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California's Neglected Promise:

How California has Failed to Prepare for its Accumulating Retiree Health Care Obligations

Adam Tatum

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Executive Summary

Large unfunded liabilities associated with pensions provided to government employees have recently garnered much attention. However, while their overall numbers are smaller, unfunded obligations for other retiree benefits are growing at an even faster rate than pension obligations.

Retiree health care is the largest component of these Other Post-Employment Benefits (OPEBs). As the Baby Boomer generation has begun to retire, we have seen an upswing in the number of retirees accompanied by both longer predicted life spans for those retirees and an overall increase in health costs. In short, more people are earning benefits for longer periods of time at higher costs.

Together, these factors will make it increasingly difficult for California to pay for these benefits in the future. Unlike pensions, which the State pre-funds by setting aside money for benefits when they are earned, retiree health care benefits are currently paid out of the State's operational budget, forgoing potential savings from investment profits.

Should the State do nothing to address them, growing OPEB costs will eventually crowd out crucial state programs in the annual budget. Our analysis of the State's OPEB liabilities found the following:

- ***Rising annual costs to the State***. The State has seen the cost of benefits for current retirees double every five years since 1999, on average. Annual benefit payments have increased from $0.30 billion to $1.58 billion. At this rate, current-year OPEB costs will consume the entire state budget within 35 years.

- ***Pre-funding saves an estimated $21 billion***. If the State starts paying its full contribution, as determined by CalPERS, this year and continues to do so annually, it will save an estimated $21 billion in paying for benefits earned as of 2011. A single year of inaction will potentially cost almost $1.70 billion in missed investment savings over 15 years, or over $300,000 per day.

- ***More retirees and more to come***. The number of retirees receiving medical benefits has increased 11.7% since 2008, from 138,300 to 154,500. This is an early phase of the upswing in retirements by the Baby Boomer generation.

Because pre-funding is dictated by the simple idea that the costs of a benefit (such as pensions) should be recognized as they are earned, it discourages irresponsible political behavior that defers costs to future generations that may not be able to bear them. Further, pre-funding accumulates secure assets towards paying future costs and supplements them with investment profits.

Absent significant cost containment measures within the health care system, OPEB costs to the State will continue to increase in the coming years. To deal with this strain on the budget, the State can either restructure the way it pays for these long-term benefits or restructure the benefit plans themselves.

Options for restructuring funding plans include committing to either fully or partially paying required contributions to pre-fund the benefit plans. Options for restructuring benefit plans include restricting eligibility for full benefits based on time worked, reducing maximum premiums covered, transitioning from defined benefit to defined contribution plans, and introducing cost sharing plans with active employees. But even as it considers changes to its benefit plans, pre-funding still offers the State the opportunity to both reduce its future out-of-pocket costs and secure funding for its current and future retirees' health benefits.

Introduction

Large unfunded liabilities associated with pensions provided to government employees have recently garnered much attention in the news and policy spheres. However, while their overall numbers are smaller, unfunded obligations for other retiree benefits such as health care are growing at an even faster rate than pension obligations. Additionally, governments have far less set aside to cover future obligations both at the state and city levels.

To date, the State of California has promised its current and future retirees $62.14 billion in retirement benefits other than pensions. The State currently pays for these other post-employment benefits (OPEBs) on a pay-as-you-go basis, meaning that it only commits money to them as the claims arise. However, because the State promises these benefits before it actually pays them, it does not begin to realize the full cost until each employee retirees. And the State's liability for these benefits is increasing as the number of participants grows and as health care costs rise.

OPEBs are rapidly consuming a growing portion of the state budget, a trend that is expected to continue into the foreseeable future. Consequently, many experts are now calling for state government to address and plan for these future costs. There are a few ways to do so. To reduce its obligations, the State can reduce the benefits it offers employees. While the State may face difficultly in reducing benefits for current employees, it can certainly reduce them for new hires. Alternatively, it can lower benefit value and raise eligibility criteria, as Governor Brown's recent plan suggested.

Short of altering or reducing benefits, the only other way for the State to reduce its overall liability is for it to set aside more assets now in OPEB trusts, pre-funding the obligation. Allocating assets for these benefits now would ensure that sufficient funding is available to provide the promised benefits in the future. Doing so conforms to the general principle of each generation of taxpayers bearing the cost of the services it receives. Furthermore, investing those assets will increase their value and reduce the State's out-of-pocket expenses in the long term.

Taking a long-term view, either choice is preferable to the current approach of funding these benefits on a pay-as-you-go basis and placing the burden of increasing costs on the State's future operating budget. As the costs rise, they will begin to crowd out crucial state programs: schools, universities and support for the disabled, among others. If no measures are taken, the State will have to pay the full cost of providing these benefits out of its operating budget, a cost it may be unable to afford in future years.

Our analysis of the State's OPEB liabilities found the following:

- The State of California currently has $62.14 billion in unfunded OPEB liabilities.

- The number of retirees receiving medical benefits has increased 11.7% since 2008, from 138,300 to 154,500. This is an early phase of the upswing in retirements by the Baby Boomer generation.

- The State of California currently funds its OPEB obligations on a pay-as-you-go basis. The State has seen the cost of benefits of current retirees double every five years since 1999, on average. At this rate, current-year OPEB costs will consume the entire state budget within 35 years.

- If the State starts paying its contribution, as determined by CalPERS, this year and continues to do so annually, it will save an estimated $21 billion in paying for benefits earned as of 2011. A single year of inaction will potentially cost almost $1.70 billion in missed investment savings over 15 years, or over $300,000 per day.

- It is unclear whether OPEBs are revocable by the State, either partially or fully. The debate is currently taking place at the city and state levels, both in the courtroom and outside it.

