

Managing Public Sector Retiree Healthcare Costs in Contra Costa County



Prepared by the
Contra Costa Economic Partnership
July 2007

DISCLAIMER

The contents of this report are based on information provided by public entities or obtained from their websites. Reasonable efforts have been made to assure the accuracy of the data provided; nevertheless, some information may not be current or complete since all jurisdictions are not required to report their OPEB liabilities this fiscal year (FY 2007-08). To the best of our knowledge, information and data contained in the report was the best available at the time the report was generated. Actions taken since then may result in a variation between the report and current conditions. Craft Consulting Group has made reasonable efforts to provide accurate information, but we cannot and do not warrant the completeness or timeliness of the information contained herein. While we have attempted to contact each public entity so that they could review the information pertaining to them, not all jurisdictions have responded. This report also does not reflect official views or policies of the public entities referenced in the report.

Table of Contents

	<u>Page</u>
Executive Summary	
A. Introduction.....	3
B. GASB 45 Requirements	5
1. What Are the New Requirements?	6
2. Compliance with GASB 45	6
3. Compliance Deadlines	6
C. Challenges Faced by Public Sector Employers .7	
1. Contra Costa County	8
2. Local Municipalities.....	17
3. School Districts	20
4. Special Districts	22
D. Shared Responsibilities.....	24
1. Private Sector Trends.....	24
2. Consumer Driven Healthcare	27
E. Managing OPEB Liabilities.....	28
1. Compliance With GASB 45.....	28
2. Emerging Views of Rating Agencies.....	29
3. Actions Needed to Manage OPEB Liabilities	30
F. Consequences of Not Addressing OPEB Liabilities.....	35
Appendices	
Definitions.....	36
Information Sources	37

Funding Provided By



The **Contra Costa Economic Partnership** is an association of business, education, and public sector leaders dedicated to creating and retaining quality jobs in Contra Costa to maintain the County's quality of life.

Report Preparation, Research, and Analysis By



Craft Consulting Group is an economic research and business advisory firm focused on assisting private and public sector clients understand and develop strategies to succeed in the increasingly complex economic environment in which they do business.

Executive Summary

The cost of retiree health benefits is fast becoming one of the most important issues facing many state and local governments nationwide. The Government Finance Officers Association estimates that 74 percent of state governments and 54 percent of local governments provide retiree health benefits.

Retiree health benefits are a form of deferred compensation that is incurred during an employee's active service, but paid for after retirement. To properly account for these costs, they should be accrued and funding set aside to pay for these future benefits. Instead, most state and local governments fund retiree healthcare on a 'pay-as-you-go' basis by simply paying the annual premiums. As a result they have accrued substantial and rapidly growing unfunded liabilities, the outlines of which are just now emerging due to a new accounting standard called GASB 45.

GASB 45 mandates that state and local governments including counties, cities, school districts, and special districts report their retiree healthcare benefits on an accrual basis, like pension liabilities.

Unless elected officials take action to adequately fund retiree health benefits and contain costs the regional economy will be affected as services are reduced or eliminated, non-profit service providers are forced to take on greater financial burdens and fees and taxes are increased to pay for the growing unfunded liabilities. The consequences of not addressing rising healthcare costs also discourage economic growth which generates tax revenue to support public services.

Employer-provided health benefits for retirees in both the public and private sector have evolved over time since the 1950's and 1960's. Since retiree healthcare benefits were first adopted life expectancies have lengthened, retirement ages have fallen, eligibility requirements have been shortened, benefits have increased, and most importantly medical costs and health insurance premiums have escalated dramatically compared to overall inflation.

Because of these realities state and local government obligations for retiree health care has dramatically increased and is expected to escalate further as the baby boom generation begins to retire.

Retiree health benefits need to be examined in light of these changing realities. We as a society need to rethink the benefit structures and the funding approaches to assure that public sector employers will be able to honor existing commitments and that the benefit programs will work for both employees and taxpayers.

Public entities need to address this growing problem now. Retiree healthcare liabilities are growing much faster than general inflation and government revenues. Unless acted upon now, escalating costs will eventually constrain the ability of local governments to fund vital public services. Not addressing the growth of unfunded liabilities threatens the long-term financial stability and credit rating of a public entity.

Compared to other counties in California, Contra Costa County is faced with a huge challenge. A 2006 independent actuarial valuation of the County's existing commitments for retiree healthcare showed an unfunded liability of \$2.57 billion. This is one of the largest unfunded liabilities of any county in California.

The actuarial study indicated that the County should be setting aside \$216 million per year in FY 2006-07 to cover both the current cost as well as the amortized unfunded liability from prior years. Instead, the County is on a pay-as-you-go basis, paying only \$33 million per year in annual premiums. If the County continues on a Pay-Go basis, it faces a tripling of its annual retiree healthcare payments over the next ten years.

Recent action by the Board of Supervisors took the first step in addressing the county's OPEB liabilities. On June 26, 2007, the Board adopted staff recommendations which set an initial funding target, identified potential financial resources, and determined what additional program cuts and/or benefit changes would be required based on the funding level. The Board of Supervisors also directed the County Administrator to establish an employee education program and begin pre-negotiation meetings with County labor representatives regarding the development of possible plans and models for benefit reform.

When approving the final plan, a funding level, based on best practices, should be adopted that maintains the County's fiscal health and credit rating, without cutting services or increasing the level of deferred maintenance. Given the magnitude of the County's unfunded liability, a phased funding strategy would seem prudent. A funding target should be adopted that is consistent with rating agency criteria and the County's pension plan.

As part of its OPEB strategy, best practices suggest that the County should set up a trust which can generate investment income thereby reducing the level of financial resources required from the County General Fund. Funding a trust also allows the County to apply a higher discount rate, which from an actuarial perspective reduces its liability because the money will be earning a rate of return higher than the Pay-Go discount rate. Best practices also indicate that the County should adopt cost containment measures that cap its future liability.

Of the 19 cities in Contra Costa County, nine have insignificant or no OPEB liabilities, eight cities have varying degrees of unfunded liabilities, and two cities still need to complete actuarial studies to determine the amount of their OPEB liability. Of the nine cities that provide OPEB, 6 have manageable unfunded OPEB liabilities of less than 35 percent of their FY 2006-07 general fund budget revenues. Three cities - Concord, Martinez and Pittsburg - have unfunded retiree healthcare liabilities in the range of 52 to 95 percent of general fund revenues. All three cities have completed actuarial studies and started the GASB 45 process by developing plans and funding strategies. Concord and Martinez have already set aside funding that will begin to reduce their unfunded liabilities. In addition to setting aside money to fund or partially fund their annual required contribution, individual cities should also adopt cost containment measures to control their rapidly escalating healthcare costs.

Four school districts - West Contra Costa, Mt. Diablo, San Ramon Valley, and Antioch Unified - must report OPEB liabilities this year. These districts have either started or will have retained an actuarial firm and completed their valuation study by early fall.

Given the magnitude of West Contra Costa's unfunded liability and escalating annual premiums it will need to adopt a phased funding strategy similar to the County.

In order to reduce its unfunded liabilities, West Contra Costa should follow best practices by capping its expenditures for retiree healthcare benefits as it has proposed doing, change from a defined benefit to a defined contribution plan, or adopt a consumer driven health plan approach. In addition, the West Contra Costa Unified School District should adopt a two tier system of benefits for new hires and current employees and move retirees onto Medicare at age 65.

The Contra Costa Community College District has unrestricted assets of \$27.5 million in Board-designated funding to cover the District's liability for retiree health benefits. Given the size of their total liability, the District has put together a plan that adds an additional \$15.6 million to the retiree funding in 2007-08 on top of an annual contribution of \$1M in annual payments to the benefit fund. In addition, the District has taken steps to contain costs by negotiating a 6% employee co-payment of insurance premiums.

Of the 17 special districts examined in this report, over half do not have to report their retiree health liabilities until FY 2009-10. Larger districts such as Central Contra Costa Sanitary District, Contra Costa Water District, and the San Ramon Valley Fire Protection District have identified their current year retiree healthcare pay-as-you-go payments. While their annual pay-as-you-go payments appear to be manageable as a percentage of their operating revenues, the size of their unfunded liability is unknown. These districts will be reporting their OPEB liabilities in FY 2008-09 to comply with GASB 45 deadlines.

In summary, to effectively manage their retiree healthcare liabilities, public sector employers in Contra Costa County need to take action now. In order to comply with GASB 45, they should prepare actuarial studies to calculate the size of their liabilities and develop plans to adequately fund their liabilities. This information then needs to be reported in their comprehensive annual financial statements. The Plans should include both cost containment and funding strategies. The lack of a plan may result in qualified financial statements, lower credit ratings, higher borrowing costs, deferred maintenance, cutbacks in important public services, and/or staff reductions.

Introduction

“Not long ago, companies [and public sector employers] enthusiastically adopted and expanded retiree health programs with seemingly little concern for the long-term financial implications. The programs were relatively inexpensive, there were not an excessive number of retirees or older workers close to eligibility, no advance funding was required, and financial disclosures were few or nonexistent.”

Financial Executive
Critical Crossroads for Retiree Health Benefits
December 1, 2003

“New accounting standards are training a magnifying glass on retiree health costs, both present and future.”

California Healthcare Foundation - 2006

The cost of retiree health benefits is fast becoming one of the most important issues facing many state and local governments nationwide. Today, the Government Finance Officers Association estimates that 74 percent of state governments and 54 percent of local governments provide retiree health benefits.

Almost all state and local governments that provide retiree health benefits cover the costs on a ‘pay-as-you-go’ basis (“Pay-Go”), funding only the current year’s benefits. As a result, these state and local governments have accrued substantial and rapidly growing unfunded liabilities, the outlines of which are just now emerging due to a new accounting standard called GASB 45.

Historical Perspective

Employer-provided health benefits for retirees in both the public and private sector have evolved over time since the 1960’s. Back then relatively few retirees were receiving benefits and the low cost of providing these benefits made them an easy concession in collective bargaining negotiations. With the enactment of Medicare in 1965 more employers began adopting retiree health plans since Medicare would pay the majority of costs for retirees over 65. Employers adopted these benefits because they helped attract a skilled workforce and the costs were insignificant. Employer sponsored retiree healthcare programs continued to expand throughout the 1970’s and 1980’s because they were relatively affordable with few retirees.

Annual insurance premiums for retiree healthcare, which a decade ago were only a few tenths of one percent of payroll, are now estimated to be about 5 to 10 percent of payroll - and are increasing very rapidly. Even the rapidly escalating Pay-Go costs, which were estimated to total \$21 billion nationally in FY 2004-05, mask the dramatic growth of the total unfunded liabilities, which are estimated by Mercer Consulting to total in the range of \$800 billion to \$1.3 trillion nationally.

In California, public sector retiree health benefit programs have followed national trends. The State of California began paying for retiree health benefits in 1961 at an initial cost of \$5 per month per employee for a total of \$4.8 million annually, or about 0.3 percent of general fund costs. Since then State retiree healthcare costs grew to \$695 million in FY 2003-04 or 0.9% of the general fund budget.

Local government agencies throughout the state have experienced similar growth for retiree healthcare benefits over the past 40 years.

As retiree health benefit programs have expanded over the years, it has become increasingly clear that:

- (1) Many of the key assumptions on which the current benefits are based have changed significantly
- Life expectancies have lengthened;
 - Retirement ages have fallen;
 - Eligibility has occurred faster;
 - Benefits have increased;
 - Medical costs and health insurance premiums have increased dramatically compared to overall inflation; and

- (2) The prevalent method and level of funding is grossly inadequate.

As a result of these changes, retiree health benefits need to be examined and the costs contained through a thorough, detailed, collaborative process involving employee organizations.

Shared Responsibilities

We, as a society, need to rethink the funding strategies and benefit structures for retiree healthcare now in place across the country, to assure that public sector employers will be able to honor existing commitments and that the benefit programs will work for both employees and taxpayers. To be successful, all stakeholders must participate in finding mutually acceptable solutions that address current realities.

Changing Realities Rethinking the Social Contract

Major social, demographic, and economic changes have occurred over the past 30-40 years since the initial adoption of retiree healthcare benefits.

