San Diego County Taxpayers Association

Targeting Waste • Promoting Efficiency

110 West C Street, Suite 714, San Diego, CA 92101

P: (619) 234-6423 • F: (619) 234-7403 • www.sdcta.org

Retiree Healthcare "101"

April 22, 2010

Public employee retirement costs have garnered increasing attention and scrutiny over the last few years, particularly in San Diego. Despite this, the discussion has mainly focused on pension benefits and has left out the other elephant in the room—other post employment benefits (OPEBs). The most common type of **OPEB** is retiree healthcare, and most cities and many public agencies in the San Diego area offer it. With Americans living longer and healthcare costs skyrocketing, providing healthcare for retirees can be costly.

Other post-employment benefit (OPEB): Benefits that are paid even after a person retires, such as retiree healthcare and life insurance.

OPEBs typically take two forms: a **defined-benefit plan** or a **defined-contribution plan**. A defined-benefit OPEB plan is one that specifies the amount of benefits employees will receive once they retire, while a defined-contribution OPEB plan only specifies how much is contributed by the employer and/or employee. It is important to note that government employees hired on or after April 1, 1986 are required to pay for Medicare coverage, regardless of whether or not they are covered under Social Security.[1]

Defined-benefit OPEB plan

Defined-benefit plans specify the amount of benefits that are to be received upon retirement.

Example: The City of Happiness offers its employees retiree dental coverage. This coverage is afforded with the City paying 100% of the premium. The City allows all employees to receive this benefit for life after they work for the City for 15 years. In this case, the level of benefit is *defined*.

Defined-contribution OPEB plan

Defined-contribution plans specify only the amount contributed by an employer and/or employees to a plan; they do not specify the level of benefits that will be awarded upon retirement.

Example: The City of Happiness offers its employees retiree vision coverage. For this coverage, the City pays $35 in year 2010. This amount is then adjusted for changes in the cost of coverage each year. In this case, the benefit level is not defined, but the contribution amount is *defined.*

Most governments choose to fund their OPEB obligations on a **pay-as-you-go** method as opposed to an **actuarially-based** method that ensures enough money is being placed into a plan to cover the employees enrolled by the time they enter retirement.[2] If governments chose to pay more than their pay-as-you-go amount, they would be **prefunding** their OPEB liabilities. An actuarial based-

---

[1] CalPERS. "Mandatory Medicare Coverage." Available from http://www.calpers.ca.gov/index.jsp?bc=/employer/program-services/federal/man-ss-medicare/man-medicare.xml. Last updated July 8, 2008. Accessed on February 25, 2010.

[2] Governmental Accounting Standards Board. "Other Post-Employment Benefits: A Plain Language Summary of GASB Statements No. 43 and No. 45." Available from http://www.gasb.org/project_pages/opeb_summary.pdf.

method typically contains two components: **normal cost** and amortization payments on **unfunded liabilities**.

Pay-as-you-go payments

Pay-as-you-go payments of OPEB liabilities refer to paying for benefits after retirement, rather than as they are earned.

Example: Joe, a hypothetical retired city administrator receives retiree healthcare from the City of Happiness. This healthcare was given to him with 100% premium coverage. The City pays a premium of $1,500 per month in 2010. Rather than setting aside money to pay for this while Joe was an active, working employee, the City decided to pay the $1,500 per month upon retirement. This means that the City is and will be bearing the burden of his retiree healthcare costs now and in the future.

Actuarial-based payments

Actuarial-based payments are payments of a sufficient amount toward OPEB liabilities today to cover future costs of retirees. This is typically referred to as the **annual required contribution** (ARC). The ARC is comprised of two components: **normal cost** (the cost of service for all active employees in the fiscal year) and a payment toward unfunded liability. **Unfunded liability** is the excess liabilities over the current actuarial value of assets within the plan. This is typically referred to as the shortfall that arises when normal cost is not paid for all employees by the time they retire. Demographic changes and investment returns, however, may also affect the level of unfunded liability. Similar to pensions, these payments are usually invested in a type of trust fund where they will earn a specified level of interest.

Example: A neighboring city, City of Jonesville, decides that they want the cost of their retired employees to be borne only during the time that the employees are actively working for the City. For this reason, they are setting aside money to pay for the employees' retiree healthcare each year until they retire. This amount was predetermined by an actuary in order to cover the cost to provide retiree healthcare upon an employee's retirement. Although the contribution amount changes each year as the cost to provide coverage changes, the City pays 18% of its payroll to provide this benefit upon retirement. This is also referred to as **prefunding OPEB liabilities.**

Governments are also able to choose between the number of employers involved in the plan. Some plans are single-employer plans wherein only one employer is involved and bears the risk. Other plans are multiple-employer plans wherein multiple governments are involved and costs can be shared in regard to benefits and administration.[3] In some instances, governments also provide retirees with the same healthcare plan enrolled by their active employees. The Governmental Accounting Standards Board (GASB) claims this may result in an **implicit rate subsidy** paid by the City as more members are enrolled in the plan and likely drive down costs for premiums.

California's Public Employees' Medical Hospital & Care Act (PEMHCA) is the legislation that governs many public agencies' health benefits. The California Public Employees' Retirement System (CalPERS) Board of Administration administers these health benefits for active and retired

[3] Cost-sharing multiple employer plans allow governments to pool risk and costs of administration as well as payment of benefits. Agent multiple employer plans do not pool costs to provide benefits but share costs of administration only.

employees. CalPERS serves as a purchaser of health benefits, and health benefits are then offered through Preferred Provider Organizations (PPOs), Health Maintenance Organizations (HMOs), and Exclusive Provider Organizations (EPOs). Although initially a State program, local public agencies can contract to provide coverage under this Act. PEMHCA outlines minimum payments as follows:

Year	PEMHCA payment per employee per month
2004	$32.20
2005	$48.40
2006	$64.60
2007	$80.80
2008	$97.00
2009	$101.00
2010	$105.00

Source: California Government Code Section 22892.

These PEMHCA rates may not express the full rate of coverage offered by the public agency in question. The employer rate is usually decided upon in collective bargaining agreements. To supplement PEMHCA rates, many public agencies provide cafeteria plans to active and retired employees. Cafeteria plans allow public employees the flexibility to receive taxable income (cash) or nontaxable benefits (such as health insurance).[4]

It is widely accepted that there are billions of dollars in current liabilities nationwide for retiree healthcare costs, however the difficulty lies in collecting and analyzing data on these liabilities, since many cities currently do not account for them in financial statements. The Governmental Accounting Standards Board adopted Statements 43 and 45 in June 2004 to require that all agencies report their OPEB current and long-term liabilities within their financial statements by Fiscal Year (FY) 2010.

The California State Controller released a statement in February 2010 that announced the State's retiree healthcare unfunded liability for Fiscal Year (FY) 2009 was $51.8 billion. Since the State did not fully (actuarially) fund its retiree healthcare obligations, this liability means that taxpayers are still footing the bill for future healthcare coverage of active employees as well as retired employees.

[4] IRS. "FAQs for government entities regarding cafeteria plans." *IRS.gov*. Available from http://www.irs.gov/govt/fslg/article/0,,id=112720,00.html#1. October 30, 2008. Accessed on February 26, 2010.