Background Information

Other Post-Employment Benefits (OPEBs) are retirement benefits other than pension benefits that an employee accumulates during his or her employment. The employer – in this case, the State of California – pays the retiree these benefits after retirement. The State generally provides OPEBs to retirees, their spouses and their dependents. These benefits commonly include health care, long term care (such as nursing home care), and life insurance after retirement. Of these, however, health care normally accounts for the largest portion of OPEBs.

California currently offers the following OPEBs to California State University employees, highway patrol, public safety, public industrial, legislative, and other miscellaneous public employees:[1]

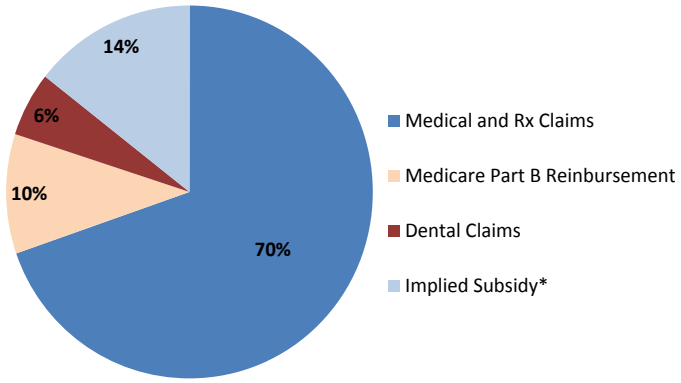
Table 1: OPEBs Sponsored by the State of California

Health Care	In accordance with State law, the State generally pays 100% of the health insurance cost for annuitants, plus 90% of the additional premiums required for the enrollment of family members of annuitants. The maximum 2011 monthly State contribution was as follows:[2] One-Party Coverage- $542.00 Two-Party Coverage - $1.030.00 Family Coverage - $1,326.00
Dental	Eligible employees can roll in the State's Dental Program. Although the California Government code does not specify the State's contribution toward dental insurance costs, the State generally pays all or a portion of the dental insurance cost for annuitants, depending upon the completed years of credited state service at retirement.
Life Insurance, Long-term Care, and Vision	Retirees pay for all costs. California has no liability.

State contributions for retiree health benefits are based on a 100/90 formula. This means state contributions are equal to 100% of the weighted average of retiree health premiums for retirees and 90% for eligible dependents.[3] Note that retiree health care is not completely paid for by the government. Medicare is a federal health insurance program that provides health care to those 65 and older, those younger than 65 who have certain disabilities, and those with permanent kidney failure. These benefits are split into two parts: Part A covers inpatient hospital care, home health care, and nursing care; Part B covers doctor bills and some medical supplies and services. Part A does not require a premium, while Part B does. Upon becoming eligible for Part A, Medicare recipients may enroll in or opt out of Part B.

Medicare, however, does not cover all medical expenses, for which many turn to secondary plans.[4] Once a retiree turns 65, if he or she is eligible for Medicare, state health care plans become secondary coverage. To participate in CalPERS-sponsored secondary plans, California requires retired members to also sign up for Part B if they are eligible. These secondary plans will pay for costs not paid by Medicare.[5] The State's reimbursements for those plans to retirees account for approximately 10% of the State's annual benefit payments (see Figure 1).

Figure 1: Expected Distribution of Benefits Payments[6]



* Implied subsidy refers to the situation when the employer allows the retiree to participate in the health plan of active employees. Since the health care for retirees is higher, this causes the average premium price to increase. Since the employer pays against the higher premiums for active employees, a cost attributable to retiree is implied even if retirees pay for all of their premiums.

Because OPEBs are written into employment contracts to be provided long after they are earned, it makes sense to track these liabilities like pensions. Hence, in 2004, the Government Accounting Standards Board (GASB) recommended in Statements 43 and 45 that government employers measure and report actuarial estimates for these liabilities (for the long and short term) on financial statements.

Estimates of OPEB liability rely on assumptions of mortality rates, investment returns, life spans, inflation, and health care costs. While the actuarial formulas used to determine this liability are quite complex, the concepts behind its methodology are fairly simple. First, an actuary forecasts the full payment of all benefits that will be paid out into the future for all current and past employees – this is called the Present Value of Projected Benefits (PVPB). This

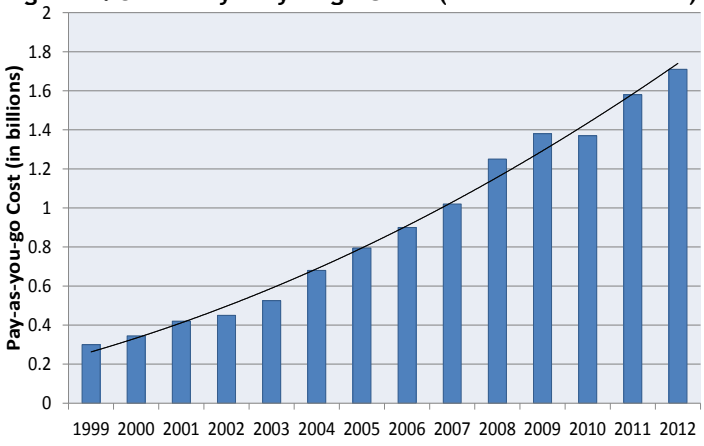
total is broken up into two portions. The first portion is already earned by employees based on past work history and is called the Actuarial Accrued Liability (AAL). The other portion is an amount that has yet to be earned called the Present Value of Normal Costs. This amount consists of future annual normal costs, which are explained later (for an Illustration see Appendix A). Because of the number of assumptions involved, these estimates of liability are highly sensitive to change and so actuarial valuations are updated every couple years.