Socio-Economic Characteristics	Then	Now
Number of Retirees	Few	Many
Age of Workforce	Younger Baby boom generation still teenagers	Older Baby boomers set to retire over next 5 years
Life Expectancy	70	78
Eligibility Requirements	Retire at 65 worked 20+ years at the same company before retiring	Early Retirement at 55 Can retire after 10+ years with public sector employer
Healthcare Costs	Affordable	Expensive increasing faster than inflation
Healthcare Technology	Simple, inexpensive	Complex, expensive
Healthcare Consumption	Minimal primarily due to youth	Increasing healthcare consumption primarily due to aging population & lifestyle
Responsibility for Paying Medical Bills	Individual	3 rd Party

GASB 45 Requirements

Local government's obligation for post-retirement health care has dramatically increased in recent years and is expected to escalate further as the baby boom generation begins to retire. Historically, governmental entities have accounted for retiree healthcare benefits as they were paid. Due to changes in financial reporting requirements, cities, counties, special districts, and school districts, must now recognize and disclose the long-term costs and liabilities associated with their commitments to provide post-employment health care and other non-pension benefits to current and future retirees.

Under the new accounting rules, governmental entities must account for these future benefits on an accrual basis.

Many public sector employers offer pensions, healthcare and other benefits as part of a total compensation package used to attract and retain qualified employees. When provided separately from a pension plan, these other retirement benefits must now be disclosed using the same accounting and financial reporting requirements used for pension benefits (i.e., the cost of benefits must be recognized as an expense as benefits are earned). Currently, most government employers fund retiree healthcare on a pay-as-you-go basis by simply paying the annual premiums.

In 2004, the Government Accounting Standards Board (GASB), which issues accounting rules for governmental entities, released Statement 45 (GASB 45), "Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions" concerning healthcare and other non-pension benefits for retired public employees. These benefits are collectively known as Other Post Employment Benefits, or "OPEB". Retiree health programs are, by far, the most costly of these benefits.

Although GASB has no power to change how governments fund retiree health, pension and other benefits, it does govern the rules that auditors must follow in preparing governmental financial statements. Audited financial statements prepared according to GASB are scrutinized by both bond rating agencies and investors in state and local bonds.

"The core requirement of Statement 45 is that at least biennially, agencies such as counties would be required to have an actuarial analysis done with respect to projected benefits ("Plan Liabilities"); against this would be measured the actuarially determined value of the related assets (the "Plan Assets"). To the extent that Plan Liabilities exceeded Plan Assets, then similar to the actuarial and accounting practices for pension plan liabilities, the difference would be amortized over a period that could be up to thirty years. The method of financial reporting for OPEB costs would be similar to financial reporting for pension plan normal costs and UAAL."

CSAC Conference
OPEB Seminar for County Officials
January 25, 2006

What Are the New Requirements?

GASB 45 requires public employers to report expenses and specific information about OPEB on their financial statements and footnotes. Specifically, GASB 45 requires that public entities disclose their unfunded liability for health benefits (and other post-employment benefits) that have been earned by all active employees and retirees and the amount that needs to be set aside in order to fund future retiree health benefits earned in the current year. For financial reporting purposes, public entities need to report two key measures:

Annual Required Contribution (ARC) - This is the amount that will be recorded as an expense on the employer's annual financial statements.

Net OPEB Obligation - is the difference between the OPEB cost and actual annual employer contribution. The net OPEB obligation will determine the OPEB liability recorded on the financial statements. To offset the net OPEB obligation, the contribution must be funded in a qualified trust.

In addition, public employers are required to include the following information in the notes to their financial statements:

- **Plan Description** – including the name of the plan, trust administrator, brief description of the types of benefits, and the authority under which benefit provisions are established.
- **Funding Policy and Status** - required contribution rates of the plan members and employer including authority under which the obligations of the plan members and employer are established or may be amended.
- **Current Year Annual OPEB Cost** and the dollar amount of contributions made.
- **Information about the *funded status of the Plan***, including the Unfunded Actuarial Accrued Liability (UAAL) and the presentation of multi-year funding progress as a required supplementary schedule.

Compliance with GASB 45

In order to comply with GASB 45, public employers need to hire a qualified actuary to conduct an actuarial valuation to determine the employer's Annual Required Contribution, Unfunded Actuarial Accrued Liability ("UAAL"), actuarial value of assets, and other related information and disclose their OPEB liabilities in their annual financial statements.

Valuations must be performed every two years for OPEB plans with more than 200 members and at least every three years for plans with fewer than 200 members.

Compliance Deadlines

The commencement date for disclosing OPEB liabilities is based on the size of the employer.

- Large employers with revenues in excess of \$100 million must start reporting in the first fiscal year after December 15, 2006 (i.e. FY 2007-08).
- Medium sized employers with revenues between \$10 and \$100 million must start reporting in the first fiscal year beginning after December 15, 2007 (i.e. FY 2008-09).
- Public entities with revenues below \$10 million must start reporting in the first fiscal year beginning after December 15, 2008 (i.e. FY 2009-10).

Challenges Faced By Public Sector Employers

“Elected officials need to face the problem and begin to help fashion measures that restore fiscal balance to an out-of-balance health care system.”

Government Finance Officers Association
An Elected Officials Guide to
Health Care Cost Containment, 2005

The challenge faced by public sector employers in funding retiree healthcare is not simply an accounting issue recently created by the new reporting requirements. The problem has been developing for some time and is being driven by 1) the level and structure of the benefit package being provided, 2) rising healthcare costs, and 3) demographics.

Governmental decision-makers must balance the need to provide a competitive compensation package without reducing the current level of services or adversely affecting their credit rating.

When local governments first adopted retiree health care programs 30-to-40 years ago, the number of retirees or older workers close to retiring was much smaller, average life expectancy was shorter, and the cost of healthcare was relatively affordable.

Today, the growing ranks of retirees and rising healthcare costs have converged to create unprecedented challenges. Elected officials need to recognize these demographic and economic trends and adapt to the changing realities.

Elected officials need to address the growing OPEB problem sooner rather than later. First, retiree healthcare costs are growing much faster than general inflation and government general revenues. As a result, these costs constrain the ability of employers to fund other important or vital public services. Second, these costs hamper government's ability to provide salary increases and other compensation to employees. Third, a large growing unfunded liability is a threat to the government's long-term financial stability and credit rating.

As healthcare costs consume a growing portion of their budgets, cities and counties must find new ways to contain costs while funding commitments made for retiree healthcare.

A balance must be struck between the level of benefits offered and the reality of what taxpayers will provide to retired public employees. Finding the right balance is the challenge faced by public entities in Contra Costa County.

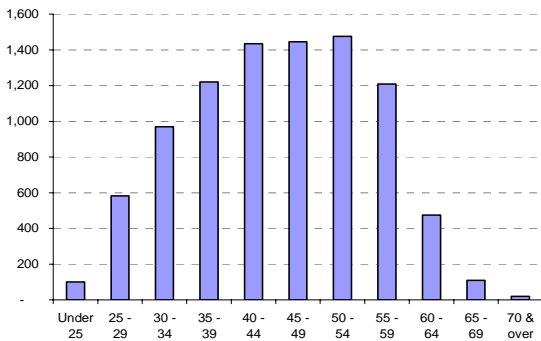
“After years of promising top-notch benefits, Contra Costa County needs to find a way to pay for \$2.6 billion in medical coverage guaranteed to its current and future retirees . . .”

Contra Costa Times
March 1, 2007

“The cost of the County’s retiree health care benefits is unsustainable”

Contra Costa Times
April 2007

Distribution of Active Members by Age as of December 31, 2005



Source: Contra Costa County Retirement System (Segal Report)

Contra Costa County

Like other counties throughout the country, Contra Costa County is experiencing similar social, demographic, and economic changes that have dramatically escalated the cost of retiree healthcare. Since the Board of Supervisors first conceived and approved retiree healthcare benefits, medical costs have skyrocketed, the number of retirees has grown substantially, and people are living longer. This post employment benefit was initially approved by the Board of Supervisors on August 22, 1961 with subsequent enhancements.

A 2006 independent actuarial valuation of the County’s existing commitments for retiree healthcare showed an unfunded liability of \$2.57 billion. The actuarial study also indicated that the County should be setting aside \$216 million per year to cover both the current cost as well as the amortized unfunded liability from prior years; instead, the County is operating on a pay-as-you-go basis paying only \$33.1 million per year in annual premiums. Given the scope of retiree benefits and the growing number of retirees, current costs will continue to represent an ever-increasing percentage of the County’s annual budget. If nothing is done the County faces a tripling of its current \$33 million annual pay-go retiree healthcare costs over the next ten years.

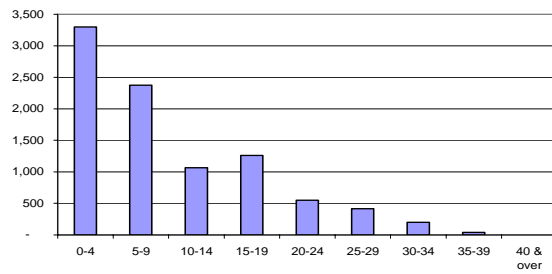
Beginning in FY 2007-08 the County is required to account for the cost of its OPEB liabilities. To address this issue the County must develop a comprehensive strategy in collaboration with employee organizations both for funding this growing liability and controlling future cost.

Changing Realities

Employer Sponsored Retiree Healthcare

Contra Costa County provides health insurance for County employees and their dependents after they retire. To be eligible, retiring employees must have been a member of a participating health plan at the date of retirement. Retired employees are allowed to continue participation in the County medical and dental plans for which the County paid \$33 million in annual premiums last year. The County contributes 75% to almost 100% of the cost of the annual premium, depending upon the health plan selected and the retiree’s age and family size. The cost of health insurance is paid for out of the General Fund, except for those

Distribution of Active Members by Years of Service as of December 31, 2005



Source: Contra Costa County Retirement System (Segal Report)

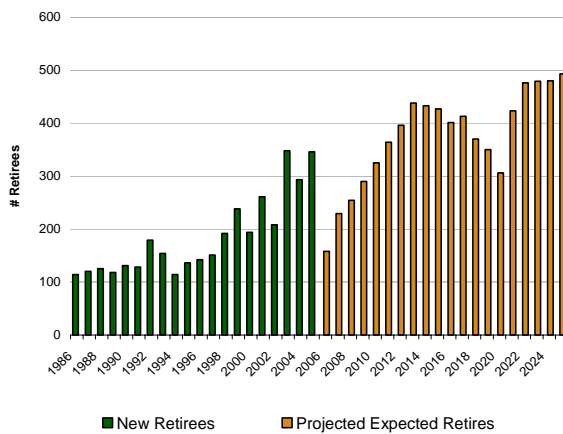
employees who work in departments where enterprise funds or grants are used to pay the costs. On average, the County contributes 80% towards the costs of retiree health insurance for most plan options. In many cases the retiree's contribution is nominal. Of the retirees, 60% are over age 65 and pay only one cent per month. Forty percent of the retirees are under age 65 and pay 20% of the cost. As more retirees reach age 65, the annual healthcare premiums will increase.

Eligibility for Retirement

To qualify for County retiree healthcare coverage the participant must be eligible for a County pension. Full benefits are available after 10 years of service and attainment of age 50. Thirty-eight percent of the County employees have ten plus years of service. Another 25% have 5-9 years of service.

Over the next five years more than half of the County's current workforce will be eligible for retirement based on the minimum years of service. As of December 31, 2006, new hires are required to have a minimum of 15 years of service with the County.

Annual Number of County Retirees - Historical & Projected

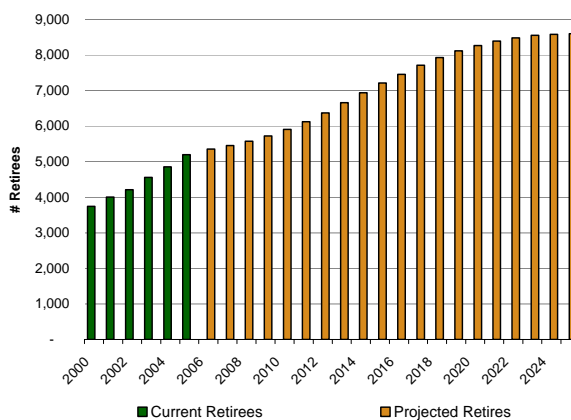


Source: Contra Costa County (Buck Consultants)

Aging Workforce

The average age of current County employees is 45.6 years with an average service of 10.1 years. More than fifty percent of the current workforce will reach retirement age over the next 5 to 10 years. Most county employees retire between the age of 57 and 62. In recent years, more employees are electing to retire before the age of 65.

