BOLTON PARTNERS

Memorandum

To: Steve Farber, Council Administrator

From: Thomas Lowman and Kevin Binder, Bolton Partners

Date: April 16, 2014

Re: Employer Group Waiver Program Analysis

Background: The net FY2015 tax supported trust contribution for the OPEB plans for the County Government, Montgomery County Public Schools, Montgomery College, and the Maryland-National Capital Park and Planning Commission has decreased from $182.4 million (estimated in June 2013) to the most recent March 2014 estimate of $100.6 million. The net trust contribution is equal to the FY2015 Annual Required Contribution (ARC) minus pay-as-you-go funding.

The reduction in the estimated trust contribution has three primary components.

- Favorable claims experience
- A reduction in the medical trend assumption
- A change to an Employer Group Waiver Program (EGWP).

The County Council has asked Bolton Partners to evaluate the proposed EGWP change and to isolate the savings due to this change.

Why there are savings from an EGWP

The Medicare Modernization Act of 2003 expanded Medicare to cover prescription drugs. The standard Medicare Part D benefit has a deductible ($310 in 2014), pays 75 percent of the charges up to an initial coverage limit ($2,850 in 2014), and provides no coverage until an out of pocket threshold has been reached ($4,550 in 2014). There is catastrophic coverage of 95 percent after the out of pocket threshold has been reached.

To incentivize employers to retain retiree medical coverage a Retiree Drug Subsidy (RDS) was offered which was meant to be approximately equal the value of a Part D plan.

The level of coverage at which no coverage is provided is colloquially called the "donut hole".

The Affordable Care Act (ACA) closed the donut hole by 2020 through requiring manufacturers to provide a 50 percent discount on brand name drug charges in the donut hole combined with gradually increasing the federal reimbursement from zero percent to 25 percent for brand name drugs and 75 percent for generic drugs.

While the Medicare Part D benefit was enhanced, there has been no corresponding increase in the RDS subsidies, creating a non-level playing field.

The EGWP splits the current plan into two plans: a basic Part D plan combined with a second supplementary plan. Together the two plans are meant to provide the same benefits as the employer plan.

This allows the employer to provide the same benefits at a lower cost because the brand name drug manufacturer and the federal government are providing additional benefits in the donut hole. The employer liability is only for the supplemental plan. The RDS is eliminated.

Accounting savings from an EGWP

There is an additional accounting savings under the GASB45 accounting standard. The GASB does not allow accrual accounting on anticipated RDS subsidies. If the employer moves to an EGWP plan, the cost savings are captured in the accrual accounting.

Is the EGWP the only way to level the playing field?

Employers can level the playing field by moving their Medicare retirees to a Medicare HMO plan or to the individual market by providing a fixed dollar subsidy through vendors that assist Medicare retirees in selecting plans on the individual market; these plans are sometimes called Connector plans. Smaller employers might find that these other approaches are the only ones they have, as the EGWP approach requires a large number of Medicare eligible retirees to pay for the implementation cost. This would not be a factor for Montgomery County.

The following table lists the advantages and disadvantages of each approach for a group the size of the County.

Approach	Advantages	Disadvantages
EGWP	Minimum disruption to plan participants	Cost savings are unknown until implementation
Medicare HMO	More and more employees are in HMOs and are accustomed to these plans	Retirees may find that their preferred hospital and doctors are not in the HMO
Connector	Retirees can tailor the plan to their needs and use premium savings to pay some of out of pocket cost	Older retirees' resistance and inability to select their own plan

What are the arguments for and against the EGWP approach?

There are real cost savings to be had. The EGWP approach captures these savings with the least disruption to the retirees. The cost savings may be less than estimated, but there will be real cost savings.

What share of the projected $81.8 million savings is due to the EGWP, cost trends, and claims factors?

Attached is the Aon spreadsheet showing a breakdown of the savings for the County Government and MCPS. In FY2015 we see the EGWP savings as $11.8 million for the County ($56.4 million less $44.6 million) and $20.1 million for MCPS ($78.4 million less $58.3 million), for a total of about $31.9 million. Their cost trend savings would be about $25 million combined and claim factor savings about $14 million combined for those two main components.