The assets already accumulated to offset this liability (Actuarial Value of Assets, or AVA) are calculated by averaging the value of assets over a moving several-year period. This will smooth out the volatility of the market value, instead of recognizing large increases and decreases in market value of assets immediately. The gap between the AAL and the AVA – between the incurred liability and existing assets to pay them – is the Unfunded Actuarial Accrued Liability (UAAL). The Funding Ratio is the percentage of AAL covered by current assets. If a plan is 100% funded, the AVA equals the AAL, and the UAAL is zero. At this point, the employer would theoretically have enough assets to fully cover the portion of future benefit costs that current employees and retirees already earned.

Why are OPEB Costs an Issue?

Currently, the State pays for OPEB obligations on a pay-as-you-go basis, which means that as those costs increase, so does the burden on the state budget. Since 1999, annual benefit payments have increased approximately 425% percent from $0.30 billion to $1.58 billion (see Figure 2). The pay-as-you-go costs in 2011 were equivalent to 2.0% of General Fund expenditures, increasing more than four-fold since 1999. At this pace, current-year OPEB costs will consume the entire state budget within 35 years.

Figure 2: State Pay-as-you-go Costs (in billions of dollars)[7]



Under-funding: An Illustration

Under-funding OPEB liabilities is akin to running a race from behind. To achieve a qualifying time, a runner calculates that he must complete each lap in a certain amount of time. Each time he runs a lap slower than he planned, he falls behind in achieving the overall qualifying time at the end of the race. After running too slowly for too long, he will eventually find himself too far behind his goal to finish the race in time. Similarly, each year that the State under-funds its OPEB liability, it falls further behind on its goal to save enough funds to cover the benefits it promised to provide employees at the end of their careers. After funding too little for too long, the State will eventually find itself too far behind its goal to fully cover the benefit costs.

Retiree health care is the largest component of OPEBs. As the Baby Boomer generation has begun to retire, we have seen an upswing in retirees accompanied by an increase in health costs. The number of retirees receiving medical benefits has increased 11.7% since 2008, from 138,300 to 154,500.[8] And, nationally, average annual health care costs have increased about 33% since 2008 for a family of four, from $15,609 to $20,728 in 2012.[9] Additionally, the average life span is also increasing. The remaining life expectancy for those at age 65 has increased by two years from 17.2 years in 1990 to 19.2 years in 2009.[10] In short, more people are earning benefits for longer periods of time at higher costs.

According to United Health Group, 67% of the increase in national health care spending is attributed to rising fees charged by health care providers.[11] These higher fees include physician fee schedules, inpatient and outpatient costs, and the costs of brand-name drugs. Treatment volumes are also increasing, partly due to chronic conditions that require continuous treatment. However, perhaps surprisingly, an increase in health care costs is not correlated with a higher quality of care.

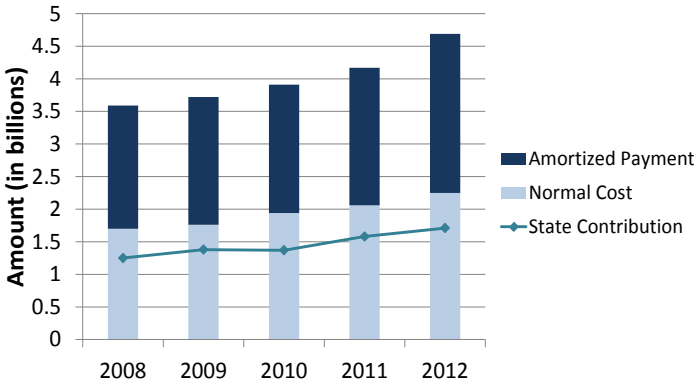
Funding Progress

While annual payment growth provides a glimpse into the matter, the UAAL figure gives a better picture of the long-term situation. As of June 30, 2011 the State of California has a $62.14 billion unfunded OPEB liability. Although volatile, this figure is not simply an abstraction. If the actuarial assumptions of health care cost growth, retirement rates, mortality rates, and rates of return are correct, the unfunded liability is the total out-of-pocket cost (in today's dollars) of providing the OPEBs that have already been earned, on top of monies that have already been set aside. This amount will be paid to retirees during the remaining lifetime of the covered employees.

The State of California currently has not set aside any as-

sets for its future OPEB obligations. Fully pre-funding requires the State to make payments into an OPEB trust that are consistent with the Annual Required Contribution (ARC). This an actuarially determined amount that represents a level of funding that, if paid every year, is projected to cover the normal costs (the cost of benefits earned that year) each year and amortize any unfunded liability over a period not to exceed thirty years. In other words, the ARC is calculated to pay towards earned benefits that have not been funded in previous years, as well as dedicating funds to benefits currently being earned. If the normal cost had been covered each year, then theoretically, the OPEB system would be fully funded for each employee at the time of his retirement, and his OPEB payments would not draw on the state's General Fund. However, that has not been the case in California. Because it has only paid its annual pay-as-you-go costs, considerably less than the normal cost (see Figure 3), the amortization component of the ARC has been rapidly growing.

Figure 3: History of the Annual Required Contribution (in billions of dollars)[12]



The State's total obligations (the AAL) currently stand at $62.14 billion, up 30% from $47.88 billion since only 2007.[13] Approximately $7.7 billion of that increase is attributable to the aggregate normal costs of those five years. Another $9.6 billion of the increase is due to the interest on the outstanding obligation "earned."[14] This cost is essentially the estimated missed savings that invested funds would have earned based on the assumed rate of return if the ARC had been paid in full. Finally, the State had underestimated certain variables, such as the retirement rate, life expectancy, and health care cost growth, resulting in an aggregated $2.7 billion OPEB liability increase. Because the annual benefit payments the State does make reduce its liability, its total payments over the five years of $5.8 billion, diminished the liability.[15] Together, these adjustments result in a $14.2 billion dollar net increase in the unfunded OPEB liability, which is illustrated below in Figure 4.

