Agenda Date: 4/10/2007
Agenda Placement: 9A

NAPA COUNTY BOARD OF SUPERVISORS
Board Agenda Letter

TO:	Board of Supervisors
FROM:	Britt Ferguson for Nancy Watt - County Executive Officer County Executive Office
REPORT BY:	Helene Franchi, Senior Management Analyst, 253-4820
SUBJECT:	Other Post Employment Benefits (OPEB) Discussion

RECOMMENDATION

County Executive Officer and Auditor-Controller request that the Board accept the Draft Retiree Healthcare Plan Actuarial Valuation January 1, 2006 and adopt a policy of fully funding the County's Other Post Employment Benefits (OPEB) obligations on the following basis:

- Contract with CalPERS to act as the custodian of the County's funds in an irrevocable trust;
- For FY 2007-08, contribute $5.9 million to CalPERS for this purpose, which will more than cover the County's FY 2007-08 cost of purchasing retiree health insurance and start to amortize (or pay-off) the County's current OPEB unfunded liability over 14 years;
- Toward the end of FY 2007-08, reevaluate the various OPEB issues and the County's fiscal condition and make a decision to continue amortizing the cost of fully funding the County's OPEB unfunded liability over 14 years or change to a 20 or 30 year amortization schedule; and
- Consistent with the Board's Budget Policies, $4.1 million of the FY 2007-08 OPEB funding would come from canceling the County's OPEB Designation in the General Fund.

EXECUTIVE SUMMARY

As the Board is aware, the Government Accounting Standards Board (GASB) issued "Statement 45", requiring states and local governments to report the unfunded accrued liability of non-pension retiree benefits (Other Post Employment Benefits (OPEB)) on the financial statements. Prior to this ruling, state and local governments typically accounted for OPEB costs on a pay-as-you-go basis. In November, John Bartel of Bartel & Associates, LLC presented the Board with a draft actuarial report regarding the County's OPEB liability. The report identified the County's unfunded liability at between $37 million and $51 million. Of Mr. Bartel's 48 public agency clients, Napa County's unfunded liability ranks in the bottom 26th percentile.

The attached report from Bartel Associates outlines the County's benefit obligations as of January 1, 2006, including the County's OPEB unfunded liability, and identifies the cost of fully funding that unfunded liability under different amortization schedules.

The issue before the Board today is to determine whether to continue funding retiree health insurance costs on a pay-as-you-go basis, or pre-fund (that is pay down the unfunded liability through contributions to an irrevocable trust) and, if the latter, to decide on the time period to fully fund (or amortize) the County's unfunded liability. If the County continues to fund its OPEB obligations on a pay-as-you-go basis, in 30 years the County's annual cost will be approximately $14 million ($3.8 million in real, or present-valued dollars), but the County's unfunded liability will have grown to over approximately $286 million and that unfunded liability will continue to grow in future years. Staff is recommending that, subject to negotiations with CalPERS: (1) the Board approve a FY2007-08 contribution of $5.9 million, which will cover the County’s FY2007-08 cost of purchasing retiree health insurance ($1.8 million) and an amount needed to amortize the County’s current OPEB unfunded liability over 14 years; and (2) toward the end of FY2007-08, the County re-evaluate the various OPEB issues and the County’s fiscal condition and make a decision to continue amortizing the cost of fully funding the County’s OPEB unfunded liability over 14 years or change to a 20 or 30 year or some other amortization schedule.

Also attached is a fact sheet that describes the Other Post Employment Benefits provided to Napa County employees.

FISCAL IMPACT

Is there a Fiscal Impact?	Yes
Is it currently budgeted?	No
What is the revenue source?	The bulk of the County's OPEB costs would need to come from the General Fund. As proposed, there would be no cost in FY2006-07. For FY2007-08, the County can cancel a $4.1 million designation to cover part of the cost. The annual cost of purchasing health insurance for the County's retirees is typically budgeted in the Employee/Retiree Benefits budget unit in the General Fund.
Is it Mandatory or Discretionary?	Discretionary
Discretionary Justification:	See the Background section of this agenda item.
Is the general fund affected?	Yes
Future fiscal impact:	The cost for FY2007-08 would be approximately $5.9 million. The cost in future years would depend on whether the County continues to amortize the cost on a 14 year schedule or changes to a 20 or 30 or some othe schedule.
Consequences if not approved:	See the Background section of this agenda item.
Additional Information:	

ENVIRONMENTAL IMPACT

There is no Environmental Impact for this item.

