DEPARTMENT OF FINANCE

Douglas M. Duncan
County Executive

Timothy L. Firestine
Director

MEMORANDUM

November 21, 2005

TO: Stephen B. Farber, Council Staff Director
Montgomery County Council

FROM: Timothy L. Firestine, Director
Department of Finance

SUBJECT: OPEB Update

The purpose of this memorandum is to respond to your request for an update on the status of the County Government's evaluation of the implications of implementing Government Accounting Standards Board (GASB) Statements 43 and 45 on accounting and reporting for postemployment benefits other than retirement (OPEB).

First, it appears based on preliminary evaluations that Statement 43, entitled *Financial Reporting for Postemployment Benefit Plans Other than Pension Plans*, does not apply in situations where the employer accounts for OPEB benefits in a proprietary fund as the County Government does. Statement 43 only applies when OPEB benefits are administered as trusts, or equivalent arrangements. Therefore, since the County does not currently have a trust established for its OPEB benefits, there is currently no accounting or reporting impact to the County related to this Statement.

The other pronouncement, Statement 45, entitled *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions* does apply to the County Government and will fundamentally change the accounting and presentation of those benefits in the financial statements. Statement 45 is first effective for the County's reporting period of FY08.

Currently, OPEB expenses are included in the County Government's financial statements where they are accounted for in a separate internal service fund and claims are funded on a pay-as-you-go basis. The funding on a pay-as-you-go basis by the General Fund and other funds is also recorded as an expenditure in those funds as the payments are made. GASB Statement 45 basically requires the employer to account for OPEB the same way that it accounts for defined benefit pension plans. This will require that liabilities attributable to OPEB, and the annual required employer contributions, be actuarially determined.

Office of the Director

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The GASB notes in Statement 45 that:

"The objective of this Statement is to improve the faithfulness of representations and usefulness of information included in the financial reports of state and local governmental employers regarding other postemployment benefits."

The GASB further notes that:

"...current financial reporting generally fails to:
- *Recognize the cost of benefits in periods when the related services are received by the employer*
- *Provide information about the actuarial accrued liabilities for promised benefits associated with past services and whether and to what extent those benefits have been funded*
- *Provide information useful in assessing potential demands on the employer's future cash flows."*

Because of the magnitude of the OPEB benefits provided to County retirees, this Statement will have a material impact on our government-wide financial statements; it will also have a potentially material effect on enterprise and proprietary funds that have significant employees/personnel costs. As you know from the work on this issue from two years ago, County agencies currently spend approximately $60 million per year on OPEB benefits. Based on an actuarial study prepared by Mercer two years ago, the accrued liability for all County agencies ranges from $2 billion to $4 billion, depending on the funding method chosen. This accrued liability is required to be disclosed in the County's financial statements. The report estimated that the annual required contribution would rise to either $200 million or $350 million, again depending on the funding method chosen. To the extent the County chooses not to fund the annual required contribution, the gap will be reflected as a growing unfunded liability (or an increasing net OPEB obligation in accounting terminology) on the County's financial statements.

The actuarially calculated expense relating to governmental fund employees, if not fully funded, will not have an impact on the governmental funds (such as the General Fund), as those funds will reflect an expense only for the amounts contributed towards OPEB benefits; the full actuarially calculated expense, and related liability for any unfunded portion of the expense, related to governmental funds will be reflected in the government-wide financial statements. However, the portion of the actuarially calculated expense relating to proprietary (primarily enterprise and internal service) funds will be required to be reflected in those fund financial statements (such as the Solid Waste, Parking Lot District, Liquor, and Motor Pool funds). To the extent that laws governing such funds require that rates be set to recover costs, then the recognition of the expense would therefore likely result in the need for increased revenues, reduced other expenses, or a combination of the two.

In order to retain the County's high credit rating, I believe it will be important to create an approach that ultimately fully funds our annual servicing of the County's OPEB liability. In a recent publication by Standard & Poor's, it was noted that:

"As part of the overall OPEB analysis, Standard & Poor's will include the implications of not only the total unfunded liability, but also how the annual required contribution is managed. For example, an increasing net OPEB obligation would be a negative rating factor, just as an increasing net pension obligation would be."

