County of Santa Clara
Board of Supervisors

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April 10, 2013

To: Supervisor S. Joseph Simitian RM

From: Jeff Segol and Roger Mialocq, Management Audit Division

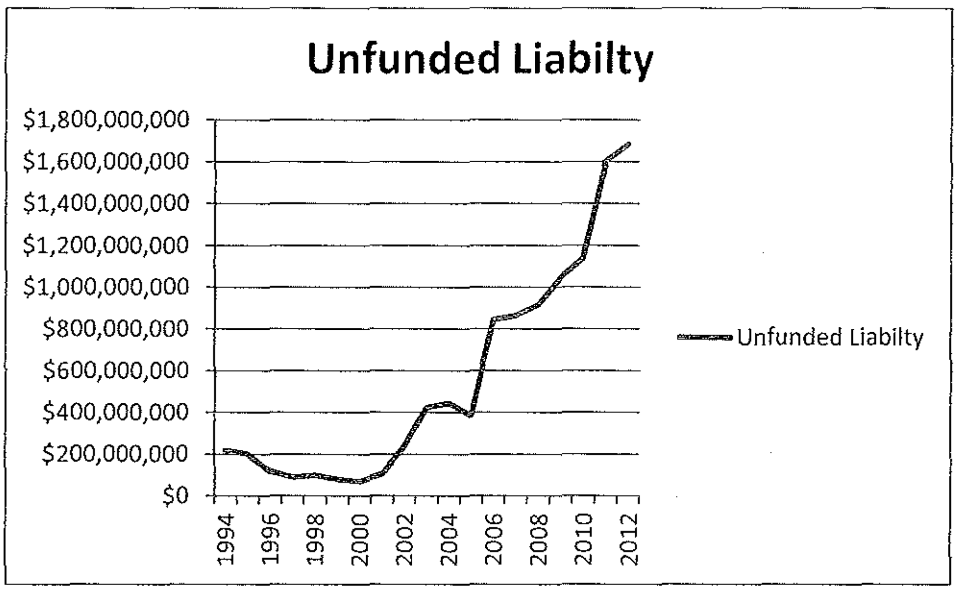
Subject: **History of Retiree Health Care Unfunded Liability and Payment Options**

Basis and History of the County's Liability

This memorandum responds to your request to provide a historical overview of the County's unfunded liability for retiree health care costs, and options for paying off the current unfunded liability over time. The County provides health care to its retirees as a benefit awarded as part of the County's collective bargaining contracts. Depending on their original hiring date, employees are eligible for health benefits as retirees upon attaining age 50, with five to 10 years of service. Retirees who retired on December 4, 1983 or earlier have their full insurance premium cost subsidized by the County, and the County meets the Part B premium cost for Medicare recipients not receiving Health-in-Lieu benefits. Retirees after December 4, 1983, receive a contribution limited to the lowest individual health care plan rate of the year in question. Retirees pay the difference between that contribution and the rate required by their enrolled plan. There is no coverage for retirees' dependents.

