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MAYDAY, MAYDAY, MAYDAY! THE COUNTY DRIFTS EVER CLOSER TO THE “OPEB” ROCKS

Growing Retiree Health Care Costs Demand Board of Supervisors Action

SUMMARY

Contra Costa County is facing a financial “perfect storm” as the cost of medical and dental benefits granted to retirees are being driven upward by increases in the number of retirees, inflation, and costly advances in medical science. The County Board of Supervisors has not adequately addressed the financial obligations of the Other Post Employment Benefits (“OPEB”) facing the County and, as a result, is mortgaging the County’s future.

Escalating retiree health care benefit costs are threatening the County’s financial condition, and with it the ability to deliver essential services. The long-standing problem is further brought into focus by the County’s need to comply with an accounting standard that takes effect in fiscal year 2007-08. Government Accounting Standards Board Statement Number 45 (“GASB 45”) requires government agencies to account for and report the anticipated total cost of providing health care to retired employees and their eligible dependents already earned but which will not be paid for by the County for decades to come.

Under GASB 45, accounting for such costs on the current pay-as-you-go basis is no longer acceptable. The County must now report the anticipated total future cost of retiree benefits for active employees and current retirees - recently estimated to be as high as \$2.6 billion. These costs are growing daily. Unless the Board of Supervisors takes timely and decisive action, its members will surely be asked to explain to the taxpayers and those dependent on County services why the cost of local government continues to escalate while the level of services provided declines.

Contra Costa County should develop a multi-year business plan to address and manage retiree health care benefit obligations, both for current and future retirees. Difficult choices must be made now. Inaction by the Board of Supervisors, while it continues to “study the problem”, only postpones the steps that are clearly required.

The complete report is available on the Contra Costa County’s Grand Jury web site: www.cc-courts.org/grandjury.

CONTRA COSTA COUNTY GRAND JURY REPORT 0708

MAYDAY, MAYDAY, MAYDAY! THE COUNTY DRIFTS EVER CLOSER TO THE “OPEB” ROCKS

Growing Retiree Health Care Costs Demand Board of Supervisors Action

TO: Contra Costa County Board of Supervisors

BACKGROUND

Contra Costa County (“County”) provides its current employees, qualified retirees, and eligible dependents with a choice of medical and dental care benefits. Under existing eligibility rules, governed by various labor agreements or Board of Supervisor (“BOS”) resolutions, retirees are entitled to the same health care benefit packages as active employees.

The County has for years paid and accounted for its share of current retirees health insurance premiums out of each fiscal year’s budget on a cash basis, also known as pay-as-you-go. Such future financial obligations are collectively referred to as Other Post Employment Benefits (“OPEB”), to distinguish them from pension obligations. Similar to pension benefits, retiree health care benefits are earned while employees are working for the County and are received following retirements. However, unlike pension benefits, the County has made no attempt to account for or fund the estimated cost of retiree health care coverage.

What is new about the OPEB obligation is that beginning with fiscal year 2007-08, the estimated future accumulated health care benefit costs must be reported in the County’s “Comprehensive Annual Financial Report”. Government Accounting Standards Board Statement Number 45 (“GASB 45”) defines this requirement.

Contra Costa County’s estimated \$2.6 billion OPEB liability is approximately four times the County’s combined outstanding debt. The current debt burden already places the County into the lowest 25% of California counties ranked in order of their declining financial health. This low ranking likely will be further depressed following the recognition of the OPEB liability that remains an obligation to the County regardless of whether or not this liability is reported. The combined liabilities of outstanding debt and unfunded OPEB liability is certain to be considered by the financial rating agencies in evaluating the future credit worthiness of the County.

GASB 45 did not create the liability. GASB 45 sets a standard that requires the accounting and reporting of the resulting liability. The liability has been growing over the years as increasing numbers of retirees receive health care benefits.

