Background Paper: Other Post Employment Benefits

- GASB Statement 45 requires state and local governments to report other post-employment benefits (OPEB) similar to the way pension benefits are presented.
- New Jersey's OPEB obligations, which consist mostly of medical benefits for State and certain local retirees, are estimated to exceed $20 billion, the State Benefits Review Task Force found.
- Mercer Consulting estimates that governments that have not set aside money for these obligations could face liabilities 40 – 60 times the current annual cost of retirees' health care, suggesting a $40 billion to $60 billion OPEB liability for New Jersey.
- The State Benefits Review Task Force (2005) recommended retiree premium sharing, among other options, to help control OPEB costs.
- Bond rating agencies will evaluate total state debt obligations: bond debt service, pension liabilities, and OPEB liabilities to see whether these liabilities are sustainable in total.

Retiree Health Care Funding Options

The effect of rising health care costs on state budgets has been a challenge for the better part of the last two decades. The Government Accounting Standards Board (GASB), concerned about health care inflation and the degree to which states' financial statements do not capture its long-term implications, issued GASB Statement 45 — the "Accounting and Financial Reporting by Employers for Post-Employment Benefits Other Than Pensions." Reporting under this statement will be required for the states beginning with the fiscal year ending June 30, 2008 (FY 2008) and a wide range of previously unmeasured liabilities will be reported as a consequence. GASB is recognized by the Security and Exchange Commission as the rule making body for state and local governments and is the source of generally accepted accounting principles used by these entities.

GASB 45 requires that government financial statements treat other post-employment benefits (OPEB) — which are largely attributable to retiree health care — in the same way pension obligations are presented. These benefits have traditionally been accounted for on a pay-as-you-go (PAYGO) basis. Although the new OPEB accounting statement does not change the nature of these pre-existing retiree health care liabilities, it should cause states as employers to focus on this issue and their plans for managing these obligations.

In general, these OPEB liabilities are very large and vary widely from state to state, depending on the generosity of the plan features and the duration of promised benefits. At that time, states will have to ascertain whether or not they can: (1) prefund these liabilities, in the same manner that pension obligations are treated; (2) continue to fund these benefits on a PAYGO basis; or (3) arrive at some middle ground.

New Jersey's OPEB Liability

The State of New Jersey Benefits Review Task Force briefly touched upon this issue in its December 2005 report to Governor Codey and made some recommendations to help bring these rising costs under control. The report found that

Background Paper: Other Post Employment Benefits (Cont'd)

the State has experienced a history of rising health care benefits costs for both State and local retirees and that these costs will continue to rise, in spite of the State's effort to control these costs through initiatives such as premium sharing for State retirees and limiting State retiree participation in the State Health Benefits Program's (SHBP) Traditional Indemnity Plan.

The State's responsibility to fund costs of health benefits for retirees and their dependents, but not survivors, from local government educational employment is the majority of State retiree health care benefit costs. Qualified local retirees from the Teachers' Pension and Annuity Fund (TPAF) and other local school board retirees are eligible to participate in the State Health Benefits Plan, pursuant to P.L.1987, c.384 (C.52:14-17.32f). These retired school board and county college employees must accrue 25 years of service (or retire on a disability) to be eligible to receive fully paid health benefits coverage in the Traditional Plan as well as the point-of-service and all managed care plans. This law gave these local retirees the same benefit provided to State retirees. State employees who accrued 25 or more years of service on or before July 1, 1997 receive fully paid health benefits coverage in the Traditional Plan as well as all the point-of-service and managed care plans and full reimbursement of the prevailing cost of Medicare Part B, under the provisions of P.L.1996, c.18 s.6 (C.52:14-17.28b). However, State employees who attain 25 years of service credit or retire on disability after July 1, 1997, are required to share in paying the cost of coverage and Medicare Part B according to terms specified in the union contract applicable to them at the time they attain 25 years of service credit, or retire for disability. This cost sharing applied only to State retirees; the teachers' plan remained unchanged.

In addition, P.L.1997, c.330 (C.52:14-17.32i) provides State paid health care benefits to retirees of the Police and Firemen's System (PFRS), the Public Employees' Retirement System (PERS) and the Consolidated Police and Firemen's Pension Fund (CPFPF) and their dependents, but not survivors, who retire with 25 or more years of service credit, or on disability, and who do not receive payment toward their health care benefits from any other employer. The State pays 80 percent of the cost of the least expensive plan for the chosen type of coverage among the State health benefits plans. The retiree pays the remainder of the cost of whatever plan is chosen and pays for Medicare Part B.

