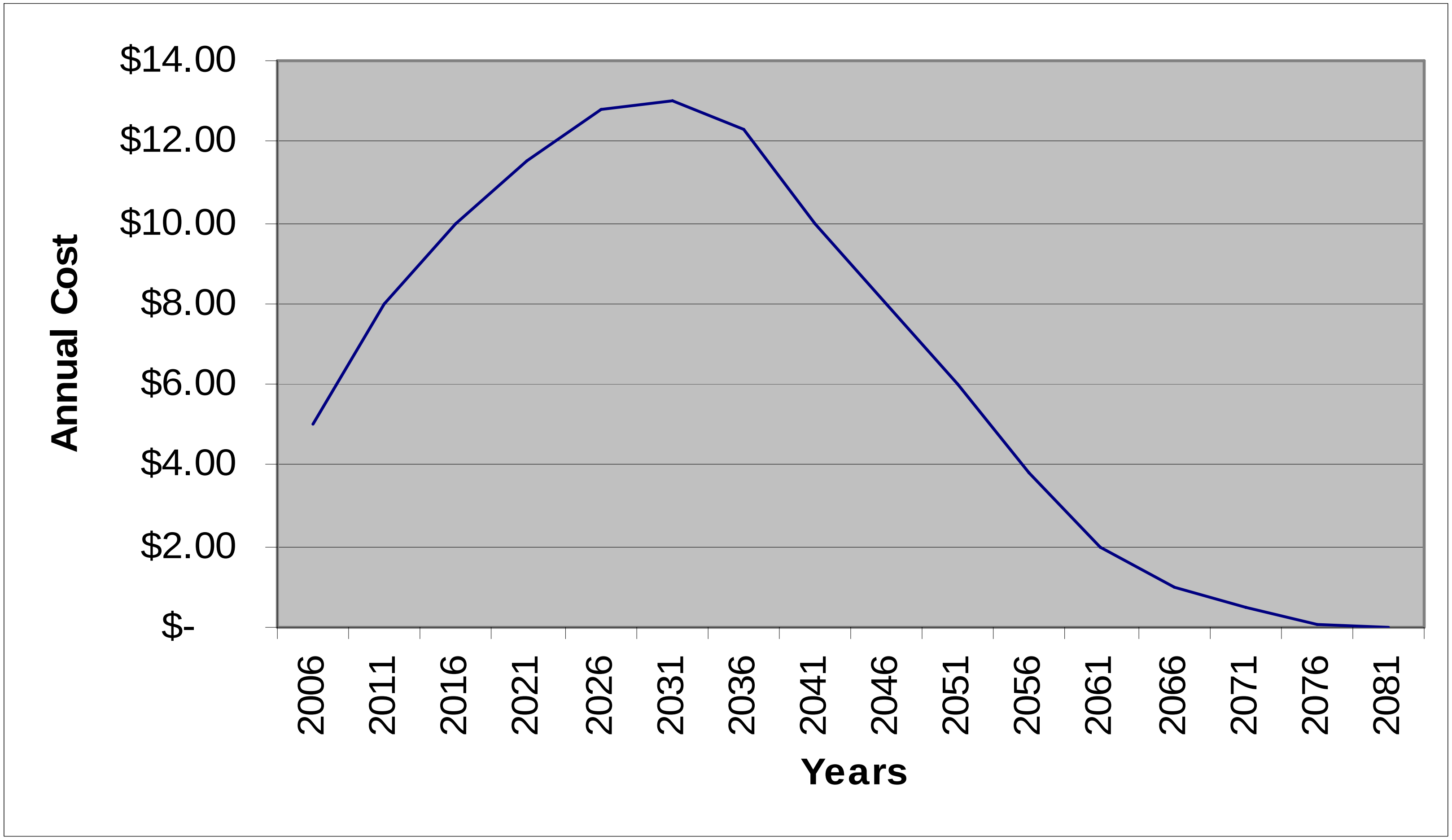
Projected Pay-as-you-go Annual Costs



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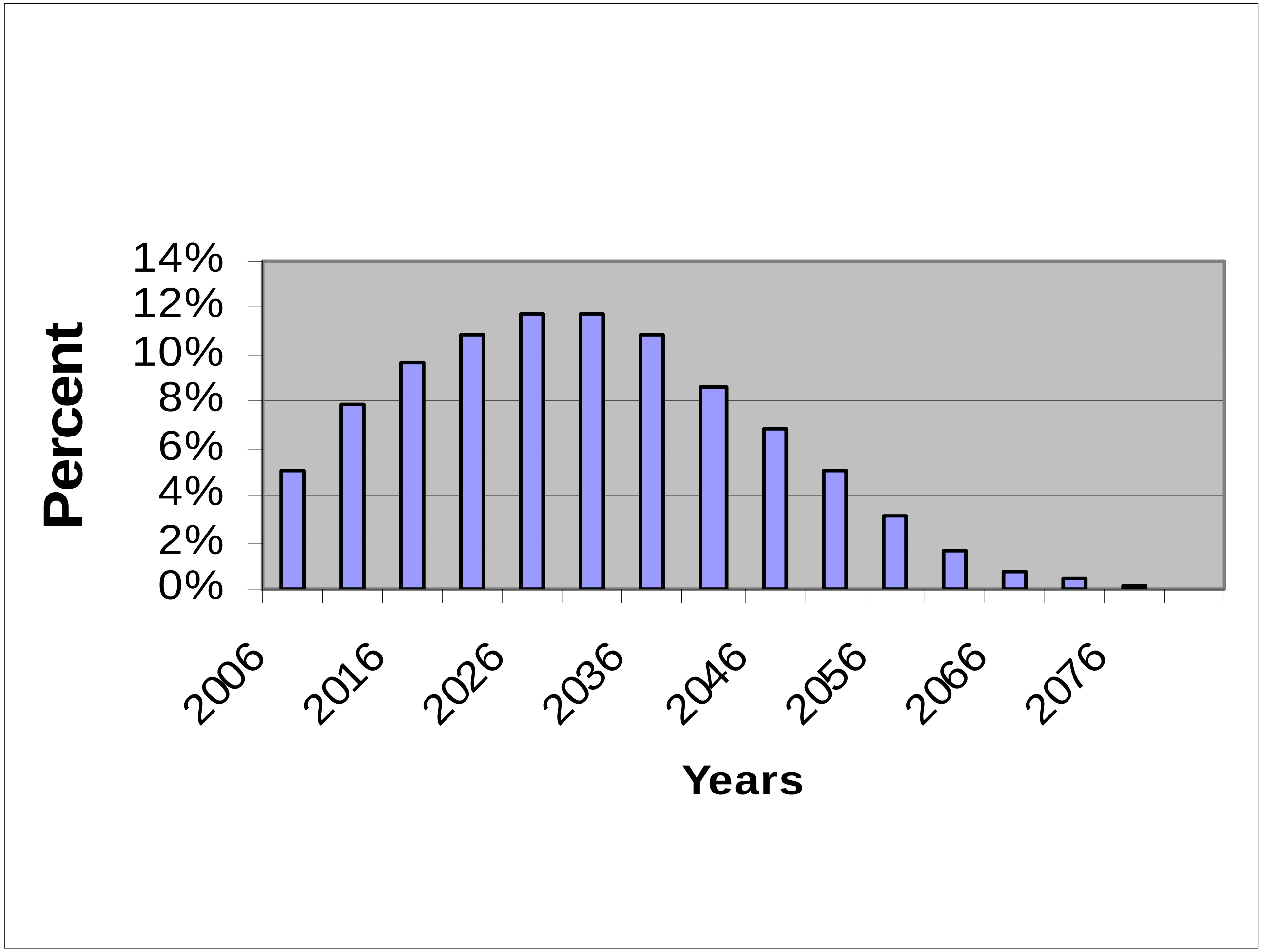
Projected Pay-Go as % of General Fund Revenue (assumes 2% GF growth)



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General Fund Encroachment Means Less Funding Available for Other Activities

Project NOO assuming cash pay-go funding

Assess impact on:

- ✓ Cost of capital/bond rating
- ✓ Borrowing restrictions that make access to capital
- ✓ markets more difficult
- ✓ Ability to meet pay-go requirements in all years
- ✓ Collective bargaining – do agreements depend on pre-funding OPEB

