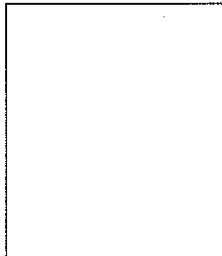


Long-Term Funding of Public Sector Retiree Health Benefits

Peter W. Saltzman



Peter Saltzman is a partner at Leonard Garder, LLP, a firm representing public and private sector labor unions. He specializes in employee benefits and represented the Amalgamated Transit Workers, Local 1555, in the 2005 negotiations with the Bay Area Rapid Transit District.

WITH THE ISSUANCE of the Governmental Accounting Standards Board (GASB) Statement No. 45 in August 2004, retiree health benefits have moved to center stage in public sector collective bargaining. GASB 45 establishes accounting standards for liabilities related to public sector health and “other post-employment benefits” (OPEB).¹ For most public sector employers, it is effective for fiscal years ending in 2008,

The 2005 negotiations between the Bay Area Rapid Transit District and Amalgamated Transit Union Local 1555 and Service Employees International Union Local 790 were among the first in the country in which the long-term funding of OPEB liabilities was addressed and resolved. Adopting a different approach, the Peralta Community College District and Peralta Federation of Teachers also have reached agreement on funding OPEB liabilities. In sharp contrast to the experience with analogous private sector accounting rules issued in 1990, these early public sector responses suggest that GASB 45 may prove to be a catalyst for progress on one of the most intractable problems in labor relations today.

The Economic Climate

It is no exaggeration to say that employee health benefits have become the scourge of collective bargaining in the private and public sectors alike. Runaway medical costs have forced union and management negotiators to expend disproportionate resources to shore up sagging health plans, precluding progress on many other pressing needs. Over the past decade, health care costs, particularly retiree health care costs, have increased by over three times the general rate of inflation.² Low Medicare reimbursement rates, uncontrolled prescription drug

costs, soaring professional fees, accelerating retirement rates, and longer expected life spans all contribute to the problem.

Employer premiums have risen even faster than the overall rate of medical inflation, as the medical industry shifts costs not paid by the Medicare and Medicaid programs. Although medical costs have abated somewhat since 2004, actuaries for the Department of Health and Human Services project national average health care costs to increase by 7.2 percent a year through 2013, with significantly higher-than-average rates in California.³ In all regions, unsurprisingly, pre-Medicare retirees are the highest-cost population.

Although public and private sector employers face the same market conditions when purchasing health care coverage for their employees, their responses to these economic pressures have been markedly different. High retiree health costs have resulted in the elimination of approximately half of all private sector retiree health benefits over the past 15 years.⁴ One of the well-known historic ironies of the Employee Retirement Income Security Act of 1976 is that it left one of the key components of retirement income security — health benefit coverage — without the vesting and funding protections afforded pension benefits. Subject to ERISA's preemptive power, but lacking these protections, retiree health benefits in the private sector have long been at risk.⁵ Political constraints and higher union density in the public sector, together with the due process and contract clauses of most state constitutions, have proved more effective than ERISA in protecting retiree health benefit promises made to employees.

One of the ostensible triggers leading to the sharp decline in private sector retiree health benefit coverage was the issuance in 1990 of Financial Accounting Standards Board (FASB) Statement No. 106, which for the first time required that liabilities for post-retirement benefits other than pensions be evaluated and reported on corporate financial statements.⁶ Actuarial valuations of retiree health liabilities

under FASB 106, as under GASB 45 14 years later, are based on the same kinds of actuarial methods and assumptions used to value pension liabilities.⁷ Surprisingly, however, OPEB liabilities typically exceed the duration of pension liabilities, due principally to the compounding effect of health care cost trends and increasing utilization at older ages. Even more than with pensions, unfunded actuarial accrued OPEB liabilities are highly sensitive to the actuarial assumptions used, as well as to (usually implicit) assumptions regarding the economic and political climate governing the private and public provision of health care.⁸

As a result of these peculiarities, valuations of retiree health liabilities have high shock value, notwithstanding the fact that neither FASB 106 nor GASB 45 can or do impose any requirement that employers prefund their health plans. In the years following the issuance of FASB 106, many non-union employers reduced or eliminated retiree health coverage altogether, claiming that the liabilities which they were required to report would keep investors away and sink stock prices. In fact, however, there were no investment downgrades related to FASB 106 in the years immediately

after it went into effect, and investment analysts have rarely, if ever, suggested that changes in investment ratings are due to OPEB liabilities.

Notwithstanding the fact that investors largely ignored FASB 106, many agencies such as BART that rely on the bond market (and thus bond ratings) to fund public works have expressed similar concerns about GASB 45. As a result, public sector bargaining parties have begun to explore long-term funding options to reduce OPEB liabilities.

