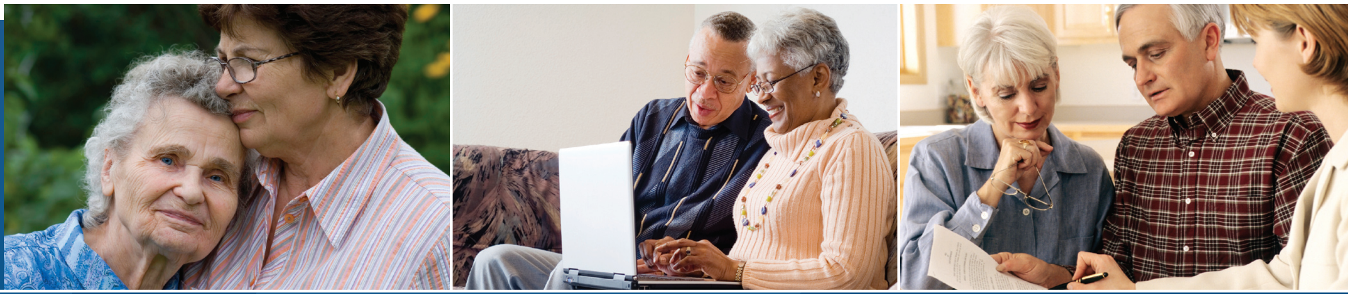
Center for State & Local Government Excellence

Issue Brief

Prefunding Other Post Employment Benefits (OPEB) in State and Local Governments: Options and Early Evidence



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Governments know that their retirement benefits have been a critical part of their compensation package, helping them attract and retain the talent they need. At the same time, it has become clear that the traditional "pay-as-you-go" approach to funding retiree health care is unsustainable.

Why must governments change course? With an aging workforce and rising health care costs, fiscal challenges will only grow in the future. Prudent actions taken now can dramatically reduce unfunded liabilities in the future.

Jerrell Coggburn and Jamie McCall take a hard look at the options state and local governments are pursuing to reduce their unfunded liabilities for Other Post Employment Benefits (OPEB). The complexity of funding retiree health obligations can be seen in the state and local government examples that they analyze.

West Virginia has taken a number of steps to address its unfunded liabilities, starting in 2006 when the state established a trust fund. At the same time, it made changes in the health care benefit plan for retirees, increasing copayments and coinsurance rates and moving Medicare-eligible retirees to a Medicare Advantage Drug Plan. And most recently, the state's Public Employees Insurance Agency voted to eliminate retiree health care subsidies for all employees hired after July 1, 2010. This recent action has been contentious, with one teachers' union filing a legal challenge to the decision.

The local government examples are equally compelling in the range of approaches they have taken to strengthen funding for their retiree obligations. Montgomery County, Maryland, developed a multi-year plan to arrive at full funding, including the establishment of a Section 115 trust in 2008 and an independent board to manage the trust and its investment policies. Oakland County, Michigan, began prefunding retiree health care liabilities in 1987 and more recently has issued OPEB bonds to help fund the County's Section 501(c)(9) Voluntary Employees' Beneficiary Association (VEBA). And Gainesville, Florida, a city with a consistent history of paying in excess of its annual required contribution, may be the first local government to complete its prefunding obligations through the sale of OPEB bonds in 2005.

The Center for State and Local Government Excellence was founded to explore issues that are important to attract and retain the talent needed for public service. Retirement security for public sector employees is a major focus of the Center's research.

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Prefunding Other Post Employment Benefits (OPEB) in State and Local Governments: Options and Early Evidence

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Introduction

Of all the benefits state and local governments offer their employees, perhaps none is so concurrently valued (by employees and retirees) and viewed as contentious (by policy makers and taxpayers) as retiree health insurance. Retiree health care, along with dental, vision, disability, long-term care, and life insurance, represent other (that is, non-pension) post employment benefits, or OPEB. For most state and local governments, OPEB is an important component of the total compensation (salary and benefits) offered employees in exchange for their services. Traditionally, governments have offered relatively generous benefits packages relative to private sector employers, in part, to help compensate for salaries that are often perceived to lag behind the market. With escalating medical costs and tightening governmental budgets, however, attention is now turning to controlling OPEB costs, particularly retiree health care.

In practice, the vast majority of state and local governments have paid their OPEB costs on an annual "pay-as-you-go" basis (Harm, 2003). Until recently, the magnitude of OPEB liabilities went largely unrealized because most governments did not calculate their long-term accrued costs for the benefits promised to employees. This has meant that many governments have operated without calculating long-term costs, addressing the escalating costs of retiree health care only incrementally within the context of the annual budget process. All of this changed, however, with the Governmental Accounting Standards Board's (GASB) issuance of new standards (discussed below) for calculating and reporting OPEB liabilities. As governments are coming to realize the hefty price tags (unfunded liabilities) attached to their OPEB promises, they are turning attention to finding funding solutions.