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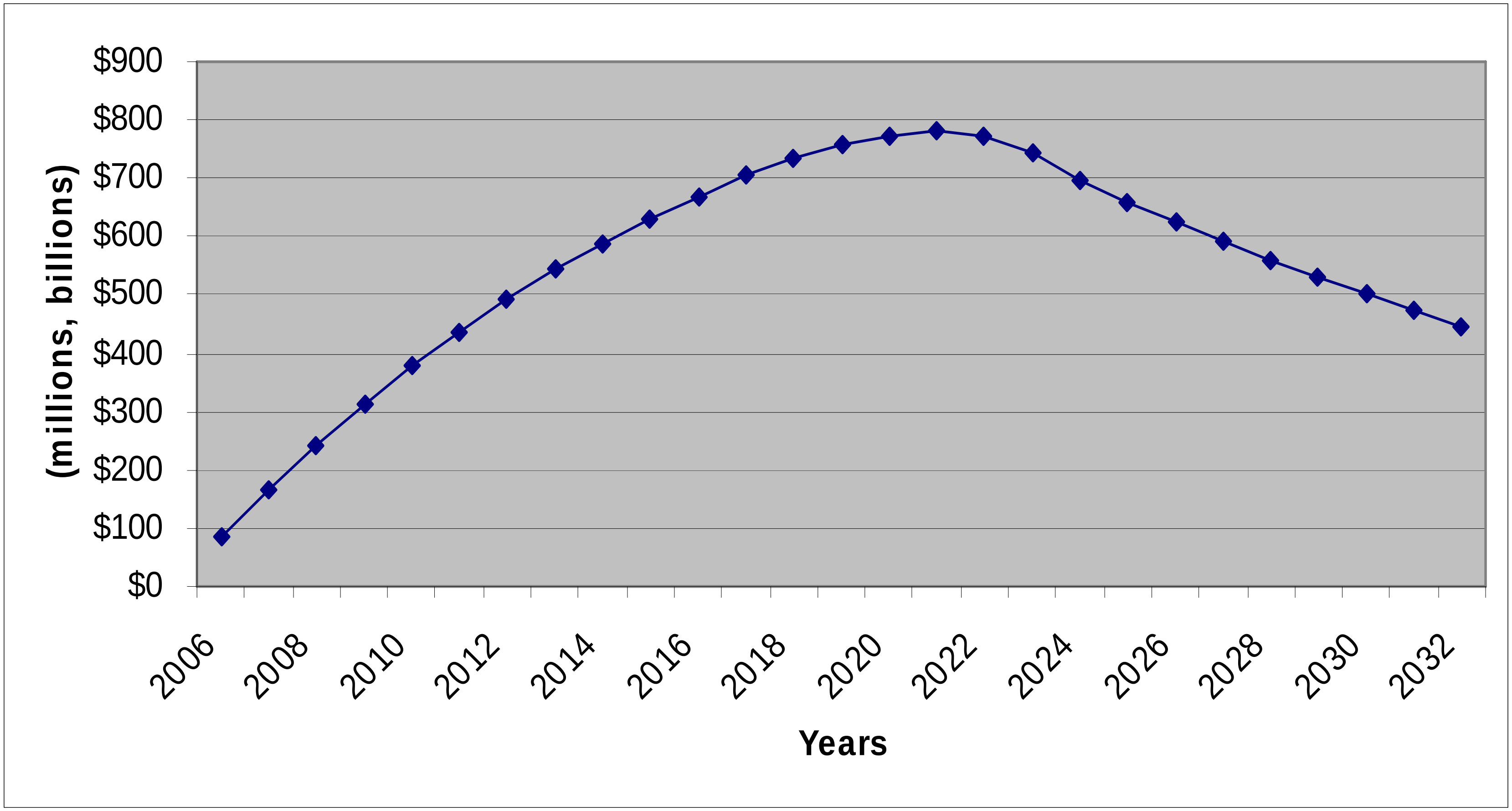
Projected NOO with PAYGO Payments



