Tax Supported
Special Report

Old Promises, Emerging Bills
Considering OPEB in Public Finance Ratings

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■ Summary

As the first deadline for implementation of Governmental Accounting Standards Board Statement No. 45 (GASB 45) approaches, Fitch Ratings has further developed its thinking on the credit implications for state and local governments of providing long-term funding for other post-employment benefits (OPEB). This report follows up on Fitch Research in June 2005 titled "The Not So Golden Years (Credit Implications of GASB 45)" *(available on Fitch's web site at www.fitchratings.com)*. It focuses on how the various approaches to managing and funding the liability will affect Fitch's credit analysis, rather than on meeting the reporting deadlines set forth by GASB 45, as Fitch expects such compliance from issuers it rates. Failure to comply will be considered a weak management practice. This report also examines several governments that have taken prudent actions related to OPEB.

■ Overview

Many governments did not anticipate the magnitude and explosive growth of health care costs, although most governments have prepared well to manage the growing pension portion of retirement costs — most pension plans have been in place for 30 years or more and are adequately funded. In many cases, gross OPEB liabilities are a sizable fraction of gross pension liabilities, but unlike the latter, few of the former are prefunded. Thus, unfunded OPEB liabilities are often significantly larger than unfunded pension liabilities.

Fitch will incorporate a government's approach to addressing its OPEB liability, as well as the magnitude of the liability itself, into its analysis of the main credit factors: finances; debt and other long-term liabilities; management; and the economy. Fitch views OPEB liabilities in the context of a number of rating parameters, including pension liability funding ratios, debt levels, and budget and tax rate flexibility. Also noted is the impact on the liability of health care inflation and investment return rates, the latter in the case of trusts set up to prefund the obligation.

As more governments receive actuarial reports that estimate the liability, Fitch will evaluate those reports and discuss the governments' plans for addressing the liability. Fitch will assess the assumptions used in the actuarial report, recognizing that they have a significant impact on the resulting liability. Fitch expects that after the actuarial report is released, municipalities will begin to develop plans that may include funding of the existing liability, benefit plan adjustments, increased employee and retiree contributions, and other programs to reduce the liability or curb its growth. Final decisions on handling this liability may go beyond the GASB 45 implementation date.

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While OPEB liabilities are not new, GASB 45's reporting requirements provide governments with a framework for quantifying them. Fitch anticipates that compliance with the standard will be a first step in a multiyear process of addressing the liabilities for most entities. Fitch will evaluate choices an issuer makes among the options available for both funding and managing the liability and will view negatively an issuer that chooses not to address the liability in any substantive way. Ratings are fundamentally an indication of comparative credit strengths and weaknesses among borrowers. The existence of a very large liability and the long-term burden that it places on an issuer's resource base will be incorporated into the analysis.

■ Impact of OPEB on Rating Analysis

The following sections describe Fitch's process for incorporating OPEB liabilities and issuers' plans for addressing them into its analysis of three main rating factors.

Management

In its analysis of management, Fitch views positively governments that are forward-thinking, anticipating potential problem issues, and taking an active approach to minimizing or eliminating them. It is in this context that Fitch will evaluate management's approach to OPEB. Many governments, particularly those subject to Phase I implementation, are now in the evaluation phase. Some actuarial studies have been completed, many are in process, and officials are reviewing and reconsidering benefits offered and participants' contribution levels, which is perhaps the most difficult part. Fitch considers timely compliance with GASB 45 requirements to be standard and views failure to meet the prescribed deadline negatively. Fitch also expects actuarial studies to employ realistic assumptions.

Fitch anticipates that many governments will explore making adjustments to retiree health care coverage, as well as the cost of continuing to provide existing coverage levels. GASB 45 sets forth the accounting method for the benefits offered, requiring the calculation to be based on benefits that an employee could reasonably expect to receive based on what is provided currently. However, GASB 45's purview does not include a determination of an entity's legal requirement to provide health care benefits.

While the legal obligation to pay pensions is clearly defined, the legal obligation to pay OPEB is not as clearly defined, varies by state, and will require judicial determination in some cases. OPEB is not always a contractual agreement, and even in cases where it is, it may be negotiable. Therefore, theoretically, governments can exert some degree of control over the liability by such actions as altering benefits provided and eligibility thresholds, increasing premium sharing with employees and retirees, and increasing copayments and deductibles. However, the extent of the legal obligation may vary by class of employee, hiring or retirement date, employment status (active employee, retiree, or future hire), and vesting status. The ability to implement changes may be limited by labor opposition, and in many states, such changes require negotiations with labor groups and could result in years of litigation.