Are the projected savings from the EGWP consistent with the experience from other jurisdictions?

The following table summarizes the actuary's estimated reduction due to the EGWP for the County Government and MCPS plans. These numbers can be found on page 3 of the County Government OPEB report and page 4 of the MCPS OPEB report.

	County Government	County Schools
1. Estimated liability before changes	$1,505,831	$1,945,077
2. Change in claims experience/pricing terms	(143,075)	(303,796)
3. Change in trend	(134,807)	(103,163)
4. EGWP impact	(134,735)	(224,537)
5. EGWP impact as percent of estimated liability (4)/(1)	(9%)	(12%)
6. EGWP impact as a percent (after other reductions (4)/{(1)+(2)+(3)}	(11%)	(15%)
Approximate impact for a different large Maryland public sector entity	(13%)	(19%)

The percent impact of the change will depend upon the order of the changes. We think the second estimate (11% for the County Government and 15% for MCPS) is probably the better measure to focus on. It assumes that the actuary measured the impact of each change according to the order presented in the report.

We would expect a lower impact for the County Government because the County Government plan includes public safety employees who retire at younger ages with a greater percentage of the liability due to pre-Medicare benefits that are not impacted by changes to the Medicare eligible program.

These estimates are somewhat lower than what we observed for a large Maryland public sector entity. However, footnote 5 of the Montgomery County report indicates that some of the cost savings are assumed to pass back to the retirees in the form of lower premiums, so that would reduce the EGWP savings somewhat.

Please note that the impact of each EGWP plan will depend upon the design. The estimates we have received for EGWP plan changes from other entities are lower than what we observed in a large Maryland public sector entity in 2012.

Are the cost projections for FY2015 and the outyears reasonable compared the prior year projections?

To determine the FY2015 impact to the OPEB trust by source we requested additional information from the plan actuary. See the attached spreadsheet. We would note the following expected trends:

1. The total FY2014 ARC declines materially after the three changes noted above (trend, claims, EGWP). However, it grows annually thereafter.

2. The pay-as-you-go cost continues to increase from FY2014 through FY2016 even though the EGWP plan provides some reduction, particularly for MCPS, which has relatively fewer pre-65 retirees.

3. The trust fund contribution declines as a result of the changes, but between FY2014 and FY2015 the plan makes the final transition to paying the full ARC.

4. Half of the RDS subsidy payments are lost in FY2015, and all are lost in FY2016 due to the EGWP design change.

The attached spreadsheet shows the impact for FY2014 when the trust fund contribution was only 7/8th of the ultimate target. However, the following table provides the impact on the contribution to the OPEB trust by source but using 8/8th (the full) target funding goal since the FY2015 budget is based on fully funding the ARC. The County Government numbers include the impact to the non-tax supported entities.

Impact to FY2014 Trust Contribution if ARC 100% funded $ in thousands			
	County[1]	Schools	Total
Prior valuation estimate	78,956	111,239	190,195
Favorable claims & new contract changes	(5,393)	(8,476)	(13,869)
Change in trend	(13,577)	(11,809)	(25,386)
EGWP	(12,948)	(24,274)	(37,222)
Reduction in excise tax	-	(4,525)	(4,525)
Other	59	(157)	(98)
Total change	(31,859)	(49,241)	(81,100)
Current valuation estimate	47,097	61,998	109,096
Lost RDS reimbursement in FY2015	1,453	3,436	4,889
Lost RDS reimbursement in FY2016	3,032	7,750	10,782

As shown above, the County Government will lose half of its Retiree Drug Subsidy (RDS) payment in FY2015 and the full RDS payment in FY2016 and thereafter. These amounts should be subtracted from the savings.

These compare to the decrease from the June 2013 estimate to the March 2014 estimate of $52.2 million (from $110.5 million to $58.3 million) for MCPS and $27.5 million (from $66.1 million ton $38.6 million) for the County Government's tax supported entities.

