MFP COMMITTEE #6
November 28, 2005

MEMORANDUM

November 23, 2005

TO: Management and Fiscal Policy Committee

FROM: Stephen B. Farber, Council Staff Director

SUBJECT: Update – GASB Statements on Other Post-Employment Benefits (OPEB)

This update deals with the impact on County agencies of Governmental Accounting Standards Board (GASB) Statements 43 and 45. These statements relate to accounting and reporting requirements for other post-employment benefits (OPEB) – chiefly retiree health benefits – as distinct from pensions.

Starting in FY08, the County and other large state and local jurisdictions will have to disclose in their financial statements their liability for OPEB. Most governments now fund these retiree benefits on a current year basis and do not set aside the large assets required to offset future benefit costs. The GASB statements do not require such pre-funding but do establish the basis for initiating it.

Previous Work by the Committee and County Agencies

Starting in February 2003, when GASB issued exposure drafts of these statements, the Committee and the agencies were among the first state and local officials to address this issue. At the Committee's request, the agencies' finance, budget, benefits, and legal staff met three times in 2003 to develop a common understanding of relevant questions. They also took an important step by obtaining updated valuations of their retiree group insurance obligations as of July 1, 2003. The slide presentation on ©A-M summarizes the report prepared by Mercer Human Resource Consulting. Several slides of are of particular interest:

- ©H, which illustrates the huge estimated annual required contribution (ARC) for FY04 if the exposure drafts had been effective July 1, 2003;

- ©K, which describes options – including different kinds of benefit reductions – that other employers are considering;

- ©L, which summarizes arguments for and against pre-funding; and

- ©M, which provides a reality check as to what could change. Two changes that have in fact since occurred are the deferral of implementation to FY08 and the inception of the new Medicare Part D prescription drug benefit.

Background Information

The GASB statements pose a major fiscal challenge for state and local governments nationwide. Several items in this packet contain useful background information:

- On ©1-4, a November 23, 2005 *Wall Street Journal* summary of efforts that some governments have already made, ranging from attempts to limit or even eliminate retiree health benefits to the issuance of "OPEB bonds".

- On ©5-9, a June 2005 special report by Fitch Ratings on the credit implications of GASB 45.

- On ©10-15, a July 2005 special comment by Moody's Investors Service that addresses a broad range of funding issues.

- On ©16-18, an October 10, 2005 *Baltimore Sun* summary of the potential impact of GASB 45 on the State of Maryland.

- On ©19-22, the executive summary of the October 2005 actuarial valuation prepared for the State of Maryland by Aon Consulting.

Updates from County Agencies

As noted above, the Committee and the agencies started to address this problem in early 2003, when GASB issued exposure drafts, and were among the first state and local officials to do so. At the November 10, 2003 Committee meeting, which reviewed the actuarial valuations prepared by Mercer, the Committee asked agency staff and consultants to develop a plan outlining options for action and the timetable for decisions; suggest how this information can best be conveyed to the agencies, employees, and the public; examine how it can be reflected in the Fiscal Plan; and provide more information on approaches like the Minnesota health care savings plan.

Recent editions of the Fiscal Plan have included the full impact of GASB 45, as outlined in the Mercer valuations that must now be updated; see, for example, line 19 of the November 2005 Fiscal Plan Summary on ©22A. Given the deferral of implementation to FY08 and the as-yet undetermined impact of the new Medicare Part D prescription drug benefit, the agencies have not recently taken collective action but are now gearing up to do so again.

For this Committee meeting, the agencies have provided useful updates on the work they have been doing individually and the next steps they project. As the Committee knows, they do not all proceed from the same starting point. Montgomery College, for example, has focused for many years on pre-funding, while M-NCPPC has also attempted to move in this direction.

The memo from Finance Director Tim Firestine is on ©24-26. The letter from MCPS Chief Operating Officer Larry Bowers is on ©27-28. The letter from Montgomery College Executive Vice President Bill Campbell is on ©29. The memo from M-NCPPC Secretary-Treasurer Patricia Barney is on ©30-31. The memo from WSSC Chief Financial Officer Tom Traber is on ©32-33.

Next Steps

The past collective efforts of the agencies' finance, budget, benefits, and legal staff have achieved important results. As these efforts now resume, in preparation for implementation of GASB 45 in FY08, the following steps appear to make sense:

- Update the actuarial valuations as of July 1, 2006, three years later than the current valuations. This will allow adjustments for current cost figures and for changes such as the inception of the new Medicare Part D prescription drug benefit.

- Create a trust – perhaps effective July 1, 2007 – if the agency has not already done so. As Mr. Firestine notes, the advantage is a higher rate of investment return, on an actual and actuarial basis, and thus a lower annual required contribution in FY08.

- Assess the costs and benefits of different pre-funding options and make specific recommendations on the extent, timing, and phasing of pre-funding.

- Assess the full range of options for limiting liability, including collective bargaining implications that may vary by agency.

- Use consultant assistance for these tasks that can draw on the growing body of experience from other jurisdictions. (Apart from the consultants used by individual agencies, the Council has in the past received expert assistance on interagency health benefits issues from Bolton Partners.)

- Provide updates to the Committee at least twice in 2006 – for example, in June and November – and regularly in 2007 until implementation begins on July 1, 2007.

- Design and implement a communications plan to keep agencies, employees, and the public informed of developments on this issue.

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MERCER

Human Resource Consulting

November 2003

Montgomery County Agencies
Post-Employment Benefits other than Pensions

MMC Marsh & McLennan Companies

A

Background

- GASB exposure drafts issued February 14, 2003
- Two exposure drafts
  - Accounting and Financial Reporting by Employers for OPEB
  - Financial Reporting for OPEB Plans
- Comment period expired April 30, 2003
- Effective date for large jurisdictions
  - Originally fiscal years beginning after June 15, 2006
  - Apparently to be delayed one year

B

Plans Covered

- Postretirement health benefits (e.g., medical, Rx, vision, dental, hearing)
- Postretirement life insurance benefits
- Legal benefits
- Other benefits

Requirements of Proposed Standards

- Accrual of postretirement benefit cost during period of active employment
- Disclosure of unfunded actuarial accrued liability in Required Supplementary Information (RSI)
- Does not require funding, only accrual as expense and disclosure

D

Actuarial Methodology and Assumptions

- Similar to GASB 27 for pension plans
- Permits any of six actuarial cost methods
- Plan assets must be segregated and restricted in a trust
- Generally use similar assumptions as pension valuations for interest rate, turnover, mortality, etc.
- However, due to the high cost of coverage prior to Medicare, retiree medical liabilities are much more sensitive to retirement rate assumptions
- Also need assumptions for claims rates, claim rate trend, and percentage participation for retirees and dependents

E

Interest Rate

- Estimated long-term yield on investments expected to be used to finance benefits
- Funded plans: expected yield on plan assets
- Unfunded plans: expected yield on employer assets
- Partially funded plan: proportionate combination of the two
- May cause more plans to become funded in order to be able to use higher interest rate

Trend Rate Assumptions

	Medical-only	Prescription Drugs-only	Medical and Prescription Drugs	Dental
1st year	12.00%	15.00%	13.50%	8.50%
2nd year	11.00%	14.00%	12.50%	8.00%
3rd year	10.00%	13.00%	11.50%	7.50%
4th year	9.00%	11.50%	10.25%	7.00%
5th year	8.00%	10.00%	9.00%	6.50%
6th year	7.00%	8.50%	7.75%	6.00%
7th year	6.00%	7.00%	6.50%	5.50%
8th year and thereafter	5.50%	5.50%	5.50%	5.50%

Estimated Annual Required Contribution

Reported Expense (Annual Required Contribution = ARC)
for FY2004 if Exposure Drafts had been effective July 1, 2003

(000's omitted)

	No pre-funding		Pre-funding	
County	$	113,183	$	67,866
Schools		176,945		104,383
College		7,435		3,819
MNCPPC		27,588		14,437
WSSC		21,577		14,789
Total	$	346,728	$	205,294

H

6-year Projections

	County Only	
	With Pre-funding	Without Pre-funding
FY2004 ARC	$ 67,866	$ 113,183
FY2004 contribution	67,866	20,591 (claims only)
FY2010 ARC	83,183	164,324
- Increase	23%	45%
FY2010 Contribution	83,183	49,389 (claims only)
Funded Ratio	30%	0%
Net OPEB obligation in CAFR	$ 0	$607,043

Report shows each Agency

H

How Could It Cost So Much?

