City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 12, 2010

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO #_52__: FUNDING PLAN FOR OTHER POST EMPLOYMENT BENEFITS (OPEB)

This budget memorandum is in response to Councilman Krupicka's questions about the funding of Other Post Employment Benefits (OPEB), which include health and life insurance benefits for Alexandria City Employee current and future retirees. This memorandum explains the accounting and bond rating agency issues involved in formulating an OPEB funding plan. It describes the previous funding plan and the new funding plan proposed with the FY 2011 budget and the reasons for those changes. Lastly, it explains the proposed OPEB funding plan in full detail.

Separately, in Budget Memo #52, we are offering possible budget reductions. If a Council member wishes to offer an add to adjust funding for OPEB upward, we would suggest choosing from those reductions as the offsetting delete.

Background: In 2004 the Government Accounting Standards Board (GASB) issued Statement No. 45 that requires local and state governmental entities to measure and report the liabilities associated with OPEB such as health and life insurance benefits. (Alexandria first began disclosing OPEB information in the FY 2006 CAFR, two years before it was required by GASB.) GASB 45 requires annual accounting statements to recognize the cost of OPEB in the period when the employment services are received, provide information about the actuarial liabilities for any such promised OPEB and provide information useful in assessing future demands on cash flows to pay these benefits. (Attachment 1 provides some questions and answers prepared by GASB about Statement No. 45.)

To some extent, the bond rating agencies were already assessing these liabilities and their potential impact on local government finances before GASB 45 information was included in annual financial statements. However, the nature and extent of the information available was greatly increased by GASB 45, and the linkage is now made more explicit by the bond rating agencies between the bond ratings given and the size of OPEB liabilities, as well as the local government's long term plan to provide funding for those liabilities.

The proposed lengthening of the OPEB funding plan is one that is within the range of options that the bond rating agencies would consider prudent and reasonable.

1. The City's OPEB liability is not considered large for a City of our budget size and credit rating.
2. The City has taken actions on the benefit side to limit and to reduce the liability (not raising the maximum health insurance subsidy and eliminating retiree life insurance for new hires).
3. Many cities and counties (most non-AAA rated) have not started funding the OPEB liabilities, or have not devised a specific funding plan.

The proposed plan is designed to accomplish several objectives:

1. Gradually reach a point where 100% of the Annual Required Contribution is being funded from the combination of all these sources. This plan accomplishes that goal by FY 2018. We believe such a plan will satisfy both GASB guidelines and bond rating agencies. The previous plan would have reached that goal sooner.
2. Limit the pace of drawing down the General Fund balance by $6.5 million to pay the OPEB trust fund. This will help the City can maintain its financial guideline level of a minimum of 10% of the General Fund balance as an unreserved fund balance. The new plan has the transfer of $6.5 million completed by the end of FY 2014. The previous plan had the transfer of funds completed by the end of FY 2012.
3. Limit the fiscal year impact to the FY 2011 General Fund budget to $1.7 million. Otherwise, an additional $1.0 million of reductions in the operating budget or an increase of $1.0 million in revenues will have to be identified. The previous plan had a $2.7 million contribution planned.
4. Control the funding increase from the General Fund over the next several fiscal years, at a period of time when the City's financial situation will be quite difficult. The new plan proposes to reach a peak of only $2.7 million in FY 2015 and gradually decline $2.5 million by FY 2018. The previous plan reached an annual funding level of $3.8 million in FY 2013 and then declined to $2.5 million by FY 2018.

