COUNCIL AGENDA: 08/07/07
ITEM: 3.11

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Alex Gurza
Mark Danaj
Scott P. Johnson

SUBJECT: RETIREE HEALTHCARE

DATE: July 24, 2007

Approved [signature] Date 7/24/07

COUNCIL DISTRICT: N/A
SNI AREA: N/A

RECOMMENDATION

It is recommended that the City Council:

1) Accept the report on retiree healthcare

2) Direct staff to develop options to achieve full pre-funding of the retiree healthcare liability

3) Direct staff to develop options to reduce the retiree healthcare liability

OUTCOME

Provide information and background on the government accounting rules related to retiree healthcare, provide information on the retiree healthcare liability, and explore options to be considered to mitigate these costs.

EXECUTIVE SUMMARY

The Governmental Accounting Standards Board (GASB) recently implemented reporting standards that require state and local governmental agencies to disclose the full cost of unfunded actuarial accrued liabilities for Other Post Employment Benefits (OPEB), such as retiree healthcare, which include medical and dental benefits. The estimated unfunded retiree healthcare liability for the City of San Jose is currently estimated to be as high as **$1.65 billion** based on the most recent actuarial analyses. Factors that contribute to the amount of the liability include the level of the retiree medical benefit, escalating costs in medical premiums, the increasing number of retirees, and the City's current level of funding retiree healthcare benefits. It is critical that the City, in partnership with employees, retirees, the retirement boards and union representatives, take prudent measures to address the liability; otherwise this liability will be even more costly in the future.

BACKGROUND

The Government Accounting Standards Board (GASB) has two accounting statements, 43 and 45, which require state and local government entities to disclose the full cost of "Other Post Employment Benefits" (OPEB). Although OPEB's include benefits such as post-employment life insurance plans, disability, and long-term care, retiree healthcare benefits account for the majority of the unfunded OPEB's facing public employers today. These new reporting requirements include identifying the unfunded actuarial accrued liabilities for such benefits and disclosing the amounts in the agency's annual financial statements, similar to pension disclosures.

Implementation of GASB 43 required the City's two retirement plans to convert to the new standard of reporting in the 2006-2007 fiscal year. GASB 45 requires the City to conform to the new standards in fiscal year 2007-2008.

Although GASB 45 does not mandate the pre-funding of OPEB liabilities, the ongoing failure to fully pre-fund these benefits may have a detrimental impact on an agency's long-term financial health and may adversely impact the agency's credit rating. Public entities, including the City of San José, must calculate the liability, decide whether and how to fund the liability, and make decisions about current and future benefits.

ANALYSIS AND COST IMPLICATIONS

RETIREE HEALTHCARE FUNDING METHODOLOGIES

Retiree healthcare benefits are paid in three primary ways:

1. **"Pay-as-you-go"**

   The "pay-as-you-go" method is the way most agencies have paid for retiree healthcare. The current year's medical insurance premiums for eligible retirees are paid from current revenues. In this method, only the current annual premiums are paid and there are no funds set aside while the employee is working in order to ensure that funds will be available when the employee retires. From an actuarial perspective, this means that the benefit is considered **100% unfunded** since no funds have been set aside to cover future benefit costs.

2. **Full Pre-Funding**

   Full Pre-Funding requires setting aside the amount of money estimated to pay the long-term costs to provide retiree medical insurance. This is the estimate that is required to be calculated pursuant to GASB 43/45 and is similar to the estimates developed to fund the pension benefit.

The full pre-funding strategy is consistent with the principle that the cost of benefits should be paid for as they accrue. In addition, by setting aside sufficient funds to pay for future benefits, the interest earned, and any other return on investments can serve to reduce the ultimate cost to the City of providing the benefits in the future. This is the same strategy used to fund the pension benefit.

3. **Partial Pre-Funding**

In Partial Pre-Funding, some funds are being set aside to pay for future healthcare liabilities, but at a level less than Full Pre-Funding.

CITY OF SAN JOSE'S CURRENT FUNDING OF RETIREE HEALTHCARE

The level and eligibility for retiree healthcare benefits for City employees are defined in the Municipal Code. Contributions from both the City and current employees provide the funding for these benefits. The contributions are made as a percentage of pay for current employees and are part of the contribution rates for the City's two retirement plans. Currently, contributions for retiree dental benefits are made by the City and the employees in the ratio of eight-to-three. Contributions for retiree medical benefits are made by the City and the employees in the ratio of one-to-one (50/50 split).

Currently, the retiree healthcare portions of the contribution rates for the City's two retirement plans are as follows:

Current Retiree Healthcare Funding		
	Employee Contribution	City Contribution
Federated	3.32%	3.82%
Police & Fire	3.78%	4.19%

Note: Calculated as a percentage of pay for current employees.

This method of funding retiree healthcare is unusual in that most agencies in California are part of the California Public Employees' Retirement System (CalPERS) and do not fund retiree healthcare as part of their retirement contribution rate.

Pursuant to the provisions of the Municipal Code, the contributions made to pay for retiree healthcare are maintained in a Medical Benefits Account established for each of the City's retirement plans as a separate account within each retirement fund. However, pursuant to the Internal Revenue Code, the maximum amount that can be contributed to the Medical Benefits Account must not exceed twenty-five (25%) of the total contributions made to the System (other than contributions to fund prior service).

The City's current funding is not "Full Pre-Funding" as discussed above and can be described as partially funded. The amount currently contributed by the City and employees is actuarially determined based on 15 year cash flow projections for the Federated City Employees' Retirement System and 10 year cash flow projections for the Police and Fire Department Retirement Plan.

Please note that the contribution rates above are only representative of the current funding for retiree healthcare and do not include the contributions for the pension benefit. The current contribution rates for the pension benefit (including the amounts listed above for retiree healthcare) are as follows:

Current Retirement Funding (including healthcare)		
	Employee Contribution	**City Contribution**
Federated	7.58%	21.98%
Fire	11.26%	25.61%
Police	11.67%	28.90%

Based on these contribution rates, in Fiscal Year 2007-2008 the City will contribute a total of approximately $136 million into the retirement funds for the pension benefit and the current level of contributions towards retiree healthcare.

ACTUARIAL STUDIES OF RETIREE HEALTHCARE LIABILITIES PURSUANT TO GASB 43/45

In order to determine the retiree healthcare liability pursuant to GASB 43/45, an actuary must perform a study. These studies produce various estimates.

Two of the key estimates resulting from an actuarial study are the following:

Unfunded Actuarial Accrued Liability (UAAL)

When an actuary develops an estimate of the retiree healthcare liability pursuant to GASB 43/45, the actuary estimates the Actuarial Accrued Liability. The Actuarial Accrued Liability is the estimated total long-term liability to provide the retiree healthcare for current retirees as well as the estimated costs of providing these benefits to current employees when they retire. After taking into account any existing assets that have been set aside to pay these benefits, the actuary estimates the total Unfunded Actuarial Accrued Liability, or UAAL.

