

TO: BOARD OF SUPERVISORS
 FROM: John Cullen, County Administrator
 DATE: September 25, 2007
 SUBJECT: OPEB Update/Trusts



Contra Costa County

SPECIFIC REQUEST(S) OR RECOMMENDATION(S) & BACKGROUND AND JUSTIFICATION

RECOMMENDATIONS:

1. ACKNOWLEDGE that the March 1, 2007 report to the Finance Committee defines and describes the Other Post Employment Benefit (OPEB) liability for Contra Costa County as of January 1, 2006;
2. ACKNOWLEDGE that an updated OPEB liability will be calculated as of January 1, 2008 and available in March 2008;
3. ACKNOWLEDGE the Contra Costa Economic Partnership's report entitled "Managing Public Sector Retiree Healthcare Costs in Contra Costa County"
4. RECEIVE report from the OPEB Task Force on the County's OPEB strategic plan;
5. APPROVE the selection of an irrevocable trust structure (Internal Revenue Code Section 115) for OPEB funding for Contra Costa County;
6. DIRECT the County Administrator to return to the Board for approval of the actual trust documents; and
7. DIRECT the County Administrator to continue to report back to the Board as major steps in the OPEB strategic plan are met.

FISCAL IMPACT:

The result of the recommendations herein, if implemented, will have significant future impact on the County's overall fiscal stability and ability to deliver services.

BACKGROUND:

On June 7, 2007 the 2006/2007 Grand Jury filed report No. 0708, which made recommendations regarding the County's process to resolve its OPEB liability. One of those recommendations was that the County adopt a comprehensive OPEB management plan. The purpose of the plan is to provide a guide and communication vehicle for the Board of Supervisors, County employees, and County residents over the next 30 years. In response to that recommendation, the Board of Supervisors indicated that the County had made progress in developing a strategic plan to address the County's OPEB liability and that continuing progress would be presented in today's and future reports.

CONTINUED ON ATTACHMENT: YES

SIGNATURE: _____

____ RECOMMENDATION OF COUNTY ADMINISTRATOR ____ RECOMMENDATION OF BOARD COMMITTEE

____ APPROVE ____ OTHER

SIGNATURE(S): _____

ACTION OF BOARD ON _____ APPROVE AS RECOMMENDED _____ OTHER _____

VOTE OF SUPERVISORS

____ UNANIMOUS (ABSENT _____)
 AYES: _____ NOES: _____
 ABSENT: _____ ABSTAIN: _____

I HEREBY CERTIFY THAT THIS IS A TRUE AND CORRECT COPY OF AN ACTION TAKEN AND ENTERED ON THE MINUTES OF THE BOARD OF SUPERVISORS ON THE DATE SHOWN.

CONTACT: Lisa Driscoll (335-1023)

CC: All County Departments

ATTESTED _____
 JOHN CULLEN, CLERK OF THE BOARD OF SUPERVISORS
 AND COUNTY ADMINISTRATOR

BY _____, DEPUTY

Contra Costa County is fully complying with Government Accounting Standards Board (GASB) Statement 45. GASB compliance requires that the County calculate the liability and recognize and disclose the liability on its Financial Statements¹. Contra Costa County received its first formal actuarial valuation in March of 2006 and has ordered the second valuation, which will be completed and released in March of 2008. Contra Costa will recognize and disclose its liability in the 2007 Comprehensive Annual Financial Report, which will be released in late December 2008.

OPEB Plan Update

I. Specific Goals and Objectives

The Board of Supervisors has set four specific goals: 1) to fully comply with GASB Statement 45; 2) to adopt and follow an OPEB financing plan, which balances our requirement to provide public services with our desire to provide competitive health care benefits for our employees both now and when they retire; 3) to minimize collateral detrimental impact to the provision of indigent health care in our County; and 4) pursue and support Federal and State legislation.