Discount Rate

The discount rate represents the time value of money. It is used to calculate the present value of a future liability. To take a simple example, if Al promises Ben to pay him $100 in two years, and we assume there is 5% inflation (and nothing else changes), the present day (discounted) value of those $100 is $90.70 =100/(1.05)^2.Generally, when discounting the liability of a future payment, the discount rate should simply be a reflection of the risk that the payment is not made. For public pension plans, for example, the payouts are virtually guaranteed, and so those liabilities should be discounted at the 'risk-free' rate of approximately 4.5%.[1] This is the discount rate that private sector pension plans are legally required to use in reporting liabilities, regardless of their actual investment performance. While CalPERS currently uses 7.61% for its expected rate of return for its OPEBs plans and for its discount rate, a number on par with most public pension plans in the country today, many economists argue this is far too high to be realistic, understating actual liabilities and overstating the funding ratio.

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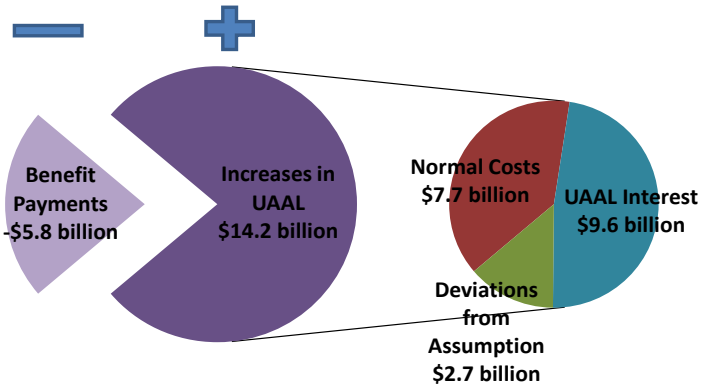
[1] Munnell et al. "Valuing Liabilities in State and Local Plans." Center for Retirement Research, 2010. <http://crr.bc.edu/wp-content/uploads/2010/06/slp_11-508.pdf>. Retrieved July 2012; and Jeffrey R. Brown and David W. Wilcox. "Discounting State and Local Pension Liabilities." The American Economic Review. Vol. 99, No. 2, 2009. pp. 538-542.

Figure 4: Breakdown of Increase in Unfunded Liability Since 2007



Pre-funding Analysis

If the State is not going to reduce or alter benefits, it should at least pre-fund them in order to protect future generations from costs incurred by previous generations. Also, the assets set aside in a pre-funded plan can earn investment returns which in turn reduce the sizes of future contributions and unfunded liabilities. Table 2 illustrates these potential savings as calculated by the state Controller based on pre-funding levels and using current GASB accounting standards. Pre-funding levels refer to the percentage of the ARC in excess of the pay-as-you-go cost that is contributed.

If the State chooses to fully pre-fund its ARC into an OPEB trust, it will reduce its unfunded liability by as much as

$21.42 billion if the investment return rate that CalPERS projects (7.61%) is met.[16] That means that in all, the State will pay $21.42 billion less towards OPEBs that employees have already earned if it starts to pay the full ARC today and continues to do so for the next 30 years. By pre-funding 50%, it can save $12.39 billion on its unfunded liability. Even if it pre-funds only at the 10% level, it can still save $2.71 billion in long term OPEB obligations. A year of inaction, e.g. starting to pre-fund next year instead of this year, may cost $1.70 billion in missed potential savings over 15 years, or about $300,000 per day.[17]

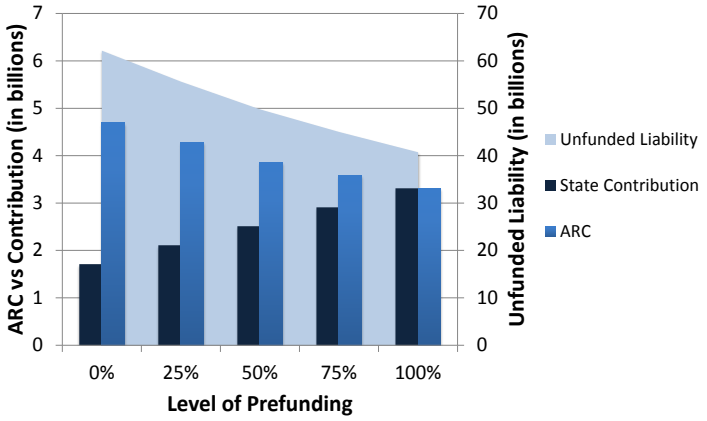
Table 2: Pre-Funding Scenarios (in billions of dollars)[18]

Pre-funding Level	Discount Rate	State Contribution	Unfunded Liability	Savings In Unfunded Liability
0%	4.50%	$1.71	$62.14	$0.00
10%	4.81%	$1.87	$59.43	$2.71
25%	5.28%	$2.11	$55.60	$6.54
50%	6.06%	$2.51	$49.75	$12.39
75%	6.83%	$2.91	$45.01	$17.13
100%	7.61%	$3.31	$40.72	$21.42

These calculations depend on the expected rate of return, a number CalPERS also uses as its discount rate (see Discount Rate box below). The rate of return is by no means guaranteed. In fact, the specific choice of the rate has been the subject of much controversy. If the assumed returns are not realized, then actual savings will differ for the pre-funding levels. For example, if the realized rate of return is going to be 6.2%, the State will save approximately $13 billion in out-of-pocket costs in the long term.[19] But even in the event that the rate of return of the OPEB trust is only equal to that of the short-term General Fund rate, approximately 4% in recent history, the State will have accumulated dedicated assets allocated toward providing these benefits.[20]

The ARC determined at the pay-as-you-go plan's discount rate listed in Figure 3 is actually somewhat misleading. If the State fully pre-funded its liability by setting aside assets in an OPEB trust, it would only need to contribute $3.31 billion annually, based on current GASB standards. Thus, pre-funding the full ARC requires $1.60 billion more than the pay-as-you-go cost as opposed to $2.98 billion more. This is due to the increase in the discount rate used by CalPERS. As the level of pre-funding increases, the applied discount rate increases (approaching the target rate of 7.61%) because the assets that are expected to be invested grow.[21] As a result, the ARC and unfunded liability decrease. The gap between the ARC and the State's contribution closes over time in the fully pre-funding scenario. This effect is illustrated in Figure 5.

