INTEROFFICE CORRESPONDENCE
Los Angeles Unified School District
Independent Analysis Unit

INFORMATIVE

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

DATE: May 6, 2018

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

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

SUMMARY

This informative provides an update of the IAU's health and welfare report of November 2017, in light of new information from the recent actuarial report on the District's long-term OPEB liabilities[2] and other information on the District budget.

Several key points that emerged from the IAU analysis of in November 2017 still stand and warrant re-emphasis:

The size of the District's OPEB liability ($15.2 billion in 2017) is intimidating, but it is more manageable than it might look. It is not necessary or desirable for the District to fund this amount completely. It is 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 $120 million per year currently budgeted for OPEB pre-funding (if continued beyond 2018), but somewhat less than the $536 million per year required to reach the 80% funding level in 30 years.

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. Some of these strategies involve difficult and painful choices, but combining strategies can mitigate the consequences of any one strategy.

Achieving a combination of permanent savings in annual benefit costs for current employees and retirees *and* prefunding the OPEB liability with these savings will reduce the size of the OPEB liability and make it manageable over time, with zero net effect on the budget. As an initial estimate, for current participants, given conservative financial assumptions, *permanent annual cost savings of $100 will reduce the OPEB liability by approximately $1,800*. By putting this $100 of savings into the OPEB trust every year, the District can reduce its unfunded liability by another $1,800 over 30 years, for a total impact of $3,600 for each hundred dollars of annual costs saved.

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

[2] Aon Hewitt. 2017. *Actuarial Valuation Report*, Los Angeles Unified School District Postretirement Health Benefits As of July 1, 2017.

Key updates in the 2017 actuarial report include:

- **The District's OPEB liability has increased from $13.5 billion to $15.2 billion**
- **The OPEB trust contains $244 million of pre-funding**. This amount is called the *Plan Fiduciary Net Position*, and is a substantial increase from last year.
- Therefore, **the *Net OPEB Liability* is $14.9 Billion**. This amount will appear for the first time on the District's balance sheet for FY 2018, per GASB 75.
- **A major reason for the increase is a lower discount rate**, making future dollars of liability weigh more in the present value of the accrued liability.
- **Though the cost of health and welfare benefits has grown over the past decade and is projected to grow for decades to come, the amount of growth is lower than projected in the last actuarial report.** The recent Health Benefits Agreement (HBA) between the District and its labor partners stipulates that until 2020, District contributions will remain steady, the Health and Welfare Fund Balance will be used to pay costs that exceed contributions until the balance teachers $100 million, and a 6-person District-labor subcommittee will be formed to pursue cost savings. All of this means that costs might not exceed contributions and the Health and Welfare Fund Balance at all, but if they do, their encroachment on General Fund expenditures is projected to be less pronounced than it was estimated to be in the last report, only reaching 20% in 2048.

SECTION ONE: COST UPDATE

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. Retiree health care benefits are referred to as *Other Postemployment Benefits (OPEB)*. 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, for that employee to qualify for lifetime health care benefits in retirement.[3]

A. Health and Welfare Costs in Context

Last fall, Health and welfare benefits provided annually to active employees by L.A. Unified were valued at approximately $14,000 per employee, and this valuation did not change per the recent Health Benefits Agreement (HBA) between L.A. Unified and its labor partners, which is in place until 2020. 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 remains $20,000.[4]

B. Update on Contributions versus Expenditures

The terms contributions and expenditures in reference to the District's employee benefits are easily confused. *Contributions* are monies transferred from the General Fund to the Health and Welfare Benefits Fund, which is where assets and liabilities associated with active and retiree benefits are counted.[5] *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).