While benefit reductions and cost-sharing practices can reduce the ultimate liability, governments will have to balance the reward of benefit expense reduction against the risk of becoming unattractive as an employer. Benefit changes are likely to have political or practical ramifications. The creation of two- or multi-tiered benefit systems for vested, nonvested, and new employees, another often discussed action, requires an examination of the tradeoffs between current expenses, long-term liabilities, and workplace morale.

A few proactive entities have begun developing and implementing plans in advance of the GASB 45 compliance dates. Others are raising awareness with their labor groups and the public about the rising costs of OPEB in anticipation of gaining the cooperation they will need to implement a solution. Fitch anticipates that most issuers it rates that have not already done so will at least make progress in developing plans over the next two years.

In contrast, if an issuer's GASB 45 compliance shows a large and growing OPEB liability and the entity chooses to defer action, Fitch's assessment of management would be negative, which could have rating implications. This is true particularly of credits that are currently rated highly, as inaction would be inconsistent with other management characteristics generally employed in such credits.

Debt and Other Long-Term Liabilities

Fitch views the OPEB liability as similar to that for a pension (i.e. a "soft" liability, as opposed to a "hard" liability, i.e. debt). Debt service payments are due on a certain date and cannot be postponed or reduced, unlike pension plan contributions, which governments sometimes defer during fiscal downturns. OPEB is an even more volatile liability than pensions because it varies with trends in medical costs, as well as retirement rates, salary patterns, employer versus employee contributions, and other factors incorporated into pension actuarial calculations.

Consistent with its treatment of unfunded pension liabilities, Fitch will not include OPEB liabilities on an issuer's debt statement. However, Fitch considers unfunded pension and OPEB liabilities in the rating analysis and quantifies them similarly to debt — as a percentage of the tax base value, as a per capita figure for local governments, and as a percentage of per capita personal income for states. For instance, a large and growing unfunded pension liability combined with a sizable OPEB obligation would negatively affect an otherwise strong debt profile.

Like the use of pension obligation bonds, the issuance of OPEB obligation debt, which a small number of entities have done and others are considering, directly affects an entity's debt ratios. The debt converts the pension or OPEB liability to a hard liability from a soft obligation and therefore makes it a more tangible credit factor. However, Fitch does include the ratios without these bonds as a secondary consideration, since the bonds replace another long-term liability. Fitch believes that the moderate use of this type of debt as part of a prudent comprehensive debt management plan can be included in an overall plan to address the OPEB liability.

However, Fitch believes that it is not necessary, and perhaps not even prudent, to fully fund an irrevocable trust through debt. Fully bonding a trust exposes an issuer to a potential erosion of assets if the value of investments drops and may lead to an increase in the liability or at least a missed opportunity to control it. The latter was demonstrated with pensions during the stock market run-up in the late 1990s and early 2000s, when many governments awarded generous benefit increases with the expectation that they would be funded with investment earnings.

An additional concern related to issuing OPEB bonds is their effect on future debt capacity. For example, in states with general obligation debt limitations, issuance of OPEB bonds could limit an issuer's ability to borrow for capital needs.

Finances

OPEB is one of many costs of government that will compete for limited resources. Therefore, Fitch will look at OPEB in the context of the entity's overall financial situation, including revenue-raising and expenditure flexibility, the size of the expense relative to overall spending (on a pay-as-you-go and accrual basis), other spending pressures, and reserve levels.

In initial discussions with municipal issuers throughout the U.S., Fitch found a wide range of OPEB liability estimates. In cases where these benefits are minimal or eligibility is restricted to long-term employees, the liability appears manageable, and full funding is likely to be accommodated within current budget parameters. In others, financial flexibility is high as a result of structural budget surpluses, low or moderate tax rates, other revenue-raising ability, or expenditure reduction options so that even a sizable OPEB liability can be funded without compromising financial operations.

However, in many situations, moving to full funding of the annual required contribution (ARC) will entail a sharp spending increase, crowding out other budget priorities. For issuers in many states, limitations on taxes, fees, and charges greatly restrict revenue-raising ability, furthering the financial pressures. For these issuers, an effective OPEB management plan will likely need to address expenditures more than revenues, which entails cooperation by all interested parties.

Even for governments without legal tax limitations, the effect of simply raising taxes to fund a large obligation with no efforts to otherwise mitigate the liability may present excessive tax burdens or service cuts that have negative economic and competitive implications. Taxpayers may be reluctant to pay additional taxes to fund a benefit most of them do not receive. This suggests a combination of more aggressive cost sharing and liability reduction actions, the possible moderate use of debt, and a phased approach to tax increases, in addition to standard economic development efforts, to maintain economic competitiveness.

