INTEROFFICE CORRESPONDENCE
Los Angeles Unified School District
Independent Analysis Unit

INFORMATIVE

TO: Members, Board of Education
Vivian Ekchian, Acting Superintendent

DATE: November 17, 2017

FROM: Glenn Daley, Director
Independent Analysis Unit[1]

SUBJECT: **HEALTH AND WELFARE BENEFITS: COSTS AND LIABILITIES**

SUMMARY

This informative discusses L.A. Unified's health and welfare benefit costs and liabilities. The report is organized into three sections. First, we discuss growth in current and future health and welfare costs. Second, we discuss liabilities associated with other postemployment benefits (OPEB), as well as the budget strategy of pre-funding those liabilities. Third, we discuss strategies other than pre-funding, ways to mitigate health and welfare benefits costs and OPEB liabilities.

An important note: when talking about millions and billions, it is easy to lose track of what's a relatively small number and what's a relatively large number, which increases the risk of misplacing priorities. Therefore, throughout the report, we draw attention to the relative scale of the numbers in discussions of these benefits, costs, and liabilities.

Several key points emerged from the IAU analysis of health and welfare benefits:

The cost of health and welfare benefits has grown over the past decade and is projected to grow for decades to come. Current health and welfare expenditures for active and retiree populations now total over $1 billion, and those expenditures are projected to continue increasing at least through 2024. This growth is the result of two factors: the retiree population continues to expand, and the cost of health care per person continues to rise.

The financial obligation represented by the future health care benefits to be paid for current retirees and current qualified employees when they retire is large and growing. The District's OPEB liability has grown from $9.9 billion in 2005 to $13.6 billion in 2015. Historically, these liabilities were not accounted for in the financial statements of public agencies, but such accounting is now required. Also historically, the District paid for these costs on a "pay-as-you-go" basis, meaning that the costs for retirees were paid out of current budgets, and no funds were specifically saved for the purpose of covering these liabilities in the future.

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[1] The authors of this informative were Britney Wise, Sydney Ganon, Q. Tien Le, John Diaz, and Andrew Thomas.

The District has begun pre-funding the liabilities for future OPEB costs, but the amount is too small to prevent the unfunded liabilities—and thus the future burden of paying for them—from continuing to grow.

While health care costs for both active and retired employees are rising and projected to increase greatly in the future, student enrollment, and therefore revenue, is declining. As a result, over time, health and welfare costs will take up an increasingly large share of the District's budget relative to other priorities. The health of those who teach our children and keep our schools open is certainly a high priority, but there is a limit to what fraction of the budget can be devoted to it while meeting other needs and keeping the District financially sustainable.

The size of the District's OPEB liability ($13.6 billion in 2015) is intimidating, but it is more manageable than it might look. First, it is not necessary or desirable for the District to fund this amount completely. It should be possible to calculate an annual pre-funding amount and a target funded percentage that would become sustainable over time even with conservative assumptions about growth. That amount will be somewhat greater than the $101 million per year currently budgeted for OPEB pre-funding, but somewhat less than the $678 million per year required to reach the 80% funding level in 30 years.

Second, enacting any permanent savings in annual benefit costs for current employees and retirees will instantly reduce the size of the OPEB liability. (Cutting benefits for future hires will not affect today's liability, but will help keep it from growing.) As an initial estimate, for current participants, given conservative financial assumptions, *permanent annual cost savings of $1 will reduce the OPEB liability by approximately $16*. Such savings will therefore also reduce the size of the annual amount required to reach any percentage pre-funding target. It will also make funds available for pre-funding the liabilities that remain, so its impact can be quite large. *This multiplier effect also works inversely: raising costs by a little increases the liability by a lot*, and increases the amount of pre-funding needed to reach a target. Such a multiplier effect on growing costs and expanding eligibility is a big part of why we are where we are today.

The OPEB liability is highly sensitive to events outside the District. It is fundamentally based on health care costs, which are currently growing but at a slower rate than a decade ago. Costs are subject to government policy such as the Affordable Care Act and Medicare, technological developments such as cancer or Alzheimer's breakthroughs, and social trends such as exercise and diet preferences. The OPEB liability is also sensitive to economic conditions (as are District revenues). While the District does not have direct control over these forces, it might have more influence than is apparent. Furthermore, the liability is calculated using conservative assumptions; it is more likely that costs will be lower than projected than higher than projected, on average over time, and intentionally so. The fact that the liability is sensitive to events in these ways should give pause to anyone who fears that the exact estimated amount is inevitable.

There is no single solution to the problem of growing health care costs and liabilities. However, by addressing a range of factors simultaneously, the District may be able to

reduce the impact so that it does not overwhelm the financial sustainability of the District. The costs of current benefits, the size of the OPEB liability, and the revenue available to the District are subject to many factors beyond the control of the Board of Education. But there are leverage points where the Board can exercise direct control or indirect influence to mitigate the problem. Many of the potential strategies at these leverage points may require cooperation and negotiation with other entities, notably the District's labor partners and their representatives on the Health Benefits Committee, the vendors in the health care market, and policy-makers at the State and Federal levels who determine funding for education and set the rules governing health care plans and District budgets. Some of these strategies involve difficult and painful choices, but combining strategies can mitigate the consequences of any one strategy. To create change, the Board of Education needs to exercise leadership in all these interactions as well as set specific policies where it has the authority to do so.

SECTION ONE: COSTS

The term *health and welfare benefits* refers generally to the full coverage health care provided by L.A. Unified to (a) active employees and, (b) qualified retirees. These benefits include medical, vision, and dental care.[2] Retiree health care benefits are referred to as *Other Postemployment Benefits (OPEB)*. To qualify for lifetime health care benefits in retirement, for employees hired in 2009 or later, a retiree's age plus years of service must total 85 years, with 25 consecutive years of service at a minimum.[3]

A. Health and Welfare Costs in Context

Health and welfare benefits provided annually to active employees by L.A. Unified are currently valued at $14,000 per employee. The annual value for retirees age 65 and older is reduced by qualifying for Medicare, and is $7,000 per retiree. The annual value for retirees under 65 is $20,000.[4] Assets and liabilities associated with active and retiree benefits are accounted for in the District's Health and Welfare Benefits Fund, which receives monies primarily from the General Fund.[5]

Health and welfare benefit costs are a substantial portion of total employee compensation. As shown in Table 1 and Figure 1, health and welfare benefit costs for active employees and retirees totaled almost $992 million in the 2016-2017 school year, accounting for about 17% of the District's expenditures toward total employee compensation.

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[2] Basic and supplemental life insurance are also made available in health and welfare, but supplemental coverage requires a contribution from the employee or retiree.

[3] School police are an exception to this qualifying rule. To qualify for lifetime benefits, years of qualifying service combined with age at retirement must total 80, with a minimum of 20 consecutive years with the District. Employees hired before 2009 also have retirement eligibility set at lower thresholds.

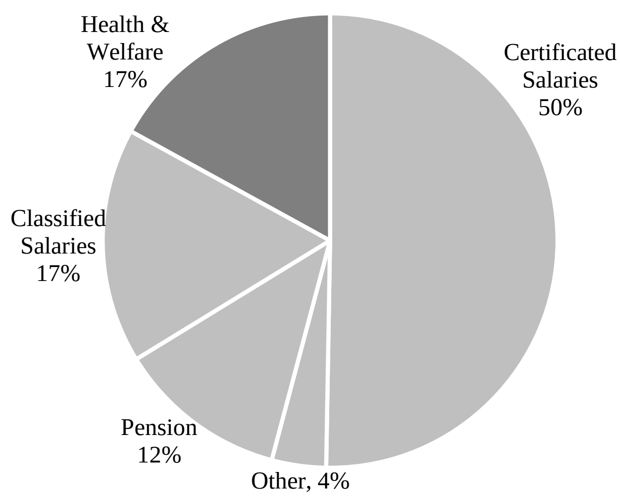
[4] Valuation of health benefits are direct reflections of 2017 District contribution rates per active employee, pre-Medicare-eligible retiree, and Medicare-eligible retiree, according to the current Health Benefits Agreement.

[5] Transfers into this fund are called 'revenues' in the confusing terminology of fund accounting. However, it does not represent new money coming into the District, but transfers to the fund to cover health and welfare expenditures. For simplicity, we call this amount the District's contribution rather than revenue. Transfers into this fund are accounted for in an internal service fund called the Self-Insurance Fund in District budget documents.

Table 1. Employee Compensation Expenditures (2016-2017)[6]

Employee Compensation	Expenditures (millions)	% of Total
Certificated Salaries	$ 2,931.9	50.26%
Classified Salaries	$ 976.7	16.74%
Health and Welfare - Active	**$ 663.9**	**11.38%**
Health and Welfare - Retiree	**$ 327.7**	**5.62%**
Pension (PERS and STRS)	$ 706.2	12.11%
Workers Compensation	$ 108.1	1.85%
Social Security	$ 117.0	2.01%
Unemployment Insurance	$ 2.4	0.04%
Total	**$ 5,833.9**	**100.00%**

Figure 1. General Fund Expenditures for Employee and Retiree Compensation (2016-2017)[7]



[6] Superintendent's Final Budget 2016-17

[7] Superintendent's Final Budget 2016-17

B. Contributions versus Expenditures

Currently, L.A. Unified fully funds health care costs for active employees and qualified retirees. As depicted in the dark line of Figure 2, the money L.A. Unified contributes toward health and welfare has fluctuated, but overall it has grown by $136 million from FY 2007 to FY 2017.

Figure 2. Health and Welfare - District Contribution vs. Expenditures (In 2016 Dollars)[8]

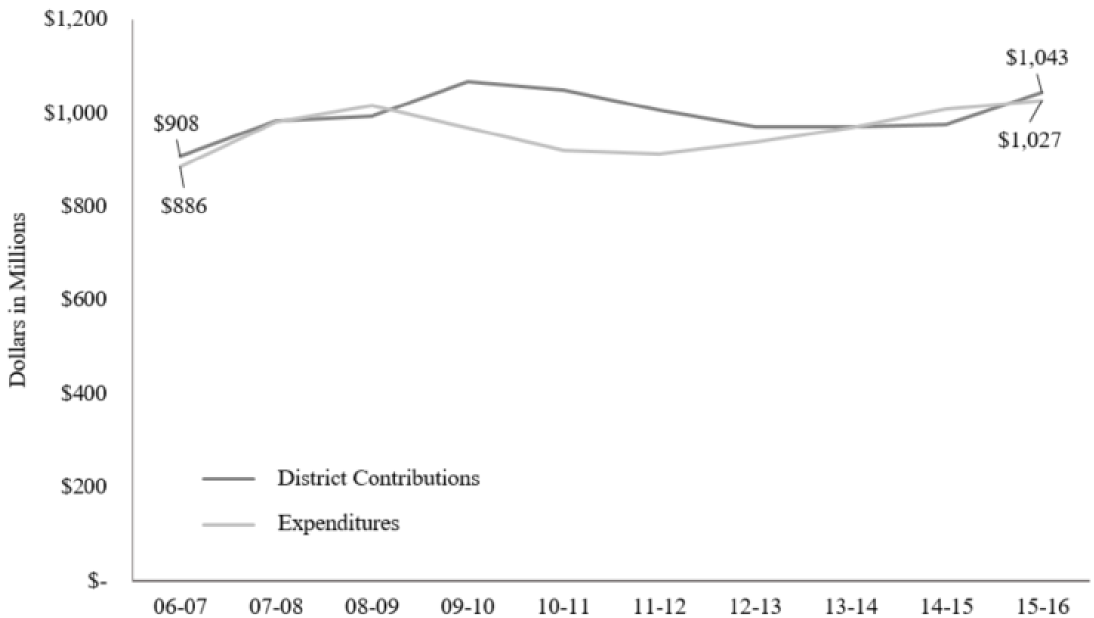


Figure 2 shows expenditures as well as contributions. These terms are easily confused. *Contributions* are transferred to the Health and Welfare Benefits Fund primarily from the General Fund in accordance with negotiated agreements. *Expenditures* are spent out of the Health and Welfare Benefits Fund on actual benefit plan costs under the oversight of the Health Benefits Committee (HBC).

