



High-Risk Update—Other Postemployment Benefits:

Significant Financial Risk Exists if the State Does Not Actively
Manage the Costs of State Retirees' Health and Dental Benefits

April 2009 Letter Report 2008-607



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Elaine M. Howle
State Auditor
Doug Cordiner
Chief Deputy

CALIFORNIA STATE AUDITOR

Bureau of State Audits

555 Capitol Mall, Suite 300

Sacramento, CA 95814

916.445.0255

916.327.0019 fax

www.bsa.ca.gov

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2008-607

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

This letter report presents a review conducted by the Bureau of State Audits (bureau) concerning the State's efforts to manage the financial risks associated with the costs of *other postemployment benefits*—or benefits in addition to pensions. Commonly referred to as OPEB, other postemployment benefits encompass primarily medical and dental insurance provided to retired state employees. This review follows up on the discussion of these risks in our May 2007 report titled *High Risk: The California State Auditor's Initial Assessment of High-Risk Issues the State and Select State Agencies Face* (2006-601).

New accounting rules that the State must follow have spotlighted the cost of medical and dental benefits for retired state employees. Under the new accounting rules, beginning in fiscal year 2007–08, the State must have an actuary estimate the amount the State needs to pay each year for health insurance premiums for retirees, as well as the amount it would need to set aside now to fund benefits it is obligated to pay in the future. In addition, the new accounting rules require the State to record the difference between the actuary's yearly estimate—known as the annual required contribution—and the amount of the State's cash payments as a liability in the State's financial statements. According to the State's most recent actuarial study, its total estimated OPEB liability for retirees was \$48 billion. In today's dollars this amount represents the cost of retiree OPEB that state employees have already earned.

Historically, state and local governments have treated the future costs of retirees' health and other nonpension benefits differently from the future costs of pensions. Most governments usually prefund the future costs of pensions—that is, most state and local governments have established dedicated trust funds in which they deposit money to finance the anticipated costs of pensions for current and past employees. The State contributes to these pension trust funds to fully or partially cover the amount needed to pay for current and past employees' *pension costs*. In contrast, the State and many other governments have not chosen historically to prefund OPEB costs through deposits to a trust fund. Rather, the State appropriates only enough money in its annual budget to pay the yearly premiums for retiree health (medical and dental) insurance. Known as *pay as you go*, this method of funding OPEB costs addresses only the current year's costs and does not set aside funds to cover any future costs to the State. For example, in fiscal year 2007–08, the State paid only \$1.25 billion of the \$3.59 billion annual required contribution for OPEB costs. Consequently, the State recorded an OPEB liability of \$2.34 billion in its financial statements. Further, the State expects to only pay \$1.36 billion of the \$3.72 billion required contribution for fiscal year 2008–09, which is projected to increase the State's

OPEB liability to \$4.71 billion. At that rate of growth, the OPEB liability reported by the State could likely begin to overshadow other liabilities in the State's financial statements and affect the State's credit rating.

OPEB will continue to be a high-risk area for the State as long as it continues to use the pay-as-you-go method of funding these costs. However, the State could reduce its short-term and long-term OPEB costs by beginning to set aside some money to fund these costs. The interest that could be earned from these funds could be used to help pay for OPEB costs. Specifically, any interest earned from these funds would lower the State's annual required contribution and its total estimated OPEB liability, depending on how much money the State sets aside. For example, if the State committed to pay the full amount of the annual required contribution for fiscal year 2008–09, and subsequent fiscal years, it would have reduced its cost by an estimated \$1.04 billion in that fiscal year. In addition, the State would achieve similar annual savings in future years, which would reduce its total estimated OPEB liability by about \$17.05 billion. Even partially prefunding these costs would also result in significant savings.

In fact, investing money now to help pay for OPEB is one of the main recommendations of the governor's Public Employee Post-Employment Benefits Commission (commission). Although the governor publicly endorsed the commission's recommendations, the Legislature has yet to earmark any funds to be set aside for OPEB in the fiscal year 2009–10 budget. The governor and Legislature will continue considering OPEB funding and other budgetary issues for fiscal year 2009–10 as part of the May revision of the budget. As a result, it remains unclear whether the State will begin prefunding OPEB obligations and how the State will manage the risks associated with its large and growing OPEB liability.

