Our Cities Need Preventive Care Too:
How Pre-Funding and Policy Changes Can Help California’s 20 Largest Cities Manage Growing Retiree Benefit Costs

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Executive Summary

Together, California’s 20 largest cities (by budget) currently have already promised $16 billion in non-pension benefits to their current and future retirees, and $12 billion of that remains unfunded. These non-pension benefits, or Other Post-Employment Benefits (OPEBs), largely consist of retiree health care.

As Baby Boomers have begun to reach their 60’s, 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.

In general, these cities are not doing enough to address and plan for these rising long-term costs. Only nine of the studied cities are currently setting aside money for future payments, or “pre-funding.” The other eleven work under “pay-as-you-go” systems, meaning they pay benefits from their operational budgets and do not accumulate assets for future payments. Should these eleven cities do nothing to address them, the growing OPEB costs could eventually crowd out crucial programs in their annual budgets.

Our analysis of the 20 cities’ OPEB obligations found the following:

- **9 pre-funding cities.** Los Angeles, San Jose, San Diego, Anaheim, Roseville, Palo Alto, Bakersfield, Burbank, and Santa Clara all pre-fund their future retiree health care benefits to some extent. Los Angeles has set aside the largest portion (59%) of what it has promised retirees, followed by Anaheim, which has set aside (30%) of what it has promised.

- **11 pay-as-you-go cities.** San Francisco, Oakland, Sacramento, Redding, Santa Ana, Long Beach, Glendale, Fresno, Riverside, Pasadena, and Santa Monica have no funds set aside to pay for future retiree health care. If those 11 cities start paying their OPEB contributions as determined by CalPERS and continue to do so annually, they will collectively save an estimated $2.2 billion in payments for benefits earned before 2011.

- **Benefit costs on the rise.** Average benefit costs among these cities have increased an average of 36% between 2008 and 2011. This figure hides substantial variation: while some cities have seen moderate growth over the period of less than 20% (Sacramento, Pasadena), others have seen their benefit costs jump more than 50% in three years (San Jose, Bakersfield).

- **San Francisco currently has the largest unfunded liability ($4.4 billion).** Though it still has no assets set aside to finance its future obligations, the City took initial steps to address this issue in 2008.

- **San Jose has the largest unfunded liability as a “percentage of covered payroll” (465%).** The city is slowly phasing in a full pre-funding plan, but given the scale of its obligations, it should consider altering its benefit structure.

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, the cost of OPEB to California’s cities will continue to increase in the coming years. To deal with this strain on their operational budgets, they can either restructure the way they pay for these long-term benefits or restructure the benefit plans themselves.

Options for restructuring their funding policy 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, lowering maximum premiums covered, transitioning from defined benefit to defined contribution plans, and introducing cost sharing plans with active employees. But even as they consider changes to their benefit plans, pre-funding still offers them the opportunity to both reduce their future out-of-pocket costs and secure funding for their current and future retirees’ health benefits.
Introduction
Large unfunded promises associated with pensions provided to government employees have recently garnered much attention in news and policy spheres. However, while the overall numbers are smaller, unfunded non-pension retiree benefit obligations such as health care are growing at an even faster rate than pension obligations. Additionally, governments have far less funding set aside to cover these future obligations both at the state and city levels.

California’s top 20 cities by budget currently have an aggregated $16 billion liability attributable to non-pension retiree benefits, or Other Post-Employment Benefits (OPEBs) as they are sometimes called. This liability is increasing as the number of participants in plans rises and as health care costs increase. In general, these cities are not doing enough to address and plan for these long-term costs. Only nine of the studied cities are currently setting aside money for future payments. The other eleven make benefit payments from their operational budgets and do not accumulate assets for future payments.

Each city has two basic options for addressing these increasing unfunded liabilities. It can reduce and/or alter the benefit structure it offers employees to reduce its obligations, or it can set aside more assets now in OPEB trusts. While a city may face difficulty in reducing benefits for current employees, it can certainly reduce them for new hires. Short of altering or reducing benefits, the only other way for cities to reduce their overall liabilities is to set aside more assets now in OPEB trusts to pre-fund the obligation.

Pre-funding conforms to the general principle that each generation of taxpayers should bear 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. Allocating assets for these benefits now would ensure that sufficient funding is available to provide the promised benefits in the future. Inaction on the part of city governments automatically places the burden of these increasing costs on future generations. As the costs rise, they will begin to crowd out crucial local services such as police and fire protection, road maintenance, and garbage collection.

This report analyzes the accrued OPEB liabilities of the 20 largest cities in California and their cities’ current efforts to contain the growth of those liabilities. Our key findings are:

- The 20 cities currently have an aggregated $16 billion liability attributable to non-pension benefits, $12 billion of which remains unfunded.
- Benefit payments among these cities have increased an average of 36% between 2008 and 2011. This figure hides substantial variation: while some cities have seen moderate growth over the period of less than 20% (Sacramento, Pasadena), others have seen their benefit payments rise more than 50% in three years (San Jose, Bakersfield). At this rate, San Jose’s entire budget will be devoted to current-year OPEB costs in 20-30 years.
- Eleven cities are currently funding their OPEBs on a pay-as-you-go basis, and the other nine cities pre-fund their obligations to various degrees. If those 11 cities start paying their contributions as determined by CalPERS and continue to do so annually, they will collectively save an estimated $2.2 billion in payments for benefits earned before 2011.
- San Francisco currently has the largest unfunded liability ($4.4 billion), but still has no assets set aside to finance its future obligations. However, the City took initial steps to address this issue in 2008.
- San Jose currently has the largest unfunded liability as a “percentage of covered payroll” (465%). It will need to negotiate higher employee contribution levels with some of its employee bargaining units in order to fully pre-fund benefits. Given the scale of its obligations, it should seriously consider altering its benefit structure.
- Recent reforms designed to manage growing unfunded liabilities, such as those of San Jose and San Francisco, are insufficient to meaningfully address the OPEB funding problem.
- It is unclear whether governments may revoke existing OPEB obligations, either partially or fully. The debate is currently taking place both in the courtroom and outside it.

This report is split into two parts. In the first, we analyze the trends across the set of 20 cities, comparing their benefits, funding strategies and funding statuses. In the second part, we investigate three cities in more depth, illustrating the three possible approaches to OPEB obligations: full pre-funding, partial pre-funding and pay-as-you-go. At a more general level, we argue that policy makers should plan for and address these increasing costs as soon as possible.
Background
Other Post-Employment Benefits (OPEBs) are retirement benefits other than pension that an employee earns during his or her employment and receives after retiring. The employer - in this case, a particular city - provides these benefits after retirement. Generally, governments also cover the retiree’s spouse and their dependents. These benefits commonly include health care, long-term care (such as nursing homes), and life insurance after retirement. Of these, however, health care normally accounts for the largest portion of OPEBs. Table 1 describes the benefits each city offers.