Based on Public Schools

(in millions)

1.	Pension normal cost	$15.6
2.	Employee contributions	4.4
3.	Amortization	0
4.	Total	$20.0
5.	Additional amortization if no assets	$43.0
6.	Revised total	$63.0
7.	Average medical benefit vs. average DB benefit	$5,147 / $4,416
8.	Employee plus spouse vs. employee alone	1.6 / 1
9.	Impact of 5.5% trend vs. 3% inflation	1.53
10.	Participation	90%
11.	Reduction for retiree contributions	.64
12.	Rough estimate of medical costs (6 x 7 x 8 x 9 x 10 x 11)	$103.5
13.	Result from direct calculations	$104.4

4

What are Others Doing?

Shift Cost to employees

- Eliminate benefits
  - Medical, dental, and/or life
  - All participants
  - Medicare-eligibles
  - Spouses
  - Future retirees
  - Future employees
- Decrease employer subsidy
  - $ cap (with or without defined trend)
  - Based on age and service at retirement
  - Lower dependent subsidy
  - Eliminate implied subsidy
- Benefit design
  - Deductibles, co-pays, and maximums
  - Medicare integration method
- Eligibility
  - Increase age and service requirements
- Account-based plan structure
  - Defined contribution approach
  - Premium reimbursement plan

What are Others Doing?

Consider Pre-funding

- Why pre-fund?
  - Reduce cost
  - GASB draft allows higher interest rate assumption
  - Increased participant security
- Why not pre-fund?
  - Better/more urgent use for cash
  - May imply greater long-term commitment to benefit plan
  - Don't have cash
- Funding vehicles
  - VEBA
  - Integral Part Trust
- Employee Contributions

What Could Change?

- Requirements of GASB statements
- Medicare
- Healthcare delivery in U.S.

THE WALL STREET JOURNAL.
ONLINE

November 23, 2005

State, Local Officials Face Looming Health-Care Tab

Rule Requiring Disclosure Of Obligations to Retirees Could Force Painful Choices

By DEBORAH SOLOMON
Staff Reporter of THE WALL STREET JOURNAL
November 23, 2005; Page A1

A looming accounting change is forcing state and local governments to fess up to something that's been lurking on their books for years: Many have made costly retirement health-care promises without planning how to pay for them.

Under a new accounting rule, governments soon must start recognizing their long-term obligations to pay for retirees' health benefits -- and, for the first time, publicly disclose what it would cost each year to fund that liability.

For many governments, the promised amount is likely to be sizeable enough to prompt big changes such as cutting retiree benefits, borrowing money and diverting tax dollars from other spending priorities -- or risk a credit-rating downgrade that could significantly boost borrowing costs. Estimates of obligations for some states range from $500 million to as much as $40 billion.

"This is going to be a big jolt to many state budgets, and this problem is one that is not immediately resolved," said Cecilia Januszkiewicz, secretary of Maryland's department of budget and management.

In many ways, the problem facing state and local governments mirrors that which has faced some companies, especially in labor-intensive, unionized industries such as autos and steel, which made big promises on pensions and health care that they ultimately couldn't afford to fund. Many governments are expected to respond in much the same way as corporations, which have slashed benefits since being forced in 1990 to recognize their retiree health-care obligations in financial statements.

But the dilemma for governments may be even thornier. Most states are legally required to provide some form of employee and retiree benefits for government workers, and changing or doing away with those benefits usually requires legislative action. While some local municipalities have more flexibility to change benefits, others must work through their state legislatures. In contrast, most public companies can easily trim benefits, especially those with weak or no union representation.

Cutting benefits for government workers is especially tough given that many employees are protected by strong unions that will challenge any such efforts. While unions representing workers in the private sector have lost significant clout, the municipal and state unions remain quite strong. Additionally, while public companies can fall back on the Pension Benefit Guaranty Corp., which insures corporate pension funds, for some of the burden, governments have no such option.

So far, no state or local government has actually defaulted on any of its benefit plans. And the new rule doesn't require governments to set aside any money to fund the long-term obligations -- only to report what those obligations are.

But the change will shed new light on their long-term liabilities. And credit-ratings companies have told governments they expect the retiree health-care liability to be dealt with in some fashion. "We're looking to see that governments don't ignore it and look to control the growth of the obligation," said Richard Raphael, an analyst with Fitch Ratings.

How the ratings agencies respond will have big consequences for local and state governments, which borrow heavily from the public markets and need to maintain good ratings to keep borrowing rates low.

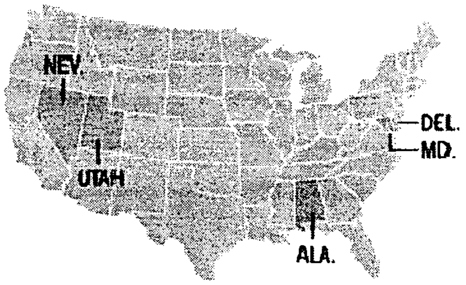
The accounting change will affect most big governments starting in fiscal 2008, which generally begins on July 1, 2007. It stems from a rule passed last year by the Government Accounting Standards Board, the independent advisory board that sets accounting standards for state and local governments.

With less than two years until the rule takes effect, governments already are scrambling to determine what they've promised to pay for retiree health care over the next 30 years -- and how to fund that liability. Until now, health-care benefits have been recorded on a pay-as-you-go basis, with budgets reflecting only the actual expense of benefits paid to employees and retirees each year.

Some already have gotten a taste of the bad news. Last month, Maryland disclosed a retiree-health-care liability of $20 billion, and said it must put aside $1.6 billion annually to fund the obligation. That's about 13% of the state's $12 billion general fund and comes on top of the $770 million Maryland shells out each year to pay for employee and retiree health-care benefits.

Scaling Back?

State and local governments are looking to curb escalating retiree health-care costs, which will come into view as the result of a pending accounting change. Here's a look at what several states are doing to respond to their long-term health-care liability:



	Maryland	Alabama	Delaware	Nevada	Utah
ESTIMATED HEALTH-CARE LIABILITY:	$20.0 billion	10.9	3.0	1.75-4.40	0.54
ACTIONS TAKEN:	Established a task force to explore ways to address health-care obligations	Increased health-care premiums for state employees who smoke; increased health-care costs for state employees who retire before 25 years of service	Committee established to review benefits unable to produce consensus around a single option or combination of options	Rejected a bill to end retiree health-care benefits for any state government employee hired after July 1, 2006	Passed legislation to end practice of allowing state employees to exchange eight hours of sick leave for one month's worth of retirement medical coverage

Source: Moody's Investors Service

Ms. Januszkiewicz said the $20 billion obligation was much higher than the $3 billion to $5 billion officials had been anticipating, and will force the state to make some hard choices.

"When I got the number I was in shock," said Ms. Januszkiewicz, adding that "there are a limited number of things we can do." A task force created by the state General Assembly earlier this year is examining the obligation and will make recommendations on how to deal with it.

The change comes at a time when many state and local governments already are struggling with other costs, such as fully funding their employee pension plans, which face shortfalls of as much as $300 billion nationwide. Some are still recovering from the recession early this decade, which dented capital-gains and income taxes and caused a shortfall in revenue. In fiscal 2002, states suffered their steepest revenue drop since the Depression, said Mr. Raphael.

"States are coming off their worst fiscal crisis in decades," said Sujit CanagaRetna, a senior fiscal analyst with the Council of State Governments. "They're not really flush with funds and it's still a dire revenue picture as far as expenditures needed down the road."

Indeed, the situation is similar to the problems facing government-employee pension plans. Officials often promised big benefits but failed to set aside enough money to fund them, preferring during the 1990s to focus on outsized investment gains which eventually disappeared. The city of San Diego, for instance, is facing a $1.1 billion pension shortfall in part because of agreements it made to sweeten benefits in exchange for reduced payments into the pension fund.

The problem has been years in the making. State and local governments began heavily expanding in the 1960s for a number of reasons, including the need for more schools as the Baby Boomers grew up and a heavier load of federal mandates, such as the 1965 Medicare law. As the number of employees grew, so did the cost of providing them benefits.

At the same time, the strength of public employees grew in tandem with the power of the American Federation of State, County and Municipal Employees, which represents public workers. By the end of 1965, AFSCME had won collective-bargaining rights in several states, which translated into better and more generous benefits. And even with some recent cutbacks, costs are expected to swell over the next few years as the Baby Boomers begin to retire and collect both pension and health-care benefits.

