

## **Unfunded Public Employee Health Care Benefits and GASB 45**

### **SYNOPSIS**

The Government Accounting Standards Board (GASB) recently released Statement 45, *Accounting and Financial Reporting by Employers for Post-Employment Benefits Other than Pensions* and its companion Statement for pooled stand-alone health care plans, Statement 43, that will profoundly affect American governmental finance. This paper will review Statement 45's potential impact on governments and review existing disclosures in financial reports as well as bond offering statements. The paper will discuss the Statement's impact on budgets and governmental operations, including collective bargaining. Funding options under Statement 45 will be detailed, including the advantages and disadvantages of irrevocable trusts and OPEB bonds. The paper will also discuss the impact of Medicare Part D subsidies received by governments, as well as the bond rating implications of policy decisions surrounding OPEB. Finally, the paper will discuss the currently limited state case law related to restructuring of benefits.

## **Unfunded Public Employee Health Care Benefits and GASB 45**

### **INTRODUCTION**

Government Accounting Standards Board (GASB) Statement Number 45, *Accounting and Financial Reporting by Employers for Post Employment Benefits Other than Pensions*, represents a significant change in governmental accounting and financial reporting that may substantially influence on financial decision-making over the next decade. The goal of this article has been to encourage governments to consider carefully a full range of options in funding and restructuring OPEB benefits. The new standards will require state and local governmental entities to disclose the full cost of non-pension-related retirement benefits. The potential liabilities are substantial. Published estimates of the entirety of the 88,000 state and local governments OPEB liabilities have been quoted at \$1 trillion (McTague 2006); however, the efficacy of this estimate will not be known until 2010 when all entities are required to provide estimates.

#### **How Did the Problem Get to Be So Big?**

An estimated 15.9 million full-time equivalent people worked in state and local government in July 2005, representing between 10-15% of the US labor force (US Census Bureau 2006). Several features distinguish government from private employees: Public sector employees are more likely to be eligible for health benefits during their employment (between 82 and 84 % of public sector workers versus 69.3 % of private-sector workers), and more accept the coverage that is offered (87.4 % of local government employees and 90.4% of state government employees compared to only 84.2 % of private sector workers) (Employee Benefit Research Institute 2005b). More public sector employees have health insurance provided in retirement (92 % of state

governments offered health benefits to retirees under age 65 in 2002, up from 76 % in 1997, while 86 % offered health benefits to retirees ages 65 and older, up from 69 percent in 1997) (Employee Benefit Research Institute 2005c) The health insurance costs are higher for public employees; costs for single and family coverage are \$3,844 and \$8,755, respectively, in the governmental sector as compared to \$3,529 and \$8,429, respectively, in the private sector. In addition, governmental employers cover a higher share of the health insurance costs (85.8% and 78.5% for single and family plans, respectively, for the government, as compared to 76.9% and 71.5% for the private sector) (Agency for Healthcare Research and Quality 2003).

While information is quite limited at the municipal level, some data is available on recent OPEB costs for state governments. 41 states reported some contributions toward retiree health insurance beyond expenditures for sick leave conversion credits. Of this total, 30 financed the costs on a pay-as-you-go basis. The other 11 had a pre-funding arrangement, and their funded levels were often lower than those for pension benefits. Aggregate state spending on OPEB totaled \$4.4 billion, of which over \$3.8 billion (86%) were pay-as-you-go. The remaining 14% represented actual state contributions to plan assets, not the assets' OPEB expenditures. Overall, states were at risk of having large future cash outflows, if retirees continued to increase relative to workers and post-employment medical cost inflation continued to outpace the general inflation rate (Wisniewski 2005, Moody's Investors Service 2006).

### **Why Is This Problem Becoming Public Now?**

Routinely, OPEB benefits have been offered to public sector employees based on services rendered. Until GASB Standard 45, public entities that have generally offered

have funded them and disclosed these pre-defined benefits on a pay-as-you-go basis (PAYGO) rather than an accrual basis, a practice that ceased fifteen years ago in the private sector.

Beginning in 1967, accounting standards required private industry to disclose the cost of benefits attributable to an employee's years of service with regard to deferred compensation. In 1980, the Financial Accounting Standards Board (FASB) released Statement 35 that required accumulated pension benefits to be recorded at actuarial value (FASB 1980). As the Governmental Accounting Standards Board had not yet been created, these new standards applied to both public and private entities. However, governments agitated at that time to split from the FASB arguing that the bankruptcy of New York City in the late 1970s and other salient governmental issues that were not sufficiently addressed by FASB standards. In 1982, FASB issued Statement 59, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units — an amendment of FASB Statement No. 35*, upon a request of the newly formed National Council on Governmental Accounting (NCGA).

In 1985, FASB addressed pension reporting through Statement 87, *Employers' Accounting for Pensions*, which fully incorporated actuarial assumptions and returns. In 1990, FASB addressed the remaining retirement-related accounting issues in Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. At that same time, GASB issued its Statement 12, *Disclosure of Information on Post-employment Benefits Other Than Pension Benefits by State and Local Governmental Employers*. Though the accounting principles were not defined, disclosure was required

of benefits provided and the accounting principles followed. Most governmental entities responded by disclosing their OPEB costs on a pay-as-you-go basis.