Local governments do not bear the entire responsibility for covering retirees’ health care costs. 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. Once a retiree turns 65, if he or she is eligible for Medicare, city health care plans become secondary coverage. City health care plans typically cover the Medicare “gap,” which refers to the costs that Medicare does not cover. Under the California Public Employees’ Medical and Hospital Care Act (PEMHCAC), retirees are provided access to group health insurance. The CalPERS board of Administration manages this program and determines the structure of benefits, copays, deductibles, providers, and premiums. In order for a public agency to participate, it must agree to provide access to health benefits for active employees and annuitants on an equal basis. This means that the employer is required to make equal contributions towards premiums costs for both groups (though the benefits offered by the plans may be different). Their levels are set by statute.

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 B). 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 OPEBs an Issue?
Across the 20 cities we analyzed, OPEB costs have increased by an average of 36% since 2008. Consequently, they are consuming ever greater portions of cities’ operating budgets (see Figure 1). On average, these costs are now equivalent to 3.28% of a city’s General Fund expenditures, a significant increase from 2.21% in 2008. For some cities, however, the increases have been dramatic. San Jose spent almost 8% of
Anaheim  
City provides a defined benefit to eligible employees hired before January 1st, 1996, Anaheim police members hired before July 6, 2001, and Anaheim Fire Association members hired before November 9, 2001. No defined benefits are provided for those hired later. Retirees as a group contribute 1.7% of total payroll.

Bakersfield  
City contributes 3% of the lowest individual rate per year of service to a maximum of 90%. Additional contributions for those who elect certain plans.

Burbank  
City pays PEMHCA minimum for all miscellaneous and safety employees. The City provides an additional medical benefit to all non-safety employees. Members contribute a hundred dollars per month, which the city matches. The benefit is up to $300 per month. The city also has a similar trust for IBEW members and 7 management employees.

Fresno  
City pays nothing. Retirees pay 100% of premiums.

Glendale  
For some employees, the City will contribute all or part of retirees’ monthly medical insurance premiums based on the accumulated unused sick days. For other employees, the City provides retiree medical benefits through its standalone health plans. This allows pre-Medicare eligible retirees to purchase health care at cheaper rates.

Los Angeles  
City contribution is based on years of service and plan with a maximum subsidy. In 2011, Los Angeles adopted an ordinance to freeze the maximum medical subsidy at the current level of $1,190 for LACERS members who retire on or after July 1st, 2011. Those who contribute 2% or 4% will be exempt from the freeze and receive vested rights to future increases in the maximum medical subsidy at an amount not less than the dollar increase in the Kaiser two-party non-Medicare Part A and Part B premium. Sixty three percent of non-retired members are making contributions.

Sacramento  
Contributions based on years of service. Those with 20 years are eligible for 100% of the maximum benefit. The benefit contributions currently range from $365 to $694 per month per participant which covers between 16% and 100% of the benefit cost depending on plan provisions.

Santa Monica  
Employees may elect coverage in the city’s health plan at the same rates as active employees. Eligible executive participants have their insurance premiums paid upon retirement. Other employees receive flat monthly premium subsidies (PEMHCA minimum benefits).

*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.

1 While Fresno, Long Beach and Riverside do not actively pay towards retiree benefits, they do incur an implied subsidy, increasing the rates for current employees. This subsidy is reflected in the pay-as-you-go costs shown in Figure 1 and UAAL shown in Figure 2.
its General Fund on OPEBs in 2011, up from 5.2% in 2008, an increase of 43%. In half of the cities listed, costs are doubling every 4-6 years.

If these trends continue, city governments will face increasingly hard choices between providing these promised benefits and providing services to their residents. For example, in Stockton, a city that recently filed for bankruptcy, OPEB costs comprised about 7.5% - a relatively large portion - of the operating budget. When the City announced its decision to file for bankruptcy, it noted that it would eliminate retiree health benefits after 2013.

Health care is the largest component of OPEBs. As Baby Boomers generation have begun to enter their 60’s, we have seen an upswing in retirees accompanied by an increase in health costs. 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. 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. 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. 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 20 cities have an aggregate $16 billion in OPEB liabilities, of which $12 billion is unfunded. Although an estimate, 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 out during the remaining lifetime of each of the covered employees.

Eleven of the 20 cities we studied fund their OPEBs on a pay-as-you-go basis and have a zero percent funding ratio (see Appendix A). The remaining nine cities set aside money to pre-fund these benefits. Full pre-funding means paying the full Annual Required Contribution (ARC) every year (see inset box). San Francisco is a pay-as-you-go city and has the largest unfunded liability - $4.4 billion - meaning that it has the largest gap between how much it has promised its retirees and how much it has set aside to fund those promises. Los Angeles, on the other hand, maintains the highest funded ratio - 59% across its three plans, as calculated based on current GASB rules (see Discount Rate box below).

When comparing the UAAL across cities of different size, a useful metric is the UAAL as a percentage of covered payroll (the total amount spent on salaries in that year). Figure 2 shows UAAL as a percentage of covered payroll across the 20 cities.

By relating a city’s obligations to its current expenditures on employees, UAAL as a percentage of covered payroll reflects a city’s ability to fund it. To account for rising costs, cities often adjust OPEB plan provisions to require employee contributions to help pay the ARC. Thus, a large UAAL as a percentage of covered payroll portends that precariously high contributions may be required from a city’s employees (since there are relatively fewer of them) and from the city’s budget to fund the benefits.

For example, San Jose’s combined plans have the highest UAAL as a percentage of covered payroll at 465%. This reflects the combination of a shrinking employee pool and an increase in UAAL since 2008. As we show in a case study below, this situation may result in extremely high contribution levels within a few years. San Francisco, meanwhile, which has the highest UAAL in absolute terms, has only the fifth highest UAAL as a percentage of covered payrolls, suggesting that its burden - while heavy - is substantially more manageable than San Jose’s.

Most cities have very low funding ratios because OPEBs were not thought to need pre-funding before 2008. Since then, cities’ funding progress has varied widely, as measured by the percent of annual OPEB costs contributed to OPEB trusts and their funded ratio (see Figure 3; Annual OPEB Cost, or AOC, approximately corresponds to the Annual Required Contribution, or ARC).