The BART Negotiations

ATU Local 1555, SEIU Local 790, and BART met from March through July 2005, much of that time in negotiations

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over health benefits for active employees and retirees. In the end, they reached the following agreement on health benefits:

- to maintain all benefits for active and retired employees, including full family coverage and choice of medical plans offered through CalPERS;

- to limit employee and retiree copays alike to \$75 a month, effective January 1, 2006, with annual 3 percent increases thereafter, and, under certain conditions, permit the diversion of up to 1.627 percent of payroll that would otherwise have gone to employees' Money Purchase Plan accounts beginning in 2013;

- for BART to fully fund a Retiree Health Benefit Trust within 30 years, with trust assets exclusively and irrevocably dedicated to the provision of health benefits for BART retirees; and

- to establish a trust review committee with union participation.

I will summarize the BART negotiations under four slogans that, I believe, best explain their success.

Focus on funding solutions, not benefit reductions. At the outset of the negotiations, BART insisted that its top priority was to reduce its unfunded actuarial accrued OPEB liability, which it valued at approximately \$267 million.⁹ Initially, BART proposed to pay the full "actuarial required contribution" (ARC) each year of the contract.¹⁰ But that plan was scuttled because the district would have incurred an operating deficit of approximately \$100 million over a proposed four-year contract term. BART initially proposed, in effect, to balance this projected deficit on the backs of employees through wage freezes, 10-fold increases in employee health contributions, changes in eligibility rules for health care coverage, and other takeaways. Of course, these proposals — and the premises they were based on — were unacceptable to the unions.

It soon became clear, however, that BART negotiators were more interested in finding a long-term solution to funding OPEB liabilities than achieving any particular

benefit reductions. Recognizing this flexibility, the unions embarked on an analysis of the available funding options, retaining their own actuarial consultant to study the different funding schedules and more modest increases in employee contributions. In this manner, the parties were able to move away from fundamentally opposing views on benefit reductions to a more constructive debate on long-term funding of OPEB liabilities.

Out-of-the-gate proposals to cut benefits do not foster common ground; discussions of how to fund existing benefit programs, on the other hand — even if they ultimately result in some benefit modifications — provide a context in which both sides can find common ground and engage in productive negotiations.

Commit to the use of a dedicated trust to fund retiree health benefits. The unions insisted that an irrevocable and jointly administered trust be used as the vehicle for any long-term OPEB funding plan. Concerned that the district had largely failed to prefund retiree health benefits for the past 11 years despite a prior agreement to do so, the unions were unwilling to agree

to divert substantial bargaining capital to retiree health benefits unless the funds were secured in an irrevocable trust whose assets were exclusively dedicated for that purpose. Indeed, GASB 45 looks favorably on employers who have "irrevocably transferred assets to a trust or equivalent arrangement, in which plan assets are dedicated to providing benefits to retirees and their beneficiaries in accordance with the terms of the plan and are legally protected from creditors of the employer(s) or plan administrator."¹¹

During the course of bargaining, the unions learned that in 2004, BART already had established a Retiree Health Benefit Trust in which it placed \$33 million in "demutualization" funds to offset its retiree health liability.¹² While the trust originally was not dedicated exclusively to the provision of retiree health benefits, BART eventually agreed to amend the Declaration of Trust to do so. Further,

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although BART did not agree to permit joint administration of the trust, it did ultimately agree to union participation in a trust review committee.¹³ Without these assurances that the negotiated funding for retiree health benefits would be held in a dedicated trust open to review by the unions, agreement on long-term funding of OPEB liabilities would not have been possible.

Ensure equal access to actuarial data and work product. The unions believed that the OPEB liabilities calculated by BART's actuary may have been overstated. In order to evaluate those liabilities and the assumptions they were based on, and to study alternative funding scenarios, the unions' actuarial consultant would have to acquire access to the underlying data and run expensive computer simulations of their own. Therefore, the unions requested that BART direct its consultants at William M. Mercer to perform computer runs according to specifications submitted by the unions' consultant.

To their credit, the BART negotiators welcomed this proposal, and agreed to pay Mercer for the additional work. This unusual arrangement provided the unions with an indispensable tool in developing funding proposals, and was critical to the success of the negotiations.

Adopt a long-term, full-funding goal with short-term flexibility. Ultimately, the parties had to agree on what constituted a sound OPEB funding plan. Both separately and together, they reviewed literally dozens of 30-year cash flow projections under a variety of actuarial assumptions, showing how the trust could be expected to perform under different funding and payment scenarios.