The OPEB unfunded liability is a major financial threat to the County. The Board of Supervisors has the responsibility to address this issue for the employees, taxpayers, residents, and those dependent on County services.

Contra Costa County's growing OPEB problem was brought to light by a Grand Jury report three years ago and subsequent Grand Jury reports have focused more attention on the issue. Few significant corrective actions have been taken to date. The Board of Supervisors continues to "study the problem" while the unfunded liability of over \$2.6 billion grows with each passing day.

FINDINGS

1. The Contra Costa County Board of Supervisors has the responsibility to resolve the County's unfunded OPEB liability issues.
2. In April 2001, an independent actuarial firm report to the County identified the unfunded OPEB liability for County retirees.
3. The subject of the unfunded OPEB liability has been the topic of three previous Contra Costa County Grand Jury reports:
 - Report No. 0404, "Take Action Now to Reduce Costs of Retiree Health Insurance" issued in 2004.
 - Report No. 0508, "Code Blue: County Health Care Costs" issued in 2005.
 - Report No. 0606, "County Ignores Retiree Health Costs: The Financial Tidal Wave" issued in 2006.
4. In 2006, an outside consultant hired by the County issued a report that suggested the County set aside \$216 million annually for the next 30 years to close the unfunded health care obligation gap.
5. In April 2007, the Board of Supervisors gave preliminary approval to a fiscal year 2007-08 budget that provides only \$33 million (vs. \$216 million) to cover the cost of health care benefits for the County's retirees and their eligible dependents.
6. The County provides combined medical and dental plan benefits to active employees, qualified retirees, and dependents of both groups. The County subsidizes most of the health care insurance premiums at rates varying from 80% to 98% for the medical plans and from 78% to 98% for the dental plans.
7. The County provides combined medical and dental plan benefits to approximately 7,800 active employees, 4,200 retirees, 330 surviving spouses of retirees and 16,000 reported dependent spouses, children and domestic partners for active and

retired employees. Approximately 28,000 individuals currently rely on the County for employment related health care benefits.

8. Health care coverage for County retirees is a benefit of employment earned during employment and largely paid for by the County after retirement.
9. The County does not currently require retirees to secure Medicare Part B medical coverage once they reach Medicare-eligible age, but allows them to continue to rely on the County's medical and dental health benefit plans available to active employees as their primary coverage.
10. County deputy sheriffs, firefighters, and their dependents are not covered by the County's medical and dental plans. These "safety" employees participate in the California Public Employees Retirement System ("CalPERS") medical and dental plans under the terms of their labor contracts with enrollment conditions set by CalPERS. The County subsidizes the CalPERS insurance premiums at a rate comparable to that paid on behalf of other County employees.
11. Like many other public employers, the County reports the cost of retiree health benefits in their "Comprehensive Annual Financial Reports" during the employee's retirement years when the health insurance benefits are received by the retiree (cash basis, also known as "pay-as-you-go" or "PAYGO"), rather than during the employee's active service when the benefits are earned (accrual basis).
12. Retiree medical benefit costs, using the PAYGO basis of accounting, have been growing at approximately 15%, compounded **annually, for the last five years** - growing from \$15.9 million in fiscal year 2001-02 to \$32.4 million for the current fiscal year 2006-07. This growth is more than double the rate of overall County expenditures and two-and-a-half times faster than revenue growth over the same period.
13. Governmental Accounting Standards Board Statement Number 45 ("GASB 45"), "Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions," sets an accounting standard analogous to the governmental pension accounting standard. This standard requires the calculation and disclosure of an unfunded liability for government employee retiree health care benefits similar to the method already in place for recognizing the cost of government employee pensions.
14. GASB 45 accounting standards become effective with the County's fiscal year 2007-08, which begins July 1, 2007. Under these standards, the County must:
 - Disclose the unfunded liability for health benefits (and other post-employment benefits other than pensions, that continue to be disclosed separately) that have been earned by all active and retired employees.

