The Art of Reducing OPEB Liabilities

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Looking at the Numbers

- $157.7 Billion
  - Combined OPEB liability of State of California and local governments as estimated by *California Common Sense in 2014 Report*
  - $23 Billion liability attributed to cities ($18 Billion unfunded)
- $ 7.3 Billion
  - The amount that has been set aside to offset OPEB liabilities (source: *Surveying California's Unfunded Retiree Healthcare Obligations*, 2014)
- 82%
  - Percentage of public entities that offer retiree healthcare benefits out of 1,200 entities surveyed in 2008 by Public Employee Post-Employment Benefits Commission
- 73%
  - Percentage of surveyed public entities that set aside no assets to cover future retirement healthcare cost (source: *California Common Sense)*

Looking at the Numbers

City	Unfunded OPEB Liability FY11
Los Angeles	$4,206,483,000
San Francisco	$4,364,273,000
San Jose	$1,844,628,000
San Diego	$1,204,090,000
Oakland	$520,882,000
Sacramento	$376,417,000
Anaheim	$206,994,000

Source: *Reform before Revenue: How to Fix California's Retiree Health-Care Problem*, Stephen D. Eide, October 2012 (assumed 6% rate of return)

Increase in Retiree Health Care Costs

- Rising health care costs
- Retiree population is increasing
- Workers are retiring younger
- Workers are living longer
- Delay in prefunding

Application of Vested Rights Doctrine to Retiree Health Benefits

A Vested Right?

Unlike pensions that are generally considered vested (but consider Marin case), whether retiree health benefits are a vested right is fact intensive and will vary from employer to employer

Key Cases

- **Orange County** (2009-2014) **-** REAOC cases
  - County separated its retirees from the active employee healthcare pool - **Upheld**
- **Sonoma County** (2013)
  - County cut health subsidy to $500/month from "substantially all of the cost" – **Upheld**
- **San Diego POA v. SDCERS** (2009)
  - Modifications to employee *eligibility requirements* for retiree health benefits of *represented* employees did not amount to an impairment of a vested contractual right
- **Sappington** (2004)
  - Extension of more generous benefits than those promised did not create a vested right to continue receiving the more generous benefits

What We Have Learned

- Recent case law has demonstrated that local governments have more flexibility to adjust retiree health benefits than they have for pension benefits

- However, the California Supreme Court established that retiree health benefits can be vested benefits

- Thus, in evaluating what a public agency can do with respect to its retiree health benefit program, resolutions, ordinances, MOUs and employment policies become critical to this analysis

Strategies Used to Constrain Costs

- Cap employer's contribution for retiree health benefits
- Change eligibility requirements (e.g., raise minimum age and service requirements, limit benefits until Medicare eligibility)
- Eliminate higher cost plans
- Eliminate coverage for future retirees (consider PEMHCA)
- Shift from defined benefit to defined contribution
- If feasible, modify benefits of current employees and retirees

Future Employees

- Future employees have no vested rights before they are hired, unless those rights are set forth clearly in an MOU or other controlling documents

- However, PEMHCA requires that an employer providing health benefits to employees through the CalPERS health benefit program also provide health benefits to retirees

Current Employees - Represented

- Recent case law suggests that in certain cases retiree health benefits are a condition of employment subject to negotiation
- Most of these cases have focused on changes to retiree health benefits that have resulted from the collective bargaining process
- If there is a pattern of changes to retiree health benefits from one MOU to another and an absence of language amounting to a guarantee of a vested benefit, changes are likely permissible

Current Employees - Represented

- Vallejo Police Officers Association v. City of Vallejo (2017)
  - City imposed $300/month cap to replace employer-paid retiree health premium for any CalPERS medical plan
  - Union argued that an earlier MOU created a vested right to continue receiving fully paid benefits in perpetuity
  - City disagreed
    - California Supreme Court decision in REAOC III
    - U.S. Supreme Court 2015 decision (M&G Polymers USA, LLC v. Tacket) holding that contractual obligations cease upon termination of the MOU
  - Court of Appeal (1st District) ruled in favor of City

Current Employees – Unrepresented

- Apply the *California League* criteria
  - Are benefits included in the public employer’s declaration of policy pertaining to employment?
  - Is there evidence that benefits are important to employees?
  - Were benefits an inducement to accept or remain in a position?
  - Is benefit a form of compensation earned by remaining in employment?
- The Supreme Court in *REAOC III* clarified *California League* to mean that the presence of the four criteria reflected the intent of the public agency to provide a vested benefit

Retirees

- Modifications are presumptively suspect, except in circumstances, where the question of *what* has been promised is ambiguous
- Examples of changes deemed permissible
  - Increase in retiree contribution toward coverage through cap on the employer contribution
  - Requiring the retiree to pay for any increases in premium
  - Changes in carriers and/or types of coverage
  - Where benefits have been tied to employee benefits, reducing retiree benefits consistent with reductions in employee benefits

Public Employees' Medical and Hospital Care Act

("PEMCHA")