GASB released their standards, GASB Statement 27, *Accounting for Pensions by State and Local Government Employers*, in 1997 and GASB Statement 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, in 1999. These two standards required disclosure of the unfunded pension liabilities for the first time but allowed delayed recognition over a forty-year period. OPEB costs were finally addressed in GASB Statement 45 in 2004, which uses as its basis the GASB pension standards. As the largest government entities are just now implementing GASB 45, estimates of the magnitude of unfunded OPEB liabilities is limited as are the strategies likely to be adopt to cover these obligations.

The basic tenets of GASB 45 are as follows<sup>1</sup>:

- Comprehensive Array of Costs: OPEB costs include not only health care costs, but also dental, vision, life insurance, disability, and long term care.
- Accrual Standards: The OPEB liability represents the unfunded actuarial accrued liabilities computed using accrual methods. The OPEB liability is increased by normal employee costs and decreased by employers' contributions to the plan and certain changes in value of the investment portfolio. However, this liability is not required to be fully recognized upfront, rather it allows deferred recognition.
- ARC Disclosure: The entity must disclose an actuarially required contribution (ARC). The ARC includes the normal cost for the year plus an amortized portion of the total unfunded actuarial accrued liabilities (or funding excess) of the plan.

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<sup>1</sup> The GASB plain-English language summary explains the standard and these terms in more depth. Unavailable at: [http://www.gasb.org/project\\_pages/opeb\\_summary.pdf](http://www.gasb.org/project_pages/opeb_summary.pdf)

- Limited (But Generous) Amortization: The total amortization period cannot exceed thirty years.
- Periodic Valuation: Valuations of any assets in a plan are to be estimated annually, while the valuation of the liability must be made at least every two years except for the smallest plans, which are triennial. These small plans with fewer than 200 employees may also use alternative measurement methods.
- Investment Assumptions: The standard requires that the valuation vary based on whether the governmental entity has in place an irrevocable trust that has regularly been funded at or above the ARC. If such a trust is in place, a long term investment return based on the actuarial rate of return of the underlying assets used to pay benefits (such as 8% in pensions) can be used; if not, then a short term rate based on a long-term view of short-term investments, inclusive of free cash (such as 2%) must be employed (Standard & Poor's 2004).
- Pension-like Disclosure Requirements: Financial report disclosures are similar to governmental pension disclosures.
- Disclosure of Rate Subsidies: The implicit rate subsidy paid by current employees to retirees and survivors must also be disclosed.
- Staged Implementation: Implementation is staggered with the largest governments implementing in FY2008, medium-sized governments (with revenues between \$10 million and \$100 million,) in FY2009 and all others in FY2010.

The GASB serves as an accounting standard-setter, which means it can require certain disclosure requirements but does not mandate financial actions. As GASB 45 addresses a complex issue, some misunderstandings have developed about what the

standard requires. Specifically, the standard does not address three issues: First, GASB 45 does not require contributions to an OPEB plan. However, if there are no contributions, the OPEB liability will continue to grow on the government's statement of net assets (i.e., its balance sheet.) This growth may add additional pressure when dealing with rating agencies, if the government does not have a funding plan and if the government's peers are managing the liability effectively. Second, for entities that budget largely on the cash basis, there is no budgetary impact with the implementation of GASB 45, unless the entity changes its annual contribution. Finally, statutory accounting in many states, reflect OPEB costs on the cash basis. So, if there is no contribution, there is no expenditure under the statutory basis of accounting.

#### **How Large will the new OPEB Annual Costs and Unfunded Liabilities Be?**

Under GASB 12, entities were required to report their most recent "pay-as-you-go" (PAYGO) expenditures. A Moody's Investor Service (2006) analysis of large cities, suggests that PAYGO expenditures ranged between zero to 9 percent of annual operating revenues in the 1997 to 2005 period with costs increasing over 10% per year.

GASB 45 will significantly increase annual OPEB expenses as governmental entities will be required to report a combination of the current PAYGO expenses and an amortization of the net unfunded liability. The Fitch rating agency estimates that the new OPEB actuarially determined annual contributions could surpass current PAYGO expenses by fivefold to tenfold. Standard & Poor's echoed these concerns and suggested that the unfunded OPEB liabilities might, in some instances, exceed the unfunded pension liability.<sup>8</sup>

State governments and the largest municipal entities are just now disclosing OPEB liabilities (see Table 1). Panel A provides the currently available information on state governments, while Panel B reports on larger municipal entities. At this point, many states and some cities have disclosed the actuarially determined unfunded OPEB liability but have not prepared annual financial statements that would offer more detailed information, such as number of plan participants, interest rate assumptions, or expected amortization periods. What can be observed from the more complete disclosures is the considerable variation in the unfunded liability per participant. However, OPEB liabilities cannot be judged by these numbers alone. To fully analyze the impact of this liability, the assumptions used in the calculation, the size of the employee, retiree and survivor population must be known and the government's portion of the contribution to OPEB costs versus the employee's contribution must be disclosed. An analysis must also include the discount rates and the medical cost trends used in each valuation. Amounts in the table below are gross of any Medicare Part D offsets taken into account before the release of the GASB technical bulletin (2006b) addressing the practice.

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Insert Table 1 Here

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As seen in Table 1, the potential costs vary considerably based on the level of promised benefits, key assumptions and funding scenarios. Having now measured the unfunded liability, governments must now decide how to respond. The rating agencies have yet to issue guidance about how they will assess the magnitude of the liability and evaluate the governments' efforts to control costs and fund the liability. Moody's (2006) offer one cash-flow-focused metric to assess the existing PAYGO burden, which is the ratio of annual PAYGO expenditures to net general fund operating revenues.