Before the focus on retiree healthcare resulting from the requirements of GASB 43/45, unfunded liabilities have been discussed primarily related to pension benefits. According to the State of California's Legislative Analyst's Office, the average public pension system in California has sufficient assets to cover approximately 88 percent of the estimated liabilities for future pension benefits, resulting in an unfunded liability equal to approximately 12 percent of these liabilities.[1] In the "Pay-as-you-go" method used by most agencies to pay for retiree healthcare, **100%** of the liability is an **unfunded** liability, and therefore the liability is considered to be 0% funded. As a comparison, based on the current partial funding, the funding ratio for retiree healthcare benefits in the Police and Fire Department Retirement Plan is 5% and 10% in the Federated City Employees' Retirement System.

Annual Required Contribution (ARC)
In addition to calculating the long-term liability, an actuary also calculates the amount of money that would need to be contributed on an annual basis in order to cover the estimated costs of the retiree healthcare benefit for current and future retirees. This is referred to as the Annual Required Contribution, or ARC. The amount of the ARC is the normal cost for the benefits earned in the current year plus an amortized portion of the total Unfunded Actuarial Accrued Liability. The ARC is calculated as a percentage of payroll, which translates to a specific annual dollar amount.

Calculating the ARC is similar to the method used to calculate pension benefits, which results in contribution rates paid into the retirement system to ensure that sufficient funds are available to pay the benefits. Although GASB does not require agencies to fund the liability and make the Annual Required Contribution, a decision whether or not to develop a strategy to address the retiree healthcare liability should be considered similar to the decision regarding funding the pension benefit. Both are significant long-term liabilities.

Assumptions
An actuary who performs retiree healthcare studies uses various assumptions in developing the estimated liability. Certain assumptions will have a significant effect on the estimated liability. One of the key assumptions is the estimated investment return or "discount rate." In order to be able to use a higher discount rate assumption, such as 8%, the agency must be contributing the full Annual Required Contribution (Full Pre-Funding) and invest those funds in a pool of investments that are estimated to produce the higher estimated rate of return. If an agency is not contributing the full ARC (such as agencies that use a "pay-as-you-go" method), a lower discount rate assumption must be used, which significantly increases the total estimated liability.

Other assumptions used by an actuary, such as estimated future increases in the cost of medical insurance and the actuarial cost method, will have an effect on the estimated liability.

THE CITY OF SAN JOSE'S RETIREE HEALTHCARE LIABILITY

The Police and Fire Department Retirement Plan Board and the Federated Employees' Retirement System Board retain their own actuaries who each conduct actuarial studies. At the Boards' requests, each actuary completed a study of the retiree healthcare liability. The most recent reports estimating the liability of the retiree healthcare benefits produced by the Police and Fire Department Retirement Plan's actuary, The Segal Company (Segal),

[1] As of July 1, 2005, the funding ratio for the pension benefits in the Police and Fire Department Retirement Plan was 97.81% and 81% for the pension benefits in the Federated City Employees' Retirement System.

and the Federated City Employees' Retirement System's actuary, Gabriel Roeder Smith & Company (GRS) are attached.

In addition to the actuaries retained by each Retirement Board, the City has retained an actuary, Bartel Associates (Bartel), to assist in exploring alternatives to move towards pre-funding the retiree healthcare liability and/or to reduce the retiree healthcare liability. In order to assist the City in exploring options, Bartel performed its own analysis of the retiree healthcare liability for employees and retirees covered by the Federated City Employees' Retirement System. Bartel's analysis (attached) resulted in an estimate of the liability that is higher than the estimates contained in the GRS report. The primary reasons for Bartel's higher estimated liability include the time value of money (GRS report of 2006 versus the Bartel report of 2007) and different economic and other assumptions.

The various estimates provided by Segal, GRS and Bartel can be found in the attached reports. However, for the purposes of this memorandum, the estimated liability uses those produced by Segal and Bartel. Based on those reports, the following is a summary of the City's retiree healthcare liability:

RETIREE HEALTHCARE LIABILITY[2]				
	Current Partial Funding		**Full Pre-Funding**	
	P&F	**Federated**	**P&F**	**Federated**
Discount Rate (Rate of Return)	5.30%	5.55%	8.0%	7.75%
Unfunded Accrued Actuarial Liability (UAAL)	$812.8M	$837.8M	$550.4M	$584.7M
Total UAAL	**$1.65 Billion**		**$1.14 Billion**	
Funded Status (ratio of assets to AAL)	5%	10%	7%	14%
Annual Required Contribution (ARC)[3]	$68.1M	$66.3M	$49.5M	$51.8M
Total ARC	**$134.4 Million**		**$101.3 Million**	

[2] Estimates are based upon the Entry Age Normal (EAN) actuarial cost method.
[3] The amounts listed are the total annual required contributions including contributions made by the City and employees.

Based on these estimates, the total Unfunded Accrued Actuarial Liability (UAAL) for retiree healthcare is as high as $1.65 billion. If the City and employees fully pre-fund the liability, the higher discount rate can be used because the money can be invested and can earn a long-term higher rate of return. This reduces the estimated liability from $1.65 billion to $1.14 billion. However, this requires making an Annual Required Contribution of $101.3 million.

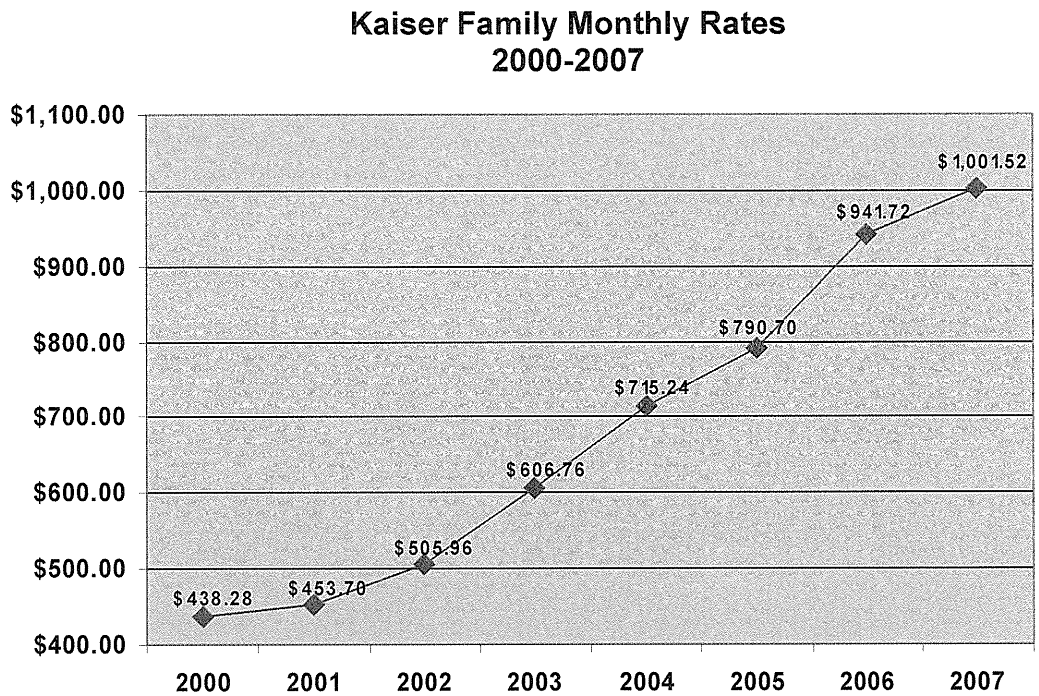
A variety of factors contribute to the high cost of providing retiree healthcare benefits. These include the dramatic increase in the cost of healthcare, the number of years that retirees receive the benefits and an increasing number of retirees due to the retirement of "baby boomers." For example, in the next five years, approximately one-third of City employees will be eligible to retire.