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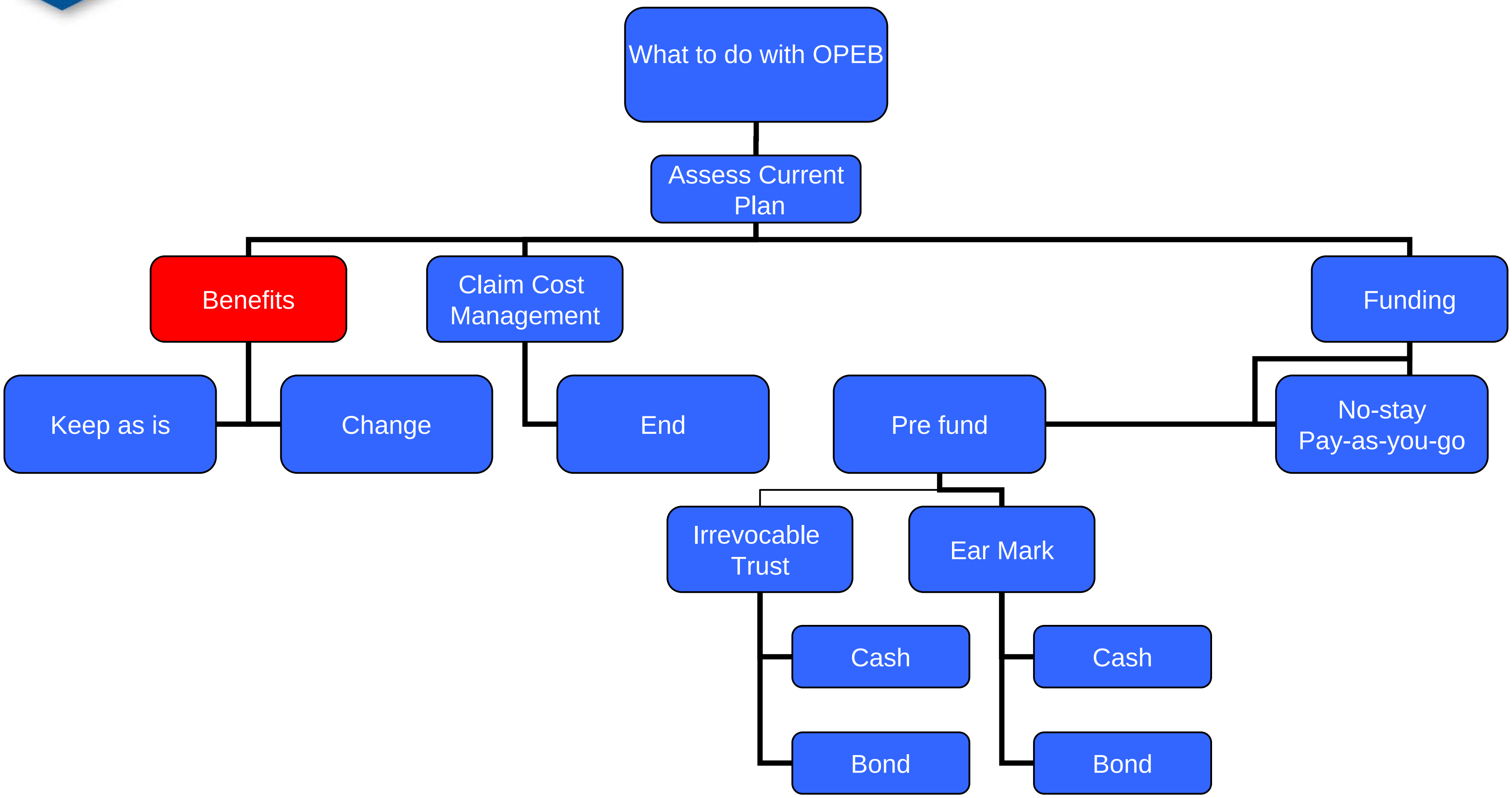
Finance Perspective



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Benefits

Can look like

- A percent of premium promised
- A flat dollar amount, with or without increases
- A flat dollar amount, pro-rated for service
- Access only (with an implicit subsidy due to the blending of the rates)
- Access only and no implicit subsidy