Currently, L.A. Unified fully funds health care costs for active employees and qualified retirees. Per the new 2018-2020 HBA, District contributions to the Health and Welfare Fund will remain at the 2017 levels, which total approximately $1.15 billion through SY 2019-2020.[6] However, health care costs are expected to rise,[7] [8] and if they do, then the cost of health care could exceed that of the District's capped

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[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 2015-2017 Health Benefits Agreement as well as the 2018-2020 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.
[6] The District's total contribution is dependent upon the number of active employees, pre-Medicare eligible retirees, and Medicare-eligible retirees.
[7] 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
[8] 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.

contribution to the Health and Welfare Fund. In the event costs exceed annual District contributions in the future, the new 2018-2020 HBA requires the HBC to use Health and Welfare Fund Balance dollars to cover the remaining costs, rather than adding new contributions and keeping such a large amount in the fund. This use of the fund would gradually deplete it. If this happens by 2020, the HBC must find a way to contain costs within the contributions cap. When the HBC institutes cost saving measures that reduce the District's OPEB liability by $200 million or more, the District will ensure the Health and Welfare Fund has a balance of no less than $100 million.[9]

The Health Benefits Committee

Decisions regarding health and welfare benefits are negotiated by the HBC. The HBA, also referred to as a Memorandum of Understanding (MOU), governs the HBC. Under the current and past MOUs, 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.[10] This definition of responsibilities means that reducing costs through the design of health plans must be accomplished through negotiation and not as a unilateral decision by the District. In addition to calling for a reduction in present costs facing the District, the 2018-2020 HBA directs the HBC to find ways to reduce the District's future costs. Per this recent agreement, the HBC established a subcommittee of six members—three appointed by the District (which includes staff and parents) and three appointed by labor—with the sole purpose of identifying and reporting on alternatives for reducing the District's OPEB liabilities. This subcommittee has not begun to meet as of May 2018.

C. General Fund Update

While health and welfare costs are expected to increase over time,[11] 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), which has meant revenue growth year over year. However, the Governor's budget recommends fully funding LCFF in FY 2018-2019 while the District expects to continue seeing an annual 2.8% decline in enrollment. Thus, overall District revenue will likely begin to decline in coming years.

While L.A. Unified is experiencing a leveling and expects a gradual decline in General Fund revenue, the current projection is that health and welfare costs will continue to grow, absent cost savings measures. In 2012-2013, health and welfare costs for actives and retirees made up 16% of the General Fund ($680

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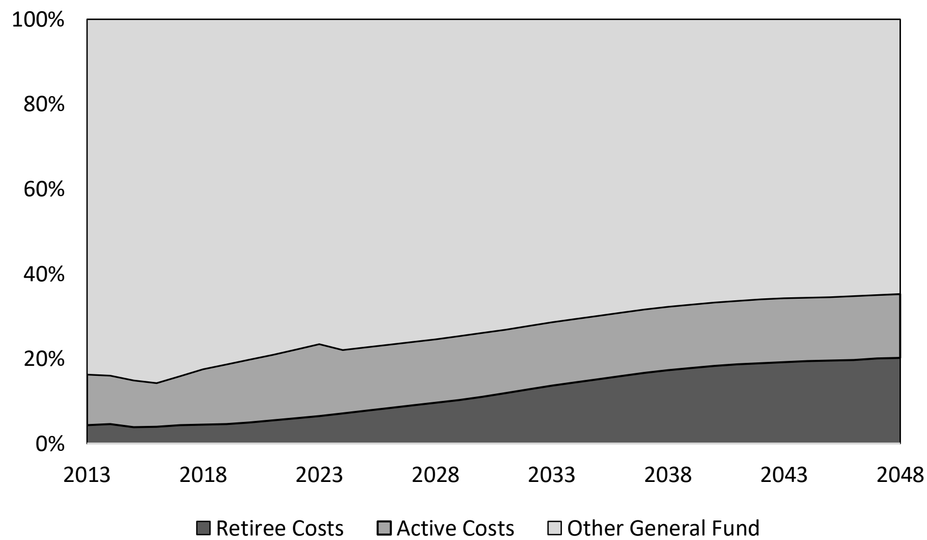
[9] 2018-2020 L.A. Unified Health Benefits Agreement