Based on early estimates, issuers generally are reporting ARCs of anywhere from two to 10 times the current pay-as-you-go amount. Fitch will review the magnitude of this differential, realizing that the ARC will generally be much higher over the next several years than the pay-as-you-go amount. For entities facing large liabilities, Fitch will consider the long-term costs of the funding decision, particularly if the decision is to continue with pay-as-you-go funding. While prefunding may be financially, practically, and politically difficult, inaction may lead to a crisis many years from now, as costs continue to rise. Fitch will review a government's funding plans, believing that it is appropriate to increase funding to reach the ARC over a "reasonable" period — one that minimizes growth in the liability while maintaining sufficient financial stability.

Fitch believes that the creation of a dedicated trust requires an understanding of the associated benefits and risks. A trust can dramatically lower the unfunded actuarial liability and the ARC by allowing for a higher, long-term investment rate. Estimates indicate that a 100-basis-point increase in the discount rate yields a 15% reduction in the unfunded liability, although actual returns may of course vary from the assumed discount rate. This argues for allocating funding as close to the level of the ARC as possible. However, funding a trust entails the irrevocable restriction of otherwise free reserves that could be available for other essential government needs. Fitch believes that reducing long-term liabilities like OPEB is a positive credit characteristic, but an adequate unreserved fund balance remains an element of a sound fiscal condition.

Some municipalities have allocated a portion of their recent operating surpluses to an OPEB reserve, which Fitch views as a good use of nonrecurring resources. Fitch will consider not just irrevocable trusts but all methods of setting aside funding for future OPEB liability, including reserves within the general fund and the establishment of a separate, dedicated fund to accumulate reserves. While an issuer would not be able to apply the same discount rate, these methods provide more flexibility.

■ Conclusion

Fitch believes that the looming OPEB liability for many governments, if not confronted over a reasonable time, will eventually manifest itself as a monumental budget challenge. Various actions, including taking more moderate and gradual measures, implemented over the near term will prevent the need for more drastic solutions and problems over the long run. Over the next few years, Fitch's credit analysis and ratings will reflect how each government develops and implement plans for OPEB funding and cost control and the impact these measures have on the total liability, funding progress, and the overall financial condition of the government.

■ Case Studies

City of Norwalk, Connecticut

Norwalk, CT (general obligation bonds rated 'AAA' with a Stable Rating Outlook by Fitch) was among the first municipalities to report its OPEB liability in a preliminary offering statement. A city of roughly 85,000 in southwestern Connecticut, nearly all municipal employees are eligible for retiree medical benefits, including Medicare-eligible retirees. For fiscal 2005, Norwalk paid approximately $7.4 million on a pay-as-you-go basis for benefits received by 928 retirees.

The city hired an actuarial firm to conduct a valuation of its retiree medical program as of July 1, 2005. The valuation illustrates some of the variability inherent in an actuarial estimate. Norwalk's baseline unfunded actuarial accrued liability (UAAL) was valued at $152.7 million, assuming a fully funded trust and a downward-trending annual medical inflation rate. Manipulating either of these assumptions varied the extent of the liability markedly. For instance, using a short-term investment return rate and adding 1% to the medical inflation rate boosted the liability to $469.6 million, a 207.6% change from the baseline amount. Similar variances existed for the ARC, which ranged from 1.6–5.1 times the fiscal 2005 pay-as-you-go amount, depending on these two assumptions.

Consistent with its high credit rating, Norwalk has already developed what Fitch believes is a sound two-part approach to managing its OPEB liability. The city will phase in funding a $13.9 million ARC (assuming an 8.25% long-term investment rate and baseline medical inflation trend rate) with $2 million in fiscal 2008 and $4 million in fiscal 2009, gradually increasing funding to reach the actuarially determined amount by fiscal 2011. The property tax levy will increase by 5.2% and 7.1%, respectively, during the same two years. Buttressing these revenue increases are projected draws on reserves of $3.0 million and $3.5 million in fiscal 2008 and fiscal 2009, respectively.

The actuary's valuation underscores the importance of examining actuarial assumptions when considering OPEB liabilities and making comparisons between municipalities. Subtle changes in investment return and medical inflation rates have significant impacts on the ultimate liability and ARC figures, as do employee turnover, retirement, and mortality calculations.