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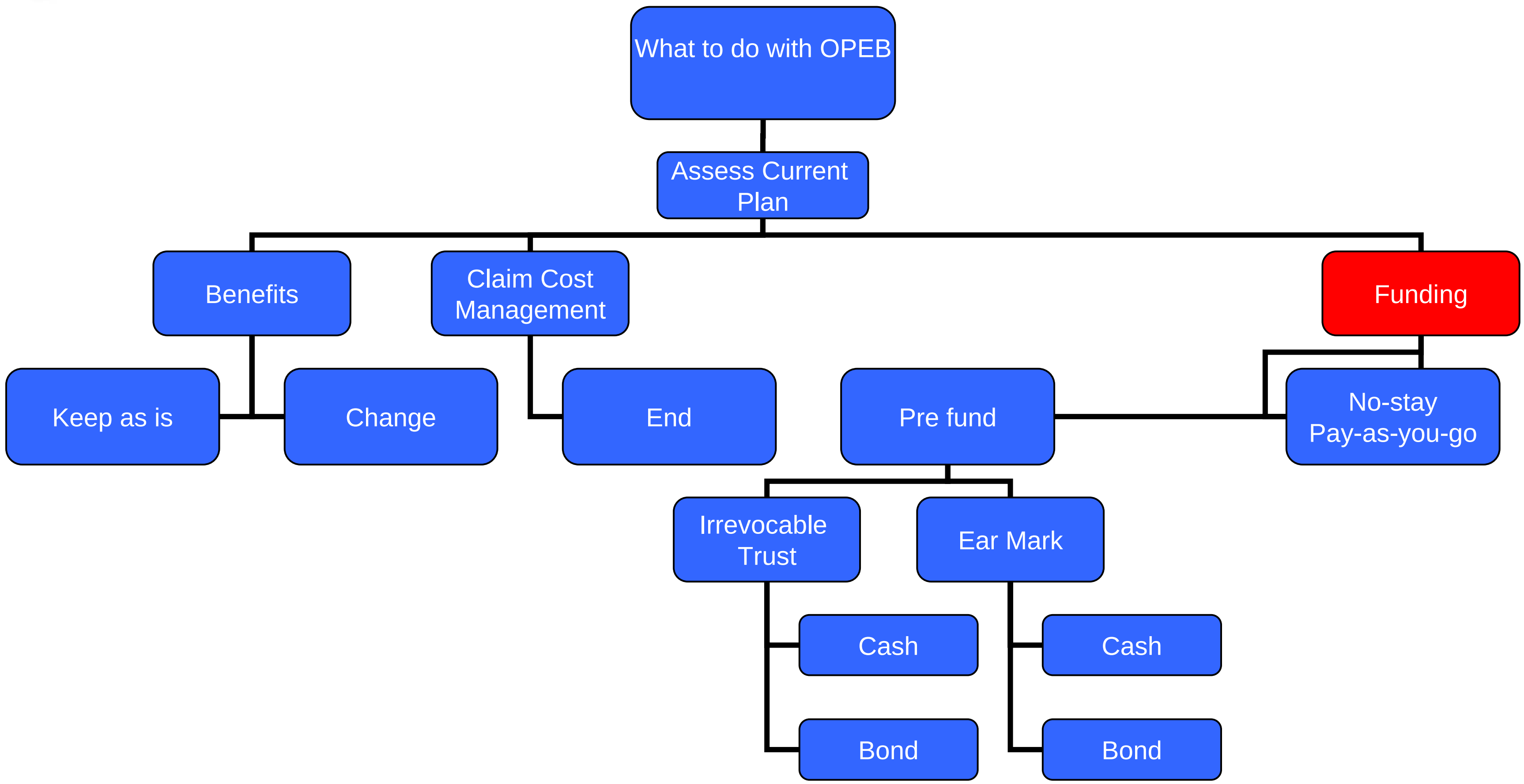