- To the extent they remain unfunded, increase its annual health care benefit cost to include the normal cost of benefits as they are earned, plus an amount that amortizes (funds over time on a systematic basis) the unfunded liability over a period not to exceed 30 years.
- Disclose the County funding policy for medical and dental benefits earned by active and retired employees to date and report this resulting liability.

15. An independent actuarial firm hired by the County analyzed the County’s OPEB unfunded liability as of January 1, 2006 using two discount rate assumptions: (1) 4.5%, which relates to the current PAYGO method and (2) 7.9% which reflects the economics of a funded trust plan based on GASB 45. The results follow:

**Contra Costa County Retiree Health Care Costs
(Dollars in Millions)**

<u>Discount Rate</u> ¹	<u>Unfunded Liability</u> ²	<u>Annual Required Contribution</u> ³		
		<u>Liability Amortization</u> ⁴	<u>Normal Cost</u> ⁵	<u>Total Contribution</u> ⁶
4.5 %	\$2,571	\$86	\$130	\$216
7.9 %	1,425	48	55	103

Notes: 1) Discount rate is the annual rate by which future payments are adjusted to reflect the current value of the obligation; 2) Unfunded liability refers to the total current value of a stream of future payments for which money has not been set aside; 3) Annual Required Contribution consists of the Normal Cost plus a portion of the total unfunded accrued actuarial liability amortization for the year; 4) Liability Amortization is the annual payment necessary to pay off a specific liability over a fixed period of time, in this case 30 years; 5) Normal cost is amount necessary to meet the current expense of the benefit earned during the period regardless of when the amount will be paid; and 6) Total Contribution consists of the Liability Amortization and Normal Costs.

16. Options to address the OPEB liability discussed to date by the County’s consultant and County staff in public meetings include:

- Continue the current PAYGO funding method that will minimize the short-term budget impact but will have long-term budget implications as deferred health care benefit costs continue to accelerate and current costs, earned by active employees, are added to the liability.
- Modify the existing medical and dental benefit plans by changing eligibility requirements, coverage amounts, deductibles, co-pays, co-insurance, changing the amount the County contributes towards coverage and the separation of the health care costs incurred by the active employees and retired participants.
- Establish and partially pre-fund an irrevocable trust that will enable the County to reduce reported liability and Annual Required Contribution by

allowing the County to use a higher discount rate. (An irrevocable trust is a separate legal entity created to hold assets dedicated to meeting the obligations to the entitled beneficiaries of the trust.)

- Combining options by modifying the current health care plans and conditions of retirement coverage plus partially pre-funding the existing liability using an irrevocable trust.
17. Creating an irrevocable trust to secure the pre-funded assets against other uses, and funding it annually, would minimize the reported liability and reduce the required minimum annual amortization amount.
 18. The County does not currently have a separate irrevocable trust for paying retiree health benefits.
 19. According to the “Comprehensive Annual Financial Report” as of June 30, 2006, the County’s debt limit (five percent of valuations subject to taxation) was \$6.6 billion. The total amount of debt applicable to the debt limit was \$0.7 billion, net of assets in the debt service funds and other deductions allowed by law. This would enable the County to issue an additional \$5.9 billion of debt.
 20. The County has issued pension obligation bonds to lock in interest rates significantly below the discount rate used by the Contra Costa County Employees Retirement Association Trust, thereby reducing the annual payment due from the County. As of June 30, 2006, \$667 million of pension obligation bonds were still outstanding. The history of previous successful pension obligation bond issues follows:
 - In 1994, the County issued \$337 million in taxable pension obligation bonds.
 - In 2001, the County restructured these bonds with a new issue in the amount of \$107 million.
 - In April 2003, the County issued \$323 million in taxable pension obligation bonds.
 - In July 2005, the Contra Costa County Fire Protection District issued \$130 million in taxable pension obligation bonds.
 21. Federal and state reimbursements for mandated services (e.g., health and social) provided by the County account for approximately 55% of the County’s total operating budget. Federal and state guidelines that establish the principles and standards for allowable reimbursements include some pre-funding costs. However, the extent to which pre-funded health benefit costs are reimbursable by the federal and state governments has not yet been formalized.
 22. Credit rating agencies have indicated that management of the retiree health care liability will influence credit ratings for public agencies. Contra Costa County,

like other counties, cities and special districts, and even states, are likewise required to report unfunded OPEB liability, if they follow GASB 45.