For local officials, the latest dilemma could mean taking some politically unpopular stands. In Nevada, a proposal by Republican Gov. Kenny Guinn to discontinue retiree health-care benefits for any state government employee hired after July 1, 2006, ignited a firestorm.

The proposal was estimated to save the state $500 million per year, but the state's employee union lobbied aggressively to scotch the legislation, and it failed in the Democratic-controlled state assembly. Nevada has estimated its retiree-health-care obligation to be as high as $4.4 billion and says it will need to put aside about $200 million annually to fund the liability.

Scott Mackenzie, executive director for the State of Nevada Employees Association, said unions understand that governments need to cut costs, but that ending benefits will turn people away from civil service, where robust benefits often make up for lower salaries.

"Government attracts people because they have a bit of a cushion there when they retire," said Mr. Mackenzie.

Other states have been unable to reach consensus on how to address the liability. A committee established earlier this year by Delaware Gov. Ruth Ann Minner, a Democrat, explored various ways to address the state's estimated $3 billion obligation and the $185 million it needs to set aside annually. The committee looked at a range of options, including reducing the state's agreement to pay 100% of health insurance for retirees, but was unable to agree on a plan. "Without exception, the options presented to the Committee included difficult and unavoidable policy trade-offs," the report concluded. "There are no straightforward 'win-win' solutions."

Some governments are opting to sell debt to finance their health-care obligation. For instance, Gainesville, Fla., issued bonds earlier this year to help finance its $30.6 million liability.

Others are trimming benefits, despite the political ramifications. The city of Arlington, Texas, recently did away with retiree health benefits for any employee hired after 2006 and trimmed the percentage of health-care costs that the city covers. Arlington Chief Financial Officer Donna Swarb said the moves cut the city's health-care obligation to $150 million from $196 million. However, a more controversial plan to charge premiums based on age wasn't adopted and the city is still facing costs that Ms. Swarb called "unmanageable."

Alabama, Utah and Ohio also have taken steps to scale back benefits, including raising health-care premiums for retirees and increasing the length of time employees must work before being eligible for retiree health care.

Other states, such as California and New York, have yet to officially determine their liabilities but policy watchers and credit-ratings analysts expect those numbers will be significant. Some have predicted that California's obligation could be $40 billion or more. The state controller's office has requested money from the governor and Legislature to perform an assessment of the liability.

Special Report

The Not So Golden Years

Credit Implications of GASB 45

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The authors wish to thank finance department staff at Montgomery County, MD for sharing the results of a preliminary study of the county's OPEB liabilities, which provided valuable context to this report.

Related Research
- "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Sept. 18, 2003
- "Local Governments Pressured by Rising Employee Health Care Costs," Dec. 13, 2004

■ Summary

A new public sector accounting standard touches on three hot topics: skyrocketing health care costs, the ongoing national debate over retirement security, and the recent emphasis on greater financial disclosure. Governmental Accounting Standards Board (GASB) Statement No. 45 relates to other post-employment benefits (OPEB) — payments and services provided for retirees other than pensions. OPEB consist mainly of retiree health care benefits. GASB 45 applies the accounting methodology used for pension liabilities (GASB 27) to OPEB and is similar in concept to an accounting standard adopted for the private sector in the mid-1990s.

The new standard, to be implemented beginning in fiscal 2008 for many large governments, is timely given the aging demographics of the governmental work force. It also reflects the consistent efforts of the GASB to improve financial statement transparency and align public accounting more closely with that of the private sector.

GASB 45 does not increase costs of employment, but attempts to more fully reveal them by requiring governmental units to include future OPEB costs in their financial statements. Under current practice, nearly all governments pay only the cost of OPEB due in the current year, with no effort made to accumulate assets to offset future benefit costs. While not mandating funding, GASB 45 does establish a framework for prefunding of future costs.

Amounts required to prefund OPEB on an actuarially sound basis are likely to significantly exceed annual pay-as-you-go outlays for these benefits. Many actuaries believe, bolstered by preliminary studies done on behalf of a few proactive governments, that actuarially determined annual contributions could be five to 10 times higher than current expenses in many cases.

Fitch Ratings views GASB 45 as a positive step toward more fully illuminating governmental obligations to retirees, but acknowledges the inherent tension between allocating scarce resources toward critical government services today and meeting the funding requirements for retirement benefits that might not be due for decades. Fitch anticipates that governments will thoroughly review retiree benefit programs and that responses to OPEB funding challenges will vary considerably. However, Fitch expects many governments will approach GASB 45 in much the same way they responded to the adoption of pension system actuarial and accounting standards, by steadily ramping up annual contributions to actuarially determined levels, altering benefit plans, or taking other actions to ensure long-term plan solvency.

Credit Highlights

- Governmental Accounting Standards Board (GASB) Statement No. 45 will be the accepted accounting practice for governments as of its implementation dates. Failure to comply would prevent auditors from releasing a "clean" audit opinion.
- The switch to actuarial funding from a pay-as-you-go practice may have a sizable fiscal impact. However, Fitch Ratings believes that meeting actuarial funding requirements for other post-employment benefits (OPEB) will be a stabilizing factor and protective of credit over time.
- Fitch expects a wide range of unfunded liability positions to result as GASB 45 is implemented, reflecting the variability of benefits offered around the U.S. Annually required contributions are likely to place disparate burdens on the budgetary resources of state and local governments.
- Initially, Fitch's credit focus will be on understanding each issuer's liability and its plans for addressing it. Fitch also will review an entity's reasoning in developing its plan. An absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor.
- For issuers choosing to ramp up annual contributions to reach full funding of actuarially determined levels, Fitch recognizes that a rising net OPEB obligation in the short term may be a by-product. Such an increase, taken in the context of a sound OPEB funding plan, will not by itself affect credit ratings.
- Fitch 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.
- Assumptions play a crucial role in calculating plan assets and liabilities. As actuarial standards for OPEB plans become clear, Fitch will review the underlying assumptions and will view negatively any that are overly aggressive. When applicable, assumptions should be consistent with those adopted for the plan sponsor's pension system.
- Fitch will view OPEB liabilities, like pensions, as soft liabilities that fluctuate based on assumptions and actual experience. Reality dictates that an entity may opt to defer OPEB funding in times of budget stress. However, indefinite deferrals are damaging to credit quality. While not debt, pension and OPEB accumulated costs are legal or practical contractual commitments that form a portion of fixed costs. Long-term deferral of such obligations is a sign of fiscal stress that will be reflected in ratings.

Failure to make actuarially determined OPEB plan contributions will most likely result in rising net OPEB obligations, which like rising net pension obligations are a deferral of financial responsibility. Therefore, over time, a lack of substantive progress in funding and managing OPEB liabilities or a failure to develop a realistic plan to meet annual OPEB contributions could adversely affect an issuer's credit rating. Conversely, in Fitch's opinion, the prudent accumulation of assets in a trust account outside the general fund and well in advance of pay-as-you-go cost escalations can avoid or forestall liquidity problems or tax capacity concerns that might lead to credit deterioration.

■ Implementation Schedule

GASB 45 will be phased in, beginning with the largest governments, effective:

- Fiscal periods beginning after Dec. 15, 2006 for governments with annual revenue greater than $100 million.
- Fiscal periods beginning after Dec. 15, 2007 for governments with annual revenue between $10 million and $100 million.
- Fiscal periods beginning after Dec. 15, 2008 for governments with revenue under $10 million.

■ Exploring GASB 45

GASB 45 furthers the effort to disclose the total cost of compensation earned by public sector employees. Some of this cost, specifically the salaries and related benefits of active workers, is already recognized on the statement of revenues, expenditures, and changes in fund balance (income statement) prepared annually. Similarly, the cost of pension benefits for current and retired workers is recognized through the implementation of GASB 27, which requires income statement recognition of annual employer contributions to pension systems and balance sheet recognition of net pension obligations (most often as a liability, but theoretically an asset). GASB 45 largely adopts the accounting and actuarial valuation methodologies used for pensions, making minor adjustments to reflect the different nature of OPEB and the reality that very few governments have funded OPEB plans.

OPEB primarily relate to retiree health care, but can also include life insurance and other benefits. OPEB contributions by employers generally take the form of direct indemnity payments or full or partial cost-sharing of annual insurance premiums, but can also take the form of an implicit subsidy. This occurs when retirees pay a health insurance premium that is based on a larger risk pool, thereby benefiting from a lower premium rate than if they had to pay the full age-based premium.