This issue brief provides an overview of several options state and local governments are considering and, in places, pursuing to address unfunded OPEB liabilities. Three prefunding mechanisms—115 trusts, 401(h) trusts, and VEBA [section 501(c)(9)] trusts—are discussed, along with survey data[1] on their adoption and/or likely adoption by state and local governments. The aggregate survey data on adoptions are followed by specific examples, drawn variously from state and local governments, where the respective approaches have been adopted. The cases highlighted are not necessarily representative of all efforts to address OPEB, nor are they offered as examples of best practice; instead, they represent experiences of early adopters of the respective OPEB strategies. Because the size of OPEB liabilities is now more readily understood, it is important for decision makers to assess potential strategies for dealing with escalating costs while maintaining this part of total employee compensation, a factor that has proven to be among the most important to employees (Center for State and Local Government Excellence, 2007).

The Impact of GASB Statement 45

In June 2004, GASB, the organization that sets generally accepted accounting principles (GAAP) for public sector entities, issued GASB No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (GASB 45).[2] GASB 45 promulgates financial reporting standards for OPEB plan sponsors, namely state and local government employers offering OPEB. The statement requires public employers to produce actuarial valuations for their OPEB, following GAAP principles, and to report these liabilities in their financial reports. Doing so provides transparency to the full costs of benefits and focuses attention on their sustainability.

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Prior to GASB 45, many state and local governments did not examine their OPEB liabilities. Since the calculated total costs of these benefits over time was not something that had to be reported, governments could—and did—avoid addressing the issue (assuming they were aware of the issue in the first place). Our review of the states' OPEB actuarial valuation reports pegs the cumulative unfunded liability for OPEB at $558 billion (Kearney et al. 2009). Estimates that include both state and local governments' unfunded OPEB liabilities range from $600 billion to $1.6 trillion (GAO 2008). Without action, these costs will simply continue to grow. The GAO (2008), for example, reports that sticking with pay-as-you-go funding could more than double annual OPEB costs in coming decades from current levels of approximately 2 percent of payroll to 5 percent of payroll or more.

One of the "myths" (Clark 2008) that has surfaced post-GASB 45 is that the statement requires OPEB sponsors to establish irrevocable trusts and to prefund retiree health care. Though such actions are not required by GASB 45, there are practical reasons why governments might choose to do so. As will be discussed below, prefunding can substantially reduce the long-term costs of OPEB. Also, many credit rating agencies have reported that they will begin taking into account OPEB liabilities, something that could have a negative impact on a government's credit ratings and increase its borrowing costs (Clifton et al. 2004; Mattoon 2008; Murphy and Zorn 2006; Voorhees 2005; Wisniewski 2005). As this suggests, GASB 45's reporting requirements may have the effect of rendering the "do nothing" strategy infeasible.

Addressing OPEB: Options and Preliminary Evidence

Prefunding Mechanisms

Though the annual pay-as-you-go approach is—and, for some time, likely will remain—the predominant approach to OPEB funding, there are a number of prefunding mechanisms available. Three such mechanisms are considered here: governmental trusts [Section 115 trusts], medical subaccounts [Section 401(h)] within qualified defined benefit pension plans, and voluntary employees' beneficiary associations [VEBA, or 501(c)(9) trusts]. Each serves as a vehicle for prefunding OPEB liabilities through the creation of a dedicated trust into which funds are deposited and subsequently invested. This combination of contributions and investment earnings, in turn, provides assets for paying OPEB costs. If such a trust is established as an irrevocable trust, governments are allowed to use different actuarial assumptions in calculating liabilities. Specifically, they are able to use a higher discount rate, which has the effect of lowering the present value of OPEB liabilities.

To fully fund OPEB liabilities, government employers must contribute an annual funding amount, referred to as the annual required contribution (ARC), that is actuarially determined and includes amounts sufficient to cover the current year's OPEB costs (referred to as the "normal cost") and the accrued liability amortized over an extended period of time, typically, but no more than, 30 years. By including payment for the amortized unfunded liability, the ARC will likely be substantially higher than annual pay-as-you-go payments. Increases in the short-term, however, can pay off in the long term, because prefunding tends to substantially reduce long-term costs as the investment of fund assets produces earnings that help finance OPEB obligations. More broadly, these prefunding mechanisms promote intergenerational equity because they set aside funds for benefits earned today but not payable for many years into the future.

It is important to note up front that, although available, these prefunding mechanisms have been adopted only by a relative handful of states and/or local governments, and that the likelihood of widespread adoptions in the future seems limited at present (see table 1).

Section 115 Trusts

Governmental (Section 115) trusts can be established by public employers to serve an essential governmental function, including providing OPEB. Contributions to these trusts are unlimited, their investment earnings are not taxed, and benefits received by participants and beneficiaries are normally tax free (GAO 2007). If established as an irrevocable trust for the sole benefit of participants and beneficiaries, a Section 115 trust should meet GASB 45 guidelines allowing government sponsors to reduce their reported OPEB liabilities (California Public Employee Post-Employment Benefits Commission 2008).

