OPEB Frequently Asked Questions
CSAC Conference
January 25, 2006

1. What is OPEB? What benefits are included?
OPEB is Other Post Employment Benefits. "Other" is intended to mean "other than pension".

OPEB includes the following postemployment items:
- -Medical benefits
- -Dental
- -Vision
- -Hearing
- -Life Insurance

Source: GASB 45 Statement, pages 46, 68

2. How large are overall OPEB liabilities for public entities (statewide & nationwide)? How much is currently being spent annually on OPEB?
A: For all state and local government entities, the total present value of OPEB liabilities are estimated at $600 billion to $1.3 trillion nationwide. Annual pay as you go benefits payments are estimated at $21 billion in FYE 2004.

For government entities in California the total is estimated at $70-$200 billion. Annual pay as you go cashflow is estimated at $4 billion in FYE 2004.

Source: OPEB for Public Entities: GASB 45 and Other Challenges - JPMorgan, page 3.

3. What portion of public entities currently prefund for OPEB?
A: As of January 2006, less than 10% of public entities currently set aside any money specifically as irrevocable OPEB contributions.

Sources: John Bartel, Bartel Associates; Brian Whitworth, JPMorgan

4. Who will have the worst problems dealing with OPEB liabilities?
A: Public entities who already have budget problems, have no money set aside, have a large number of retirees, a shrinking number of current employees, who expect to borrow extensively for non-OPEB needs, and who have irrevocably committed to pay the full cost of retiree healthcare.

Sources: John Bartel, Bartel Associates; Brian Whitworth, JPMorgan

5. How are the rating agencies reacting to GASB 45?

A: "Fitch Ratings is concerned about the financial stress OPEB liabilities will present to state and local governments. However, we do not expect to immediately lower ratings when a sizable OPEB liability is reported, or raise ratings for issuers with little or no exposure. Rather, we'll be looking at how issuers plan to address the problem, viewing favorably early consideration and a well-thought out plan that makes sense for that entity."

"Moody's does not expect to make any rating changes simply as a result of the disclosure of a large OPEB liability. Instead, we plan to assess both the level of an issuer's liability compared to its peers and the issuer's plan to manage the liability. Over time, some outliers --those with unusually large or small liabilities, those with unusually weak or strong plans -- could see an upward or downward rating adjustment.

Moody's does not believe that an issuer should embark on a plan to fully fund an OPEB liability merely because a large number has appeared in its financial statements. Instead an issuer should decide to fund any portion of the liability only if it makes sense for financial, legal, or public policy reasons. In those cases where an issuer has, for sound reasons, chosen to fund its liability, Moody's believe that bonds can be an appropriate part of the funding plan."

For more on the rating agencies and OPEB, please see:

- Fitch, "The Not So Golden Years," June 2005
- Moody's, "Special Comment On Other Post Employment Benefits," July 2005
- S&P, "Reporting & Credit Implications of GASB 45 Statement on Other Postemployment Benefits," December 2004

Sources: Ken Kurtz, Moody's; Amy Doppelt, Fitch

6. When should we get our actuarial study?

A: Sooner rather than later. Having this information will aid in planning, budgeting, and management for OPEB. In some cases, the information will be relevant for upcoming collective bargaining. As mentioned above, rating agencies find it important that public entities know what their OPEB liabilities are, in order to be able to manage those liabilities.

Sources: John Bartel, Bartel Associates; Brian Whitworth, JPMorgan

7. We don't guarantee to provide benefits to our retirees, but have done so for decades, do we have to book an OPEB liability under GASB 45?

A: Very likely yes. Quoting from the GASB 45 Statement:

> "employers often stipulate, for example, that postemployment healthcare benefits are not vested, or that the employer has the right to amend or discontinue benefits unilaterally…the current substantive plan - including any amendments made and communicated to plan members by the valuation date - and the employer's historical pattern of actions up to the time of the valuation with regard to the sharing of benefit costs provide the most objective and reliable basis for projection of benefits for financial reporting purposes. The [GASB] Board considered but rejected suggested

techniques such as reducing projected benefits for specific contemplated plan amendments or discounting projected benefits at a higher rate to anticipate future reductions of benefits"

Source: GASB 45 Statement, page 93.

8. If we don't pay for any part of our retiree's medical insurance premiums, do we need an actuarial study?

A: You should check with your actuary or accounting firm. If retirees participate in the same health care plan as current employees, and pay the same premiums as current employees, you will probably need an actuarial study and need to book a GASB 45 liability for an "implicit subsidy."