It should be noted that the above costs do **not** include the cost to fund the pension obligation and only include the retiree healthcare liability. Apart from the issue of the cost of retiree healthcare, the City's retirement contribution rates have been increasing. In 2000, the City's contribution rate was 16.09% of pensionable compensation for the Federated City Employees' Retirement System and 15.70% for the Police and Fire Department Retirement Plan. Currently, the City's contribution rates are 21.98% for Federated, 28.90% for Police and 25.61% for Fire. This represents an increase of approximately 37%, 84%, and 63%, respectively. (Retirement benefit increases for sworn Fire personnel are subject to the pending arbitration, and the contribution rates may increase.)

CURRENT RETIREE HEALTHCARE BENEFITS

The level and eligibility for retiree healthcare benefits are contained in the San José Municipal Code as part of the retirement plans. Generally, employees are eligible for retiree medical insurance coverage at fifteen (15) years of service. Even employees with 15 years of service in the Federated City Employees' Retirement System and 20 years of service in the Police and Fire Department Retirement Plan who leave City service prior to retirement can qualify for lifetime retiree medical insurance upon retirement.

For eligible retirees, the benefit provides for **100%** of the premium cost for the lowest priced plan available to active employees for either single **or** family coverage. (This is a higher level of benefit than active employees receive.) Since the current benefit is tied to the cost of the premium rather than a fixed-dollar amount, the long-term costs of providing this benefit is integrally tied to the rising cost of healthcare, which is both a local and a national issue. For example, the current monthly cost for Kaiser family coverage is $1,001.52. As the chart below indicates, only seven years earlier, the monthly cost for family coverage was $438.28. This is an increase of **129%**. During the same period, the Consumer Price Index (CPI) in the Bay Area increased by only 21.06%.



In addition to medical insurance, generally employees in the Federated City Employees' Retirement System who have five (5) years of service and retire directly from active City service are eligible to receive dental benefits. In the Police and Fire Department Retirement Plan, employees with 15 years of service (or 20 years of service for those who leave City service prior to retirement) can qualify for lifetime retiree dental insurance upon retirement. The plans provide 100% of the premium cost for this benefit.

RETIREE HEALTHCARE BENEFIT COMPARISON

Since all public agencies are required to comply with GASB 43/45 in the reporting of retiree healthcare liabilities, it is understandable to conclude that all agencies face similar challenges. However, this is not the case. Of course, the liability will vary according to the size of the agency and the resulting number of retirees eligible for retiree healthcare. However, a variable that significantly affects the size of the liability is the differences in the level of retiree healthcare benefits provided by different public agencies.

City staff compared the healthcare benefit provided to retirees of cities and counties serving populations of 100,000 or more in Santa Clara County, Alameda County, San Mateo County, San Francisco City and County, and Contra Costa County. (These are the same agencies used for other comparative purposes.) In evaluating the retiree healthcare benefit provided by these cities and counties, it was found that the majority of the surveyed agencies either contribute a fixed dollar amount or use a formula to determine their contribution toward retiree medical premiums, which generally results in a lower employer contribution towards retiree healthcare benefits.

In some agencies, the retiree healthcare benefit varies by employee group. The following is a comparison of the maximum 2007 monthly contributions for retiree healthcare premiums provided to retirees of the largest non-public safety employee group in each of the comparable agencies. The amounts were calculated for a retiree with 15 or 30 years of service.

Agency[4]	15 Years	30 Years
Oakland	$80.80	$80.80
Fremont	$170.00	$170.00
Hayward	$226.01	$226.01
Santa Clara (City)	$264.00	$264.00
Daly City	$404.56	$465.00
Santa Clara County	$418.81	$418.81
Alameda County	$341.54	$455.38
Sunnyvale	$492.53	$492.53
Berkeley	$444.73	$494.14
San Jose	**$1,001.52**	**$1,001.52**
Contra Costa County	$1,102.59	$1,102.59
Concord	$1,121.04	$1,121.04
San Francisco	$1,149.03	$1,149.03

While the City of San Jose's benefit is currently tied to 100% of the cost of single or family coverage, the majority of the agencies tie the retiree healthcare contribution to a fixed dollar amount or to a formula which is more or less equivalent to a single coverage premium. Since family coverage is currently $1,001.52 per month compared to $402.22 for single coverage, the City's benefit is significantly richer and its costs contribute significantly to the retiree healthcare liability.

The long-term costs of any retiree healthcare benefit that is tied to the cost of a premium will be significantly affected by the increases in healthcare costs as compared to benefits that are based on a formula or a fixed dollar amount.

STEPS TAKEN BY OTHER CALIFORNIA AGENCIES TO ADDRESS RETIREE HEALTHCARE LIABILITIES

The long-term liability for retiree healthcare benefits will have a significant impact on government agencies. The Civil Grand Juries in both Marin County and Contra Costa County recently issued reports specifically on retiree healthcare benefits. The Contra Costa Civil Grand Jury report states that escalating retiree healthcare benefit costs are

[4] San Mateo County is not included above because they do not provide a lifetime contribution towards retiree medical premiums. Retirees may use their unused, accrued sick leave balances to receive a certain level of retiree healthcare contributions. Upon exhaustion of the sick leave balance, the agency provides no further contribution toward retiree healthcare.

threatening the County's financial condition and with it the ability to deliver essential services. The Marin County Civil Grand Jury report states that the County cannot afford to pay the liability without drastic changes in its priorities, including raising taxes and/or reducing services.

Cities and counties across California are beginning to take steps to address and mitigate the costs associated with unfunded retiree healthcare benefits. Employers who have been using a "pay-as-you-go" approach are coming to the realization that this funding methodology is no longer sustainable considering the estimated long-term liabilities of providing retiree healthcare benefits.

The City of San José, as well as agencies throughout California, must find solutions to address the significant unfunded liability of retiree healthcare benefits. The following are brief descriptions of the approaches taken and challenges facing several California agencies.

Contra Costa County

Contra Costa County's retiree healthcare liability is estimated to be $2.6 billion. An outside consultant advised the County to set aside $216 million annually for the next 30 years to reduce their liability. The County's Board of Supervisors approved a fiscal year 2007-2008 budget which provides $33 million for retiree healthcare, compared to the $216 million estimated annual required contribution. The County continues to work on strategies to fund the obligation in future years.

City of Fremont

The City of Fremont provides a maximum monthly reimbursement for retiree healthcare, and the amount varies by employee group. For example, one union contract provides retirees with a flat rate of $200 per month as a retiree medical reimbursement. In recent negotiations with this group, the benefit was reduced for employees hired after July 1, 2006, and the monthly maximum now varies from $0 to $200. (Only retirees with 20 or more years of service are eligible for the monthly maximum reimbursement of $200.) This flat rate method does not increase with the cost of healthcare.