23. An outside consultant hired by the County has advised that the credit rating agencies will look favorably on public agencies that develop mitigation plans and demonstrate progress in implementing those plans to address the OPEB liability.
24. County employees, other than safety employees (deputy sheriffs and firefighters), employed on or after January 1, 2007, must have worked for the County for 15 years, and have retired directly from the County, to receive retiree health care benefits.
25. The County does not segregate the costs of medical and dental plan coverage for active employees and retirees. Instead, it combines or “pools” the costs for both groups and calculates a common or “blended” premium rate that is applied to all eligible parties. This has the effect of masking the higher health care costs for retirees and means the active employees, with their relatively lower health care requirements, subsidize a portion of the higher cost of providing benefits to retirees.
26. When Medicare Part B medical benefits are assigned to the County’s insurance carriers, Medicare becomes the primary provider, leaving the County responsible only as a secondary provider. Retirees covered by Medicare are given credit for Medicare Part B premiums they pay directly to Social Security. Medicare health benefits are not uniformly assigned to the County’s health plan carriers to help pay for the participants’ medical care. The current coverage rules result in higher costs being absorbed by the County.

RECOMMENDATIONS

The 2006-07 Contra Costa County Grand Jury recommends that the County Board of Supervisors:

1. Identify the County’s legal obligation to provide medical and dental care to retired employees and to what extent the obligation can be modified for active employees and retirees.
2. Negotiate with collective bargaining units, and implement for non-represented County employees, stricter health care benefit plan options to help stabilize current costs and limit future open ended obligations. Plan changes should consider more limited coverage, increased premium sharing by retired employees, a cap on the County’s premium contributions, increased patient deductibles and co-payments and reduced annual and/or lifetime maximums.

3. Segregate active and retiree health insurance pools to allow more accurate recognition of actual costs attributed to the respective participant groups to better manage future medical and dental plan costs.
4. Require all Medicare eligible retirees to secure Medicare Part B medical coverage and assign their Medicare benefits to the County's health plan carriers.
5. Establish an irrevocable trust for OPEB benefits and mandate a policy that requires the current normal cost and an amount to amortize the unfunded liability annually, over a period not to exceed 30 years. Select a realistic discount rate reflecting the earning capability of the investment pool (discount rate) that will be met or exceeded 50 percent of the time.
6. Consider pre-funding a portion of the irrevocable trust with proceeds from OPEB obligation bonds.
7. Adopt a comprehensive OPEB management plan. The plan should be a formal, multi-year plan that would provide a guide and communication vehicle for the Board of Supervisors, County employees and County residents over the next 30 years of the initiative. This plan should include, but not be limited to the following:
 - Specific goals and objectives.
 - Due diligence on the issues, options and implications.
 - Selected economic and census assumptions and rationales that are both realistic and fair.
 - Selected benefit redesigns, reductions and cost containments, and respective phase-in periods.
 - Selected funding levels for Annual Required Contribution to systematically fund the liability.
 - Description and conditions of an irrevocable trust that funds the OPEB liability.
 - Actions and conditions that pre-fund a portion of the liability with OPEB bonds, if appropriate.
 - General schedule of employee and resident communication forums and information sessions.

REQUIRED RESPONSES

Findings:

Contra Costa County Board of Supervisors: 1 – 26

Recommendations:

Contra Costa County Board of Supervisors: 1 - 7