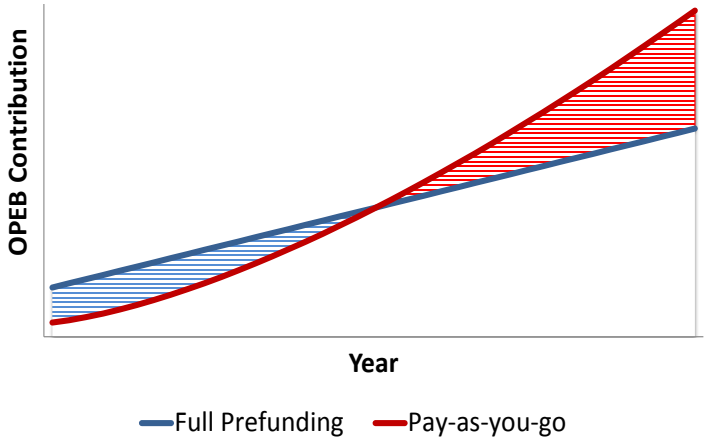
Figure 5: Pre-funding Illustration (in billions of dollars)



As we point out, the linking of the discount rate to the expected rate of return (which allows CalPERS to decrease the ARC as more assets are accumulated), is highly controversial. Most economists argue that liabilities should be discounted at the "risk-free" rate of approximately 4.5%, since the liability is virtually guaranteed to be paid (at least in the case of pensions, see "Are OPEB Obligations Revocable" below).[22] Thus, it may be more prudent for the State to forgo the downward adjustment to the ARC, and instead phase in the higher ARC payments over time. However, regardless of the choice of discount rate applied to the liabilities, the potential savings stemming from pre-funding are real, though the exact amount of those savings is difficult to predict.

Though in the long-term pre-funding is the more cost effective option for the State, in the short-term, the pay-as-you-go costs are lower than the costs required to pre-fund its OPEB obligations. But because pay-as-you-go costs are increasing faster than the ARC, they are on track to overtake annual full pre-funding costs in the coming years (see Figure 6). The State's actuary projects that by 2017, pay-as-you-go costs will have doubled since 2008.[23] And ultimately, once a plan is fully funded (which will take up to 30 years), the ARC drops significantly because the State will no longer be making amortization payments to cover the cost of past under-funding. At that point, if assumptions hold true, the ARC will be completely composed of costs incurred only during that service year.

Figure 6: Pay-as-you-go vs. Full Pre-funding Plan Illustration[24]



As Figure 6 shows, in the long term, a pay-as-you-go policy is the most expensive OPEB funding option. The real question is, if the State is not going to pay the ARC now because it is too expensive, how does it plan to manage a much higher annual pay-as-you-go cost in future years?

Are OPEB Obligations Revocable?

To draw down its obligations, the State may opt to change the provisions of its OPEB plans. These changes may include requiring employee contributions, reducing premium coverage, or making eligibility requirements stricter. However, the extent to which the State may retroactively change or reverse OPEBs for current employees and retirees is uncertain.

A benefit is considered "vested" if the employee has an irrevocable right to that specific benefit. In April 2011, Superior Court Judge Ronald Prager ruled that the city of San Diego does not have an obligation to provide health care to its current employees after they retire.[25] The lawsuit, *Christopher Ellis vs. Jackson DeMarco Tidus & Peckenpaugh* was brought by two San Diego police officers after the city administration placed a cap on their health benefits in 2009.[26] San Diego currently has $1.1 billion in unfunded liabilities and is in the process of renegotiating its obligations with labor leaders.[27]

The plaintiffs argued that these benefits are vested and that therefore approval by city employees is required to change them. However, Judge Prager ruled for the City, opining that these rights are not vested because they exist outside the pension system and therefore are an optional benefit funded by taxpayers. While this ruling only applies to the two officers in the lawsuit, it may have great influence on future negotiations as the San Diego aims to reduce its $1.1 billion in unfunded liabilities.

Another case yielded different results. In November 2011, in *Retired Employees Association of Orange County, INC vs. County of Orange*, the California Supreme Court ruled that retiree health care benefits may not be eliminated if they were clearly promised to the employees by state or local governments.[28] The decision stated that county employees may have a vested right to health benefits under certain circumstances.[29] As a result, Orange County employees may be able to show they had an implied contract that prevents the County from changing the plan provisions.

To what extent these decisions set precedents remains to be seen. Ultimately, however, they illustrate the precarious nature of retiree benefits. As the costs of providing them continue to rise, each city may be pressured to reduce them. The way to ensure that future retirees can receive their promised benefits is to set aside sufficient funding for them today as they are actually being earned.

Recent Efforts to Address the Unfunded Liability

Bargaining units of state workers' unions have made nominal concessions to pre-fund OPEBs. In August 2009, the California Association of Highway Patrolmen (CHP) reached an agreement with the State to establish a trust that would pre-fund OPEBs. In this agreement, CHP members and the State would make matching contributions to the CHP OPEB trust. However, the contribution rates are so low that as of June 30, 2011, the total balance in this trust is only $6.5 million, equating to a 0.02% funding ratio.[30]

Additionally, in July 2010, the Craft and Maintenance Bargaining Unit (BU-12) and the Physicians, Dentists, and Podiatrists Bargaining Unit 16 (BU-16) reached separate agreements with the State to pre-fund OPEBs.[31] Under the agreements, BU-12 and BU-16 members are to make yearly contributions of 0.5% of payroll effective July 1, 2012. Again, this level of pre-funding is so low that it will not even result in an increased discount rate.