In 2008-2009, actual costs proved to be greater than District contributions, resulting in a $21 million deficit. Since that year, the HBC has negotiated District contribution rates using higher average health care cost projections. Contributions have proven to be greater than expenditures in most years since, as shown in Table 2, thereby creating a positive fund balance of $358.5 million in FY 2017. District contributions toward health and welfare are expected to increase in the coming years to keep pace with rising health care costs.[9]

[8] Superintendent's Final Budget: Revenues by Fund, Expenditures by Fund 2010-2011, 2011-2012, 2012-2013, 2013-2014, 2014-2015, 2015-2016,2016-17

[9] District contribution rates shown here are reflective of the rates set in the expiring Health Benefits Agreement. These rates, and future rates, are subject to change pending HBC negotiations.

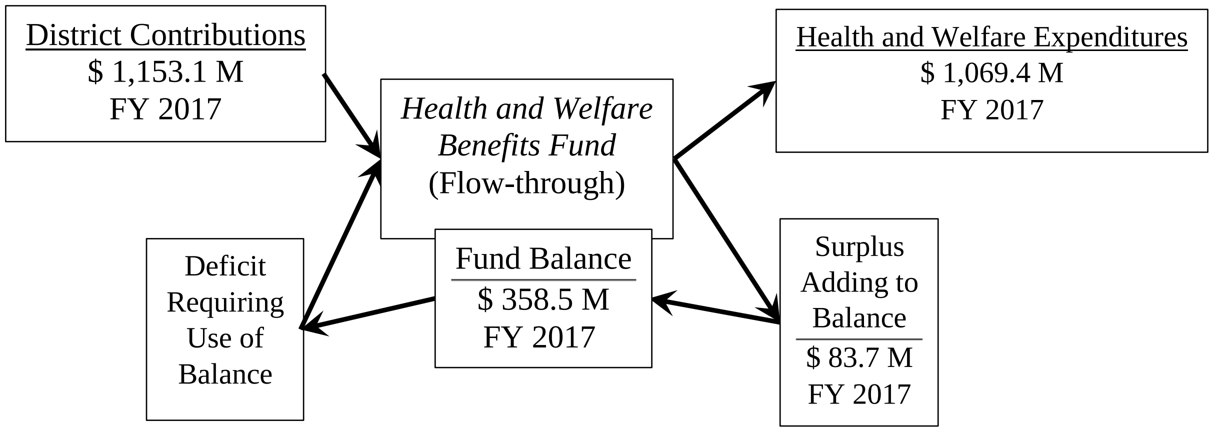
Table 2. L.A. Unified Health and Welfare Benefits Fund: Contributions and Balance (Dollars in Millions)[10]

Fiscal Year	Annual District Contributions	Annual Expenditures	Annual Change (Contributions - Expenditures)	Fund Balance ('Reserve')
2010	$958.50	$831.52	$127.00	$127.00
2011	$958.57	$860.10	$98.47	$225.46
2012	$927.12	$899.30	$27.82	$253.28
2013	$928.70	$918.80	$9.90	$263.18
2014	$950.06	$977.10	($27.04)	$236.14
2015	$987.60	$1,020.00	($32.40)	$203.75
2016	$1,089.66	$1,018.60	$71.06	$274.81
2017	$1,153.10	$1,069.40	$83.70	$358.50

As shown in Figure 3, the Health and Welfare Fund functions both as a channel for the flow of funds from the General Fund to actual expenditures, and as a buffer against fluctuations in actual costs. Unspent funds remain as an ending balance and are carried over to the next year, to be used in case expenditures exceed contributions. The current fund balance of $358.5 million equals approximately one-third of the District's annual health and welfare expenditures.

[10] Source: Summary of Total Budget FY 2010-2017. Some details do not match Table 1 because they were taken from different sources, some information is missing (particularly the 'other cost' categories), and the numbers in Table 2 are adjusted for inflation in 2016 dollars. Reconciling budget numbers from different sources is warranted as a follow up from this study.

Figure 3. How Funds Move Into and Out of the Health and Welfare Benefits Fund



Decisions regarding health and welfare benefits are negotiated by the Health Benefits Committee (HBC). Created in 1993, the HBC addresses issues related to health and welfare benefits for L.A. Unified active employees and retirees. The HBC is comprised of committee members for each union, in addition to one official District representative.[11] The District and each union have one vote apiece. Any recommended changes to existing benefits require a two-thirds vote of members present and voting. The HBC designs the health and welfare programs of the District within the contribution amount budgeted by the District.

The Health Benefits Agreement, also referred to as a Memorandum of Understanding (MOU), is the culmination of the HBC negotiating process. Previous MOUs have established a set of purposes for the HBC and the process by which health and welfare benefits are determined within L.A. Unified. These purposes include but are not limited to setting annual District contribution rates to the Health and Welfare Fund, incentivizing the HBC to enact changes to District plan designs to live within the Health and Welfare budget, and addressing the District's growing unfunded liability resulting from OPEB in accordance with the Governmental Accounting Standards Board's (GASBs) Statement 45.[12] [13]

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[11] The HBC consists of the following representatives: L.A. Unified, the United Teachers of Los Angeles Association, the Associated Administrators of Los Angeles, the California School Employees Association, the Los Angeles County Building and Construction Trades Council, the Los Angeles School Police Association, the Los Angeles School Police Sergeants and Lieutenants Association, the Service Employees and International Union, and Teamster - Local 572.

[12] 2015-2017 L.A. Unified Health Benefits Agreement

[13] Governmental Accounting Standards Board (GASB) Statement No. 45 relates to accounting and financial reporting standards by employers for postemployment benefits other than pensions (OPEB). It states that employers must measure and disclose an amount for annual OPEB cost on the accrual basis of accounting, including the normal cost for the year and the amortization of the total unfunded actuarial accrued liabilities of the plan. The Statement also requires information as to how and to what extent OPEB benefits have been funded.

Under the MOU, the HBC is responsible for all plan design modifications including but not limited to co-pays, deductibles, premium contributions and assessments, as well as selection, addition, and termination of health plans/providers for all active and retired employees, provided that the HBC does not recommend any changes that would expand eligibility.[14] Among other things, this means that reducing costs through the design of health plans is currently done through negotiation and not as a unilateral decision by the District.

C. District Revenues and Declining Enrollment

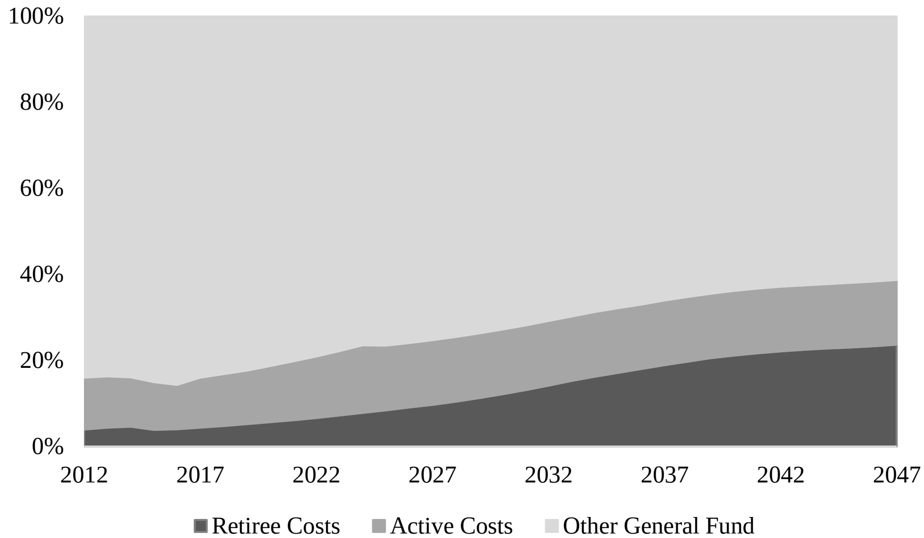
While health and welfare costs are increasing over time, L.A. Unified is simultaneously experiencing declines in enrollment. A majority of the revenue streams for the District generate funds on a per student basis. Therefore, declining enrollment means declining revenue. The District's overall revenue decline has been partially masked since 2013-2014 due to the gradual implementation of the Local Control Funding Formula (LCFF). According to the Superintendent's 2017-2018 Final Budget, LCFF is expected to be funded at or above 99% of its targeted levels by the 2019-2020 school year.[15] However, once LCFF reaches its full funding levels, the District expects to continue seeing an annual 2.8% decline in enrollment, which will continue reducing revenue.

While L.A. Unified experiences a decline in General Fund revenue, health and welfare costs continue to grow. In 2012-2013, health and welfare costs for actives and retirees made up 16.01% of the General Fund ($231 M retirees, $717 M actives). As seen in Figure 4, which shows a simplified growth of these costs as a percentage of the General Fund, this is projected to grow to approximately 38.64% by 2047 ($1,673 M retirees, $1,061 M actives).

[14] 2015-2017 L.A. Unified Health Benefits Agreement

[15] Superintendent's Final Budget 2017-2018

Figure 4. Health and Welfare Costs for Actives and Retirees as Percentage of General Fund Revenue[16]



National health expenditures have been predicted to increase 5.7% per year through 2023 with the rising number of baby boomers aging into Medicare and the dropping number of uninsured individuals.[17] As a result of the national rising cost of health care and the expected growth of the District's retiree population relative to its active employee population, health and welfare expenditures for L.A. Unified are expected to increase in the coming years. The Independent Analysis Unit projections indicate that in 30 years, the District's health and welfare contributions in relation to the General Fund will increase by 23 percentage points relative to today. This growth places a substantial strain on the District's operating budget, limiting the other resources available for the education of children.

[16] General Fund revenue amounts are sourced from the 2010-2011 through 2014-2015 actuals and the 2015-2016 third interim report. Projections beyond 2017-2018 use the following assumptions: 2.75% rate of inflation; LCFF dollars fully funded in 2020-2021; ADA average of 97%; a declining average enrollment of 2.8% each year; and 5.8% increases in health care costs per year for actives until 2024. After 2024, for actives the cost remains steady at 15% of the General Fund, a conservative and simplified assumption. For retiree costs, projections are based on AON's 2015 Actuarial Report.

[17] Sisko, A. M. et al. (2014). National health expenditure projections, 2013–23: faster growth expected with expanded coverage and improving economy. *Health Affairs*, 10-1377.

SECTION TWO: OPEB LIABILITIES

A. Background

Other postemployment benefits (OPEB) refers specifically to retiree health care benefits and does not include pension benefits. This year's benefits for current retirees are paid from current funds, but benefits for *future* retirees and *future payments for current retirees* are also on the books as debt obligations. This debt is simply called the *OPEB liability*.[18] Pensions also create debt for future payments, but those have been studied in detail, whereas less attention has been paid to OPEB liabilities. In 2004, the GASB started requiring public agencies to disclose projected costs for retiree health benefits. This requirement led to increased public attention on OPEB liabilities.[19]

To pay for retiree health care benefits, public agencies and school districts have typically adopted a *pay-as-you-go* model, which pays for current retirees with current revenues. However, to address the rising cost of postemployment benefits, some districts and public agencies have started to pre-fund retiree health benefits, as traditionally has been done for pensions. In other words, an agency may choose to place funds in a trust account to cover OPEB benefit costs in the future. The net of the OPEB liability minus total pre-funding is called the *unfunded OPEB liability*.

This section describes how OPEB liabilities are estimated in general and the amount estimated for L.A. Unified's OPEB liability. Next, the current pay-as-you-go model is explained. Finally, the process of pre-funding is discussed.