We recommend a set of additional measures. The unfunded OPEB liability could be assessed similarly to outstanding debt. The resulting ratios would be to compare this liability to Gross State Product, the state's personal income, or state population. Once the audited financials become available than the current annual OPEB burden can be evaluated. The ARC could be evaluated relative to total governmental revenues and covered payroll. The percentage of each year's ARC that is contributed could be computed. A third group of measures could address governments' long term ability to fulfill their OPEB obligations. These measures would compare ARC growth to the growth in the cost drivers of the OPEB liability, specifically the health care cost trend, growth in plan participation, and salary increases. As the health care cost trend rate is a major factor in the actuarial calculation, particular focus on this rate relative to the ARC is important.

### **THE CORPORATE EXPERIENCE**

To help better understand the range of options available to governmental agencies, it is helpful to examine the response of the private sector to recognizing OPEB costs. In 1990, FASB addressed the health care portion of benefits accounting in Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. The OPEB liabilities revealed by the new standards were substantial: Chrysler, Ford and General Motors reported one-time charges of \$4.7 billion, \$7.5 billion and \$23.5 billion, respectively (Haddad et al. 1995). The OPEB underfunding remains large: According to a December 2005 report by Standard & Poor's, the under-funded OPEB liability of the

Standard & Poor's 500 equaled \$292 billion, nearly double the unfunded pension liabilities reported by these same firms.

While the FASB and GASB OPEB standards differ in the allowable measurement and presentation choices, both sets of standards allow delayed recognition of the unfunded liability and discretion in determining key estimation parameters.<sup>2</sup> Two common responses to SFAS 106 by publicly traded corporations may serve as a guide to likely governmental responses: First, 10% of early (1991) adopters amended their OPEB plans, while 31% of 1992 adopters and 38% of 1993 adopters did so (Amir and Ziv 1997). Second, firms made a series of “strategic” reporting assumptions about their parameters. Firms with larger OPEB obligations and more leverage used more aggressive discount rates and health care cost trend rates, which helped to reduce the OPEB total. Conversely, firms that amended their plans and had extreme earnings-price ratios tended to make conservative assumptions, which helped to raise the OPEB total (Amir and Gordon 1996). Heavily unionized firms were also much more likely to elected immediate rather than delayed recognition of the OPEB liability (D’Souza et al. 2000).

### **LESSONS FROM EARLY GASB OPEB ADOPTIONS**

Having examined the effects of accrual-basis OPEB accounting on the private sector, we now consider some early OPEB disclosures. Relatively few governmental entities adopted an OPEB disclosure prior to GASB 45. Due to its financial strength arising from mineral revenues, the State of Alaska started funding OPEB in the 1980s and had funded \$1.9 billion of a \$2.7 billion actuarially accrued liability as of June 30,

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<sup>2</sup> For a more detailed rationale for these differences, see “Why Governmental Accounting And Financial Reporting Is—And Should Be—Different”, a 2006 GASB White Paper available at: [http://www.gasb.org/white\\_paper\\_main.pdf](http://www.gasb.org/white_paper_main.pdf).

2003 (State of Alaska 2005). The City of Orlando, Florida, generally regarded as a governmental entity with high quality financial reporting, partially adopted GASB 45 in its 2004 Comprehensive Annual Financial Report (CAFR). It undertook the required actuarial valuation and disclosed that the result of the OPEB valuation process had been to terminate OPEB benefits for employees hired after January 1, 2006 (City of Orlando, Florida 2004). It also disclosed that it was a PAYGO entity and as it adopted early, it chose not to disclose how it planned to amortize the OPEB costs. The City of Newton, Massachusetts undertook its actuarial valuation earlier than required and disclosed the unfunded OPEB liability under the no-trust fund and trust fund scenarios in its 2005 CAFR (City of Newton, Massachusetts 2005). Having completed an actuarial valuation in advance of the required implementation date, the City elected to disclose this material information but deferred adopting the complete requirements of GASB 45.

While GASB 45 outlines the requirements for disclosure in the audited financial statements, it does not address disclosure in other statements, such as a bond official statement. State and local governments are exempt from securities-related registration and filing requirements, they are still subject to certain provisions of the securities laws and regulations, most notably the anti-fraud provisions. The enforcement of these provisions falls under the purview of the Securities and Exchange Commission (SEC). The State of Maryland undertook an actuarial valuation that was nearly \$23 billion (gross of the Medicare Part D subsidy) and chose not to disclose this valuation in an April 2006 bond offering statement. When interviewed, Cecilia Januszkiewicz, Maryland's secretary of budget and management stated: "[E]verybody knew the state had an OPEB liability and had already started putting money aside to pay for it.... We have a triple-A bond

rating from each of the bond rating houses, we discussed with them these liabilities, we discussed what we were doing about them, and we got the triple-A rating.... They reaffirmed our triple-A rating, so I mean what more can we say?"(Ackerman 2006). Martha Mahan Haines, chief of the SEC's Office of Municipal Securities took a different view: "Issuers should include material information about OPEB liabilities in disclosure documents as soon as they are known, even if the final numbers are not yet available. GASB's effective dates for inclusion in financial statements do not justify withholding information from investors." (Ackerman 2006). Clearly, issuers of bonds need to be very careful as to the timing and the extent of disclosure even when draft OPEB numbers become available to management.