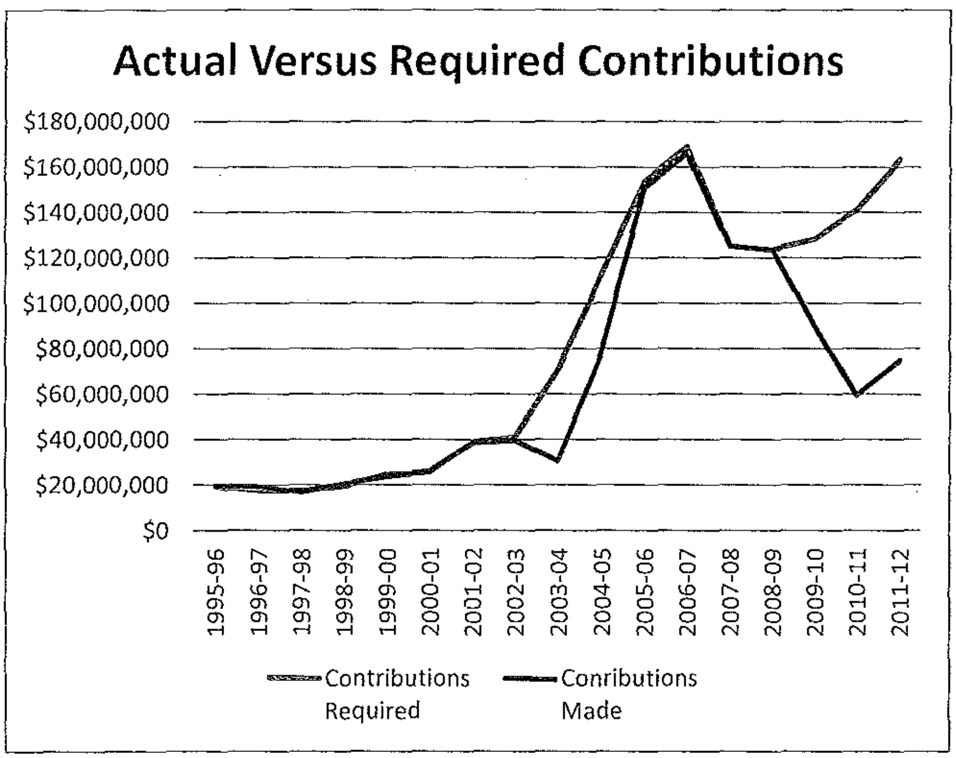
Because the decision to provide this benefit creates a financial liability for the County, the County annually obtains a report from an independent actuarial firm estimating the County's liability for the payment of future retiree health care costs at a given point in time. Current accounting standards require the County to recognize the liability in its financial statements, but not to set aside assets to pay the future cost. That is, the County could decide to simply pay each year's costs for current retirees from current revenues as they come due. However, because of the potential for future costs to overwhelm other spending priorities, and in order to pay for liabilities in the year in which they are incurred, the County has chosen to set aside such assets to pay future costs. Doing so has the additional advantage of generating investment returns that can help to pay for the ongoing liability, thereby reducing the future cost to the County when the actual expense is incurred. However, the accumulated assets at this time do not equal the estimated liabilities; consequently, the County has an unfunded liability, which is the subject of this memorandum.

<u>Unfunded Retiree Health Care Liability</u>



The chart above shows the County's unfunded liability from Fiscal Year 1993-94, which is the most distant point at which the Employee Services Agency could provide an actuarial study showing the unfunded liability, through June 30, 2012, the effective date of the most recent actuarial study. As the chart shows, the unfunded liability was relatively steady from 1994 until about 2001, when it began to spike. Between June 30, 2001 and June 30, 2003, the unfunded liability increased from about $105 million to $425 million (Attachment 1 and 2). The June 30, 2006 actuarial report indicates that several factors increased the County's liability during this period, including higher-than-expected claim costs for current claims, which affected future cost assumptions, a change in the retirement benefit formula for pensions, which was assumed to cause more employees to retire sooner than they otherwise would have. Also, the County changed its funding method for that actuarial report, from the Projected Unit Credit method to the Entry-Age Normal Cost method. The latter was the method used to value the County's regular pension benefits provided to employees.

In addition, the June 30, 2006 report followed the first of two periods during which the County did not make its full required contribution to the retiree healthcare fund. As part of its report, the actuary annually calculates the amount the County should pay to stay on track in meeting its obligations, by paying enough into the retiree health care fund to pay for the costs of future benefits earned by employees in the year just concluded, and also enough to cover the cost of benefits earned in previous years for which the County has not yet set aside sufficient monies. That payment history is shown in the chart below:



As the chart shows, through FY 2002-03, the County made the recommended contributions. It did not do so in FY 2003-04 or FY 2004-05, due to the budget difficulties caused by the economic downturn in the nation generally, and in the high-technology sector specifically, which adversely affected County revenues. Consequently, the unfunded liability grew to $844.6 million as of June 30, 2006 (Attachment 3).

Similarly, the County has not made required contributions since FY 2008-09, as a result of the Great Recession. In FY 2009-10, the County made 70.2 percent of the required contribution, in FY 2010-11, 42.2 percent, and in FY 2011-12, 46.0 percent. In each of the last two years, the County contributed enough to pay the normal cost contribution for benefits earned by employees in that year, but not enough to pay for any of the existing unfunded liability, which amounted to $1.682 billion as of June 30, 2012 (Attachment 4).