Cummulative Growth in Number of County Retirees thru 2025



Source: Contra Costa County (Buck Consultants)

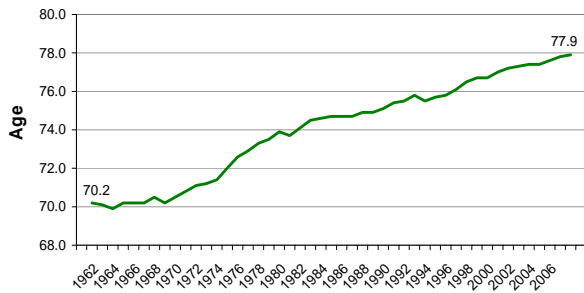
Growing Pool of Retirees

As of January 1, 2006, the County had 8,428 active employees, with 4,856 retired county employees and 360 surviving spouses receiving retirement benefits.

Over the next three years the number of retirees is projected to increase by 22.5% to 5,946 retirees. Between 2010 and 2015 the number of retirees will increase another 17.9% to 7,010. Not until 2025 is the number of retirees expected to level off.

Assuming the County continues to provide the same level of services without staff reductions, there will be more retirees than active employees by 2025.

**Life Expectancy Has Increased 7.7 Years Since 1961
When Retiree Healthcare Benefits Were First Approved by the County**



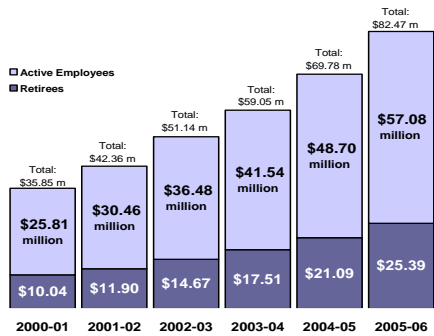
Source: National Vital Statistics Reports, U.S. Census Bureau, National Center for Health Statistics

Increased Life Expectancy

In addition to a growing number of retirees, people are expected to live longer. Since 1961 when the Board of Supervisors first approved retiree healthcare benefits life expectancy has increased by 7.7 years. Retirees who reach 65 can expect on average to live another 18.7 years. Mortality rates used in the valuation assumptions are based on 1993 CalPERS Service Retirement for males and females which have a shorter life expectancy than today. Depending on their age at retirement, retirees could receive retirement benefits for longer than the minimum of 10 to 15 years of service that is required for eligibility.

Rising Cost of Health Insurance Premiums Up 130% in Past Six Years

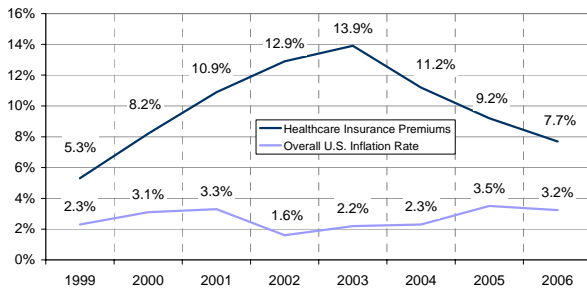
**County's Healthcare Insurance Premiums Rise
130% in Six Years**



Source: Contra Costa County Auditor's Office, Contra Costa Times Chart

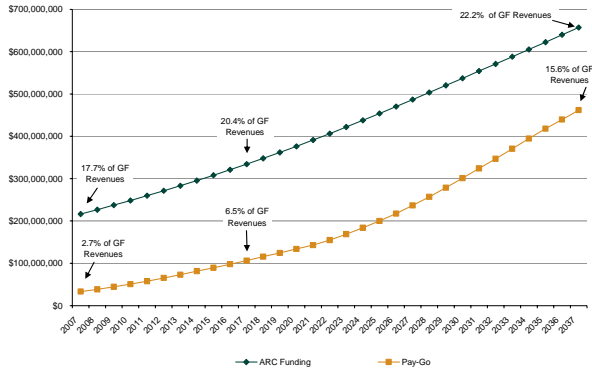
The cost of healthcare continues to increase at alarming rates that significantly exceed the rate of inflation. According to the Kaiser Family Foundation and the Health Research and Educational Trust 2006 annual national survey of private and public employers, on average employer-sponsored health insurance continues to outpace the rate of inflation even though there has been a moderation of health insurance costs in recent years. The County's healthcare insurance premiums have risen by 130% since 2000, which was faster than the national average. If healthcare costs continue at the same rate of growth experienced in recent years, the County's healthcare cost will more than double within the next five years.

**Increase in Healthcare Insurance Premiums
Compared to Inflation, 1999-2006**



Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits:1999-2005, California Healthcare Foundation, California Employer Health Benefits Survey: 2005-2006, Bureau of Labor Statistics

Given the Scope of Benefits and Retirement Rates Annual OPEB Costs Under Pay-Go Will Nearly Triple in Ten Years



Source: Contra Costa County (Buck Consultants)

Escalating Liability under Pay-Go Option

Under the Pay-Go option, the County's annual retiree healthcare payments will nearly triple to \$100 million over the next ten years due to rising healthcare costs and the growing number of retirees. General Fund revenues which are growing at a slower pace will have to absorb the cost of retiree healthcare. This represents 6.5% of projected General Fund revenues in 2010, up from 2.7% in 2001.

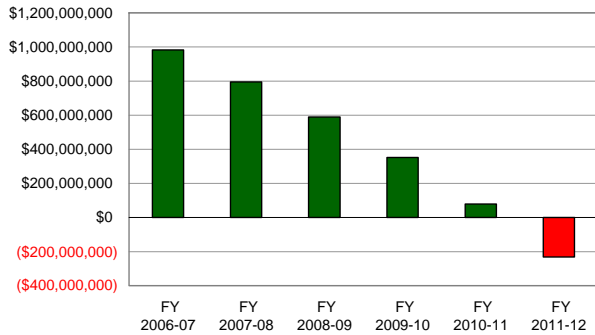
Steps must be taken to control escalating retiree healthcare costs. If the County continues on a Pay-Go basis, its unfunded OPEB liability will continue to grow and the cost of "catching up" will skyrocket. Failure to budget the ARC causes a massive fiscal hole. The growing unfunded liability will wipe out the County's net assets and by fiscal year 2012, the County will be technically bankrupt.

County's OPEB Funding Challenge

How to honor existing commitments without reducing service levels while controlling costs and providing a compensation package that will attract and retain qualified employees is the challenge facing the County.

There are two types of actions that the County must take to keep the size and growth rate of retiree healthcare costs and the unfunded liability within reasonable bounds. These actions include adopting cost containment measures and a funding strategy. Unless these actions are taken, the County's OPEB obligation will continue to grow and represent an ever increasing percentage of its annual budget.

Net Assets Will be Reduced if the County Does Not Adequately Fund its OPEB Obligation

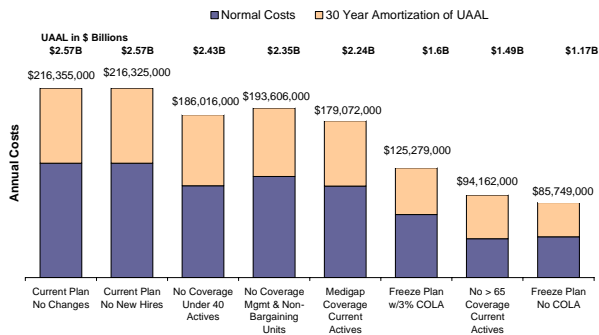


Source: Contra Costa County

Cost Containment Options

A number of options exist for the County to scale back on the level of benefits being offered without adversely impacting retirees. These options include adoption of a two tier system for new hires, increasing the age of retirement and years of service, freezing the current level of benefits, capping the County's future contribution, moving retirees over age 65 onto Medicare, increasing co-payments and deductibles, changing to a defined contribution plan, or adopting a three tier cost-sharing structure used in consumer driven health plans with the County, employees, and insurer sharing the risks. The County is looking at various benefit plan models that have various degrees of cost containment and/or service cutbacks.

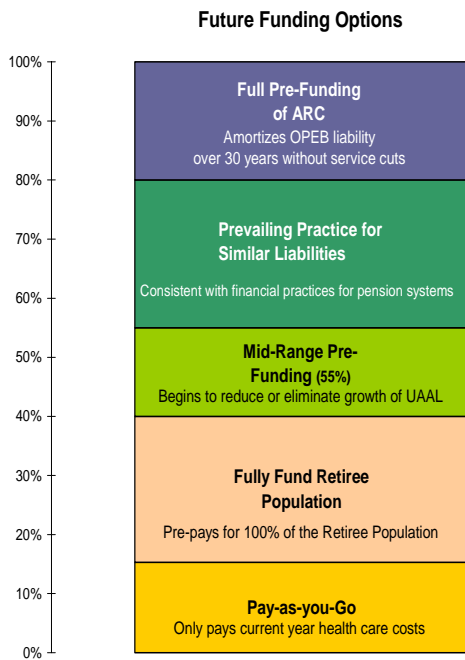
Cost Containment Options Will Help Reduce County's OPEB Liability



Source: Contra Costa County, March 1, 2007

“Health care as an employee benefit is one of the fastest rising—and seemingly most uncontrollable—costs for employers.”

Attempting to Control Health Care Costs – Again
 Graziadio Business Report, 2004, Volume 7, Issue 3
 Graziadio School of Business and Management
 Pepperdine University



Source: Adapted for Contra Costa County based on “Benefits in the Balance: the Uncertain Future of Public Retiree Health Coverage, California HealthCare Foundation. 2006

Funding Strategies

To date the County has not set aside any pre-funding. The lack of any pre-funding has allowed the unfunded liability to escalate beyond levels that are easily manageable. Fully funding the annual required contribution would involve significant budget trade-offs. The Pay-Go approach to funding retiree health benefits is also problematic given that the annual Pay-Go expense is growing faster than general fund revenue, contributes to a rapidly growing unfunded liability, and shifts current costs to future taxpayers. Funding options include:

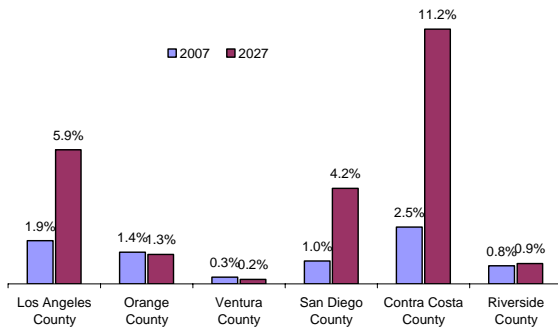
- **Pre-funding** - The ideal would be to fully fund the annual required contribution in order to amortize the unfunded liability. As noted earlier, the amount to cover both the future costs of today’s employees, plus paying off the County’s unfunded liability over 30 years is approximately \$216 million annually in FY 2006-07 and growing. Moving to this level of funding immediately may be unrealistic.
- **Partial Pre-funding** - Partially pre-funding the annual required contribution and moving to full funding over a 5 to 10 year period is more realistic. The level of pre-funding needs to be balanced against maintaining existing levels of public services and the County’s credit rating.
- **Utilizing a Trust to Generate Investment Income** - If a trust is setup investment earnings from funds set aside today would help reduce future budget pressures. Establishing a dedicated trust consistent with GASB 45 requirements will allow the County to use higher interest rate assumptions to reduce the UAAL and ARC. Properly managed a trust can generate investment surpluses to help fund OPEB obligations.

The County must choose whether and to what extent it will pre-fund retiree healthcare. Recent actions by the Board of Supervisors have looked at three different scenarios and approved a funding target that would fully fund the amount of the liability for the retiree population, which currently equates to approximately 40% of the total liability. A higher funding target would be more consistent with funding levels for California pension systems. The actual funding level must also be weighed against financial standards established by the credit rating agencies.