Background

Legislation that became effective in January 2005 authorizes the bureau to develop a risk assessment process for the State and to identify, audit, and issue status reports for high-risk areas. The bureau's May 2007 report identified *other postemployment benefits*—or benefits in addition to pensions—as a statewide high-risk area because of the increasing cost to the State of providing these benefits to retired state employees. Commonly referred to as OPEB, other postemployment benefits encompass medical and dental insurance primarily. Additionally, our report indicated that on an actuarial basis as of June 30, 2007, California's total OPEB liability was estimated to be \$48 billion.

Furthermore, the report highlighted that the State faces risk in at least two areas: Providing the level of benefits promised to its employees and at the same time protecting its credit rating. Reporting OPEB information in accordance with the Governmental Accounting Standards Board's (GASB) requirements will, among other things, provide readers of financial statements with information useful in assessing potential demands on the State's future cash flows.¹ Bond-rating agencies have already made it clear that they will look with disfavor on governments that do not sufficiently plan for managing such liabilities. To protect its credit rating and ensure that it can borrow at the lowest available interest rates, the State will need to demonstrate that it is adequately managing the long-term costs of its OPEB. This letter report assesses the State's progress in managing this liability.

Overview of the State's Other Postemployment Benefits for Retirees

New accounting rules issued by GASB spotlighted the cost of medical and dental benefits for retired state employees. In exchange for their services, state employees receive compensation in various forms. In addition to the salaries and benefits that employees receive, they also earn benefits that they will not receive until after their employment with the State ends. The most recognized type of these postemployment benefits is a pension. In addition, the State, like many other government employers, provides retired employees with OPEB, or health (medical and prescription drug) and dental benefits.² The State generally pays 100 percent of the health insurance costs for retirees and 90 percent of the additional insurance premiums for retirees' family members. In addition, the State generally pays all or a portion of retirees' dental insurance costs, depending on the retirees' years of state service at retirement. As of June 30, 2008, approximately 138,300 retirees were receiving health benefits, and 112,600 retirees were receiving dental benefits.

For financial reporting purposes, The University of California and 58 county superior courts (trial courts) are considered separate employers. As separate employers, these entities determine their own benefits, benefit levels, and funding policies. The benefit plans for the University of California and the trial courts currently cover about 32,900 and 2,700 retirees, respectively. Because these entities have separate actuarial surveys to determine their OPEB costs, we have generally excluded them from our analysis. In addition, most California cities, counties, and other local governmental

¹ GASB is the entity that establishes accounting standards that governments must follow when providing audited financial statements.

² The State also offers life insurance, long-term care, and vision benefits to retirees; however, because these benefits are completely paid for by retirees, there is no OPEB liability to the State.

entities have OPEB liabilities. However, the State is not directly responsible for these entities' OPEB liabilities, so we omitted them from most of our analyses.

Accounting for OPEB Costs Has Been Different Than Accounting for Pensions

Historically, state and local governments have treated the future costs of retirees' health and other nonpension benefits differently from the future costs of pensions. Most governments usually prefund the future costs of pensions—that is, most state and local governments have established dedicated trust funds in which they deposit money to finance the anticipated costs of pensions for current and past employees. The State contributes to these pension trust funds to fully or partially cover the amount needed to pay for current and past employees' *pension costs*.³ Various actuaries prepare periodic reports indicating the amount of money the State needs to deposit into pension trust funds each year to meet both current and future pension costs. In addition, the amount that each trust fund pays for current retirees each year appears on fund records as a reduction of assets in the trust fund's financial statements. Moreover, to comply with generally accepted accounting principles, the State must also calculate and then disclose in its annual financial statements an estimate of the future costs of employee pension benefits.