Cities that lie on or above the Annual OPEB Cost (AOC) consistency bar are following or exceeding actuarial funding recommendations and are progressing toward paying off

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**Annual Required Contribution**

The Annual Required Contribution (ARC) is an actuarially determined amount for a given OPEB plan which, if paid every year, will theoretically result in that plan being fully funded for each employee at the time of his or her retirement. In other words, the retiree’s benefits would be paid only from the designated trust, instead of directly from the government’s operating budget. The ARC is composed of “normal cost” and “amortized cost.” The normal cost is a portion of the Present Value of Projected Benefits that is earned with the current year of service by each employee, in other words, the additional cost that the city will have to pay down the line because the employee worked this year. The amortized cost is the portion of the current unfunded liability due that year. The unfunded liability, in turn, simply the sum of all past normal costs that were not paid and the missed earnings they would have accrued if paid on time.

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The average percentage of the annual OPEB costs that the city has contributed. Having a 100% funded ratio means that the aggregated actual contributions equal the aggregate annual OPEB costs over the last four years.
their unfunded liabilities (see Table 2). Anaheim has contributed the largest amount of its annual OPEB costs over the last for years - 285%. This means that every year, on average, it paid three times the AOC. Meanwhile, fifteen of the 20 cities lie below.

The AOC consistency bar represents a path to attaining a 100% funded ratio by the end of the amortization period, usually 30 years. In other words, this is the amount a city needs to contribute to fully meet expected OPEB obligations over the next 30 years. By this measure, only five cities (Anaheim, Burbank, Palo Alto, Los Angeles, and Santa Clara) are following or exceeding the amortized payment plan: it is not a coincidence that these are also the five cities with the five highest overall funding ratios. Roseville, Bakersfield, San Diego, and San Jose have taken incremental steps toward offsetting their UAALs by partially paying their ARCs. The remaining cities operate under pay-as-you-go plans.

Table 2: Accumulation of Assets

<table>
<thead>
<tr>
<th>City</th>
<th>Starting Funding Ratio</th>
<th>Accumulated Assets (in thousands of dollars)</th>
<th>End Funding Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anaheim</td>
<td>0%</td>
<td>0</td>
<td>63,097</td>
</tr>
<tr>
<td>Bakersfield</td>
<td>4%</td>
<td>4,800</td>
<td>4,800</td>
</tr>
<tr>
<td>Burbank</td>
<td>37%</td>
<td>11,065</td>
<td>14,478</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>55%</td>
<td>2,830,204</td>
<td>3,002,129</td>
</tr>
<tr>
<td>Palo Alto</td>
<td>0%</td>
<td>0</td>
<td>24,616</td>
</tr>
<tr>
<td>Roseville</td>
<td>0%</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>San Diego</td>
<td>2%</td>
<td>29,637</td>
<td>41,497</td>
</tr>
<tr>
<td>San Jose</td>
<td>11%</td>
<td>141,994</td>
<td>141,182</td>
</tr>
<tr>
<td>Santa Clara</td>
<td>0%</td>
<td>4,502</td>
<td>4,502</td>
</tr>
</tbody>
</table>

Funding ratios are computed by CalPERS based on each city’s actuarial discount rate (see Discount Rate box below).

* Burbank’s starting ratio is from 2009, since not all three of its plans had full GASB OPEB reporting until then.

Why Pre-fund?

Although pre-funding requires higher contributions in the short term, it is actually the cheaper option in the long term (see Figure 4). Annual pay-as-you-go OPEB costs eventually surpass annual pre-funding OPEB costs and, over time, the positive difference between the ARC and the pay-as-you-go cost (shown in red, dashed), will outweigh the higher upfront costs (shown as blue, dashed). The actual trends will vary, but the concept will remain the same. Cities realize the advantages of pre-funding OPEBs for active employees when those active employees retire. Pre-funding OPEBs allows a city government to secure its promises by allocating assets towards funding future benefit payments, to save on out-of-pocket expenses in the future, and to maintain a good credit standing. Finally, it protects future generations from costs incurred by previous generations and enforces fiscally responsible policies.

Figure 4: Pay-as-you-go vs. Pre-funding

1. Building up Assets to Fund Liability and Secure Promised Benefits

Setting aside funds for a promised benefit at the time the employee actually earns it ensures that when the employee retires, sufficient funding will be available to pay for the benefit (if assumptions are met and absent catastrophic investment losses). The cities in Table 2 have been accumulating assets and some are well on their way to achieving 100% funded ratios. Those cities will be able to use these assets to pay for future OPEBs.

15. The actual trends will vary, but the concept will remain the same.
2. Savings on Out-of-Pocket Expenses

If the actuarial assumptions prove sound and cities do not reduce their health benefits, they must eventually pay their projected liabilities. However, pre-funding can supplement the amount paid out of the annual operational budget with investment earnings, thereby reducing the amount a city must spend out-of-pocket in the long run. By fully pre-funding, the pay-as-you-go cities can save an estimated $2.2 billion among them (see Table 3).17

If the assumed return rates are not realized, then actual savings will (see Table 3 below). For example, if the realized rate of return will be 6.2%, then the total savings will be closer to $1.4 billion.18 But even if the investment return of the OPEB trust is only equal to that of the short-term General Fund’s investment return rate, approximately 4% in recent history, the cities will have accumulated dedicated assets allocated toward providing these benefits.19 But ultimately, pre-funding into an irrevocable OPEB trust should result in significant savings compared to continuously paying for OPEBs out of the General Fund.

Table 3: Pre-funding Savings (dollars in thousands)20

<table>
<thead>
<tr>
<th>City</th>
<th>UAAL At Current Rate</th>
<th>Savings at 6.2% return rate</th>
<th>Savings at 7.61% return rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fresno</td>
<td>$84,252 (4%)</td>
<td>$22,704</td>
<td>$33,752</td>
</tr>
<tr>
<td>Oakland</td>
<td>$520,882 (4%)</td>
<td>$140,367</td>
<td>$208,670</td>
</tr>
<tr>
<td>Pasadena</td>
<td>$31,678 (4%)</td>
<td>$8,537</td>
<td>$12,690</td>
</tr>
<tr>
<td>Sacramento</td>
<td>$376,417 (4.25%)</td>
<td>$91,353</td>
<td>$142,522</td>
</tr>
<tr>
<td>San Francisco</td>
<td>$4,400,000 (4.25%)</td>
<td>$1,067,840</td>
<td>$1,655,964</td>
</tr>
<tr>
<td>Santa Ana</td>
<td>$122,720 (4.25%)</td>
<td>$29,783</td>
<td>$46,465</td>
</tr>
<tr>
<td>Riverside</td>
<td>$54,900 (4.5%)</td>
<td>$11,803</td>
<td>$19,539</td>
</tr>
<tr>
<td>Glendale</td>
<td>$103,947 (4.5%)</td>
<td>$22,347</td>
<td>$36,995</td>
</tr>
<tr>
<td>Redding</td>
<td>$125,500 (4.75%)</td>
<td>$23,386</td>
<td>$41,716</td>
</tr>
<tr>
<td>Long Beach</td>
<td>$120,714 (5%)</td>
<td>$18,918</td>
<td>$37,191</td>
</tr>
<tr>
<td>Santa Monica</td>
<td>$20,173 (5%)</td>
<td>$3,162</td>
<td>$6,216</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,440,200</strong></td>
<td><strong>$2,251,720</strong></td>
<td></td>
</tr>
</tbody>
</table>