Recommendations

Although growing OPEB liabilities have only recently been on the public radar, there have been several high profile recommendations for dealing with this situation. On December 28, 2006, Governor Arnold Schwarzenegger established the Public Employee Post-Employment Benefits Commission to address unfunded post-employment benefits.[32] This commission's January 2008 report argued that the costs of promised benefits should be fully identified and paid with-

in the working career of those receiving the benefit. The commission recommended that "public agencies providing OPEB benefits should adopt pre-funding as their policy. As a policy, pre-funding OPEB benefits is just as important as pre-funding pensions." The commission also recommended that if the public agency does not adopt such an approach, it should establish a clear alternative as well as justification for not doing so.

More recently, California State Controller John Chiang has argued that the State should pre-fund its OPEB obligations and grow those assets through investment to "reduce the impact on future generations."[33] Similarly, Governor Jerry Brown's proposed Twelve Point Pension Reform Act would require employees to work for the government longer to receive health care benefits upon retirement. New employees would have to work 15 years to become eligible to have portions of their retirement costs paid for. Only after serving 25 years would they become eligible to receive the maximum benefit. And even this maximum benefit would be reduced from its current level. Under the plan, the maximum would equal the average of premiums the State paid in the last three years the employee was active.[34] In addition to fully enforcing rules that require retirees to seek Medicare, the Governor's plan would also address "the anomaly of retirees paying less for health care premiums than current employees."[35]

If the State is unable to afford to provide these benefits, it will ultimately need to reduce them or reduce funding to other programs to make up the difference. Aside from contributing less toward the overall premium and introducing a vesting schedule as proposed in Governor Brown's plan, there are many ways to address OPEB costs. The State may consider switching to defined contribution plans from the current defined benefit plan system. Under a defined contribution plan, rather than covering a specified portion of a retiree's health and dental premiums as they come due, the State would set a defined amount to contribute towards OPEB benefits and place the funds into an OPEB trust. This option eliminates the uncertainty of runaway OPEB costs and transfers the risk of rapidly increasing health costs from the State to its retiree.

The State may also require active employees to make contributions towards these benefits. In this strategy, employees typically contribute specified percentages of their salary towards covering their normal costs. Employee contributions help offset the employer's normal costs and, thus, the overall ARC.

Another increasingly popular plan is opting for narrow-network HMOs. These plans eliminate especially expensive physicians and hospitals from the provider networks. This approach reduces health care costs by ensuring that retirees seek less expensive options. It is estimated that narrow network HMOs can reduce costs by 25%.[36] Of course, such a change has potential downsides. Although insurers contend that narrow HMOs do not dramatically reduce employee choices,[37] health advocates argue that by limiting the number of available physicians and hospitals, patients with chronic, life threatening, or specific needs condition may be harmed.

Another possibility is for the State to buy out the retiree's benefits. For example, to deal with its $58 million unfunded OPEB liability, Beverly Hills recently offered current employees the option to opt out of their defined benefit plans.[38] Instead, these employees would receive a one-time lump sum payment. This amount was the actuarially determined value of their post-retirement medical coverage based on their individual plan provisions. A portion of that payment went into the defined contribution plan. The remaining portion could be exchanged for a cash payment or also placed into a defined contribution plan. Fifty eight percent of the incumbent employees agreed to participate in the new option. Overall, this innovative plan not only reduced the growth of unfunded OPEB liability, but decreased it by $13 million for fiscal year 2010-2011.

As we have discussed, the State may find it difficult to reduce OPEBs for active employees and retirees, but it can certainly reduce them for new hires. Still, because this will not address the current unfunded liability, which will still have to be paid, the restructuring of benefits for future employees should be combined with pre-funding.

Conclusion

California faces OPEB costs that consume a growing proportion of its budget. These costs have already doubled twice in the past decade. Unless the health care system sees substantial reforms, these costs will continue to increase significantly into the future, primarily due to rising health care costs and the increasing number of retirees. We have reviewed a number of changes to benefit plans that can reduce costs. But even as it pursues changes to its plans, the State should pre-fund them to help reduce its future out-of-pocket cost. If nothing is done to address them, OPEB costs will eventually crowd out crucial state programs such as schools, universities, and support for the disabled.

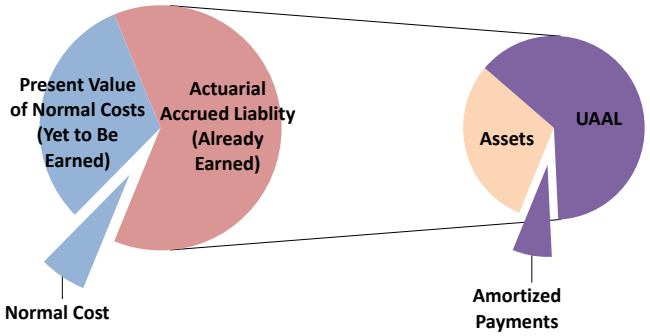
Pre-funding accumulates assets towards paying future costs and supplements them with investment profits. By starting to pay an extra $1.6 billion per year today, the State may save $21.42 billion over the long term. Every year that California delays pre-funding, it misses $1.7 billion in potential savings from investments (over the next 15 years). Pre-funding is also dictated by the simple idea that the costs of a benefit (such as pensions) should be recognized as they are earned. In addition to any normative arguments, this discourages irresponsible political behavior that saddles future generations with costs they may not be able to bear. Facing up to the reality of these growing obligations cannot be delayed forever.