BACKGROUND AND DISCUSSION

As reported to the Board in November of 2006, the Governmental Accounting Standards Board (GASB) has established standards for the measurement, recognition, and reporting of costs associated with Other (than pensions) Post Employment Benefits (OPEB) which are offered by many state and local government employers as part of a total compensation package for employees. OPEB includes retiree healthcare benefits, as well as other forms of post employment benefits such as life insurance, dental insurance, and optical coverage. The GASB standards address financial statement and disclosure requirements for reporting OPEB expenses and related accrued liabilities.

Because OPEB expenses constitute compensation for employee services, they are considered part of the overall salary and benefit package. The County, as is typical for local and state agencies, has accounted for this obligation using a "pay-as-you-go" methodology. Under GASB 45 the County and all other public employers are required to recognize and report in financial statements the value of the benefits.

Under the "pay-as-you-go" methodology costs are reported on a cash basis only after an employee retires as part of the normal operating expenses in a given year. GASB 45 requires the accrual and reporting of the estimated cost of the benefits in financial statements each year during the years that employees are providing services to the County. By identifying the accrued liability associated with these benefits the amount of any unfunded liability can be calculated. Recognizing and reporting this unfunded liability more accurately reflects the true cost of the services the County provides to its constituents.

During the presentation in November, the Board discussed the advantages of pre-funding the County's OPEB liability and directed staff to look at funding alternatives. To consider a retiree healthcare plan pre-funded for GASB 45 purposes, assets must be set aside in an irrevocable trust that cannot, legally, be used for any purpose other than to pay retiree healthcare benefits. This is similar to the situation that currently exists with regard to PERS pension benefits. A plan with assets not set aside in an irrevocable trust is not a pre-funded plan under GASB 45. This has significant implications on the discount rate assumptions used to calculate plan liabilities.

Some of the advantages to pre-funding pointed out by CalPERS in a September 2006 circular letter are:

- By not pre-funding, the employer's credit rating might be affected, making it difficult or more expensive to issue bonds;
- Earnings on assets reduce employer contributions significantly;
- Investment return assumption (discount rate assumptions) will be higher, making annual expense and the unfunded liability lower;
- Prevents net OPEB obligation from becoming a significant liability on balance sheet; and
- Enhanced security for members.

As of January 1, 2006, the County had an Unfunded Actuarial Accrued Liability (UAAL) for retiree healthcare benefits of approximately $34 million. This represents the amount of the liability earned at the valuation date that must still be funded. In Fiscal Year 2006-07, the County established a designation of $4.1 million for purposes of the OPEB liability.

In his report today, Mr. Bartel has identified the County's benefit payments in FY 2006-07 and 2007-08 (that is the amount required to pay health insurance premiums for current retirees) as $1.5 million and $1.8 million, respectively. If the County continued to pay those annual insurance premiums on a pay-as-you-go basis, the annual costs would increase to approximately $14 million at the end of 30 years and the unfunded liability at the end of that period would be approximately $286 million. The issue before the Board today is whether to continue to pay for retiree health insurance costs on a pay-as-you-go basis, or pre-fund (that is pay down the unfunded liability through contributions to an irrevocable trust) and, if the latter, to decide on the time period to fully fund (or amortize) the County’s unfunded liability.

Pay As You Go or Pre-Fund?

From staff's perspective it makes sense to pre-fund the County's unfunded liability, primarily for the reasons identified by CalPERS in its September 2006 circular identified above. As indicated, if the County continues to fund its OPEB obligations on a pay-as-you-go basis, in 30 years the County's annual cost will be approximately $14 million ($3.8 million in real, or present-valued, dollars), but the County's unfunded liability will have grown to over approximately $286 million, and that unfunded liability will continue to grow in future years. In addition, it is becoming clear that bond rating agencies will likely exact a significant penalty in terms of ratings (and thus interest rates) from those local governments that are not pre-funding, though it is not clear at this point what level of pre-funding the rating agencies will expect.