Funding

If you want to stay pay-go-

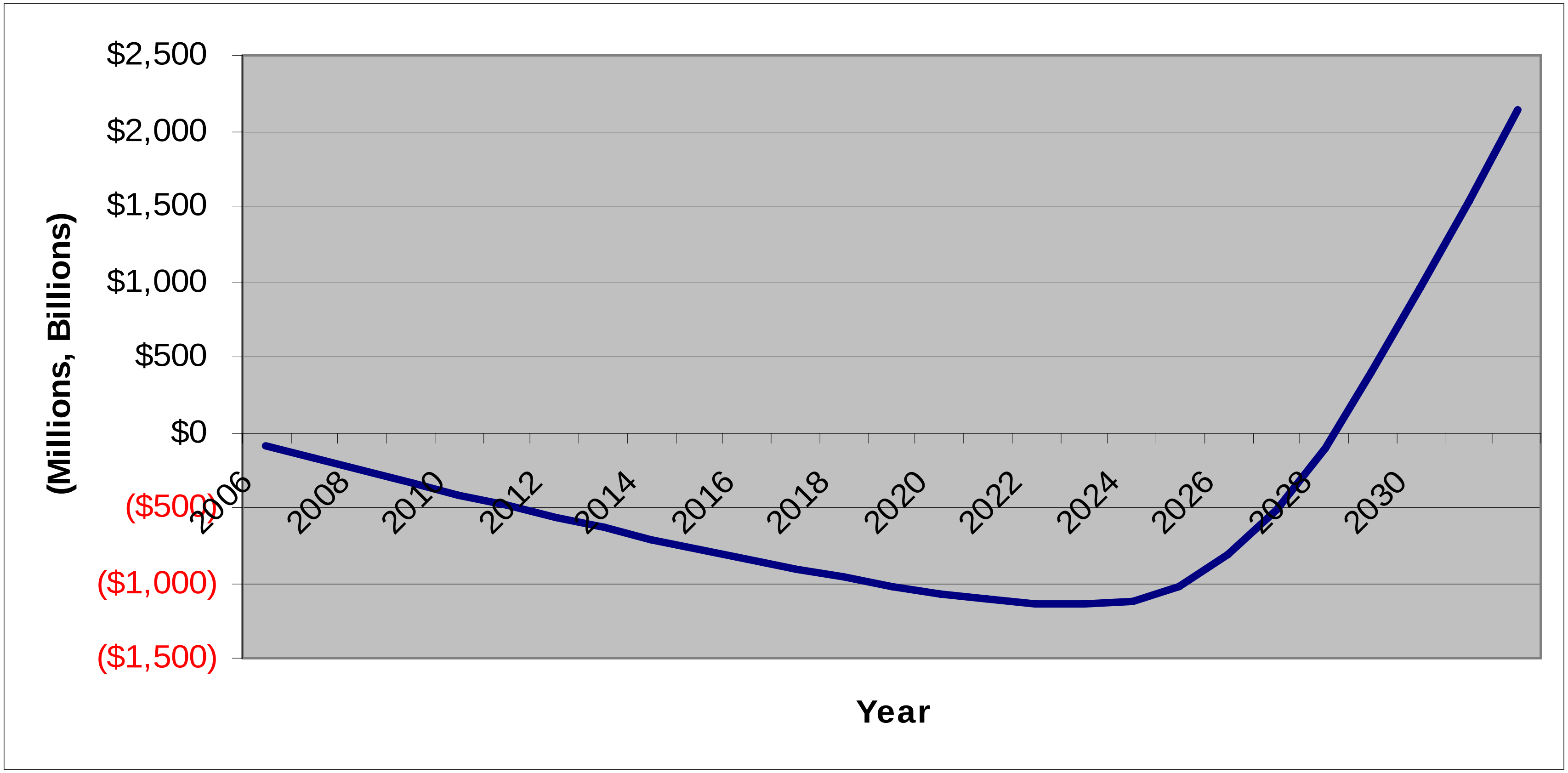
- No financial impact to governmental entity as a result of pay go funding
  - Bond rating stable
  - clear and acceptable funding policy to meet benefit requirements
  - no impact on ratings, hence no impact on cost of capital
  - no additional restrictions on borrowing
  - encroachment on general fund at acceptable levels

Funding continued...

If you want to pre-fund

- Pre-funding is affordable (define "affordable") or
- Pre-funding is viewed as the only alternative (may occur when benefits are absolutely fixed)
- Remember the difference in the ARC when using different discount rates

Affect on General Fund for ARC Funding
(cumulative difference between ARC and Pay-Go)



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Pre-funding

Irrevocable trust (and ARC funding)

- Look at liabilities, ARC, NOO, based on higher return assumption
- Must look at risk of funds being irrevocable
- Calculate amount of general revenue “freed up”
- look at encroachment under pay-go vs. trust with pre-funding
- Determine existence of (or need for) legislative authority to set up trust (and the related investments)