San Diego County

San Diego County initially approved a plan to cut off health benefits for employees who retired after March 2002 to reduce its unfunded healthcare liability. As a compromise, recent retirees receive an additional $400 a month in pension payments to help pay for medical insurance which is paid from reserves. The County would like to create a trust to continue to make the monthly payments to retirees instead of using reserves. However, negotiations over the development of the trust have not yet resulted in agreements. Several County and union officials expect that this issue may go unresolved until the expiration of the current union contracts.

Orange County

Orange County's unfunded liability was recently estimated at $1.4 billion. The County was able to significantly reduce its unfunded liability by making several significant changes in negotiations with employee groups. The bulk of the savings came from medical program changes such as establishing a medical trust to manage and invest County and employee contributions and moving retirees into their own health insurance pool, separate from active employees. Capping the annual increases of the amount contributed towards retiree healthcare to 3% is also expected to result in significant savings.

Orange County has taken other actions such as reducing medical grant payments by 50% once a retiree becomes Medicare eligible, reducing insurance payments for workers retiring before age 60 and raising insurance payments for those over age 60, and freezing lump sum severance benefits at current levels for those employees leaving County employment. All of these actions combined have worked to significantly reduce Orange County's unfunded liability.

City and County of San Francisco

From 2001 to 2006, San Francisco's annual costs for retiree healthcare more than quadrupled from $23 million to $101 million. In an effort to reduce San Francisco's unfunded retiree healthcare liability, San Francisco created a new Retiree Health Benefits Fund and has included $500,000 in this fund as part of the Fiscal Year 2007-2008 budget. However, this is a very small amount compared to the estimated $4.9 billion unfunded liability.

San Francisco is currently looking at other ways it can reduce its unfunded liability. The City of San Francisco is exploring the model used for its pension plan, which uses a combination of City and employee contributions to fund the system.

PRIMARY OPTIONS

The two general strategies identified to address the healthcare liability, as well as demonstrated by the actions taken by other agencies, are pre-funding the cost of future healthcare benefits and making changes to the retiree healthcare benefits themselves in order to reduce the total liability. Within both of these strategies, there are several options.

Pre-funding

As stated earlier in this memorandum, the full funding strategy is consistent with the principle that benefit costs should be paid for as they accrue. In addition, by setting aside sufficient funds to pay for future benefits combined with the higher rate of return on investments of those funds, it can serve to reduce the long-term cost of providing future benefits for current City employees. This is the same strategy used to fund the pension benefit.

Many agencies are considering the implementation of Trust Accounts to allocate monies for pre-funding retiree healthcare liabilities. Currently, employees and the City contribute to a Medical Benefits Account that is a separate account in each of the retirement funds. Because of the IRS limitation on maximum contributions into the Medical Benefits Account, if the City and employees were to fully pre-fund the liability by making the Annual Required Contribution, a separate Trust would need to be established.

However, full pre-funding of the current retiree healthcare benefit is very expensive for both the City and employees. As described above, full pre-funding requires the City and employees to contribute the Annual Required Contribution of $101.3 million per year. This amount is *in addition* to the contributions required to fund the pension benefits.

Partial pre-funding to phase into full pre-funding over time is a less costly option up front, but may result in increased long-term costs. Absent any investment returns that may have been earned by full pre-funding now, the City and employees would be required to pay what would otherwise be offset by those returns in future years. Any portion of the liability that is unfunded must be disclosed by the City as a debt and any portion of the annual contributions that are not funded must be recorded on the City's financial statements which may have an adverse impact on the overall financial stability of the City.

The cost of full or partial pre-funding will require the City and employees to make many difficult choices. The City will have to explore both revenue increases and diverting funds from existing programs and services to begin funding its portion of the liability.[5]

<u>Benefit Changes</u>

As noted on the comparative chart presented earlier in this report, the current benefits provided to City of San José retirees are among the richest provided relative to comparable agencies. Changes to current benefits that result in a reduction in cost would in turn reduce the overall liability.

Many options exist regarding potential changes to the current benefits that would result in a reduction in liability. Some of the changes implemented by other agencies include healthcare plan design changes, adjustments to eligibility criteria and the elimination of the "implicit subsidy" resulting from combining both active employee and retiree populations in healthcare rates.

The affected population can be divided into three general segments:

1. Current retirees

2. Current employees

3. Future employees

[5] In fiscal year 2007-2008, $2 million was set aside for this purpose. However, these are one-time funds.

While changes in benefits could be applied to only selected segments of the affected population and not to others, this limits any possible reduction in the current total liability.

Approximately 50% of the liability is attributable to the cost of the benefits for current retirees. However, there are legal issues involved in changing benefits for current retirees and changing benefits for current retirees may be subject to legal challenge.

If benefits are unchanged for current retirees, this leaves options to changes in the benefits for current and future employees only. Drastic reductions or even the elimination of healthcare benefits for future employees with no change in benefits for current employees would yield virtually **no** decrease in the liability for many years. This is because the estimated unfunded liability primarily consists of the costs to provide benefits to current retirees and current eligible employees when they retire.

It is important to note that any changes to the benefits for current and future employees is subject to the meet-and-confer negotiation process between the City and the bargaining groups representing the affected employees. Additionally, there are also legal issues with regard to changing benefits for current employees which require review.

It is recognized that both pre-funding and benefit changes are extremely sensitive and difficult choices impacting the City, its employees and the community. However, the longer there is a delay in addressing the liability, the more costly and difficult those choices will become in the future.

Health-Risk Management (Wellness)

While pre-funding and benefit changes are the primary approaches to managing the retiree healthcare liability, it is important to note that wellness initiatives are important complementary measures. In pursuing these, organizations can potentially reduce the rate of increase of healthcare premiums by providing employees and retirees with programs that assist individuals in addressing the health risks and chronic diseases that drive large premium increases (such as hypertension, heart disease, obesity, and diabetes). The City has already begun conversations with stakeholders and plans to roll-out a health-risk management program before the end of this fiscal year.

CONCLUSION

GASB Statements 43 and 45 now require public agencies to report the long-term liability for retiree healthcare and to record any portion of annual contributions that are not funded. Actuaries have estimated the City's unfunded retiree healthcare liability to be as high as $1.65 billion. If fully pre-funded, the liability requires the City and employees to make an Annual Required Contributions (ARC) of approximately $101.3 million. This amount is in addition to the current contributions made to fund the pension benefit. Funding the cost of this liability is a significant challenge for the City and employees. The City must take the necessary steps to mitigate this liability; otherwise the liability will continue to escalate.

EVALUATION AND FOLLOW-UP

It is important to educate our stakeholders to understand the retiree healthcare costs and the current liability. A Retiree Healthcare (GASB) Team has been established consisting of representatives of the City Manager's Office, the Office of Employee Relations, the Budget Office, and the Departments of Human Resources, Finance, and Retirement Services. The Team is responsible for establishing partnerships with various stakeholders, including coordinating meetings to provide information and education regarding the retiree healthcare liability, as well as gathering input from a variety of stakeholders. Key stakeholders and partners in this effort include bargaining unit representatives, the City Labor Alliance (CLA), the Executive Management Forum, the Benefits Review Forum (BRF), the Retirement Boards and the Retiree Associations.

It is very important to remain mindful that any proposed changes for current and future employees must be discussed as part of the negotiation process with the City's bargaining unit representatives. The City is currently in negotiations with several bargaining units and will be negotiating with five additional bargaining units during fiscal year 2007-2008.