The four key comparisons between the previous plan and the new plan are shown below:

Previous OPEB Funding Plan ($ in millions)

Fiscal Year	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Cash Flow	$ 5.3	$ 6.1	$ 6.6	$ 7.1	$ 7.4	$ 7.5	$ 7.8	$ 8.1	$ 8.4
Current General Fund	**$ 2.5**	**$ 2.7**	**$ 3.0**	**$ 3.8**	**$ 3.5**	**$ 3.4**	**$ 3.1**	**$ 2.8**	**$ 2.5**
Fund Balance Draw Down	$ 3.1	$ 2.1	$ 1.3	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
% of Annual Required Contribution Funded	100%	100%	100%	100%	100%	100%	100%	100%	100%

Proposed OPEB Funding Plan ($ in millions)

Fiscal Year	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Cash Flow	$ 5.3	$ 6.1	$ 6.6	$ 7.1	$ 7.4	$ 7.5	$ 7.8	$ 8.1	$ 8.4
Current General Fund	**$ 2.5**	**$ 1.7**	**$ 1.8**	**$ 2.0**	**$ 2.4**	**$ 2.7**	**$ 2.7**	**$ 2.7**	**$ 2.5**
Fund Balance Draw Down	$ 2.8	$ 1.6	$ 1.2	$ 0.7	$ 0.2	$ -	$ -	$ -	$ -
% of Annual Required Contribution Funded	97%	86%	88%	90%	92%	94%	96%	99%	100%

The complete fiscal year 2011 budget proposes the following funding sources for the OPEB program:

Other Post Employment Benefits
FY 2011 Plan for Funding ($ in millions)

	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Medical Subsidy	$ 1.9	$ 2.5	$ 2.7	$ 3.0	$ 3.3	$ 3.3	$ 3.5	$ 3.7	$ 3.9
Reimbursement	$ 2.8	$ 3.0	$ 3.2	$ 3.3	$ 3.3	$ 3.4	$ 3.5	$ 3.6	$ 3.7
Life Insurance	$ 0.6	$ 0.6	$ 0.7	$ 0.8	$ 0.8	$ 0.8	$ 0.8	$ 0.8	$ 0.8
Total Cash Flow	$ 5.3	$ 6.1	$ 6.6	$ 7.1	$ 7.4	$ 7.5	$ 7.8	$ 8.1	$ 8.4
Current General Fund	**$ 2.5**	**$ 1.7**	**$ 1.8**	**$ 2.0**	**$ 2.4**	**$ 2.7**	**$ 2.7**	**$ 2.7**	**$ 2.5**
Fund Balance Draw Down	$ 2.8	$ 1.6	$ 1.2	$ 0.7	$ 0.2	$ -	$ -	$ -	$ -
Total Annual Contributions	$ 10.6	$ 9.4	$ 9.6	$ 9.8	$ 10.0	$ 10.2	$ 10.5	$ 10.8	$ 10.9
Required Contributions	$ 10.9	$ 10.9	$ 10.9	$ 10.9	$ 10.9	$ 10.9	$ 10.9	$ 10.9	$ 10.9
% of Annual Required Contribution Funded	97%	86%	88%	90%	92%	94%	96%	99%	100%

Definitions:

- The Total Cash Flow (the 4th line down) to fund OPEB is composed the value of the medical cross subsidy from active employees to retired employees (line 1), the required payments from retirees for health insurance premium costs in excess of

$260 a month (line 2), and the City's pay-as-you go subsidy for the cost of life insurance premiums for retirees (line 3).

- The current General Fund amount (line 5) represents an annual lump sum payment from the General Fund to the OPEB trust fund.
- The Fund Balance Draw Down (line 6) is an amount to be transferred annually from the general fund balance to the OPEB trust fund. This amount is shown as a designated fund balance in the Proposed FY 2011 budget.
- The Total Annual Contributions (line 7) is the sum of lines 4, 5 and 6.
- The Required Contributions (line 8) is the annual amount determined by an independent actuary to be required in order to meet the long term liabilities incurred to pay the benefits.
- The % of Annual Required Contribution (line 9) is line 7 divided by line 8.