[10] 2018-2020 L.A. Unified Health Benefits Agreement

[11] 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, absent substantial cost savings measures, the District's health and welfare contributions in relation to the General Fund will increase by 18 percentage points relative to today.

million for actives, $249 million for retirees). As seen in Figure 1, which shows a simplified growth of these costs as a percentage of the General Fund, this proportion of healthcare expenses to the General Fund is projected to grow to approximately 35% by 2048 ($1,349 million for retirees, $1,000 million for actives), assuming no cost cutting measures. This is less than the 39% growth the IAU projected in November. However, we should emphasize that the HBA includes stipulations designed to reduce costs such that the encroachment may not happen at all. On the other hand, these provisions go into force only when costs exceed contributions before 2020, which they may not do. It is likely, however, that at some point in the next decade, health care costs will exceed District contributions, so continued vigilance is important.

Figure 1. Health and Welfare Costs for Actives and Retirees as Percentage of General Fund Revenue[12]



SECTION TWO: OPEB LIABILITY

A. The Newly Reported OPEB Liability

This year's OPEB 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*.[13]

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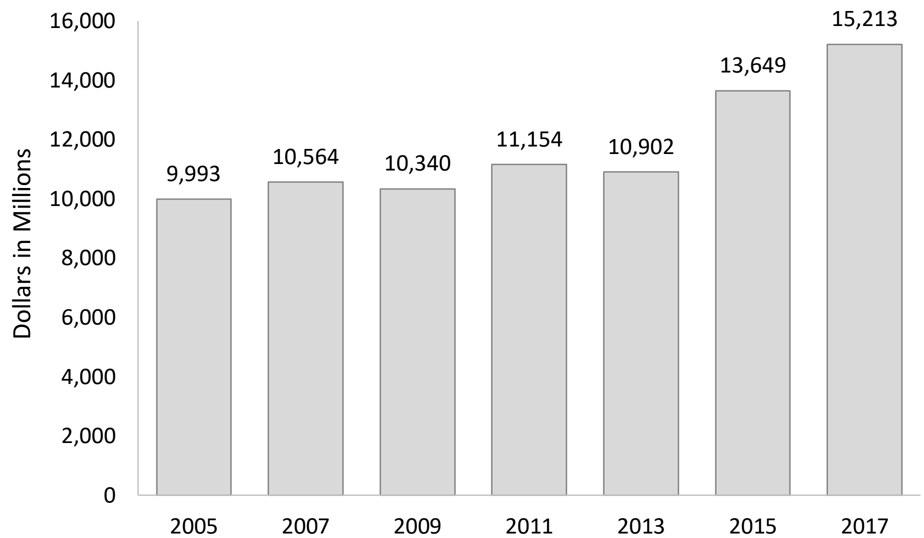
[12] General Fund revenue amounts are sourced from the 2010-2011 through 2016-2017 actuals and the 2017-2018 second interim report. Projections beyond 2017-2018 use the following assumptions: 2.75% rate of inflation; LCFF dollars fully funded in 2018-2019; ADA average of 97%; a declining average enrollment 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 2017 Actuarial Report.

[13] 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.

The District's OPEB liability is calculated every other year in an actuarial report. A new report was released recently (late 2017).[14] 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 fluctuated, but over time have increased from approximately $9.9 billion in 2005 to approximately $15.2 billion in 2018, as shown in Figure 2.[15]

Figure 2. Postemployment Benefit (OPEB) Accrued Liability[16]



Since the original version of this IAU report in Fall 2017, the OPEB liability increased by about $1.6 billion from about $13 billion to about $15 billion, primarily for five reasons:

- Because the OPEB liability is a debt the District incurs for payment in the future, counting its value in the current account statements is a bookkeeping challenge. To do so, the District must measure the *current value* of future liabilities by *discounting* the total accrued liability. In the past, the discount applied was large, but standard accounting practices now call for a more conservative discount rate, which is more accurate and prudent, but also expensive. Every time the discount rate is decreased, the present value of the OPEB liabilities goes up. In the current valuation, the change in discount rate from 4.7% to 3.6% increased the liability by $2.6 billion.