In contrast, the State and many other governments have not chosen historically to prefund OPEB costs through deposits to a trust fund. Rather, the State appropriates only enough money in its annual budget to pay the yearly premiums for retiree health (medical and dental) insurance. Known as *pay as you go*, this method of funding OPEB costs addresses only the current year's costs and does not set aside funds to cover any future costs to the State. One of the main reasons for the difference in the treatment of pension costs and OPEB costs is that GASB has not previously required state and local governments to calculate and report the future cost of the retiree benefits beyond pensions that the governments promised to current and past employees. Pensions generally provide retirees with fixed benefits, and actuaries use formulas that include such factors as the inflation rate, investment returns, and retiree life span to calculate total pension costs. Therefore, these formulas can reasonably predict how much the State needs to set aside each year to fund future pension costs. However, retirees' health insurance costs have typically grown faster than inflation, making the future costs more difficult to predict.

³ Most current state employees participating in the California Public Employees' Retirement System also make contributions toward their pension benefits during each pay period.

The State Must Now Estimate and Disclose Future OPEB Costs

Titled *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, GASB Statement No. 45 (GASB 45) required the State to begin recognizing in its financial statements for fiscal year 2007–08 the current and future cost of state retirees' health benefits. For previous fiscal years, GASB had required governments to provide basic information about their OPEB plans and the amount of benefits paid in a particular fiscal year. The GASB's new reporting requirements for OPEB costs are now similar to those for pensions. Specifically, it requires that state and local governments move from a cash basis method of accounting for OPEB costs to one that recognizes both the current and future cost of these benefits. In other words, instead of simply showing the amount that the State is paying for current retirees' medical insurance each year, the State must now estimate and show the total amount that it will owe to all of its employees—both current and past—when they retire. The State must also report the extent to which it is funding this amount. This new requirement applies only to the way in which OPEB costs are accounted for—that is, how each government's financial statements show the costs. The new requirement does not mandate that the government pay for these costs, nor does it require governments to set aside money to fund these future payments. However, the requirement to disclose the full extent of these costs has highlighted the existence of a large liability facing the State that will continue to grow unless the State begins to prefund OPEB costs.

Because the State needs to calculate its total OPEB amount owed and the amount that it would need to pay each year to fully fund this liability—the annual required contribution—GASB now requires the State to have an actuarial study performed at least every two years. See the text box for definitions of key terms related to OPEB.

According to its second and most recent actuarial study, as of June 30, 2008, the State's total estimated OPEB liability was \$48.22 billion. In today's dollars this figure represents the future cost of retiree health benefits that state employees have

Definition of Key Terms Related to Other Postemployment Benefits

Annual required contribution—An amount actuarially determined in accordance with the parameters of Governmental Accounting Standards Board Statement No. 45 (GASB 45). This contribution represents a level of funding that, if paid on an ongoing basis, is projected to cover the cost of benefits earned during the current year and a portion of the cost for benefits earned in prior years.

Employer contributions—The payments an employer makes (1) directly to or on behalf of a retiree or beneficiary, (2) to insurers for medical insurance premiums, or (3) to a trust (or equivalent arrangement), which is dedicated to providing benefits to retirees and is legally protected from creditors of the employer and plan administrator.

Annual other postemployment benefits (OPEB) expense—The annual required contribution plus (1) one year's interest on any existing OPEB liability at the beginning of the year and (2) an actuarial adjustment for past contribution excesses or deficiencies.

Recognized OPEB liability—The liability that the employer reports in its financial statements is the annual OPEB expense less the employer's contributions plus any existing OPEB liability at the beginning of the year. It is also known as the *net OPEB obligation*.

Total estimated OPEB liability—The future cost in today's dollars (or present value) of retiree health benefits attributable to employee benefits previously earned, also known as the *actuarial accrued liability*.

Total unfunded OPEB liability—The excess of the total estimated OPEB liability over the value of any assets set aside to pay for OPEB expenses, also known as the *unfunded actuarial accrued liability*. GASB 45 does not require the employer to record this liability in its financial statements; instead this liability is gradually recognized if the employer does not fully fund the annual required contribution.