PUBLIC OUTREACH/INTEREST

☐ **Criteria 1**: Requires Council action on the use of public funds equal to $1 million or greater.
(Required: Website Posting)

☐ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

☐ **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

While this item does not meet the criteria above, this item will be placed on the August 7, 2007, Council Agenda and the memorandum will be available to the public on the City's website.

COORDINATION

This memorandum was coordinated with the Budget Office, the Department of Retirement Services and the City Attorney's Office.

In advance of the August 7th City Council meeting, copies of this memorandum will be provided to the bargaining unit representatives, the Retirement Boards, the Retiree Associations and members of the Executive Management (Unit 99) Forum. In addition, the memorandum will be discussed with the City Labor Alliance.

CEQA

Not a project

Alex Gurza Employee Relations Director	Mark Danaj Human Resources Director	Scott P. Johnson Finance Director

For questions please contact Alex Gurza at 408-535-8155.

Attachment 1: The Segal Company Report, dated January 12, 2007
Attachment 2: Gabriel Roeder Smith & Company (GRS) Report, dated December 19, 2006
Attachment 3: Bartel Associates Report, dated July 2007

SEGAL

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January 12, 2007

Via EMAIL and US MAIL

Mr. Edward F. Overton
Director/Retirement Services
City of San Jose Police and Fire Department Retirement Plan
1737 North First Street, Suite 580
San Jose, CA 95112-4505

Re: **City of San Jose Police and Fire Department Medical and Dental Insurance Plan GASB Statements No. 43 and No. 45 Results Using Requested Assumptions**

Dear Ed:

Our original draft valuation report for the City of San Jose Police and Fire Department Medical and Dental Insurance Plan dated October 24, 2006 was presented to the Board of Retirement on November 2, 2006. After the draft report was presented to the Board, a number of questions arose regarding differences in assumptions and methodologies between our draft valuation report and the valuation report issued by GRS (actuary for the Federated System) for the Federated Medical and Dental Plan.

We met with representatives of the City, GRS, representatives of the Retirement Boards and Macias and Gini (auditors for the City and the Retirement Systems) on December 8, 2006 to discuss the differences in assumptions and methods between GRS and Segal. As a result of that meeting, we were requested by your office to recalculate the GASB 43 and 45 results with both an 8.0% discount rate and a 5.3% discount rate, using both the Entry Age Normal (EAN) and Projected Unit Credit (PUC) cost methods. In addition, we have addressed several issues in this letter that were raised in our December 8 meeting.

- **Rerun the GASB 43 and 45 results using both a 5.3% discount rate and an 8.0% discount rate.**

Our original draft valuation report contained the results using both a 4.5% discount rate and an 8.0% discount rate. The 4.5% discount rate was predicated on the assumption that there would be no change in the Police and Fire Board's contribution policy to fund the cashflows for the medical and dental benefits payable over the next 10 years while the 8.0% discount rate was provided for illustrative purposes assuming that the liability would be funded on a full actuarial basis.

In the GRS report for the Federated Medical and Dental Plan, they provided the calculation using only the 8.25% discount rate they used for the Federated retirement benefit valuation assuming that the liability would be funded on a full actuarial basis.

At the December 8 meeting, the City requested that we provide an additional set of results assuming a 5.3% discount rate under the current 10-year cashflow funding policy. The 5.3% discount rate was calculated by weighting an assumed rate of 5% that the City believed it would be able to earn on its investment with the 8% return that the Police and Fire System would earn for contributions deposited under the current 10-year cashflow funding policy.

At the meeting, we requested the City to confirm that their 5% investment return assumption was a long term assumption because at the current time, the yields on 10-year and 30-year Treasury bonds are in the range of 4-5%. We have also confirmed, based on a review of a 2006 study prepared by the Police and Fire Board's investment consultant (that we received for another California public retirement plan client) that their prediction for return on shorter term cash investments was about 3.6% per annum over the next 20 years.

At the meeting, Macias and Gini opined that the 5.3%[1] discount rate requested by the City for the Police and Fire plan was within the reasonable range for such an assumption under GASB 43 and 45. We would defer to the Police and Fire Board's auditor as the final authority in the matter of selecting the ultimate discount rate.

- **Rerun the GASB 43 and 45 results using both the Entry Age Normal (EAN) and Projected Unit Credit (PUC) actuarial cost methods**

Our original draft valuation report contained the results using the EAN actuarial cost method, the same funding method adopted by the Police and Fire Retirement Board for budgeting contributions for retirement benefits. GRS had prepared results for the Federated Medical and Dental Plan using the PUC method even though the Federated Board uses the EAN method for funding retirement benefits.

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[1] For the Federated Plan, the rate requested by the City was 5.6%.

The EAN method develops cost as a level percentage of payroll over each member's active working lifetime. The PUC method develops costs that accrue in proportion to the value of the service rendered by each member. The PUC costs generally start out lower but they will continue to increase as a percentage of each member's pay over their active working lifetime. Both methods are acceptable under GASB 43 and 45 and we believe there are merits for using a consistent actuarial funding method (i.e., EAN) for valuing the full actuarial accrued liability for retirement, medical and dental benefits. However, the choice of actuarial funding method is at the full discretion of the Retirement Board.

> **Healthcare trend assumption**

Our original draft valuation report used an initial healthcare trend assumption of 12% per year, grading down 1% per year down to an ultimate rate of 5%. The GRS valuation report for the Federated Medical and Dental Plan used an initial healthcare trend assumption of 12% per year, grading down 1% per year down to an ultimate rate of 4%. The 4% ultimate healthcare inflation assumption was also used by GRS as the general price inflation assumption. The initial issue was that Segal's ultimate medical trend assumption was higher than the general price inflation.

At the meeting, we explained our belief that there would continue to be increases in the utilization of medical services, etc. that would cause healthcare expenditures to outpace general price inflation. Since there would be real growth in wages, we do not believe a higher healthcare trend assumption would result in a prediction that healthcare expenditures would constitute a higher and higher percent of the U.S. economy over a very long period of time. In addition, at a recent meeting among a number of actuaries that perform GASB 43 and 45 studies in California, the general consensus was that ultimate healthcare inflation would be higher than general price inflation. The above arguments together with the observation that actual healthcare expenditures have exceeded our near term healthcare trend assumption over the last several years led us to continue to recommend to the Police and Fire Board the assumptions outlined in our draft report dated October 24, 2006.

It is our understanding your auditor is comfortable with our 5% ultimate trend rate assumption and GRS would also provide an alternative set of results assuming an ultimate healthcare trend of 4.5%.

> **Percentage of Medicare Eligibles**

Our draft valuation report stated that we were using an assumption that 90% of retirees reaching age 65 were eligible for Medicare. A question was raised at our December 8 meeting as to the appropriateness of the 90% assumption, given that individuals not eligible for Medicare at age 65 are required to enroll in Medicare.

After reviewing our valuation program we believe this assumption is appropriate, although the use of this assumption has no impact on the valuation results. The reason that this assumption has no impact on our valuation results is that regardless of whether a member is in Medicare, the Plan will pay the maximum subsidy for all members reaching age 65 when we take the Medicare Part B premium reimbursement into account.