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[14] Aon Hewitt. 2017. *Actuarial Valuation Report*, Los Angeles Unified School District Postretirement Health Benefits As of July 1, 2017.
[15] 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.
[16] L.A. Unified's OPEB liabilities changed since the FY2015 actuarial report. One reason for the increase from $13.6 billion to $15.2 billion is a change in the discount rate used for the calculation. The discount rate changed from 4.7% to 3.6%, resulting in an increase in liabilities. Sources: Comprehensive Annual Financial Report 2005-2006, Comprehensive Annual Financial Report 2011-2012, Comprehensive Annual Financial Report 2015-2016, and AON's 2017 Actuarial Valuation Report.

- The good news is that overall healthcare cost increases were lower than assumed in the prior valuation, which decreased expected costs by $1.8 billion.
- In addition, an Employer Group Waiver Plan (EGWP) was implemented for certain Medicare eligible participants effective January 1, 2016, which resulted in cost savings of $1.1 billion.
- The demographics of District staff also changed in ways that lead to a lower estimate of health care costs by $400 million.
- Finally, demographic assumptions (mortality, turnover, retirement, and disability rates) were updated to reflect the assumptions used in the most recent CalPERS/CalSTRS valuations. This resulted in a small increase of $600 million in expected costs.

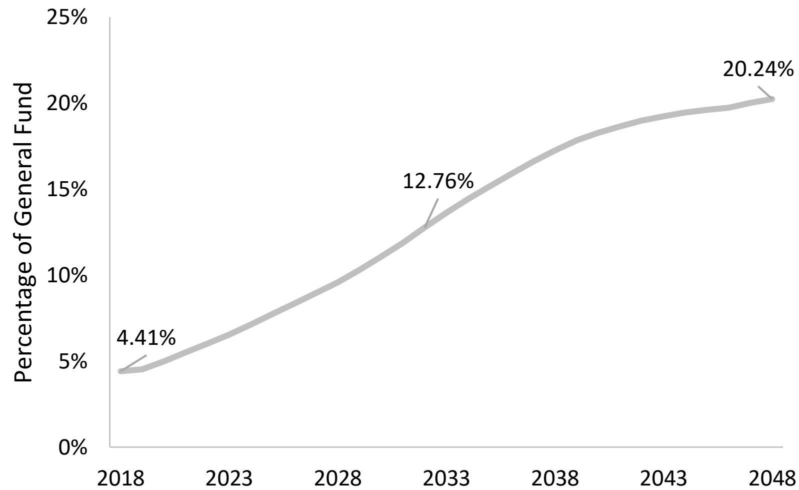
B. Pay-As-You-Go

The District has historically used a pay-as-you-go model for current retiree OPEB costs. With a pay-as-you-go model, a district 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.

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. However, given that annual revenues are expected to decline and costs of healthcare are expected to rise, the pay-as-you-go model will consume an ever-increasing portion of the General Fund. That encroachment of OPEB costs into the General Fund, illustrated in Figure 3, is now somewhat lower than the IAU projected in 2017 due to lower projected health cost increases.

Figure 3. Pay-As-You-Go as a Rising Burden[17]



C. Pre-Funding the OPEB Liability

Though the District's OPEB liabilities have grown substantially, the amount the District saves—pre-funds—for this debt remains small.

To pre-fund future retiree health benefits, 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.[18]

As of the 2017 actuarial report, L.A. Unified had a total of $244 million in trust assets, resulting in a funded ratio of 1.60%. This ratio means that the District has only saved about two percent of what it would need to cover all of its current employees' and retirees' postemployment benefits.