Estimating OPEB liabilities

In general, the OPEB liability is the amount of money that would adequately cover the costs of retiree health care benefits if the money were needed today for all employees and retirees.[20] [21]

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[18] One might suppose that *liability* emphasizes the total debt owed by the employer, while *liabilities* emphasizes the fact that the debt is owed to many persons for payments over many years. There is no formal distinction, though.

[19] Pozen, Robert. (May 2015). Renegotiating retiree health care plans after new Supreme Court guidance. *The Brooking Institute*. https://www.brookings.edu/blog/health360/2015/05/07/renegotiating-retiree-health-care-plans-after-new-supreme-court-guidance/

[20] Kapphahn, Kenneth. (September 2017). Update on School District Retiree Health Benefits. *Legislative Analyst's Office*. http://lao.ca.gov/publications/report/3704

[21] In the case of employees who have not yet reached full eligibility, the liability is accrued to reflect the accounting principle that the benefits are earned while working year to year instead of being earned all at once upon retirement. Thus, the OPEB liability for any active employee who has not reached full eligibility is greater than zero but smaller than the OPEB liability for a retiree or eligible employee.

This means that OPEB liability is much larger than annual spending on retiree health benefits because the liability represents projected annual costs covering several decades.

Estimating this liability requires making assumptions about the values of several sets of key variables. Three assumptions that can have substantial impact on liabilities are:[22]

- Medical cost trends: OPEB liability estimates need to take into account how much the cost per person or family for retiree health care coverage will increase or decrease in the future.
- Cash-flow valuations: OPEB liability estimates need to include projections about the future cash flows that will pay for retiree health care benefits. Factors that affect future cash flow include not only cost trends, but also the participant pool's employee and retiree age, projected age at retirement, number of dependents, and life expectancy.
- Discount rate: The projection needs to include an estimate of what money invested or obligated now will be worth in the future.[23] A change in discount rate of even one percent can have a substantial impact on liabilities.[24]

OPEB liabilities for state and local governments nationwide are expected to increase before they start to decline in a few decades. Specifically, future costs in these projections for currently active participants rise until about 2040, at which point mortality has more impact than medical cost inflation, and the annual liability associated with active employees and retirees declines.

L.A. Unified's OPEB liability

The District's OPEB liability is calculated every other year in an actuarial report, the most recent of which is from 2015 and another is due in December 2017.[25] Taking into account data about active and retired employees, their ages and years of service, as well as assumptions about the three sets of variables just described, estimates of the District's total accrued OPEB liability have

[22] Eyre, B. and Whitcher, M. (May 2013). OPEB Liability – Does it Matter? *Benefits Magazine*. http://www.ifebp.org/inforequest/0163756.pdf

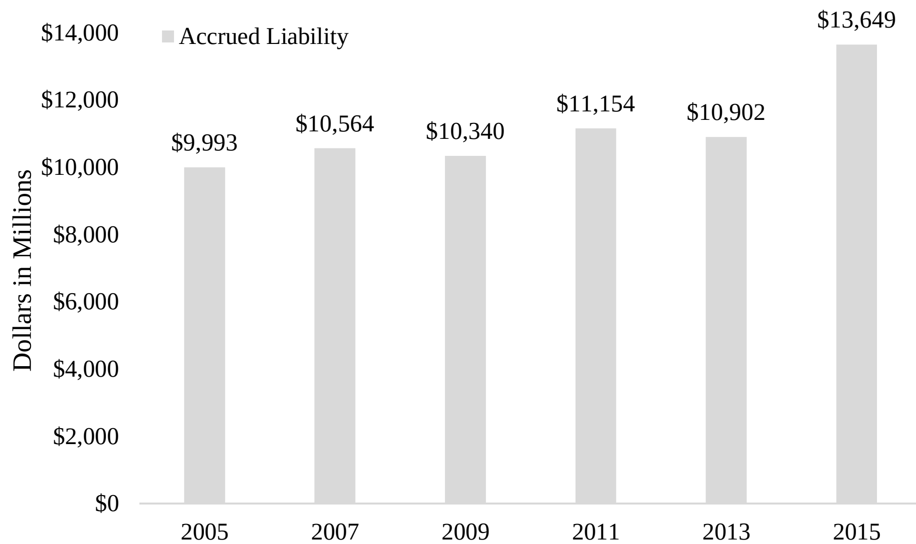
[23] The OPEB liability is discounted according to financial principles to reflect the fact that payments closer in time to the present have more value in the present than payments farther in time from the present. In other words, the OPEB liability is the present value of future benefits, and is smaller than the actual amount projected to be paid for those benefits. These estimates are frequently done with assumed interest rates and are based on the economic climate.

[24] "State Retiree Health Care Liabilities: Multiple factors contribute to improving picture in many states." (May 2016). *The PEW Charitable Trusts*. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/05/state-retiree-health-care-liabilities

[25] Aon Hewitt. 2015. *Actuarial Valuation Report*, Los Angeles Unified School District Postretirement Health Benefits As of July 1, 2015.

fluctuated, but over time have increased from approximately $9.9 billion in 2005 to approximately $13.6 billion in 2015.[26]

Figure 5. Accrued Postemployment Benefit (OPEB) Liability[27]



B. Pay-As-You-Go

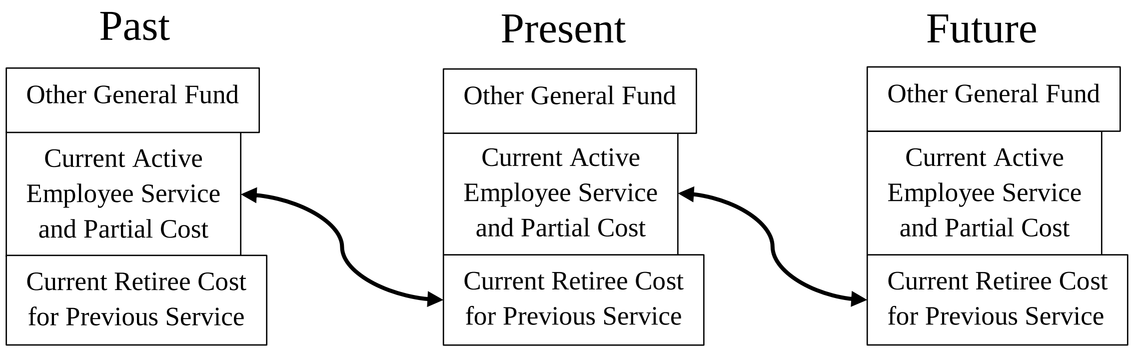
The District has historically used a pay-as-you-go model for current retiree OPEB costs. With a pay-as-you-go model, an agency only budgets and pays out the required costs for the current fiscal year. The pay-as-you-go model covers current retirees' annual costs and no more.

At several points in the past, the District made decisions to increase retirement health benefits for its current employees and new hires without ensuring that the funds to pay for those benefits would be available upon each employee's retirement in the future. In effect, the District borrows from future General Fund resources to provide current employees incentives for their service in the present. Put another way, future funds are being committed to subsidize present service, thereby making present service look less expensive than it really is. Figure 6 illustrates that current retiree costs are compensation for previous service and not for current service.

[26] In this report, OPEB liabilities are based on AON's 2015 actuarial report. Most of the pre-funding numbers and annual cost numbers are taken from either the FY 2017 or FY 2018 budget. Therefore, there are some discrepancies between these numbers and other reports. However, the emphasis here is not on the exact numbers as in a financial statement, but on the relative size of the numbers for thinking about policy decisions.

[27] Sources: Comprehensive Annual Financial Report 2005-2006, Comprehensive Annual Financial Report 2011-2012, and Comprehensive Annual Financial Report 2015-2016.

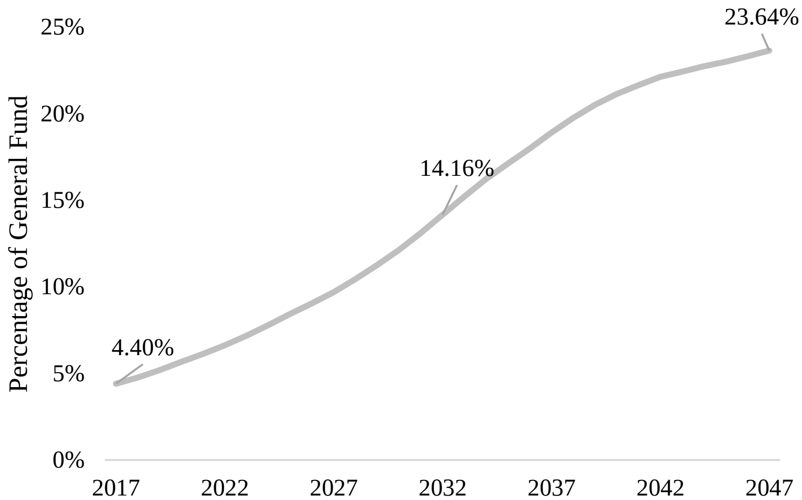
Figure 6. Pay-As-You-Go as a Subsidy across Time



This pay-as-you-go model would be infinitely sustainable and the OPEB liability would never need to be pre-funded if (a) annual revenues did not decline, (b) annual retiree costs did not rise (whether through higher health costs or expanding eligibility), and (c) there were sufficient net funds remaining available to achieve the goals of the District. Unfortunately, *none of those three assumptions holds true*. The bottom boxes in Figure 6 have not remained the same from year to year, but have grown over time, reducing the funds available for future current employee compensation and other General Fund uses.

On its face, the pay-as-you-go model simply requires that there be sufficient funds in any year to pay for the current OPEB costs in that year. In reality, given declining revenues and rising costs, the simple pay-as-you-go model will consume an ever-increasing portion of the General Fund, as shown in Figure 7. This model is common among school districts, but it is not sustainable. That being the case, the District needs to acknowledge that the *true cost* of employing one person today includes an allocated portion of that person's future retirement benefits. That true cost exists whether or not it is accounted for.

Figure 7. Pay-As-You-Go as a Rising Burden[28]



While pay-as-you-go costs currently make up approximately 4.4% of the costs covered by the General Fund, in the next 30 years the costs will grow to 23.6% of the General Fund dollars. The California Legislative Analyst's Office (LAO) finds that, within three decades, fully pre-funded districts will be spending substantially less than districts that pay only current costs without pre-funding future costs.

C. Pre-Funding the OPEB Liability

OPEB liabilities for public agencies have grown substantially over time but the amounts saved—pre-funded—for this debt have not. Thus, unfunded OPEB liabilities have grown quite large for many agencies. Unfunded OPEB liabilities for local and state governments across the country are estimated to be around $1 trillion dollars, or one-third of local and state government revenue.[29] A recent study found that only seven states have an OPEB funding ratio of 30% or higher. The State of California's funding ratio is less than one percent.[30] The funded ratio for employee

[28] General Fund revenue amounts are sourced from the 2010-2011 through 2014-2015 actuals and the 2015-2016 third interim report. Projections beyond 2017-2018 use the following assumptions: 2.75% rate of inflation; LCFF dollars fully funded in 2020-2021; ADA average of 97%; a declining average enrollment of 2.8% each year; and 5.8% increases in health care costs per year for actives until 2024. After 2024, for actives the cost remains steady at 15% of the General Fund, a conservative and simplified assumption. For retiree costs, projections are based on AON's 2015 Actuarial Report.

[29] Lutz, B., & Sheiner, L. (2014). The fiscal stress arising from state and local retiree health obligations. *Journal of health economics*, *38*, 130-146.

[30] "State of Retiree Health Plan Spending: An examination of funding trends and plan provisions." (May 2016). The Pew Charitable Trusts. http://www.pewtrusts.org/~/media/assets/2016/09/state_retiree_health_plan_spending.pdf

pensions is often targeted to 80%, but there are enough differences between OPEB and pensions that there is as yet no consensus on a similarly desired target for OPEB liability.