> **Implicit Subsidy**

It is our understanding that for premium setting purposes, retirees not eligible for Medicare are pooled with active members. In general, the cost of healthcare for retirees is more expensive than for active members. For example, the true cost for a retiree may be $500 per month and the true cost for an active member under age 65 may be $200 per month. When they are pooled, the average cost may be $350. The difference between the $500 true cost for retiree coverage and the $350 "pooled cost", or $150 per month, is an "implicit subsidy" that must be valued under the GASB 43 and 45 requirements. Both Segal and GRS included the costs for the "implicit subsidy" in their valuation reports.

However, GRS reduced the "implicit subsidy" based on the idea that retirees generally have fewer children covered than actives. We have reviewed our internal calculations and have concluded that any adjustment we might incorporate to reflect the lower number of children for retirees would not have a material impact (less than 1% of payroll under the 4.5% discount rate scenario where the total Annual Required Contribution is 31.3% of payroll) on our valuation results.

Summary

We believe that all the actuarial assumptions and methods we used in our draft valuation report are in accordance with accepted actuarial principals. At the request of your office, we have prepared additional results using a 5.3% discount rate and an 8.0% discount rate, under both the EAN and PUC actuarial cost methods.

The attached exhibit contains our original valuation results and the results using the assumptions and methods requested by the Board. All results in the table are based on the same data used for our draft valuation report as of June 30, 2006. All actuarial assumptions are identical to the assumptions used in our draft valuation report, with the exception of the discount rate and the actuarial cost method, as noted above.

If you have any questions, please let us know.

Sincerely,

Paul Angelo, FSA, EA, MAAA
Senior Vice President & Actuary

Andy Yeung, ASA, EA, MAAA
Associate Actuary

Enclosure

MAM/bqb

SUMMARY OF VALUATION RESULTS AS OF JUNE 30, 2006

ACTUARIAL COST METHOD	EAN*	EAN	PUC	EAN*	PUC
DISCOUNT RATE	**4.50%**	**5.30%**	**5.30%**	**8.0%**	**8.0%**
Actuarial Accrued Liability by Participant Category					
Current retirees, beneficiaries and dependents	$469,344,884	$422,456,701	$422,456,701	$310,871,446	$310,871,446
Current active members	493,493,935	428,760,659	454,702,457	277,893,924	265,904,549
Total	$962,838,819	$851,217,360	$877,159,158	$588,765,370	$576,775,995
Actuarial Value of Assets	$38,381,423	$38,381,423	$38,381,423	$38,381,423	$38,381,423
Market Value of Assets	$40,519,000	$40,519,000	$40,519,000	$40,519,000	$40,519,000
Unfunded Actuarial Accrued Liability	$924,457,396	$812,835,937	$838,777,735	$550,383,947	$538,394,572
Funded Ratio	4%	5%	4%	7%	7%
Annual Required Contribution (ARC)					
Normal cost	$41,956,307	$34,053,189	$31,551,711	$17,495,644	$16,908,634
Amortization of the unfunded actuarial accrued liability	33,006,106	32,255,372	33,284,808	30,079,973	29,424,722
Less Employee Contributions	(8,260,094)	(8,260,094)	(8,260,094)	(8,260,094)	(8,260,094)
Adjustment for timing (payable throughout the year)	1,686,654	1,757,177	1,718,168	1,903,025	1,853,334
Total annual required contribution, including adjustment for timing	$68,388,973	$59,805,644	$58,294,593	$41,218,548	$39,926,596
ARC as percent of payroll (based on projected payroll of $218,521,000 for fiscal year 2006-2007)	31.3%	27.4%	26.7%	18.9%	18.3%

* Results presented in draft report dated October 24, 2006.

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December 19, 2006

Mr. Edward F. Overton and Mr. Thomas Webster
Director, Department of Retirement Services
1737 N. First Street. Suite 580
San Jose, CA 95112-4505

Re: Valuation Results using Alternate Actuarial Assumptions

Dear Ed and Tom:

As you requested, we are providing alternate scenarios for the June 30, 2006 actuarial valuation results. We have calculated results using the following scenarios:

- Lower discount rate of 5.6% with Projected Unit Credit (PUC) funding
- Lower discount rate of 5.6% with Entry Age Normal (EAN) funding
- Lower discount rate of 5.6%, PUC funding and higher ultimate medical trend rate of 4.5%
- Lower discount rate of 5.6%, EAN funding and higher ultimate medical trend rate of 4.5%

Other than the changes noted above, we have used the same data and assumptions for this study as those used in the June 30, 2006 valuation of retiree health benefits.

The Annual Required Contribution (ARC) is the amount that must be expensed under GASB Statement No. 45. We have calculated the change in the ARC under the four scenarios, all using 30-year amortization:

- If the discount rate is lowered from 8.25% to 5.6%, the ARC increases by $11,135,541 to $35,485,078.
- If the discount rate is lowered to 5.6% and EAN funding is used, the ARC increases by $10,814,423 to $35,163,960.
- If the discount rate is lowered to 5.6% and the ultimate medical trend rate is changed to 4.5%, the ARC increases by $13,727,416 to $38,076,953.
- If the discount rate is lowered to 5.6%, EAN funding is used, and the ultimate medical trend rate is changed to 4.5%, the ARC increases by $14,176,501 to $38,526,038. Results of our calculations are enclosed.

In the two scenarios in which the ultimate trend rate has been increased to 4.5%, we retained the ultimate trend rate for dental at 4%.

With 30-year amortization of the unfunded liability, the results are interesting. As would always be the case, the accrued liabilities are higher under EAN than PUC due to EAN's recognition of liability earlier in an individual's career. However, there is higher normal cost under PUC, largely due to the relatively old average age of the active membership. If a much shorter amortization period was used, the expense under EAN would be significantly higher than under PUC.

Enclosed is a bill. We are only charging you for three of the four scenarios presented. Once it became apparent that the PUC and the EAN expense were reasonably close if 30-year amortization is elected, we wanted to show two scenarios under EAN instead of the one scenario initially proposed.

Please call if you have any questions.

Sincerely yours,

Rick Roeder

Rick Roeder, FSA

Rebekah Bayram

Rebekah Bayram, FSA

City of San Jose
Summary of Valuation Results
Scenarios with Alternate Actuarial Assumptions
June 30, 2006

We have calculated the Annual Required Contribution (ARC) as described in GAS 45 for Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. Note that this amount is an accounting requirement, not a funding requirement. GAS 45 does not mandate pre-funding.