3. Maintaining Good Credit Standing

Even if city governments determine that the pay-as-you-go costs will be manageable in future years and that the additional savings from pre-funding into OPEB trusts are not sufficiently attractive, there remains another downside to a pay-as-you-go policy. Credit ratings agencies Fitch Ratings, Standard and Poor’s, and Moody’s have stated that they will consider OPEB funding status in their evaluations of a government’s current financial status. Credit rating agencies evaluate the OPEB liability for each city on a case-by-case basis. OPEB funding policy and progress are becoming increasingly important among the factors that they use to evaluate a city’s credit ratings.22 Fitch, for example, has stated that it “does not expect OPEB plan funding ratios to reach the generally high levels of pension systems for many years, but steady progress toward reaching the actuarially determined annual contribution level will be critical to sound credit quality.”23 Standard and Poor’s has commented that, “while the funding schedule for these long-term liabilities can be more flexible than a fixed debt repayment schedule, in our opinion these liabilities can also be more volatile and could lead to fiscal stress if not managed.”24 Failure to make progress toward a fully funded plan may not have immediate side effects, but it may result in lower credit ratings and increased borrowing costs to cities down the road.

Arguments Against Pre-funding

Despite the advantages of adopting a pre-funding plan, there are important countervailing considerations that

Are OPEBs Obligations Revocable?

To draw down its obligations, cities may opt to change the provisions of their OPEB plans. These changes may include requiring employee contributions, reducing premium coverage, or making eligibility requirements stricter. However, the extent to which a city 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, the San Diego Superior Court ruled that the city of San Diego does not have an obligation to provide health care to its current employees after they retire. The lawsuit, Christopher Ellis v 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. San Diego currently has $1.1 billion in unfunded liabilities and is in the process of renegotiating its obligations with labor leaders.

The plaintiffs argued that these benefits are vested and that therefore approval by city employees is required to change them. However, Judge Ronald Prager ruled for the City, opining that these rights are not vested because they exist outside the pension system and therefore are an option 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 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 the government employer. The decision stated that county employees may have a vested right to health benefits under certain circumstances. 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.
must be noted. Setting money aside for future payments permanently redirects it away from current services and programs. This practice may be risky for cities with more limited financial resources, smaller OPEB liabilities and lower pay-as-you-go costs.

An alternative to full pre-funding is adopting a phase-in plan which requires making increasing contributions until the ARC is paid in full. Consistency, however, is essential in order to maintain the benefits of pre-funding. Improvements in the funding ratio will evaporate if payments are not consistently made. Still, any assets allocated towards funding OPEB benefits will help pay for these costs, at least partially, in future years.

Each city must weigh the options for itself. Indeed, investments come in many forms, not all of them financial. In some cases, funds may be more productive in certain education programs, infrastructure projects, redevelopment projects, or other initiatives that may grow a city’s tax base down the road. However, cities must closely monitor OPEB obligations to avoid being blindsided by ballooning costs.

**Conclusion**

The implementation of GASB Statements 43 and 45 has made the true costs of providing OPEBs more transparent. These costs have increased 36% on average since 2008 and are expected to continue increasing rapidly in the future. In some cities, they have increased more than 50% in just three years. At this pace, these cities’ entire budget will be devoted to OPEBs in 20-30 years. Of the 20 California cities we studied, only nine have allocated assets towards offsetting their future OPEB liabilities, and of these, only five have met or exceeded their Annual Required Contributions, setting them on a path toward being fully funded. The other 11 cities pay their OPEBs on a pay-as-you-go basis from their operating budgets each year. These budgets will be squeezed as OPEB costs grow.

Pay-as-you-go funding also transfers the cost of the present generation’s benefits to future generations. It remains uncertain whether courts will determine retirees to be legally entitled to OPEBs promised to them. Pre-funding offers the opportunity to hedge against that uncertainty because it helps to ensure that a city has sufficient assets available to provide these benefits in future years, while potentially resulting in savings and a better credit standing. However, each city must ultimately evaluate its specific financial situation to determine how to structure its OPEB plans and its funding policy so as to most effectively address its rising OPEB costs.

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The terms of retiree benefits and their funding methods vary widely. The cities of San Francisco, San Jose, and Palo Alto represent the spectrum of policies from pay-as-you-go, to partial pre-funding, to full pre-funding, and their respective consequences. We chose San Francisco as the pay-as-you-go case study for its large unfunded liability and current zero percent funded ratio. We chose San Jose as the partial pre-funding case study for its large UAAL as a percentage of covered payroll and its unusually well-documented “phase-in” approach to increasing its OPEB contributions. We chose Palo Alto as the full pre-funding case study for its high contributions to its OPEB trust and the accessibility of its future projections.

Case Study: San Francisco

San Francisco currently has the largest unfunded liability of any city in California. It is a pay-as-you-go city that took an initial step toward pre-funding its future OPEB liability when its residents passed Proposition B 2008. That step, however, does not address any existing unfunded liability, and because the effects of its implementation have yet to be recorded, we consider it a pay-as-you-go city. San Francisco’s case clearly illustrates the growing magnitude of OPEB costs.

In 2008, San Francisco residents passed Proposition B, which increased the number of service years required for employees to qualify for employer-funded retiree health benefits. Prop B affected employees of the City and overlapping districts who retire under the San Francisco Employees Retirement Systems (SFERS) or the California Public Employees’ Retirement System (CalPERS) and were hired on or after January 10, 2009 (see Table 4). Before Prop B, these employees were eligible for employer-funded retiree health care benefits after five years of service.

Table 4: San Francisco Retiree Health Care Benefits

<table>
<thead>
<tr>
<th>Hire Date:</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before January 10, 2009</td>
<td>The city’s contribution is determined as follows: When a retiree is not eligible or enrolled in Medicare: • The city contributes less than 50% of the contributions required for an active employee in the same plan. • Spouse subsidy is equal to 50% of the incremental premium required to add a spouse When a retiree is enrolled in Medicare: • The city contributes the “10 county survey amount” • The city contributes 50% of the incremental premium required to add spouse coverage</td>
</tr>
<tr>
<td>After January 10, 2009</td>
<td>The city’s contribution is determined for those hired before January 10, 2009 and then multiplied by the following percentages based on years of service: • Less than 10 years: 0% • 10-15 years: 50% • 15-20: 75% • 20 or more years of service: 100%</td>
</tr>
</tbody>
</table>

In addition to contribution changes, Prop B established a separate trust fund that is dedicated to funding retiree health care for employees hired on or after January 10, 2009. Employees contribute up to 2% of their pre-tax compensation and employers contribute 1% of employees’ pre-tax compensation costs. Thus, together, San Francisco’s employees and employers would set aside 3% of covered payroll for future payments. Under a fully pre-funded plan, the future normal costs for San Francisco are estimated to be 2.9% of payroll. Therefore theoretically, going forward, this plan would cover the OPEB obligations earned through new years of service.

