

OPEB Made Simple(r)

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Introduction

Many in Westport have said we have a big OPEB problem, but few have described it. We will try to do that here. OPEB stands for “Other Post Employment Benefits,” which in the case of Westport means primarily the health benefits the Town provides to its retired employees. Typically, we provide health coverage to retired employees and their spouses for the rest of their lives. Before they reach 65, we provide full coverage, and after 65 we provide “Medicare Gross Up” coverage, which supplements the benefits provided under Medicare. Our retirees contribute to the cost of this coverage by paying a percentage of the premium applicable to the plan, usually either 50% or 40%. In some cases the amount the retiree pays increases if the cost of coverage increases. In other cases the amount the retiree contributes is set at retirement and does not increase even if the cost of coverage goes up.

The Cost

It is easiest to think in terms of an individual hypothetical employee to understand how much this coverage costs. Consider Sally, a hypothetical employee in 2011 who is 45 and who has worked for the Town for 18 years. Assume that Sally is going to retire in 7 years at age 52, after having worked for the Town for 25 years, and that the Town will provide medical coverage to Sally and her husband, who is the same age as Sally, until they both die at the actuarially estimated age of 77. Based on the assumptions described below, at the time of Sally’s retirement in 2018, the Town of Westport would need to set aside \$458,947 to have sufficient funds (when combined with the future earnings from investing that amount) to pay the Town’s share of Sally’s and her husband’s medical coverage. The Town would be able to accumulate this amount if it put aside \$8,365 every year that Sally worked and was able to invest that at the assumed rate (6% in this case). As of 2011, the present value of the Town’s liability for Sally’s future medical benefits would be \$305,226, and the Town’s Accrued Liability, which is the amount of the cost allocable to Sally’s 18 previous years of work, would be \$219,763.

Detailed Explanation (Skip this if you don’t like numbers)

Our actuaries have estimated that Westport this year spends about \$16,000 per person for full coverage and about \$8,000 per person for “Medicare Gross Up” coverage for one year of coverage for a typical retiree. Because Sally’s retiree coverage will begin in 7 years and will then continue for an estimated 25 years, we need to know how much coverage will cost during the 25 years starting 7 years from now. To do this, the actuaries estimate the rate of medical cost inflation. They have estimated that medical costs will go up at annual rates starting at 9% and decreasing to 4.5% over the coming years. Working through all these numbers will give us a schedule of how much we expect to spend on Sally’s and her husband’s coverage starting in 7 years. We then reduce those amounts by Sally’s cost share contribution in each year, which we assume for this example to be 40% and fixed upon retirement, to get the net amount that Westport will have to pay in each of those future years.

So far we only have a schedule of costs that we expect to have to pay in the future, but what we really want to know is what that is worth today. To answer this question, the actuaries figure how much cash we would have to invest today to be able to pay those bills when they are due in the future. This process is called “discounting” and requires choosing an assumed interest rate. The actuaries did our

analysis using alternative interest rates of 4.5%, 6.0% and 7.5%, and for this example we will use 6.0%. Discounting the schedule of expected future costs at 6.0% to 2011 gives us a present value of \$305,226. The actuaries then say that about 18/25 (or \$219,763) of that amount is attributable to past work, called the Accrued Liability, and 7/25 of that amount is attributable to the work Sally will do in the future. This allocation is based upon Sally having completed (as of 2011) 18 out of the total of 25 years she will have worked for the Town when she retires. Using these assumptions, if the Town had invested \$8,365 to earn 6% every year that Sally will have worked when she retires, the town would accumulate \$458,947 by Sally's retirement date. This is the amount the Town would need then to be able to invest to fully fund Sally's and her husband's coverage over their remaining lives.

The Actuaries' New Report

The actuaries' actual calculations are, of course, more complex than just described, but given the Accrued Liability of \$219,763 for Sally in our simplified example, it is not hard to see how the actuaries calculated a total OPEB Accrued Liability for the 893 current and retired employees covered by the report of \$95.7 million at 6% (and \$122.1 million at 4.5% and \$77.1 million at 7.5%). The characteristics we assumed for Sally - that she was close to retirement at a relatively young age - made her benefits expensive. The average Accrued Liability for the 893 current and retired employees covered by the report is about \$107,000 using the actuaries' calculations at a 6% interest rate.

Some people may say that these numbers are too high because the assumed medical cost inflation rate is too high or because the interest rate used to discount is too low. In the past, the experts' projections of medical cost inflation have usually turned out to be too low. We use a 7.5% interest rate to do a similar analysis on our pension liabilities, and over the last 10 years the actual rate that we have been able to earn has been under 4%. It is important to remember that if the assumptions prove wrong and the actual cost is higher than anticipated, the taxpayers of Westport are obligated to make up for any shortfall.

The most recent Actuaries' report was delivered to the Town in September 2011, but does its calculations as of July 1, 2009, at which point there was \$2.4 million in trust to fund the OPEB liabilities. The Town has wisely decided to obtain a new report each year (rather than every two years as was the previous policy). To put these liabilities in context, Westport is budgeted to raise approximately \$165 million in property tax revenues this year with a mill rate of 17.43. An approximate \$100 million liability is equivalent to about 60% of one year's tax revenues. Of course, this liability will be funded over many years, not one. We should also be aware that because we are discounting the liability based on present value analysis, the measured size of the liability will increase as time passes (at the rate of our assumed interest rate).