		Alternate Scenarios			
	6/30/2006 Original Valuation	**Lower discount PUC**	**Lower discount EAN**	**Lower discount Higher Ultimate Trend PUC**	**Lower discount Higher Ultimate Trend EAN**
Actuarial Liability					
Actuarial Liability - Active Lives	$169,292,376	$278,409,616	$318,388,171	$295,586,681	$332,052,460
Actuarial Liability - Inactive Lives	$7,852,245	$12,304,747	$12,304,747	$13,034,246	$13,034,246
Actuarial Liability - Retired Lives	$266,168,891	$349,254,205	$349,254,205	$357,851,959	$357,851,959
Total Actuarial Liability	$443,313,512	$639,968,568	$679,947,123	$666,472,886	$702,938,665
Funded Status					
Actuarial Value of Assets	$81,288,000	$81,288,000	$81,288,000	$81,288,000	$81,288,000
Actuarial Liability	$443,313,512	$639,968,568	$679,947,123	$666,472,886	$702,938,665
Unfunded Actuarial Liability	$362,025,512	$558,680,568	$598,659,123	$585,184,886	$621,650,665
Plan Funded Ratio	18%	13%	12%	12%	12%
Required Expense and Net Obligation					
Normal Cost	$3,613,887	$12,273,140	$10,291,002	$13,763,819	$12,697,832
Amortization of Unfunded Actuarial Liability	$20,735,650	$23,211,938	$24,872,958	$24,313,134	$25,828,206
Annual Required Contribution (ARC)	$24,349,537	$35,485,078	$35,163,960	$38,076,953	$38,526,038
Annual OPEB Cost	$24,349,537	$35,485,078	$35,163,960	$38,076,953	$38,526,038
Net OPEB Obligation	$0	$0	$0	$0	$0
Amortization Period (years)	30	30	30	30	30
Assumed Discount Rate	8.25%	5.60%	5.60%	5.60%	5.60%
Payroll	$275,558,882	$275,558,882	$275,558,882	$275,558,882	$275,558,882
ARC as percent of payroll	8.8%	12.9%	12.8%	13.8%	14.0%
Medical Trend	12% graded down to 4%	12% graded down to 4%	12% graded down to 4%	12% graded down to 4.5%	12% graded down to 4.5%
Dental Trend	6% graded down to 4%	6% graded down to 4%	6% graded down to 4%	6% graded down to 4%	6% graded down to 4%
Change in ARC in relation to original valuation		*$11,135,541*	*$10,814,423*	*$13,727,416*	*$14,176,501*

Attachment 3

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

City of San José

BARTEL ASSOCIATES, LLC

Retiree Healthcare Plan
June 30, 2007 Actuarial Valuation
Federated City Employees

July 2007

City of San José – Federated City Employees
June 30, 2007 Retiree Healthcare Actuarial Valuation

On June 21, 2004, the Governmental Accounting Standards Board approved Statement No. 45 (GASB 45), Accounting Standards for *Other* (than pensions) *Post Employment Benefits* (OPEB). This report is based on the financial reporting standards established under GASB 45. Historically the City has partially funded the retiree healthcare benefits. GASB 45 will require the City account for the retiree healthcare benefits on an accrual basis (as benefits are earned). We understand the City is required to implement GASB 45 for its 2007/08 fiscal year[1].

STUDY RESULTS

Funding Policy: Currently the City contributes 50% of the cost of medical benefits and 73% (8/11ths) of the cost of dental benefits for retired Federated City employees, with the active Federated employees paying the remainder of the cost. The contributions are actuarially determined based on 15 year cash flow projections. For 2007/08, the City contribution rate for retiree medical and dental benefits is 3.82% of payroll; with the employees contributing 3.32% of payroll.

Funded Status: The plan funded status is equal to the Actuarial Liability (see definitions and assumptions section below) less plan assets. When assets equal liabilities, a plan is considered on track for funding.

To consider a retiree healthcare plan funded for GASB 45 purposes, assets must be set aside in a trust that cannot legally be used for any purpose other than to pay retiree healthcare benefits. The City's Federated retiree healthcare plan is currently partially funded. Plan assets are invested in an irrevocable trust together with the Federated City Employees' Retirement System assets. This has important implications on the discount rate assumption used to calculate plan liabilities (see definitions and assumptions section below). We have prepared valuation results under 2 scenarios:

- Continue Current Funding Policy – Uses a blended discount rate of 5.55%, which represents actual contribution that is 20% between Pay-As-You-Go (5%, assumed long term rate of return on City's General Fund) and full pre-funding (assumed 7.75%).
- Full Pre-Funding – Contributions made to an irrevocable trust with diversified assets which are assumed to earn a 7.75% long term return.

The following table summarizes the Federated plan's June 30, 2007 funded status (000s omitted):

	Current Funding Policy 5.55%	**Full Pre-Funding 7.75%**
Actuarial Liability (AL)		
• Actives	$ 489,704	$ 333,186
• Retirees	441,616	345,096
• Total	$ 931,320	$ 678,282
Plan Assets[2]	93,537	93,537
Unfunded AL (UAL)	$ 837,783	$ 584,745

1 Assumes the City was a Phase I GASB 34 implementer.
2 Estimated assets as of 6/30/2007.

Annual Required Contribution (ARC): GASB 45 doesn't require an agency make up any shortfall (unfunded liability) immediately, nor does it allow an immediate credit for any excess assets. Instead, the difference is amortized over time. Annual Required Contribution is nothing more than the current Normal Cost, plus the amortized unfunded liability or less the amortized excess assets. Simply put, this contribution is the value of benefits earned during the year plus something to move the plan toward being on track for funding. For the City's Federated valuation we calculated the total ARC as the total Normal Cost plus a 30-year amortization (as a level percent of pay) of the Unfunded Actuarial Liability. The estimated 2007/08 Federated employee contributions are then subtracted to determine the remaining portion of the 2007/08 ARC (000s omitted):

	Current Funding Policy 5.55%	**Full Pre-Funding 7.75%**
Total Normal Cost	$ 26,463	$ 15,387
UAL Amortization	39,842	36,450
2007/08 Total Annual Required Contribution	$ 66,305	$ 51,837
Less 2007/08 Federated Employee Contributions (with interest to end of year)	9,561	9,661
2007/08 Annual Required Contribution	$ 56,744	$ 42,176
2007/08 Annual Required Contribution as a percentage of estimated 2007/08 payroll	20.2%	15.0%

Net OPEB Obligation (NOO): The Net OPEB Obligation is the historical (from implementation)[3] difference between actual contributions made and the Annual Required Contributions. If an agency has always contributed the required contribution, then the Net OPEB Obligation equals zero. However, an agency has not "made" the contribution unless it has been set aside and cannot legally be used for any other purpose.

[3] GASB 45 specifies the initial Net OPEB Obligation (at implementation) be set to zero.

Annual OPEB Cost (AOC): GASB 45 requires the Annual OPEB Cost equal the Annual Required Contribution, except when an agency has a Net OPEB Obligation at the beginning of the year. When that happens the Annual OPEB Cost will equal the ARC, adjusted for expected interest on the Net OPEB Obligation and reduced by an amortization of the Net OPEB Obligation (000s omitted):

	Current Funding Policy 5.55%	Full Pre-Funding 7.75%
2007/08 Annual Required Contribution	$ 56,744	$ 42,176
Interest on Net OPEB Obligation	0	0
Amortization of Net OPEB Obligation	0	0
2007/08 Annual OPEB Cost	$ 56,744	$ 42,176

The following illustrates the City's estimated June 30, 2008 Net OPEB Obligation for the Federated City employees (000s omitted):

	Current Funding Policy 5.55%	Full Pre-Funding 7.75%
June 30, 2007 Net OPEB Obligation	$ 0	$ 0
2007/08 Annual OPEB Cost	56,744	42,176
2007/08 Estimated City Contributions	(11,001)[4]	(42,176)[5]
June 30, 2008 Net OPEB Obligation	$ 45,743	$ 0

The actual June 30, 2008 Net OPEB Obligation for Federated employees will differ slightly from the above because the City contribution will be different from estimated.