Under GASB 45, governments providing benefits to more than 200 plan members are required to have an actuarial valuation of their OPEB plans done every two years. Most governments accessing the capital markets fall under this requirement. The OPEB plan is defined as whatever constitutes the "substantive plan," incorporating written and documented plan elements, as well as nondocumented elements that have been communicated and understood between the employer and employees. The actuarial valuation determines the actuarial present value of future liabilities — in essence, the amount that, if invested at the valuation date, would be sufficient to meet all liabilities, assuming embedded assumptions hold true.

From the actuarial valuation, an annually required contribution (ARC) is determined. The ARC is the portion allocated to the current year of the amount needed to pay both the normal costs (current and future benefits earned) and to amortize the unfunded liability (past benefits earned but not previously provided for). GASB 45 requires amortization of unfunded liabilities over a maximum of 30 years.

GASB 45 requires an accounting of a government's compliance in meeting its ARC. Contributions in an amount less than the ARC result in a net OPEB obligation, which is to be recorded as a liability on the governmentwide financial statements and full accrual-based fund statements. Only the employer's payments count toward the ARC; employee matching payments do not. The direct payment of benefits counts as a contribution toward the ARC. However, since nearly all plans will have some past service liability to amortize, simply continuing with pay-as-you-go funding is likely to result in rising net OPEB obligations.

Unlike GASB 27, which covers employer accounting for pensions, under GASB 45 there will be no net OPEB obligations reported at transition (unless a government volunteers to record one). Unfunded OPEB plan liabilities will be present as governments begin to implement the standard, but governments will be required to disclose their compliance in meeting the ARC only on a going-forward basis. The footnotes to the financial statements will include information on compliance in meeting ARCs, the cumulative net OPEB obligation, and the actuarial funding ratio of the OPEB plan (assuming a trust account is established).

■ OPEB Trust Funds

A critical element to making OPEB plans affordable and actuarially sound is GASB 45's requirement that, in order for actuaries to permit the use of a long-term investment return assumption, governments must set aside plan assets in an irrevocable trust. Funds accumulated or earmarked but held outside an irrevocable trust are limited to an investment return assumption consistent with general government investments, which are typically shorter in duration and lower in yield. Partially funded plans are required to use a blended rate, based on the proportion of contributions being used for asset accumulation versus payment of current benefits.

The ramifications for OPEB plan valuation are enormous, as long-term return assumptions are usually at least twice those of short-term investments. The higher the investment return assumption (discount rate), the lower the present value of future liabilities and the corresponding ARC will be.

Governments and actuaries are currently exploring different types of trust mechanisms, with no clear consensus emerging to date. Options include 401(h) accounts, voluntary employee benefit accounts, section 115 governmental trusts, and others. The type of trust account used may vary depending on the design of the OPEB plan. One consideration for governments may be weighing the financial benefits of establishing a trust against the legal and human resources management implications. Many governments reserve the right to unilaterally revoke OPEB. Establishing a trust fund may be seen as conferring a permanency to the benefit plan that might not be intended.

■ Role of Assumptions

As they do for pension systems, economic and demographic assumptions will play a critical role in determining the magnitude of OPEB plan liabilities (and eventually assets). Beyond the discount rate assumption discussed in the previous section, projections of health care costs and retirement rates and ages will be crucial to OPEB plans.

Health care costs have risen rapidly since the mid-1990s, with double-digit growth rates in some years. The pace of health care cost growth outstrips the salary and general inflation assumptions embedded in pension plan valuations, making OPEB liability growth potentially more volatile. Fitch expects initial variability in medical inflation assumptions, with actuaries making adjustments over time based on experience.

Retirement rate assumptions project how many plan members will leave active service and begin collecting OPEB during the valuation period. Studies have shown that the public sector work force is disproportionately made up of baby boomers, who are nearing retirement age. The pace at which they retire will have a significant effect on liability valuations and could even affect investment performance, as plan managers may have to adjust investment allocations to maintain liquidity sufficient to meet current benefit expenses. Retirement age is also important, given the existence of Medicare. In most cases, OPEB health care costs would be at least partially offset by Medicare. However, retirement age rules vary significantly among and within governments, with some plans having to carry OPEB for 10–15 years until Medicare eligibility is reached, and others facing much shorter exposure.

■ Implementation Issues

GASB 45 potentially creates legal, technical, and policy issues for the public sector.

Defining the "Substantive Plan": Determining the precise definition of an OPEB plan is the task of the employer, in consultation with the actuary. Written documentation of the benefit plan may or may not accurately reflect the currently understood version of the plan. Employers have a financial interest in more narrowly defining the substantive plan, which may put them at odds with employee groups. Legal challenges or labor grievances can be envisioned.

Legal Status of OPEB: In many states and localities, pension benefits are constitutionally protected, statutorily defined, or otherwise codified. While OPEB may have the same status in some jurisdictions, many governments have greater administrative control over OPEB. If employers seek to modify or eliminate OPEB for some workers or retirees, legal clarification may be required.

Medicare Part D: The implementation of the new prescription drug benefit under Medicare is under way and scheduled to go into effect Jan. 1, 2006. Integration with government OPEB plans will take time and will be complex. It is not clear at present whether this federal program will provide a financial benefit to or impose additional costs on state and local governments.

Labor Relations: Faced with potentially large costs to prefund OPEB plans, governments may seek concessions from active and retired employees. Conflicts could lead to work stoppages or recruitment and retention problems. Fitch expects such difficulties to appear in the more heavily unionized areas of the country.

■ Potential Funding Solutions

Governments will likely explore switching employees to a defined contribution system for OPEB. Once the government makes its scheduled contribution to employees or beneficiaries, all risk is transferred to the employee. While an attractive option for employers, it is likely achievable only for new hires, as existing beneficiaries have an interest in retaining the current system. Prolonged resistance by employee groups to defined contribution pension funding underscores this difficulty.

Governments facing large unfunded liabilities and steep ARCs may consider OPEB funding bonds. However, state laws are generally not explicit regarding issuing bonds for this purpose, creating a potential impediment to capital financing for OPEB. If legally allowable, OPEB funding bonds may be structured in the same manner as pension obligation bonds, which attempt to take advantage of the interest rate differential between taxable municipal bonds and the assumed investment return on plan assets. Bonds could be issued to fund all or a portion of a sponsor's unfunded OPEB liability, with the hope that the debt service on the bonds would be less than what the sponsor would otherwise have to pay in annual OPEB ARC costs over the long term.

Fitch believes that OPEB funding bonds, if used moderately and in conjunction with a prudent approach to investing the proceeds and other plan assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices could expose the plan sponsor to market losses.

Because a sponsor's unfunded OPEB liability will be factored into the rating, bond issuance would simply move the obligation from one part of the governmentwide or full accrual-based fund financial statements to another. However, Fitch notes that OPEB or pension funding bonds create a true debt, one which must be paid on time and in full, rather than a softer liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, issuing bonds to fund an OPEB plan could have a significant effect on financial flexibility over time.

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Special Comment

July 2005

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Other Post-Employment Benefits (OPEB)

New Accounting Requirements to Shed Light on Cost of State and Local Retiree Health Benefits; Funding Pressures Expected to Vary Widely

Summary

Just as U.S. local and state governments are emerging from one of the most difficult fiscal periods in recent memory, they face a new hurdle in the form of accrued retiree health-care liabilities. The costs associated with retiree health benefits, though they have been magnified by growth in healthcare spending, are not a new phenomenon. Governments in coming years will have to improve their measurement and disclosure of OPEB costs and liabilities under statements 43 and 45 of the Government Accounting Standards Board (GASB). For many state and local governments rated by Moody's, the rules will apply to fiscal years starting after Dec.15, 2006. A wide range of previously unmeasured liabilities will be reported as a consequence, and the expected drive to address these liabilities will add to the fiscal pressures governments already face from programs such as public education, Medicaid, and employee pension funding.