In our initial survey research, respondents in only five states (Alabama, Alaska, Colorado, Maine, and Massachusetts) reported having adopted a dedicated governmental trust, though a fairly sizable number (15 states) indicated a likelihood of doing so in the near future.[3] A similar pattern emerged for local governments (see Table 1). This suggests that Section 115

Table 1. *Adoption of OPEB Prefunding Mechanisms by State and Local Governments*

States/municipalities have several options for funding retiree health care obligations. How likely is your state/ municipality to adopt the following options in the next five years?	Municipal+			State^		
	Already Adopted	Likely to Adopt	Unlikely to Adopt	Already Adopted	Likely to Adopt	Unlikely to Adopt
Governmental Trust [Section 115]	3% (54)	9% (196)	32% (674)	10% (5)	30% (15)	52% (26)
Medical Subaccount [401(h)]	1% (22)	4% (83)	36% (773)	4% (2)	8% (4)	80% (40)
Voluntary Employee Benefit Association [501(c)(9)]	3% (56)	5% (111)	34% (722)	6% (3)	2% (1)	84% (42)

**Survey responses were collapsed such that answers for "Very Likely to Adopt" and "Likely to Adopt" are included under "Likely" and answers for "Unlikely to Adopt" and "Very Unlikely to Adopt" are included under "Unlikely."*
+ N = 2,136. Remaining percentages are missing values.
^ N = 50. Remaining percentages are missing values.

trusts are likely to become the favored vehicle for state and local governments that opt to prefund OPEB liabilities.

The state of West Virginia represents an interesting case study of a Section 115 trust adopter for at least a couple of reasons. First, the state demonstrates the effect of establishing a trust (along with other OPEB plan changes) on estimated OPEB liability. Second, it illustrates the confusion over OPEB funding that can exist among plan participants (employees and retirees).

In response to GASB 45, West Virginia undertook an initial OPEB actuarial valuation in 2006 (CCRC 2006). The result was a reported unfunded OPEB liability of $7.8 billion. To address this liability, the state created a trust fund, the West Virginia Retiree Health Benefits Trust, and undertook a variety of retiree health care reforms, including increasing copayments and coinsurance rates and moving Medicare-eligible retirees to a Medicare Advantage Drug Plan (Terry 2007). These changes had some effect: the subsequent valuation (CCRC 2007) reported a dramatically reduced OPEB liability of $3.4 billion (see also Terry 2007). As mentioned above, the adoption of an irrevocable trust allows governments sponsoring OPEB plans to adjust actuarial assumptions in calculating liabilities. This, in part, explains the dramatically different liability levels reported by West Virginia from the 2006 valuation report, which used a discount rate of 4.5 percent, to the 2007 report, which used a 5.22 percent rate.[4]

West Virginia's experience also exemplifies how the complexity of OPEB funding can create confusion on the part of employees and retirees. Given the magnitude of their OPEB obligations, governments that create prefunding mechanisms are also likely to modify existing health care options, including raising premiums, copayments, coinsurance rates, and the like. This has been the case in West Virginia. During a series of benefits forums where these changes were being discussed, retirees and active employees wondered why their out-of-pocket costs (copayments and coinsurance) were increasing when the state had $330 million sitting in a trust fund. The common sentiment, which reflected a general unawareness of the purpose of an OPEB trust fund, was that these funds should be exhausted before increasing participants' costs (PEIA 2008). The lesson here is that public officials and OPEB administrators need to clearly communicate the purpose of trust funds and their relation to current costs.

Montgomery County, Maryland, has taken steps to address its OPEB liabilities, which were estimated at $3.2 billion in 2008.[5] In 2008, the county established a Section 115 trust, the Retiree Health Benefits Trust, to prefund benefits for retirees and their dependents under the county's health plan. A board was appointed by the county government to manage the trust and create policies governing the trust's philosophy on the balance between capital preservation and growth. Investment decisions for the trust are made by an investment manager appointed by the board. County contributions to the trust are dictated by county council appropriations, and the county reserves the right to make no contributions. In accordance with the Section 115 Trust structure, withdrawals for payments to cover eligible health care expenses are exempt from federal taxes (Montgomery County 2008).

Along with the trust, the county established a multi-year plan for arriving at full funding. The initial plan was to arrive at fully funding the ARC over a five-year phase-in period but, in a sign of the times, the original plan was lengthened to eight years due to prevailing economic conditions that strained the county's finances (to the tune of a $410 million shortfall for FY 2009). After ramping up to the ARC, the country projects its annual OPEB costs will be approximately $270 million (Montgomery County Department of Finance n.d.). At a time when few local governments are prefunding OPEB liabilities, Montgomery County stands out against this trend (Lopes 2006). Still, the county's experiences vividly demonstrate the difficulties facing governments as they struggle to meet competing (and more immediate) demands in a tough fiscal environment.