And:

"While the payment of pension and other post employment benefits are just two of a large number of factors that go into a complete rating analysis, cases may arise in which OPEB obligations, due to their relative magnitude, adversely affect creditworthiness."

Also:

"Close attention will be paid to the newly quantified OPEB unfunded liabilities, given their expected magnitude, and to employers' strategies for managing them."

Considerations for Next Steps

While we continue our work on assessing the full impact of Statement 45, it is apparent that implementing this Statement will present two types of considerations that must be addressed: accounting and reporting considerations and related workload; and, liability management considerations and related workload.

Accounting and Reporting Considerations and Workload

- Prepare an updated actuarial valuation (FY08). Need to incorporate impact of Medicare Prescription Drug Program which was not incorporated into 2003 valuation, as this federal program was implemented after that date. Currently, reliable data on the Medicare program, and its impact on employer OPEB liabilities, may still be subject to significant estimates and judgments.
- Create a trust and assign an entity to administer the trust in order to take advantage of higher rate of investment return, on an actual basis and for actuarial calculation purposes, thereby reducing annual required contribution (FY08).

Liability Management Considerations and Workload

- Evaluate OPEB benefit and employee contribution levels.
- Consider alternative approaches to limiting liability, i.e., defined contribution and premium reimbursement plans.

Because of your leadership the County is ahead of many other state and local governments in assessing the impact of Statement 45 on the County's financial statements. I appreciate your willingness to continue to coordinate the County's efforts.

Montgomery County Public Schools

850 Hungerford Drive * Rockville, Maryland * 20850-1747

Telephone (301) 279-3626

November 21, 2005

Mr. Steve Farber
Council Staff Director
Montgomery County Council
100 Maryland Avenue
Rockville, Maryland 20850

Dear Mr. Farber,

This letter is in response to your request of November 8, 2005, for an update on the Governmental Accounting Standards Board (GASB) Statement Numbers 43 and 45, Financial Reporting for Other Post-employment Benefits (OPEB), which require governmental agencies to disclose the liability for the cost of health benefits current employees and retirees will receive during retirement. An actuarial study for all county agencies completed in 2003 estimated the total liability of the Montgomery County Public Schools (MCPS) at just over $1 billion for Fiscal Year 2003, assuming that MCPS begins to set aside funds for this obligation through pre-funding. Without funding, the estimated liability is over $2 billion.

The additional liability that would have to be recognized by MCPS in Fiscal Year 2006, if these accounting statements were implemented now, would be $115.7 million (or $213.2 million without pre-funding). This disclosure originally was required to be implemented in Fiscal Year 2006; however, implementation has been delayed by the GASB twice, now to Fiscal Year 2008. MCPS does not intend to implement this standard prior to Fiscal Year 2008.

Since the original study was completed, the following have occurred:

- Health care costs have continued to increase at a rate much greater than inflation.
- MCPS has continued to phase in the change to the cost sharing percentage for retirees participating in the prescription plan.
- Plan design changes such as mandatory mail order intended to control prescription cost increases have been implemented.
- The federal government has implemented Medicare Part D prescription coverage that some retirees may select as an alternative to MCPS coverage, potentially reducing MCPS' liability. MCPS has applied to receive the federal subsidy to actuarially equivalent plans.

Although we have not estimated the impact that these changes will have on the MCPS expenses and liability, we do not believe they will have a significant impact on the total liability.

Montgomery County needs to address the issue of OPEB funding as part of its overall financial planning. MCPS continues to work closely with the County Council and other county agencies to address this issue cooperatively. MCPS staff will be present to participate at the November 28, 2005, Management and Fiscal Policy Committee meeting.