There are, however, two concerns with pre-funding:

- First, while generating cost-savings in the long term, pre-funding can result in significant additional costs in the near-term. For example, compared to pay-as-you-go, pre-funding on a 14 year amortization schedule would cost the County roughly an additional $18 million ($16 million present-valued) in the first five years and $41 million ($34 million present valued) in the first 20 years, while yielding a savings of $5 million ($19 million in additional cost on a present value basis) over 30 years (over 50 years the County would achieve cost savings on a present value basis as well).

- Second, money set aside in an irrevocable trust cannot be used to meet any other County needs that may arise (including disasters or other emergencies). It is also possible, though not likely that the County's irrevocable trust could become super-funded (that is, have more assets than needed to cover the County's OPEB liabilities). In that case, money that could otherwise be used to fund County operations would be unavailable.

From staff's perspective, these are legitimate concerns, though they can be addressed in part by the amortization schedule the County utilizes. For example, by utilizing a 20 year amortization schedule rather than a 14 year schedule, the County could reduce the average annual cost in the early years by approximately $500,000 (in non-present valued dollars). If a 30 year amortization is used, the average annual cost in the early years could be reduced by approximately $1 million (again, non-present valued) compared to the 14 year amortization schedule. In addition, if the County decides to pre-fund it would be important to closely monitor and continually re-evaluate the level the County's pre-funding status to minimize the downside risk. Ultimately, though, the downside of not pre-funding in terms of bond ratings and concerns about saddling future generations with significant unfunded debt, convinces staff that pre-funding at some level is the appropriate course to take.

Alternative Pre-Funding Schedules

In terms of the amortization schedule, the report from Bartel Associates looks at three long-term options for pre-funding the County's unfunded OPEB liability and covering annual insurance costs:

- A 14 year amortization;
- A 20 year amortization; and
- A 30 year amortization.

In all cases, these amortization schedules would result in fully funding, or eliminating, the County's unfunded liability by the end of the amortization period.

Key numbers associated with these three options can be summarized as follows:

AMORTIZATION OPTIONS (Approximate Cost in Thousands of Dollars)

	Pay as You Go	14 Year	20 Year	30 Year
Annual Cost Year 5	$2,500	$ 6,100	$5,400	$4,800
Cumulative Cost Year 5	$9,800	$28,200	$25,200	$22,200
Present Value - Annual Cost Year 5	$2,100	$4,100	$4,600	$4,100
Present Value - Cumulative Cost Year 5	$8,900	$25,900	$23,100	$20,400
Annual Cost Year 20	$7,600	$5,000	$9,900	$8,900
Cumulative Cost Year 20	$87,100	$128,200	$140,500	$125,300
Present Value - Annual Cost Year 20	$3,400	$2,300	$4,500	$4,000
Present Value - Cumulative Cost Year 20	$54,200	$88,000	$92,000	$82,000
Annual Cost Year 30	$14,000	$8,300	$8,300	$8,300
Cumulative Cost Year 30	$205,000	$202,600	$214,000	$246,600
Present Value - Annual Cost Year 30	$3,800	$2,400	$2,400	$2,400
Present Value - Cumulative Cost Year 30	$95,500	$114,700	$118,100	$124,800

As can be seen, as a general rule, the longer the amortization schedule, the lower the near-term costs but the higher the total cost to the County. So, for example, in the first five years the cumulative present value cost of amortizing the County's OPEB unfunded liability over 14 years is approximately $5.5 million higher than the cost of amortizing the liability over 30 years. At 30 years out, however, the cumulative present-value cost of a 14 year amortization is approximately $10.1 million lower than the cost of the 30 year amortization.