401(h) Accounts

A health benefits [401(h)] account is a separate subaccount within a preexisting qualified pension plan. Contributions to the subaccount are subordinate to pension fund contributions, meaning that no more than 25 percent of the employers' total annual contribution to the defined benefit pension plan can be allocated to the health benefit subaccount (GAO 2007). This can be an important limitation for a public employer with a well-funded pension plan because the ARC for the pension plan would be small, hence the ability to address a large unfunded OPEB liability would be constrained (Ruggini 2008). The subaccount is separate from the pension fund for accounting purposes, but the assets from both can be commingled for investing purposes. The survey results reported in Table 1 show that few governments have established 401(h) trusts, although some governments—for example, Indiana—are in the process of adopting them.

The state of Alaska has been identified as an early adopter of OPEB prefunding (Berman and Keating 2006). The state is interesting for present purposes not only because it has a 401(h) subaccount, but also because it has recently moved away from that approach as its primary means for addressing retiree health care funding.

In 1997, Alaska created the Retiree Health Fund, a 401(h) health benefit subaccount within its state pension plan. The fund was created to provide self-insured health care benefits to retirees from the public employees, teachers, judicial, and elected officials retirement systems. As originally designed, the state's retiree health care plan was very generous, though subsequent amendments have made it less so with the creation of several benefit tiers. These tiers are summarized in the most recent actuarial valuation for the Public Employees' Retirement System (PERS) (Buck Consultants 2008, 52):

> Major medical benefits are provided to retirees by the PERS for all employees hired before July 1, 1986 (Tier 1). Employees hired after June 30, 1986 (Tier 2) with five years of credited service (or ten years of credited service for those first hired after June 30, 1996 (Tier 3)) must pay the full monthly premium if they are under age sixty and will receive benefits paid by the PERS if they are over age sixty. In addition, Peace Officers with twenty-five years of Peace Officer service and other employees with thirty years of membership service receive benefits paid by the PERS, regardless of their age or date of hire.

As a subaccount of the pension fund, the Retiree Health Fund had, unlike most other states, accrued considerable assets for OPEB prior to the issuance of GASB 45. The funded ratio for the state's OPEB liabilities was recently reported at 65 percent (Pew Center on the States 2007). Still, the state faced escalating retiree health care costs that, the state argued, were not adequately accounted for by the state's long-time actuary,[6] resulting in continued decline in the state's pension funding ratio. In response, the state passed Senate Bill 141 in 2005 establishing a defined contribution plan for all employees hired after July 1, 2006. This, however, did not eliminate existing OPEB liability.

As of its most recent independent auditor's report (KPMG 2008), the Retiree Health Fund covered almost 32,000 retirees and held assets of $177.6 million. This represents a net decrease of $155 million, or roughly 47 percent, in the Retiree Health Fund's assets from fiscal year 2007. This decrease is associated with the adoption of a Section 115 trust, the Alaska Retiree Health Care Trust. As of July 1, 2007, the new trust replaced the 401(h) fund as the main vehicle for prefunding retiree health care; thus the employer contributions that once flowed to the 401(h) account now go directly into the Alaska Retiree Health Care Trust. Still, certain members remain under the 401(h) plan, so it must continue to have sufficient funds to meet costs.

The state of Ohio established its 401(h) subaccount, the Post-Employment Health Care Plan, in 1974—eons ago in OPEB time. The plan is administered by the Ohio Public Employees Retirement System (OPERS). Not surprisingly, the state is one of the few public employers that has accumulated significant assets to help pay for OPEB liabilities. According to the state's 2007 Comprehensive Annual Financial Report (CAFR),[7] the state's Post Employment Healthcare Fund had assets totaling $12 billion and actuarially accrued liabilities of $30.7 billion for a funding ratio of 39 percent. The most recent estimates[8] (March 31, 2009) for the plan place its assets at $9.2 billion, down considerably from the $12 billion mark.

As for structure, OPERS has taken steps to ensure the sustainability of its 401(h) funded plan. In 2007, OPERS implemented the Health Care Preservation Plan (HCPP) with the explicit goal of improving the long-term solvency of the health care fund. Under HCPP, retirees receive a monthly allowance based on their length of service and the year in which the year they were eligible to retire. These factors create three groups (or tiers) of benefits (OPERS 2008):

- **Group 1:** Members who are retired or are eligible to retire prior to Jan. 1, 2007, will receive an allowance equal to 100 percent of the cost of health care coverage in 2007. Eligible family members will receive an allowance of between 75 and 90 percent of the cost of health care depending on the retiree's years of service.
- **Group 2:** Members who will be eligible to retire after Jan. 1, 2007, and were hired prior to Jan. 1, 2003, will receive an allowance if they have at least 10 years of qualifying service credit at retirement. The allowance will increase with each year of service and range from 50 percent of the cost of health care coverage for between 10 and 15 years of service, to 100 percent for 30 years of service. Eligible family members will receive an allowance of between 25 and 90 percent of the cost of health care depending on the retiree's years of service.
- **Group 3:** members who were hired after Jan. 1, 2003, with no prior service credit will receive an allowance if they have at least 10 years of qualifying service credit at retirement. Members with between 10 and 15 years of service at retirement will receive an allowance equal to 25 percent of the cost of health care coverage. The allowance will increase with each year of service and range from 25 percent for 15 years of service to 100 percent for 30 years of service. Eligible family members will receive an allowance of between 12.5 and 65 percent of the cost of health care depending on the retiree's years of service.