“Statewide estimated cost of retiree health care benefits for counties was over \$491 million in FY 2004-05. If current trends continue, this estimated cost for retiree health care benefits will exceed \$1 billion by FY 2008-09 and \$2.1 billion by FY 2012-13.”

The Center for Government Analysis
An Analysis of Public Sector Health Care Costs
in California, September 2006

Contra Costa County's Annual Cost for Retiree Health Care Among Highest in the State



Source: Center for Government Analysis

Comparison with Other Counties

In September 2005, the California State Association of Counties conducted a survey of the State's 58 counties regarding retiree healthcare benefits. Of the 49 counties responding, 48 reported that they provided some type of healthcare benefits to retired employees.

Of the counties that provide retiree healthcare, 76% use a Pay-Go approach, 4% fully fund their annual required contribution, and 20% partially fund their annual OPEB obligations.

Forty-three percent of the counties pay for the benefits using a combination of funding from the county and the retiree; in 14% of the counties, retirees pay the full cost; in another 14%, the county pays the full cost; in 9% of the counties, the retirement system pays; and the remaining 20% use some other combination.

About half the counties fund retiree healthcare benefits directly from county operating budgets, and another 25% utilize funds from retirement systems or trusts.

Forty-three counties offer healthcare benefits to retirees after the age of 65, and 44 counties extend coverage to retirees' dependents. Of the counties offering retiree healthcare, 15% have tiered benefits. Sixty-eight percent of the counties have capped their contributions in one of the following ways:

- Minimum per employee
- Annual increases capped
- Percentage of payroll

Ventura County has never provided retiree benefits for its general workforce. In 1999 county supervisors approved a health retirement plan for managers, covering premiums for up to five years depending on the length of service. Most retirees get nothing other than the option to buy into the county's health plan with their own money. Orange County set up a trust which provides retirees with a fixed monthly grant to help pay for medical expenses or insurance. Riverside County phased out healthcare for early retirees, which reduced the county's long-term liability by about 70%.

Four Bay Area counties have estimated OPEB liabilities in the range of 30% to 90% of General Fund revenue, two counties have unfunded liabilities greater than 200%, and one county has a liability of less than 10%.

Comparison with Other Counties

County	General Fund Revenue	OPEB UAAL	OPEB UAAL as a % of GF	Funding Status	Cost Containment Strategy
Bay Area					
Contra Costa	\$ 1,194.1 M	\$2,573 M	215%		
Alameda	\$ 1,770.6 M	\$ 613 M	34%	\$70 M rate subsidy \$450 M Retirement System \$94 M Net UAAL	Fixed monthly medical allowance Medical care benefits are not a vested right
Santa Clara	\$ 1,931.3 M	\$ 1,200 M	62%	\$320 M Trust Fund began prepaying retiree costs in 1984	Increased number of years an employee must work for county from 5 to 10 years
San Mateo	\$ 799.4 M	\$ 70 M	9%	\$29 M already set aside \$50-\$70 M FY07 Budget	
Sonoma	\$ 464.1 M	\$ 398 M	86%		Increased co-pay and deductible, alternative plan with lower benefits and costs, capped funding
Solano	\$ 187.2 M	Valuation in Process	N/A		Does not provide OPEB
San Francisco	\$ 2,473.8 M	\$ 4,900 M	200%	MOU with Unions to develop funding recommendations	
Marin	\$ 369.1 M	Valuation in Process	N/A		
Napa	\$ 48.7 M				
Other California					
Los Angeles	\$ 12,331.2 M	Valuation in Process	N/A	Planning to create Trust	
San Diego	\$ 2,548.0 M	\$ 640 M	25%		
Orange	\$ 2,290.7 M	\$ 598 M	26%		Split benefit pool Capped growth at 3% Medicare integration
Riverside	\$ 1,993.9 M	\$ 275 M	13%	Establishing Trust Initial funding \$10 M	
Sacramento	\$ 1,900.2 M	\$300 - \$500 M	16% - 26%		

Source: Legislative Analyst Office, Contra Costa County, Contra Costa Times

“The statutory framework that authorizes counties to provide retirement health care benefits does not create a vested benefit. Actually, to the contrary, under the 1937 Act, for example, the counties are authorized to utilize the funding mechanism of excess earnings to provide retirement health care benefits, but the ability to provide such benefits is contingent on there being sufficient excess earnings to pay for such benefits. Based upon the statutory framework authorizing the granting of retirement health care benefits, counties may create a vested retirement health care benefit if they desired, but there is no obligation to do so. Therefore, **counties must be careful in how they describe the retirement health care benefits to insure that they do not inadvertently create a vested benefit if their intent and desire is not to do so.**”

OPEB Seminar for County Officials
Session on Cost Containment Strategies
California State Association of Counties Conference
January 25, 2006

“The California Supreme Court has generally ruled that public sector employees have a “vested right” to the pension benefits they are offered when hired and these promises can not be changed without providing an alternative equal or greater benefit. The California Supreme Court has not made a similar ruling on OPEB yet. This ruling, when it occurs, may be the ultimate factor in determining whether or not public sector employees have a “vested right” to OPEB.”

OPEB FAQ's
CSAC Conference
January 25, 2006

Legal Status of Healthcare Benefits

According to the California State Association of Counties, “the statutory framework that authorizes counties to provide retirement health care benefits does not create a vested benefit.” However, in California most benefits are negotiated as part of collective bargaining agreements, and therefore local governments may have created a contractual “vested right” either intentionally or unintentionally. Local jurisdictions therefore are advised to include a legal review as part of their OPEB analysis. Some collective bargaining agreements clearly specify that coverage for retirees is vested beyond the expiration of that particular agreement. Some plan documents and communications with employees and retirees clearly communicate that benefits are or are not guaranteed. In some cases vesting, promises, obligations, and/or guarantees are unclear. Ultimately, the ability of public sector employers to make changes in the benefit structure will require negotiations with the appropriate collective bargaining units.

Conclusion

In addressing its growing OPEB liability Contra Costa County should follow best practices in the development of its plan and adopt both cost containment measures and a funding strategy that sets an appropriate funding target with adequate financial resources.

On June 26, 2007, the County Board of Supervisors took the first step in the process by adopting the outlines of a plan that established guidelines for funding its long-term obligations, set an initial funding target, and identified financial resources that if redirected would provide \$588 million reserved at the end of fiscal year 2022-23 with \$100 million added annually thereafter. The Board of Supervisors’ action also directed the County Administrator to begin pre-negotiation meetings with County labor representatives regarding the development of possible plans and models for benefit reform. The County’s overall strategy for dealing with its OPEB liability also includes an employee educational component.

The County must now identify alternative benefit structures and adopt cost containment measures based on best practices. Involvement of the collective bargaining units in preparation of the plan is a positive step in the development

of the alternative benefit structures. The County staff report identified three benefit plan options: the current plan, freezing current benefits with a 3% annual adjustment, and a no-growth plan. Each option showed various funding levels and additional program cuts and/or changes to benefits that would be required depending on the option and targeted funding level.

The final step is for the County to begin its negotiation and educational process with its employees and collective bargaining units on an alternative benefit plan structure, then adopt a funding strategy that adequately funds its OPEB obligations. The staff report also noted that funding less than the annual required contribution (ARC) would result in a Net OPEB Obligation being reported on the County's balance sheet that would grow over time. Any target funding level would have to be re-evaluated each year or so to assess the County's status. A balance must be struck between funding retiree healthcare and the County's fiscal health, without reducing the level of services or deferring maintenance.

“The midrange statewide estimated cost to cities for retiree health care benefits grew from over \$487 million in FY 2003-04 to over \$656 million in 2005-06. If current trends continue, these costs will exceed \$1 billion in FY 2008-09 and \$2 billion in FY 2013-14.”

The Center for Government Analysis
“An Analysis of Public Sector Health Care Costs in California”, September 2006

Local Municipalities

Government employees earn post-employment benefits over their years of service but do not receive these benefits until they retire. However, most municipalities fund these future expenses on a Pay-Go basis, which greatly understates the magnitude of the obligation that is accumulating.

Like the County, local cities must record an obligation for all costs and commitments related to OPEB not funded in the period in which the benefit is earned. The 19 cities in Contra Costa are generally at the beginning of the OPEB process – if they provide OPEB they are currently receiving or reviewing their actuarial studies and starting to develop their funding plans. There are two cities that have not formally started the OPEB process. Pinole is due to report in FY 2008-09, and has not yet scheduled its actuarial study. Pleasant Hill has a defined contribution plan that makes benefit payments directly to retirees. This significantly reduces the magnitude of their liability. The city anticipates doing an actuarial study and conducting a formal OPEB process to implement GASB 45 no later than FY 2008-09.

Status

Based on a survey of local municipalities, the remaining cities fall into four broad categories as follows:

1. Insignificant or No OPEB Obligations

There are eight cities that do not provide OPEB to their retirees - Clayton, Danville, El Cerrito, Hercules, Lafayette, Moraga, Oakley, and Orinda. In addition, a ninth city, Walnut Creek has an implicit rate subsidy that allows retirees to buy city negotiated health insurance at their own expense. Cities in this category have no real OPEB liabilities, and generally do not have to take any action other than report their status on their annual financial statements.

2. Estimated OPEB Liabilities of Less than Ten Percent

San Ramon, which updated its July 2005 actuarial study in January 2007, has pre-funded more than half its OPEB liability. As of FY 2008-09, San Ramon will cease to contract with the County for public safety, and will manage its own police department. At that point, it will likely begin to incur additional OPEB liabilities for its police department employees.

3. *Estimated OPEB Liabilities in the Range of 10 to 49 Percent*

There are 4 cities in this category – Antioch, Brentwood, Richmond and San Pablo. All 4 have or will soon receive their actuarial studies. All 4 are developing plans. As part of their plan development, all four have set aside substantial amounts for partial pre-funding that will decrease their unfunded liabilities significantly.

Antioch is scheduled to receive an updated actuarial study in July 2007, and has set aside \$5.1 million in an account while it assesses its options. Brentwood will receive its actuarial study in June 2007, and has set aside \$5.2 million as it assesses its options. Richmond received its actuarial study in May 2007, has set aside \$2 million, and will fund the ARC annually. San Pablo completed its actuarial study in December 2005 and has set aside \$2.0 million; staff has indicated that the city will make payments of \$500,000 annually until its unfunded liability is fully paid.

All 4 cities in this category have manageable OPEB liabilities, and will continue to pre-fund and/or pay their ARC's from ongoing operating revenues.

4. *Estimated OPEB Liabilities in the Range of 50 to 100 Percent*

There are 3 cities in this category - Concord, Martinez and Pittsburg. All 3 cities have or will soon receive their actuarial studies. All 3 are developing plans. As part of their plan development, two have set aside substantial amounts for partial pre-funding that will decrease their liabilities significantly.

Concord received its actuarial study in March 2007, and has set aside \$15 million in funding to date. In April 2007, the Concord City Council authorized the establishment of an irrevocable trust which takes advantage of investment earnings to lower its liability. An employee task force has been formed to study a less cost-prohibitive approach to retiree health benefits. Martinez received their actuarial study in June 2007, and has set aside \$4 million. Pittsburg received an updated actuarial study in January 2007, is assessing its options, and is looking at setting aside some funding this fiscal year (2007-08) as part of a formal OPEB process.

Although the three cities in this category have challenges their OPEB obligations are manageable. A reasonable approach for the three cities would be to adopt cost containment measures along with appropriate funding strategies that reduce their OPEB liabilities over time.

City Summary

In summary, it appears that at least 14 of the 19 cities in the county have manageable OPEB liabilities – the 9 cities that have insignificant or no OPEB liabilities, and the 5 cities that have unfunded OPEB liabilities of less than 35 percent of their FY 2006-07 general fund budget revenues.

The three cities with unfunded OPEB liabilities in the range of 52 to 95 percent of general fund revenues will need to adopt cost containment measures along with funding strategies. Importantly, all three of these cities have started the OPEB process with the goal of developing plans and addressing the issues. Concord and Martinez have already set aside funding that will reduce their unfunded liability.