Sources: GASB Statement No. 45 Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions; Other Postemployment Benefits: A Plain-Language Summary of GASB Statements No. 43 and No. 45; and State of California Retiree Health Benefits Program: GASB Nos. 43 and 45 Actuarial Valuation Report As of June 30, 2008 (dated September 15, 2008).

already earned. Because the State has not established a trust or set aside any money to pay for these benefits, this entire liability is currently unfunded. GASB does not require that the State show this entire unfunded amount as a liability in its financial statements. Instead, the State is allowed to recognize a portion of this liability each year, over a period of up to 30 years. The State includes this annual portion, along with amounts to cover the costs of benefits earned during the current year, in the calculation of its annual required contribution. Essentially, the annual required contribution is the amount that the State would need to contribute each year to fully fund the estimated benefits that state employees have earned but that the State will not pay until sometime in the future. According to GASB, as long as an employer sets aside funds each year that are sufficient to cover the annual required contribution, the employer does not need to record a liability in its financial statements.

However, in fiscal year 2007–08, the State paid only \$1.25 billion toward the annual required contribution of \$3.59 billion. Therefore, it reported in its financial statements a \$2.34 billion liability for future OPEB costs as of June 30, 2008. This underfunding occurred because the State was using the pay-as-you-go funding approach and paying only for current retirees' medical and dental insurance premiums as they occurred.

For fiscal year 2008–09, the State's annual required contribution is \$3.72 billion, of which the State expects to pay \$1.36 billion for the current cost of retirees' medical and dental insurance premiums under the pay-as-you-go funding method. Table 1 lists the components of the calculation of the projected OPEB liability for fiscal year 2008–09, which is a projection based on the actuarial report since fiscal year 2008–09 has not yet ended. Because the State did not pay enough of its annual required contribution in fiscal year 2007–08, it must include interest on the \$2.34 billion liability from that year, as well as an actuarial adjustment, in its calculation of the annual OPEB expense for fiscal year 2008–09. Based on this calculation, the full OPEB expense for fiscal year 2008–09 will be \$3.73 billion. However, because the State expects to pay only \$1.36 billion, it projects that its liability in the current year will increase by \$2.37 billion. The State must add this increase to the \$2.34 billion liability recognized in fiscal year 2007–08, for a total recognized OPEB liability of \$4.71 billion that the State will need to disclose in its financial statements for the fiscal year ending June 30, 2009.

Table 1
Projected Calculation of the State's Liability for Other
Postemployment Benefits
Fiscal Year 2008–09
(In Thousands)

	AMOUNT
Annual required contribution	\$3,715,201
Interest and actuarial adjustments*	12,810
Annual Other Postemployment Benefits (OPEB) Expense	\$3,728,011
Expected employer cash payments	(1,360,672)
Increase in Projected Liability	\$2,367,339
Recognized OPEB Liability—July 1, 2008	\$2,340,886
Projected OPEB Liability—June 30, 2009	\$4,708,225

Source: *State of California Retiree Health Benefits Program: GASB Nos. 43 and 45 Actuarial Valuation Report As of June 30, 2008* (dated September 15, 2008).

Notes: This table does not include the University of California or the trial courts.

Because fiscal year 2008–09 has not yet ended and because the State's actual contributions for this fiscal year are currently unknown, this calculation is a projection based on the actuarial report.

* This amount is the net of interest on the July 1, 2008, OPEB liability and an actuarial adjustment resulting from the fiscal year 2007–08 contribution deficiency.