  Funds could be used for other purposes

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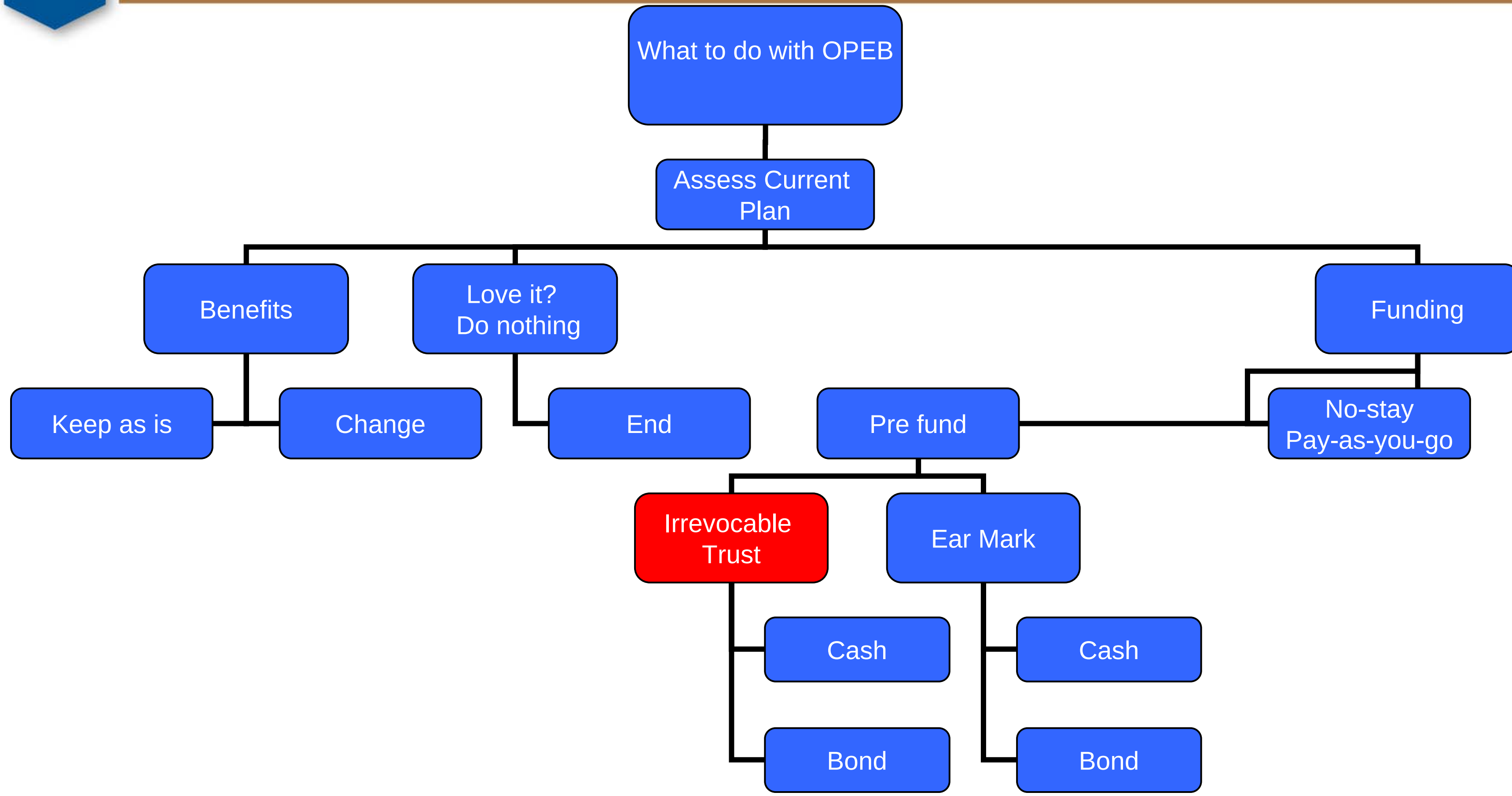
Finance Perspective



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Irrevocable Trust With Pre-funding

Cash

- Affordability
- General fund encroachment, improvements to general fund vs. pay-go over longer horizon

Bonds

- Must establish trust to receive and invest bond proceeds
- Determine authority to issue OPEB bonds
- Impact on debt ceiling
- Measure net present value of contribution arbitrage
  - obtain bond flow from potential bond manager so expenses and timing are accurately displayed