To pre-fund future retiree health benefits, funds are set aside in irrevocable trust accounts, which cannot be modified or terminated without the permission of the beneficiary. L.A. Unified established an irrevocable OPEB trust in 2013-2014 with CalPERS—the California Employers' Retiree Benefit Trust (CERBT)—to address its fiscal obligation in relation to its OPEB liability.[31]

As of 2015, L.A. Unified had set aside a total of $90 million in trust assets, resulting in a funded ratio of 0.66%, as shown in Figure 8. This ratio is roughly comparable to the State of California's. The District has pre-funded more in the two years since 2015, but the new ratio cannot be calculated yet because the OPEB liability has not been updated. This ratio means that the District has only saved about one percent of what it would need to cover all of its current employees' and retirees' postemployment benefits.

Figure 8. Unfunded Liability (99.34%) and Pre-funded Assets (0.66%) Relative to Total Liability as of 2015[32]

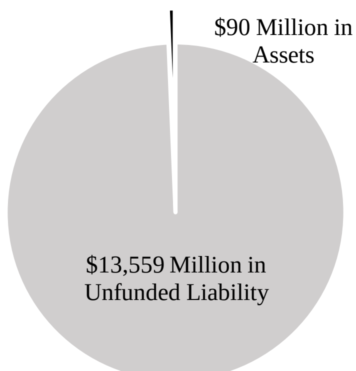


Table 3 shows the amount L.A. Unified has contributed to the OPEB Trust and has budgeted for the next three years. Though the Superintendent's Budget 2017-2018 allocated $100.9 million for the OPEB Trust, it should be noted that the fiscal stabilization plan submitted with that budget proposes canceling all pre-funding to the Trust for three years.

[31] Though generally thought of as the pension agency, CalPERS offers several services related to retirement other than pensions.

[32] Aon Hewitt. 2015. *Actuarial Valuation Report*, Los Angeles Unified School District Postretirement Health Benefits As of July 1, 2015.

Table 3. District's Contribution to OPEB Trust[33]

Fiscal Year	Contribution
2013-2014	$60 million
2014-2015	$30 million
2015-2016	$51 million
2016-2017	$65 million
2017-2018	Planned contribution of $100.9 million
2018-2019	Planned contribution of $100.9 million
2019-2020	Planned contribution of $100.9 million

At $100.9 million per year, the contribution made to the OPEB Trust is not enough to fully fund the existing OPEB liability in a 30-year period. At a level percent of payroll, an annual contribution of $594 million for 30 years is necessary to fully amortize the OPEB liability that exists now.

However, the liability continues to grow every year. As of the 2015 report, the liability was projected to increase by $478 million per year to account for future benefits being earned on an accrual basis by active employees during the year. On the other hand, the District is also paying benefits during the year for current retirees ($328 million in FY 2017), which reduces the OPEB liability by fulfilling some of the obligations it represents. The unfunded liability is also reduced by the pre-payment of $65 million in FY 2017.

Combining these amounts, the total requirement to meet annual obligations and amortize the liability in 30 years is $1,072 million per year or 23.3% of current payroll. Of that requirement, the District actually paid or pre-funded $392 million in FY 2017, leaving $680 million of the requirement unpaid for that year.[34] Figure 9 shows these relationships in graphical form.

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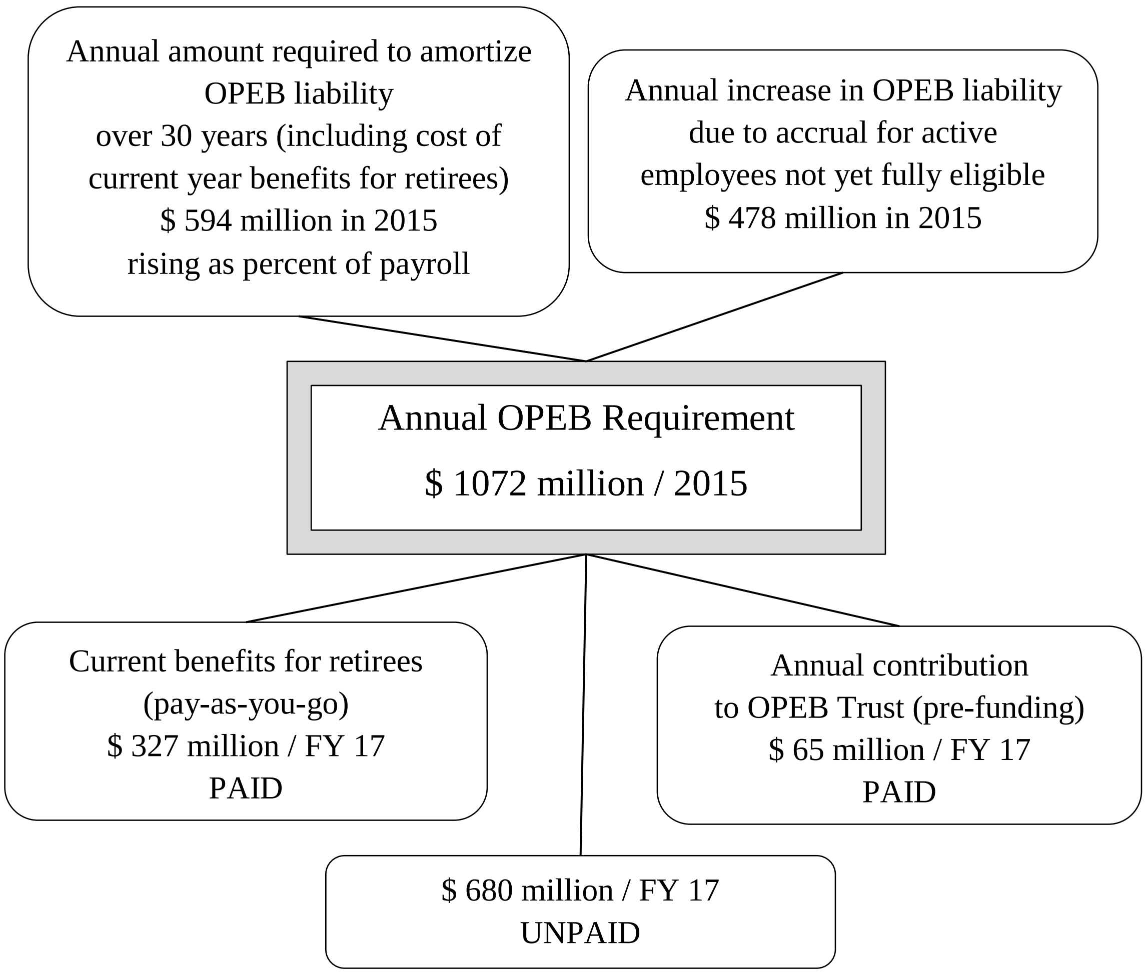
[33] Sources: Comprehensive Annual Financial Report 2014-2015, Comprehensive Annual Financial Report 2015-2016, and Superintendent's Budget 2017-2018.

[34] Aon Hewitt. 2015. *Actuarial Valuation Report*, Los Angeles Unified School District Postretirement Health Benefits As of July 1, 2015.

Figure 9. Annual OPEB Cost Components and Paid Amounts



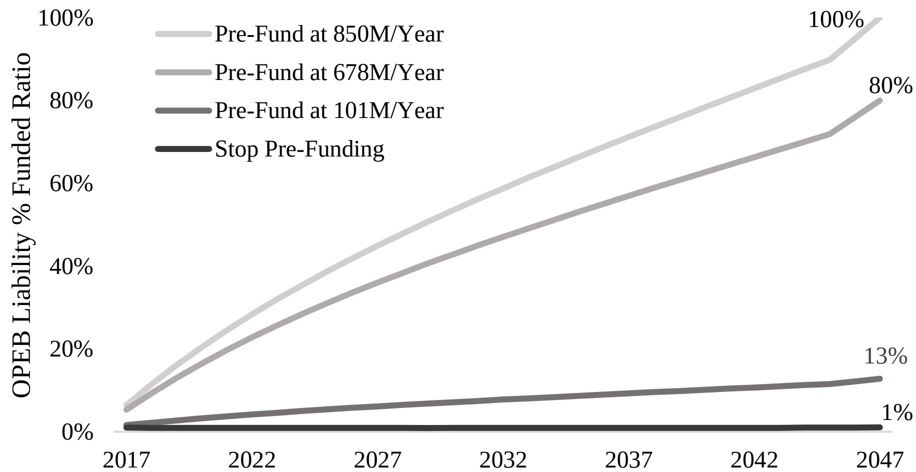
This does not count the cost of current benefits for active employees, which amounted to $664 million in FY 2017. Including both active employees and OPEB obligations, the combined cost of health and welfare benefits in FY 2017 was $1,736 million (plus whatever amount the OPEB liability estimate might have gained between 2015 and 2017). Of that $1,736 million annual cost, the District funded $664 million. The unpaid $680 million effectively enlarged OPEB liabilities for the next year.

Figure 10 shows projections of the estimated amount of pre-funding required to meet different percentage targets over a thirty-year period.[35] The estimates in Figure 8 indicate that if the

[35] Technical note: The *level percent of payroll method* used in the actuarial report requires a level of funding that increases over time. For Figure 10, the Independent Analysis Unit used a simpler method, *level dollar cost funding*, without actuarial variables, to estimate the payments required to achieve different funding ratios in 30 years. Note that these numbers correspond to the actuarial estimate for amortizing the current liability ($594 million, growing with payroll). They do not include the cost of accruing benefits each year for active employees, which increases the liability if unpaid ($478 million, growing with payroll). On the other hand, they also ignore the annual current payments for retiree benefits, which come out of the OPEB liability ($327 million in FY 2017). This is a net

District continues to fund the OPEB Trust with $100.9 million over the next 30 years, by 2047 the funded OPEB ratio would only be 13%. If the District increased funding to the Trust almost seven-fold with approximately $678 million per year, in 30 years it would reach an 80% funded ratio. Finally, the District would need to fund the OPEB Trust at $850 million per year to be fully funded in 30 years.

Figure 10. Funded Ratio Projections for OPEB Liability[36]



These numbers may make the situation seem dire; however, even contributing smaller amounts does help in the long run. Pre-funding has multiple advantages besides simply reducing the unfunded liability dollar for dollar. First, the contributions earn interest over time. Second, the contributions improve the District's credit rating, which helps get better interest rates on bonds for capital improvements.[37] [38] Third, an agency that annually pre-funds its OPEB liability even at a low rate can increase the discount rates used in the actuarial estimates of the liability, which

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increase in OPEB liability of $151 per year that is included in the actuarial projections but not the projections shown here. For comparability, add $151 million/year to the payments shown here, e.g., $850 projected plus $151 equals $1,001, which is very close to the actuarial projection of $1,072. But the District already pays the current cost of retiree benefits annually, so the amount needed to pre-fund the Trust is somewhat lower than this.

[36] Note that this is not an actuarial projection, but a simplified and more conservative projection with fewer variables. This estimation projects actuarial accrued liability using the initial $13.6 billion from the 2015 L.A. Unified CAFR, a 2.75% inflation rate, and actuarial value of assets projections with a discount rate of 4.8%. The ratio of assets to accrued liability is the funded ratio over time.

[37] Dickerson, Jason. (n.d.). Retiree Health Care: A Growing Cost for Government. *The Legislative Analyst's Office*. http://www.lao.ca.gov/2006/ret_hlthcare/retiree_healthcare_021706.htm

[38] Sielman, Rebecca. (August 2008). Investment trusts for OPEB: The right thing at a better price. *Milliman*. https://www.gasb45help.com/Investment_Trusts_for_OPEB.pdf

can substantially reduce those estimates.[39] For example, when Michigan began pre-funding, it raised its discount rate from 4% to 8%. This helped the state drop its reported OPEB liabilities by 46% in three years. [40] [41] As a result of virtually no pre-funding of its liability, L.A. Unified has experienced the opposite effect, seeing lower discount rates and thus higher estimates in the 2015 actuarial report.