Figure 4 shows projections of the estimated amount of pre-funding required to meet different percentage targets over a 30-year period.[19] The estimates in Figure 5 indicate that if the District continues to fund the

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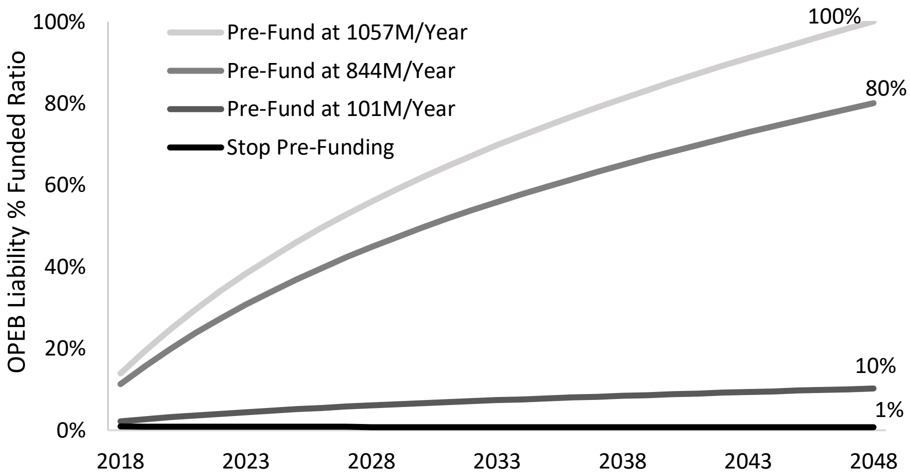
[17] General Fund revenue amounts are sourced from the 2010-2011 through 2016-2017 actuals and the 2017-2018 second interim report. Projections beyond 2017-2018 use the following assumptions: 2.75% rate of inflation; LCFF dollars fully funded in 2018-2019; ADA average of 97%; a declining average enrollment 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 2017 Actuarial Report. The actuarial calculations found that healthcare cost increases were lower than assumed in the 2015 valuation, resulting in a small decline in the estimated percentage of the general fund that will be taken up by pay-as-you-go costs in the next 30 years.

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

[19] 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 results in a net

OPEB Trust with $100.9 million over the next 30 years, by 2047 the funded OPEB ratio would only be 10%. If the District increased funding to the Trust almost seven-fold with approximately $844 million per year, in 30 years it would reach an 80% funded ratio. Finally, the District would need to fund the OPEB Trust at $1 billion per year to be fully funded in 30 years.

Figure 4. Funded Ratio Projections for OPEB Liability[20]



These numbers may make the situation seem dire. However, even contributing smaller amounts regularly does help in the long run and produces secondary benefits such as earned interest and improved credit rating.[21] [22] [23]

Pre-funding the entire OPEB liability, for a 100% funding ratio would tie up resources that could otherwise be used to serve the present needs of children. Fortunately, **making the transition to full pre-funding or 80% pre-funding in 30 years is not necessary.** A lower target such as 50% or 70% may be

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increase in OPEB liability of $151 million 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.

[20] 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 $15.2 billion from AON's 2017 actuarial report, a 2.75% inflation rate, and actuarial value of assets projections with a discount rate of 3.6%. The ratio of assets to accrued liability is the funded ratio over time. As the actuarial accrued liability has changed from $13.6 billion in 2015 to $15.2 billion in 2017, the amount necessary to reach 100% and 80% pre-funding in 30 years has increased. In addition, the actuarial report states that the District plans to contribute $120 million in FY 2018 and $0 afterwards.

[21] 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

[22] 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

[23] "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

sufficient to ensure the District's financial sustainability and its ability to pay health and welfare benefits to employees and retirees.

In any case, **it remains critically important to take actions to decrease costs over time**. In the November 2017 report, the IAU discussed cost-cutting options in detail. For this update, it is important to emphasize the hybrid strategy, which relies on a combination of pre-funding and cost-cutting.