## **BUDGETARY IMPACTS UNDER DIFFERING ASSUMPTIONS**

### **When Funding is Pay-As-You-Go**

Most governments do not budget on a GAAP basis. Rather, they use a modified cash method. Budget expenditures are cash outflows, so budget decisions are based on expected cash flows out into the future. Since GASB 45 does not require that post-employment benefits be funded, governments can continue to follow PAYGO with no effect on the budget. However, a portion of the unfunded OPEB liability will be disclosed in the Statements of Net Assets. This amount equals the unfunded OPEB balance sheet amount from the prior period, plus the ARC, less the amount actually funded by the governmental entity. As the PAYGO amounts will generally be less the ARC, the OPEB liability on the balance sheet will grow markedly over time as it represents the cumulative annual differences between contributions made and the ARC.

The City of Newton offers a good example of how dramatic a change can be over time. From 2004 to 2005, the actuarial accrued liability grew from nearly \$520.5 million to \$654.2 million, an increase of over \$133.7 million or nearly 26%. In contrast, the General Fund spending from 2004 to 2005 was only 4% (City of Newton, Massachusetts 2004). Unless the Board of Aldermen in Newton decides to dramatically change the way that their post–employment benefits are funded or offered, this liability will likely grow at a rate far above that of the operating budget.

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INSERT FIGURE 1 HERE

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Figure 1 depicts this phenomenon using Newton’s amortization schedules of its liability, which was provided to the authors. Newton assumed an escalation of its “normal” cost of 10% in 2007, ranging down to an ultimate rate of 6% in 2014. Normal costs are the additional retiree benefit costs incurred due to employees working during a particular year. As can be seen, Newton is paying the majority of its costs, if it chooses to pay only the normal cost. However, even the normal costs are growing at a far faster rate than the general fund spending. So, new growth in tax revenues will have to pay these bills. Since the full ARC is not being paid, a balance sheet liability will grow at 5% per year. This liability represents an ever growing portion of the unfunded liability (or legacy costs) as of 2006. In 2036, at current assumptions, \$57.1 million will still be owed to participants for 2006 costs (the blue segment in the graph).

The amortization schedule may differ substantially for governmental entities whose employee age distributions differ substantially from Newton’s. 53% of Newton’s active, inactive and retired employees are over 45, which may reflect well the demographics of larger and older communities. In an article in the February 2006

Governing Magazine, a Rockefeller Institute 2002 study was quoted, stating that at that time, 46.3 percent of government workers were 45 or older, compared with 31.2 percent of private-sector workers. The Commonwealth of Massachusetts's actuarial valuation noted that the average age of the Commonwealth's employees is approximately 46.

### **Under Partial or Full Funding and the Role of Revocable and Irrevocable Trusts**

If a government funds more than its PAYGO costs, it is considered to be, at least, partially funded. Depending on the vehicle that is holding these funds, the government may be able to make a case to use a higher rate of return. The success of making this case will cause a dramatic lowering of a government's liability. In Newton's case, the unfunded rate of return used was 2%, which is the applicable investment return. The funded rate of return used was 8%, a rate undoubtedly similar to the City's rate of return on its pensions. Instead of \$654.2 million, the City's unfunded liability was cut by over 63% to \$240.9 million on June 30, 2006. Though still large, \$240.9 million is far more manageable than \$654.2 million.

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INSERT FIGURE 2 HERE  
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Figure 2 overlays the fully funded with irrevocable trust fund liabilities onto the PAYGO scenario. As can be seen in Figure 2, if Newton fully funds OPEB, the bottom two slices are far less in later years than if unfunded. Partial funding would move the amortization curve somewhere in the middle. Partial funding creates challenges in estimation since the rate of return calculation will depend on a weighted average of assets to total ARC.

The key to achieving this lower amortization is to fund it with cash contributions into an irrevocable trust. GASB defines a contribution as payments to retirees or

beneficiaries, associated payments to insurers, an irrevocable asset transfer to a trust, or a similar arrangement, in which plan assets are dedicated to providing benefits to retirees and their beneficiaries. Governments cannot designate assets, or earmark surplus or other resources to finance benefits.

### **The Impact of Medicare Part D**

One of the more controversial elements of Statement 45 is the treatment of the Medicare Part D subsidy received by governments (or their health care trust fund or shared services entity) if they offer plans that exceed the provisions of Part D drug coverage. The FASB in 2004 issued a “staff position”, allowing for an offset amounting to the present value of the expected Part D subsidies to an entity’s OPEB liability. The initial reduction upon implementation would be treated like any other actuarial or experienced gain. However, GASB has a different approach. GASB recently released a technical bulletin 2006-1, which called the Medicare Part D subsidies a voluntary “non-exchange” transaction. Because of the non-exchange nature, the GASB view is that the receipt of Medicare Part D subsidies is recorded solely as a revenue event, and furthermore, it is not predictable so that expected future subsidies cannot be used to offset a government’s OPEB liability.

While there are important reasons that GASB accounting requirements should differ from similar FASB pronouncements (GASB 2006a), the impact of the GASB’s proposal is dramatic and makes comparisons to private firms difficult. In the case of the State of Maryland, the difference is over \$2.5 billion in present value. The discounted stream of Medicare Part D subsidies equals over 11 percent of Maryland’s total actuarial liability of \$22.9 billion.