Options to Pay for the Unfunded Liability

As of June 30, 2012, the most recent date for which data is available, the County's unfunded liability for future retiree health care costs is estimated at $1,682,707,687, consisting of the following elements:

Actuarial Accrued Liability Estimated by The Segal Company:	$2,121,600,247
Actuarial Value of Assets in PERS Retiree Benefit Trust Fund (CERBT):	(264,138,560
Value of Assets Retained in Retiree Healthcare ISF (Attachment 5)	(174,754,000)
Unfunded Actuarial Accrued Liability	**$1,682,707,687**

Since 2008, the County has made payments in the California Employers' Retiree Benefit Trust Program (CERBT), which is part of the California Public Employee Retirement System (PERS). CERBT invests the funds and administers the County's retiree health care obligations, pursuant to a contract between the County and PERS. Prior to that, the County administered these obligations itself, through an internal services fund, which is a restricted trust fund pursuant to federal regulations. Monies in that fund have been used since 2008 to assist in making the County's contributions to CERBT, and the remaining assets in it are therefore restricted and can only be used for retiree healthcare purposes.

Assuming the County were to pay the unfunded liability off over 30 years, which is the generally the longest amortization period used for retirement benefits, repayment would require equal payments of $56,090,256. However, because the amount owed would be paid in installments, rather than all at once, the County would not get the full advantage of investment returns at the California Public Employee Retirement System assumed investment rate of return, currently 7.5 percent annually. Therefore, the annual contribution actually required to fund the unfunded liability is $61,687,538, or payments totaling $1,850,626,140 over 30 years.

However, because this liability relates to all County employees, only a portion of it would need to be paid for from County General Fund discretionary sources, such as property taxes. That is, a portion of the liability would be distributed to non-General Fund departments, such as the Roads and Airports Department and Parks Department, Department of Child Support Services and others, which are paid for with non-discretionary funds. Another portion would be distributed to General Fund departments that receive substantial funding from dedicated sources, such as the State and federal funding provided to the Social Services Agency for welfare programs, and the funding provided by contract cities, the courts and the Valley Transportation Authority for services by the Sheriff's Department. Based on information on the distribution of retiree medical care costs in the FY 2012-13 budget, we estimate that approximately 73.7 percent of the liability is attributable to General Fund departments where funding would come from discretionary sources, or to Valley Medical Center, which would also require discretionary funding based on the substantial General Fund subsidy that the hospital receives. Based on this allocation, we estimate the portion of the unfunded liability that must come from General Fund discretionary sources at $45,488,390 annually, or total payments of $1,364,651,716 over 30 years. We have identified two potential sources for these payments, which would be ***in addition*** to what the County is now paying toward retiree health care costs.

Allocations from Year-end General Fund Balance

As the result of revenues that exceed budgeted amounts, expenditures that fall short of budgeted amounts and reserve funds for contingencies that end up not being required, the County has historically generated a substantial year-end General Fund balance. The following table shows the amount of that balance for the previous 10 years, as reported in the County's Comprehensive Annual Financial Report for the fiscal year ending June 30. Because the fund balance reported is as of the end of each fiscal year, that ending number is the starting fund balance for the succeeding fiscal year, so that the fund balance shown in the table as available in FY 2012-13 is the fund balance reported as of June 30, 2012.

Prior Year General Fund Balances Available to Fund the Subsequent Year Budget
FY 2002-03 to FY 2011-12

Fiscal Year	Gross General Fund Balance*	Reserved or Legally Restricted	General Fund Balance Not Legally Restricted	Contingency Appropriation	Remaining General Fund Balance	Surplus General Fund Balance (Unreserved, Undesignated & Unassigned)
2012	267,030,000	50,638,000	216,392,000	$96,921,000	$119,471,000	$ 201,749,000
2011	235,845,000	47,031,000	188,814,000	$91,376,397	$97,437,603	$ 159,730,000
2010	245,853,000	25,738,000	220,115,000	$91,144,521	$128,970,479	$ 140,955,000
2009	402,420,000	30,010,000	372,410,000	$93,760,139	$278,649,861	$ 183,195,000
2008	463,199,000	41,807,000	421,392,000	$93,200,000	$328,192,000	$ 109,734,000
2007	399,359,000	27,012,000	372,347,000	$87,744,712	$284,602,288	$ 201,824,000
2006	437,941,000	34,560,000	403,381,000	$87,730,182	$315,650,818	$ 254,434,000
2005	483,304,000	27,700,000	455,604,000	$76,640,120	$378,963,880	$ 245,412,000
2004	445,291,000	66,521,000	378,770,000	$43,805,944	$334,964,056	$ 121,804,000
2003	450,957,000	82,742,000	368,215,000	$37,000,000	$331,215,000	$ 139,737,000
Average	**383,119,900**	**43,375,900**	**339,744,000**	**79,932,302**	**$259,811,699**	**$175,857,400**

*Excludes Measure B monies reported in General Fund.