SECTION THREE: STRATEGIES

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

The Pre-funding Strategy

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 $1,816 million of the OPEB liability over 30 years.[24]

The Cost-cutting Strategy

A permanent reduction of $100 million a year in retiree benefit costs 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 $1,816 million. [25]

The Hybrid Strategy Revisited

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 annually as the example:

1. Find a way to permanently reduce retiree benefit costs by $100 million per year.
2. That immediately reduces the OPEB liability by $1,816 million.
3. It also frees up $100 million per year of the budget.

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[24] This figure is the present value of a stream of cash flows, in this case contributions to the OPEB trust fund, of $100 million over 30 years at a rate of return of 3.60%, the discount rate used in the 2017 actuarial report to discount the OPEB liability itself. A higher rate of return is probable, which would increase the coverage.

[25] This figure is the present value of a stream of cash flows, in this case cost savings, of $100 million over 30 years at a discount rate of 3.60%, the rate used in the 2017 actuarial report to discount the OPEB liability itself.

4. Use that $100 million per year to pre-fund the OPEB Trust.
5. This promises over time to pre-fund the OPEB liability by $1,816 million.
6. Combined, the two actions would relieve the OPEB liability by $3,632 million, half instantly and half in installments over thirty years.

Other amounts could be chosen to hit different targets. As another example of using this strategy, we estimate 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 $120 million is sustained, and adopting a target of pre-funding 70% of the liability, the critical savings target is calculated to be $266.4 million per year. By saving $266 million a year on retiree benefit costs, and placing that $266.4 million into the OPEB Trust, the impact on the budget is zero. But the result is first that the OPEB liability drops from $15,213 million to $10,374, and second that the total pre-funding of the OPEB liability increases over 30 years to the point where it equals 70% of the liability.

For simplicity, the above example assumes that the trust fund would earn the same 3.60% rate of return as the discount rate used in the actuarial report to determine the present value of the liability. However, the trust fund can be expected to earn a greater return than this. Any rate of return on the assets of that fund greater than the discount rate applied to the liability will be to the District's advantage. Using the same estimate of a 7.28% return that the actuarial report uses in its estimates, the cost savings required to hit the 70% pre-funding target with no increase in the budget would be $203.3 million per year.

Table 1 illustrates four strategies, all targeted to achieve a 70% pre-funding ratio in 30 years. Column (a) shows that the amount of pre-funding per year to reach this target, at a 3.60% rate of return, would be $452.9 million per year. Column (b) shows that the cost savings per year required to reach this target, while using the savings to pre-fund the liability at a 3.60% rate of return, would be $266.4 million per year. Note that this is achieved with a net zero impact on the budget. Column (c) shows the pre-funding only strategy with a higher 7.28% rate of return. The pre-funding required under this assumption is $345.6 million per year. Column (d) shows the hybrid strategy with a 7.28% rate of return. The cost savings required are $203.3 million per year, again with a net zero impact on the budget.

Table 1. Comparison of Hybrid Strategy with Pre-funding Only Strategy

(Dollars in millions)	(a) Pre-funding Only @ 3.60%	(b) Hybrid Strategy @ 3.60 %	(c) Pre-funding Only @ 7.28%	(d) Hybrid Strategy @ 7.28 %
OPEB liability (2017)	$ 15,213	$ 15,213	$ 15,213	$ 15,213
Permanent annual cost savings to be achieved	**-**	**$ 266.4/year**	**-**	**$ 203.3/year**
New OPEB liability after cost savings	$ 15,213	$ 10,374	$ 15,213	$ 11,520
Target pre-funding level at 70%	$ 10,649	$ 7,262	$ 10,649	$ 8,064
Pre-funded Trust balance (2017)	$ 244	$ 244	$ 244	$ 244
Currently budgeted annual pre-funding (if continued)	$120/year	$120/year	$120/year	$120/year
Additional annual pre-funding needed to reach target	**$ 452.9/year**	**$ 266.4/year**	**$ 345.6/year**	**$ 203.3/year**
Net cost impact on current budget (additional annual pre-funding minus cost savings)	$ 452.9/year	none	$ 452.9/year	none