However, it should be emphasized that pre-funding the entire OPEB liability, for a 100% funding ratio, would unnecessarily tie up resources that could otherwise be used to serve the present needs of children. Time is of the essence in education; a second grader cannot wait until eleventh grade for her second-grade classroom to be properly funded. It is as important for the District to avoid *over-funding* OPEB liabilities as it is to avoid under-funding them. Right now, though, there is no risk of over-funding OPEB liabilities with the District's available resources. This is simply a point to keep in mind to avoid placing too much emphasis on the idea of eliminating OPEB liabilities completely.

Fortunately, **making the transition to full pre-funding or 80% pre-funding in 30 years may not be necessary.** Pre-funding a substantial portion of the OPEB liability is sufficient to ensure the District's financial sustainability and its ability to pay the health and welfare benefits expected by employees and retirees.

In thinking about pre-funding levels required to meet specific targets, it is useful to note the following:

> **Pre-funding the OPEB liability by $100 million in one year reduces the unfunded liability by $100 million, but no more, and would lock up $100 million in current budget funds.**
>
> **Pre-funding the OPEB liability by a commitment of $100 million each year for 30 years will eventually reduce the unfunded liability by approximately $1,591 million in today's dollars.** [42]

---

[39] "State Retiree Health Care Liabilities: Multiple factors contribute to improving picture in many states." (May 2016). *The PEW Charitable Trusts*. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/05/state-retiree-health-care-liabilities

[40] Standard & Poor's Ratings Services, "Diverging Trends Underlie Stable Overall U.S. OPEB Liability," 3.

[41] "State Retiree Health Care Liabilities: Multiple factors contribute to improving picture in many states." (May 2016). *The PEW Charitable Trusts*. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/05/state-retiree-health-care-liabilities

[42] This uses standard financial present value calculations with the same discount rate of 4.7% used in the actuarial report of 2015; $159 million is the present value of a stream of payments of $10 million for 30 years. You can think of this like a mortgage. If you were to buy a house for $1,591 million on a 30-year mortgage fixed at 4.7% and paid annually instead of monthly, your payment would be $100 million per year. It is appropriate to compare these numbers to the $13.6 billion of OPEB liability, which is also in present value terms. Changes in the discount rate could change both values substantially.

As noted previously, pre-funding can have secondary beneficial effects on the District's financial status and perhaps reduce the liability a little more than suggested by this one-to-one ratio, but the primary effect on the liability in any given year is dollar for dollar. Regular pre-funding can have additional beneficial effects on the District's financial status, by demonstrating a commitment to pre-fund regularly. However, the actual reduction will take place gradually over 30 years, not immediately.

Given realistic assumptions about trends in revenues and costs, it may be possible to calculate a sustainable rate of pre-funding as a percent of the budget, which keeps the unfunded liability from growing in the face of declining revenues and rising costs, and provides a ratio that satisfactorily represents financial stability to the District's stakeholders. That amount will certainly be greater than the $101 million currently budgeted for pre-funding but less than the $850 million required to eliminate today's OPEB liability in 30 years.

In any case, **it remains critically important to take actions to increase revenues and decrease costs over time**. This report is not the place to detail strategies for increasing revenues, except to state that any actions that strengthen enrollment, attendance, and revenues from any source will also help reduce the proportional burden of OPEB liabilities on the General Fund. The other side of the challenge is to decrease health and welfare costs and liabilities. Strategies for doing so are discussed in the next section.

SECTION THREE: COST REDUCTION STRATEGIES

The previous section discussed the strategy of pre-funding the OPEB liability. This section focuses on possible strategies to reduce costs, which will in turn reduce the liability. As compared to pre-funding, cost reductions are *high leverage* strategies because they reduce the liability immediately and also save funds that can be used for other purposes including pre-funding the remaining liability. But some cost reduction strategies are higher leverage than others.

A recent presentation to the Board of Education by District staff described a number of options for changing health and welfare benefits to reduce costs and mitigate OPEB liabilities.[43] This report by the Independent Analysis Unit overlaps with that presentation, but presents policy options through a different analytical lens. The focus here will be less on detailed cost and savings figures, and more on identifying strategic leverage points for policy decisions to have greater or lesser impact. The list of options here is not comprehensive. It may be considered a starting point for more thorough study.

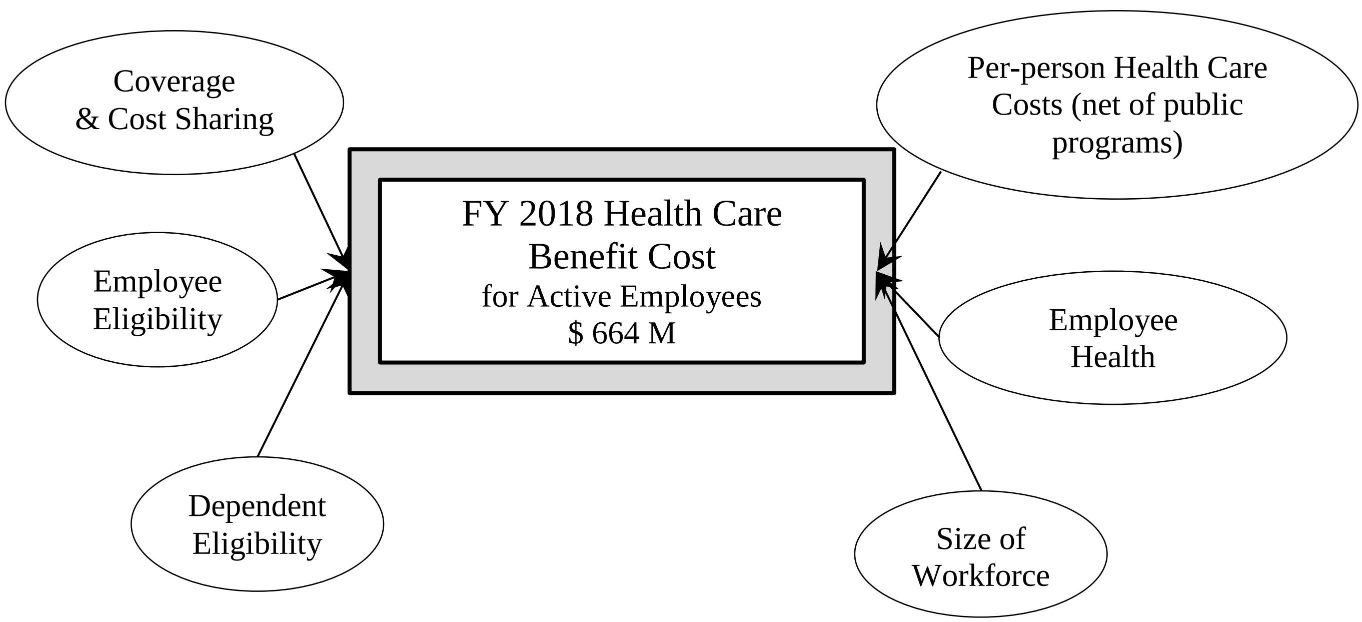
[43] L.A. Unified School Board Retreat. *Health and Welfare Discussion*. August 2017.

A. Factors that Affect Health Care Costs

To create change, it helps to identify the factors that contribute to change. In this section, we look at the factors or determinants of change in annual health care benefit costs for active employees and then for retirees. Several of these factors correspond to potential areas for cost-reduction strategies that will be examined in detail in subsequent sections.

In Figure 11, the rectangle represents what the District budgeted in FY 2018 to pay the health care benefit costs for active employees: $664 million. The oval bubbles represent some of the salient factors that influence this cost. The bubbles therefore illustrate leverage points for strategic action to reduce costs.

Figure 11. Factors that Impact Health Care Benefit Costs for Active Employees



This figure does not include retiree benefits. However, many of the actions that would reduce these health care costs for current employees would also reduce health care costs for retirees. The structure of factors influencing retiree benefits is very similar to that shown in this figure, except that it is more complex due to the need to project costs into the future and address the liabilities that they represent, as seen in Figure 12 below.

The rectangles down the middle of Figure 12 show how the OPEB unfunded liability is derived from the District's annual spending on health care for retirees. At the top is the approximately $328 million spent on current retiree health care benefits in FY 2017. The OPEB liability is derived by taking this amount, projecting it forward for 30 years and adding to it the estimated future health care benefits costs for active employees and will be tomorrow's retirees.

Subtracting the pre-funded amount in the OPEB Trust brings us to the total *unfunded* OPEB liability.

Figure 12. Factors that Impact Health Care Benefit Costs for Retired Employees and the OPEB Liability

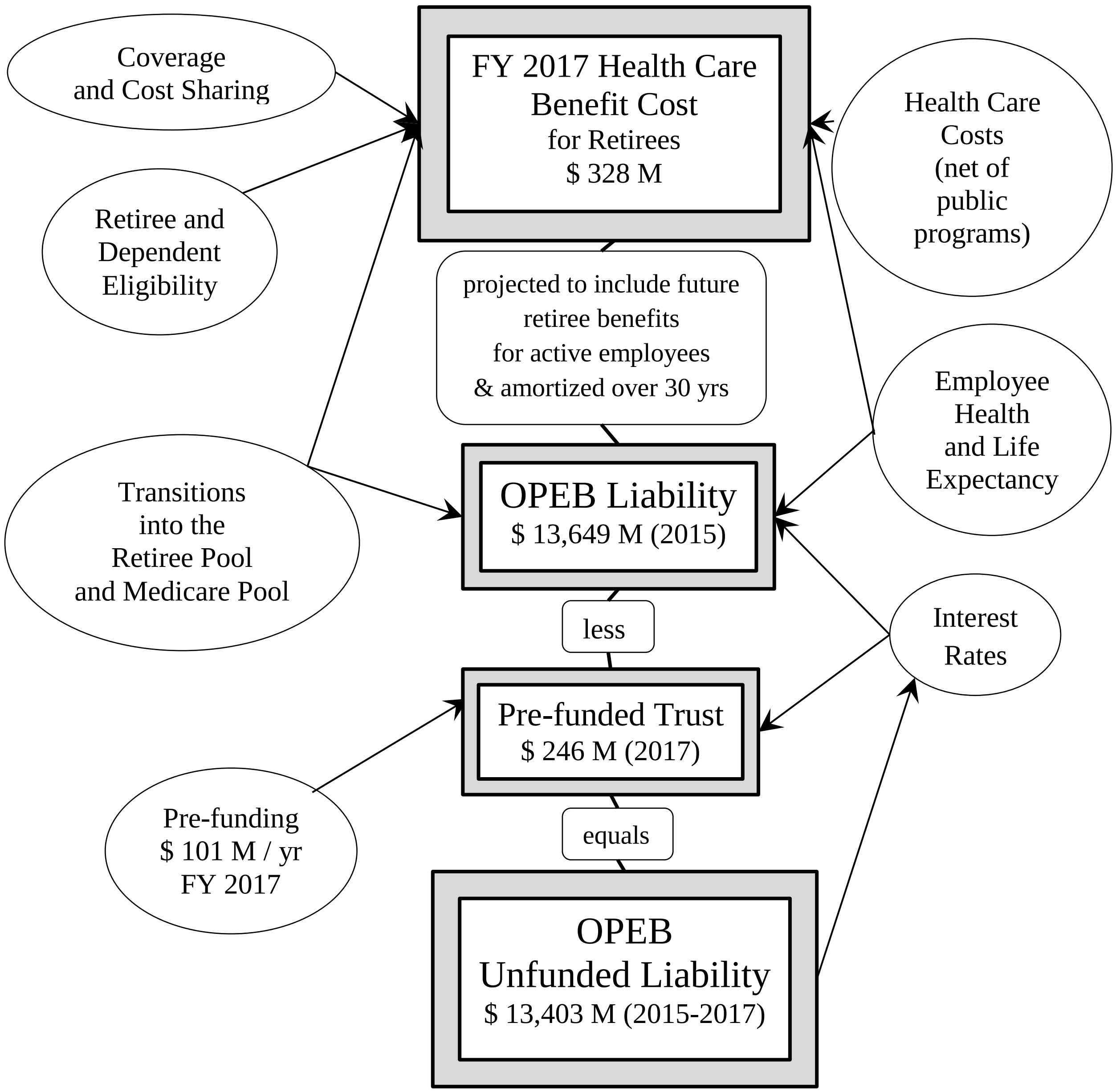


Figure 12 includes most of the bubbles in the previous figure, but adds several more related specifically to retiree costs and liabilities, such as interest rates and transitions into the retiree and Medicare pools. The figure illustrates a core principle in strategic thinking about the OPEB problem:

Any actions that permanently reduce annual retiree benefit costs save money now *and* every year hereafter, thereby automatically reducing the OPEB liability.