Discussion

The reduction due to baseline claims of 10 percent for the County Government and 16 percent for MCPS seems higher than we are accustomed to seeing for one year's experience. If there was an increase in premiums (and retiree contributions) that was greater than the increase in the per capita claims costs, especially for post-65 retirees, then leveraging could explain the large decrease. In the absence of leveraging, if the actuary was expecting a 9 percent increase, it would imply a decrease in per capita spending of about 1 percent for the County Government and 7 percent for MCPS. We are seeing a number of jurisdictions with small increases in per capita costs (3 to 5 percent) but few with decreasing per capita costs.

The reduction due to the medical trend decrease of 9 percent for the County Government and 5 percent for MCPS is not unusual and is reasonable due to lowering medical trends we are observing.

The combined decreases of the claims and trend change of 19 percent for the County Government and 21 percent for MCPS are consistent with what we are observing for other governments.

[1] Take 86.5% of these numbers to get tax supported portion.

Outyears

The projected FY2016 to FY2020 trust payments show more decreases than increases. If you add the projected trust contributions to the projected pay-as-you-go costs presented on page 10 of the County Government report and page 6 of the MCPS report (see below for MCPS), the total spending is increasing by 3 percent per year. This percentage increase is slightly lower than we would expect. The reason may be due to the fact that the actuary is using an open 30 year amortization factor. If the amortization method was changed to a closed amortization schedule, we estimate that the total ARC would increase by about 4 percent per year. The change from open to closed amortization period would increase the cash payments to the trust by $2.0 million in FY2016, gradually increasing each year to about a $12 million over the current estimates by 2020.

MCPS Current Estimates for Total ARC				
Fiscal Year	Pay-go	Trust Contribution	Total (ARC)	Percent Increase
2015	64,400	58,300	122,700	
2016	70,600	55,600	126,200	3.0%
2017	72,100	57,900	130,000	3.0%
2018	73,800	60,000	133,800	3.0%
2019	80,400	57,400	137,800	3.0%
2020	87,300	57,400	144,700	5.0%

What other factors or variables should the County consider?

Due to the EGWP, favorable experience and moderating medical trends, there is a windfall of approximately $81.8 million. We would recommend that the County consider using some of the windfall for additional OPEB funding either through a policy of contributions somewhat above the 2015 ARC or by using more conservative methods or assumptions (for example, a shorter amortization period than 30 years) for the following reasons:

1. The projected cash payments are estimates.

2. Our recommendation to the Council in 2008 was that the amortization period be "open" only prior to when the full ARC was being funded. Page 7 of the November 24, 2008 report of the Multi-Agency OPEB Work Group contained the following statement:

   "However, given the current fiscal situation, and since we are still ramping up to the full ARC, the Work Group agreed that each tax supported agency would use the open method... If the fiscal situation significantly improves later during the phase-in period, that decision would be revisited."

   It certainly seems that the fiscal situation has significantly improved.

3. The actual amounts could be higher for the following reasons:

    - The EGWP savings estimates may turn out to be overly optimistic. A large Maryland public sector entity's actual EGWP cost savings (not the accounting savings) were two thirds of the estimate.
    - Investment return experience may be less than 7.5 percent.
    - Medical trends may increase more than anticipated

4. The actuarial cost method and assumptions are prevalent assumptions. However, by 2020 OPEB benefits will be under a new accounting standard similar to the GASB68 accounting standard for pensions. The new accounting standard will:

    - Require the use of the entry age normal (EAN) cost allocation method instead of the projected unit credit (PUC) funding method for accounting purposes. The EAN funding method will generate somewhat higher liabilities than the PUC method.
    - Require the County to document that the expected rate of return is consistent with the asset allocation policy and the long term expectations for investment return by asset class. This change might increase pressure on the County to lower the investment return assumption (especially over the long term).
    - Demonstrate that the plan is projected to stay solvent or use a lower blended (with a local government bond index) discount rate. To demonstrate that the plan is solvent the amortization period will have to be closed.
    - Separate accounting from funding. To determine the trust contribution the County Government and MCPS could do a separate calculation using the current PUC method for funding and the EAN method for accounting. However, we expect many governments will simplify and use the same actuarial cost method for both accounting and funding.