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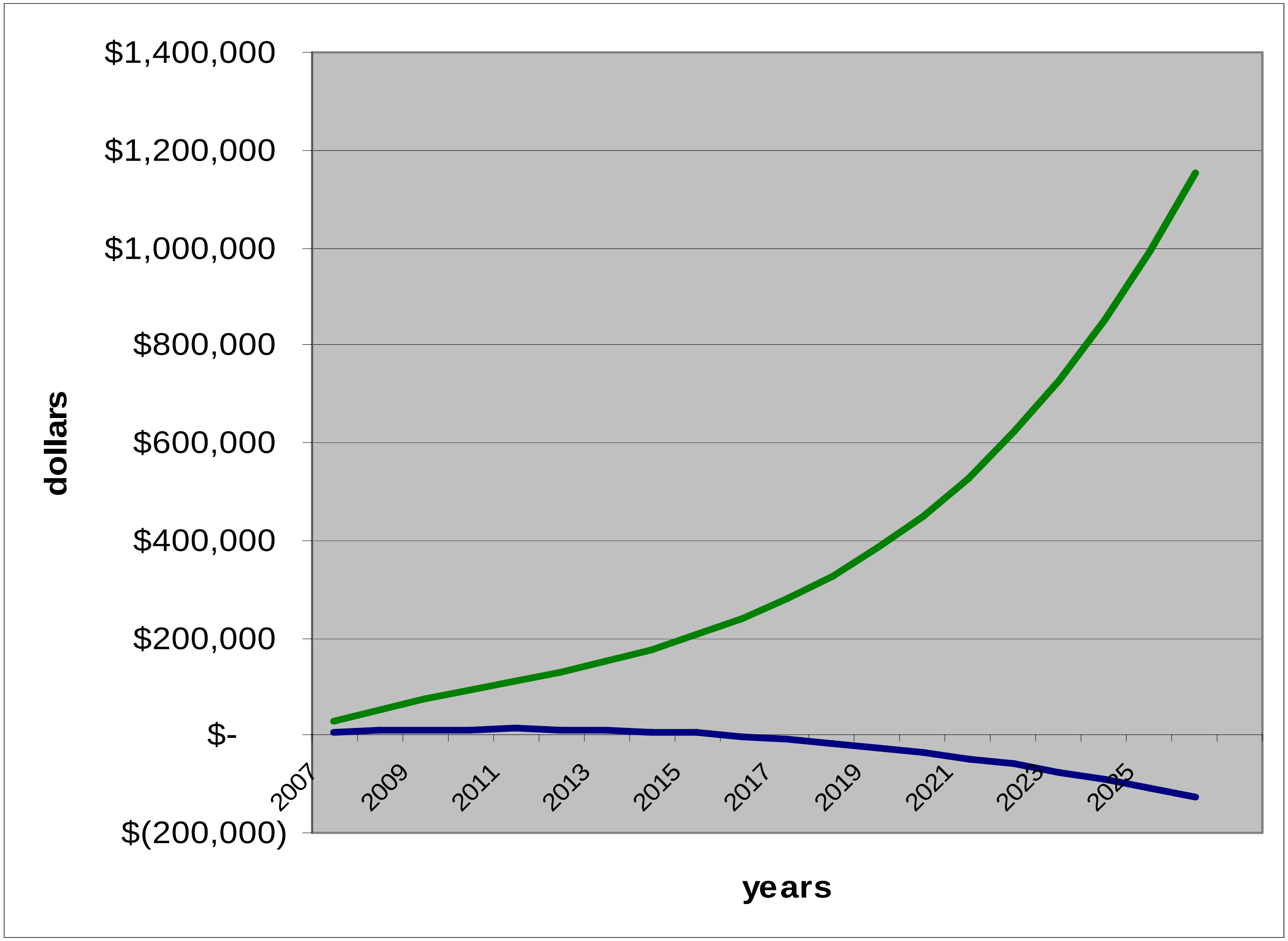
Cumulative Difference, Bond vs. Cash Funding (for complete analysis add bond repayments)



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Irrevocable Trust With Pre-Funding continued…

- If bond proceeds go into trust, model varying interest rate arbitrage (or negative) scenarios
- UAL goes from soft to hard debt on a year by year basis. Determine if there is flexibility in the debt service structure (e.g. interest only or capital appreciation bonds)
- Measure lower NPV if interest rate arbitrage exists
- Factor in time and effort required to issue bonds

What Other Entities Have Done

- A California Community College
  - Previous agreements for lifetime health insurance
  - Part of solution – “tiered” benefits-eliminated for new hires
  - Net present value - $132 to $196 million
    - Note: funding the existing OPEB was key in securing labor agreements and discontinuing benefits for new hires

Assessment Process

- Retiree health benefits = 5% of general fund revenues
- With “paygo”, rises to 8.5% in 15 years
- Funding the ARC would raise expenditures 250%

Alternatives

1. *Ignore* – increases risk of future financial pressure
2. *Eliminate the benefit* – labor issues and potential litigation
3. *Fund the ARC* – financially impossible
4. *Refinance with OBEB bonds*
   - PAYGO 5% (grows to 8.5%)
   - ARC 13%
   - Bond 7% after 2011

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A nearby State

- Moved to a more defined contribution approach (the plan already had a part of this feature)
- Allows new hires to use their accumulated sick leave to purchase their retiree medical benefits
- This caps the State's liability
- Employees feel the flexibility in the use of their money

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A Southern California Water District

- Converted from a premium promise to a flat dollar benefit
- Could also grant increases based on funding
- Cut the liability by over 2/3
- No longer “paying” for medical trend