

**Contact: Leslie Lea
Foreperson
(925) 957-5638**

Contra Costa County 2008-2009 Grand Jury Report No 0907

Retiree Healthcare Benefits Leave County Taxpayers on the Hook

**A New Approach is Required to Deal With Unsustainable Retiree
Healthcare Benefits Provided to Most Contra Costa Governmental Employees**

**TO CONTRA COSTA COUNTY
Board of Supervisors
School Boards
City Councils
District Boards**

SUMMARY

A fiscal disaster is looming on the horizon for Contra Costa County and other local governmental entities-school districts, cities and special districts. Retiree medical plans, by far the most costly of the Other Post-Employment Benefits (OPEB) now provided to retired employees, cannot be continued in their present form without requiring that potentially drastic reductions be made in the staffing of police, fire, education, health care, and social services. These enormous liabilities were approved by past government officials without a provision for future funding. The senior executives of Contra Costa County and other local governmental entities must recognize that these unfunded benefits could lead them into financial ruin. A significant reduction in public services is occurring now and there can be no alternative in the future but to anticipate further significant reductions in public services to those needing them the most: vulnerable children, the disabled, the frail elderly, and the needy.

The liabilities and required annual contribution totals represent only a reasonable accounting approximation of the amounts that will have to be borne by the County's taxpayers if the current plans continue without change. The estimated liability for these programs now exceeds \$3.1 billion. County governments are presently paying an average of only 34% of the Annual Required Contribution necessary to both amortize these OPEB liabilities and cover the current year's costs. Because 66% of those annual obligations are being deferred (approximately \$162 million or 8% of total County property tax revenues), they will have to be borne by future County taxpayers. Failure to address this shortfall is both irresponsible and indefensible.

GLOSSARY

Accrual Accounting:

A method of accounting whereby income and expense items are recognized and recorded when income is earned and expense is incurred, regardless of when cash is actually received or paid.

Actuarial Accrued Liability (AAL)

The portion of the actuarially determined present value of benefits allocated to the prior service already performed by the covered employees.

Annual Required Contribution (ARC)

The actuarially determined amount of retiree healthcare expense that GASB 45 requires be recorded as a current year expense. It is comprised of the amount that should be set aside to fund retiree health benefits earned during the current year plus the amount necessary to amortize the unfunded AAL over not more than 30 years.

Government Accounting Standards Board Statement No. 45 (GASB 45), “Accounting and Financial Reporting by Employers for Post-Employment Benefits other than Pensions”

GASB 45 now requires larger public employers to report OPEB expenses and related specific information in their financial statements.

Other Post-Employment Benefits (OPEB)

OPEBs include the following benefits that are earned by employees during their active service but are paid to them by their employers after they retire: medical, prescription drugs, dental, vision care, hearing, life insurance, long-term care and long-term disability benefits. Healthcare benefits constitute the vast majority of OPEB liabilities.

BACKGROUND

Retiree healthcare benefits are a form of deferred compensation earned by employees during their active working career but paid to them after they retire. To properly account and pay for the costs of these plans, expenses should be recognized, and funding set aside, during each covered employee’s years of active employment. Most larger Contra Costa County governmental entities providing retiree benefit plans have not done this. They have ignored the fact that there is a need to fund the benefit during the period that each employee is actually providing services.

Governmental entities providing these benefits have generally recognized that they have a retiree healthcare cost only when an employee actually retires and begins to receive the promised benefits. Previous accounting rules were shortsighted and technically allowed governmental employers to ignore the cost of these plans during the active service period in which the employees earned the benefits.

A new Government Accounting Standards Board Statement, called GASB 45, was recently adopted. This new standard now requires larger governmental entities to begin recognizing (but not necessarily funding) retiree healthcare benefit costs in their most recently completed fiscal year, and smaller governmental entities to begin accounting for them during the next two years.

OPEB liabilities incurred by County governments have generally been looked at on an individual governmental entity basis; few are looking at these debts from an overall county-wide

perspective. The payment source for substantially all of the retiree healthcare benefits promised by Contra Costa County's local governments will be borne by local taxpayers. The great majority of these County OPEB obligations have not been funded, and the Grand Jury determined that it would attempt to estimate their amount in total. To accomplish this, a survey was sent to substantially all school districts, cities and special districts that comprise County local governments and a significant majority of these surveys were completed and returned. Approximately 30% of these entities indicated that they did not offer OPEBs to their employees. The information submitted by the responding entities with OPEBs, supplemented by information drawn from recent studies and from other public documents, provided the basis for the facts, figures and statistics shown in this report.

