City of Lawrence
Finance Department

MEMORANDUM

DATE: April 25, 2014
TO: Dave Corliss, City Manager
FROM: Ed Mullins, Finance Director

RE: Other Post Employment Benefits

Background

In 2004, the Governmental Accounting Standards Board (GASB) released Statement 45 (GASB 45) which issued a new set of accounting rules concerning health and other non-pension benefits for retired public employees. These benefits, also referred to as "other post-employment benefits" (OPEB), include non-pension benefits such as life insurance, dental coverage and long-term care, as well as retiree health benefits. GASB 45 strongly encourages public sector employers to set aside funds for OPEB benefits, instead of a "pay-as-you-go" funding method. Employers are strongly encouraged to fully fund OPEB benefits in order to show a more favorable financial statement.

The intent of GASB 45 was to bring governmental accounting standards more in line with private company standards. Though GASB has no power to change how governments fund retiree benefits, it does establish the rules that accountants must follow in preparing governmental financial statements. Audited financial statements prepared according to GASB are scrutinized by investors in state and local bonds and rating agencies to judge the likelihood those bonds will be paid off.

OPEB Valuation Methodology

GASB 45 requires that an actuarial valuation be conducted every two years to determine the annual OPEB liability. Since the adoption of GASB 45, the City of Lawrence has had three valuations. The latest was performed by L & E Actuaries. As part of their engagement, the City had L & E review the past assumptions and recommend any changes that were more appropriate. Based upon their, review several assumptions were modified. Their report provides the basis for the OPEB liability to be recorded on our financial statements for the periods ending December 31, 2013 and 2014.

The basis for measurement of annual OPEB cost is the actuarially determined annual required contribution (ARC). The ARC has two components: the normal cost (the present value of benefits accrued by active workers allocated to the current year), and the amortization of the unfunded liability for all prior years. Although GASB 45 does not require that OPEB obligations be funded, the ARC is the level of employer contribution that would be required on a sustained, ongoing basis to systematically fund the normal cost and to amortize, or pay off, the unfunded liability attributed to the prior service time of the employees. The prior service costs are amortized over a 30 year period of time of which 24 years remain.

Lawrence OPEB Costs

The OPEB liability as defined by GASB 45 includes explicit and implicit costs.

The explicit costs of the city's OPEB plan are that portion of the premiums charged by the insurance company or in the case of self funded plans, the premium equivalent, which are not covered by the payments made by the retirees. Currently, the City covers 20% of the individual and family premiums until the retiree is eligible for Medicare for each retiree receiving KPERS/KPF benefits and his/her covered dependants.

The additional implicit cost is determined based on the combined demographics of the active and retired populations. The rates actually charged to the retirees will be lower than the rates that would be charged if the retiree group was rated separately, due to the higher average age resulting in higher medical costs. To measure this implicit cost, GASB 45 requires that OPEB liabilities be determined based on age-adjusted premium or claim amounts.

A history of the City's OPEB liabilities as determined by our actuaries is shown in the table below. A significant portion of the increases from 2007 to 2009 was the result of increases in the plan's healthcare costs. Approximately 40% of the increase in Liability as a % of Pay in 2011 compared to 2009 was due to fewer employees and lower than projected salary increases. The reduction in 2013 valuation is primarily due to lower projected medical costs.

	2007	2009	2011	2013
Present Value of Benefits	$9,285,000	$26,930,000	$34,890,000	$17,196,867
Accrued Liability	5,521,200	16,186,403	21,303,407	9,414,166
Normal Cost	300,000	905,000	1,165,000	648,864
Accrued Liability as % of Pay	13.7%	37.1%	49.9%	21.6%
Annual Required Contribution	527,203	1,543,000	2,063,000	1,152,197

The 2013 projections were based upon the following changes in assumptions from the prior calculations:

The valuation interest rate was lowered from 4.0% to 3.5%. This is based on our analysis of long-term return experience of short-term fixed assets and considering recent emerging experience.

The assumed salary scale was changed from KP&F / KPERS assumptions to 6.5% - Police & Fire and 3.5%- All Other.

The assumed retiree coverage tier distribution is 65% Single, 25% Single + Spouse and 10% Family. This is based on retiree elections as of 1/1/2011, 1/1/2013 and 11/1/2013. The prior actuary may have assumed 50% Family coverage.

Based on an analysis of the retiree and active census, the assumed age difference between male retirees and their wives was lowered from 3 to 2 years.

Considering retiree enrollment experience from 2007 to 2013, the assumed future retiree enrollment was decreased from 65% to 60%.

The assumed Medical / Rx trend rates were changed from 8.5%, 9.0%, 8.0%, 7.0%, 6.0%, 5.0% (to Ultimate) to 7.00%, 6.75%, 6.50%, 6.25%, 6.00%, 5.75%, 5.50%, 5.25%, 5.00% (to Ultimate). We considered plan experience, industry surveys and historical industry experience in our evaluation of trends.

The assumed Dental cost trend was lowered from 5.0% to 3.5%.

The aggregate payroll growth assumption was lowered from 4.0% to 1.5% in order to reflect only inflationary effects as stipulated in the GASB 45 Implementation Guide.

Budgetary Impacts

In 2010, the City Commission assigned $250,000 from the retained earnings of the Health Care Fund for future retiree health care costs. Health care reports now include separate sections on the revenues and expenses for active employees and revenues and expenses related to retirees. The $250,000 designated for retiree health care was included in the section displaying retiree health care revenues and expenses.

The actuary study projects that the annual cost of retiree health care will increase from $909,000 in 2014 to $1.09 million in 2015 and $1.9 million in 2022. Retiree contributions will offset a portion of these costs and are estimated at $567,000 in 2014 and $663,000 in 2015. The estimated retiree contribution for 2022 is $1.2 million.

Ignoring the OPEB will result in future budget constraints as the pay as you go cost of retiree health care continues to increase. The city's bond rating may be negatively impacted as the liability continues to grow and the city has no plan to address it. A rating down grade will result in higher interest payments on the city's debt.

Future Actions

There are several possible methods for funding future health care expenses. They include a Voluntary Employee Benefit Trust (VEBA), a 401(h) Account, a Health Savings Account (HSA), and a Retiree Health Savings Account. For these contributions to count towards the city's OPEB liability they would have to be part of an irrevocable trust. Assets in the plan are dedicated to providing benefits to the retirees and family members. These plan assets must also be legally protected from creditors.

To fund a portion of the OPEB, you may want to consider designating a portion of future health care premiums toward retiree health care. This may be a combination of employee and employer contributions. The future OPEB cost is related to the length of time between retirement and when the retiree is eligible for Medicare. As a result, the OPEB premium should be related to the expected retirement age. Other options include designating part of accrued sick leave or longevity to retiree health care. If the Health Care Fund retained earnings are sufficient, you could assign an additional amount for retiree health care.

You may also want to modify the benefits. For example, you could require 10 years of service to be eligible for retiree healthcare benefits. Another alternative would be to develop a vesting schedule that would tie the subsidy to the length of service. Another option would be to limit the explicit subsidy to a set number of years after retirement. You could also limit the benefit to just the employee and dependents and exclude the spouse.