Permanently reducing OPEB costs by $100 million per year will immediately reduce the liability by approximately $1,591 million in today's dollars, and release $100 million in current budget funds. [44]

For example, paying lower rates for medical services would reduce the current spending on retiree health benefits *and* the unfunded liability because the cost savings would continue every year. Such an action would impact the District budget *both* by reducing the proportion of the budget allocated to cover benefit costs *and* by reducing the proportion of the budget that must be allocated to cover the liabilities now or in the future.

In contrast, pre-funding the liability by adding money to the OPEB Trust now would reduce the unfunded liability (bottom rectangle in Figure 12), but without changes to annual spending on health care, it would have a smaller impact. In general, the higher upstream the intervention, the greater leverage it has on the overall problem.

In the remainder of this section, we focus on five areas of cost-reduction strategies that correspond to some of the factors that affect costs:

- Changing health care costs
- Changing coverage benefits and cost sharing options
- Changing eligibility for benefits
- Supporting change in the health of employees and retirees
- Managing transitions into the retiree pool and the Medicare pool

Finally, we present an analysis of a hybrid strategy that is a combination of pre-funding and cost containment and has several benefits.

B. Changing Health Care Costs

Changes to vendor contracts

We start with one of the less difficult areas to deal with. The Independent Analysis Unit is not engaged in the negotiations involved in managing the District's health care costs, which are primarily the domain of the Health Benefits Committee (HBC). Thus, we are not able to address this area in detail at this time, but suggest it as an area for further examination. Possible actions

[44] As elsewhere in this report, this uses standard financial present value calculations with the same discount rate of 4.7% used in the actuarial report of 2015; $159 million is the present value of a stream of payments of $10 million for 30 years. Changes in the discount rate could change both values substantially.

range from negotiating less expensive per employee and retiree rates to eliminating contracts with the providers who offer the most expensive plans.

Regarding lower rates, it is probably true that the HBC has already negotiated beneficial rates, so there may be no low-hanging fruit remaining. However, the high-leverage value of every dollar saved on health care costs in reducing the OPEB liability makes this area worth careful consideration. In addition to rates for existing plans, there may be creative ways to use the District's buying and bargaining power to develop alternative supply paths for different elements of health care, such as carving out a separate provider for pharmaceutical orders.

Eliminating the most expensive providers, or the most expensive plans from providers with multiple plans, could cut costs. In addition, entering vendor contract negotiations with the intent to eliminate the most expensive providers or plans could prove to be an effective negotiating tactic and result in increased cost savings on the plans that are retained. Table 4 offers a premium cost comparison across each plan offered by the District, with the more expensive plans in bold.[45]

Table 4. Premium Cost Comparison across Plans[46] [47]

Provider	Total Active Enrollees	Total Retiree (<65) Enrollees	Total Retiree (>=65) Enrollees	Monthly Employee Rate	Monthly Retiree Rate (<65)	Monthly Retiree Rate (>=65)
Kaiser Permanente	28,683	2,302	13,402	$475.82	$798.30	$202.73
Anthem Blue Cross HMO	16,791	1,216	N/A	$499.27	$808.92	N/A
Anthem Blue Cross EPO	**3,651**	**829**	**15,735**	**$574.71**	**$1,096.28**	**$538.61**
Health Net	**6,736**	**480**	**1,028**	**$723.88**	**$868.01**	**$390.25**
United Health Care Advantage	N/A	N/A	1,061	N/A	N/A	$343.00
Opt-Out	3,752	N/A	N/A	$250	N/A	N/A

[45] L.A. Unified School Board Retreat. *Health and Welfare Discussion*. August 2017.

[46] The premium costs reflected here are equal to the District monthly COBRA rates. COBRA rates are the best estimates for premium costs as the District calculates and contributes an average annual cost per employee and retiree, which does not reflect true costs per plan. The District offers $3,000 per year to active employees who wish to opt-out of health care coverage. This number was divided by 12 to yield a monthly District opt-out rate.

[47] August Board Retreat Presentation

In making such decisions, the health needs and preferences that motivate active employees and retirees to enroll in a specific plan would have to be taken into consideration. This is part of the role of the HBC and its members representing labor partners. But the HBC is also required to work within a health and welfare budget negotiated by the District and approved by the Board of Education. Since these cost-cutting changes would be easier than cutting benefits or eligibility, there is a strong incentive for cooperation on these strategies.

Taking advantage of government subsidies, grants, and programs

L.A. Unified has taken advantage of the Employer Group Waiver Plan (EGWP) subsidy, which the 2010 Affordable Care Act made more accessible to employers.[48] The EGWP is a federal subsidy program available to plan sponsors, which saves the District an average of $480-$840 per Medicare retiree per year and lowers the District's OPEB liability.[49] In essence, the EGWP subsidy moves more of the pharmacy cost of benefits onto the federal government, lowering the pay-as-you-go costs and liability.[50]

Although this subsidy is already used by the District, and thus does not represent an opportunity for additional savings, there may be other government subsidies, grants, and programs available. District staff may have already identified and accessed such programs, but it is worthwhile to look for new programs or any that have been overlooked.

Political advocacy

This is a time of profound changes in the health care market, due primarily to the Affordable Care Act (ACA) but also to state-level programs created under or in addition to the ACA, and the continuing struggle to define a long-term direction for health care in this country. The District has a powerful voice in Sacramento and Washington that it has used to advocate funding for education. It could use that voice to influence the future of health care in ways that reduce health care costs for employees and retirees, thus reducing the OPEB liability.

While legislative advocacy can take time to have an effect, especially in controversial matters, it is important to keep the appropriate time horizon in mind when formulating strategies regarding health care. The OPEB liability is estimated on a 30-year basis, which is equivalent to seven and a half presidential administrations and fifteen Congresses. An employee who is hired tomorrow at age 25, works until age 65, and receives retirement benefits until age 85, will be covered by

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[48] "State Retiree Health Care Liabilities: Multiple factors contribute to improving picture in many states." (May 2016). *The PEW Charitable Trusts*. http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/05/state-retiree-health-care-liabilities

[49] "OPEB Liability – Does it Matter?" (n.d.). *Keeping the Promise Advisors*. http://www.ktpadvisors.com/wp-content/uploads/2013/01/OPEB-Liability-Does-it-Matter-FINAL-5.1.13.pdf

[50] Eyre, B. and Whitcher, M. (May 2013). OPEB Liability – Does it Matter? *Benefits Magazine*. http://www.ifebp.org/inforequest/0163756.pdf

some form of health care plan for sixty years. For perspective, remember that sixty years ago, Medicare did not exist, the Department of Health, Education and Welfare was only four years old, polio vaccinations were only two years old, and HMOs were hardly more than an evolving idea. The long-term nature of OPEB costs and benefits means that the District can and should pursue a long-game strategy of public advocacy.

Within such a long-term time horizon, it is plausible that the country will adopt single-payer health care, which could eliminate or drastically cut OPEB liabilities. The State of California might get there before the Federal government. There is resistance, but it seems to be inevitable eventually, and the sooner the better for the District (depending on the tax plan used to fund it). Short of such a milestone, a policy such as expanding Medicare eligibility down to age 55 would save the District a very large part of its OPEB costs. The ACA itself is in need of improvement, which if shaped right could help the District's OPEB situation. Reform of the pharmaceutical market could save the District money. These changes would all have very high leverage on OPEB costs and liabilities, being worth hundreds of millions if not billions of dollars to the District over time.

As the District engages in legislative advocacy, its objectives should include pushing toward beneficial changes in the health care policy environment. Furthermore, this is an area where the District can find strategic allies besides other school districts. When the District advocates for more money for education, it competes with all other demands for public money. When advocating for changes in health care policy, it may be opposed by some special interests but it will be joined by many sectors of society and ultimately the public in general. In other words, this is not just a legislative advocacy strategy, but a public political advocacy strategy. Unlike the other strategies described in this paper, the political advocacy strategy offers not only high leverage but relatively low cost.

C. Changing Coverage and Cost Sharing Options

The August Board retreat presentation included several options for changes in plan design, including different levels of cost sharing. This section does not repeat the details provided in that presentation, but it provides additional perspective and discusses some of the considerations raised by those options. Finally, it describes a plan design strategy that was not included in the presentation, namely adjusting the level of cost sharing to the income of the employee in a gradual, progressive fashion.

L.A. Unified has fully funded health care premium costs for all qualifying active employees, retirees, and their dependents since 1969. Introducing varying levels of premium cost sharing for active employees and retirees would aid in containing the District's health care costs. Any increase in the share paid by employees or retirees, for themselves or their dependents, would reduce benefit costs. However, such options would also increase the cost to the employees or retirees. In some cases that would provide employees or retirees with an incentive to shift to lower-cost plans among those available. In some cases it may be helpful to consider increases in employee salaries as a partial offset to increases in benefit costs. But it may be necessary for some or all of the participants in these benefits to experience cutbacks. One of the themes of this paper is that such individual losses may be mitigated to some degree by combining any cuts with other strategies to minimize the size of the cuts.

According to the Independent Financial Review Panel report of 2015, L.A. Unified offers generous health care benefits to its employees compared to other districts. The District partially attributes its ability to attract and retain talent to its generous benefits package. Other public institutions such as the City of Los Angeles, San Diego Unified School District, and Long Beach Unified School District cover full premium costs for their current employees. However, these institutions do not provide full health care coverage for retirees or their dependents.

To reduce the future cost of retiree health benefits, several districts in California renegotiated health care coverage agreements. For instance, to address a budget deficit and threat of a state takeover, Fresno Unified School District negotiated with the teachers union to cap the amount spent on health care and to end lifetime health care benefits for all employees hired after July 2005. In addition, during negotiations, Fresno Unified added a $250 deductible and co-pays for doctor visits to reduce the cost of health care benefits.[51]

Similarly, Clovis Unified School District made changes to lifetime health care benefits to reduce future costs. In 2007, Clovis Unified began requiring new employees to have at least 30 years of service with the district to qualify for lifetime health care benefits. In prior years, the district required 15 years of service.

Several cities in California have declared bankruptcy due, in part, to the rising cost of benefits promised to employees. As part of their bankruptcy plan, the city of Stockton totally eliminated health care benefits while leaving most pension benefits unaffected. Similarly, the city of San Bernardino, as part of its bankruptcy plan, reduced retiree health care benefits.

Although the District is more competitive than most districts regarding benefits, it is less competitive when it comes to salary scale. This is a tradeoff that has resulted from a long history of negotiations, but it suggests that different ways of balancing the tradeoffs might be possible. If the District were to increase employee salaries to a level of competitiveness with other districts, while reducing benefit contribution rates, it might be able to keep total employee compensation constant while reducing future liabilities. Such a strategy would require careful analysis of the cash flows involved over time to be sure that the positive savings in benefits substantially outweigh the negative effect on current budgets.[52] Since total employee compensation is determined during the collective bargaining processes among the District and the various

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[51] Torres, Zahira. (March 2015). Health benefits are a promise school districts find hard to keep. *The Los Angeles Times*. http://www.latimes.com/local/education/la-me-schools-health-benefits-20150308-story.html

[52] Note that any discussion of employee compensation trades between salary and health benefits must also include calculations as to the impact on pension obligations.

bargaining units, and benefit plan design is carried out by negotiation in the Health and Welfare Committee, it might be difficult to find a balance between current costs and future savings within the District's budget constraints, but it could have high leverage on the OPEB liability.