Sincerely,

Larry A. Bowers

Larry A. Bowers
Chief Operating Officer

LAB:hls

Copy to:
Members of the County Council
Members of the Board of Education
Dr. Weast
Mrs. DeGraba
Mr. Girling
Dr. Spatz

Montgomery
College

November 18, 2005

Mr. Steve Farber
Montgomery County Council Staff Director
100 Maryland Avenue
Rockville, MD 20850

Dear Mr. ~~Farber~~ Steve:

As you know, Montgomery College has been concerned about the liability associated with post-retirement group insurance benefits for some time. We elected to comply with FAS106 beginning in FY'94 and while we were never able to fully fund our obligation, we did set aside funds on an annual basis to the extent possible until FY'04. We have continued to have an annual Post-Retirement Benefits Valuation performed each year to determine our actuarial accrued liability. As of June 30, 2005, the College's Accumulated Post-Retirement Benefit Obligation (APBO) was $66,718,464 as compared to the APBO of $52,086,859 as of June 30, 2003. The Fair Value of our plan assets is $18,703,246. This valuation did include consideration for Medicare D which will become effective in January 2006. We expect to continue to have this valuation performed in accordance with FAS106 standards until the GASB standards become effective.

The College believes that its decision to pre-fund for post-retirement benefits was a prudent approach in light of the escalating health care costs and the expected increase in retiree group insurance participants. Therefore, we continue to support the idea that some funding of the liability is based on sound financial decision making. The problem is the allocation of financial resources and deciding what the priorities should be in an educational environment where budget requests are greater than the available financial resources. In addition, the College has been cost conscious in its health plans for active employees and retirees to hold costs to minimum levels. Although the prospect of fully funding all of the agencies' liabilities is not reasonable to expect, beginning to discuss the issues and potential fiscal impacts again and to make plans to partially pre-fund this obligation in some capacity clearly appears to be a reasonable alternative.

We look forward to resuming the discussions surrounding this GASB obligation with the MFP Committee and our colleagues from the other County-funded agencies.

Sincerely,

Bill Campbell

William E. Campbell
Executive Vice President for Administrative
and Fiscal Services

cc: Ms. Lawyer
Mr. Moore
Mr. Mullinix
Ms. von Bargen

MEMO

THE MARYLAND-NATIONAL CAPITAL PARK & PLANNING COMMISSION
Department of Finance, Office of Secretary-Treasurer

PCB05-97
November 18, 2005

TO: Management and Fiscal Policy Committee

FROM: Patricia Colihan Barney, Secretary-Treasurer

SUBJECT: Update on M-NCPPC Other Post Employment Benefits (OPEB) – response to GASB Statement No. 45

Per your request, this memo summarizes the background and current status of work related to Other Post Employment Benefits, which include medical, dental, and life insurance benefits at the Maryland-National Capital Park and Planning Commission.

BACKGROUND: Prior to the creation of the County's working group on OPEB, the Commission had pre-funding retiree medical on the radar screen. Two actuarial valuations had been done, one in 1992 and another in 1997. Anticipating a move on GASB's part, the Commission began to accumulate excess employer pension contributions. The excess was generated when budgeted pension contributions were higher than required pension contributions due to positive market performance.

After researching various potential funding vehicles, the Commission established a 115 Trust and began to pre-fund retiree medical in July of 1999. Although contributions were not based on an actuarially determined amount, when excess pension contributions were generated, the Commission continued to transfer them to this fund.

At the end of fiscal year 2002, the Commission-wide fund had grown to $9 million. Beginning in fiscal year 2003, the Montgomery County Council directed that these funds be used to pay for current retiree medical costs. By the end of fiscal year 2005, with the fund almost depleted, the Commission decided to retain a small balance to keep the 115 Trust Fund open and ready to receive pre-funding contributions at a future date.

CURRENT STATUS: The Commission participated with the County's working group and received an updated valuation report as of July 1, 2003. Based on that valuation, the Commission's actuarial accrued liability with pre-funding was determined to be $137 million with a required contribution of $14.4 million for the entire Commission. The actuarial accrued liability without pre-funding was determined to be $287 million with an annual required contribution of $27.6 million.

The Commission has currently engaged Aon Consulting to compare Commission other post-employment benefits with other Montgomery County agencies, Prince George's County, WSSC, the State of Maryland and the Federal Government. The next phase of the study will include a focus on plan design, eligibility, contribution strategy and pricing and cost.