Sources: John Bartel, Bartel Associates; GASB Statement 45, pages 86-90

9. Typically, how much larger will the annual required contribution for OPEB be, versus the current pay as you go cost?

A: This depends on several factors, including: whether there is a plan in place to fund the liabilities over time, whether there is any existing prefunding, and whether the number of employees is growing or shrinking. For public entities with a stable number of employees and a plan to prefund, the annual required contribution is often 3 times as large (or more) as pay-as-you-go costs. For growing public entities with no plan to prefund, the annual required contribution accrual could be much larger, 4-10 times the current cash outlay.

Sources: Ira Summer, Public Pension Professionals; John Bartel, Bartel Associates

10. Over how long a period can we amortize our unfunded liability?

A: "The maximum acceptable amortization period for the total unfunded actuarial liability is 30 years."

Source: GASB 45 Statement, page 9

11. Does GASB 45 require that we prefund?

A: No. However, some public entities have a requirement for a balanced budget based on accrual accounting.

There are usually good reasons to prefund at least a portion of the liability:

- Lower ultimate cost of providing the same benefits. This is a primary reason why pay as you go pension funds are extremely rare.
- With zero prefunding, variations in OPEB costs directly affect the current year's cash budget. With even a modest percentage of prefunding, unexpected changes in cost can be smoothed out over a period of years and insulate the general fund budget from wide unpredicted swings in OPEB costs.
- Completely unfunded programs will book cumulative and annual liabilities which are much larger than a similar partially or fully funded program. GASB 45 requires the use of lower interest rates for discounting completely unfunded plans.

- For those who stay pay-as-you-go, large OPEB accruals can consume all net assets over time and show a large accrual deficit. In a few cases, the present value of OPEB commitments will be larger than all assets of any kind.

Sources: Brian Whitworth, JPMorgan; John Bartel, Bartel Associates

12. Will we need to form an OPEB trust? What form should it take? Can we join a group investment trust of some form?

A: A public entity that wants to start funding its liabilities needs to have an appropriate place to put the money. A large portion of public entities do not have an existing trust, pension fund, retirement association, or other entity to which they can make irrevocable OPEB contributions and have those assets invested in long term bonds, equities, or other securities commonly used for pension investments.

We expect many public entities to either create standalone OPEB trusts, create new group OPEB trusts, or have an existing pension fund manage the money. Part of this is due to the desire to manage OPEB assets much like pension assets. GASB 45 also plays a role. It discourages merely earmarking General Fund money for OPEB:

> *"[An] employer has contributed to an OPEB plan **if** the employer has (a) provided benefits directly to retired plan members or their beneficiaries, (b) paid insurance premiums to insure the payment of benefits, or (c) **irrevocably** transferred assets to a qualifying trust, or equivalent arrangement, in which plan assets are dedicated to providing benefits to retirees and their beneficiaries in accordance with the terms of the plan and are legally protected from creditors of the employer(s) or plan administrator. The preceding criteria **preclude** counting as contribution (a) designations of net assets of a governmental or proprietary fund to be used for OPEB or (b) internal transfers of assets to a separate governmental or proprietary fund for the same purpose."* [emphasis added]

Please note that currently, CalPERS does not accept prefunding money for OPEB.

Source: GASB 45 Statement, page 105

13. Can an OPEB trust invest in equities, corporate bonds, and other investments in a manner similar to pension funds?

A: In California, a properly structured OPEB trust can invest in these securities.

Source: Roger Davis, Orrick

14. Can we issue OPEB bonds (similar to Pension Obligation Bonds)? What are the benefits and drawbacks?

A: In depth discussions with several bond counsels have led to similar conclusions that CA public entities can issue properly-structured OPEB bonds, usually subject to validation proceedings. In other states, the situation may be different.

Potential benefits include:

- The ability to increase funding levels for OPEB liabilities quickly, resulting in lower booked liabilities and annual accruals than pay-as-you-go or level amortization;
- Lower expected out of pocket cash flow than amortizing the unfunded liability in 30 level payments;
- A lower expected net present value cost of providing the same benefits;
- Flexible debt service structures, potentially including interest-only or capital appreciation bonds;
- A lower chance of discontinuation of benefits, or sudden large reductions in benefits to current and future retirees; and
- Long-term taxable interest rates that are much lower than historic averages. This provides an incentive to issue sooner, since interest rates in 2007 are uncertain and might not be as advantageous.