However, the estimated normal cost of 2.9% of covered payroll assumes a discount rate of 7%. This discount rate would be more appropriate if the majority of the plan’s population was composed of post-Prop B employees. But in fact, it is estimated that even by 2033, the majority of retirees receiving benefits and over three quarters of the City’s unfunded liability will still be from employees hired before January 10, 2009, whose benefits are not pre-funded. Thus, in the near-term, pre-Prop B liabilities will dominate the City’s overall OPEB liability, so the accumulated assets will only cover a small fraction of the overall liability. Hence, a more appropriate discount rate would be a blended one close to the City’s current pay-as-you-go plan’s 4.25% discount rate.

When the liabilities are discounted with that blended rate, the normal cost will be closer to 5.8% of payroll, which exceeds the 3% level of pre-funding specified by Prop B. In the near-term, therefore, even post-Prop B employees will still accrue unfunded liabilities because their normal costs will not be fully funded. In 2033, the unfunded liability is projected to be $9.7 billion, $8.0 billion of which will be attributable to employees hired before January 10, 2009. Ironically, post-Prop B employees will still generate a $1.7 billion unfunded liability (see Figure 5). The City will not realize the full effect of Prop B until all pre-Prop B employees have retired and received all benefits due.

Figure 5: Implications of San Francisco Prop B (2008) Projected into Year 2033

![Figure 5: Implications of San Francisco Prop B (2008) Projected into Year 2033](chart.png)

- AAL ($12.3 billion)
- UAAL for Prop B Eligible Employees ($1.7 billion)
- UAAL for Pre-Prop B Eligible Employees ($8 billion)
- Employee Prefunding ($0.87 billion)
- City Pre-Funding ($1.73 billion)
- Savings in AAL from Prop B ($1.6 billion)
Looking in the long-term, Prop B is certainly a step in the right direction as it saves $1.6 billion in AAL and pre-funds OPEB obligations for new hires. In the coming years, San Francisco will become a legitimate partially pre-funding city. However, because this plan does not dedicate any funds to the unfunded liability attributable to employees hired before January 10, 2009, it fails to fully address the City’s annual operating budget. In that sense, Prop B is still insufficient in addressing the City’s unfunded liability. This plan might have been effective had the city not already accrued a large unfunded liability.

San Francisco’s pay-as-you-go costs are projected to increase by about 350% by 2038 to $500 million (see Figure 6). In 2011, the pay-as-you-go costs were equivalent to 6% of General Fund expenditures and this proportion is expected to continue growing in the coming years.

**Figure 6: San Francisco Projected Pay-as-you-go Costs (in millions of dollars)**

![Graph showing projected pay-as-you-go costs](image)

In 2010, another proposition, Prop B 2010 (The Adachi Initiative), was placed on the ballot that would increase employee contributions to the retirement benefit system, decrease employer’s contributions to the health care system and change rules for arbitration proceedings for the City’s collective bargaining agreements. It would have required a city employee to pay for 50%, rather than 25%, of his family’s post-retirement health care coverage. It was estimated that this proposition would save the San Francisco $167 million a year on OPEBs and pensions. Ultimately, voters defeated this initiative in November 2010. As a result, the growing unfunded liability will pose increasing risk to San Francisco’s financial future.

Moody’s credit rating for San Francisco reflects this risk. In 2010, Moody’s downgraded San Francisco from an Aa1 to an Aa2 rating. The agency stated that the City’s OPEB liability is “extremely large and will be a significant long-term challenge,” and indicated that San Francisco has not done enough to address its already outsized unfunded liability. However, the agency expressed confidence “that the city will prepare a long-term solution to this funding challenge which it will implement when economic conditions improve.” Though its concern about San Francisco’s OPEBs are growing, Moody’s does not yet consider them an urgent danger.

**Case Study: Palo Alto**

Palo Alto is an example of a city that has pre-funded its OPEB liability since the implementation of GASB statements 43 and 45 in 2008. Palo Alto’s plan shows that pay-as-you-go costs increase faster than the ARC. It also provides a cautionary evidence that a city’s unfunded liability may grow even if payments consistent with the ARC are made due to changes in actuarial assumptions.

**Table 5: Palo Alto Retiree Health Care Benefits**

<table>
<thead>
<tr>
<th>Type</th>
<th>Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical</td>
<td>Hired before January 1, 2004:</td>
</tr>
<tr>
<td></td>
<td>• Retired Before 2007: Full premium of the employee and</td>
</tr>
<tr>
<td></td>
<td>• Retired After 2007: Full premium for the employee is</td>
</tr>
<tr>
<td></td>
<td>Hired After January 1, 2004:</td>
</tr>
<tr>
<td></td>
<td>• City contributions based on years of service ranging from</td>
</tr>
<tr>
<td></td>
<td>For Mgmt./Conf, SEIU, and UMPAPA employees that retire after</td>
</tr>
<tr>
<td>Dental and Vision</td>
<td>None</td>
</tr>
</tbody>
</table>

With rising health care costs, Palo Alto has negotiated several cost saving measures to cap the health care premiums it must pay every year. It implemented a vesting schedule and reduced its maximum payment for medical premiums from the highest plan to the second highest plan for employees retired after January 1, 2007.

On August 2, 2010, the City Council authorized a 90/10 cost sharing plan between the City and members of the Service Employees International Union. Under the new plan, the City and its employees will split the cost of the annual increase in medical premium costs, capping the employee share at 5% increase in the premium per year. Once the employee contribution reaches 10% of total premium cost, it
will remain there with the City picking up the other 90%. It is estimated that cost sharing reduced the City’s unfunded liability by $14.2 million.

As shown in Figure 7, the City has contributed more than its annual OPEB costs over the last four years. In 2008, Palo Alto established an irrevocable trust for retiree medical benefits. The City intends to fully fund the ARC in future years by making contributions as a constant percentage of an increasing covered payroll. As time passes, the pay-as-you-go cost increases faster than and approaches the ARC (see Figure 8). This happens because as Palo Alto’s overall funding ratio increases and its assets accumulate through saving and investment gains, the City will have to dedicate fewer funds to paying off its unfunded liability. An extrapolation to 20 years will provide a similar illustration to that of Figure 1.