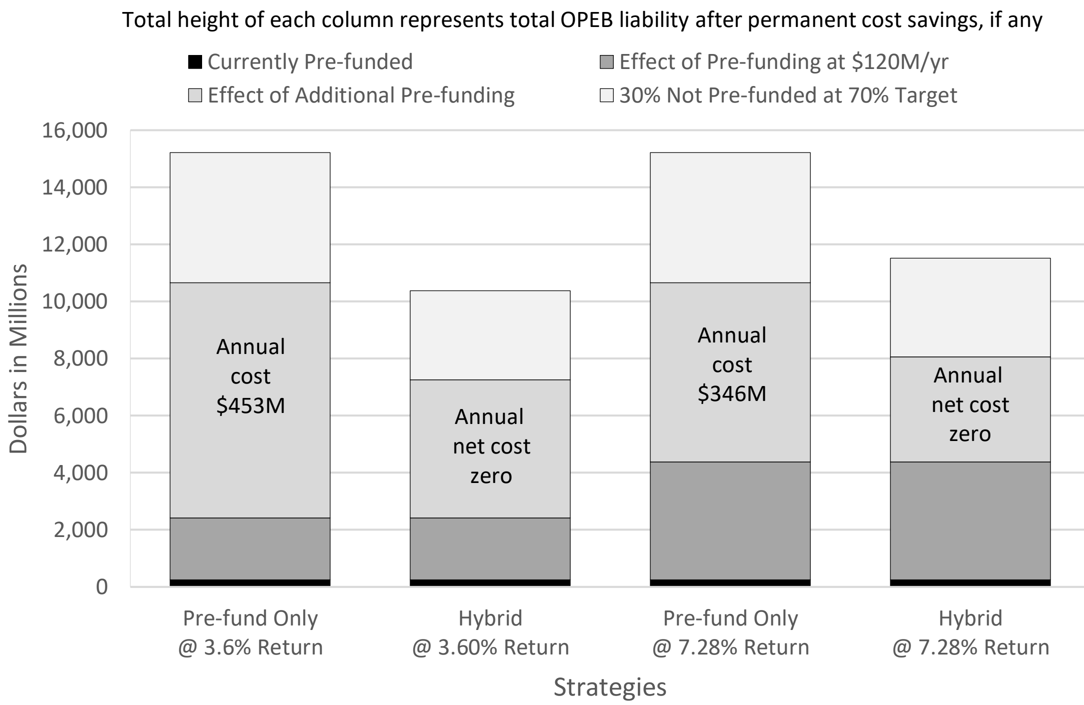
These examples assume a target of a 70% pre-funding ratio for the $15.2 billion present value of the OPEB liability as accrued as of July 1, 2017. In fact, the OPEB liability is growing, and this update does not estimate how much will be needed in the future to fund that growth. However, **the cost savings from the hybrid strategy will not only shrink the current OPEB liability; they will apply to future employees and thus will reduce or eliminate that growth**. Furthermore, several of the cost-saving ideas suggested in the 2017 IAU report on health and welfare benefits **would also apply to current employee benefits**, for a net impact that reduces the budget rather than the zero impact shown here.

Note also that a lower funding ratio target than 70% would allow achieving the goal with self-funding cost savings even lower than the $266 million or $203 million calculated here.

The amount of savings needed to reach a goal of prefunding 70% or more of the liability is not trivial under any of these ssumptions. It will probably require a combination of several cost-cutting measures. However, the size of the liability is extremely sensitive to health care costs and public health policy, so it makes sense to pursue cost reforms and favorable changes in health policy while also implementing a variety of other cost reductions more directly.