Appendix: Actuarial Methods Illustration

The Present Value of Future Benefits (PVFB) is composed of two parts. The first part is the present value of benefits that have yet to be earned called the Present Value of Normal Costs. The second part is the present value of benefits already earned based on past years of service, called the Actuarial Accrued Liability (AAL). The AAL is also broken up into two parts. One part is covered by assets and the other part that is unfunded. The amount that is unfunded is called the Unfunded Actuarial Accrued Liability (UAAL). The Annual Required Contribution (ARC) represents an amount that is designed to pay off benefits already earned and those that have just been earned. Thus, this calculation takes a piece of the "yet to be earned" potion and a slice of the "UAAL" portion. This sum results in the ARC. If the ARC is paid each year, employers will theoretically have enough assets to pay the OPEBs of each employee after retirement.

Present Value of Future Benefits (PVFB)

Year	AVA	AAL	UAAL	Funded Ratio	Payroll	UAAL % of Payroll
2007	$0.00	$47.88	$47.88	0%	$17.94	267%
2008	$0.00	$48.22	$48.22	0%	$17.89	270%
2009	$0.00	$51.82	$51.82	0%	$18.45	281%
2010	$0.00	$59.91	$59.91	0%	$17.54	341%
2011	$0.00	$62.14	$62.14	0%	$18.01	345%



[1] Coverage terms are taken from Gabriel Roeder Smith & Company. "State of California Retiree Health Benefits Program: GASB Nos. 43 and 45 Actuarial Valuation Report", Chicago, IL, 2008, 2009, 2010, 2011. . The valuations can be found on the state Controllers website. In particular, the valuation for June 30, 2011 can be found at http://www.sco.ca.gov/Files-EO/CaliforniaGASB45_2011ReportFinal.pdf

[2] John Chiang. "California's Comprehensive Annual Financial Report." California State Controller's Office. 2011. Notes to the Basic Financial Statements section. This information is contained on page 164 for the year 2011. <http://www.sco.ca.gov/ard_state_cafr.html>. Retrieved June 2012.

[3] California Legislative Analyst Office. "Retiree Health Care: A Growing Cost for Government." <http://www.lao.ca.gov/2006/ret_hlth-care/retiree_healthcare_021706.htm>. Retrieved July 2012.

[4] California Registry. "Medicare - A Federal Health Insurance Program for the Elderly and Certain People with Disabilities." Medicare -How It Works (and Doesn't Work). <http://www.calregistry.com/resources/ medicare.htm>. Retrieved July 2012.

[5] Gabriel Roeder Smith & Company 2011, p. 28.

[6] Ibid, p.17. This comes from the Expected Net Employer Cash Flow for the 2012 fiscal year.

[7] Costs for 1999 to 2006 are taken from "Retiree Health Care." Costs for 2007 to 2012 are taken from Gabriel Roeder Smith & Company, 2008-2011. The pay-as-you-go-costs for 2012 are estimated by the State's actuary.

[8] Supra note 2.

[9] Milliman. "2012 Milliman Medical Index." Web. June 2012. <http://publications.milliman.com/periodicals/mmi/pdfs/milliman-medical-index-2012.pdf>. Retrieved June 2012. p. 1. Assumes the family of four is insured by an employer sponsored PPO plan.

[10] U.S Department of Health and Human Services. Health, United States, 2011 With Special Feature on Socioeconomic Status and Health. <http://www.cdc.gov/nchs/data/hus/hus11.pdf#022>. Retrieved June 2012. p. 108.

[11] United Health Group. "Why Are Health Care Costs Rising?" 2010. <http://www.unitedhealthgroup.com/ hrm/UNH-Health-Care-Costs.pdf>. Retrieved June 2012. pp. 9-10.

[12] Gabriel Roeder Smith & Company 2011, p.24. The State's contribution for 2012 in estimated by the State's actuary.

[13] Supra note 1.

[14] Ibid, "Gain Loss Analysis" table, p.15 in 2011 document.

[15] The pay-as-you-go costs are projected by the States actuary each year in order to calculate the AAL. Any deviations by the actual payments are adjusted for in the next valuation.

[16] The assumed rate of return on investment for a fully pre-funded California Employers' Retiree Benefit Trust (CERBT) plan is set at 7.61%. This rate is down from 7.75%, the discount rate CalPERS set for the Public Employees' Retirement Fund, because the CalPERS board concluded that "the current strategy was no longer likely to yield a long term assumed return of 7.75% and maintain the risk level expected of it." The value of 7.61% represents the 50th percentile (median) of projected future returns, meaning that there a 50% chance that the actual long-term rate of return will be greater than or equal to that amount. CalPERS. "Informational Letter to Actuaries and CERBT Employers." April 1st, 2011. <http://www.calpers.ca.gov/eip-docs/employer/retiree-ben-trust/letter-to-actuaries.pdf>. Retrieved June 2012; CalPERS. "Agenda Item 7c." March 15th, 2011. <http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agenda/bpac/201103/item7c-0.pdf'>. Retrieved June 2012.

[17] If the ARC is paid in full, the state will contribute $1.5 billion into an OPEB trust. Assuming that the trust earns an rate of return of 7.61%, it will earn $1.6 billion more over 15 years than it would in the general fund (assuming 4.5% rate of return).

[18] These projections are taken from the OPEB Pre-funding Analysis table create by the State Controller. (http://www.sco.ca.gov/Files-EO/OPEB_Pre-funding_Analysis.pdf). In this table, the savings in unfunded liability due to increased discount rate are amortized over a 15 year period, rather than a 30 year period, per the policy of the actuarial calculations performed by Gabriel Roeder Smith & Company. Additionally, the figures in the pre-funding analysis table can be found in their 2011 Actuarial Valuation. The changes in discount are generated by blending 7.61% and 4.5% rartes by pre-funding level. The savings in this table can be mimicked by rediscounting the initial

unfunded liability at the specified discount rate over 15 years.