As of June 30, 2011, the City’s assets were valued at $44.8 million. But even with the new cost sharing plan and the establishment of the OPEB trust, Palo Alto still saw its unfunded liability rise 28% from $105 million in 2009 to $134.7 million in 2011. This increase is due primarily to changes in the actuarial assumptions, as broken down in Table 6. Implementing a cost-sharing plan decreased the unfunded liability by $14.2 million. However, after the City adopted the plan, it saw a spike in retirements. As cost sharing was implemented, there were more retirements than the City originally projected for the 2009 to 2011 period. These additional retirements added $2.7 million to the unfunded liability. Medical premiums also increased at a higher rate than expected, which increased the unfunded liability by $4.8 million. Furthermore, premiums have increased slower than claims costs, meaning that the premium prices will eventually experience a spike to more accurately reflect the increased claims costs. This accounts for an additional $3.4 million in liability. Maintaining a closed amortization period increased the unfunded liability by another $12.4 million. In all, deviations from the original actuarial assumptions led to a sizable increase in Palo Alto’s unfunded liability despite the fact that the City has made payments consistent with its ARC.

As a result, some questions were raised as to whether the calculation of the unfunded liability was too conservative. Councilman Larry Klein observed that the huge increase of $29 million may cause the higher annual payments to cut into other local funding priorities such as infrastructure. He estimated that retiree health care contributions would be close to 10% of the City’s General Fund budget. He stated, “[Fully pre-funding], to me, is freezing out various expenditures which may in fact be better for the health of our community in the long run. I can make an argument that paying large sums into this [OPEB trust] may not be healthy for the community long-term financially.”

However, the benefits from this funding plan will be seen in the long term. Although it requires higher contributions now, if Palo Alto maintains the current funding plan, it will accumulate enough assets so that in future years, benefit payments will come out of the OPEB trust rather than the General Fund. This will provide more financial flexibility in the future because the long-term savings can be dedicated to other programs to help maintain the health of the community. A pre-funding plan makes the cost of providing OPEBs more certain and manageable.

Case Study: San Jose
San Jose has begun to phase-in pre-funding for its two OPEB plans. Its contributions illustrate gradual progress towards meeting its ARC, with a large planned contribution spike in the fifth year. Implementing that contribution spike will require negotiations between the City and some of its employees. The City’s UAAL as a percentage of its volatile covered payroll is still the highest among the 20 cities and its overall funding ratio has seen little improvement thus far, meaning that the benefits of San Jose’s pre-funding plan have yet to occur. Indeed, it is the only pre-funding city to see a decrease in its funded ratio since starting to pre-fund.

The city of San Jose has two separate retirement health

<table>
<thead>
<tr>
<th>Adjustment</th>
<th>Change in Unfunded Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life Span Increases, decreasing retirement age, etc.</td>
<td>+$8 million</td>
</tr>
<tr>
<td>Spike In Retirements</td>
<td>+$2.7 million</td>
</tr>
<tr>
<td>Medical Premium Increases</td>
<td>+$4.8 million</td>
</tr>
<tr>
<td>Premiums Increase Slower than Claims</td>
<td>+$3.4 million</td>
</tr>
<tr>
<td>Cost Sharing Implementation</td>
<td>-$14.2 million</td>
</tr>
<tr>
<td>Migration of Employees to More Expensive Medical Plans</td>
<td>+$7.7 million</td>
</tr>
<tr>
<td>Asset Smoothing</td>
<td>+$4.6 million</td>
</tr>
<tr>
<td>Other Factors</td>
<td>+$12.4 million</td>
</tr>
<tr>
<td>Net Change:</td>
<td>+$29 million</td>
</tr>
</tbody>
</table>
care plans: the Police and Fire Departments Postemployment Health Care Plan (PFDRP) and the Federated City Employees’ Postemployment Health Care Plan (FCERS). There are 1,798 and 3,073 retirees currently receiving benefits under the two plans respectively. San Jose combines active employees and retirees in its health care plans, and because retiree health costs are higher, the average cost to provide health care to active employees increases as well. This cost increase that is not explicitly attributed to the retiree plans is referred to as an implied subsidy. The benefits provided by both plans to eligible retirees are listed in Table 7.

San Jose is currently phasing in a funding plan for its OPEB obligations. It has contributed increasing amounts over the last four years, but because its contributions are far below the ARC, its aggregated funded ratio has dropped from 11% to 9% during that time.

San Jose is currently phasing in a funding plan for its OPEB obligations. It has contributed increasing amounts over the last four years, but because its contributions are far below the ARC, its aggregated funded ratio has dropped from 11% to 9% during that time.

San Jose currently has the highest UAAL as a percentage of covered payroll. A high UAAL in relation to covered payroll indicates a high retiree to active employee ratio. From 2010 to 2011 alone, the number of active employees decreased from 5839 to 5027, leading to a reduction in covered payroll from $551 million to $419 million. Meanwhile, the number of retirees receiving medical benefits increased from 4619 to 5002. As a result, San Jose currently has the largest ARC as a percentage of covered payroll in 2011 - 26%. These high values have critical implications for the City because its employees contribute portions of their payroll to fund OPEBs. If the number of active employees continues to decrease, the burden of funding the City’s OPEB obligations will be increasingly spread over fewer employees during the phase-in process. This may pose problems when the City begins to negotiate with the employees regarding instating higher contribution rates in 2014.

The San Jose Federal City Employee Retirement System and the San Jose Police and Fire Department Retirement Plan have different contribution agreements and funding status, so we will discuss them separately.

San Jose Federal City Employee Retirement System

The bargaining units representing the Federated City Employee Retirement System (FCERS) members entered into a Memorandum of Agreement that took effect on June 28, 2009. It increased the employee and employer contribution rates for retiree health and dental coverage in order to phase-in funding rates with a goal of fully pre-funding the ARC over a five year period. The contributions are split between both employees and the City. This agreement also contains a cap that prevents either employee or City contribution rates from increasing by more than 0.75% per year until the last year of the phase-in when the City must contribute the full ARC.

Table 8 documents the five-year phase-in plan for San Jose FCERS. The phase-in plan includes incremental increases in contributions with a large increase in 2013-2014 for both the City and its employees, totaling 32.34% of covered payroll. This is a significant spike in contributions. That doubling of the contribution level will bring it up to the level of the full ARC (see Figure 8). The accuracy of the percentages of payroll required, however, relies on the assumption that it will grow 3.25% per year. Based on the decline in covered payroll since 2008, this seems unlikely to occur. Thus, in order to meet the ARC by fiscal year 2014, the contributions as a percent of covered payroll will likely have to be adjusted even further upward.