Significant Financial Risks Exist if Governments Do Not Actively Manage OPEB Liabilities

OPEB will continue to be a high-risk area for many governments as long as they continue to use the pay-as-you-go method of funding OPEB costs without setting aside additional funds or taking other actions to address OPEB liabilities. In future years, the OPEB liability reported by the State, if the State has not substantially funded those costs, could grow so rapidly that it could begin to overshadow other liabilities on its financial statements and affect the State's credit rating. In fact, in its April 2009 official statement for general obligation bonds, the State acknowledged, "The long-term costs for other post-employment benefits may negatively affect the state's financial reports and impact its credit rating if the State does not adequately manage such costs." A weaker credit rating could compound the State's budget problems by increasing the costs of borrowing money when it issues bonds. As previously described, the projected \$4.71 billion liability for fiscal year 2008–09 is about double the \$2.34 billion liability as of June 30, 2008. In addition, the initial OPEB liability of \$2.34 billion represented 1.6 percent of the State's total liabilities of \$147.8 billion as reported in its financial statements for fiscal year 2007–08. If total liabilities remained the same, this percentage could increase to 3.2 percent in the State's fiscal year 2008–09 financial statements as the reported OPEB liability grows from \$2.34 billion to \$4.71 billion. Furthermore,

according to the State's second actuarial survey, its total unfunded OPEB liability grew to \$48.22 billion as of June 30, 2008, which is an increase of approximately \$340 million from the \$47.88 billion estimated in May 2007 in its first actuarial survey. If the State continues to use its pay-as-you-go funding method, the State's second actuarial study concludes that "the annual OPEB costs could range from three to five times the pay-as-you-go costs and the balance sheet liability could grow exponentially."

A majority of other public agencies within California face the same risks that exist at the state level according to data compiled by the commission. In December 2006 the governor created the commission to report on how the State and California's local governments were addressing their OPEB liabilities. Released in January 2008, the commission's report included the results of a survey that took place in May and June 2007 at public agencies throughout California in part to identify the agencies' practices for addressing OPEB liabilities. In addition to evaluating the State and the University of California, the commission surveyed cities, counties, special districts, school districts, and community college districts. With the exception of trial courts, which the commission's report did not include, almost 1,200 entities responded. Survey respondents included all counties and more than two-thirds of California's cities, special districts, school districts, and community colleges as measured by their total revenues. As Table 2 shows, approximately 78 percent of the survey respondents reported that they are using the pay-as-you-go method of funding OPEB, while only 22 percent partially or fully prefund their OPEB obligations.

In addition, as Table 2 indicates, these public agencies reported a combined unfunded OPEB liability of more than \$71 billion according to their most recent actuarial valuations at the time of the survey. Moreover, the commission's report acknowledged that the combined OPEB liability is probably understated because only 37 percent of the agencies that reported offering OPEB also included data on their OPEB liability. The commission indicated that this low response rate most likely reflected the fact that at the time of the survey, many agencies were still in the process of complying with the new OPEB accounting standards and may not have released their actuarial valuations publicly.

Table 2
The Funding Policies and Total Unfunded Liability for the Other Postemployment Benefits of Public Entities in California

	CALIFORNIA GOVERNMENTAL ENTITIES			FUNDING POLICIES		TOTAL UNFUNDED LIABILITY FOR OTHER POST-EMPLOYMENT BENEFITS (IN BILLIONS)
	TOTAL CONTACTED FOR SURVEY	TOTAL RESPONDED TO SURVEY	PERCENTAGE RESPONDING	PERCENTAGE USING PAY-AS-YOU-GO METHOD	PERCENTAGE USING PARTIAL OR FULL FUNDING	
Counties	58	58	100%	77%	23%	\$28.0
School districts	1,036	475	46	79	21	15.9
University of California	1	1	100	100	0	11.5
Cities	478	231	48	80	20	8.8
Special districts	2,052	374	18	78	22	3.5
Community colleges	72	39	54	51	49	2.5
Trial courts*	–	–	–	–	–	1.3
Totals	3,697	1,178	32%	78%	22%	\$71.5[†]

Source: *Funding Pensions & Retiree Health Care for Public Employees: A Report of the Public Employee Post-Employment Benefits Commission* (commission).

* We obtained trial court data from separate actuarial surveys dated July 1, 2007, because the commission's survey did not include trial courts. As a result, we include only the total unfunded liability for trial courts. However, those trial courts that offer other postemployment benefits (OPEB) use the pay-as-you-go method.