As the table shows, on average, the County over the past 10 years has entered the fiscal year with an average General Fund balance, from the prior fiscal year, of $383.1 million.

Of that amount, an average of $43.4 million annually was legally restricted to spending for a specific purpose, or represented assets that were not available for spending, such as inventories.

The vast majority of the fund balance, averaging $339.7 million annually, was available for any legal purpose. The primary use of these monies was to fund the annual contingency appropriation and to subsidize the Valley Medical Center budget, and the remainder was available for capital, technology and operating appropriations. Although a large amount was appropriated through the budget process in a contingency fund to pay for unexpected expenses during the fiscal year, the fund balance estimates included in the annual budget and used for this allocation were substantially lower than the actual fund balance that was ultimately reported in the audited financial statements. In general, the fact that contingency funds were not needed in the amounts budgeted, and the fact that the revenues exceeded and expenditures fell short of budgeted amounts, resulted in a significant fund balance being available at the end of each year for rebudgeting in the succeeding year.

Consequently, given the history of the County's General Fund balance, the Board could decide to dedicate a portion of future General Fund balances to pay a portion of the additional General Fund contribution required for retiree health care, in place of other priorities for which fund balance was previously spent. Currently, the largest single use of year-end fund balance is to provide a contingency reserve, which amounts to $96.9 million in Fiscal Year 2012-13, or about 5.0 percent of total General Fund expenditures, less expenditure pass-throughs and aid payments. However, since the differential between the average annual General Fund balance and the average annual contingency reserve is about $260 million, use of a portion of the annual fund balance to pay a portion of the retiree health care unfunded liability is a feasible option, recognizing that such a policy may mean deferring other capital, technology or one-time expenditures.

Funds from RDA Dissolution

In Fiscal Year 2011-12, the Legislature and the Governor approved legislation terminating redevelopment agencies. In the County of Santa Clara, the formation of redevelopment agencies had resulted in approximately $283.5 million of annual property tax revenues, which otherwise would have flowed to the County, school districts and special districts, instead being retained within the redevelopment agencies. As a result of the State's action, those redevelopment property tax increment revenues are expected to flow back to the County and other taxing entities, once contractual obligations previously incurred by the redevelopment agencies are satisfied. The County Finance Agency currently estimates that this source will provide ongoing revenue of at least $5.5 million annually to the County, starting in Fiscal Year 2013-14, plus one-time revenue in FY 2013-14 of an additional $6.5 million.

Furthermore, the County's share of former redevelopment agency property tax revenue will increase annually over the next 30 years as former RDA obligations are paid off. By the end of the 30 years, in about 2042, the County's annual share will amount to about $40 million in FY 2011-12 dollars. The Controller's Office has the Recognized Obligation Payment Schedules for each of the nine former redevelopment agencies in the County, as well as the current net property tax proceeds that would have gone to the redevelopment agencies had they not been dissolved. Based on this information, the Controller's Office could prepare a 30-year schedule of estimated annual property tax proceeds to the County from this source, and a portion of this revenue also could be dedicated by Board policy to paying a portion of the increased General Fund retiree healthcare contribution.

On a combined basis, these two funding sources could substantially or fully pay for the retiree healthcare unfunded liability over the next 30 years. These are the two largest General Fund funding sources that we identified as having the greatest potential for dedication by the Board to fund the General Fund portion of the County's $1.6 billion unfunded retiree health care liability. The Office of Budget and Analysis and the Office of the County Executive may have additional suggestions to be considered.

If the Board chooses to consider implementation of the suggested funding options and establish a long-term funding policy to extinguish the retiree health care unfunded liability, it is recommended that the Board formalize the policy by amending the administrative provisions of the annual budget resolution to provide specific direction to the Controller as follows:

> "Annually, upon closing the County's accounts at the end of each fiscal year, and before determining the amount of the remaining unexpended General Fund balance, the Controller shall transfer to the Retiree Health Care Fund $XX,XXX,XXX. After the year-end transfer to the Retiree Health Care Fund, the Controller shall report the remaining balance of the General Fund, which is available for appropriation for any legal County purpose, to the Board of Supervisors and the County Executive. In addition, during each fiscal year, the Controller shall transfer up to $XX,XXX,XXX of property tax proceeds formerly allocated to redevelopment agencies in the County, to the Retiree Health Care Fund, from the Redevelopment Agency Dissolution Trust Fund. Any monies in excess of $XX,XXX,XXX that is allocated to the County in any fiscal year from the Redevelopment Agency Dissolution Trust Fund shall be transferred to the County General Fund."