[19] 6.2% is the "100-year rate of return for a hypothetical mix of equities and fixed income investments" that matches CalPERS investment mix (Joe Nation. "Pension Math: How California's Retirement Spending is Squeezing The State Budget." Stanford University. 2011. p. 13 . <http://siepr.stanford.edu/system/files/ shared/Nation Statewide Report v081.pdf>. Retrieved July 2012.

[20] The State of California generates earnings from its General Fund based on investments in short-term securities in the Pooled Money Investment Account (PMIA). In the past fifteen years, this average annual rate of return was approximately 4.00% on a nominal basis, with 1.5% attributed to real returns and 2.5% attributable to inflation. Actuarial projections estimate that returns will remain at 1.5% and that inflation with be 3%, totaling to a 4.5% rate of return. This is a projected rate of return that may or may not be met.

[21] Partial pre-funding will result in a blended discount rate. This is because a portion of the contributions will come from General Fund and some will come from the OPEB trust. The blended discount rate is an average based the expected rate of return of both accounts and what portions of the payments are coming from them.

[22] For a discussion of appropriate discount rates to be used for such plans see Munnell et al. "Valuing Liabilities in State and Local Plans." Center for Retirement Research, 2010. <http://crr.bc.edu/wp-content/uploads/2010/06/slp_11-508.pdf>. Retrieved July 2012; and Jeffrey R. Brown and David W. Wilcox. "Discounting State and Local Pension Liabilities." The American Economic Review. Vol. 99, No. 2, 2009. pp. 538-542.

[23] These are found in the GASB 45 Closed Group Projections performed by Gabriel Roeder Smith & Company. This document is available at http://www.sco.ca.gov/Press-Releases/2009/2009_02_pr09012_closed_group_lttr.pdf. These are fairly rough estimates, and for the purpose of this paper, they serve as illustrative purposes. These projections show the pay-as-you-go costs compared to the full funding ARC over time.

[24] This figure is for illustrative purposes only. The pay-as-you-go costs vs. full funding may be different. However, over time, the full funding option will be cheaper than the pay-as-you-go, although the ARC may not drop below the pay-as-you-go until the funding ratio is 100%, at which point the ARC will only be composed of normal costs.

[25] Craig Gustafson. "Ruling on Retiree Health Care Could Spur Negotiations." UT San Diego, 29 Apr. 2011. <http://www.utsandiego.com/news/2011/apr/29/judge-retiree-health-coverage-not-mandatory-curren/>. Retrieved June 2012.

[26] This is case number 37-2010-00086284-CU-PN-CTL. This case is public record and can be found in the database of the San Diego County Court System. <http://www.sdcourt.ca.gov/portal/page?_pageid= 55,1641155&_dad=portal&_schema=PORTAL>. Retrieved July 2012.

[27] Gustafson 2011.

[28] Maura Dolan. "Retired Public Workers Can Count on Promised Benefits, Court Says." Los Angeles Times. 21 Nov. 2011. <http://articles.latimes.com/2011/nov/21/local/la-me-1122-health-benefits-20111122>. Retrieved June 2012.

[29] Leagle.com. "Retired Employees Assn. of Orange County, INC vs. County of Orange." November 21st,. 2011. <http://www.leagle.com/xmlResult.aspx?page=8&xmldoc=In%20CACO%2020111121047.xml& docbase=CSLWAR3-2007-CURR&SizeDisp=7>. Retrieved June 2012.

[30] Supra note 1.

[31] Ibid, p. 4.

[32] California Public Employee Post-Employment Benefits Commission. "Funding Pensions & Retiree Health Care for Public Employees." p. 5. <http://www.pebc.ca.gov/images/files/final/ 080107_PEBCReport2007.pdf>. Retrieved June 2012.

[33] Chiang wrote that "[a]s the State's obligation to pay health and dental benefits for its current and retired workforce continues to grow, it is critical that we begin making down payments on this tab and adopt strategies to reduce health care costs, because this bill is not immediately due, California has the time and the opportunity to reduce the impact on future generations by putting additional dollars into the annual payments so that we can invest those funds, grow that money and tackle our obligation in a responsible manner." California State Controller's Office. "Press Releases: Chiang Unveils Costs for State Retiree Health Benefits, Offers Solutions." California State Controller's Office March 14, 2011. <http://www.sco.ca.gov/eo_pressrel_9810.html>. Retrieved June 2012.

[34] Legislative Analyst's Office. Review of Proposition. April 20, 2012. <http://www.lao.ca.gov/ballot/2012/120207.aspx>. Retrieved June

2012.

[35] Governor Jerry Brown. "Twelve Point Pension Reform Act." October 27, 2012. <http://gov.ca.gov/docs/Twelve_Point_Pension_Reform_10.27.11.pdf>. Retrieved June 2012.

[36] PFM Asset Management LLC. "Pension and OPEB Liabilities: Managing Liabilities, Cost Drivers and the Message." Public Power. 2011. p. 16. <http://www.publicpower.org/files/BandF/FaberMiller.pdf>. Retrieved July 2012.

[37] Phil Daigle. "Employers Buying 'Narrow Network' HMO Plans." Health Shopper. 2011. <http://www.health careshopper.com/blog/2011/04/narrow_network_hmo_plans.html>. Retrieved July 2012.

[38] Scott G. Miller, CFO. "Comprehensive Annual Financial Report for the City of Beverly Hills." Beverly Hills, CA. <http://www.beverlyhills.org/government/admin/finance/budget.asp>. Retrieved July 2012. See the Post Employment Health Care Benefits Section (p. 84). Additionally, the figure of 58% participating rate came from PFM Asset Management LLC 2011, p. 19.