FINDINGS

1. Retiree health benefits have traditionally been a form of compensation earned by County and local government employees (e.g., pension income) over their working career, but paid to them over the years they spend in retirement. In prior years the cost of these benefits was usually recognized as an expense only when actual payments began following an employee's retirement (This method of recognizing an expense is commonly described as "pay-as-you-go" or "paygo".)
2. GASB 45 now requires that larger governmental entities commence accounting for (but not necessarily funding) these benefits on an Accrual basis – during the employees' period of active service when the benefits are actually earned.
3. GASB 45 requires the following expenses to be recognized:
 - the current year's cost to fund that year's earned benefits, plus
 - the amount necessary to fund the unfunded OPEB liability for benefits earned but not funded in prior years.

In most cases, these rules first became effective for public entities with revenues in excess of \$100 million for the fiscal year ended June 30, 2008. Smaller public entities will be required to comply during the following two fiscal years.
4. To date in Contra Costa County there has been little or no funding of the OPEB liabilities for most governmental entities offering retiree medical benefits, including County, school districts, cities, and special districts.
5. Most larger County governmental employers provide their employees with extraordinarily generous retiree health benefits.
6. Property taxes accounted for almost 93% of Contra Costa County tax revenues in the most recent fiscal year with sales and other taxes making up the balance of total tax revenues received. These locally derived taxes also represented a significant portion of the revenue of school districts, cities and special districts located in the County.
7. The Board of Supervisors of Contra Costa County has committed to a future OPEB liability funding schedule for the County, including a commitment to contribute \$20

million during the 2008-2009 fiscal year. Although no actual payments were made into the County's OPEB Irrevocable Trust as of January 31, 2009, \$10 million is held by the County Treasurer in a designated account.

8. As of January 1, 2008 the County's OPEB obligation was determined to be \$2.367 billion, or almost four times the County's covered payroll (annual payroll of active employees covered by the plan) of \$610 million. Its Annual Required Contribution for the fiscal year ended June 30, 2008 was \$195 million, or almost 32% of covered payroll.
9. The calculation to determine a liability for future payments is primarily dependent upon the interest rate assumption. If the interest rate assumption is higher then the liability is lower; if the interest rate assumption is lower, then the liability is higher. If no funding mechanism is in place, and there is no expectation of putting money aside, the rules under GASB 45 require that a lower interest rate assumption be used.

The interest rate assumption that was used for the calculation of the OPEB liability and ARC for the fiscal year 2007-2008 was 4.5%. The basis for allowing the use of a higher interest assumption rate is that the entity will earn a rate of return on investments that can be used to help pay for the future benefits. Because the funding commenced with the current fiscal year, the assumed interest rate was increased to 7.75% in 2008-2009.

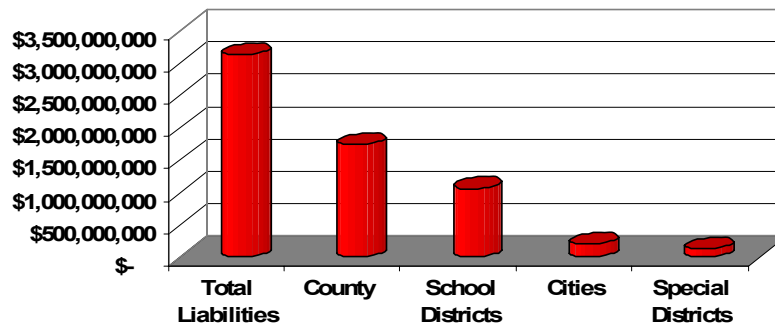
The result of the assumed interest rate increase was the OPEB liability dropped from \$2.3 billion to 1.7 billion, almost solely due to the interest rate assumption change.