(b) *Post-retirement Health Care Benefits* .

All County employees hired prior to August 12, 1996, with at least five years of service after attaining age 50 are covered under the County's Retiree Health Care Program upon retirement. For employees hired after August 12, 1996, the eligibility requirements were increased to a minimum of eight years of service after attaining age 50.

For the 1,055 surviving retirees who retired on or before December 5, 1983, benefits payments cover premium of any medical program available to active employees. Actual County contributions to this program totaled approximately $1,641,300 in fiscal 2001. For the 3,860 surviving retirees who retired after December 5, 1983, benefits are limited to covering the premiums of the lowest cost medical plan. Participants may obtain additional coverage for themselves or their spouses and qualified dependents by paying any incremental costs. Actual County contributions to the program for these participants and for future retirees totaled approximately $25,929,600 in fiscal 2001. The actuarially determined contribution, for both programs combined, was approximately $25,383,700.

Upon reaching age 65, the retiree is also eligible for full or partial reimbursement of Medicare Part B premiums. During fiscal 2001, 1,887 participants received approximately $1,044,800 in actual Medicare Part B reimbursements.

The County advance funds all post-retirement medical benefits on an actuarially determined basis. An actuarial review of such benefits, as of July 1, 2001, estimated the following:

Accrued actuarial liability	$ 301,315,600
Net assets available in the plan	196,737,900
Unfunded portion of accrued actuarial liability	$ 104,577,700

The study used the individual level salary projected unit credits actuarial valuation method. Liabilities are recognized through normal costs over the working lives of active employees. A 23.7-year County career, with an average of 9.5 years employment, is expected of the current active population. Prior to fiscal 2001, the unfunded actuarial liability was amortized as a level percent of payroll over a 30-year period that began on July 1, 1991. The County has adopted a funding policy to amortize the unfunded actuarial liability over a seven-year period beginning with fiscal 2001. The valuation assumed a discount rate of 7.00% and annual salary increases of 5.50%. Starting in fiscal 2002, health care cost trends of 7.00% and 10.00% are assumed for the medical plan and Medicare Part B premiums, respectively, with both reaching an ultimate cost trend of 6.00% in the fourth and fifth year, respectively.

Attachment 1

Summary of Results
Funded Status

Below is a summary of the funded status as of June 30, 2003.

FY 2003/2004 Covered Payroll based on June 30, 2003 census	$934,917,295
Actuarial Accrued Liability	$671,151,675
Actuarial Value of Plan Assets	$245,923,892
Unfunded Actuarial Accrued Liability	$425,227,783
Funded Ratio	36.64%
Unfunded Actuarial Accrued Liability as a Percentage of Covered Payroll	45.48%

Attachment 2

Valuation Results

7.75% Discount Rate

Calculation of Annual Required Contribution (ARC) and Annual Expense under the Projected Unit Credit (PUC) Method and the Entry Age Normal (EAN) Method

	PUC	EAN
1. Actuarial Accrued Liability		
a. Retired employees	$ 558,815,725	$ 558,815,725
b. Active employees	583,875,557	623,853,326
c. Total	$ 1,142,691,282	**$ 1,182,669,051**
2. Actuarial value of assets[1]	338,048,737	338,048,737
3. Unfunded Actuarial Accrued Liability (UAAL)	$ 804,642,545	**$ 844,620,314**
4. Normal cost	$ 55,153,402	**$ 49,474,889**
5. Projected payroll	$ 1,053,381,749	**$ 1,053,381,749**

Level Dollar Amortization	PUC	EAN
1. Amortization factor based on 30 years	0.0805	0.0805
2. Amortization of UAAL over 30 years	$ 64,773,725	$ 67,991,935
3. Normal cost	55,153,402	49,474,889
4. Interest on 2. and 3.	4,560,466	4,466,908
5. Annual Required Contribution (ARC)(2. + 3. + 4.)	$ 124,487,593	**$ 121,933,732**
6. ARC as a percentage of projected payroll	11.8%	**11.6%**

Level Percent of Pay Amortization	PUC	EAN
1. Amortization factor based on 30 years	0.0595	0.0595
2. Amortization of UAAL over 30 years	$ 47,876,231	$ 50,254,909
3. Normal cost	55,153,402	49,474,889
4. Interest on 2. and 3.	3,917,905	3,792,422
5. Annual Required Contribution (ARC)(2. + 3. + 4.)	$ 106,947,538	**$ 103,522,220**
6. ARC as a percentage of projected payroll	10.2%	**9.8%**

Cash Flow	PUC	EAN
1. Projected first year cash flow	$ 39,610,883	$ 39,610,883

[1] Assuming that current assets are considered Plan Assets for the purpose of meeting GASB 45 requirements.