The ARC (including employee contributions) is projected to increase to about 47% of covered payroll before dropping down to 32% in 2014. This is the same year that the City is expected to contribute the ARC in full. The decrease in ARC in 2014 results from the switch from a partially pre-funded plan to a fully pre-funded plan. Because the City will be
paying the ARC in full, the discount rate will switch the blended rate for the full 7.5% expected rate of return of the OPEB trust (though as we point out in the Discount Rate box above, this kind of discount rate adjustment is widely objected to and should not be relied upon).

Although the plan provisions are in place, the transition in 2014 is a huge jump in contributions that may prove difficult to implement. Rather than smoothing out the phase-in plan evenly over the 5 years, the city and its employees have only minor increases in contributions from 2009 to 2013. Most of the phase-in comes all in one-year. A decreasing number of active employees will have to contribute significantly greater portions of their covered payroll to successfully follow through with a fully funded plan in 2014. Will San Jose be able to muster payments at the combined level of 35% of payroll come 2015? Given the City’s history, and the fact the FCRS has yet to commit to the 2014 hike, it is doubtful that it will be able to. Darkening this already ominous scenario is the possibility that CalPERS’s actual returns will be less than projected 7.61%, thereby further increasing the City’s ARC.

San Jose Police and Fire Department Retirement Plan
The members of the San Jose Police and Fire Department Retirement Plan (PFDRP) are also under a five-year phase-in plan. There is a two-year delay for the Fire members because they entered into this phase-in funding plan in 2011, not 2009. In this plan, however, the OPEB contributions have limits of 10% of covered payroll for employees and 11% of covered payroll for the City. If the ARC is higher than this total, the City will have to renegotiate the contributions with the San Jose Police Officers’ Association and the San Jose Fire Fighters, Local 230, and IAFF. These negotiations shall also include alternatives to reduce retiree health care costs.

Analysts project that the actual contributions must exceed those limits for the ARC to be fully funded (see Figure 11). Thus San Jose must enforce higher contribution rates or reduce retiree health care costs. With the caps in place, the ARC will be severely underfunded. If the City and PFDRP employees are unable to agree on increased contributions, they will not be able to follow through with their phase-in pre-funding plan. The ARC (including employee contributions) is projected to grow to over 45% of payroll in the next 15 years. As the ARC increases and the contributions remain constant, OPEB obligations will continue to rise and asset growth will be stunted. The pay-as-you-go costs will climb from 15% of payroll to about 26% over the next 15 years, thereby outpacing the scheduled contributions.

These phase-in funding plans have yet to yield any progress towards the City’s overall funding ratio. The turning points will be the transitions between partially and fully funding the ARC. For both plans, this requires at least doubling the current contributions. According to City Manager’s forecasts, total pension and OPEB contributions are projected to consume 25% of the General Fund budget by fiscal year 2014-2015. This is a sizeable increase from 17% in fiscal year 2010-2011 and just 6% in fiscal year 2000-2001. To cope with these costs, San Jose and its employees must reduce or alter benefits, find alternate sources of funding, or place an even greater burden on the General Fund budget.

Stockton Hindsight
On June 28th, 2012, Stockton, California became the largest city in U.S history to file for bankruptcy. Several factors led this outcome, including the housing market crash, an
ill-timed bond offering, and unsustainable employee compensation promises. As of 2011, Stockton had approximately $544 million in liabilities attributable to OPEBs. The City paid for these benefits on a pay-as-you-go basis out of its operational budget and, therefore, this future liability was completely unfunded. The City saw its OPEB costs rise 12% per year on average between 2004 and 2011, with pay-as-you-go costs equivalent to about 8% of its General Fund budget in Fiscal Year 2010. To reduce these benefits in 2011 to limit their growth to about 7% per year. Ultimately, its OPEB obligations were deemed unsustainable, and in its preliminary bankruptcy plan, the city eliminated retiree health care benefits altogether after fiscal year 2013. While Stockton is clearly an outlier in the intensity of its crisis, rising health care cost will place pressure on cities across the state.

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. This commission’s January 2008 report argued that the costs of promised benefits should be fully identified and paid within 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.

If the State and its cities are unable to afford to provide these benefits, they will ultimately need to reduce them or reduce funding to other programs to make up the difference. One of the ways of reducing a city’s unfunded liabilities is to implement a vesting schedule. Rather than contributing full health premiums to all retirees, these benefits can be vested based on years of service. For example, in San Francisco, new employees must work at least 10 years before they can receive 50% of the maximum benefit. Only after 20 years will they receive 100%.

Aside from introducing a vesting schedule, there are many ways to reduce the cost of OPEBs. Cities may consider converting to defined contribution plans rather than defined benefit plans. Under a defined contribution plan, rather than covering a specified portion of a retiree’s health and dental premiums as they come due, cities would set a defined amount to contribute towards OPEB benefits and place the funds into OPEB trusts. This option eliminates the uncertainty of runaway OPEB costs and transfers the risk of rapidly increasing health costs from a city to its retirees. Currently, none of the top 20 cities use a defined contribution plan.

A city 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 the overall ARC. For example, the cities of Redding and San Jose currently require employee contributions that are on par with city contributions.

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%. Of course, such a change has potential downsides. Although insurers contend that narrow HMOs do not dramatically reduce employee choices, 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 a city 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. 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, cities may find it difficult to reduce OPEBs for active employees and retirees, but they 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

Unless the health care systems see substantial reforms, pay-as-you-go costs will continue to increase significantly into the future, primarily due to rising treatment costs and increasing numbers of retirees. Indeed, among the 20 cities we surveyed, these costs increased 36% since 2008. In
some cities like San Jose and Bakersfield, the costs are on track to double in the span of five years. In this report, we reviewed a number of potential strategies California’s cities can implement to adjust benefit plans to reduce costs. Cities can also reduce their total out-of-pocket costs by pre-funding the obligations. But if nothing is done to address the rising OPEB costs, they will eventually crowd out crucial local programs such as police and fire protection, road maintenance, and garbage collection.

Only nine of the top 20 cities have actually implemented a pre-funding plan. In some cities, the pay-as-you-go costs are more manageable than in others. For example, these costs have grown to be quite large in San Francisco and San Jose, but they have remained smaller in cities such as Santa Monica and Riverside. If the 11 pay-as-you-go cities we surveyed begin fully paying their ARC into OPEB trusts this year and continue to do so annually, they will collectively save an estimated $2.2 billion towards the out-of-pocket cost of OPEBs already earned.