Two cities have not completed actuarial studies and their OPEB liabilities are unknown at this time.

Best practices indicate that all cities should adopt some level of cost containment and begin some level of pre-funding to keep the growth rate of their OPEB liabilities within a manageable range.

On the funding side, cities could ramp up their funding through a series of target funding levels, with the goal of phasing in to fully funding their ARC within a 5 to 10 year period. This phased pre-funding approach, in conjunction with an investment strategy such as a trust or similar vehicle that allows higher returns for the amounts they have already set aside, will provide part of the resolution to their issues.

On the cost containment side, cities should adopt some cost containment measures in order to keep their unfunded liabilities under control. This may include capping city contributions, setting up a two tier benefit program for new hires without affecting commitments to existing employees, focusing on plan management and individual health management.

Status of City OPEB Obligations

City	Compliance Deadline	Actuarial Study Completed	General Fund Budget 2006-07 (A)	OPEB AAL (B)	Current Funding ** (C)	OPEB UAAL as a % of GF *** (B-C/A)
Insignificant or No OPEB Obligations						
Walnut Creek	FY 2007-08	N/A	\$ 66,016,389	(T)	N/A	N/A
Danville	FY 2008-09	N/A	\$ 16,713,523	(T)	N/A	N/A
El Cerrito	FY 2008-09	N/A	\$ 23,954,151	N/A	N/A	N/A
Hercules	FY 2008-09	N/A	\$ 13,805,623	N/A	N/A	N/A
Clayton	FY 2008-09	N/A	\$ 3,398,140 *	N/A	N/A	N/A
Oakley	FY 2008-09	N/A	\$ 14,800,000	N/A	N/A	N/A
Lafayette	FY 2008-09	TBD	\$ 6,614,518	\$20,000 (e)	\$25,000	0.3% (e)
Moraga	FY 2009-10	N/A	\$ 4,338,322	N/A	N/A	N/A
Orinda	FY 2009-10	N/A	\$ 10,869,236	N/A	N/A	N/A
OPEB Liabilities of Less than 10%						
San Ramon	FY 2008-09	January 2007	\$ 35,496,000	\$ 5,585,371	\$ 3,800,700	5.0%
OPEB Liabilities Between 10% to 49%						
San Pablo	FY 2008-09	December 2005	\$ 14,599,233	\$ 5,500,000	\$ 2,000,000	24.0%
Brentwood	FY 2007-08	May 2007	\$ 39,306,534	\$ 15,000,000	\$ 5,200,000	24.9%
Antioch	FY 2007-08	July 2007	\$ 43,677,544	\$ 16,000,000	\$ 5,090,000	25.0%
Richmond	FY 2007-08	May 2007	\$125,198,817	\$ 42,600,000	\$ 2,000,000	32.4%
OPEB Liabilities Between 50% to 100%						
Concord	FY 2007-08	March 2007	\$ 72,309,409	\$ 52,855,000	\$ 15,000,000	52.4%
Martinez	FY 2008-09	April 2007	\$ 20,700,000	\$ 18,085,000	\$ 4,000,000	68.0%
Pittsburg	FY 2008-09	January 2007	\$ 35,159,658	\$ 33,173,000	\$ 0	94.4%
OPEB Liabilities To Be Determined						
Pinole	FY 2008-09	TBD	\$ 12,680,819	TBD	TBD	TBD
Pleasant Hill	FY 2008-09	TBD	\$ 18,796,143	Defined Contribution Plan	TBD	TBD

Note: Healthcare plans and programs vary among individual jurisdictions, but do not impact the findings of this report. Specific detailed descriptions can be obtained by contacting the appropriate public entity.

TBD – To Be Determined

N/A – Not Applicable

(e) – Estimated

(T) – Implied Rate Subsidy

* 2005-06 General Fund Revenue

** To be counted as an offset against the AAL, funding must be set aside in a dedicated trust that is GASB 45 compliant

*** Funding that has been set aside in a dedicated trust reduces the ALL. Assumes current funding has been or will be placed in a dedicated trust that is GASB 45 compliant

School Districts

The California Education Code requires local school districts to adopt a budget by July 1 of each year. County superintendents are required to examine the adopted budget for each school district.

Like other units of local government, school districts are subject to GASB 45. As such, they must complete actuarial studies and disclose any OPEB expenses and liabilities on their financial statements in accordance with the compliance deadlines.

School districts with long-term OPEB obligations must submit a management plan for financing their OPEB obligations to the County Office of Education. The County Office must certify to the California Department of Education that a complete management plan has been submitted.

School districts that have completed plans to meet their outstanding long-term fiscal obligations for OPEB may receive up to \$15,000 as a reimbursement for the costs of developing such plans. Under a plan by the County Office of Education, several districts are considering going out with a joint RFP to retain an actuarial firm to complete the valuation study by early fall 2007.

Four school districts - West Contra Costa, Mt. Diablo, San Ramon Valley, and Antioch Unified - must submit plans this year. Twelve school districts must conduct studies next year and two districts must report in FY 2009-10.

Phase One School Districts

Of the four largest school districts, most districts appear to be in relatively good fiscal health.

San Ramon Valley Unified School District - appears to be in the best shape. The District budgets and pre-funds its ARC of \$3.2 million for the past 10+ years. They have also placed caps on the annual increases. An updated actuarial study will be completed in Oct 2007.

Antioch Unified School District - provides retiree healthcare to age 65. An actuarial study has been completed.

Mt. Diablo Unified School District - offers subsidized health insurance until age 65 for eligible retirees. Such benefits are authorized through the District's collective bargaining agreements. The District recognizes the cost of providing those benefits and related administrative costs when paid. As of June 30, 2006, 1,519 retirees were eligible with annual payments totaling \$3,403,062.

West Contra Costa Unified School District - is one of only a few school districts in the State to provide health care benefits for life. Since the District's unification in 1965, the District has fully covered the cost of health insurance premiums for both active employees and retirees. Healthcare costs are increasing faster than District revenues having shot up 129% in the last five years.

West Contra Costa conducted an actuarial valuation as of July 1, 2006. At that time, the unfunded liability was \$705,331,066. At the valuation date, the District was holding assets of \$7,500,000. If placed in an irrevocable trust these funds combined with potential investment income would reduce the District's unfunded liability. However, the current annual cost for retiree health benefits will more than double over the next five years unless efforts are also made to contain costs. The District is proposing to cap its health benefit contribution at the current Kaiser rates for current employees. This proposal would result in cost sharing between the district and employees, a system that currently exists in almost all school districts in California. The District is also proposing to adopt a vesting schedule for future employees to contain future OPEB costs. These proposals are subject to negotiations with the District's collective bargaining units.

Statewide, over 95% of all school districts have capped their contributions for retiree healthcare benefits. WCCUSD proposal would be consistent with school districts statewide.

The **Contra Costa Community College District** has OPEB liabilities of \$225 million with unrestricted assets of \$27.5 million in Board-designated funding. The District has put together a plan that adds an additional \$15.6 million to the retiree funding in 2006-07. The College District is also taking steps to contain costs by negotiating a 6% employee co-payment of insurance premiums.

School District OPEB Obligations

School District	Compliance Deadline	Actuarial Study Completed	General Fund Revenue 2005-06	OPEB AAL	OPEB UAAL as a % GF	Annual Cost
Elementary						
Brentwood Union	FY 2008-09		\$ 47,241,258			\$ 25,084
Byron Union	FY 2008-09	N/A	\$ 10,584,118	N/A	N/A	\$ -
Canyon	FY 2009-10	N/A	\$ 586,243	N/A	N/A	\$ -
Knightsen	FY 2009-10		\$ 3,915,476			\$ 23,316
Lafayette	FY 2008-09		\$ 24,007,324			\$ 89,380
Moraga	FY 2008-09	N/A	\$ 14,339,617	N/A	N/A	\$ 30,000
Oakley Union	FY 2008-09		\$ 30,871,732			\$ 43,641
Orinda Union	FY 2008-09		\$ 21,582,304			\$ 143,374
Walnut Creek	FY 2008-09		\$ 23,358,678			\$ 94,350
High School						
Acalanes Union	FY 2008-09		\$ 49,535,095			\$ 275,000
Liberty Union	FY 2008-09		\$ 41,226,341			\$ 9,880
Unified						
Antioch	FY 2007-08	Fall 2007	\$ 140,409,325			\$ 1,196,316
John Swett	FY 2008-09		\$ 13,568,268			\$ 166,642
Martinez	FY 2008-09		\$ 28,808,275			\$ 129,524
Mt. Diablo	FY 2007-08	Fall 2007	\$ 266,499,944	\$ 3,403,062	12.8%	\$ 174,096
Pittsburg	FY 2008-09		\$ 68,740,792			\$ 452,314
San Ramon Valley	FY 2007-08	Oct 2007	\$ 171,986,379	\$ 36,789,000	21.4%	\$ 1,832,000
West Contra Costa	FY 2007-08	Sept 2006	\$ 267,229,260	\$ 705,331,066	263.9%	\$13,512,404
College District						
Contra Costa Community	FY 2007-08	June 2006	\$ 201,159,147	\$ 225,080,400	90.5%	\$ 7,342,881
CCCOE	FY 2008-09	June 2007	\$ 72,327,550	\$11,492,654	15.3%	\$ 427,292

Note: Healthcare plans and programs vary among individual school districts, but do not impact the findings of this report. Specific detailed descriptions can be obtained by contacting the appropriate entity.

Education Code Section 42140 requires Local Educational Agencies that provide health and welfare benefits to retirees beyond age 65 to provide information annually to the governing board, at a public meeting, regarding the estimated accrued but unfunded cost of those benefits based on an actuarial study obtained at least every three years. Although *EC* 42140 requires that this information be provided to the board at a public meeting, it does not require that it be included in the financial statements.

TBD – To Be Determined
N/A – Not Applicable

Source: California Department of Education, Local School Districts, Contra Costa County Board of Education, Contra Costa Community College District

Special Districts

Contra Costa County has more than 255 special districts. Only 43 have independently elected boards and the remaining districts (212) are under the jurisdiction of the County, a city council, or joint powers authority, which serves as the Special District's governing board.

Special districts are a unique, but little understood form of local government. In California, depending on their source of funding, special districts are either enterprise districts that bill customers directly for services (such as water districts) or non-enterprise districts that are funded with voter-approved taxes or assessments (such as sanitary and fire districts).

Special districts are often chosen to provide needed services rather than form a city or annex their area to an existing city. Special districts can be single purpose or multi-purpose.

In Contra Costa County, there are 43 independent special districts with single well-defined focuses to meet specific needs or solve particular problems. Some of the services they provide include drinking or irrigation water, health care, fire protection, vector control, wastewater collection, treatment and reuse, public transit, recreation, cemetery, and community services.

Of the nine types of special districts, this report focuses only on the fire protection, sanitary, water, transit, and health services districts, which are among the largest of the county's special districts.

Although there are a large number of special districts in Contra Costa County most of them are relatively small (i.e. less than \$10 million in annual revenue) with few employees. Most of the special districts fly under the radar screen of the general public and financial information about them is not readily available. Most of the county's special districts need to determine their OPEB liabilities, conduct an actuarial study, and prepare comprehensive annual financial reports with notes regarding their OPEB liabilities and funding status.

Of the 23 special districts examined in this report, only one is considered a large employer (i.e. have annual revenues over \$100 million). Over half of them are small and do not have to report their OPEB liabilities until FY 2009-10.

The Sanitary Districts appear to be in relatively good shape with the larger ones having taken a proactive approach by starting their OPEB process early. Delta Diablo, for example, conducted a preliminary actuarial valuation in December 2005 which it will update this fiscal year. As part of their OPEB process Delta Diablo is considering using a trust which will qualify for a more favorable discount rate. Ironhouse recently completed its actuarial study and has set aside some initial funding. Central San is updating its 2005 actuarial study, has set aside approximately \$3.3 million with another \$2.7 million budgeted this year, and is looking into setting up a trust. The updated study will serve as the basis for determining the appropriate funding level. West County Wastewater is currently in the process of conducting an actuarial study to determine its OPEB liability.