Based on the above, staff concludes that if long-term cost savings to the County were the only consideration, it would make sense to select a shorter rather than longer amortization schedule. However, long-term cost savings cannot be the only consideration. Other considerations include shorter-term cash flow requirements and the need to meet other critical expenditure obligations and uncertainty regarding the longer term status of employer-provided healthcare. In addition, it is not clear at this point how the bond rating agencies will react to different pre-funding scenarios. Thus far, the rating agencies have indicated that they will expect some level of pre-funding, but not specified what criteria they will use to determine how a particular approach will effect a local government's ratings. Staff is confident that a 14 year amortization will be looked on very favorably by the rating agencies. It is likely that a 20 year and even a 30 year amortization will be viewed favorably, though not as favorably in terms of bond ratings as a 14 year amortization.

Taking everything we know at this point into consideration, staff's recommendation is that, subject to negotiations with PERS (see below): (1) the Board approve a FY2007-08 contribution of $5.9 million, which will cover the County's FY2007-08 cost of purchasing retiree health insurance ($1.8 million) and an amount needed to amortize the County's current OPEB unfunded liability over 14 years; and (2) toward the end of FY2007-08, the County re-evaluate the various OPEB issues and the County's fiscal condition and make a decision to continue amortizing the cost of fully funding the County's OPEB unfunded liability over 14 years or change to a 20 or 30 year or some other amortization schedule. Staff makes this recommendation for the following reasons:

- A critical unknown factor as this point is how the bond rating agencies will look at different levels of pre-funding. At the present time staff is certain that a 14 year amortization schedule will be looked on very favorably and believes that a 20 or 30 year amortization may be looked on somewhat less favorably, though still positively. However, the exact impact of the longer amortization schedule on bond ratings is unknown. Hopefully, within a year, better information will be available about what other local governments are doing and how the rating agencies are reacting.
- Because the Board prudently set aside $4.1 million in a designation for OPEB pre-funding, the County is in the position of being able to pre-fund in FY2007-08 at the 14 year amortization level without impacting other expenditures. That designation will not be available in future years, however, and the cost of pre-funding the County's OPEB liability will need to be balanced against other County program needs. Fortunately, because Napa County's unfunded liability is relatively small compared to many other agencies, we are in a better position to afford a shorter amortization schedule generally.
- The County is currently or will soon be in negotiations with both labor unions that represent County employees. The outcome of those negotiations could have a significant impact on County's fiscal situation. Once available, that new information can be taken into account in evaluating the County's OPEB options.
- Pre-funding as much of the OPEB unfunded liability as early as possible results in higher investment earnings and thus reduces the long-term cost to the County.

Establishing an Irrevocable Trust

As noted above, the County will only receive the benefits of pre-funding if the money set aside to fund the County's unfunded liability is placed in an irrevocable trust. This can be accomplished in a number of ways, including the County establishing such a trust with a financial institution. In addition, CalPERS has recently been authorized to provide these services to its members. Staff believes that, given CalPERS' expertise and investment track record, using CalPERS' services in this area would be the most prudent course of action. At this point, however, there is still uncertainty concerning the CalPERS OPEB trust. Thus, staff's recommendation is to authorize the County to deposit our OPEB unfunded liability contributions into a CalPERS irrevocable trust, provided the CalPERS contract does not place undue restrictions on the County.

Future OPEB Costs

Finally, it should be noted that, in addition to evaluating issues related to OPEB unfunded liability scenarios, staff is examining a number of approaches that could be used in the management of future OPEB costs, including sharing these costs with our employees. This option, if pursued, would need to be negotiated with our employee unions to seek their participation in the management of these costs. Other options may include negotiating a change in benefit structure and/or consideration of a defined contribution plan rather than the current defined benefit plan. A combination of two plans is also possible. These matters must be addressed at the bargaining table with the unions representing County employees. Staff recognizes the importance of pre-funding this obligation and is committed to working with the County's employees to insure fair and equitable benefits.

SUPPORTING DOCUMENTS

A . Retiree Healthcare Plan Actuarial Valuation Executive Summary

B . Retiree Healthcare Plan Actuarial Valuation Jan 2006 Full Report

C . Fact Sheet on OPEB for Napa County Employees

CEO Recommendation: Approve

Reviewed By: Helene Franchi