The key valuation results for the current and prior years are shown.

SUMMARY OF VALUATION RESULTS

	June 30, 2012	June 30, 2011
Actuarial Accrued Liability (AAL)	$2,121,600,247	$2,035,456,192
Actuarial Value of Assets	264,138,560	251,788,734
Unfunded Actuarial Accrued Liability	1,857,461,687	1,783,667,458
Funded Ratio	12.45%	12.37%
Market Value of Assets	$264,138,560	$251,788,734
Annual Required Contribution (ARC) for Fiscal Year Ending:	**June 30, 2013**	**June 30, 2012**
Normal cost (beginning of year)	$76,219,014	$73,985,1200
Amortization of the unfunded actuarial accrued liability	94,174,596	91,054,222
Adjustment for timing, payable throughout fiscal year	5,491,887	5,367,278
Total Annual Required Contribution, including adjustment for timing	$175,885,497	$170,406,700
Covered payroll	$1,329,863,895	$1,328,611,978*
ARC as a percentage of pay	13.23%	12.83%
Total Participants (Excludes Married Spouses)	22,801	22,353
Annual OPEB Cost (AOC) for Fiscal Year Ending:	**June 30, 2013**	**June 30, 2012**
Annual Required Contribution payable at end of fiscal year	$181,554,392	$175,948,528
Interest on Net OPEB Obligations	14,299,585	7,919,396
ARC Adjustments	-11,793,684	-6,520,408
Total Annual OPEB Cost	$184,060,293	$177,347,517
AOC as a percent of pay	13.84%	13.35%

**Based on updated covered payroll for 2011/2012 fiscal year.*

Attachment 4

COUNTY OF SANTA CLARA

Combining Statement of Fund Net Assets
Internal Service Funds

June 30, 2012
(In thousands)

	Workers' Compensation	Employee Benefits	Retiree Healthcare	Pension Obligation	Total
Assets:					
Current assets:					
Cash and investments:					
Unrestricted	$ 50,622	$ 10,554	$ 161,725	$ -	$ 274,951
Restricted with fiscal agent	-	-	-	-	14,001
Other restricted	-	426	-	-	426
Accounts receivable, net	1,843	431	1,476	569	5,007
Due from other governmental agencies	-	-	520	-	566
Inventories	-	-	-	-	1,150
Prepaid rent/insurance	-	-	-	-	3,251
Total current assets	52,465	11,411	163,721	569	299,352
Noncurrent assets:					
Advances to other funds	-	-	11,040	-	11,040
Net pension asset	-	-	-	371,166	371,166
Other assets	-	-	-	2,370	2,370
Capital assets:					
Nondepreciable	-	-	-	-	1,295
Depreciable	-	-	-	-	4,751
Total noncurrent assets	-	-	11,040	373,536	390,622
Total assets	52,465	11,411	174,761	374,105	689,974
Liabilities:					
Current liabilities:					
Accounts payable	436	919	7	6	5,509
Accrued salaries and benefits	63	-	-	-	582
Accrued liabilities	-	-	-	7,355	7,355
Due to other funds	-	-	-	130	130
Unearned revenue	-	-	-	-	1,986
Current portion of insurance claims	20,753	2,390	-	-	34,117
Current portion of accrued vacation and sick leave	15	-	-	-	254
Current portion of bonds payable	-	-	-	4,040	4,040
Total current liabilities	21,267	3,309	7	11,531	53,973
Noncurrent liabilities:					
Noncurrent portion of insurance claims	66,301	-	-	-	82,604
Noncurrent portion of accrued vacation and sick leave	317	-	-	-	3,870
Noncurrent portion of bonds payable	-	-	-	408,923	408,923
Net OPEB obligation	-	-	208,161	-	208,161
Total noncurrent liabilities	66,618	-	208,161	408,923	703,558
Total liabilities	87,885	3,309	208,168	420,454	757,531
Net assets:					
Invested in capital assets, net of related debt	-	-	-	-	6,046
Unrestricted (deficit)	(35,420)	8,102	(33,407)	(46,349)	(73,603)
Total net assets (deficit)	$ (35,420)	$ 8,102	$ (33,407)	$ (46,349)	$ (67,557)