As mentioned previously in this paper, while changing options for employees hired in the future reduces future liability, it does not change the amount already accrued for current and past employees. Unless the changes apply to current and past employees, they will not change the $13.6 billion liability of today, but will reduce increases in that liability decades into the future.

We do not need to comment on the changes in cost sharing described in the August Board retreat, except for one suggestion for further consideration. If cost sharing is one of the strategies to be seriously considered, a close look at the possibility of a stepped or progressive system is warranted. In such a system, anyone whose pay is below a certain level—perhaps that of an entering teacher—might not have to pay any premium, while someone above a certain level of income has to pay a larger fraction of the premium. For employees between the two boundaries, the premium could rise at a steady percent depending on income. The details of such an approach would require careful study, but if it turns out to be possible, it might be preferable to a change that imposed cost-sharing on everyone in a group at the same dollar amount.

D. Changing Eligibility

Changing which new hires are eligible for retiree health care benefits and how they become eligible would help control the growth of the OPEB liability, but to substantially decrease the current liability, which has accrued due to past service of active and retired employees, changes in eligibility would have to apply to current employees and retirees.

Since the establishment of lifetime benefits in 1966, the District has expanded eligibility for its retirement health care benefits six times, with each change affecting new hires and grandfathering in current employees. The presentation at the August Board retreat identified several possible options for eligibility changes to reduce OPEB costs, so those do not need to be restated here.

Such changes entail a high degree of difficulty. They involve collective bargaining and also mean that some group of people would be losing benefits for which they are currently eligible. The details of the policy change would determine who is affected by having their eligibility changed. The District might change eligibility for new hires while grandfathering existing employees and retirees. In this case, the benefit to the District would not be seen until decades in the future, but it might adversely affect the ability to hire new employees in the short term unless offset by other forms of compensation. Careful analysis would be necessary to ensure that such a policy change would have a net positive impact.

E. Supporting Change in the Health of Employees and Retirees

Although the cost of health care coverage in any given year is fixed by negotiation, regardless of the medical expenses incurred by participants during that year, over the long run the health care patterns and costs experienced by members of the coverage pool will have an effect on the premiums available to the District. A healthy population of employees and retirees is desirable in itself for many reasons, but it also reduces benefit costs in the long run.

According to the most recent Prescription Benefits Review of L.A. Unified, conducted by CVS Health, costs associated with prescription drugs for chronic preventative, maintenance, or symptomatic medications are growing.[53] Examples of chronic conditions being managed by L.A. Unified employees are type 1 and 2 diabetes, cardiovascular diseases such as hypertension and high cholesterol, asthma, neurologic disorders, arthritis, and depression. Heart disease, type 2 diabetes, and arthritis are among the most costly, and preventable, chronic conditions to the American public. These conditions can be attributed, in part, to health risk behaviors such as poor eating habits, smoking, and lack of exercise.[54]

Reducing health care costs associated with preventable chronic conditions is a strategy for L.A. Unified, with leverage that depends on its comprehensiveness and success. To reduce health care costs associated with managing chronic disease, employers across industries have expanded the healthy lifestyle incentive packages, referred to as wellness packages, being offered to employees.[55] According to the Department of Health and Human Services (HHS), employers looking to incentivize their employees to lead healthier lifestyles can choose from two types of wellness programs, participatory wellness programs and/or health-contingent wellness programs.[56] Participatory wellness programs often offer incentives for employees to partake in wellness programs without requiring a particular health outcome. Examples of participatory wellness programs include, but are not limited to, reimbursement for gym memberships, rewards or reimbursements for participation in smoking cessation programs, or rewards for attending health education seminars. Health-contingent wellness programs require participants to achieve a health standard set by their employer to receive the reward.

Currently, the Blueprint for Wellness policy governs total wellness initiatives across L.A. Unified. In the policy, L.A. Unified puts forth a reduction in health care costs as one of its

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[53] Prescription Benefits Review. Apr 2017 – Jun 2017. CVS Health

[54] "Chronic Disease Overview." (June 2017). *Centers for Disease Control and Prevention*. https://www.cdc.gov/chronicdisease/overview/index.htm

[55] Hand, Larry. (Winter 2009). Employer health incentives. *Harvard School of Public Health*. https://www.hsph.harvard.edu/news/magazine/winter09healthincentives/

[56] "Health Coverage Portability (HIPAA) Compliance FAQs." (n.d.). *US Department of Labor - Employee Benefits Security Administration*. https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs/hipaa-compliance

primary objectives in promoting total wellness.[57] To incentivize healthy lifestyle habits, L.A. Unified provides access to total wellness information online and has partnered with 24 Hour Fitness to offer L.A. Unified employees a discounted corporate membership rate.[58] However, the District does not offer monetary incentives to active employees for health-related behavior.

To incentivize active employees to lead healthier lifestyles, L.A. Unified could employ a participatory wellness program with targeted outreach strategies to ensure take up among desired populations.[59] More research and cost-benefit analyses are required to estimate potential cost savings associated with the launch of District-sponsored wellness programs.

Furthermore, there may be opportunities to introduce wellness-related benefits to retirees. This is a relatively untried approach, but researchers have found that retiree wellness programs can improve health and reduce costs. A large-scale randomized control trial of 4,700 retirees showed significant differences between retirees randomly assigned to a wellness program and retirees in the control group on the following outcomes: systolic blood pressure, pounds over ideal weight, seat belt use, high salt intake, high dietary fate, and health risk score. After analyzing claims data, researchers found that retirees who were randomly assigned to the wellness program saw significant reductions in claims, meaning that those in the treatment group saw substantial decreases in health care costs.[60] The results from this study are consistent with the wider research literature on employee wellness programs, which finds that participation in workplace wellness programs can increase healthy behaviors, reduce absenteeism, and increase job satisfaction.[61]

In 2008, the state of New Jersey initiated the Retiree Wellness program for state employees. The program provides for early detection of health risks, encourages healthy lifestyles, provides reminders of critical tests and screenings, and provides guidance to those now struggling with chronic disease.[62] Participation in the Retiree Wellness Program results in the waiver of the required health contribution of 1.5% of the retirement benefit. Enrollees who do not complete the components of the Retiree Wellness Program will pay the state required health contribution of 1.5% of the retirement benefit.

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[57] "Blue Print for Wellness: Healthy Choices for Lifelong Health." (January 2016). https://achieve.lausd.net/cms/lib/CA01000043/Centricity/Domain/453/MASTER_Blueprint%20for%20Wellness_061316.pdf

[58] L.A. Unified and 24 Hour Fitness Partnership

[59] Desired populations refers to employees currently managing or exhibiting risk factors for chronic conditions.

[60] Fries, J. F., Bloch, D. A., Harrington, H., Richardson, N., & Beck, R. (1993). Two-year results of a randomized controlled trial of a health promotion program in a retiree population: the Bank of America study. *The American journal of medicine*, *94*(5), 455-462.

[61] Parks, K. M., & Steelman, L. A. (2008). Organizational wellness programs: a meta-analysis. *Journal of occupational health psychology*, *13*(1), 58–68.

[62] "State Health Benefits Program (SHBP): Retiree Wellness Program." (April 2015). *State of New Jersey Division of Pensions and Benefits*. http://www.state.nj.us/treasury/pensions/shbp-wellness-program.shtml

Though retiree wellness programs are not common, there is strong evidence that they provide a viable way of reducing costs for employers and improving the health of retirees. A program such as this would have a longer-term impact rather than changing OPEB costs immediately. However, with a 30-year time horizon for planning and implementing reductions to the current OPEB liability, there is plenty of time to plan, implement, and benefit from a retiree wellness program. Wellness programs for employees should take a higher priority, though, to make an early and lasting impact on behavior-related illness. In any case, when considering an expansion of the District's wellness programs for employees, consideration should be given to extending such programs for retirees and designing other programs especially for retirees.

Finally, the District should explore ways to enlarge the idea of a wellness program beyond the current norms of education programs and incentives for desired behaviors. It may be hard for District personnel, especially those in schools, to go to scheduled activities. It also takes a certain level of motivation for someone to leave their daily routine to investigate options. Creating a program that brings activities directly to where employees are may have a greater chance of success. They may be more expensive, but an effective expensive program makes more sense than an ineffective inexpensive one. Like retiree wellness programs, this is an idea that offers much potential as well as many opportunities to be innovative. None of the wellness programs is as difficult as some of the changes in eligibility or coverage described previously. But if they are effective, they can make a big difference in health care costs for decades to come.

F. Managing Transitions into the Retiree Pool and Medicare Pool

The District has at times offered financial incentives for early retirement when faced with a need to reduce the workforce and/or trim pension costs, which increase substantially with every additional year of qualified service and with ending salary. Unlike pensions, health and welfare benefits do not increase with service and salary, but currently follow an all-or-nothing rule. Qualified retirees receive the same benefit package regardless of their years of service and ending salary, and retirees who do not qualify do not receive benefits. Thus, any thought of offering early retirement options must be examined carefully to ensure that it does not actually increase OPEB liabilities.

A major factor affecting OPEB costs for retirees is the federal Medicare program and its eligibility age of 65. L.A. Unified retirees who are 65 or older have a substantial portion of their health care costs covered by Medicare, so their annual coverage cost is much lower than for younger retirees or active employees. Encouraging employees to retire early, e.g., at 55 instead of 65, increases the number of years that their health coverage is at its most expensive.

It may be that the optimal strategy for the District is to offer employees incentives for delayed rather than early retirement. This might reduce their total OPEB cost even though it increases their pension cost. These cost factors must be calculated for every combination of age, service years, and ending salary before proposing a retirement incentive plan. Calculating a probable break-even amount for an early or late retirement incentive requires actuarial as well as financial data. Identifying the right amount for the incentive is as important as identifying what behavior to incentivize, to avoid the unintended consequence of a program that costs more than the benefit it generates. Regardless, the potential leverage of a successful program could be great, so it is worth examining the numbers to determine whether it is feasible.

G. A Hybrid Strategy[63]

As discussed previously, there is a fundamental difference between a pre-funding strategy and a cost-cutting strategy:

Pre-funding

A one-time payment of $100 million to pre-fund the OPEB liability accomplishes the following:

- It takes $100 million away from the current year budget available for other purposes.
- It reduces the unfunded OPEB liability by $100 million.

A credible commitment to pre-fund $100 million a year for 30 years accomplishes the following:

- It takes $100 million a year away from the budget available for other purposes.
- It *gradually* covers $1,591 million of the OPEB liability over 30 years.

Cost-cutting

A permanent reduction of $100 million a year in retiree benefit cost accomplishes the following:

- It saves the budget $100 million a year that would otherwise be spent on the benefit cost.
- It *instantly* (or as soon as the first actuarial report is issued that reflects the change) reduces the OPEB liability by $1,591 million.

Hybrid

There is a hybrid strategy that combines these two approaches for greater impact than either one alone. This strategy would involve the following steps, using $100 million as the annual example:

- Find a way to permanently reduce retiree benefit costs by $100 million per year.
- That instantly reduces the OPEB liability by $1,591 million.
- It also frees up $100 million per year of the budget.
- Use that $100 million to pre-fund the OPEB Trust.

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[63] The calculations in this section assume a discount rate of 4.70%, which is the same as in the actuarial report. The present value of a series of payments of $100 for 30 years is $1,591. The same proportion of 1.591:1 holds true for other payment amounts as well.