Moody's does not anticipate that the liability disclosures will cause immediate rating adjustments on a broad scale. In fact, certain positive long-term effects seem likely to stem from the new requirements. This special comment describes the GASB statements and how they may affect the state and local government credit rating process. For municipal issuers, the credit impact of the new statements probably will depend on the following factors:

- The absolute size of unfunded actuarial accrued liability (UAAL) and UAAL size relative to key financial measures such as size of payroll, budget and tax base
- The plan for UAAL amortization as well as ongoing funding of new OPEB costs as incurred, on an accrual basis
- Actuarial assumptions, including discount and medical cost inflation rates, used to determine values of liability and pledged assets
- Retirement benefits promised to current workers and retirees as well as the ability (under contract or statute) to modify benefit offerings
- The impact of full funding on the issuer's financial flexibility and strength, based on measures such as debt or reserve levels
- The current credit assessment of the issuer and other factors affecting financial flexibility

Moody's Investors Service
Global Credit Research

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NEW RULES ARE INTENDED TO IMPROVE DISCLOSURE OF PUBLIC PAYROLL COSTS

Statements 43 and 45 will improve disclosure of costs that, along with salaries, pension benefits and pre-retirement health insurance, make up government employees' total compensation package. Like pensions, OPEB are a form of deferred pay, part of an exchange of salaries and benefits for employees' service. Their costs to employers accrue over the period of employment, even though the benefits are not provided until later. GASB's new standards require governments to measure and report OPEB costs as they are incurred, during the employment period. This mandate will force significant changes in government practice. Most governments, by measuring as expense only the outlays associated with current retirees' OPEB, have failed to capture the accrued cost and liabilities of promising retirement benefits to active workers. The actuarial methods used to estimate the cost of OPEB will be similar to those already applied to pensions. Biennial actuarial valuations of OPEB assets and liabilities will be required under the new accounting rules for state and local governments with 200 or more benefit plan participants; smaller plans will have to conduct valuations every three years and in some cases may be able to use an alternative method not requiring use of an actuary.

OBLIGATIONS COVERED BY THE STANDARDS CONSIST PRIMARILY OF HEALTH INSURANCE

OPEB refers to retirement benefits besides pensions and early-retirement incentive (or termination) payments. These include various health-related benefits, as well as disability, life and long-term care insurance provided outside of defined-benefit pension plans. The largest component will be health insurance for which the employer pays some or all of retirees' premiums. The magnitude of this obligation will reflect the increases in prescription drug and other medical costs that have accounted for much of the recent growth in Medicaid, the joint state-federal health program for the poor.

GASB's new standards also require the inclusion in OPEB liability calculations of any implicit rate subsidy provided to retirees whose coverage is derived from a pool serving current employees (*see box*). It is because of this subsidy that even those state and local governments that do not explicitly pay part of their retirees' premium costs will likely have OPEB liabilities.

IMPLICIT RATE SUBSIDIES

A government's retirees in many cases are able to purchase health insurance at the same premium rate as current employees, based on the blending of premium rates that would apply to the two groups independently. The cost per participant of covering both groups together is higher than current-employee coverage would be on its own, and not as high as the cost per participant in a group consisting solely of retirees. Because of this arrangement, retirees with blended-rate health benefits are said to receive implicit rate subsidies. The new standards require measurement and reporting of the rate subsidy of retirees, even in situations where the retirees are required to pay 100% of their stated premiums.

The rules apply to state and local governments and to government-sponsored enterprises, as well as government-owned hospitals, universities, and utilities. Non-profit organizations are covered by standards issued by GASB's sister organization for the private sector, the Financial Accounting Standards Board (FASB). Statement 43 applies to financial reports prepared by health insurance or other OPEB plans, and 45 applies to the governments themselves.

STANDARDS ARE PART OF BROADER EFFORT TO IMPROVE ACCOUNTING FOR PENSIONS AND RELATED COSTS

The new accounting standards are part of a long-running effort in which GASB and FASB have mandated more disclosure of pension and other retirement benefit costs. FASB's Statement No. 81, issued in 1984, outlined disclosure practices for post-retirement health care and life-insurance benefits; Statement No. 87, in 1985, did the same for pension costs. Further clarification of OPEB cost reporting procedure followed when FASB issued Statement No. 106, in 1990. The same year, GASB published Statement No. 12, providing for disclosure of OPEB-related data in notes to governments' financial statements. These disclosures generally were to include the covered year's OPEB expense; the groups receiving (and the eligibility requirements for) the benefits; the respective contribution requirements for beneficiaries and employers; the statutory, contractual or other basis for the benefits, and a description of funding policy (either pay-as-you-go or paying in advance of future costs). Statement No. 12, which was intended as an interim measure, did not require the calculation of an actuarial accrued liability (AAL) or the recognition of current employees' accrued benefits. GASB in 1994 issued Statement No. 25 and Statement No. 27 to clarify how governments should report pension costs. Also at that time, it released Statement No. 26, providing interim guidance on financial reporting practices for post-employment healthcare plans administered by defined-benefit pension plans.

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INCREASED BENEFIT PRE-FUNDING, OPEB-BOND ISSUANCE AMONG LIKELY GOVERNMENT RESPONSES

Under the new rules, a government will determine the annual required contribution (ARC) needed to amortize its actuarial liability (in no more than 30 years) and to cover the "normal cost" associated with services rendered by employees during the current year. The UAAL will appear in the notes to financial statements and in a required multi-year schedule of funding progress. But to the extent that a government in a given year fails to make the full ARC, that year's funding deficit will create (or add to) a liability called the net OPEB obligation, which will appear in the statement of net assets. The rules require calculation of an annual OPEB cost that differs from the ARC once this net obligation is recorded. This cost, which must be recognized as an expense in accrual-basis financial statements, will be derived from the ARC plus interest on the net OPEB obligation.

Because failure to pre-fund benefits will result in new balance-sheet liabilities, governments may begin to set aside assets for future OPEB obligations to an increasing extent. Moreover, the rules allow a higher assumed discount rate (and hence a lower present-value actuarial liability) for plans with assets set aside in a trust for OPEB obligations than for those with no (or insufficient) assets set aside. Governments may seek to address large, unfunded liabilities for retiree healthcare through the issuance of taxable bonds similar to pension-obligation bonds. An early example of this practice is the city of Gainesville, Florida, which has issued bonds to address a $30.6 million liability in its self-insured Retiree Health Care Plan. The credit impact of borrowing to address a retiree health plan funding deficit will depend, as it does with pension-obligation bonds, on the extent to which the debt is part of a realistic plan to address these liabilities, and on its effect on the issuer's overall debt burden.

GOVERNMENTS HAVE BEGUN TO ADDRESS OPEB COST GROWTH

Some state governments, partly in response to the new standards, have already taken steps to reduce growth rates of their OPEB costs. Moody's expects this trend will continue, in part because improved OPEB information will encourage restraint in legislative debates and contract talks where benefits are determined. Alabama (rated Aa3 on watch for a possible upgrade) has enacted legislation increasing the premium payment obligation for various types of employees, including smokers and those who retire after a relatively short period of service. Ohio (Aa1) has modified its retiree health plan so that full coverage is available only to the employees with at least 30 years of service (*see box*).

OHIO'S APPROACH TO POST-EMPLOYMENT BENEFITS

Ohio is one of the few states that already have accumulated assets pledged to retiree health obligations. The Ohio Public Employees Retirement System (OPERS) oversees an $11 billion healthcare fund. Even so, because of rapid growth in both medical costs and the number of covered retirees, the OPERS trustees determined in 2003 that the health benefits fund would be used up in less than a dozen years. In September 2004, the trustees acted to restrain the fund's cost growth. They cut the portion of insurance premium coverage available to retirees with only 10 years of service to 50% for workers hired in 2002 or earlier, and to 25% for those hired later. For workers who retire with 30 years of service, however, 100% coverage was retained. The overhaul also reduced retiree spouse coverage and mandated increased contributions from active workers and employers. These actions are expected to extend the solvency of the health benefits fund to 18 years. Annual benefits and program adjustments will be reviewed periodically to maintain a balance between responsibilities of the system and its members.

Utah (Aaa) passed legislation this session to change its practice of providing retirees a month of health insurance for every day of unused sick leave. This policy, which was initiated when health insurance costs were substantially lower, will be modified so that the wages for each day of unused sick leave are placed in retiree health savings accounts, which retirees will then be able to use to purchase their own health coverage. The state still will have to address the liability accumulated through its existing policy, which remains in effect through the end of calendar year 2005. Other states that have taken steps to prepare for compliance with the new OPEB accounting rules include Delaware (rated Aaa), which in May of this year formed a committee to oversee an actuarial assessment of retiree health liabilities. In 2003, Delaware performed an actuarial analysis of its retiree health benefits using a preliminary version of the GASB standard. Georgia (rated Aaa), also in May, enacted a law creating the Georgia Retiree Health Benefit Fund to receive annual contributions based on the state's ARC.