City of Gainesville, Florida

A medium-sized city of approximately 121,000 in north central Florida, Gainesville is notable for its adoption in the mid-1990s of several best practices related to managing OPEB liabilities. More recently, it became one of the first local governments to issue OPEB bonds (Fitch rated the appropriations-backed issuance 'A+' with a Stable Rating Outlook). Fitch views positively the city's thorough, early actions to identify and address the liability.

Gainesville provides retiree medical insurance benefits for 1,688 active members, 664 retirees and beneficiaries, and 302 terminated, vested, and limited members. The city began undertaking biennial actuarial valuations of its retiree health care obligations in 1994. Having identified its normal cost and a UAAL amount, it established a fiduciary fund and began annual payments to cover the full ARC. It also sought to manage the liability by increasing employees' contributions. Beginning April 1, 1995, employees with 10 years of experience became responsible for 20% of their health plan costs; those hired after that date or with fewer years of experience became responsible for 50% of plan costs.

Despite the city's head start in funding a trust, a March 2005 OPEB valuation found the plan's unfunded liability to be $34.7 million. The plan's ARC was calculated at $4.2 million, 63% higher than the level three years prior. To address the rising UAAL and take advantage of low market interest rates, the city issued $35.2 million in OPEB bonds in July 2005, secured by a covenant to budget and appropriate non-ad valorem revenues equal to debt service and with a short, 10-year maturity. Bond proceeds were deposited into the retiree benefit trust, fully funding the remaining liability accrued to date. Following the OPEB bond issuance, Gainesville's debt burden was an above-average but manageable 4.8% of taxable market value, including the OPEB bonds and a separate series of pension bonds; without the OPEB and pension bonds, the city's debt would be a more moderate 1.6% of taxable market value. Fitch does not believe that this issuance of OPEB bonds jeopardizes the city's solid financial flexibility or increases debt beyond affordable levels.

Washington, D.C.

Since a deep fiscal crisis in the 1990s that led to recurring operating shortfalls and external financial oversight, Washington, D.C. (general obligation bonds rated 'A' with a Positive Rating Outlook by Fitch) has made broad financial reforms, including stringent expenditure controls and maintenance of prudent statutory reserves. With the economy's surge early in this decade, the city has benefited from strong revenue growth, leading to operating surpluses well beyond its statutory reserve requirements. Consistent with its adherence to strong financial discipline and enhanced flexibility, the city has made substantial and early progress toward addressing OPEB liabilities despite challenges it faces from rising spending needs, a high debt burden, and limits on revenue raising.

The district's OPEB burden is partly mitigated by the federal government's assumption of retiree obligations for district employees hired prior to Oct. 1, 1987. Even so, the district's latest actuarial valuation calculated an unfunded liability of about $425 million as of March 1, 2004 and projected a liability of $562 million as of Oct. 1, 2005. While well under the district's approximately $3.8 billion in tax-supported debt, the OPEB obligation represented a per capita liability of approximately $966 and 0.65% of 2005 market value. Moreover, district managers anticipated that the liability would grow to $1.5 billion within eight years, with growth in health care costs, as well as growth in the number of post-1987 retirees.

To begin addressing the liability, the district reserved portions of unanticipated operating surpluses. Its fiscal 2006 budget plan transferred $138 million of prior-year surplus funds to its OPEB trust and laid out a multiyear plan to raise its annual contribution to the actuarial required contribution level beginning in fiscal 2008. The transfer brought the trust fund's level to $153 million, leaving the unfunded liability at $409 million, equal to $702 per capita, or 0.42% of 2006 taxable market value.

County of San Diego, California

The county of San Diego, CA (certificates of participation rated 'AA–' with a Positive Rating Outlook by Fitch) is proposing to sharply cut plan expenses that had been a longstanding but not vested part of employee benefits. The county offers its retirees health care and dental benefits through the San Diego County Employees Retirement Association (SDCERA), a cost-sharing, multiple-employer defined benefit pension plan that also administers retiree health benefits. The SDCERA conducted a preliminary valuation of its postretirement benefits in 2005 and estimated a $639.5 million actuarial accrued liability.

To manage the OPEB liability, county supervisors voted unanimously in December 2006 to request that the SDCERA eliminate health care subsidies for virtually all employees who retired after March 8, 2002, the date pension benefits were increased. In the opinion of the county's counsel, state law guarantees retirees' pension benefits but does not guarantee health care benefits, and the county is not part of any collective bargaining agreement requiring the provision of retiree health care benefits. Instead, retirees receive health care benefits on a pay-as-you-go basis to the extent that the board of supervisors and the SDCERA funds them, as had been the case since the 1970s. The SDCERA retiree health care benefit program provides limited benefits for Medicare-eligible retirees. Thus, the county's leadership believes it has the legal flexibility to unilaterally limit the benefit, including those for some beneficiaries who have already retired.