In Figure 5, the same four strategies are represented graphically in terms of the total liability. The height of each column represents the present value of the OPEB liability after any permanent annual cost savings are applied. Note that the pre-funding only columns reflect the full current liability of $15.2 billion, while the hybrid strategy columns reflect the reduced liability of between $10.4 billion and $11.5 billion achieved with the cost savings shown in Table 1. The dark band at the bottom shows the currently pre-funded balance of $244 million. The dark gray band above it shows the impact of the currently planned pre-funding of $120 million per year, if sustained beyond 2018. The medium gray band shows the impact of the additional pre-funding required under each strategy to reach the 70% target. And the light gray band at the top of each column shows the remaining unfunded liability, *i.e.*, the 30% left unfunded after reaching the targeted 70% ratio.

Figure 5. Effect of Strategies on OPEB Liability



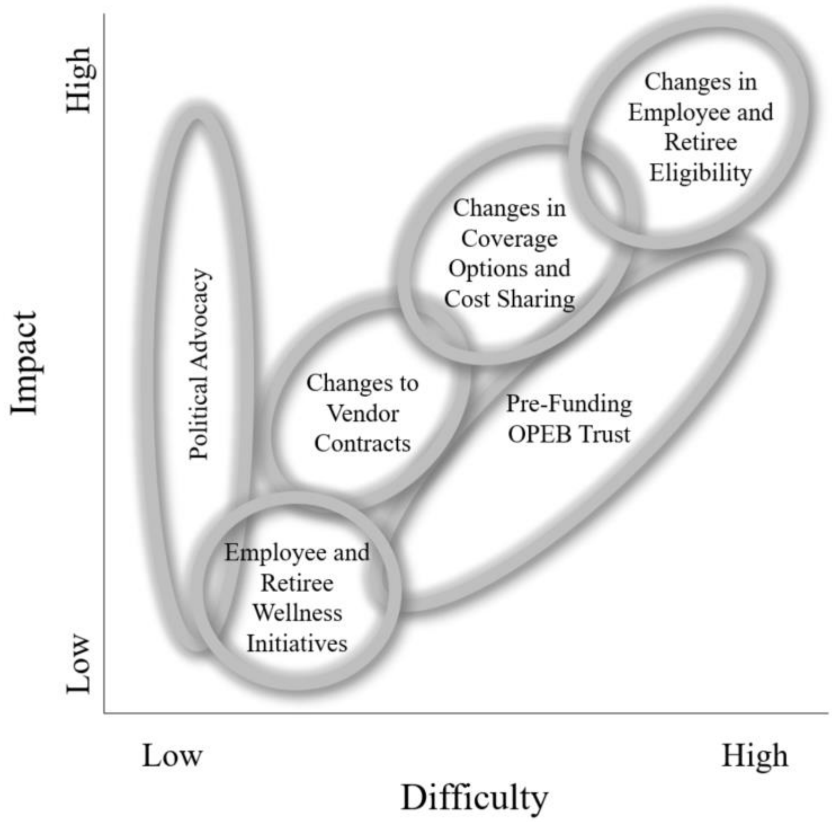
CONCLUSION

The IAU's health and welfare report of November 2017 included an in-depth discussion of strategic leverage points for addressing OPEB liability concerns. The leverage points included cost sharing, changes to eligibility requirements, changes to vendor contracts, pre-funding the liabilities, public advocacy, and implementing wellness programs. Figure 6 is a conceptual tool that can be used to envision the tradeoffs associated with several of the strategic leverage points described in that report.

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.

Figure 6. Tradeoffs between Impact and Difficulty[26]



The District's unfunded OPEB liability of about $15 billion looks intimidating, especially to stakeholders and public constituents who may be less familiar with accounting for benefits. In this update, we want to re-emphasize the following perspectives on this situation:

- The $15 billion does not all have to be paid in advance, but leaving it completely unfunded (pay-as-you-go) is not a healthy option. However, there is a partial level that is self-sustaining 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 the cost of benefits for retirees brings a double, possibly triple advantage**: it reduces the OPEB liability, it generates savings that can be used to pre-fund the remaining liability, and depending on the approach, it might reduce the cost of benefits for current employees as well. The amount of savings needed annually to accomplish this represents a difficult challenge for the District, but it is lower than might be apparent from the size of the liability alone.

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