For each group, the monthly allowance is applied toward the monthly health care premium. Retirees select coverage options from a cafeteria-style plan, meaning they choose from available medical, pharmacy, dental, vision, and long-term care options. If the costs of the selected options exceed the monthly allowance, the difference is deducted from the retirees' monthly benefit check. If the costs are less than the monthly health care allowance, the remaining funds are deposited into an individual Retiree Medical Account (RMA), which a retiree can use to pay for qualified medical expenses.

In sum, Ohio has taken a number of steps to prefund OPEB liabilities and reduce overall retiree health care costs. The state's experience suggests that substantial prefunding absent structural change may not be sufficient for adequately addressing OPEB liabilities.

Santa Barbara County's (California) recent experience with establishing a 401(h) account to fund OPEB provides insight to the complexity local governments may face in not only adequately reporting their liabilities, but also ensuring compliance with federal tax law. Santa Barbara is one of 20 California counties authorized by the California Employees Retirement Law of 1937 to establish its own retirement system. The county's system, created in 1944, is known as the Santa Barbara County Employees' Retirement System (SBCERS). SBCERS operates as a cost-sharing multi-employer plan, providing a defined benefit pension and OPEB. The SBCERS pension trust fund is governed by Section 401(a) of the federal tax code.

Regarding OPEB, for county retirees who select a county-sponsored retiree health care plan, SBCERS provides a monthly subsidy equal to $15 per month per year of service (e.g., a retiree who worked for 20 years would receive $300 per month). Retirees opting not to participate in a county-sponsored plan receive $4 per month per year of service (e.g., a retiree who worked for 20 years would receive $80 per month). Putting aside the size of the retiree health care subsidies, the real issue between the county and SBCERS concerns how the two viewed these retiree health benefits under the GASB 45 guidelines.

Subsidies paid by SBCERS were traditionally drawn from the pensions fund's "excess earnings." In a given year, the system deposited earnings that exceeded the pension fund's long-term earnings assumptions (less 1 percent for contingencies) into non-valuation reserve accounts—meaning these funds were not included in the actuarial valuations of the pension fund assets—to pay OPEB subsidies. The county contended that such an approach yielded the OPEB plan unfunded (per GASB 45) because funds were not deposited into a tax-compliant trust and, furthermore, that the SBCERS's funding approach violated Section 401(a) pension rules requiring that the pension trust's assets be used only for retirement pensions. The result was wildly different financial reporting for the county's OPEB liability: SBCERS reported OPEB assets of approximately

$94 million in 2007, while the county, in a separate OPEB valuation, reported OPEB assets of $0 and an unfunded OPEB liability of $132 million (County of Santa Barbara 2008).

In June 2008, Santa Barbara County sued SBCERS "to ensure the implementation of a viable and legal solution for funding of the retiree medical program" (County of Santa Barbara 2008, 90). The parties reached an agreement in September 2008 that included the creation of a 401(h) subaccount within SBCERS's pension plan. Instead of funding OPEB with pension fund assets, as had been the case prior to the agreement, the county will, for the first time, make separate OPEB payments to SBCERS for the $15 and $4 per month per year subsidies directly through the 401(h) trust, with the goal of ultimately prefunding these liabilities.

Section 501(c)(9) Trusts: Voluntary Employees' Beneficiary Association (VEBA)

The third OPEB prefunding mechanism is a voluntary employees' beneficiary association, or VEBA. VEBAs function as independent, tax-exempt entities (normally trusts) that exist for the benefit of a voluntary membership of active employees and retirees and their beneficiaries (GAO 2007). Employer and employee contributions are made on a pre-tax basis and distributions for qualified health care expenses are normally tax free. VEBAs allow for funding up to 100 percent of OPEB liability (Ruggini 2008). The use of VEBAs was popularized by the private sector, where automotive companies like General Motors recently bargained with the United Autoworkers Union to set up VEBA trusts with a planned large one-time payment from the company (Bernstein 2008).

To be tax-exempt, VEBAs need to obtain a private qualification letter from the IRS. Though this sounds straightforward, it is not always the case in practice. In 1993, for example, the state of Washington attempted to establish a VEBA for state employees that mirrored an existing VEBA the state had created for teachers. The IRS, however, issued an unfavorable determination letter and the separate VEBA was dropped. In 1998, the legislature authorized state agencies to join the existing school district VEBA, a move that was approved by the IRS (Heffelinger 2000).