What Westport Did Wrong

Until 2008 Westport never calculated how much it owed for retiree medical costs (no accounting rules required it). Unfortunately, the report done in 2008 mistakenly excluded about half the employees it should have included, and so understated the liability by about half. In addition, the report's assumptions about medical cost inflation were too low.

As we saw in Sally's example above, Westport should have been putting about \$8,365 away each year in the years before Sally retired in order to have enough to pay her medical benefits after she retired. This would have resulted in the residents of the Town at the time that Sally was providing services to

the Town paying the full cost of her employment. Until 2009, Westport (like many municipalities) never put any money aside to pay for medical benefits promised to retirees. The Town paid for retiree medical costs as the bills came in (referred to as “pay as you go”). Even after the Town’s 2008 calculation (which we now know was incorrect and the amounts too low), the Town did not always fund the full amount it should have. As a result, current and future Town taxpayers will have to pay for part of the cost of the services provided to decades of previous Town residents.

In part because the Town did not fully understand the cost of its medical benefits for retirees, it may have agreed to more generous union contracts, implemented early retirement programs, and permitted one-off contract modifications, all of which exacerbated the problem and might have been avoided had there been a better understanding of the costs.

Under Connecticut labor law, towns and unions who can’t agree on a contract must submit to “binding arbitration.” In this process, one critical factor is the financial ability of the Town to meet the unions’ requests. Because Westport overstated its financial strength by excluding and miscalculating its OPEB costs and liabilities, the Town has not been as effective an advocate in contract negotiations and arbitrations, and as a result, may be paying higher salaries and benefits than it should be.

What to Do Now

The most important thing to do now is stabilize the situation. We should show clearly the full amount of the Accrued Liability. For this calculation we should use an interest rate, such as 6%, that we have some reasonable possibility of achieving. Going forward, we should pay at least the accrued interest on our Unfunded Accrued Liability (at whatever interest rate we assume) and pay enough additional to fully pay for the cost accrual for our current employees for the current year. This will help make sure that our unfunded liability does not grow any larger. We can then pay down the balance of the obligation as we are able. This will also assure that the true financial position of the Town is known to taxpayers and considered in contract negotiations and arbitrations.

The Town must also undertake a thorough evaluation of our employees’ compensation and benefits, not only on an absolute basis, but relative to nearby towns and private sector employers as well. We want to be able to attract and retain high quality employees with competitive compensation and benefits, but we must also be fair to taxpayers who are under continuing financial stress.

This error is not just a reporting error, but a management failure by the Town to understand and control the cost of benefits granted to employees. We must find out how the error occurred and institute better internal financial controls to help protect against it being repeated. The taxpayers of Westport must be able to see readily the true cost of the promises the Town is making and judge whether Town officials are effectively managing those costs.

Technical Appendix

Shortcomings of the New Report: Implied Subsidy and Methodology

The new OPEB report was delivered a year late, but we still do not have complete confidence that it was done accurately and fairly. The first issue relates to a subtle actuarial concept called “implied

subsidy.” This refers to an employer’s increased cost that results when retirees are admitted to a medical insurance program and charged the average cost for the program even though the retirees are expected to have higher medical costs than the younger active employee participants. The retirees are allowed to pay an average cost rather than their actual marginal cost to the plan. The employer effectively picks up the difference. This arrangement describes some of our Board of Education programs, and it appears that the relevant employees were left out of the report again. This exclusion should be less significant than the previous mistake, but especially in light of that previous error, it is incredible that it happened at all. It highlights a continuing weakness in Westport’s financial controls that we must fix.

Even if the report were completely accurate, it may not be a “fair” presentation of our costs and liabilities. This is because the report (like other such analyses) is based on many choices regarding assumptions and methodology, and those choices may result in a biased view. Some choices result in faster recognition of cost and higher liability, and others just the opposite. In a fair report, we would expect a mixture of slow choices and fast choices so the result is balanced. Unfortunately, the choices here all seemed designed to slow down the recognition of cost and minimize what our liability appears to be.

Specifically, the report 1) uses a retirement assumption that seems more favorable to the Town than those assumed by other towns for similar employees, 2) changes the cost accrual method from straight line to percentage of payroll, which slows down the recognition of cost, 3) changes the amortization method for the Unfunded Accrued Liability from straight line to percentage of payroll, which slows down the amortization, and 4) changes to a 30-year open period from a closed period to amortize the Unfunded Accrued Liability, which slows down the amortization (and results in it never fully amortizing). In fact, under this methodology, the amortization of our Unfunded Accrued Liability can be less than the interest accrued on it, so that the liability can increase even if we fully fund the stated amortization amount. In addition, the Administration has recommended a 7.5% discount rate, which is at the high end of the permissible range, which also tends to reduce our reported liability.

It is of particular concern that the new report fails to identify the changes in methodology mentioned above even though it contains a separate section that purports to discuss changes from the old report. The assumptions and methodology for the report should be discussed and decided in a public Board of Finance meeting (attended by the Town’s actuaries) so that taxpayers understand the implications and appropriateness of the choices made. To do otherwise will increase the likelihood that at some point in the future we will confront another underfunding shock, even after paying full Annual Required Contributions (commonly referred to as the ARC).

Note: We are not actuaries or accountants. This discussion is based on our understanding of the issues, but it likely contains some mistakes and over simplifications and is not a substitute for a thorough analysis of our medical plans and reporting processes by qualified professionals. If you have the interest and stamina to have read this far, please consider getting involved in Town government.