II. Economic Census Assumptions and Rationales

Prior to ordering the first formal OPEB liability valuation, the OPEB task force met with actuaries from Buck Consultants and developed economic census assumptions and rationales for the actuarial valuation. Buck provided initial recommended assumptions in our first draft valuation report dated 03/13/2006. This began the process of input and sign off by the County on the assumptions that were used. The County requested a comparison of specific local assumptions versus statewide benchmarks. Further discussions of the valuation assumptions occurred prior to the finalized valuation report².

III. Funding Strategy

While the County has paid for health care costs on a Pay-As-You-Go ("Pay-Go") basis for over forty years, the Board has publicly acknowledged the need to begin to partially pre-fund the benefit. Due to the size of the liability it is impossible for the County to fully pre-fund the liability immediately; rather partial pre-funding will be phased in over thirty years. It is the Board's intent to eventually fully pre-fund OPEB benefits.

IV. Funding Levels

The Board established an initial 40% pre-funding target for the County. This target addresses the entire amount associated with the current retiree population, which currently equates to approximately 40% of the total liability. This means that during the next 30 years, we will need to incorporate new accounting and Health Care policies and cost changes into our financing plan in order to fully fund our OPEB benefits. Before recommending this target level, the Task Force researched recommendations for specific funding guidelines for financial long-term obligations and considered the Government-wide balance sheet impact of various funding levels, the liability impact of various funding levels, volatility of the assumptions/risk of funding, and ability to fund/affordability (for more information see the June 26, 2007 report to the Board).

1 GASB 45 applies to any employer that provides Other Post Employment Benefits (OPEB). It establishes the requirements for measurement and recognition of the employer's expense, or expenditures and liabilities, and for disclosures and required supplemental information related to the employer's OPEB commitment, for reporting in the employer's financial statements.

2 In general, the most recent CCCERA valuation report available in January of 2006 was the 2004 valuation. The 2006 CAFR, dated December 2006, uses 2005 CCCERA data. Buck's set of assumptions were deemed reasonable for governmental employees and retirees in California. CalPERS assumptions were mainly used because the County has CalPERS plan participants and those assumptions do cover the majority of governmental employees in California. For the upcoming valuation we are considering adjusting some of our assumptions to match CCCERA pension valuation assumptions (those that are up-to-date). These valuation assumptions are normally based on an experience study and do best represent Contra Costa County employee and retiree expected experience. Under this approach, earning assumptions would take into account the smaller amount of funds in the County's OPEB trust.

V. Pre-funding resources

As an initial step towards funding the County's OPEB liability, the Board of Supervisors adopted the allocation of resources (and the future investment income earned) detailed in the table below in millions of dollars.

| Resource | Beginning FY | Amount |
|--|---------------|--------|
| Redirect Workers Compensation | 2008/09 | \$10 |
| Redirect UAAL Rate Adjustment | 2009/10 | \$10 |
| Redirect POB Bond payments | 2014/15 | \$33 |
| Redirect POB Bond payments | 2022/23 | \$47 |
| Total Annual Future Resource Redirection | 2024 - onward | \$100 |

Ten million of resources that had been allocated to Workers' Compensation³ will be set aside beginning in fiscal year 2008/09⁴, there will be \$588 million (plus interest) reserved by the end of fiscal year 2022/23, and \$100 million added annually thereafter. As a reminder, the Task Force specifically excluded routine annual revenue growth in the General Fund as a source of pre-funding the OPEB liability, as these funds will be needed to cover normal service delivery cost increases in the future.

As recommended by the Grand Jury, the County will consider issuing OPEB bonds. It should be noted that OPEB bonds, like Pension Obligation Bonds (POBs), must be issued on a taxable basis and will generally be more expensive than the County's traditional tax-exempt Lease Revenue Bonds. However, OPEB bonds may still offer a beneficial arbitrage when compared to the actuarial discount rate (currently 7.5%) used in estimating the OPEB liability. Issuing OPEB bonds would replace what is currently an internal "soft" liability with public bonds that must be paid on time when due, thereby reducing to some degree the County's future financial flexibility. In the current environment of high potential for change in the national health benefit and cost environment, the County would want to exercise caution in bonding, and certainly would not want to bond the entire Unfunded Actuarial Accrued Liability (UAAL).