- This promises over time to pre-fund the OPEB liability by $1,591 million.
- Combined, the two actions would relieve the OPEB liability by $3,182 million, half instantly and half in installments over thirty years.

Other payment amounts could be chosen in the same way. Using this strategy, how much cost savings would be needed to achieve a target funding ratio for the OPEB liability? Assuming the District's current pre-funding level of $101 million is sustained, and adopting a target of pre-funding 70% of the liability, the critical savings target is calculated to be $291 million per year. By saving $291 million a year on retiree benefit costs, and placing that $291 million into the OPEB Trust, the impact on the budget is zero. But the result is first that the OPEB liability immediately drops from $13,649 million to $9,026, and second that the pre-funding of the OPEB liability is increased over 30 years to the point where it equals 70% of the liability. Note that a lower funding ratio target than 70% would allow achieving the goal with self-funding cost savings even lower than the $291 calculated here. Table 5 illustrates this strategy.

Table 5. Details of Hybrid Strategy

(Dollars in millions)	Pre-Funding Only	Hybrid Strategy
OPEB liability (2015)	$ 13,649	$ 13,649
Permanent cost savings achieved	-	$ 290.5/yr
New OPEB liability after cost savings	$ 13,649	$ 9,026
Target pre-funding level at 70%	$ 9,554	$ 6,318
Pre-funded Trust balance (2015)	$ 90	$ 90
Currently budgeted pre-funding	$100.9/yr	$100.9/yr
Additional pre-funding needed to reach target	$ 493.9/yr	$ 290.5/yr
Net cost impact on current budget (additional pre-funding minus cost savings)	$ 493.9/yr	$ 0/yr

The same approach could be applied with different target percentages, different levels of cost savings, and different decisions about maintaining the currently budgeted pre-funding schedule of $100.9 million per year. It is important to note that regardless of the current liability and the target percentage to pre-fund, *it will always be possible to calculate a level of savings that will allow reaching the target with zero impact on the current budget. And that level of savings will always be less than the amount of funding required under a pre-funding only strategy to hit the same target.*

It is still challenging to save $291 million per year on retiree benefit costs. Several of the options described in the August Board retreat presentation showed more than $291 million per year savings, but involved serious consequences for various groups of employees or retirees. However, some of the solutions that were less than $291 million per year might be combined to reach that total while spreading out the burden. More importantly, this report has identified several strategies for reducing costs that have high leverage on the OPEB liability with less negative impact on participants. Some strategies reduce costs and generate *positive* impacts on participants. By pursuing multiple strategies simultaneously, it should be possible to achieve the necessary $291 million in savings with fewer negative consequences than trying to take it all in a single cut.

Finally, when considering the difficulty of a $291 million per year reduction in retiree benefit costs, consider it next to the $494 million per year cost of pre-funding the OPEB liability to the same 70% level without cost savings. And the $494 million per year required to pre-fund to that level would have to come out of the General Fund or other sources that would otherwise be available to support instructional programs or other District goals.

This section has not been intended to propose an exact solution. Many of the numbers are estimates based on specific assumptions, some suffer from rounding errors, and some come from different fiscal years and thus may ignore changes between those years. However, the numbers are based wherever possible on the actuarial report of 2015 and the Superintendent’s budget from FY 2017, and estimates are based on the same discount rate used in the actuarial report. One element that is missing is the actuarial data that provides much more nuanced projections, but we found that our projections were largely in the same ball park as the actuarial projections.

SECTION FOUR: CONCLUSION

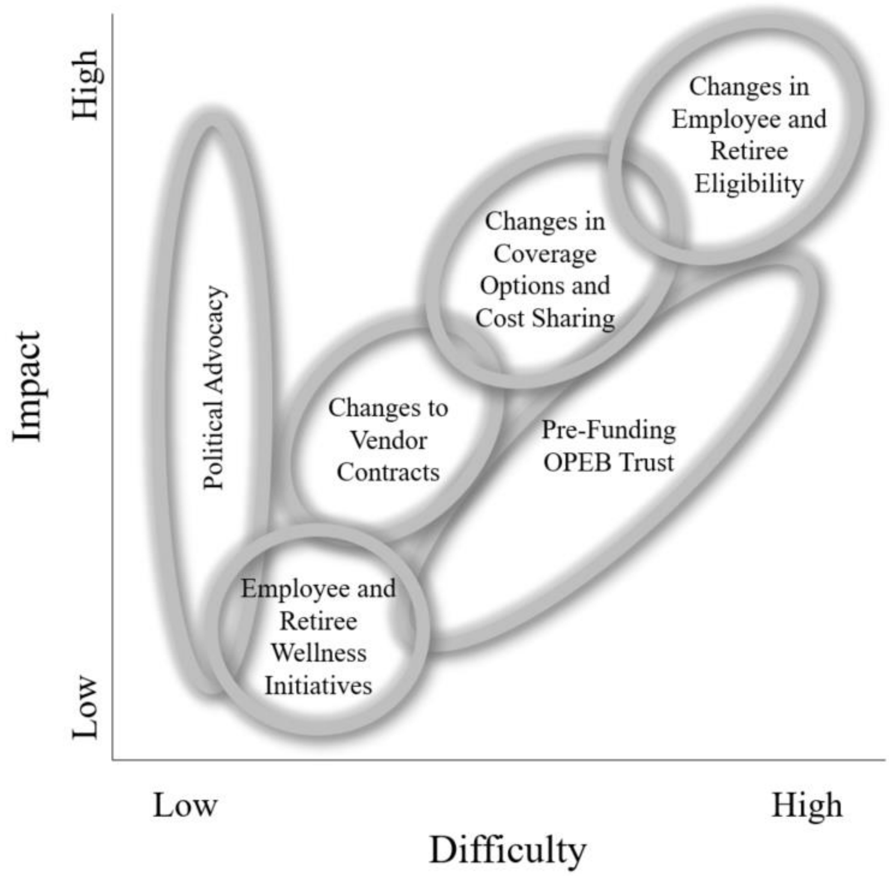
There is no single solution to the growing health care costs and liabilities. However, by addressing a range of factors simultaneously, the District may be able to reduce the impact of these problems so that they do not overwhelm the finances of the District in the near to medium-term future. The costs of current benefits, the size of the OPEB liability, and the revenue available to the District are subject to many factors beyond the control of the Board of Education. However, there are areas or leverage points where the Board can exercise direct control or indirect influence to mitigate the problem. Many of these leverage points require cooperation and negotiation with other entities, notably the District's labor partners and their representatives on the Health and Benefits Committee, the vendors in the health care market, and the policy-making agencies at State and Federal level that set many of the rules governing health care plans and District finances as well as determining the overall level of funding available for education.

- **The problem is not infinite**. Both health care costs and the retiree population are projected to continue increasing through the medium-term future. However, the retiree population will eventually begin to contract as a result of demographic change and current reductions in the workforce. Further, the rise in health care costs per person is slowing and must eventually level off, because in a practical sense it is impossible for these costs to grow so large as to overtake the entire economy.

- **Pay-as-you-go is unsustainable** because the liability is already too large to be ignored, health care costs are still rising, and the ratio of retirees to active employees is still increasing. Unless some portion of OPEB liabilities is pre-funded, the burden of paying for retiree benefits will overwhelm the budget.
- **Pre-funding 80% or 100% of OPEB liabilities is unnecessary and undesirable**. It would tie up resources that could be better used for the education of students now. In any case, it is not feasible for the District to reach this level within current revenue constraints.
- **Some level of annual pre-funding could be calculated to be sustainable** within certain assumptions. This level will be somewhat greater than the $101 million allocated in FY 2017, but somewhat less than the $850 million required to fully fund the OPEB liability over 30 years. The District should calculate this amount and strive to pre-fund it annually if feasible. This level will be lower, and more feasible, for every reduction in OPEB costs.
- **Any change that reduces OPEB costs for current retirees and those projected for active employees when they retire will instantly shrink the OPEB liability**. In contrast, any change that reduces OPEB costs for new hires will not affect today's OPEB liability, but will reduce its future growth.
- **Permanent cuts in OPEB costs not only shrink the OPEB liability, they free up funds that can be used to pre-fund a substantial portion of the remaining liability.** As an approximation for understanding this point, every $100 million/year of such cuts reinvested in the pre-funding Trust will ultimately reduce the unfunded liability by about $3,182 million in today's dollars. Of that amount, half will come from immediately reducing the OPEB liability, and half will come from pre-funding the liability gradually over 30 years. And this can happen without any additional cost to the General Fund, unlike simple pre-funding.

Figure 13 is a conceptual tool that can be used to envision the tradeoffs associated with several of the strategic leverage points described in this report.

Figure 13. Tradeoffs between Impact and Difficulty[64]



The conceptual tool consists of two dimensions: impact or leverage on cost-savings, and difficulty within the District's situation. The ovals are deliberately fuzzy and overlapping, since this is a way of visualizing general concepts rather than a plot of actual numbers. The ovals tend to slope upward, since in general the greater the impact a strategy offers, the more difficult it tends to be to implement. The notable exception is Political Advocacy, since it is a relatively low-cost strategy that can potentially have a very high impact, but mainly in the long term and with no guarantee of success.

The long oval for pre-funding OPEB liabilities signifies that pre-funding options might range from a few million dollars a year at the low-impact low-difficulty end, to several hundred million dollars a year at the high-impact high-difficulty end. The impact on OPEB liabilities would vary directly with the amount contributed. The difficulty would also vary with the amount, although as a budget item its difficulty may be intrinsically less challenging than other strategies that require negotiation among stakeholders.

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[64] Difficulty refers to financial or human cost, collective bargaining relationships, time, etc.

The District's unfunded OPEB liability of over $13 billion looks intimidating, especially to stakeholders and public constituents who may be less familiar with accounting for benefits. This report emphasizes the following points of perspective on this situation:

- The $13 billion does not all have to be paid in advance, but leaving it completely unfunded (pay-as-you-go) is not a viable option. However, there should be a partial level that is self-sustaining level in the long run.
- There are many strategies available for reducing benefit costs, at varying levels of difficulty and varying impact. Combining strategies is preferable to relying on one strategy, and may allow spreading out any negative consequences more thinly.
- Cutting benefit costs for retirees brings a double advantage; it reduces the OPEB liability, and it generates savings that can be used to pre-fund the remaining liability. The amount of savings needed to accomplish this is lower than is apparent from the liability alone.

<u>A note about the Independent Analysis Unit's examination of these issues</u>

In this study, the Independent Analysis Unit worked with three goals in mind.

First, we hoped to identify new or untried approaches to solving these problems. We learned that there is very little that has not already been considered or tried, since a large number of experts at various levels of government and advisory roles have been working on this issue area. However, the problem has enough facets that we believe the search for such new ideas is worth continuing vigorously.

Second, we hoped to help the Board understand these issues by framing them in such a way as to highlight the relative scale and scope of different elements of the problem, important relationships among those elements, and differences between such things as fund balances and the flows into and out of those funds. We found that much of the communication about health and welfare benefit costs and liabilities needs greater clarity, and we sought to provide more clarity in key areas. We also sought to describe policy options in terms of their leverage and their feasibility.

Third, as part of the charge of the Independent Analysis Unit, we hoped to provide independent validation of the information provided to the Board by District staff in recent discussions of these issues. We did not find reason to disagree with staff on any substantive matters, although we chose to frame some of the issues in different terms for the purpose of our analysis.

In short, this report does not provide any revolutionary breakthrough in solving the problems it describes, *except perhaps the hybrid strategy*, but it should help Board Members understand the problems and evaluate some of the possible mitigating strategies available. Most importantly, it shows how important it is to cut current costs and not simply to pre-fund future costs. Subject to the direction of the Board, the Independent Analysis Unit is ready to continue and build upon this study to probe more deeply into these challenges and identify ideas for meeting them.