Pre-funding accumulates assets towards paying future costs and supplements them with investment profits. It is also dictated by the simple idea that the costs of benefits (such as pensions) should be realized as they are earned, not deferred into the future. In addition to any normative arguments, pre-funding discourages irresponsible political behavior that saddles future generations with costs they may not be able to bear. Ultimately, while each city must adopt a policy that best fits its circumstances, acknowledging the reality of these growing obligations simply cannot be delayed forever.
## Appendix A: Funding Progress and UAAL

<table>
<thead>
<tr>
<th>City</th>
<th>Unfunded Liability</th>
<th>Funding Ratio</th>
<th>Funding Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>San Francisco</td>
<td>$4,400,000,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Los Angeles</td>
<td>$2,514,508,000</td>
<td>59%</td>
<td>Fully Pre-fund</td>
</tr>
<tr>
<td>San Jose</td>
<td>$1,706,082,000</td>
<td>9%</td>
<td>Partially Pre-fund</td>
</tr>
<tr>
<td>San Diego</td>
<td>$1,131,543,000</td>
<td>9%</td>
<td>Partially Pre-fund</td>
</tr>
<tr>
<td>Oakland</td>
<td>$520,882,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Sacramento</td>
<td>$376,417,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Anaheim</td>
<td>$147,994,000</td>
<td>30%</td>
<td>Fully Pre-fund</td>
</tr>
<tr>
<td>Roseville</td>
<td>$146,097,000</td>
<td>19%</td>
<td>Fully Pre-fund</td>
</tr>
<tr>
<td>Palo Alto</td>
<td>$139,701,000</td>
<td>22%</td>
<td>Fully Pre-fund</td>
</tr>
<tr>
<td>Redding</td>
<td>$125,500,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Santa Ana</td>
<td>$122,720,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Long Beach</td>
<td>$120,714,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Glendale</td>
<td>$103,947,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Bakersfield</td>
<td>$101,430,667</td>
<td>11%</td>
<td>Partially Pre-fund</td>
</tr>
<tr>
<td>Fresno</td>
<td>$84,252,383</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Riverside</td>
<td>$54,900,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Pasadena</td>
<td>$31,678,052</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
<tr>
<td>Burbank</td>
<td>$30,431,511</td>
<td>51%</td>
<td>Fully Pre-fund</td>
</tr>
<tr>
<td>Santa Clara</td>
<td>$23,855,000</td>
<td>23%</td>
<td>Fully Pre-fund</td>
</tr>
<tr>
<td>Santa Monica</td>
<td>$20,173,000</td>
<td>0%</td>
<td>Pay-as-you-go</td>
</tr>
</tbody>
</table>
**Appendix B: 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.

2 PEBC. “Public Employees’ Medical and Hospital Care Act (PEMHC) and Contracting Agencies.” Public Education and Business Coalition. N.p., n.d. Web. July 2012. <Public Employees’ Medical and Hospital Care Act (PEMHC) and Contracting Agencies>.

3 This value is computed by averaging the individual cities’ percentage change between 2008 and 2011 pay-as-you-go costs for the 18 included cities. This figure excludes Burbank and Anaheim. Also, the total uses an estimate for the pay-as-you-go costs of Long Beach for the year 2011. The pay-as-you-go costs are taken from the Other Post-Employment Benefit sub-section of each city’s CAFR, in the Notes to Financial Statements section.

4 Benefit Plans are described in the Comprehensive Annual Financial Reports (CAFR) pursuant to GASB 43 and 45. These can usually be found on the website of the Finance Department of each city.

5 This chart excludes the cities of Burbank and Anaheim. Explicit pay-as-you-go costs were not found for these cities. The 2011 value for Long Beach is estimated, because the official figure has not been posted as of this writing.


12 This figure comes from adding the assets and unfunded liabilities for each city. These specific figures can be found in the OPEB Section of the Notes to Financial Statements in the CAFR for each of the cities.

11 Ibid, 2011. Most cities list the UAAL as percent of covered payroll, several others were computed by the author. The values for the 2010 are used for Long Beach, since it has not yet released its 2011 CAFR.

13 Ibid. The values were computed by summing the annual actual contribution by each city and dividing it by the sum of the annual OPEB costs for that city. The values for Long Beach are from 2007-2008 fiscal year to 2009-2010 fiscal year.

14 See note 4.

15 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.

16 This information was gathered from:


17 Because these savings are realized throughout the lifetime of the covered employees, this is not a defined period. Savings will continue to accrue as recently hired employees live out their retirement, 30, 40, even 50 years into the future.


19 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 will be 3%, totaling to a 4.5% rate of return. This is a projected rate of return that may or may not be met.

20 The savings in unfunded liability are estimated by rediscounting the UAAL from each plan using a discount rate of 7.61% over a 15 year period. Actuarial methods vary for each city, including the original discount rate used (which is listed in the Actuarial Assumptions sub-section of the OPEB section of each city’s CAFR). The calculation of these savings relies exclusively on the increased discount rate and accuracy of the unfunded liability estimate. If the real rate of return is less than expected, the savings will be lower.

21 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. 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. See “Informational Letter to Actuaries and CERBT Employers.” CalPERS, 1 Apr. 2011. Web. June 2012. <http://www.calpers.ca.gov/eip-docs/employer/retiree-ben-trust/letter-to-actuaries.pdf>.


26 Ibid, sections 9(C) and 9(D).


29 Ibid, p. 4.

30 Ibid, p. 5.


32 Ibid, p. 10. The General Fund expenditure numbers are taken from the San Francisco’s FY2011 CAFR.


36 Annual numbers are taken from Palo Alto CAFR, FY 2008-2011, which may be found at <http://www.cityofpaloalto.org/gov/depts/asd/reporting.asp>.


41 These figures can be found in “Postemployment HealthCare Plans” section of San Jose 2011 CAFR, which may be found at http://www.csjfinance.org/.

42 Ibid.

43 Ibid., see the Annual Other Postemployment Benefit (“OPEB”) Cost and Net Obligation sub-sections.


45 See the Notes to Financial Statements section of San Jose 2011 CAFR, which may be found at http://www.csjfinance.org/.

46 Cheiron 2012, p. 12.

47 Funding plan information was obtained from the projections in Cheiron 2012, pp. 6-7. Note that the Actual Contribution amounts will most likely be higher for 2012 and 2013 than shown, if the pay-as-you-go costs match projections.

48 OPEB section of the San Jose 2011 CAFR (supra note 41).


Police and Fire Members are subject to the same contribution limitations.

51 Cheiron 2012, pp. 6-7.


53 Evans et al. 2012.

54 Technically known as a “pendency plan,” it lays out the approach for dealing with the existing budgetary gap during bankruptcy pro-
ceedings.


59 These numbers come directly from the Notes to Financial Statements in the Comprehensive Annual Financial Reports for each city from 2008 to 2011. Note that the most recent numbers for Long Beach are from 2010. UAAL is computed using a discount rate that reflects the amount of funds set aside by each city, up to the full rate of 7.61% as set by CalPERS. See Discount Rate inset for additional discussion.