4 Estimated 2007/08 City contribution = 3.82% of estimated Federated payroll, with interest to end of year.
5 Assumes full ARC is contributed.

Projected Benefit Payments: The Federated results presented in this report include the City's cash subsidy as well as the implied subsidy (see definitions and assumptions section below). Following are 15-year Federated benefit payout projections separated into cash and implied subsidy (000's omitted):

Year	Cash Subsidy	Implied Subsidy	Total
2007/08	$ 20,886	$ 2,719	$ 23,605
2008/09	23,504	3,180	26,684
2009/10	26,410	3,739	30,149
2010/11	29,639	4,288	33,926
2011/12	33,070	4,753	37,824
2012/13	36,534	5,154	41,688
2013/14	39,955	5,549	45,504
2014/15	43,585	6,053	49,638
2015/16	47,556	6,667	54,222
2016/17	51,325	7,253	58,578
2017/18	54,852	7,711	62,563
2018/19	58,518	8,260	66,778
2019/20	62,543	8,972	71,515
2020/21	66,662	9,698	76,360
2021/22	70,437	10,313	80,750

Sensitivity: The above results are based on a 30-year amortization of the unfunded liability. Following illustrates the impact of changing the amortization period to 20 years (000s omitted):

	Current Funding Policy 5.55%	Full Pre-Funding 7.75%
■ 30-year amortization		
• ARC $	$ 56,744	$ 42,176
• ARC %	20.2%	15.0%
■ 20-year amortization		
• ARC $	$ 70,972	$ 51,572
• ARC %	25.3%	18.4%

BASIC DEFINITIONS AND ASSUMPTIONS

Present Value of Benefits: When an actuary prepares an actuarial valuation, (s)he first gathers participant data (including active employees, former employees not in payment status, participants and beneficiaries in payment status) at the valuation date (for example June 30, 2007). Using this data and actuarial assumptions, (s)he projects future benefit payments. (The assumptions predict, among other things, when people will retire, terminate, die or become disabled, as well as what salary increases, general (and healthcare) inflation and investment return might be.) Those future benefit payments are discounted, using expected future investment return, back to the valuation date. This discounted present value is the plan's present value of benefits. It represents the amount the plan needs as of the valuation date to pay all future benefits – if all assumptions are met and no future contributions (employee or employer) are made. The June 30, 2007 Federated retiree healthcare Present Value of Benefits is $1.2 billion using a 5.55% discount rate ($798 million using a 7.75% discount rate), with $442 million of this for former employees who have already retired ($345 million using a 7.75% discount rate).

Actuarial Liability: This represents the portion of the present value of benefits that participants have earned (on an actuarial, not actual, basis) through the valuation date. The June 30, 2007 Federated retiree healthcare Actuarial Liability is $931 million using a 5.55% discount rate ($678 million using a 7.75% discount rate), with $442 million of this for former employees who have already retired ($345 million using a 7.75% discount rate).

Plan Assets: To consider a retiree healthcare plan funded for GASB 45 purposes, assets must be set aside in a trust that cannot legally be used for any purpose other than to pay retiree healthcare benefits. The City's Federated retiree healthcare plan is currently partially funded. Plan assets are invested in an irrevocable trust together with the Federated City Employees' Retirement System assets. Estimated plan assets for the Federated retiree healthcare plan as of 6/30/2007 are $93.5 million.

Normal Cost: The Normal Cost represents the portion of the present value of benefits expected to be earned (on an actuarial, not actual, basis) in the coming year. The June 30, 2007 total Federated retiree healthcare Normal Cost is $26.5 million (9.4% of payroll) using a 5.55% discount rate and $15.4 million using a 7.75% discount rate (5.5% of payroll). The Normal Cost, after subtracting the expected employee contributions, is $16.9 million (6.0% of payroll) using a 5.55% discount rate and $5.7 millions using a 7.75% discount rate (2.0% of payroll).

Actuarial Cost Method: This determines the method in which benefits are actuarially earned (allocated) to each year of service. It has no effect on the Present Value of Benefits, but has significant effect on the Actuarial Liability and Normal Cost. The City's June 30, 2007 retiree healthcare valuation was prepared using the Entry Age Normal, level percent of pay cost method.

Implied Subsidy: GASB 45 requires that the implied subsidy for retirees be included in the AAL and the ARC for plans that are not community rated. An implied subsidy exists when the premium for a group of employees is determined by aggregating the experience of the group. For example, assume we have one active employee and one (non-Medicare eligible) retiree with a $600 monthly premium. The underlying medical cost varies by age and gender and might actually be $300 per month for the younger active employee and $900 per month for older retiree. In this case, the premium for the employee is subsidizing (by $300) the premium of the retiree. We valued the implied subsidy for all the City's health plans.

Actuarial Assumptions: Under GASB 45, an actuary must follow current actuarial standards of practice, which generally call for explicit assumptions - meaning each individual assumption represents the actuary's best estimate.

GASB 45 requires that the discount rate is based on the source of funds used to pay benefits. This means the underlying expected long-term rate of return on plan assets for funded plans. Under the City's current funding policy, the City contributes more than Pay-As-You-Go but less than the full ARC. In this case, GASB 45 requires the discount rate be based on a blended rate. For this valuation, a blended rate of 5.55% was used, assuming the actual contribution is 20% between Pay-As-You-Go (5%, assumed long term rate of return on City's General Fund) and full pre-funding (assumed 7.75%). We also show results at 7.75% to show the impact of full pre-funding. The appropriate discount rate will be determined based on the plan's actual asset diversification.

Another key assumption is future healthcare inflation rates. Actual 2007 medical premiums were used in the valuation. The inflation rate for HMO's starts at 10.4% (the increase in 2008 premiums over 2007) and grades down to 4.5% (2017 premiums over 2016) and remains at 4.5% into the future. The inflation rate for PPO's starts at 11.3% (the increase in 2008 premiums over 2007) and grades down to 4.5% (2017 premiums over 2016) and remains at 4.5% into the future. This assumption means healthcare is assumed to increase, on the average, 7.4% for HMO's and 7.9% for PPO's a year for the next 10 years. Furthermore, since the valuation's general inflation assumption is 3%, it also means healthcare is assumed to level off at 1.5% over general inflation.

BENEFIT PROMISE

The following table summarizes medical benefits:

■ Medical Eligibility	■ Service or disability retirement directly from City with either: ➢ 15 years City service, or ➢ Receiving ≥ 37.5% final pay ■ Deferred vested members eligible at retirement if terminated with 15 years City service
■ Medical Benefit	■ 100% of lowest cost health plan available to active employees ■ 2007 Caps: ➢ Single - $399.28 (Blue Shield HMO) ➢ Family - $999.40 (Kaiser) ■ Same dollar Caps pre and post Medicare eligibility ■ Spouses, domestic partners, dependent children covered
■ Dental Eligibility	■ Service or disability retire directly from City with 5 years City service
■ Dental Benefit	■ 100% dental premiums for employee and dependents
■ Vision and Life	■ Available at retiree's expense
■ Surviving Spouse Benefit	■ Eligibility: ➢ Death while retired or before retirement but eligible for retiree medical and/or dental benefits, and ➢ Survivor receiving monthly survivorship allowance ■ Benefits: ➢ Same medical and dental benefits continue