The Water, Fire, and Transit Districts are among the larger special districts. None of these districts have to report their OPEB obligations this current fiscal year. Those districts with OPEB obligations typically fund them on a pay-as-you-go basis. While their annual payments for OPEB appear to be manageable as a percentage of their operating revenue, the size of their unfunded liability is unknown until they complete their actuarial studies. CCWD has been proactive in conducting a preliminary actuarial study early on and has set aside \$7.1 million prior to their compliance deadline. Kensington Fire District also conducted an actuarial study early on, but will need to update its actuarial study by its compliance deadline in FY 2009-10.

The Mt. Diablo Health Care District which operated a hospital in Concord until 1997, when voters approved the public hospital's merger with the John Muir Health system, no longer has a say over the operation of that facility. The District had an unfunded liability of \$425,000 at the end of 2005, because of lifetime health care benefits promised to board members who served more than 12 years. This benefit has been discontinued for future board members.

Special District OPEB Obligations

Special District	Compliance Deadline	Actuarial Study Completed	2006-07 Revenue	OPEB AAL**	Funding Status *	OPEB UAAL as a % of Revenue
			(A)	(B)	(C)	(B-C/A)
Sanitary Districts						
Byron Sanitary	FY 2009-10	N/A	\$ 184,700	N/A	N/A	N/A
Central Costa Costa	FY 2008-09	August 2005	\$ 84,277,952	\$ 65,300,000	\$ 6,000,000	70.4%
Crockett-Valona	FY 2009-10		\$ 1,437,784			
Delta Diablo	FY 2008-09	December 2005	\$ 28,803,147	\$ 10,346,000	\$ 0	35.9%
Ironhouse	FY 2009-10	July 2007	\$ 5,922,700	\$ 2,286,000	\$ 329,000	33.0%
Mt. View	FY 2009-10		\$ 4,069,449			
Rodeo	FY 2009-10		\$ 580,000			
Stege	FY 2009-10		\$ 730,000			
West County Wastewater	FY 2008-09	Fall 2007	\$ 12,191,151			
Water Districts						
Byron-Bethany Irrigation	FY 2009-10		\$ 1,510,535			
Contra Costa Water	FY 2008-09	December 2005	\$ 146,145,317	\$ 41,538,000	\$ 7,106,000	23.6%
Diablo Water	FY 2008-09		\$ 10,209,452			
East Contra Costa Irrigation	FY 2009-10		\$ 1,000,000			
Fire Protection Districts						
Kensington	FY 2009-10	July 2004	\$ 2,622,862	\$2,164,219	\$ 0	82.5%
Moraga-Orinda	FY 2008-09		\$ 14,600,000			
Rodeo-Hercules	FY 2009-10		\$ 4,575,377			
San Ramon Valley	FY 2008-09		\$ 46,140,871			
Transit Districts						
Central Contra Costa Transit	FY 2008-09		\$ 40,288,106			
Western Contra Costa Transit	FY 2008-09	N/A	\$ 10,322,873	N/A	N/A	N/A
Eastern Contra Costa Transit	FY 2008-09		\$ 17,440,241			
Health Services Districts						
Los Medanos Community	FY 2009-10		\$ 690,000			
Mt. Diablo Health Care	FY 2009-10		\$ 253,000	\$ 425,000		168.0%
West Contra Costa Healthcare	FY 2008-09	N/A	\$ 12,856,227	N/A	N/A	N/A

Note: Healthcare plans and programs vary among individual jurisdictions, but do not impact the findings of this report. Specific detailed descriptions can be obtained by contacting the appropriate public entity.

* Assumes current funding has been or will be placed in a dedicated trust that is GASB 45 compliant. Funding that has been set aside in a dedicated trust reduces the ALL.

** Under GASB 45 the OPEB AAL is the present value of the benefits which can be funded over a 30 year period.

TBD – To Be Determined N/A – Not Applicable, No OPEB Obligation

Source: Craft Consulting Group survey, July 2007

Shared Responsibilities

Private Sector Trends

Private corporations began to account for retiree liabilities in the early 1990's when the Financial Accounting Standards Board (FASB) released FAS 106.

FAS 106 required most private companies to significantly alter the way they accounted for their retiree health benefits beginning with fiscal years after December 15, 1992. The OPEB liabilities revealed by FAS 106 were considerable – General Motors, Ford and Chrysler, for example, reported one-time charges of \$23.5 billion, \$7.5 billion, and \$4.7 billion. These charges dramatically impacted the calculations of profits and losses for many companies, and created incentives for financial managers to limit retiree health expenses.

As a result of increasing costs for retiree health benefits and FAS 106 requirements, many firms examined their retiree health benefit programs in detail and modified some provisions, often fine tuning the programs by making incremental changes for several years in sequence. Employers have placed dollar caps on retiree health benefits, modified vesting schedules, and changed from defined benefit to defined contribution programs with healthcare becoming more of a shared responsibility.

The changes made to private sector retiree health benefits did not impact existing retirees. They were most likely to impact future retirees who were not yet or might not become eligible for retiree health benefits.

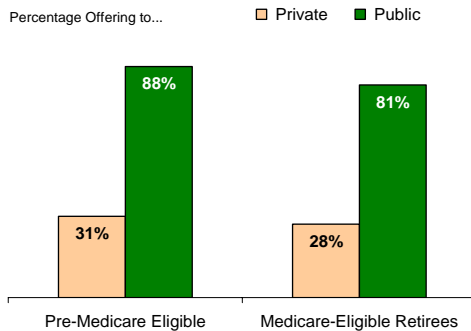
The reporting of OPEB liabilities did not by itself solve the issues of unfunded OPEB liabilities. In spite of the FAS 106 reporting requirements, unfunded OPEB liabilities remained a significant issue for many larger companies in traditional industries. A report from Standard & Poor's in 2005 listed the unfunded OPEB liabilities of the S&P 500 at \$292 billion, almost double the amount of the S&P 500 pension liabilities. General Motors and Ford accounted for \$94 billion or 32 percent of the unfunded liabilities.

In the years since the release of FAS 106, private sector retiree health benefit programs have evolved steadily.

"In California, the public sector offers retirees medical coverage at almost three times the rate in the private sector, whether or not they are eligible for Medicare"

California HealthCare Foundation
"Benefits in the Balance: The Uncertain Future of Public Retiree Health Coverage", 2006

Employers Offering Retiree Coverage, Public vs. Private Sector, 2005



Source: Mercer National Survey of Employer-Sponsored Health Plans, 2005

Number of Private Sector Employers Offering Retiree Healthcare Benefits is Declining

In 1980, 85.6% of medium and large firms provided some form of retiree health benefits. By 2000, the percentage reporting these benefits had dropped to 37.1%. The percentage of large firms offering retiree healthcare has continued to drop to about 33% in 2005.¹ With the 2003 amendment to Medicare, employers were encouraged to provide Medicare coverage by subsidizing prescription drug costs, offering expanded prescription drug coverage directly to individual employees, and establishing tax-advantaged health savings accounts to contribute toward retiree medical costs.

The creation of complementary vehicles such as Medigap coverage, Voluntary Employees Beneficiary Associations (VEBA) or 501(c)(9) trusts and 401(h) accounts, has provided a series of customized and cost-effective options to pay for retiree health costs. The overall result has been the gradual development of a more diverse, flexible system to structuring retiree healthcare benefits, containing costs, and funding the benefits.

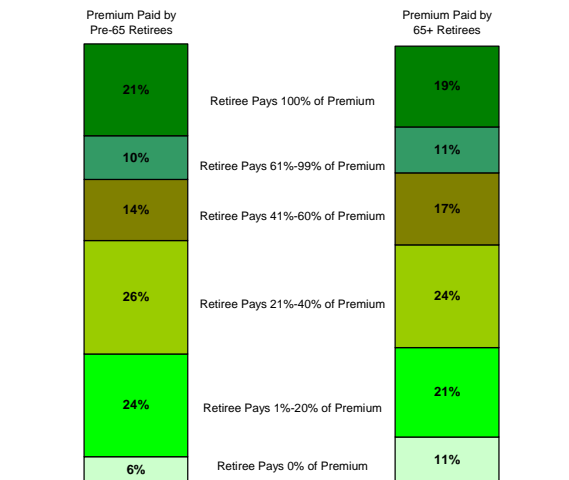
For the most part, large employers continue to sponsor retiree healthcare benefits, but with substantial curtailments in what they are able to offer.

The most common ways that plans have been modified without being eliminated include:

- Increasing periods of service under the plan in order to qualify for benefits at retirement age
- Implementing a sliding schedule of premium payments based on service under the plan
- Capping the dollar amount the employer will contribute for retiree health premiums, and
- Shifting to defined contribution plans where a balance is accumulated over the period of work for an employer and that balance can be used to pay part of the premium for retiree health insurance during retirement.

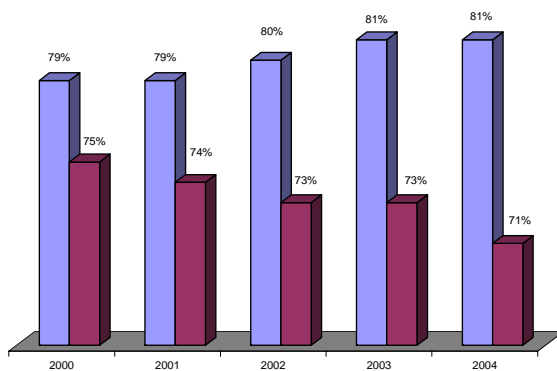
All of these methods are being used extensively to manage retiree healthcare liabilities in the private sector today.

Distribution of Employers by Share of Premium Paid by Retiree
(May not equal 100% due to rounding)



Source: Kaiser/Hewitt 2004 Survey on Retiree Health Benefits

Private Sector Moving from Defined Benefit Plans to Defined Contribution Plan
(Share of Health Insurance)



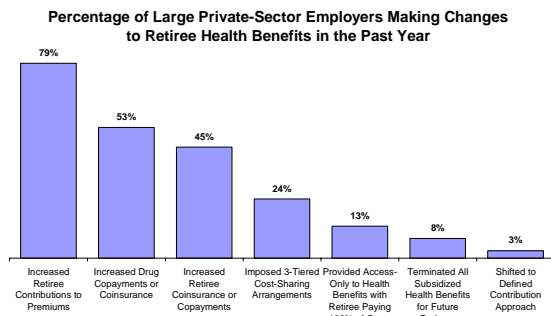
Source: Centers for Medicare and Medicaid Services, Office of the Actuary, National Health Statistics Group, and Office of Personnel Management, Bernstein Journal

■ Public ■ Private

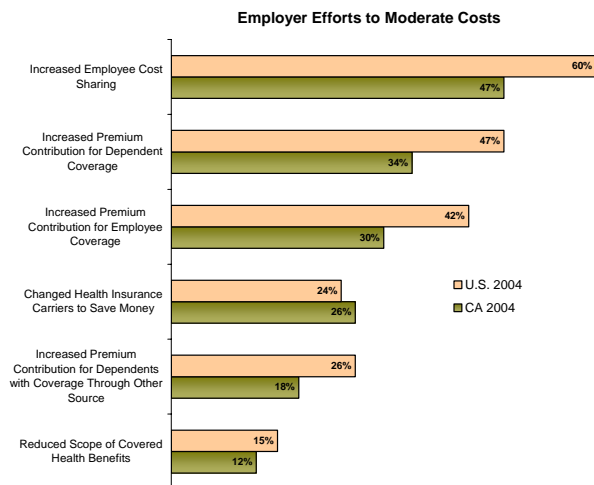
¹ Kaiser Family Foundation, "Current Trends and Future Outlook for Retiree Health Benefits, Findings from the Kaiser/Hewitt 2004 Survey on Retiree Health Benefits", December 2004

“Increasing employee cost sharing and premium contributions are the most common strategies for reining in employers’ health care costs”

California HealthCare Foundation
 “Health Care in California: Perspectives from
 Employers and Consumers”, 2005



Source: Kaiser/Hewett 2004 Survey on Retiree Health Benefits, December 2004



Source: California HealthCare Foundation

Findings from a 2004 survey confirm that employers are continuing to modify retiree health plans in ways similar to what they have done in the past. Costs are continuing to rise at double-digit rates, leading employers to increase retiree contributions and cost-sharing and to consider eliminating subsidized retiree health coverage for new hires in particular. Nevertheless, surveyed employers project that the majority of their current workers will continue to be eligible for health benefits when they retire.