Local governments also have begun to scale back retirement health-benefit offerings for new employees. After performing actuarial assessments of liabilities, Orlando, Florida (Aa2), and Arlington, Texas (Aa2), modified the percentages of employees' healthcare premiums that are covered, as well as length-of-service requirements for eligibility.

RETIREMENT HEALTH BENEFITS VARY WIDELY AMONG STATES AND LOCAL GOVERNMENTS

Retiree health benefits offered to public employees vary dramatically among state and local jurisdictions. States such as Iowa (Aa1) and Mississippi (Aa3) offer little or no health-care coverage to retired workers. Some, such as Wisconsin (Aa3) and Montana (Aa3), offer post-employment health insurance but require retirees to pay most of the cost. Still other states, such as California (A3), fully cover many retirees' health-insurance premiums as well as the majority of the premium costs for retirees' dependents. New Jersey covers retiree health insurance costs of local school teachers and college and university professors in addition to those of its regular employees. As a result, its OPEB expenditures for existing retirees already account for more than 3% of its general fund budget. A Kaiser Family Foundation survey of state governments found that in 2002, monthly premiums ranged from as little as $105 per month for the Indiana (Aa1) Medicare complement plan to as much as $668 per month in an indemnity-style plan provided by Alaska (Aa2).[1]

State and local governments are further distinguished by benefit eligibility requirements, the legal measures that provide for the benefits, and the demographic characteristics of covered employee and retiree groups. As a result, there is likely to be great variation in the relative sizes of OPEB liabilities reported.

OPEB FUNDING STATUS WILL BECOME A MORE VISIBLE FACTOR IN CREDIT RATING PROCESS, SIMILAR TO PENSION OBLIGATIONS

As governments and their retirement benefit plans begin issuing financial reports in compliance with the new rules, OPEB funding status will become more visible among the many attributes Moody's assesses in the municipal credit rating process. While it will most closely resemble pension funding status, there are differences between the two types of obligations. OPEB obligations reflect medical cost trends, while those for pensions are based on salaries, over which a government's management has more control. On the other hand, retiree health benefits may be somewhat easier to modify than pensions, which may have stronger legal or contractual protection. Moody's views both OPEB and pension obligations as less binding than bonded debt, because they tend to allow some flexibility to alter the terms of the benefits (such as eligibility requirements), the assumptions used to derive the actuarial values of plan assets and liabilities, the liability amortization schedule, or other variables.

Moody's therefore will exclude OPEB liabilities from calculations of state or local debt burdens, but include them as a factor in the overall credit assessment of an issuer. This practice is consistent with Moody's approach to municipal pension liabilities. Some governments provide post-retirement health benefits through pooled programs known as cost-sharing, multiple-employer plans. For these governments, the new standards will require reporting of OPEB payments in relation to the amount contractually mandated by their cost-sharing plans. Moody's may have to rely in these cases on the financial reports of the plans, rather than of the governments participating in them, for actuarial information on OPEB funding.

IMPORTANCE OF OPEB TO RATING PROCESS WILL DEPEND ON ISSUER'S OVERALL CREDIT STANDING

The extent to which OPEB funded status becomes an influential or decisive credit factor will depend on an issuer's current rating and how consistent its other attributes are with that rating. State and local governments' liabilities may be large in many cases, given the lack of prefunding in the past. For some issuers, it is possible that efforts to satisfy OPEB funding requirements will exacerbate fiscal pressure. Even so, Moody's does not anticipate that the disclosures required by the new rules will cause immediate and widespread rating adjustments. It is more likely that rating levels will be affected by observations of changes in OPEB funding measurements over time. Statistics such as the UAAL-to-covered payroll will be made available under the new rules, and Moody's expects to use these in the rating process. Plans for UAAL amortization, amortization periods, use of debt, and differences between actual and required contributions will also figure into the analysis, along with actuarial assumptions about medical costs and other variables key to estimating OPEB liabilities. Issuers' flexibility under relevant statutes or contracts to modify their post-employment health benefit offerings will likely be another focal point. Moody's also will monitor financial reserve, liquidity and debt levels that will be affected as issuers begin to set aside funds for OPEB. In general, a state or local government's effectiveness and initiative in OPEB liability management probably will influence our overall assessment of the government's management strength.

1. *Hoadley, Jack: "How States are Responding to the Challenge of Financing Health Care for Retirees"; The Henry J. Kaiser Family Foundation, September 2003.*

LONGER-TERM IMPACT OF REPORTING REQUIREMENTS WILL BE LARGELY POSITIVE

Even though compliance with the new accounting rules is expected to exert financial stress and to bring to light previously unknown liabilities, Moody's expects the disclosure effects will be largely positive over the long term. As previously mentioned, the rules will require governments to disclose and record the full current cost of benefits provided to employees. Governments will have a strong incentive, though not an obligation, to set aside funds for benefit obligations as they are incurred, which is in keeping not only with accounting principles but also with prudent financial management. Any resulting fiscal strain is likely to be more than offset in most cases by the positive implications of management practice improvements under the accounting rules.

Until the release of audited reports subject to the standards, the lack of actuarially derived OPEB liability information limits Moody's ability to make a more detailed assessment of how these future costs will affect state and local government credit. Expenditures on current retirees' healthcare costs are already incorporated in the rating process. GASB's schedule for compliance with the new OPEB reporting rules is staggered, with smaller-revenue governments afforded additional time *(see Appendix I)*. For states, the first financial reporting periods subject to Statement No. 45 will be those ending during calendar year 2008. A comprehensive overview of states' OPEB funding status is therefore not likely until early 2009, when published comprehensive annual financial reports covering fiscal 2008 become available. At that time, Moody's will focus on the OPEB factors listed earlier, including the UAAL size relative to key financial indicators and the plan for UAAL amortization. Before compliant financial statements become available, Moody's may request information from issuers on various aspects of health plans and other retiree benefits that factor into OPEB liabilities *(see Appendix II)*.

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Appendix I

Effective Dates	
GASB 45	
Government Description	**Effective Date**
Tier 1 (annual revenues > $100 mln*)	Yrs Starting After 12/15/2006
Tier 2 (annual revenues > $10 mln)	Yrs Starting After 12/15/2007
Tier 3 (annual revenues < $10 mln) Yrs Starting After 12/15/2008	
GASB 43	
Plan Description	**Effective Date**
Tier 1 (annual revenues > $100 mln)	Yrs Starting After 12/15/2005
Tier 2 (annual revenues > $10 mln)	Yrs Starting After 12/15/2006
Tier 3 (annual revenues < $10 mln) Yrs Starting After 12/15/2007	

** Tiers are based on first fiscal year ending after June 15, 1999, the same basis as applied to Statement No. 34.*

Appendix II

Following are examples of questions Moody's will pose pending disclosure under the new rules:

1) Has an actuarial assessment of OPEB liabilities been performed? If so, what were the accrued actuarial liability, actuarial value of plan assets, and funded ratio?

2) What health-care and other post-employment benefits subject to the standards are provided? What are the benefits' eligibility requirements?

3) Describe the mechanisms (e.g., single-employer or agent multiple-employer defined- benefit plans) through which benefits are provided.

4) What legislative or other actions would be required to reduce the benefits' cost?

5) What is the total cost of retiree health and related benefits in the budget? How much has this sum changed in recent years, and what has accounted for that?

Related Research

Special Comments:

GASB 34: What Does It Mean for the Rating Process?, December 2002 (#76862)

Moody's Perspective On Increased Pension Costs For California Local Governments, June 2003 (#78417)

Rating Methodology:

Moody's State Rating Methodology, November 2004 (#89335)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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New rule may settle fate of state surplus

Retiree benefit accounting change could force Md. to set aside millions

BY ANDREW A. GREEN

SUN REPORTER

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Just when Maryland's budget picture is finally improving, state lawmakers are faced with a little-known accounting rule change that could force them to set aside hundreds of millions of dollars a year for employee retirement benefits that are decades away.

This eat-your-spinach dictum from the nonprofit Government Accounting Standards Board requires state governments to acknowledge the long-term costs of health benefits for current workers after they retire, as well as those for today's retirees. Such expenses have crippled ill-prepared private-sector employers such as Bethlehem Steel and General Motors.

Bond rating agencies are responding to the change, which takes effect in 2007, by pressuring states to set aside money for those costs, rather than paying for them on a year-by-year cash basis, as most now do - Maryland included.