The State's OBEP current obligation has initially been estimated to exceed $20 billion, the Review Task Force found (page 13). To put this $20 billion obligation in perspective, consider that State pension fund obligations are approximately $94.9 billion for the fiscal year ending June 30, 2004 (FY 2004). The key difference, however, is that whereas the State pension fund has more than $83 billion in valuation assets to help cover its estimated liability, leaving an unfunded actuarially accrued liability of nearly $12 billion, the OPEB liability is almost entirely unfunded. Furthermore, the largely unfunded $20 billion liability will grow unless the State actively addresses the OPEB issue.

Notwithstanding the unofficial estimate of $20 billion for New Jersey's OPEB liability, Mercer Consulting, a global corporate consultant firm, estimates that OPEB liability will be 40-60 times an entity's annual medical expenditures. This suggests that New Jersey's OPEB liability is in the $40 billion to $60 billion range.

Table 1 below displays projected State costs to fund State and local retiree health care benefits on a PAYGO basis. Costs associated with prefunding retiree health care benefits would be in addition to these PAYGO costs.

Background Paper: Other Post Employment Benefits (Cont'd)

Table 1: Estimated Retiree Health Care Benefit Costs (in millions)

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Health Benefits - Retired	$ 911.2	$ 1,015.2	$ 1,254.0	$ 1,533.6	$ 1,875.8	$ 2,294.5

Source: State of New Jersey Benefits Review Commission Task Force, page 13.

Other States' Experience

As a government employer, New Jersey is not alone with respect to the OPEB liabilities to be recognized under GASB 45. Any government employer that provides a commitment for a retiree health care benefits subsidy will be in a similar position.

For example, an actuarial valuation for the State of Maryland estimated the OPEB liability in that state at approximately $20.4 billion. Virginia offers a minimal subsidy for retiree health care coverage, and therefore has negligible OPEB liabilities. While Virginia has not commissioned an actuarial valuation relating to the GASB 45 requirements, it has informally estimated that its liability would be less than $1 billion.

Other states' research into funding OPEB, such as task force reports from Maryland and Delaware, seems to have produced consensus around the following principles:

1. PAYGO funding is not a viable long-term solution;
2. In light of the magnitude of projected unfunded accrued liability for retiree health care and the potential effect on state bond ratings, the ultimate goal should be to fully fund the obligations set forth under GASB 45; and
3. Partial funding of unfunded accrued liability for a number of years is an acceptable approach as long as the time required to "ramp up" to full funding is not excessive.

Benefits Review Task Force

New Jersey's Benefits Review Task Force (2005) made some specific recommendations for structural reform of health care benefits. One of these recommendations is that both State and local government retired employees should contribute to their health care. For example, if retirees are required to contribute 5 percent to the projected cost of providing benefits this coming fiscal year, FY 200 savings to the State would total $62. million. Other recommendations include:

1. Merge Traditional and NJ PLUS health care plans into a new Preferred Provider Organization option (combined annual savings $104 million for State and local governments);
2. Increase use of generic drugs and obtain State's own Pharmacy Benefits Manager (estimated savings $2 - $45 million); and
3. Immediately apply health care benefits changes negotiated by the State in the current contracts to local school boards and local employers ($23 million in annual savings for local governments).

The FY 200 budget reflects implementation of cost savings measures similar to those outlined in point number 2 above.

Background Paper: Other Post Employment Benefits (Cont'd)

Perspective of the Bond Rating Agencies

At present, bond rating agencies do not anticipate making immediate rating changes based on the liabilities established under GASB Statement 45; however, these rating agencies will be reviewing a number of factors after the effective date of the GASB 45 requirements. These factors will include: OPEB managerial credit factors; financial methodology used for determining OPEB liabilities; whether the liabilities are a surprise to the employer; and whether the obligation to pay retiree health care benefits is a firm legal obligation.

In terms of financial credit factors, the concern will be whether the government employer's budget can afford to make both PAYGO annual obligations and to prefund the liability and whether the financial flexibility of the government employer will be limited as a result. Finally, the debt credit factors will include evaluating whether the total cost for bond debt service, pension liabilities, and OPEB liabilities are sustainable.