Potential obstacles and disadvantages include:

- There must be a retirement system, trust, or other entity in place to receive and invest the bond proceeds. Many public entities do not yet have such a trust, or have not yet confirmed that a retirement system is willing and able to receive large amounts of prefunding.
- Long term investment returns could be lower than borrowing costs for OPEB bonds. Pension obligation bonds have similar economics to OPEB bonds, and most pension obligation bonds have been economically beneficial to their issuers. However, past performance does not guarantee future results.
- Lower-rated issuers will have higher borrowing costs.
- Time and effort are required for any bond issue.

Sources: Roger Davis, Orrick; Brian Whitworth, JPMorgan

15. Can we make major changes in our benefit structure?

A: This varies tremendously from one public entity to another. Public entities have made a wide variety of commitments to provide postretirement medical coverage. The nature of the promise can affect the amount which a public entity accrues for future liabilities, its ability to make any future changes in the plan, and employees'/retirees' certainty of obtaining benefits.

Often these commitments vary within the same entity. For example, police and fire employees may have different benefits than civilian employees. Union and nonunion employees may have different benefits. Employees hired or retiring after a particular date may have different benefits.

OPEB promises vary in four primary ways:

- The amount or type of benefits, which vary in a myriad of ways, including: flat dollar amount paid per month; percentage of premium paid by employer; coverage of spouses/dependents; fixed dollar with and without a cost of living adjustment; dental/vision/life insurance coverage. "Of the 60+ OPEB actuarial studies Bartel

Associates has prepared, we find very little similarity in the benefits from one agency to the next," John Bartel;

- The length of time for which particular benefit levels are guaranteed (e.g., for the lifetime of the employee, or until the end of the current collective bargaining agreement);
- The nature of the promise to provide benefits (e.g., state constitution, law, county charter, collective bargaining agreement, Council/Board resolution, etc.); and
- Which entity makes the commitment. In many cases, benefit levels are dictated by someone besides the employer. For example, state law may require minimum contribution levels by counties, or participation in a particular medical program may require a certain level of retiree premium subsidy.

Sources: John Bartel, Bartel Associates; Igor Balevich & Brian Whitworth, JPMorgan

16. What types of obstacles or surprises should we be aware of in dealing with OPEB and the new GASB requirements?

A: There are many, including:

- Actuarial studies often produce future liabilities and annual accruals which are much higher than the public entity previously expected. This is one reason to get your actuarial study sooner rather than later.
- If you wait until 2007 to get an actuarial study, actuaries may be more difficult to retain, more expensive, and have more difficultly delivering a timely study.
- You may not currently have an appropriate place to put any OPEB prefunding (a good reason to investigate your options early).
- You may have much more flexibility, or much less, than first expected regarding potential benefit modifications. This is very common, even among rather astute public entities.
- Doing nothing else while waiting for an actuarial study to arrive is risky. During that time, you could be: investigating where to put any prefunding; researching the nature of current commitments; seeing if any new policies or entities will be required (e.g., investment policy, starting an OPEB trust). Additionally, actuarial estimates could be widely circulated in the media or become topics of political debate before a public entity fully understands its current situation or its options.
- Estimates of OPEB liabilities are more volatile from one actuarial study to the subsequent study than pension liabilities.

Sources: Brian Whitworth, Jim Kelly, Igor Balevich, Garth Salisbury, JPMorgan; John Bartel, Bartel Associates; Roger Davis, Orrick

17. What can the public sector learn from the private sector regarding OPEB?

A: Before private sector rules (SFAS 106) were implemented there were no reporting standards for OPEB. Liabilities of many plans were completely unquantified, and companies were surprised at size of expected future costs.

Private sector rules are less flexible than GASB 43/45. The private sector reacted very quickly to eliminate benefit promise for many employees and even some retirees. Public sector is in a different position, particularly in California: most benefits are bargained, there may be “vested rights” issues, GASB 45 allows for more reasonable accruals and public sector can pre fund (private sector can not). The parallels are not perfect. There are many reasons to believe that changes in the public sector will not be as large or widespread:

- Unionization - Stronger and more widespread unions exist in the public sector.
- Fewer competitive pressures of the type which have resulted in industries like airlines trying to eliminate OPEB liabilities through bankruptcy. Bankruptcies in the public sector are very rare, and strategic bankruptcies to shed particular liabilities are virtually unheard of. Many public entities are not even eligible for bankruptcy, including state governments and most school districts.
- Political realities
- Legal requirements - Many public entities are obligated by charter, law, or State constitution to pay benefits. These are more difficult to change than renegotiating benefits with unions. Changing State constitutions would be especially difficult. These types of changes were seldom required to modify private-sector benefits.
- Associations - Public entities are much more likely to be part of associations, joint power authorities or retirement systems which dictate the benefits being provided.
- Lower turnover - Public entities typically have lower turnover than private entities. This means that any change in postretirement benefits which affects only new employees will take longer to yield material results, both on a cash flow and accrual basis.
- Less desire to change - A 2003 Segal Company poll found that only 15% of state governments said they might consider reducing retiree benefit levels in the next one to three years. None of the states responding to the survey were contemplating eliminating retiree health benefits.

Sources: John Bartel, Bartel Associates; Igor Balevich, JPMorgan; 2003 Segal State Health Benefits Survey: Medical Benefits for Employees and Retirees

18. What determines whether the Other Post-Employment Benefits an agency has either granted or negotiated are legally vested?

A: The nature of the promise discussion in question 14 is relevant here. In many cases, vesting is imposed by state law or constitution, city or county charter, or similar law.

Some collective bargaining agreements clearly specify that coverage for retirees is vested beyond the expiration of that particular agreement. Some plan documents and communications with employees and retirees clearly communicate that benefits are or are not guaranteed.

Unfortunately, in some cases vesting, promises, obligations, and/or guarantees are unclear. Agreements may have changed over time, making it unclear which agreement applies to a future retiree. Various documents (e.g., collective bargaining and plan documents) may contain confusing or conflicting provisions. In the private sector, litigation involving Unisys in one group of cases and General Motors in another may provide useful background information.

For example, in California, the California Supreme Court has generally ruled that public sector employees have a "vested right" to the pension benefits they are offered when hired and these promises can not be changed without providing an alternative equal or greater benefit. The California Supreme Court has not made a similar ruling on OPEB yet. This ruling, when it occurs, may be the ultimate factor in determining whether or not public sector employees have a "vested right" to OPEB.

As mentioned in question 15, many otherwise astute public entities do not yet know what their obligation is to provide benefits, or what their choices are for potential future modifications. Adjacent counties or cities often have rather different situations. Thorough research of a particular public entity's documents and good counsel can be quite valuable on this topic.

Sources: John Bartel, Bartel Associates; Brian Whitworth, JPMorgan

19. What are union interests related to OPEB, its current and future funding, and how do these affect negotiations over cost management?
A: There are exceptions, but unions appear to be focused on maintaining benefits and short term cash flow, meaning that they generally don't seem to be interested in long term funding options.

Source: John Bartel, Bartel Associates; Robin Bramwell, JPMorgan

20. Is an employer's promise to pay only a flat amount toward OPEB (1) a defined benefit plan or (2) a defined contribution plan? Does the distinction matter in determining actuarially sound funding requirements?
A: It is a defined benefit plan unless it meets the qualifications in the second paragraph below. If a plan is a true defined contribution plan as described in the second paragraph below, accounting is different than for defined benefits.

"Defined **benefit** plans are plans having terms that specify the *benefits* to be provided at or after separation from employment. The benefits may be specified in dollars (for example a flat dollar payment or an amount based on one or more factors such as age, years of service, and compensation), or as a type or level of coverage (for example, prescription drugs or a percentage of healthcare insurance premiums).

In contrast, a defined **contribution** plan is a plan having terms that (a) provide an individual account for each plan member and (b) specify *how contributions to an* ***active plan member's account*** *are to be determined*, rather than the income or other benefits the member or his or her beneficiaries are to receive at or after separation from employment. In a defined contribution plan, these benefits will depend ***only*** on the amount contributed to the member's account, earning on investments of those contributions and forfeitures of contributions made for other members that may be allocated to the member's account." [emphasis added]

Source: GASB 45 Statement, page 2. A description of accounting for defined contribution plans begins on GASB 45 Statement, page 21.

21. Does it matter whether employee and employer funds are pooled together in an OPEB Trust?

A: For purposes of GASB 45, employer and employee contributions can be pooled together, as long as they are irrevocable. Both contributions would count towards the annual required contribution (ARC). OPEB contributions should not be commingled with regular operating funds, or with pension assets.

Source: Igor Balevich, JPMorgan

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