Private Sector Employers Offering Retiree Healthcare Are Placing Caps on Future Obligations

Despite ongoing efforts to manage the cost of retiree health programs, the total cost of providing retiree health benefits has been rising rapidly in recent years. High costs have contributed to both the decline in employer sponsorship of retiree health benefits in the past decade and the shift in costs from employers to retirees. According to a survey of the S&P 500, 307 companies (61.4%) had OPEB obligations. Only four companies were fully funded. Most companies have started capping their annual contributions, limiting the annual increases or requiring retirees to convert over to Medicare.

Many large employers have placed caps on their future financial obligations for retiree health coverage in response to the rising cost of providing retiree health benefits and FASB 106 reporting requirements.

Health Benefit Plan Design Modifications

Most employers who continue to provide retiree health coverage make modifications to control the future growth of health expenses, such as:

- Tightening eligibility (e.g., raising minimum age and service requirements);
- Increasing the retiree’s contribution to the total health care premium and for payment of out-of-pocket expenses, or both;
- Capping the employer’s contribution to the cost of retiree health care;
- Eliminating subsidized retiree health coverage for future retirees, mainly for new hires, but also in some cases for current employees and even for current retirees.

Consumer Driven Healthcare

One approach to cost containment is the consumer-driven health plan (CDHP), a relatively new and rapidly evolving type of plan that encourages plan participants to play more of a direct role in managing the costs of their own health care.

The term CDHP refers to a wide variety of types of plans. Their most common characteristic is that they are relatively customized plans that are used to create tiers of cost coverage that assign differing elements of risk to the employer, the employee, and the insurer. CDHP plans include:

- **Health Savings Account (HSA)** – The most common form of CDHP, this pairs a savings account with a deductible insurance plan. The employer and the employee make pre-tax contributions to the HSA, which can be used to pay for routine and preventative medical care. The insurance provides coverage for catastrophic or high-cost events. The HSA offers a route to relatively affordable premiums and tax advantages in exchange for high deductibles. The tax savings can pay for uncovered doctor visits, co-pays, premiums, etc. It is distinct from health insurance but must be used in conjunction with it. The HSA is fully portable and employees can take it with them when changing jobs. The HSA can help fill any Medicare coverage gaps in retirement.
- **Tiered Networks** - The employer offers employees a choice of medical plans, which include medical systems of varying costs.
- **Menu-driven** - Employers provide online information to help employees customize their own benefit plan by selecting co-pays, deductibles, etc.
- **Managed Competition** - The employer provides a subsidized basic medical plan with buy-up options. Plans can be from the same or multiple insurers.
- **Defined Contribution** - The employer gives each employee a fixed dollar contribution to apply to the employee's choice of available health care options through either direct compensation or a voucher. The employee is then responsible for finding and purchasing their own medical coverage.

Prototype of a Consumer Driven Health Plan		
Tier	Financial Risk Assumed By	Sample Thresholds
Highest	Insurer	Over \$ 2,000
Middle	Employee	\$1,000 - \$ 2,000
Lowest	Employer	\$0 - \$1,000

Source: Government Finance Officers Association, "An Elected Officials Guide to Health Care Cost Containment", 2005

Managing OPEB Liabilities

Compliance with GASB 45

In order to comply with GASB 45 local governments need to:

- **Determine and Document Any OPEB Liability.** Employers may have either an “implicit rate subsidy” where retirees and current employees are insured as a group and the premiums paid by retirees are lower than they would be if insured separately, or a liability based on a “substantive plan” as understood by the employer and plan members. Employers should also determine what commitments have been made regarding OPEB benefits and what are the legal obligations to meet retirees’ healthcare? Is there a written plan? What was promised and whom is it promised to (retirees; spouses or dependents; active employees)? Who is paying for these promises and are they vested?
- **Quantify Magnitude of OPEB Liability Through An Actuarial Valuation.** Retain an actuarial firm to estimate OPEB liabilities using reasonable assumptions for projections.
- **Recognize and Disclose OPEB Liability on Financial Statements.** Local governments must report OPEB expenses and liabilities on their financial statements and footnotes. For financial reporting purposes, local governments need to report two key OPEB measures: the annual required contribution and the net OPEB obligation. In addition, local governments are required to include a description of the Plan, funding policy, current year annual OPEB cost, and the dollar amount of contributions made.

By reporting annual OPEB costs and the unfunded actuarial accrued liabilities, public entities will provide “**improved accountability and a better foundation for informed policy decisions** about the level and types of benefits provided and potential methods of financing those benefits.”

GASB Statement 45 on OPEB
Accounting by Governments

GASB 45 does not require the annual OPEB costs to be pre-funded. The extent to which the annual required contribution is not fully funded must be shown as an unfunded liability on the local government’s financial statements. How a local government actually finances retiree healthcare benefits or the level of benefits to be provided, is a policy decision made by local government officials.

“... we plan to assess both the level of an **issuer’s liability compared to its peers and the issuer’s plan to manage the liability**. Over time, some outliers - - those with unusually large or small liabilities, those with unusually weak or strong plans – could see an upward or downward rating adjustment.”

Moody’s Investor Services
OPEB FAQ’s CSAC Conference
January 25, 2006

“As governments near the effective dates for implementing GASB 45, they **must be able to articulate a plan for funding OPEB liabilities**. . . . 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.”

Fitch Ratings
Government Finance Review
October 1, 2005

“OPEB Unfunded Actuarial Liabilities are huge, but **the underlying danger may really be escalating OPEB Pay-Go costs**. . . . OPEB annual payments may be the fastest growing item in a government’s budget.”

Standard & Poor’s
16th Biennial Forum of Government Auditors
May 17, 2006

“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, and the;
- Current credit assessment of the issuer, and other factors affecting the entity’s financial flexibility.”

Moody’s Investor Services
July 2005

“Generally, a current funding ratio of 70%–80% or better is considered by Fitch to be adequately funded from a credit perspective.”

Fitch Ratings commenting on pension plans
September 18, 2003

Emerging Views of Rating Agencies

The emerging views of the rating agencies on GASB 45 confirm that they are taking a measured approach, given the scope and complexity of incorporating OPEB into existing financial reports and developing effective plans to address OPEB liabilities that vary significantly by jurisdiction.

The rating agencies use four fundamental factors to evaluate the creditworthiness of public jurisdictions – economy and tax base, finances, debt level and structure, and management. OPEB liabilities could have a significant impact on ratings, because OPEB could affect three of these four basic factors.

A review of the comments by Fitch, Moody’s and Standard & Poor’s highlights how the rating agencies will evaluate public sector employers. The elements of OPEB costs that would be of concern to the three rating agencies would be:

- OPEB liabilities that are significantly larger than those of a jurisdiction’s peers;
- unusually optimistic assumptions used in estimates;
- an inability or unwillingness to address cost and benefit structures as needed;
- any impacts of full funding on a jurisdiction’s financial flexibility and strength based on debt or reserve levels, and;
- the absence of a credible plan to address OPEB liabilities.

Implied in their comments is a message from the rating agencies that development of a plan to address OPEB liabilities and steady progress in implementing the plan will be key factors in assessing how well government agencies comply with GASB 45. In fact, according to Fitch Ratings, “an absence of action taken to fund OPEB liabilities or otherwise manage them will be viewed as a negative rating factor.” (The Not So Golden Years: Credit Implications of GASB 45, June 22, 2005)

“It will be impossible . . . to meet presently promised public sector pensions, including promised healthcare benefits for seniors, simply because those promises are too generous compared to future resources. Benefits will have to be scaled back, in some cases, significantly.”

“Public sector resources needed to fund existing pension and healthcare promises over the long-term will raise serious solvency issues if these systems are not reformed.”

“How much debt can a government comfortably bear before its solvency is threatened? When looking back through history, we find that as debt approached 170-180% of national income, public finances usually became stressed.”

The Effects of Aging on Public Sector Pensions and Healthcare Systems: A Rating Agency Perspective
Prepared for: The Senate Special Committee on Aging

Vincent J. Truglia
Managing Director
Sovereign Risk Unit
Moody's Investors Service
May 18, 2004

Actions Needed to Manage OPEB Liabilities

Sound fiscal management requires that local governments do more than simply retain an actuary to prepare a set of calculations that appear on the organization's financial statement. In addition to disclosing their liabilities, local governments need to take action to control the size and growth rate of the liability.

Essentially, there are three options that local governments can use to address their OPEB liabilities - develop funding strategies to set cash aside for higher returns, negotiate alternative benefit structures, and adopt measures to contain costs.

Step 1: Develop a Comprehensive Plan

There is no single magic bullet that can resolve the issues faced by local government retiree health benefit programs. The first step is to develop a sound, credible plan including benefit structures, cost containment measures, and funding strategies that addresses and eventually resolves the issues. This will require commitment and compromise by all parties involved.

Each public entity must review and evaluate their post-employment retiree healthcare programs. They then must determine and document the retiree healthcare benefit promises based on the substantive plan as mutually understood by the employers and employees.

The magnitude of OPEB liabilities and the key drivers affecting cost must be determined by actuarial studies. Ways to reduce current and future liabilities must be identified and evaluated. Decisions must then be made working in partnership with collective bargaining units to find reasonable solutions.

We cannot afford to ignore these issues and simply hope the crisis will vanish of its own accord. All parties must recognize that the current benefit levels cannot be sustained and that action must be taken immediately to (1) contain cost and (2) adequately fund retiree healthcare obligations.

Step 2: Adopt Cost Containment Measures

In order to effectively manage future costs local public entities should develop a cost containment strategy for new hires, active employees, and retirees. This may involve changing the benefit structure, capping employer expenses, shifting to a defined contribution plan, and/or adopting some form of consumer driven healthcare.

For Current Employees: Options to change benefit structures for active employees may be limited. Benefit structures that contain costs for current employees has an immediate impact on actuarial valuations. The goal is to negotiate alternative benefit structures that limit the employer's liability without significantly impacting the level of benefits promised. Scaling back generous early retirement programs would save money and encourage valuable workers to stay on the job.

For New Hires: Establish two-tier benefit programs that shift newly hired workers into lower-cost retirement plans. This approach reduces health benefits for employees hired after a specific date, while maintaining agreed-upon benefit packages for existing workers. Options include:

- Increasing length of service requirements for eligibility for future employees;
- Extending the retirement age for future employees;
- Starting medical coverage later for future employees;
- Increasing the share of benefit costs paid by new employees (e.g., premiums, deductibles, co-payments);
- Capping employer contributions (by establishing COLA limits, changing to defined contribution plans, etc).

Benefit structures that contain costs for new hires will generate impacts much later, but may be a factor in actuarial terms by reducing the level of future liabilities.

For Retirees:

- Explore cost sharing arrangements with other local governments;
- Move retirees on to Medicare at age 65.

Additional Cost Containment Measures

In addition to the above measures, there are three types of approaches widely used to help contain costs once a benefit structure has been determined. These include:

Plan management, which focuses on making continuous improvements to existing plans through encouraging cost-conscious decisions related to deductibles, co-pays, and co-insurance. The intent of the improvements is to have retirees receive better benefits while containing or even reducing costs through more active management. Options include:

- Moving from one-tier co-pays to two- or three-tier co-pays for prescription drugs;
- Moving from drug tiers based strictly on cost to tiers based on cost-effectiveness;
- Developing a tiered approach to hospital utilization;
- Eliminating cost sharing for health care actions that have a pay-off (e.g., stopping smoking);
- Use cost differentials to encourage use of in-network providers, generic drugs, non-emergency care.

Vendor management, which focuses on maximizing competition among vendors, periodically rebidding contracts, and continuously reviewing relationships with vendors to contain costs. Vendor management approaches include:

- Use of a third party to audit claims;
- Periodically review historical claims data;
- Develop performance guarantees.

Individual health management, which includes both disease management and wellness programs. Disease management focuses on common chronic conditions such as asthma, diabetes, obesity, depression, lower back pain and cardiovascular diseases. A standard rule in health care is that the drivers of health costs are not the retirees who are in good health, but the 10% who have chronic conditions and account for 70% of the costs. Wellness programs focus on providing improved services to retirees about nutrition, exercise and similar initiatives that result in lower health care costs.