† As noted on page 8, because many agencies were still in the process of complying with Governmental Accounting Standards Board requirements at the time of the commission's survey, only 37 percent of the agencies that reported offering OPEB also included data on their OPEB liability. Consequently, this amount is understated.

Like California, most other states use the pay-as-you-go method to fund OPEB and thus underfund their OPEB liability. According to a report released in December 2007 by the Pew Charitable Trusts' Center on the States (Pew Center), only six states (Arizona, Ohio, Oregon, North Dakota, Utah, and Wisconsin) had a policy of fully funding their annual required contribution, and only three states (Wisconsin, Arizona, and Alaska) had funded more than 50 percent of their total estimated OPEB liability. Since the report's publication, some states have begun to move toward partial or full funding of OPEB. However, states like California that continue to allow their OPEB liability to grow unchecked may see negative effects on their credit ratings.

Prefunding OPEB Could Result in Potentially Significant Savings

The State has three basic options for funding its estimated OPEB liability: the current pay-as-you-go method, partial-funding method, or full-funding method. Table 3 on the following page shows the advantages and disadvantages of each funding method. The pay-as-you-go approach, which the State currently uses, means that it pays only for medical and dental insurance for employees already retired when the insurance premiums are due. The pay-as-you-go method requires the smallest annual employer cash payment of the three funding methods—a situation that benefits the

State's short-term cash-flow situation. However, the approach also results in the largest annual OPEB expense and the fastest-growing OPEB liability recognized in the State's financial statements because the State is not setting aside any funds to pay for retirees' future health benefits. The partial-funding method entails setting aside some cash reserves each year to pay for future OPEB costs in addition to paying for the medical and dental premiums of employees already retired. Under this funding approach, the annual cash payment that an employer makes is less than the required contribution, and this circumstance means that the OPEB liability reported in the employer's financial statements will continue to grow; however, the liability will grow at a slower rate than under the pay-as-you-go method. As Table 3 shows, the full-funding method requires the largest cash payment by the employer, and it means that the employer is making the full amount of the annual required contribution every year and therefore does not need to recognize an OPEB liability in its financial statements as long as the employer has always fully funded OPEB. Moreover, the full-funding method results in the lowest annual OPEB expense, as compared to the pay-as-you-go or partial-funding approaches.

Table 3
Advantages and Disadvantages of Different Methods of Funding Other Postemployment Benefits

APPROACH	EMPLOYER CONTRIBUTIONS	ANNUAL OTHER POSTEMPLOYMENT BENEFITS (OPEB) EXPENSE	RECOGNIZED OPEB (FINANCIAL STATEMENT) LIABILITY
Pay-as-you-go	Smallest cash payment amount (only actual health and dental premiums for retired employees). Improves short-term cash-flow situation.	Largest annual OPEB expense reported in the financial statements and highest long-term cost.	Largest and fastest-growing liability reported in the financial statements.
Partial-funding	Cash payment of more than the actual health and dental premiums for retired employees but less than the full actuarially required amount. Allows plan assets to start accumulating for future benefits, but it may reduce short-term cash flows.	Annual OPEB expense between that of the pay-as-you-go and the full-funding approach.	Smaller and slower-growing liability than the pay-as-you-go funding method, but larger than the full-funding approach.
Full-funding	Largest cash payment required (full actuarially required amount). Negatively affects short-term cash flows.	Smallest annual OPEB expense reported in the financial statements and lowest long-term cost.	No liability reported in the financial statements if fully funded from the year of implementation of Governmental Accounting Standards Board (GASB) Statement No. 45.

Source: *State of California Retiree Health Benefits Program: GASB Nos. 43 and 45 Actuarial Valuation Report As of June 30, 2008* (dated September 15, 2008).