## **FUNDING OPTIONS**

Governments are examining various funding options. Rhode Island is considering using the proceeds from securitizing tobacco master settlement payments to fund an irrevocable trust (State of Rhode Island 2006). In New York City, Mayor Bloomberg is proposing funding a trust fund with anticipated one-time surplus from real estate and the City's personal income taxes as well as reduced pension funding in 2006 and 2007 (Bloomberg 2006).

Many governments are considering OPEB bonds, which are similar to pension bonds. The OPEB bonds that have been issued are taxable, affording investment flexibility of proceeds. Governments considering bonds may view the following benefits: The investment rate of return outweighs the interest expense generated by the bonds – thereby creating a legal arbitrage play. The OPEB bonds may have a minimal effect on the total debt of the government and its debt rating. There is a legal basis under state and local statutes to issue the bonds. There are allowable investment vehicles (irrevocable trusts) that can support the payment of OPEB liabilities for the life of the bonds, and the avenues to reduce OPEB costs are not as economically attractive.

While OPEB bonds have attractive features, they may not be the solution to all of a government's OPEB woes. First, the sale of these bonds reflects the government's decision to fund its OPEB liability. Many governments may choose not to fund this liability. Second, the healthcare cost trend rate automatically increases the risk of issuing OPEB bonds with the goal of fixing future costs. If the health care cost trend rate exceeds the needs extinguished by the issuance of the bonds, the government will have to fund the difference by other means. Third, any OPEB bond issuance will have to be timed right to take into account the economic factors above. Indeed, there may be a

market for taxable municipal debt, but it is different than traditional non-taxable municipal issuances. Taxable refunding bonds or ones with call provisions are even more rare. Governments will have to recognize that while OPEB bonds may allow for a net positive arbitrage between the taxable issue and the trust's investment returns, they may not solve all funding issues. Specifically, the investment return may, in some years, be less than the cost increases of health care, thereby *increasing* the OPEB costs during a period of economic weakness. Finally, funding OPEB limits the government's financial flexibility associated with these costs. A government may find it difficult to change the terms of an OPEB plan or deal with intergenerational issues once it is well funded.

### **The Early OPEB Bond Issues**

The City of Gainesville, Florida sold the first OPEB bonds in July 2005. The \$31 million taxable issue was rated A+ by the Fitch ratings service. Fitch raised the City's existing pension bonds to similar ratings with the sale. Fitch also cited the City's solid debt service coverage by pledged revenues, sound legal provisions, and the city's general credit characteristics. Fitch also believes in its report that the additional debt service, although it reduces certain debt service ratio covenants in the near term, was carefully planned to match ongoing general fund operating cost reductions and the additional debt fund's projects in the capital plan that previously did not have identified funding sources. (Fitch Ratings, October 24, 2005).

The State of Wisconsin sold \$1.8 billion in taxable pension bonds in 2003. The state sold the bonds in a record low-interest-rate environment, far below the rate of 8% earned by its retirement system. The transaction reportedly saved the state in excess of \$140 million in the last fiscal biennium and will generate at least 30% in net present-

value savings over the life of the debt. The state also fully funded its only OPEB cost – the ability to convert unused sick leave to a lump-sum cash payment. Wisconsin’s capital finance director Frank Hoadley observed: “We get danged pretty heavily for not having a rainy-day fund or other reserves, or for not having stronger liquidity, but when you add pension and OPEB ratios into the mix, the state is much better off than many others on a comparative basis” (Shields 2006b). Regardless of Wisconsin’s success in fully funding OPEB, it is the State uses an uncommon practice because the State’s non-pension benefits offered to retirees are limited to unused sick time.

### **Ratings Implications Even If Governments Do Not Bond**

It is unclear how rating agencies will view the funding status of OPEB liabilities. Amy Doppelt at Fitch suggested that it will look at the OPEB liability of a government relative to the budget and how the government will manage it and any bond proceeds; Douglas Benton of Moody's Investors Service emphasized that the funding plan and OPEB bonds “should not be used to plug a short-term budget problem” (Shields 2005a). In a 2005 report, Fitch analysts remarked: “[I]ndefinite deferrals are damaging to credit quality. [O]PEB accumulated costs are legal or practical commitments that form a portion of fixed costs. Long-term deferral of such obligations is a sign of fiscal stress that will be reflected in ratings” (Fitch Ratings 2005). If Fitch’s report is indicative of a typical rating agency’s stance on OPEB, governments should think about the size of the estimated unfunded OPEB liability but also the speed and approach to funding it.

### **MANAGING OPEB BENEFITS THROUGH RESTRUCTURING**

Governments are under increasing pressure to manage health care and other post-employment costs. Unlike corporate pensions, there is no Employee Retirement Income

Security Act of 1974 (ERISA) or Pension Benefit Guaranty Corporation (PBGC) to bail out defined-benefit health care plans either for private industry or for government, so governments must consider how to handle these obligations themselves. Several alternatives are available, including, but not limited to:

- Doing nothing and continuing in whatever fashion the government currently manages OPEB, or
- Partially or fully funding OPEB at a higher cost to taxpayers, or at a cut to current programs and services (if alternative revenues cannot be raised), using either current cash flow or bonding mechanisms as discussed previously, or
- Capping, curtailing or eliminating benefits to current or future workers.