Step 3: Develop a Funding Strategy

How to finance the benefits that have been granted is a policy decision made by elected officials.

Pay-As-You-Go: While PayGo may be less expensive initially, it will be more expensive over the long term. The current system of funding will result in large unfunded liabilities on a public entity's financial statements, which will have to be funded at some future date. The ability to make these future payments may require taking more severe action later that eliminates retiree health benefits, results in layoffs, or cuts valuable public services. To move from Pay-Go funding to increasing levels of pre-funding will require detailed investigation of potential funding options. It is likely that several options will be needed to develop a solid funding strategy. Funding strategies, other than Pay-Go may include:

Pre-Funding: OPEB liabilities could be fully funded by paying the Annual Required Contribution. Paying more now can dramatically reduce costs over the long term. Pre-funding:

- **Can Be More Economical.** Pre-funding a dedicated trust will generate investment earnings that would help offset contributions toward the unfunded liability. This would allow local governments to pay for retiree health care benefits with fewer budgetary resources.
- **Will Contribute to Higher Bond Ratings.** Bond rating agencies, whose evaluations help determine the interest rates paid on County debt, monitor the funding status of the retiree health program. Large, unfunded retiree health obligations may be viewed negatively, especially if no action is being taken to address them.
- **Will Help Secure the Benefits Expected by Employees.** Pre-funding creates a pool of assets with which to support future benefits that public employees expect to receive. These assets would strengthen the Public Sector's ability to provide these benefits over the long term.

Partial Pre-funding: Partial pre-funding of retiree healthcare is an option. Moving to fully funding the ARC immediately may be unrealistic. Partial pre-funding may be more realistic. Any amount of pre-funding reduces the unfunded liability.

Phase-in Funding: Payment of the ARC could be phased in over a 5 to 10 year period. Investment earnings from funds set aside today would help reduce future budget pressures.

Dedicated Trust: Establishing a dedicated trust can reduce the UAAL and ARC. Properly managed trusts can increase rates of return that help fund OPEB liabilities with investment surpluses. Trust options for public sector employers include:

- **IRC 401(h)** Medical Sub-Account in a pension plan has broad investment powers, and may be established by a single employer or multiple employers.
- **IRC 115 Government Trust**
- **IRC 501(c)(9)** Voluntary Employee Benefit Association - this vehicle is used widely in the private sector.

Taxable Bonds: Issuing OPEB bonds can reduce the UAAL and ARC and lower long term funding costs, but they concentrate investment risk and decrease financial flexibility. OPEB Bonds also will appear as hard debt on financial statements that must be paid back as opposed to soft debt (i.e. the UAAL) where legislative bodies can elect to fund or not fund the annual contribution.

Revenue Sources: Regardless of the funding strategy employed, funding to pay for retiree healthcare benefits ultimately comes from:

- General Fund Current Revenue;
- General Fund Reserves;
- Special Tax Measures that are approved by the voters to raise revenues to fund OPEB;
- New revenue sources or redirected funding that can be earmarked for retiree health benefits;
- Investment income if the funding strategy involves setting up a GASB approved trust.

Actions Needed to Address OPEB Liabilities

Comprehensive Plan	Cost Containment	Funding Strategy
Conduct Actuarial Study to determine magnitude of OPEB liabilities	Create Separate Tier for New Hires	Establish Dedicated Trust
Develop strategy to adequately fund OPEB Liabilities	Increase Length of Service requirements for eligibility for new hires	Issue OPEB Bonds
Take steps to contain costs	Increase the retirement age for new hires	Pre-pay all or part of OPEB liabilities
Report OPEB liabilities on Annual Financial Statements	Reduce benefits after age 65 when Medicare starts	Identify current or future revenue, reserves, or redirected funding
	Change from Defined Benefit Plan to a Defined Contribution Plan	Pass Special Tax Measure Approved by Voters
	Reduce or Control Benefits	

Justification for Taking Various Actions

Reduce or Control Benefits	Set up a Dedicated Trust	Implement Favorable Actuarial Assumptions	Issue OPEB Bonds	Pre-fund OPEB Obligations
<p>Pros</p> <ul style="list-style-type: none"> Modifying existing benefit plans can help reduce the UAAL and annual premiums Alternative plan structures can help control future cost increases 	<p>Pros</p> <ul style="list-style-type: none"> Trust fund moves discount rate to 7%-8% vs 4%, decreasing PV of unfunded liabilities. Potential for investment income 	<p>Pros</p> <ul style="list-style-type: none"> Reduces PV of unfunded liabilities 	<p>Pros</p> <ul style="list-style-type: none"> Immediately funds UAAL Potential for investment gains 	<p>Pros</p> <ul style="list-style-type: none"> If annual budget contribution equals the ARC, no balance sheet liability Reduces UAAL May help credit rating
<p>Cons</p> <ul style="list-style-type: none"> Difference in employer & retiree interests Escalating annual budget cost may result in service cuts 	<p>Cons</p> <ul style="list-style-type: none"> Advantages & disadvantages vary by the type of trust 	<p>Cons</p> <ul style="list-style-type: none"> Limit on how much actuaries will allow Aggressive assumptions may have negative credit rating implications 	<p>Cons</p> <ul style="list-style-type: none"> Permanent OPEB liability until bonds are paid off Reduces budget flexibility Fixed debt vs soft liability 	<p>Cons</p> <ul style="list-style-type: none"> Lack of funding means growing Net OPEB Obligation on balance sheet

Funding Vehicles for Public Sector Retiree Healthcare Benefits

	General Fund	401(h) Medical Account	501 (c)(9) VEBA	115 Public Sector Grantor Trust
Description	General Fund revenue earmarked to pay health care benefits for retirees, spouses, dependents	Separate account established under IRC 401(h) within the pension trust to provide health care benefits for retired pension plan members, spouses, dependents	Separate tax-exempt entity (trust) established under IRC 501(c)(9) to provide health care benefits for active and retired VEBA members, dependents, and beneficiaries	Separate trust established as an "integral part" of the state or under IRC 115 to provide for essential governmental functions, including health care benefits for active and retired employee
Satisfies GASB Trust Requirement	No – earmarked funds do not qualify unless a trust is established	Yes – assets protected through pension investment mix	Yes – assets protected through VEBA trust	Yes – assets protected through separate governmental trust
Investment Diversification	Low – typically allows only short-term fixed income securities	High – allows broadly diversified investment mix	High – allows broadly diversified investment mix	High – allows broadly diversified investment mix
Revenue Source	Current Revenue Reserves Special Tax	General Fund Revenue Investment Income Special Tax Employee Contribution	General Fund Revenue Investment Income Special Tax Employee Contribution	General Fund Revenue Investment Income Special Tax Employee Contribution
Administrative Complexity	Low – no separate trust fund established	Low/Moderate – account established within the existing pension trust. 401(h) assets may be invested with pension assets but must be accounted for separately	High - requires initial IRS approval. However, governments are generally exempt from annual filings of Form 990 (unless there is unrelated business income)	Moderate – requires establishing separate trust, but does not require IERS approval or annual IRS filings. (IRS approval recommended)
Asset Reversion	Assets are always the property of the government	Upon termination and satisfaction of all liabilities, any remaining assets are returned to the employer	Upon termination, VEBA assets may be (i) transferred to another VEBA providing similar benefits to the same group of members or (ii) distributed to VEBA members so long as highly compensated employees do not receive disproportionate benefits	Upon termination and satisfaction of all liabilities, any remaining assets are returned to the employer

Consequences of Not Addressing OPEB Liabilities

Not developing a plan to actively address OPEB liabilities may have a variety of consequences for public sector entities including:

- **Qualified Financial Statements:** The auditors will produce the basic information to comply with GASB 45 in their audited financial statements. To produce annual financial statements the auditors need to prepare not only estimates of the agencies' OPEB costs on an accrual basis, but also notes on a plan to fund the liabilities and funding progress. Lack of a plan could result in a qualified statement.
- **Lower Credit Rating:** Failure to follow GASB 45 could result in a downgrading of the public entity's credit rating.
- **Higher Borrowing Costs:** For those local governments (the County, Cities, School Districts, and Special Districts) that do not have a plan for funding their retiree benefits, their bond rating could be negatively affected, thereby increasing their borrowing costs.
- **Deferred Maintenance:** One of the easiest budget items to cut is maintenance costs. Deferred maintenance only results in higher repair costs in the future. GASB 34 requires local governments to begin reporting on infrastructure assets, such as roads, and how they are maintained.
- **Service Cutbacks:** Increasing unfunded OPEB liabilities will eventually impact some jurisdictions' ability to provide essential public services. The underlying reason for this is that escalating OPEB Pay-Go costs are the single fastest growing item in many jurisdictions' budgets.
- **Staff Reductions:** Salaries and benefits are the largest cost component of public sector employers. Escalating healthcare costs may require staff reductions.

Higher future Pay-Go costs for OPEB will eventually result in trade-offs between paying for retiree healthcare premiums versus employee layoffs, declining levels of service, deferred maintenance, and higher borrowing costs.

Definitions

Below are definitions to some of the more important terms used in this report

Post Employment Benefit - any benefit that is paid or provided after an employee has retired, but which is provided because of that service. The benefit is considered to be earned over the period of service of the individual employee.

Other Post Employment Benefits - OPEB is an acronym for Other Post Employment Benefits. Healthcare benefits constitute the vast majority of other post employment benefits. These other benefits could include medical, prescription drug, dental, vision care, hearing, life insurance, long-term care, and long-term disability benefits (not covered under a pension plan). OPEB could also include items such as swim passes and transit passes.

Defined Benefit Plan - A defined benefit plan fixes the benefits that will be received by the employees when the conditions to receive the benefits are met. For example, a pension could be calculated at 3% of highest year's salary for every year worked once an employee reaches the age of 50 and retires.

Defined Contribution Plan – A Defined Contribution Plan fixes the contribution by the employer, but the interest earned, the balance on hand, the cost of the benefit or premium, etc., are variable. As a result, how much benefits can be purchased under a defined contribution plan program cannot be guaranteed.

Normal Cost - the amount that needs to be set aside in order to fund future retiree health benefits earned in the current year. The normal cost plus a portion of the unfunded liability or "catch-up" make up the annual contribution to the plan.

Annual Required Contribution (ARC) - the actuarially determined annual amount which should be contributed to the plan. It is made up of the Normal Cost and the "catch-up." Credit is also given for any payments made directly for retiree benefits under the "pay-as-you-go" or PAYGO plan.

Net OPEB Obligation - the cumulative unfunded annual required contribution. Under PAYGO, the Net OPEB Obligation will grow and eventually turn the unrestricted net assets shown on the annual financial statements into a deficit.

PAYGO - abbreviation given to "pay-as-you-go," which has been the method used by most governmental agencies to fund retiree health benefits. Under this method the cost is recognized when the payment is made for retirees, rather than as the employee earns the benefit throughout their working career. Most governments are paying the current cost for retiree health care premiums in a given fiscal year, but are accruing a deficit with respect to future retirees.

Actuarial Accrued Liability (AAL) – The portion of the actuarial present value of benefits allocated to all periods prior to the valuation date also known as the accrued benefit.

Unfunded Actuarial Accrued Liability (UAAL) - the amount of funding that should have been set aside to pay for the retiree health benefit to date. This is also called the "catch-up" because an employer can fund the "catch-up" over a period not to exceed 30 years. This actuarially calculated amount is added to the normal cost to determine the amount which should be funded each year.

For governments that fund retiree health benefits on a pay-as-you-go basis, one hundred percent (100%) of the liability will be considered "unfunded". Unfunded liabilities, like those for the pension system will be determined by actuaries and accountants based on certain assumptions regarding 1) future healthcare costs, 2) inflation, 3) retiree age vs. mortality tables, and 4) investment returns. To the extent the funds set aside each year are insufficient to cover the projected benefit costs, the system is said to have an unfunded liability.

Actuarial Present Value – the value of all benefits estimated to be payable to plan members discounted at the assumed discount interest rate back to the valuation date.

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