Conclusions

We have three major conclusions:

1. Overall we believe that moving to the EGWP is a good idea.

2. The Aon projections for FY2015 seem reasonable.

3. There are factors in FY2015 and beyond that lead us to suggest that some of the savings in the OPEB funding cost be retained. These include:

    - Plan experience may not be as good as anticipated.
    - Expected changes in accounting rules might cause you to reconsider funding practices.
    - It may be appropriate to consider changes in the amortization policy.

Montgomery County Government

	(a) UAL	(b) ARC	(c) Estimated Pay-go Benefit Payments	(d) Estimated Implicit Subsidy	(e) Funding Factor	(f)=[(b)-(c)-(d)] x (e) Expected Additional Contributions	(g) Estimated RDS Subsidy Payments[1]	(h)=(f)-(g) Pay go Cost	
Expected FY2014 Before any Changes	1,351,538	137,437	40,937	17,544	7/8	69,226	2,710	59,429	Budgeted vs Recommended Contribution in FY14
Asset and Other Experience	966	59	-	-	7/8	52			
New Claims and Premiums[2]	(143,075)	(14,882)	(6,643)	(2,846)	7/8	(4,719)			
New Trend Rates[2]	(134,807)	(13,577)	-	-	7/8	(11,880)			
EGWP Change[2]	(134,735)	(12,948)	-	-	7/8	(11,330)			
Expected FY2014 After all Changes	939,887	96,089	34,294	14,698		41,349			
Estimated FY2015									
- Pay Go Current Plan (After all changes except EGWP)	1,073,270	111,035	38,234	16,385	8/8	56,416	2,907	53,509	
- Pay Go EGWP Plan	935,374	97,684	37,135	15,915	8/8	44,634	1,454	43,181	
Estimated FY2016 Full Year Pay go impact of EGWP Change									
- Pay Go Current Plan (After all changes except EGWP)	1,082,321	113,829	42,922	18,394	8/8	52,513	3,032	49,481	
- Pay Go EGWP Plan	943,525	100,161	40,129	17,198	8/8	42,834	-	42,834	

1/ would include full year reimbursement for FY2014 and 6 months for FY2015

2/ Includes Excise Tax adjustment

Montgomery County Public Schools

	(a) UAL	(b) ARC	(c) Estimated Pay-go Benefit Payments	(d) Estimated Implicit Subsidy	(e) Funding Factor	(f)=[(b)-(c)-(d)] x (e) Expected Additional Contributions	(g) Estimated RDS Subsidy Payments[1]	(h)=(f)-(g) Additional Contribution from General Funds	
Expected FY2014 Before any Changes	1,809,154	185,737	74,498		7/8	97,333	6,077	83,700	Budgeted vs Recommended Contribution in FY14
Asset and Other Experience	(2,595)	(157)	-		7/8	(138)			
Upd claims reflecting recentexperience and benefit changes	(303,796)	(24,478)	(16,002)		7/8	(7,417)			
Lower healthcare trend rates	(103,163)	(11,809)	-		7/8	(10,333)			
EGWP savings	(224,537)	(24,274)	-		7/8	(21,240)			
Healthcare reform excise tax	(47,791)	(4,525)	-		7/8	(3,959)			
Expected FY2014 After all Changes	1,127,272	120,494	58,496			54,246			
Estimated FY2015									
- Pay Go Current Plan (After all changes except EGWP)	1,360,461	147,926	69,526		8/8	78,400	6,872	71,528	
- Pay Go EGWP Plan	1,119,781	122,659	64,352		8/8	58,307	3,436	54,871	
Estimated FY2016 Full Year Pay go impact of EGWP Change									
- Pay Go Current Plan (After all changes except EGWP)	1,377,844	152,261	81,358		8/8	70,903	7,750	63,153	
- Pay Go EGWP Plan	1,133,663	126,247	70,599		8/8	55,648	-	55,648	

1/ would include full year reimbursment for FY2014 and 6 months for FY2015