The third alternative appears quite attractive at first. Other post-employment benefits, unlike pensions, are less likely to be contractually required by state statute or labor contract. A Moody's Investor Services (2006) survey of 55 cities indicates that only 23% of cities have OPEB obligations required by state statute or labor contract as compared to 46% that were granted through city charter and 2% that had no obligation.<sup>3</sup> However, many believe in the existence of a social contract exists with governmental workers to pay for health insurance and other post-employment benefits in exchange for lower current pay. The OPEB disclosures are causing governments to revisit this social contract and shift their traditional emphasis on the short-term, budgetary view to a longer-term decision-making perspective.

However, the employees feel that the retirement obligations should be paid in full. At the GASB public hearing on GASB 43 and 45 in May 2003, union representatives

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<sup>3</sup> Although 29% of the cities offered no explanation of the genesis of their OPEB obligations.

testified, (a rarity at a GASB hearing), urging that the exposure draft be set aside and arguing that it could lead to the curtailment of long-standing governmental defined benefit plans. The unions' willingness to fight became apparent during the Christmas shopping season of 2005. Thirty thousand New York City transit workers went on strike illegally, primarily to protest being required to contribute for the first time to their health care costs. The Metropolitan Transit Authority was asking workers to contribute only 1.5% to their current and retiree health care costs.

### **Michigan: Lowering OPEB Liability by Increasing Employee Contributions**

A few states have already changed their OPEB benefits. In 2000, the State of Michigan amended retiree health care plans, increasing co-payments and deductibles for retirees as well as the out-of-pocket maximums for prescription drugs – two major cost drivers for OPEB. In 2005, six public school retirees in the State of Michigan sued the Michigan Public School Employees' Retirement Board, the Michigan Public School Employees' Retirement System, the Department of Management and Budget and the Treasurer of Michigan, charging that the modifications violated Michigan's constitution. The Michigan Supreme Court sided with the state, holding that health care benefits do not constitute "accrued financial benefits" subject to protection of impairment or diminishment. The Court also held that Michigan's statute that established health care benefits had, in effect, created a contract but that the subsequent legislative changes were insubstantial (Michigan Supreme Court 2005).

### **Utah: Funding OPEB Using Accumulated Sick Leave and Vacation Time**

Many government employees are permitted to accumulate substantial sick leave and vacation leave and receive monetary compensation at retirement, raising the employee's

final compensation and long term retirement benefits. Utah developed a program in 1970 that allowed a 100% contribution of unused sick time to the employee's portion of OPEB costs. The legislature allowed a partial cash payout instead in 2004, but reverted to the old 1979 legislation in 2005. The State of Utah in 2006 was sued by the Utah Public Employees' Association on behalf of five anonymous plaintiffs, charging that the Utah legislature had changed the rules of vesting and contributions in the 2005 bill. The value of this change for the plaintiffs was probably significant, in that they had accumulated more than 8,000 hours of unused sick leave prior to January 1, 2006. The Court held that the legislative change was not an unconstitutional taking and that the plaintiffs do not have a property interest in the specific use of unused sick leave. As to vesting, the Court found that Utah statute and case law was ambiguous at best, concluding "that the State's offer was to exchange the unused sick leave for a benefit upon retirement, but not necessarily any particular benefit. The various changes... did not intend to bind the State forever to redeem 100% of the unused sick leave hours for any one use, and in particular not necessarily for medical and life insurance" (Supreme Court of the State of Utah 2006).

### **Other Restructuring Options Undertaken**

Other governments are looking at the expenditure side. In Rhode Island, Governor Carcieri has proposed that the State's Investment Commission be used to pool State and Municipal assets to help realize cost efficiencies and economies of scale in funding the statewide OPEB liability. In Duluth, Minnesota, where the per-household cost of OPEB is \$8,000, the Mayor cut services and froze hiring, resulting in 80 unfilled positions, in order to deal with the free lifetime retiree health insurance (Cauchon 2006). The State of

Ohio has amended its retiree health plan so that only employees with 30 or more years of service are eligible for full coverage (Ohio Public Employees' Retirement System 2004). Alabama has increased the premium payment obligation for certain employees, including smokers and individuals with short service periods. Other similar amendments have taken place in Delaware and Georgia, as well as cities like Orlando and Arlington, Massachusetts (Moody's Investors Service 2005).

### **Other Alternatives that Governments Could Consider**

Other potential solutions on the expenditure side are caps and conversions. The federal government has effectively capped its liability related to prescription drugs in Medicare Part D. A similar measure could be used to contain overall retiree benefits costs. Capping a government's OPEB liability affords additional flexibility in: (1) fixing the cost of OPEB and (2) allowing the cap to be selective to future employees instead of current employees or different classes of employees. Cost caps can also be used to limit a government's cost of retiree health care per retiree. Caps are recognition that there is a problem, but by the use of a cap rather than a percentage, the problem will not spread beyond current conditions.

Probably the most dramatic measure that still includes a health care plan is to convert from a traditional defined benefit plan to a defined contribution plan. The conversion shifts the risk entirely to the employee or retiree. Under GASB 45, in a defined contribution plan, the government would only have to disclose what it is required to contribute to the plan and how much it actually did, as it is not responsible for the investment performance or available payout from these plans. Conversions to defined contribution pension plans are starting to gather steam in some states. Alaska, Florida,

Colorado, Michigan, Ohio and Oregon have converted their pension systems from defined benefit to defined contribution.

## **CONCLUSION**

Governments routinely make promises with regard to benefits to attract and maintain employees. Before GASB 45, many governments may not have fully understood the ramifications of those promises. Now they will.