With the assistance of their consultants, the unions argued that immediate ARC funding was neither necessary nor desirable. GASB 45 encourages some degree of prefunding but does not require the full ARC to be contributed each year. Adoption of a specific and serious funding schedule intermediate between "pay as you go" and

full ARC funding, the unions believed, would be looked upon favorably by the rating agencies, particularly in an area like health care, which is fraught with economic, political, and actuarial uncertainty. On the other hand, rating agencies may not look favorably on entities that devote too large a proportion of available funds to retiree health benefits, removing resources from wages and other essential requirements. Eventually, BART agreed with this view, although it insisted that its contributions must "ramp up" to the full ARC within an eight-year period.¹⁴

At this point, with both sides close to agreement on an appropriate funding vehicle and funding philosophy, the unions offered moderate increases in employee copays and the diversion of certain funds that otherwise would flow to their Money Purchase Plan accounts commencing in 2013. This modest increase in employee contributions enabled the actuaries to fine tune the cash flow projections to the satisfaction of all, and agreement finally was reached on the long-term funding of OPEB liabilities. As a result, the \$100 million, four-year operating deficit that had formed the basis for BART's initial

contract proposals was reduced by approximately half, enabling the parties to reach an acceptable resolution of other economic items and, ultimately, the entire contract.

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The Peralta Community College District OPEB Bond Issue

At about the same time that the BART negotiations were proceeding, a different approach to funding OPEB liabilities was jointly developed by the Peralta Community College District and the Peralta Federation of Teachers. Having evaluated their OPEB liabilities at \$153 million, the PCCD obtained judicial validation to issue a 40-year, \$153 million "OPEB bond," the first and still the only of its kind in the country. The bond was issued in December 2005 and quickly was oversubscribed. The proceeds from the bond issue were

invested through a trust dedicated exclusively to the provision of retiree benefits. Retiree health care costs are paid out of the trust; debt service on the bond is paid out of the district's general fund. The trust investments are projected to produce in excess of the combined annual retiree health payments plus debt service. After reviewing the arrangement, Standard & Poors gave the PCCD an AA rating.¹⁵

Conclusion

Although the majority of public agencies in California and other states have not yet evaluated their OPEB liabilities or addressed the funding issues raised by GASB 45, the 2005 BART negotiations and the PCCD experience suggest that collective bargaining over the long-term funding of OPEB liabilities can provide an impetus to increase the long-term stability and security of public sector retiree health benefits. *

1 Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, <http://www.gasb.org/>.

2 Centers for Medicare and Medicaid Services, *National Health Care Expenditures Projections 2003-2013*, <http://www.cms.hhs.gov/NationalHealthExpendData/>.

3 *Id.*

4 See, e.g., California Legislative Analyst's Office, *Retiree Health Care: A Growing Cost for Government* (February 2006); see TIAA-CREF Institute, *Financing Retiree Health Care* (July 2005); Mercer Human Resources Consulting, *2004 and 2005 Trends in Employer-Sponsored Health Plans*.

5 In recent years, federal courts have increased this risk in a series of decisions culminating in *Sprague v. General Motors Corp.*,

133 F.3d 388 (6th Cir. 1998). In *Sprague*, the Sixth Circuit upheld General Motors' decision to eliminate health coverage for some 84,000 retirees. The Supreme Court declined to review the case.

6 Financial Accounting Standards Board Statement No. 106, *Employers Accounting for Postretirement Benefits Other than Pension*, <http://www.fasb.org/>.

7 In certain ways, GASB 45 is more flexible than FASB 106. For example, unlike FASB No. 106, it permits retiree health accruals to be based on a level percentage of payroll, which results in lower accruals.

8 Jeffrey Petertil, *Measuring Terminable Postretirement Obligations*, Society of Actuaries (2004).

9 Using what they believed to be more realistic assumptions, the unions valued the unfunded liability at approximately \$222 million.

10 As with pension funding, actuarial funding under GASB 45 consists of a "normal cost" — the cost of current year accruals — plus amortized costs to defray past unfunded liabilities.

11 GASB Statement No. 45, par. 13(g).

12 Demutualization funds are assets derived from insurance investment policies that are converted to stock when an insurance company demutualizes. Under authority of Secs. 53620-53622 of the Government Code, local agency funds designated for the payment of employee retiree health benefits are not subject to the investment restrictions on other surplus funds, and thus BART was able to invest the assets in the trust more aggressively.

13 The unions pointed out that California Attorney General Opinion 91-205 provides that an agency and union may jointly administer a trust established under Sec. 53206 of the Government Code, but BART and its attorneys were not willing to agree to do so.

14 It is interesting to note that the specific funding model adopted by the parties (30 year full funding with an initial ramp-up) has begun to attract the attention of other public sector entities and their advisors. See, e.g., LAO Report, *supra* fn. 4 ("we recommend that the state ramp up to an increased level of contributions over a period of several years. The near-term target should be the state's normal cost level under GASB 45.")

15 As with the BART model (cf. fn. 14), other entities are now looking at the PCCD bond issue with interest.