The state of Montana[9] authorized the creation of a VEBA for employees and retirees in 2001. The trust was established in April 2003 and received a favorable letter of determination from the IRS in June of that year. The trust, State of Montana Health Benefit Plan and Trust, functions as a health care reimbursement account (HRA) and is commonly referred to as the Montana HRA VEBA. The plan includes active employees and retirees and is funded with employer contributions. Eligibility for joining Montana VEBA HRA, as specified in statute,[10] broadly includes employee associations from public employers, the latter of which "means a legally constituted department, board, commission, or any other administrative unit of state government, a county, an incorporated city or town, or any other political subdivision of the state, including a school district, or a unit of the university system." Employee groups or associations (e.g., retiring employees, separating employees, bargaining units) may decide to join the VEBA but, if approved, all employees in the group must participate.

The primary source of funding for the plan (and the only source for state employees) is sick leave cash-outs, though the statute provides for other sources, including periodic employer contributions, group salary contributions, unused benefit dollars, percent of raise contributions, longevity payments, etc., as determined by collective bargaining agreements or a participating employer's policy (and as agreed to by the employee group). For state employees, sick leave cash-out contributions can only come at the time of separation, though other employee groups (e.g., from cities, school districts, etc.) may be able to contribute sick leave on an annual basis (that is, sick leave in excess of 240 hours in a given year). Participants can use their VEBA accounts to pay for qualified health care expenses on a tax-free basis. All contributions and investment earnings are tax free.

The creation of the Montana VEBA HRA represents a defined contribution approach to funding health care, one that shifts risk to the employee or retiree. Participants can use their VEBA accounts to pay for all or part of their health care premium costs, as their respective account balances allow. Such an approach is likely to be attractive to public employers looking for ways to continue offering retirees the benefit of health care coverage while simultaneously looking to control their unfunded OPEB obligations.

OPEB Bonds

In addition to the various OPEB prefunding mechanisms, state and local governments have choices about how to raise funds to deposit into OPEB trusts. Current evidence suggests that many governments will continue to fund their OPEB obligations on a pay-as-you-go basis, at least in the short run and until some of the

Table 2. *Likelihood of State and Local Governments Issuing OPEB Bonds*

	Municipal+			State^		
	Already Adopted	Likely to Adopt	Unlikely to Adopt	Already Adopted	Likely to Adopt	Unlikely to Adopt
*In the next five years, how likely do you think your state/local government is to issue **OPEB bonds** to finance its unfunded liabilities for retiree health care (OPEB)?*	.05% (1)	2% (43)	43% (907)	0% (0)	6% (3)	38% (19)

**Survey responses were collapsed such that answers for "Very Likely to Adopt" and "Likely to Adopt" are included under "Likely" and answers for "Unlikely to Adopt" and "Very Unlikely to Adopt" are included under "Unlikely."*
+ N = 2,136. Remaining percentages are missing values.
^ N = 50. Remaining percentages are missing values.

uncertainty surrounding OPEB is cleared up (Kearney 2008). For governments that do opt for prefunding, most will attempt to make annual required contributions (ARC) as determined by actuarial valuations or, minimally, to make modest annual payments (i.e., above the annual normal costs) into OPEB trusts until they are able to meet the ARC. Such an incremental approach makes sense because, in comparison with the pay-as-you-go approach, meeting the ARC entails substantially larger annual payments.

Using OPEB bonds to finance liabilities is an alternative financing option, albeit a potentially risky one. Similar to pension obligation bonds, OPEB bonds involve raising cash by selling bonds and then using that cash to prefund OPEB liabilities. The approach is based upon the idea that the government issuing the OPEB bonds will be able to invest the cash, earning returns that exceed debt service costs. As noted by the Government Finance Officers Association (2007), which urges considerable caution for governments contemplating OPEB bonds, the approach is risky for a number of reasons, including the volatility of OPEB actuarial valuations (due to uncertain health care costs), the fact that health care benefits are not necessarily guaranteed benefits (hence they could be reduced or even eliminated), and uncertainty about federal health initiatives that could have an impact on OPEB. As shown in Table 2, the use of these bonds is rare, though there appears to be some very slight interest. It should be noted that in addition to state and local governments, a handful of school districts have already utilized OPEB bonds, with mixed results (see Miller 2008). Two examples are briefly considered here: the city of Gainesville, Florida and Oakland County, Michigan.[11]

The city of Gainesville has demonstrated a consistent history of paying in excess of yearly required (pay-as-you-go) contributions to build up funding for health care liabilities. In 2004, the city had prefunded 23 percent of its health care liability and decided to investigate the possibility of using OPEB bonds to fully fund the rest of its actuarial obligation (city of Gainesville 2005).