Partial or full funding of OPEB results in lower costs and liabilities than does pay-as-you-go funding because the partial- or full-funding methods allow the employer to use a higher assumed rate of return in its actuarial calculations. The assumed rate of return is a primary variable influencing the calculation of the

annual required contribution and total OPEB liability, and actuaries determine this rate using a long-term perspective. The State's second actuarial study from September 2008 explains this process:

The interest discount rate is based on the assets available to pay benefits. Plan sponsors that finance benefits on a pay-as-you-go basis typically pay retiree health care benefits from the general fund. Because an employer's general fund is primarily invested in short-term securities, a low investment return assumption, such as four percent to five percent, is typically used to develop the present value of future benefits. However, plan sponsors that fully-fund retiree health care benefits in a separate trust may be able to construct a diversified investment portfolio that generates much higher returns such as seven percent to eight percent. Using a higher discount rate such as eight percent will produce a lower [annual required contribution] when compared to a discount rate of four percent. Also, as assets in the trust accumulate, investment income will also grow thus lowering the overall costs to the employer.

Table 4 on the following page provides a practical illustration from the State's second actuarial study that shows how the State's funding policy affects the assumed rate of return and, by extension, the annual required contribution and the recognized OPEB liability for fiscal year 2008–09. Although prefunding has clear advantages, the budget crisis precipitated by the economic downturn has led to a shortfall in revenues for the State, and this shortfall has created cash-flow difficulties and made the State's ability to fully fund OPEB less feasible in light of competing fiscal priorities and limited resources.

As Table 4 on the following page indicates, if the State were to commit to fully funding OPEB in fiscal year 2008–09 and in future years, it would save an estimated \$1.04 billion by reducing the State's annual required contribution in that fiscal year. It would achieve similar savings in subsequent fiscal years, which would lower by about \$17.05 billion the total estimated OPEB liability. Even by committing to partially prefunding OPEB at 50 percent, as shown in Table 4, the State would save an estimated \$630 million by reducing the annual required contribution that fiscal year and, over time, would lower by about \$9.92 billion the total estimated OPEB liability. Thus, in both the short term and long term, prefunding would provide significant savings to the State.

A comparison of the funding methods used by the city of Los Angeles (Los Angeles) and the city and county of San Francisco (San Francisco), using information from the commission's report, further illustrates the benefits of prefunding. Table 5 on page 13 provides this comparison. Although these public entities differ in the

Table 4
Comparison of the Effects on Liabilities of California's Contributing Different Levels of Cash Payments for Other Postemployment Benefits
Fiscal Year 2008–09
(Dollars in Billions)

	FUNDING METHOD		
	PAY-AS-YOU-GO FUNDING POLICY	PARTIAL-FUNDING POLICY (50 PERCENT)	FULL-FUNDING POLICY (100 PERCENT)
Assumed rate of return on investments*	4.50% [†]	6.125%	7.75%
Total Estimated Liability for Other Postemployment Benefits (OPEB) as of June 30, 2008	\$48.22	\$38.30	\$31.17
Savings over pay-as-you-go funding policy	-	9.92	17.05
Annual Required Contribution	\$3.72	\$3.09	\$2.68
Savings over pay-as-you-go funding policy	-	0.63	1.04
Expected Employer Cash Payments	\$1.36	\$2.02	\$2.68
Projected OPEB Liability for Fiscal Year 2008–09	\$4.71	\$3.44	\$2.39[‡]

Source: *State of California Retiree Health Benefits Program: GASB Nos. 43 and 45 Actuarial Valuation Report As of June 30, 2008* (dated September 15, 2008).

Note: The University of California and trial courts had separate actuarial studies performed so the amounts in this table excluded these public entities.

* Governmental Accounting Standards Board Statement No. 45 requires that employers use the long-term assumed rate of return on the investments that employers expect to use to pay OPEB benefits as they come due.

[†] Although the actuarial study based this 4.5 percent for the State's pooled money investment account on a long-term perspective, the actual rate of return on these underlying investments will vary and was only 1.8 percent in March 2009.