The result is that in order to maintain its exemplary bond rating, which saves taxpayers money in interest costs, Maryland could be compelled to squirrel away millions - no one knows how much - in a way that might or might not save money in the long run.

"We just have to start paying more for what we already have," said Warren Deschenaux, the General Assembly's chief fiscal analyst.

The accounting change adds a new wrinkle to an evolving debate over what to do with tax revenues that are coming in faster than expected in the state's $24 billion budget. Gov. Robert L. Ehrlich Jr. has talked about an election-year property tax break, and other leaders, such as Comptroller William Donald Schaefer, want pay increases for workers.

But pressure from Wall Street could force the state to use the excess funds for what amounts to a ledger-book entry - which pays far fewer political dividends.

Red ink on the books

The new standard - adopted last year after more than a decade of study - will bring government accounting in line with the private sector by treating retirement health benefits as part of the compensation workers earn while they are actively employed. Rather than putting the money for those benefits in a worker's paycheck, the state effectively gives those employees an IOU, to be paid in the form of health insurance subsidies when they retire.

The accounting rule change means governments will have to tally up the value of those IOUs and list them as red ink on their books. The change was needed, said Karl Johnson, a project manager for the Government Accounting Standards Board, because the pay-as-you-go systems most states use may be less feasible as baby boomers begin to retire.

Both Moody's Investors Service and Standard & Poor's, two prominent bond rating agencies, have said they will treat those obligations like debt and, if states don't take steps to address the issue, could lower their credit ratings.

"What rating agencies have said is they don't expect us immediately to address this issue ... but, ultimately, we will need to save money to pay for that health care," said state Budget Secretary Cecilia Januszkiewicz.

The impending change has sounded alarms among advocates for retirees and public workers. When private companies were required to make similar disclosures in 1990, many of them cut benefits to eliminate a drag on their balance sheets.

Steven Kreisberg, the collective bargaining director for the American Federation of State, County and Municipal Employees, which represents state workers in Maryland, said the union is worried that politicians, like CEOs 15 years ago, will see the large price tag associated with these benefits and cut them.

"It will be distorted by some folks who are just hostile to public employees and public employment benefits," Kreisberg said.

He added that the union considers Ehrlich among that group, in large part because of the governor's attempt last year to charge current employees more for health care against the General Assembly's wishes.

But Januszkiewicz said the state is in a very different position than private companies that cut or curtailed benefits after being forced to list their costs. Governments are more stable than private companies and have less flexibility in altering their promises, she said.

"The government is not going out of business," Januszkiewicz said. "And the health care that is available is set within statute."

According to an AARP report on the issue, 41 states offer some kind of retiree health insurance, and 30 of them, including Maryland, fund the benefits on a pay-as-you-go basis.

According to the report, Maryland's benefits are in some respects among the most generous, with retirees paying just a fraction of the premiums charged to former employees in other states. But unlike many states, Maryland does not offer retirees a prescription drug benefit.

Maryland also has more to lose than other states if Wall Street fiscal analysts don't think the state is doing enough to prepare for these costs. The state is one of a few with AAA bond ratings from all the major agencies, a recognition of its strong fiscal health. That means Maryland gets better interest rates when it issues debt, saving taxpayers millions when the state builds roads, schools and other projects.

Parry Young, a director in Standard & Poor's public finance department, said analysts will be closely watching the new disclosures and states' reactions to them.

States could avoid having that debt drag down their credit ratings by paying each year for current retiree benefits as well as for the future benefits of those working now. But Young said that in order to do that, states might find themselves paying two or three times what they now contribute for retiree health.

"It's going to be a big hit" if they decide to pay in advance, he said.
Deschenaux said Maryland spends about $300 million a year on retiree health. If Young's estimate is right, that would mean that paying upfront for the retirement benefits of current workers could nearly wipe out the state's progress in the past few years in balancing projected revenues and spending.

Long-term savings

The bond rating agencies and others have argued that setting aside money will lead to long-term savings because those funds would earn interest before they are used. But Januszkiewicz said that health care costs are rising so fast that the earnings might not make much of a dent in the final costs.

The state is conducting a study to figure out how large its long-term retiree health benefit liability is, a figure officials say is likely to be in the billions. A committee of lawmakers will meet Nov. 3 to begin discussions with the administration on how to handle the change, which goes into effect for the budget year that begins July 1, 2007.

Deschenaux said the effects of the accounting change might not be as great as some fear. Maryland doesn't need to do everything bond rating agencies want - it just needs to do as much as the other AAA states, he said.

"I don't think we'll be able to afford being the most virtuous of the virtuous," Deschenaux said. "If we can keep up with Delaware ... we'll be OK."

Executive Summary

The ***State of Maryland ("the State")*** provides medical, prescription drug, behavioral health, dental and vision benefits to retirees and their covered dependents. The State pays a portion of the cost for retirees, disabled retirees, spouses and dependents. All active employees who retire or are disabled directly from the State and meet the eligibility criteria will participate.

The State also offers life insurance and long term care to retirees. Since these benefits are completely paid by the retirees, there is no GASB 45 liability for the State.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 was enacted on December 8, 2003. As a result of this legislation, employers providing drug coverage to Medicare eligible members, that is at least actuarially equivalent to the standard benefit provided by Medicare, will receive a federal subsidy, starting January 1, 2006.

Aon has determined that the State's drug coverage for retirees is better than actuarially equivalent to Medicare's standard coverage in 2006. A reduction in liability for the subsidy is reflected in the results.

This summary identifies the value of benefits at July 1, 2005 and costs for the 2006 Fiscal Year:

	July 1, 2005		
	Initial Results ($ billions)	**Medicare Prescription Savings ($ billions)**	**Final ($ billions)**
Present Value of all Projected Benefits	27.406	2.980	24.426
Present Value of Benefits Earned to Date (Actuarial Accrued Liability)	22.903	2.528	20.375
2006 FY Annual Required Contribution (ARC) * +			1.959
2006 FY Annual OPEB Cost +			1.959
2006 FY Expected Benefit Premiums +			0.311

*** The Annual Required Contribution reflects a 30-year, level amortization of the Unfunded Actuarial Accrued Liability.**

+ Reflects reduction in cost due to Medicare Part D subsidy, starting January 1, 2006.

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Executive Summary (continued)

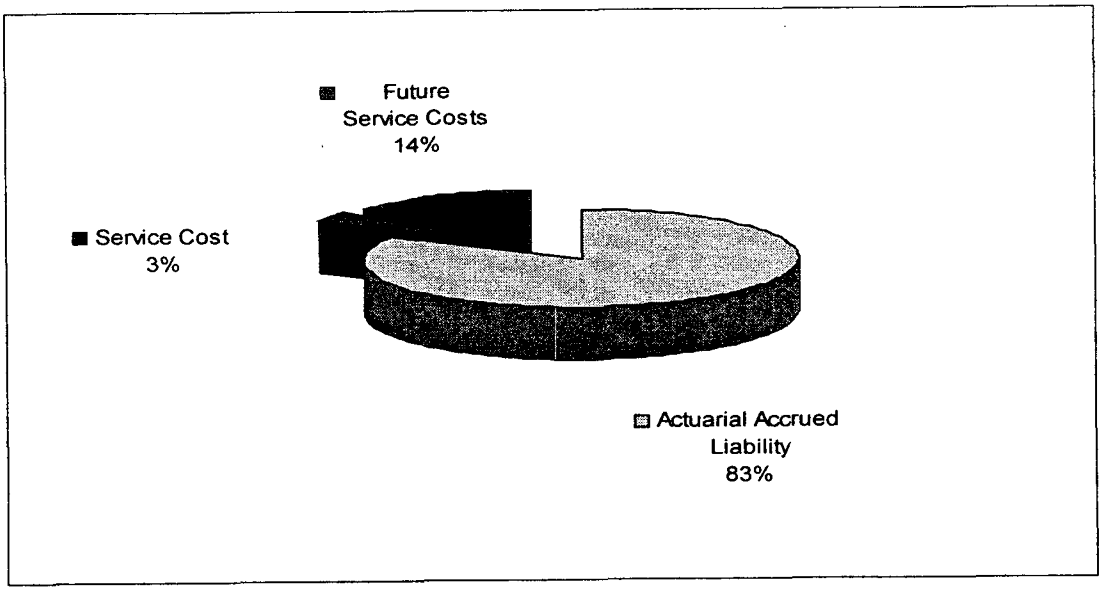
This section presents detailed valuation results for the State's Plan.