Under the supervisors' proposed plan, more recent and future retirees will maintain health care insurance benefits but have to pay their own premium costs at a separate rate from active employees'. According to the plan proposed by the board of supervisors, the employer-funded benefit would remain in place for employees who retired prior to 2002. County supervisors estimate that the move will reduce the projected ARC to $20 million–$30 million from $60 million–$70 million. The plan must also be approved by the SDCERA board, but county supervisors have announced the intention of eliminating all retiree health care funding if the SDCERA's board does not agree to the move.

As one of the first issuers to propose a widespread change in employee contributions to OPEB funding, Fitch believes San Diego's experience will provide valuable information about issuers' ability to make such changes and the ramifications of doing so.

Carroll County, Maryland

Carroll County, MD (general obligation bonds rated 'AA+' with a Stable Rating Outlook by Fitch) provides health insurance benefits to retirees of the primary government and library system with at least 10 years of continuous county service. In fiscal 2006, the county paid $1.8 million on a pay-as-you-go basis for 278 eligible participants. In addition, the county's board of education paid $1.4 million on a pay-as-you-go basis for 702 eligible participants.

An actuarial valuation performed for Carroll County for the fiscal year ending June 30, 2008 identified a $98.2 million liability — assuming the creation of a trust fund — and a $10.3 million ARC; the valuation accounted for the implicit rate subsidy to retirees and included Medicare-eligible participants. The board of education's liability was an additional $52 million, with a $5.6 million ARC. Actuaries used a 7% investment rate of return assumption and a downward-trending annual health care inflation rate of 11.5% for fiscal 2006 to an ultimate rate of 5.5% after six years.

Carroll County has announced a two-part approach to managing its OPEB liability. First, the county plans to establish a trust fund in fiscal 2008 to start accruing funds toward the liability for county retirees. Second, the county will begin to contribute an additional $6 million annually toward its ARC through fiscal 2012, for a total of approximately $8 million annually, as part of an ultimate plan to raise payments equal to the full ARC.

State of Delaware

The state of Delaware (general obligation bonds rated 'AAA' by Fitch) began prefunding its OPEB expenses earlier this decade and is now taking steps to bring annual contributions up to its ARC. The state's strong credit is based on its economic and financial resources, including mechanisms to ensure annual surpluses. The state's tax-supported debt of nearly $1.9 billion totals about 6% of 2005 personal income, although nearly 80% of debt amortizes in 10 years; moreover, pension systems are overfunded. In addition to pensions, the state provides retirees with broad health care benefits, including coverage of premium payments, claims reimbursement for pre-Medicare retirees, and Medicare supplemental payments for eligible retirees.

In 2000, Delaware established an investment fund for retiree health premiums. The state established an annual prefunding level for contributions to the fund, as either a lump sum or a percentage of payroll. The state contributed $10 million to the fund in each of fiscal years 2005 and 2006 and is contributing 0.3% of payroll in fiscal 2007, equal to approximately $5 million. The fund currently has a balance of $25.2 million.

In anticipation of GASB 45 reporting requirements, Delaware is increasing annual funding to address the liability. An actuarial estimate based on July 2003 data revealed an OPEB liability of $3.2 billion, more than $1.3 billion higher than the state's level of tax-supported debt and equivalent to 10.2% of state personal income. The ARC was calculated at $210 million per year, equal to 7.1% of fiscal 2003 expenditures; the estimate excluded pay-as-you-go funding, which totaled $68.1 million in fiscal 2003. Since then, the pay-as-you-go level has continued to rise, reaching $96 million in fiscal 2006.

Fitch views favorably the state's timely development of a plan to address the liability. It appears manageable financially and includes actions to limit the size of the liability. The governor has announced a proposal to bring state funding up to the ARC within six years through a combination of funding and savings initiatives. As part of the plan, the state would establish an irrevocable trust to replace the existing investment account. Prefunding contributions to the trust would rise to 0.54% of payroll in fiscal 2008, or $9.6 million. The state also is focusing more broadly on identifying savings in its health care program delivery to current and former employees. In the past two years, it has identified $40 million in savings, much of it in management of prescription drug benefits; the state is shifting $30.5 million of the resulting surplus funds in its employee health insurance fund to address OPEB. If the proposals are enacted, the state anticipates reaching $70 million in funding by the end of fiscal 2008.