[‡] Under the full-funding policy, this amount is any previously recognized OPEB liability for prior fiscal years (in this case, only fiscal year 2007–08), with interest and actuarial adjustments.

exact benefits and plans they offer to their retirees, the entities are similar in terms of revenue and the total number of active and retired employees that they reported in response to the commission's survey. An important distinction between their plans is that Los Angeles requires an employee to reach a minimum age of 55 and to have 10 years of service before an individual can receive health benefits, and it bases its contribution on the employee's years of service. San Francisco provides retired employees with health benefits at a minimum age of 50 if the employees retire with five or more years of service. This distinction is significant and could, by itself, result in a higher OPEB liability for San Francisco. However, the approaches that both public entities use to fund future OPEB costs also affect OPEB expenses and liabilities.

Los Angeles fully prefunds the estimated OPEB liability for the retirees of its largest retirement system, while San Francisco uses a pay-as-you-go funding policy. As previously discussed, a

prefunded plan can use a relatively higher assumed rate of return than can a plan using the pay-as-you-go method. As a result, Los Angeles used an 8 percent rate of return in its actuarial study, while San Francisco used a 4.5 percent rate. Further, San Francisco's annual OPEB expense and total estimated OPEB liability were \$409 million and \$4.04 billion, respectively, while the same amounts for Los Angeles's were only \$109 million and \$585 million. Los Angeles's much smaller annual OPEB expense and total estimated OPEB liability illustrate the benefits of a full-funding policy.

Table 5
Comparison of Similar Entities' Use of Different Methods to Fund Their Retirees' Other Postemployment Benefits
 (Dollars in Millions)

	CITY OF LOS ANGELES*	CITY AND COUNTY OF SAN FRANCISCO†
Similar Characteristics		
Total number of active and retired employees	45,011	49,359
Total revenues	\$5,300	\$5,700
Policy Choices		
Other postemployment benefits (OPEB) funding method	Full-funding	Pay-as-you-go
Benefit vesting policy	Minimum age of 55 and 10 years of service	Minimum age of 50 and 5 years of service
Impact on OPEB		
Assumed rate of return on investments	8.0%	4.5%
Annual OPEB expense	\$109	\$409
Total estimated OPEB liability	\$585	\$4,036

Sources: *Funding Pensions & Retiree Health Care for Public Employees: A Report of the Public Employee Post-Employment Benefits Commission*, and Los Angeles's and San Francisco's consolidated annual financial reports for fiscal year 2007–08.

* Los Angeles City Employees' Postemployment Healthcare Plan.

† San Francisco Health Services System.

The State Is Exploring Prefunding Options, but It Has Yet to Set Aside Any Funds

For all of the reasons discussed previously, one of the commission's key recommendations is that the State establish prefunding of OPEB as a policy and budget priority. The governor endorsed the commission's recommendations in May 2008. The governor directed the Department of Finance (Finance) and the Department of Personnel Administration (Personnel) to research options

that would allow the State to begin prefunding OPEB obligations without raising taxes or using General Fund money. Finance and Personnel's complete analysis of these options was not publicly available at the time of our report. However, in its April 2009 general obligation bond official statement, the State indicates the two agencies have identified four general approaches: (1) use lower-cost health-plan options, (2) direct contributions to an OPEB trust fund by active employees, (3) increase the vesting period for retiree health care benefits, and (4) use incentives to promote longer careers among state employees. In response to the first option, the fiscal year 2009–10 Governor's Budget anticipates partially prefunding OPEB beginning in fiscal year 2010–11 by using savings expected from contracting for lower-cost health care coverage. According to the Governor's Budget, the savings would be about \$180 million, which the State presumably would have put into a trust fund. However, the budget initially approved by the Legislature did not incorporate this proposal. The governor and Legislature will continue considering OPEB funding and other budgetary issues following an update of revenues and expenditures from Finance as part of the May revision of the budget. As a result, it remains unclear whether the State will begin prefunding OPEB obligations and how the State will manage the risks associated with its large and growing OPEB liability.

We prepared this letter report under the authority vested in the California State Auditor by Section 8546.5 of the California Government Code.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Staff: John Baier, CPA, Audit Principal
Michael Tilden, CPA
Nick Lange, CPA, CIA

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
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