- The ***Present Value of all Projected Benefits*** is the total present value of all expected future benefits, based on certain actuarial assumptions. The Present Value of all projected benefits is a measure of total liability or obligation. Essentially, the Present Value of all projected benefits is the value (on the valuation date) of the benefits promised to current and future retirees. The Plan's present value of all projected benefits (at July 1, 2005) is $24.426 billion. The majority of this liability is for current active employees (future retirees).

- The ***Actuarial Accrued Liability*** is the liability or obligation for benefits earned through the valuation date, based on certain actuarial methods and assumptions. The Plan's Actuarial Accrued Liability (at July 1, 2005) is $20.375 billion. The majority of this obligation is for active employees. The Actuarial Accrued Liability represents approximately 83% of the present value of all projected benefits.

- ***Service Cost*** is the value of benefits expected to be earned during the year, again based on certain actuarial methods and assumptions. The 2006 Fiscal Year Service Cost is $633.7 million.

The following graph illustrates the Present Value of all Projected Benefits, the yellow area representing the Actuarial Accrued Liability in total:



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Executive Summary (continued)

The results were calculated based upon plan provisions, as provided by the State, along with certain demographic and economic assumptions as recommended by Aon with guidance from the GASB statement.

Demographic Assumptions

Data was provided by the State as of July 1, 2005. Demographic assumptions used to project the data are the same as those used to value the pension liabilities under GASB 27. There is no assumption for future new hires.

Economic Assumptions

The GASB statement requires that the discount rate used to determine the retiree healthcare liabilities should be the estimated long-term yield on the "investments that are expected to be used to finance the payments of benefits". Since the State does not pre-fund the retiree healthcare liabilities, the discount rate should be based on the portfolio of the State's "general assets" used to pay healthcare benefits:

Asset Class	Target Allocation %
Repurchase Agreements (Repos)	75
1 - 3 Year Treasuries or Agencies	25

This portfolio could suggest a 3.0% to 4.0% discount rate (actual return for the period July 1, 2004 through June 30, 2005 was 2.26%). However, Aon recommends using a rate closer to the required rate under the Financial Accounting Standards Board No. 106 (FAS 106) to value postretirement healthcare benefits for private employers. FAS 106 discount rates as of July 1, 2005 were 5.0% to 5.25%. Aon recommends the lower end of this range, 5.0%, to be conservative.

The trend assumption is used to project the growth of the expected claims over the lifetime of the healthcare recipients. The GASB statement does not require a particular source for information to determine healthcare trends, but it does recommend selecting a source that is "publicly available, objective and unbiased".

Executive Summary (continued)

Aon developed the trend assumption utilizing the short term rates expected on the State plan along with information in published papers from other industry experts (actuaries, health economists, etc.) suggesting a 5.0% long term trend rate for all healthcare benefits except dental.

The balance of this report provides greater detail for the above results.

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County Executive's Recommended FY07-12 Public Services Program

Tax Supported Fiscal Plan Summary

($ in Millions)

		App FY05	Actual FY05	App FY06	Estimate FY06	% Chg. FY06-07	% Chg. FY06-07	Rec FY07	% Chg. FY07-08	Projected FY08	% Chg. FY08-09	Projected FY09	% Chg. FY09-10	Projected FY10	% Chg. FY10-11	Projected FY11	% Chg. FY11-12	Projected FY12
		5-20-04		5-20-04		Rec/Bud	Rec/Est											
1	**Total Resources**																	
2	Revenues	2,870.7	2,937.7	3,040.9	3,132.5	12.2%	8.9%	3,411.9	7.9%	3,682.9	6.6%	3,926.6	6.2%	4,168.6	6.1%	4,423.3	5.6%	4,668.9
3	Beginning Reserves Undesignated	120.7	134.5	144.6	213.4	47.4%	-0.2%	213.0	-48.5%	109.7	8.7%	119.3	12.3%	133.9	10.6%	148.1	10.9%	164.3
4	Beginning Reserves Designated	0.0	1.0	1.9	1.9	28.6%	-81.0%	2.4	36.0%	3.3	18.5%	3.9	16.5%	4.6	7.4%	4.9	0.0%	4.9
5	Net Transfers In (Out)	(11.9)	(12.0)	25.0	24.4	2.6%	4.9%	25.6	-2.6%	26.3	2.7%	27.0	2.7%	27.7	2.7%	28.5	2.7%	29.2
6	**Total Resources Available**	2,979.6	3,061.2	3,212.3	3,372.2	13.7%	8.3%	3,653.0	4.6%	3,822.2	6.7%	4,076.8	6.3%	4,334.8	6.2%	4,604.8	5.7%	4,867.4
7	**Less Other Uses of Resources (Capital, Debt Service, Reserve)**	329.3	390.9	335.7	488.1	17.1%	-19.5%	393.0	8.1%	424.8	4.2%	442.8	5.6%	467.3	4.6%	488.6	3.2%	504.4
8	**Available to Allocate to Agencies**	2,650.2	2,670.2	2,876.6	2,884.0	13.3%	13.0%	3,260.0	4.2%	3,397.3	7.0%	3,634.0	6.4%	3,867.5	6.4%	4,116.1	6.0%	4,363.0
9	**Agency Uses**																	
10	Montgomery County Public Schools (MCPS)	1,491.7	1,483.2	1,592.2	1,592.2	7.3%	7.3%	1,708.5	-3.6%	1,647.4	4.7%	1,724.7	-3.8%	1,658.5	4.0%	1,724.7	-3.8%	1,658.5
11	Montgomery College (MC)	151.5	149.1	164.4	164.4	5.5%	5.5%	173.5	-0.3%	172.9	1.9%	176.3	-0.3%	175.7	1.9%	179.0	-0.2%	178.6
12	MNCPPC (w/o Debt Service)	77.5	77.5	84.3	84.3	5.0%	5.0%	88.5	-0.2%	88.3	0.0%	88.3	0.0%	88.3	0.0%	88.3	0.0%	88.3
13	MCG	929.6	960.4	1,035.7	1,043.2	8.9%	8.2%	1,128.2	0.5%	1,134.0	0.0%	1,134.2	-0.2%	1,132.2	0.1%	1,133.6	-0.1%	1,132.9
14	**Subtotal Agency Uses**	2,650.2	2,670.2	2,876.6	2,884.0	7.7%	7.4%	3,098.6	-1.8%	3,042.7	2.7%	3,123.5	-2.2%	3,054.8	2.3%	3,125.6	-2.2%	3,058.4
15	**Subtotal Other Uses of Resources (Capital, Debt Service, Reserve)**	329.3	390.9	335.7	488.1	17.1%	-19.5%	393.0	8.1%	424.8	4.2%	442.8	5.6%	467.3	4.6%	488.6	3.2%	504.4
16	**Total Uses**	2,979.6	3,061.2	3,212.3	3,372.2	8.7%	3.5%	3,491.7	-0.7%	3,467.5	2.8%	3,566.3	-1.2%	3,522.1	2.6%	3,614.2	-1.4%	3,562.8
	Tier 1																	
17	**(Gaps)/Available at Major Known Commitments**							161.3		354.7		510.5		812.7		990.5		1,304.6
	Tier 2																	
18	**Other Expenditure Pressures**							(34.0)		(277.3)		(136.5)		(285.2)		(144.4)		(281.6)
19	**Government Accounting Standards Board Statement Number 43/45**							0.0		(156.3)		(160.6)		(164.9)		(169.2)		(169.2)
20	**(Gaps)/Available with Other Expenditure Pressures and GASB 43/45**							127.3		(79.0)		213.4		362.6		676.9		853.8
	Tier 3																	
21	**Property Tax @ FIT**							(128.8)		(266.6)		(383.3)		(501.9)		(628.1)		(746.2)
22	**(Gaps)/Available**							(1.5)		(345.6)		(170.0)		(139.3)		48.8		107.6
	Tier 4 - Closing the Gap																	
23	**Total Agency Uses at Historic Rates of Growth**							0.0		3,744.8		3,702.8		3,807.3		3,758.6		3,844.4
24	**(Gaps)/Available**							(1.5)		(345.6)		(170.0)		(139.3)		48.8		107.6

22A

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.

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Office of the Director
101 Monroe Street, 15th Floor • Rockville, Maryland 20850 • 240/777-8860, FAX 240/777-8857

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).

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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

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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.