A large issue facing governments today is the pending retirement of a significant portion of the state and local governments' employee base. As mentioned, a Rockefeller Institute 2002 study indicated that 46.3 percent of government workers were 45 or older, and the average age of Massachusetts state employees is 46. In many states, the average age of employees is high with most employees already vested. For example, the average employee working for the Commonwealth of Massachusetts has served 12.75 years, making that employee already vested for OPEB benefits (Aon Consulting 2006). As the older employees retire, governments are going to have to staff up in a short period of time, while competing in the same talent pool with private industry.

Government has traditionally competed on compensation, including benefits. Despite perceptions that public sector employees are less well paid, they are paid both higher salaries and benefits than private sector workers; the higher compensation is partially due to the higher educational requirements and physical risks. In addition, higher participation rates in the public sector drive up the average employee benefit costs (Employee Benefit Research Institute 2005a). It is widely believed that governments need to keep providing those benefits to attract and retain employees. As discussed herein, those benefits are a major and rising cost. For government managers, managing

those costs to a reasonable level given the available tools and funding those costs for current employees and retirees will be a large challenge.

**Table 1**  
**Recently Disclosed Public Sector OPEB Liabilities**

**Panel A: States**

<b>Government</b>	<b>Participants (if available)</b>	<b>OPEB Liability/ (Asset) (\$M)*</b>	<b>Liability per Participant</b>
Alabama – State Employees		\$3.8 - \$5.3	
Alabama - Teachers		\$14.6 - \$17.8	
Alaska		\$2.7	
Arkansas		\$2.7	
Delaware		\$3.1	
Maryland	249,061	\$22.9	\$91,957
Massachusetts	140,729	\$7.6 – \$13.3	\$53,730 - \$94,416
Michigan – Teachers		\$15.8**	
Michigan – State Employees		\$6.5**	
Michigan – State Police		\$4.4**	
Montana		\$1.7 - \$3.1	
Nevada		\$1.8 - \$4.4	
North Carolina		\$23.9	
New Jersey		Over \$20.0	
New York		\$27.0 - \$54.0	
Oregon		\$0.6	
Rhode Island		\$0.6	
South Carolina		\$9.2	
Tennessee		\$0.2	
Utah		\$0.5 - \$0.7	
Vermont- Teachers		\$0.4 - \$0.9	
Vermont – State Employees		\$0.3 - \$0.5	
Virginia		\$2.0 - \$4.3	
West Virginia		\$9.2	
Wisconsin		\$0.4	

**Table 1**  
**Recently Disclosed Public Sector OPEB Liabilities (continued)**

**Panel B: Municipal Entities**

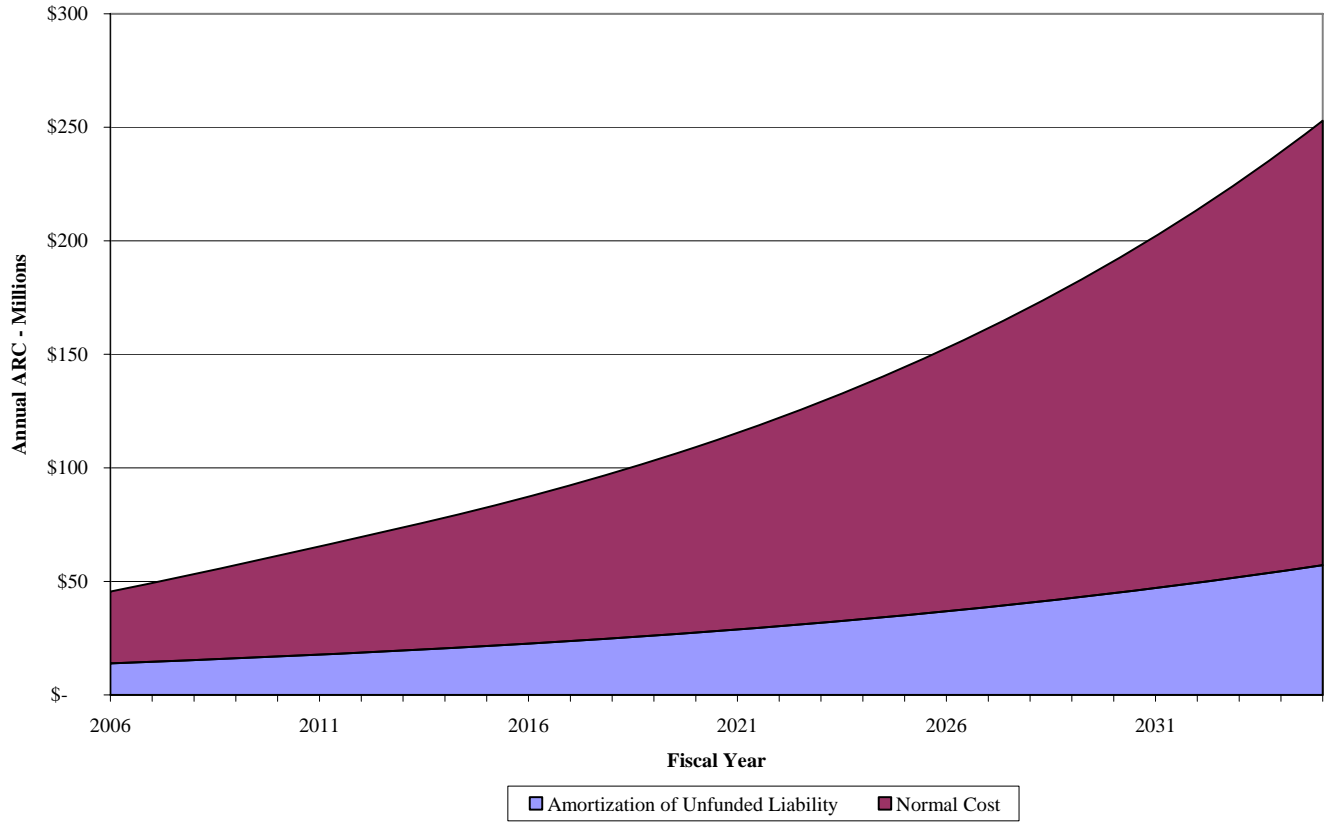
<b>Government</b>	<b>Participants (if available)</b>	<b>OPEB Liability/ (Asset) (\$M)*</b>	<b>Liability per Participant</b>
City of Aurora, IL	1,165	\$177.1	
City of Duluth, MN	1,883	\$310.9	\$165,109
City of Gainesville, FL	3,210	(\$30.5)	(\$9,501)
City of Newton, Massachusetts	4,902	\$240.9 to \$654.2	\$49,143- \$133,456
City of New York, NY		\$50,544.0	
City of San Diego	14,585	\$978.3	\$67,076
District of Columbia		\$400	