VI. Employee Communication Forums and Information Sessions

The County Administrator has scheduled OPEB informational sessions throughout the County and has invited his employees to attend. The purpose of the presentations is to provide information regarding OPEB and to answer employee questions. There are four more sessions scheduled for September and October. Additional sessions will be held as needed/requested.

VII. Establishment of a Trust Fund

During presentation of the County's response to the Grand Jury report on August 7, 2007, the Board of Supervisors directed staff to return with a recommendation regarding establishing an irrevocable trust for OPEB benefits. See discussion on Trust Fund structure below.

³ As a reminder, the County's Workers' Compensation Internal Services Fund was seriously under-funded in the not so distant past. The next most recent actuarial study (September 2007) presented a much improved picture with confidence levels back to a financially prudent funding level (86%). If the County continues to enjoy the experience of the last several years, allocations to the fund can be reduced without negatively impacting confidence levels.

⁴ As a reminder, the allocation of an on-going revenue stream towards the liability allows the County to apply a discount rate higher than that for the pay-go level on the portion of the liability being funded; any unfunded portion of the liability would use the lower pay-go discount rate (4.5%). In the aggregate, the total potential liability will be less because the reserved money will be earning a rate of return indicative of a diversified portfolio rather than the lower rate of return of the County's cash pool. During the June 26 report presentation the Board acknowledged that although the Task Force was fairly confident that these resources would be available in the future, there are contingencies.

VIII. Future Milestones □

September 2007

County selects an irrevocable trust structure.

September 2007

County selects and contracts with a Benefit Design consultant.

September–December 2007

County works with consultants to continue to analyze/research County demographics, our and other jurisdictions' health benefit programs and cost, and alternative plan structures.

January 2008

County begins development of the FY 2008/09 budget.

Fall 2007

County begins negotiation with labor.

December 2007

County establishes an irrevocable trust.

March 2008

Buck Consultants to provide County with updated OPEB liability.

May 2008

Board adopts FY 2008/09 budget including \$10 million in OPEB pre-funding resources redirected from Workers Compensation. Task Force evaluates and offers recommendations on the use of OPEB bonds.

Trust Fund Structure

As was noted above, the Board of Supervisors directed staff to return with a recommendation regarding establishing an irrevocable trust⁵ for OPEB benefits. Establishing an irrevocable trust dedicated to OPEB benefits, which is well planned and managed, has many benefits to the County and its employees/retirees. As was noted in the recent Economic Partnership report on the subject, properly managed trusts can increase rates of return that help fund OPEB liabilities with investment surpluses. The Task Force has been working with the County's tax attorney to evaluate the four basic GASB compliant trust options available for public sector employers. They are the Section 115 Governmental Trust, the Integral Part Trust, the Voluntary Employee Benefit Association (VEBA) Trust, and the Section 401(h) Account. There are many similarities between the trust structures; the following are some of the basic elements of each:

Section 115 Governmental Trust [IRC 115 Internal Revenue Code]

In this structure, assets to fund retiree health benefits would be held in trust and treated as wholly separate from the County's assets. The assets would be held solely for the benefit of participants and beneficiaries. There is effectively no tax regulation of consequence of the trust, and the income of the trust is tax exempt. However, there is the customary regulation by the income tax laws on the ability to provide tax free medical benefits. Investment responsibility is determined by the trust's governing document – for example, either the board of trustees or a bank trustee may have investment responsibility. Some fiduciary responsibility for investments may be delegated from the governing board of the trust to an investment manager or other entity. The IRS will issue rulings on 115 trusts, but issuance of a ruling usually takes at least 6 months. It is not necessary to obtain a ruling to have a valid 115 trust.

Integral Part Trust [tax exempt as an "integral part" of the County for tax purposes]

This structure is very similar to the Section 115 Governmental Trust. As with a 115 trust, there is little tax regulation of an integral part trust and the income of the trust is tax exempt. However, the rules that govern this type of trust are less clear than those for a 115 trust, and the IRS currently will not issue rulings on an integral part trust. For example, the amount of employee contributions that can be

⁵ The criterion of irrevocability means that the employer does not have ownership or control of the assets, except for any reversionary right once all the benefit obligations have been paid, if then. In other words, the trust must be set-up so that assets may flow from the employer to the plan, but not from the plan to the employer.

made to an integral part trust is unclear. The IRS requires that a County exert significant influence over this type of trust, which likely requires retaining the power to amend, terminate and perhaps having control over daily operations. However, even though the County will have this type of influence, this type of trust should meet the GASB requirements.