Attachment: GASB Statement 45 on OPEB Accounting by Governments: A few basic questions and answers (Issued by GASB)

GASB STATEMENT 45 ON OPEB ACCOUNTING BY GOVERNMENTS
A FEW BASIC QUESTIONS AND ANSWERS

1. **Why was Statement 45 on OPEB accounting by governments necessary?**

   Statement 45 was issued to provide more complete, reliable, and decision-useful financial reporting regarding the costs and financial obligations that governments incur when they provide postemployment benefits other than pensions (OPEB) as part of the compensation for services rendered by their employees. *Postemployment healthcare benefits,* the most common form of OPEB, are a very significant financial commitment for many governments.

2. **How was OPEB accounting and financial reporting done prior to Statement 45?**

   Prior to Statement 45, governments typically followed a "pay-as-you-go" accounting approach in which the cost of benefits is not reported until after employees retire. However, this approach is not comprehensive—only revealing a limited amount of data and failing to account for costs and obligations incurred as governments receive employee services each year for which they have promised future benefit payments in exchange.

3. **What does Statement 45 accomplish?**

   - When they implement Statement 45, many governments will report, for the first time, annual OPEB cost and their unfunded actuarial accrued liabilities for past service costs. This will foster improved accountability and a better foundation for informed policy decisions about, for example, the level and types of benefits provided and potential methods of financing those benefits.

   The Standard also:

   - Results in reporting the estimated cost of the benefits as expense each year *during the years that employees are providing services* to the government and its constituents in exchange for those benefits.
   - Provides, to the diverse users of a government's financial reports, more accurate information about the *total cost of the services* that a government provides to its constituents.
   - Clarifies whether the amount a government has paid or contributed for OPEB during the report year has covered its annual OPEB cost. Generally, the more of its annual OPEB cost that a government chooses to defer, the higher will be (a) its unfunded actuarial accrued liability and (b) the cash flow demands on the government and its tax or rate payers in future years.
   - Provides better information to report users about a government's *unfunded actuarial accrued liabilities* (the difference between a government's total obligation for OPEB and any assets it has set aside for financing the benefits) and changes in the *funded status of the benefits* over time.

4. **What are the most common misconceptions about Statement 45?**

   a. **That it requires governments to fund OPEB.** Statement 45 establishes standards for *accounting and financial reporting.* How a government actually finances benefits is a policy decision made by government officials. The objective of Statement 45 is to more accurately reflect the financial effects of OPEB transactions, including the amounts paid or contributed by the government, whatever those amounts may be.

   b. **That it requires immediate reporting of a financial-statement liability for the entire unfunded actuarial accrued liability.** Statement 45 does not require immediate recognition of the unfunded actuarial accrued liability (UAAL) as a financial-statement liability. The requirements regarding the reporting of an OPEB liability on the face of the financial statements work as follows:

      - Governments may apply Statement 45 prospectively. At the beginning of the year of implementation, nearly all governments will start with zero financial-statement liability.
      - From that point forward, a government will accumulate a liability called the *net OPEB obligation*, if and to the extent its actual OPEB contributions are less than its annual OPEB cost, or expense.
      - The net OPEB obligation (not the same as the UAAL) will increase rapidly over time if, for example, a government's OPEB financing policy is pay-as-you-go, and the amounts paid for current premiums are much less than the annual OPEB cost.

      Statement 45 does, however, also require the *disclosure* of information about the *funded status* of the plan, including the UAAL, in the notes to the financial statements—and the presentation of multi-year funding progress trend information as a required supplementary schedule.

   c. **That it requires governments to report "future costs" for OPEB.** It is misleading and incorrect to describe accrual accounting for OPEB as requiring the expensing of "future costs." From an accrual accounting standpoint (the basis of accounting required for all transactions in the government-wide financial statements), the reported expenses relate entirely to transactions (exchanges of employee services for the promised future benefits) that *already have occurred.* Statement 45 requires governments to report costs and obligations incurred as a consequence of receiving employee services, for which benefits are owed in exchange. The *normal cost* component of annual expense is the portion of the present value of estimated total benefits that is attributed to services received in the current year. The annual expense also includes an amortization component representing a portion of the UAAL, which relates to past service costs. Estimated benefit costs associated with *projected future years of service* are *not reported.*