The PEMHCA Dilemma

- Employers providing health benefits through CalPERS cannot eliminate retiree health benefits even for future employees
- Contribution arrangements permitted under PEMHCA:
  - Equal contribution rule (GC Section 22892(b))
  - Unequal contribution rules (GC Section 22892(c))
  - Retiree health vesting schedule (GC Section 22893)

Working with PEMHCA

- Election of vesting schedule under GC Section 22893
  - Employer contribution rate set by State
  - Percentage of contribution determined on the basis of years of service with a CalPERS employer, minimum of 5 years with the agency contracting for the benefit
  - Requires retirement but 20 year service exception
- Move from defined benefit (i.e., cost of specified plan) to defined contribution (i.e., specified amount) obligation
- Explore use of PEMHCA rate groups

Working outside of PEMHCA

- Ability to reduce retiree health benefit contribution to no less than the minimum employer contribution (“MEC”)
  - Currently $128/month ($133 for 2018)
- Create tiers based on hire date, retirement date or employee group
- May impose service requirements but consider vesting restrictions under PEPRA Section 7522.40
- Use of cafeteria plan to provide higher contribution for employees and HRA for eligible retirees
- Retirees limited to MEC can have benefit supplemented with a defined contribution model

Working outside of PEMHCA

CalPERS has informally stated that these arrangements work if:

- The employer designates a portion of contribution to the plan as its contribution for health coverage for both active employees and retirees.
- The cafeteria plan must offer at least one other nontaxable benefit in addition to health coverage.
- The employee must have the discretion to determine how the employer's contribution, over and above the minimum amount designated in its resolution with CalPERS, will be spent. Caveat: Consider ACA implications.

Funding OPEB Obligations

Retrospective

- Historically most public agencies paid retiree health benefits using a “pay-as-you-go” method without reporting the obligations as liabilities
- GASB Statement Numbers 43, 45 and 57, while not requiring a change in how OPEBs are paid, forced public agencies to account for OPEB obligations as liabilities on their financial statements

Pre-Funding OPEB Liabilities

- What does it mean? Setting aside funds **irrevocably** for the express purpose of paying for OPEB costs
  - Dedicated fund within the public agency's treasury is insufficient
  - Reduces liabilities that must be recorded on financial statements
  - Higher investment returns lead to lower long-term costs

OPEB Trust Options

- Section 401(h) account
  - Account within a 401(a) qualified retirement plan
  - Contribution limitation – 25%
- Section 115 Trust
  - Independent trust
  - Exempt to the extent that income is derived from the exercise of an essential government function
  - Examples: PARS, CERBT, single agency trust
- Section 501(c)(9) VEBA Trust
  - Independent trust
  - Requires annual information returns
  - Examples: Nationwide PEHP, single agency trust

Funding Sources for OPEB Trusts

- Employer contributions
- Mandatory employee contributions
  - Percentage of salary
  - Flat amount
  - Conversion of accrued leave (cannot have cash option)
- OPEB bonds

Case Studies

Reducing OPEB Liabilities: Case Study 1

- City A wanted to reduce its OPEB liabilities
- Relevant facts:
  - Materials describing health benefits did not present post-employment health benefits as an inducement for employees to either accept or remain in their positions
  - Nothing guaranteed a specific benefit
  - City did not participate in PEMHCA

Reducing OPEB Liabilities: Case Study 1

- Adopted solution:
  - Current employees – decreased contribution towards retiree health benefits to the same amount that the City agrees to contribute towards health benefits during employment
    - Subject to meet and confer requirements for represented employees
  - Future employees – no retiree health benefits
    - Note if participate in PEMHCA, would have to pay minimum contribution
  - Current retirees – froze benefit levels
  - Adopted cafeteria plan for current employees and HRA for retirees
  - Achieved substantial savings

Reducing OPEB Liabilities: Case Study 2

- City B wants to reduce its OPEB liabilities
- Relevant facts
  - City participates in PEMHCA
  - City has represented and unrepresented employees
  - Current benefit structure: City pays percentage of health insurance premium directly to CalPERS, employee pays remaining percentage

Reducing OPEB Liabilities: Case Study 2

- City's proposed solution
  - Current employees:
    - Receive a City contribution for a percentage of CalPERS health premiums
    - PEMHCA minimum contribution will be paid directly to CalPERS
    - Balance of the City contribution will be paid through a Section 125 plan (salary reduction for employee's share of premiums)
    - Employees hired before a certain date have the option to irrevocably waive City contribution under 125 plan during retirement and instead receive a 401(a) contribution equal to up to 3% of the compensation deferred to a 457(b) plan

Reducing OPEB Liabilities: Case Study 2

- City's proposed solution
  - Future employees:
    - Receive City contribution to the 125 plan during employment but not upon retirement
    - Instead, they will receive a contribution to a 401(a) plan equal to up to 3% of the compensation deferred to a 457(b) plan
    - City contributes PEMHCA minimum to CalPERS

Reducing OPEB Liabilities: Case Study 2

- Potential Issues
  - 401(a) structure does not provide intended tax-free treatment for retirees
  - Retiree participation in 125 plan
- Proposed Alternative Solution
  - Adopt retiree-only HRA to fund reimbursements for retirees
    - Can prefund using 115 trust

Questions

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Answers

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