10. Based on information available to the Grand Jury, the current Actuarial Accrued Liability for OPEB benefits due to employees of all larger Contra Costa County local governmental entities, including those promised by the County, school districts, cities and special districts, now exceeds \$3.1 billion. These liabilities are summarized and shown graphically as follows:

Liabilities of Contra Costa County and Local Government Entities

Contra Costa County	\$1,737,000,000
Contra Costa County School Districts	1,060,000,000
Contra Costa County Cities	199,000,000
Contra Costa County Special Districts	<u>124,000,000</u>
Actuarial accrued liability for OPEB benefits	\$3,120,000,000

Liabilities of CC County and Local Governments



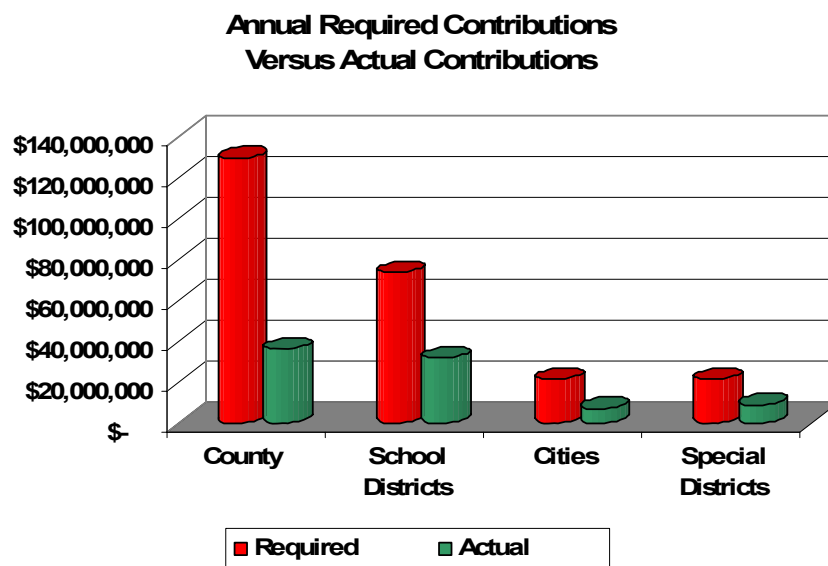
11. Based on the same sources, the current Annual Required Contribution (ARC) and the actual expense recognized (generally the current year's payment of health, dental and vision insurance premiums for retirees receiving benefits) are summarized as follows:

Annual Required Contribution

Contra Costa County	\$129,638,000
Contra Costa County School Districts	73,326,000
Contra Costa County Cities	21,199,000
Contra Costa County Special Districts	<u>21,161,000</u>
Total annual required contributions under GASB 45	\$245,324,000

Annual Actual Expense Recognized (Actual Contributions)

Contra Costa County	\$36,000,000
Contra Costa County School Districts	31,699,000
Contra Costa County Cities	6,986,000
Contra Costa County Special Districts	<u>8,663,000</u>
Total actual annual expenses paid for OPEBs	\$83,348,000



12. As the summary numbers shown in Finding 11 indicate, County local governments are currently only paying 34% (\$83,348,000 / \$245,324,000) of the Annual Required Contribution set forth in GASB 45. This means that the unpaid balance of the Annual Required Contribution, (\$245,324,000 - \$83,348,000) \$161,976,000, is being transferred to future taxpayers. This transfer to future taxpayers takes place every year.

13. The 2007-2008 property tax revenue for the entire County was \$2.077 billion. Projections are that this amount will decline significantly during the next several fiscal years because of the current widespread decline in property values.

14. Larger Contra Costa County governmental entities with identified retiree healthcare plans are:

- County: Contra Costa County
- School Districts: Lafayette Elementary, Acalanes Union, John Swett Unified, Mt. Diablo Unified, Pittsburg Unified, San Ramon Valley Unified, West Contra Costa Unified and Contra Costa Community College.
- Cities: Antioch, Brentwood, Concord, Martinez, Pittsburg and Richmond.
- Special Districts: Central Contra Costa Sanitary, Delta Diablo Sanitary and East Bay Regional Parks.

15. Recent information provided to the Contra Costa County Board of Supervisors makes clear that tax revenues and state support to the County are likely to decline for at least the next several years. This reduction in projected revenue has been currently offset by County Departments reducing their budgeted 2009-2010 full-time equivalent headcount by 191 public safety, health care and social services positions. If the County were to commence fully funding its ARC, its only practical source of near term future funding would be to further lower its staffing levels.