Voluntary Employee Benefit Association [Internal Revenue Code section 501(c)(9)]
VEBAs are now employer established instead of "voluntary". Assets to fund retiree health benefits would be held in a trust that is treated as wholly separate from the County. Generally, no income is taxable to the trust because the trust is tax exempt. There are rules regarding 1) non-discrimination of benefits provided, 2) amounts of funding, 3) holding assets for the exclusive benefit of participants, 4) the use of surplus assets, 5) governance, and 6) other issues. It is not likely that any of these issues would cause problems for the County, though it is important to properly comply with the tax laws. Furthermore, an annual return must be filed with the IRS for a VEBA. Mandatory IRS approval is required for this type of fund, which add approximately six months to the time it would take to establish its tax exemption⁶. Finally, VEBA regulations require that, to be tax exempt, a VEBA must be "controlled" by its membership. The meaning of this requirement for governmental VEBAs is not clear compared to the private sector where it is effectively ignored. Therefore, if a VEBA is recommended in the future, the County may wish to explore the IRS' views of the required governance structure for a VEBA⁷.

Section 401(h) Account

Of these four structures, this structure is the least flexible. Basically, a separate account would be set-up as a part of the Contra Costa County Employees Retirement Association (CCCERA). There are rules regarding 1) the maximum amount of contributions that can be made in any one year, which varies with the "normal cost" of CCCERA for the year, 2) the way assets are accounted for within CCCERA, 3) the use of "surplus" assets on termination, 4) the allocation of CCCERA earnings to the health account assets, and 5) other similar issues. There are no "discrimination" rules for the account to be tax exempt. CCCERA rather than the County would have control and responsibility of the funds and the investment of those funds.

Summary

The OPEB Fiscal Working Group, which consists of the County's Auditor-Controller, Treasurer-Tax Collector, Senior Deputy County Administrator/Finance, Financial Advisor, and County Counsel, met several times to review and discuss trust structure. There is no right or wrong trust. Each has pros and cons that must be considered along with the culture of the County. After a thorough review, the OPEB Fiscal Working Group agreed to recommend a Section 115 Trust for Contra Costa County's OPEB funds. One of the reasons is that of the four structures, this structure takes little time to establish and is largely unregulated by the IRS. It also should provide more flexibility for possible future changes in the health care system, such as the establishment of national health insurance. Currently there is little such flexibility for a VEBA, for example. In the near future, the type of fund chosen is less important than establishing a funding stream to put in the fund. As the County develops plan improvements, it may turn out that a different trust structure would be more beneficial to the County. In that case, the County can establish a second trust. It is important that the County establish a trust now rather than wait until later so that it can begin the process of partially pre-funding the OPEB liability in the 2008/09 fiscal year.

Contra Costa Economic Partnership

Contra Costa Economic Partnership recently released a report entitled "Managing Public Sector Retiree Healthcare Costs in Contra Costa County". The report does an excellent job describing the challenges faced by public sector employers in addressing the issue of retiree health care. Contra Costa County is a member of the Economic Partnership and has worked closely with the authors to share information on OPEB. In fact, all of the information in the report regarding the County is the same material developed by our OPEB Task Force and presented to the Board and public during this past year. The efforts of the Contra Costa Economic Partnership to help our entire community better understand OPEB, its impact and long-term financial consequences on County and city service delivery viability is to be commended.

⁶ The county can set it up and fund it, but there is no guarantee of exempt status until IRS issues a letter on the trust.

⁷ The County has contacted the IRS and they indicated they probably would rule favorably if the trust were structured like an ERISA trust, but there are no guarantees. To get a definitive answer, a letter application must be filed.