After the completion of the study, the Commission will review the recommendations and changes adopted will be incorporated into the next valuation along with the impact of Medicare Part D and the new requirement for consideration of implicit subsidies.

Although the GASB does not require pre-funding, a failure to do so will result in the recording of a liability on the entity-wide financial statements of an amount equal to any unfunded required annual contribution beginning in fiscal year 2008. We are aware that the rating agencies will be looking for plans to be in place to address the pre-funding issue. It should be noted that the Prince George's County side of the Commission has factored in full annual pre-funding requirements in the long-term fiscal plan.

The Commission's Finance Department recently briefed the Commissioners on GASB Statement No. 45 so they will be informed as we move forward with both counties in determining how to establish a plan to address this issue.

v:\Update on MNCPPC OPEB-2005

WASHINGTON SUBURBAN SANITARY COMMISSION

Interoffice Memorandum

TO: STEVE FARBER
MONTGOMERY COUNTY COUNCIL STAFF DIRECTOR

FROM: TOM TRABER
WSSC CHIEF FINANCIAL OFFICER

DATE: NOVEMBER 21, 2005

SUBJECT: GASB 45 ISSUES

The impending detonation of GASB 45 is not that much different from the situation that faced many governmental retirement systems in the 1970's. Namely, many municipal retirement plans funded annuity payments on a Pay-As-You-Go basis. This (then) accepted funding methodology was viewed as having limited negative exposure from an employee perspective because of the immortality of the organization providing the funding, thereby guaranteeing the annuity payments. Obviously, this assumption was faulty, in that, while the agency's existence was stable, the PAYGO funding levels were volatile because of the rapid increases in wages and inflation. Municipal budgets, which are based on gently increasing tax revenues, were stressed by the annuity requirements. The financially prudent approach to this situation was to fund the retirement years during the employees' working lives, thus matching the total compensation expense to the revenue earning periods. Governments performed realistic actuarial valuations, established long-term funding plans, and adhered to the required funding levels. Adequate funding, combined with prudent investment of the trust funds, have resulted in stable, healthy, municipal retirement plans. Private pensions, whose corporate governing boards utilized unrealistic actuarial valuations and inadequate funding levels, are failing.

Most municipal retirement plans have been in existence for over 30 years, and, therefore, are relatively stable with regards to the number of retirees. This stability would generally allow for a PAYGO funding methodology for health care coverage. However, as we all are aware, beginning in the 1990's health care costs have rapidly escalated. These increases were in the double-digit range, and continue at that level today, and for the foreseeable future. The mismatch of rapidly increasing costs versus lesser increasing revenues creates problems in funding.

From WSSC's perspective, health care benefits after retirement, combined with its defined benefit plan, are significant factors in recruiting and retaining high-quality employees. While we cannot offer salaries or bonuses at the level of corporations, we can offer stability after peoples' employment graduates into retirement. Losing either would detrimentally affect the quality of our personnel assets.

FitchRatings recently prepared a special report on the credit implications of GASB 45. They said that currently recognizing the post-employment obligations is a positive financial step, and, as they analyze the credit worthiness of governmental entities, they will be looking not only for a realistic plan for addressing other post-employment benefits (OPEB), but for progress in funding OPEB liabilities. WSSC has no intention of jeopardizing its AAA bond rating, and fully understands the necessity for addressing the OPEB issue and putting a plan in place.

Based on the rough estimations provided in the Mercer report, it appears that the prior service liability is not of such magnitude that it could not be financially addressed through the health insurance trust. The Commission does have experience with this situation, in that when WSSC took over administration of the retirement plan from the State, a prior service liability was a component of the initial liability. The trust would be similar in operation to the WSSC Employees' Retirement Plan Trust, which includes a separate entity, plan document, trust agreement, and investment board.

In order to formulate the plan, we anticipate obtaining an actuarial study by the end of FY 2006. The fiscal impact of our plan would be more accurately defined and would enable WSSC to incorporate OPEB trust funding into the FY 2008 Spending Affordability process.