16. On May 6, 2008, the Contra Costa County Administrator presented the following challenge to the Board of Supervisors:

“The ever growing health care expense demand on the general fund will consume our ability to provide public services. Given the size of our liability, we cannot responsibly eliminate enough programs to fund our current health care programs; we must contain and change the County’s cost of health care.”

CONCLUSIONS

A number of County governmental entities do not offer their employees retiree healthcare benefits. Moreover, in a few cases local governments have substantially funded those benefits. The conclusions and recommendations contained in this report do not pertain to them.

A significant number of the larger governmental entities in the County offer very generous retiree healthcare benefits, and most have provided little or no funding to pay for those benefits. These local governments must adopt a new paradigm – a new framework to deal with this issue. Given the present economic environment facing Contra Costa County government entities, funding the accumulated and accruing benefits under these plans is not a realistic option. The Grand Jury concurs with the inherent solution to the challenge made by the County Administrator to the Board of Supervisors on May 6, 2008 - the only practical solution for both the County, and other affected County governmental entities, is to reduce the benefits offered under these programs.

The plan documents, plan descriptions and underlying legal documents differ widely. Retiree healthcare benefits are frequently subject to collective bargaining. Consequently, each separate governmental entity will have to consult with its own counsel and advisors to determine what design changes should be made or negotiated for its various employee groups.

A “business-as-usual” position with respect to continuing to offer the same retiree health plans is not a sustainable strategy.

RECOMMENDATION

Contra Costa County government entities in most cases do not have the financial ability to prudently pay for the current retiree healthcare benefits that have been, and are continuing to be, earned by their employees. The Grand Jury recommends that these governmental entities implement sustainable strategies to reduce retiree healthcare benefits.

Several alternatives are:

- Option 1. Implement a new defined contribution type retiree healthcare program for employees hired after July 1, 2009. Under this type of plan, the government employer would contribute annually an agreed upon amount into each covered employee’s separate account. This contribution would grow with investment earnings until withdrawn. Each covered employee would be entitled, at retirement, to draw from this account. The amount withdrawn would be used to purchase a health insurance policy of choice. There would be no employer responsibility to make any payments to, or on behalf of, the retired employee following his/her actual retirement.
- Option 2. Freeze the employer-provided portion of the retiree health plan for currently covered active employees, regardless of age. Any future cost increases would be borne by employees when they commence to receive their retiree healthcare benefits. (With the concurrence of legal counsel, this action could also be adopted for current retirees by freezing the employer’s payment at their current premium rate.)
- Option 3. Require greater benefit or premium cost sharing from retirees. This could take the form of increases in program deductibles, co-pays, co-insurance and out-of-pocket maximums paid for by retirees, and/or it could require that retirees commence paying a larger portion of the insurance premium amounts.
- Option 4. Require retirees to pay all, or a portion, of the cost of dependent coverage.

These options are not all inclusive and are intended to be illustrative only. Individual Contra Costa County governmental entities will arrive at different plan design solutions that they deem appropriate for their employee groups and financial situations. The important point is that benefits provided under retiree healthcare plans for most County governmental employees must be reduced.

REQUIRED RESPONSES

Findings

Contra Costa Board of Supervisors: 1 through 9 and 12 through 16

School Boards for: Lafayette Elementary, Acalanes Union, John Swett Unified, Mt. Diablo Unified, Pittsburg Unified, San Ramon Valley Unified, West Contra Costa Unified and Contra Costa Community College. 1 through 6, and 12 through 14

City Councils for: Antioch, Brentwood, Concord, Martinez, Pittsburg and Richmond. 1 through 6, and 12 through 14

Districts Boards for: Central Contra Costa Sanitary, Delta Diablo Sanitary and East Bay Regional Parks. 1 through 6, and 12 through 14

Recommendation

Contra Costa Board of Supervisors

School Boards for: Lafayette Elementary, Acalanes Union, John Swett Unified, Mt. Diablo Unified, Pittsburg Unified, San Ramon Valley Unified, West Contra Costa Unified and Contra Costa Community College.

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