In 2005, the city became one of the first local governments, if not *the* first, to prefund OPEB obligations through the sale of OPEB bonds. Over $35.2 million dollars in bonds were issued (at coupon interest rates of 4.05 to 4.71 percent), which at the time fully funded the city's retiree health care liability. In response to the budget impacts of the bonds and other fiscal policy changes, a rating agency upgraded the city's debt to A+ (from A) because it believed the city's approach to managing debt and cash flow had improved (Fitch Ratings 2005). The debt service payment (interest plus principal) for 2009 is estimated to be $4.5 million and will increase annually through October 2014 ($7.8 million) when the bond issue will be completely amortized. As structured, the city anticipates savings of approximately $7 million over the 10-year bond period.

In its 2008 Comprehensive Annual Financial Report (CAFR), Gainesville reported OPEB assets of $48.3 million and an actuarial accrued liability of $57 million, for a funded ratio of about 85 percent for the city's OPEB liabilities. In comparison with most public employers, this represents an enviable OPEB funding situation. It is worth noting, however, that the city's OPEB trust fund has incurred losses in the current market turmoil. From the 2007 to 2008 actuarial valuation, the value of the city's OPEB assets fell by $10 million (from $58.2 to $48.3 million). Interestingly, the funded status actually *improved* due to changes in the city's OPEB plan. In addition to establishing an irrevocable trust into which the city's OPEB assets were deposited, the city altered retiree benefits with a modest tiering plan. The effect was to reduce the total actuarially determined OPEB liability from $74.9 million in 2007 to $57 million in 2008.

Oakland County, Michigan, is another noteworthy local government for its multi-faceted approach to addressing OPEB liability, an approach that includes the issuance of OPEB bonds. Oakland County began prefunding its retiree health care liabilities in 1987, when the county eschewed the pay-as-you-go approach in favor of calculating accrued liabilities and funding the associated ARC. According to a report by the county executive (Oakland County 2006), the county experienced a cumulative increase in health care costs of 86 percent between 1999 and 2005, with the rate of increase being most pronounced (173 percent) for retirees. That, coupled with changes to the actuarial assumptions (per GASB 45) used in calculating the ARC for the retiree health plan,[12] resulted in ARC increases of 30 percent from 2005 to 2006 and an additional 46 percent from 2006 to 2007. Facing the prospects of tough budgetary tradeoffs if the ARC was to be met, the county considered OPEB bonds.

As discussed in its 2008 CAFR,[13] the county issued $557 million in taxable certificates (at a rate of 6.23 percent over 20 years) in July 2007 to fund its OPEB liability. The proceeds were deposited in a newly established trust, the Interim Retiree Medical Care Benefits Trust, which in turn is used to fund the ARC for the county's VEBA. Oakland County's VEBA is an irrevocable trust established for the purpose of paying retiree health care costs. Similar to Gainesville, Oakland County's OPEB trust has experienced recent investment losses: for the fiscal year ending September 2008, investment income losses totaled $54 million. Still, as in the preceding years, the county was able to fully fund its $60.2 million ARC in 2008.

In addition to the OPEB bond-funded VEBA, the county established a new defined contribution retirement plan for employees hired after January 1, 2006. These newer employees are enrolled in a retirement health care savings plan. They are partially vested (at 60 percent) in the plan after 15 years and the vested amount grows (at 4 percent annually) until 100 percent vesting is achieved after 25 years. Together, the county expects these efforts to generate OPEB savings of $100 million over 20 years.

In sum, the use of OPEB bonds to prefund liabilities is not widespread, and it is unclear how the prevailing economic environment will affect receptivity to OPEB bonds. The marketplace for issuing debt—and perhaps more important, finding buyers for that debt—has undergone radical change in past year. Miller (2009), who has urged caution for governments considering OPEB bonds, recently suggested that the time may be ripe for issuing debt as the "benefits bonds window" (i.e., the point in time near the bottom of a recession when investors seek the relative safety of government debt) for issuing such debt may be opening soon.

Conclusion

Overall, retiree health care is a popular benefit offered across the vast majority of both state and local governments. Currently, however, most governments are not dealing with the long-term costs of this benefit because they primarily utilize pay-as-you-go funding, and, as suggested by our survey data, most indicate no plans to adopt prefunding mechanisms in the near future. However, as time passes, the amount of funding required to fund ever-increasing OPEB costs will likely—absent radical changes to the structure of retiree health plans—render pay-as-you-go an unattractive and unsustainable option. As this brief has shown, state and local governments have several options to consider for prefunding OPEB liabilities, though GASB 45 does not require them to do so. Still, we anticipate that those who do will likely follow Oakland County's approach, addressing OPEB liabilities in a multi-faceted fashion.