\* Several entities disclosed a range of liabilities. This is necessary due to the provisions of Statement 45. The lower bound estimate represents a valuation based on an irrevocable trust arrangement, while the higher bound assumes a non-trust, or free cash flow funding scenario.

\*\* Represents an estimate assuming OPEB costs are pre-funded.

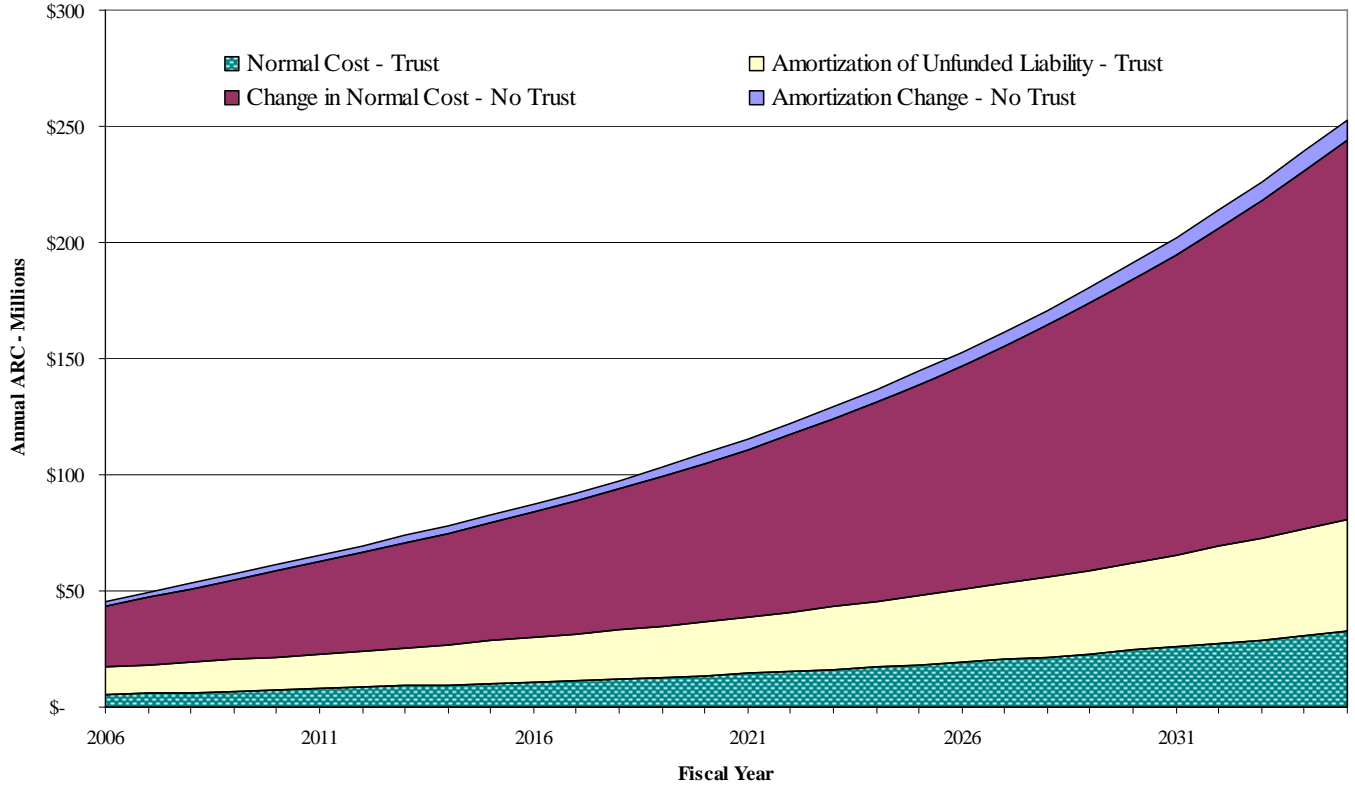
**Figure 1**

**City of Newton OPEB Funding by Fiscal Year**



**Figure 2**

**City of Newton OPEB Funding by Fiscal Year**



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