Epilogue

In the weeks since this issue brief was originally drafted, one of the states profiled, West Virginia, has moved more aggressively to limit its estimated $7 billion unfunded OPEB liability. Following a series of public hearings across the state, the Public Employees Insurance Agency (PEIA) voted to eliminate retiree health care subsidies for all employees hired after July 1, 2010 (PEIA 2009). If the change is enacted, West Virginia will become one of the first states—if not *the* first—to fundamentally alter the structure of retiree health care by removing subsidies entirely.[14] New employees could, upon retirement, still buy retiree health care, but state subsidy (currently estimated at 72 percent) would be eliminated.

Despite the boldness of PEIA's recent action, uncertainty remains as to whether the subsidy elimination will stick. Not surprisingly, participants in the aforementioned public hearings demonstrated strong opposition to the change. For their part, PEIA officials feel they have little option but to move forward with the subsidy elimination given the seemingly unsustainable costs of OPEB. Public employees and unions, in contrast, are concerned about the effects the elimination will have on government's ability to recruit new employees and on retirees' income and health security. One teachers' union, West Virginia Education Association, is proceeding with legal action challenging the PEIA's decision (Saxton 2009). Meanwhile, Governor Joe Manchin is attempting to forge a compromise, working collaboratively with various stakeholders to craft legislation by year's end that will both assuage employee and union fears and allow the state to make meaningful progress in addressing its unfunded OPEB liability. Successful or not, West Virginia will no doubt be one of the most watched states in the coming months as governments across the country look for ways to address their own OPEB challenges.

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Endnotes

1 Separate mail surveys of state and local governments were carried out between December 2007 and March 2008. In both cases, the surveys followed the tailored design method (Dillman, 2000), which entails multiple contacts with survey targets to increase response rates. For more complete details, please see previous issues briefs on OPEB prepared for the Center for State and Local Government Excellence.

2 It should be noted that in April 2004, GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (GASB 43). GASB 43 establishes financial reporting requirements for OPEB plans (e.g., stand-alone financial reports for OPEB trust funds or for retirements systems), whereas GASB 45 established the same for OPEB plan sponsors, namely state and local governments.

3 Since the survey, several states have, in fact, adopted governmental trusts, including West Virginia as discussed in the brief.

4 It should be noted that actuarial assumptions cut both ways: In the 2008 valuation (CCRC 2008), the discount rate was again changed, but this time downward to 3.72 percent. The result of this change alone was to increase the unfunded actuarial accrued liability by $1.6 billion. All told, changes in assumptions placed the total OPEB liability back to $6.4 billion, an increase of about 107 percent.

5 Source: Aon Consulting. Montgomery County Government: Post-Employment Benefits Other than Pension Actuarial Valuation (as of July 1, 2007). http://www.montgomerycountymd.gov/content/finance/OPEB/ActuarialValuations/GASB_Valuation_Report_072007.pdf

6 In fact, the state sued its actuary, Mercer Human Resource Consulting, Inc., for $1.8 billion, claiming that the firm's miscalculations (e.g., the growth rate of health care costs) contributed to the pension system's woes. See S. Cockerham, "State Seeks $1.8 Billion in Pension Case," *Anchorage Daily News* (12/07/2007).

7 The report is available at: https://www.opers.org/pubs-archive/investments/cafr/2007-cafr-hires.pdf#zoom=80

8 OPERS posts quarterly estimates of its investment performance at https://www.opers.org/investments/health-care/total.shtml

9 This discussion draws from material posted on the Montana VEBA HRA's website: http://www.montanaveba.org/

10 See the Voluntary Employees' Beneficiary Association Act, Montana Code 2-18-1301: http://data.opi.state.mt.us/bills/mca_toc/2_18_13.htm

11 Another OPEB case worthy of consideration is the Peralta Community College District, California. In December 2005, the district sold $153.7 million of OPEB bonds. The district's case is interesting because its bond proceeds were not deposited into an irrevocable trust, as was the case in Gainesville and Oakland County. The district has also engaged in a series of interest rate swaps in an attempt to manage risk associated with its 2005 bond sale, which was structured with six bond series with variable interest rates. In February 2009, the district issued $49 million of taxable OPEB refunding bonds for the purpose of refinancing a portion of its original 2005 bond sale. As this demonstrates, prefunding with OPEB bonds and serving the debt can be quite complicated. An independent audit of the district's financial reporting found several material weaknesses associated with it OPEB bond reporting. For more see: http://www.peralta.cc.ca.us/Projects/403/Peralta_CCD_-_Annual_Financial_Report_2008.pdf

12 These changes included decreasing the amortization period from 40 years to 30 years and changing from a percent of payroll to a level dollar approach (associated with closing the traditional retiree health care plan to new members after January 1, 2006) in determining the ARC.

13 Available at http://www.oakgov.com/fiscal/assets/docs/2008_cafr.pdf

14 It should be noted that several other states have never offered these subsidies in the first place, leaving it to retirees to cover their own retiree health care premiums (though, perhaps, at the same rates as active employees, thereby creating an "implicit subsidy" under GASB).

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