MOODY'S
INVESTORS SERVICE

SECTOR IN-DEPTH
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Contacts

Sunny Zhu +1.415.274.1721
Analyst
sunny.zhu@moodys.com

Thomas Aaron +1.312.706.9967
VP-Senior Analyst
thomas.aaron@moodys.com

Eric Hoffmann +1.415.274.1702
Senior Vice President/Manager
eric.hoffmann@moodys.com

Leonard Jones +1.212.553.3806
MD-Public Finance
leonard.jones@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
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Japan	81-3-5408-4100
EMEA	44-20-7772-5454

Local government - California

Cities make slow progress in addressing retiree healthcare liabilities

Similar to pensions, other post-employment benefits (OPEB) — principally retiree healthcare — are liabilities that pose credit risks for some local governments. With rising healthcare costs, longer life spans and aging workforces, OPEB costs are escalating rapidly in some cases and unfunded liabilities are becoming a material source of balance sheet leverage. Positively, numerous California (Aa3 positive) cities, including San Jose (Aa1 stable), San Francisco (Aaa stable) and San Diego (Aa2 stable), have taken proactive steps to curb OPEB costs. Few cities have meaningfully reduced these liabilities to date because most cost-containment strategies will take years to provide substantial savings. If unaddressed, rising OPEB expenses threaten to curtail other local government spending priorities.

» **California cities are using a variety of strategies to address OPEB cost growth.** Common approaches include pre-funding liabilities, scaling back benefits, increasing employee contributions and switching to defined contribution plans. In California, cities have made broader changes to their OPEB programs than pension plans, because retiree healthcare benefits are often not subject to the same stringent legal protections as pensions. Nonetheless, the legal flexibility to reduce benefits does not necessarily equate to political ability or willingness to cut them.

» **Few California cities have markedly reduced OPEB liabilities to date as savings take years to materialize.** Glendale (Aa2 stable) successfully eliminated almost all of its OPEB liabilities through benefit changes for all current and future retirees, but cost savings will be slower to materialize for cities that have only altered benefits for new employees. Nonetheless, many cities such as Sunnyvale (Aaa negative), Palo Alto (Aaa), Roseville (Aa2) and Los Gatos (Aaa) have accumulated more OPEB assets in recent years, providing some cushion against rising expenses.

» **Large OPEB burdens threaten to strain operating budgets.** OPEBs are becoming a material source of balance sheet leverage in many instances and adding to fixed costs, which limits financial flexibility. Absent sustained revenue growth and/or benefit reforms, rising OPEB costs have the potential to curtail spending on essential services and infrastructure investments — a dynamic known as "crowd-out" risk. For example, Oakland (Aa2 stable) projects a growing gap between recurring revenues and expenses largely attributable to rising pension and OPEB costs.

California cities are using a variety of strategies to address OPEB cost growth

A growing number of California cities are taking proactive steps to address rising OPEB costs. In our study of 15 cities, common strategies include pre-funding liabilities, restricting eligibility, scaling back benefits, instituting employee contributions, and switching to defined contribution plans (see Exhibit 1). The implementation of these strategies generally involves collective bargaining and, in some cases, requires charter amendments.

Exhibit 1

Most California cities in our study have taken a multitude of steps to curb OPEB liability growth

City	Pre-fund liability	Restrict eligibility*	Cap or scale back benefits		Increase employee cost-sharing		Switch to defined contribution plan		Other
		New hires	Existing employees	New hires	Existing employees	New hires	Existing employees	New hires	
Anaheim	X	X							
Beverly Hills	X	X		X			Optional	X	Buy out liability (existing employees)
Fresno									
Glendale									Remove implied subsidy (all)
Los Angeles	X		X	X	X	X			
Los Gatos	X			X					
Oakland	X		X	X					
Palo Alto	X	X	X	X	X	X			
Roseville	X	X	X	X		X		X	
Sacramento	X	X	X	X					
San Diego	X	X						X	
San Francisco	X	X		X	X	X			
San Jose	X	X	X	X	X	X	Optional	X	
San Luis Obispo	X								
Sunnyvale	X								

*Includes restricting eligibility to defined benefit plan or OPEB plan all together
Cities are shown in alphabetical order.
"New hires" refers to employees hired after certain dates specific to a city.
"Buy out liability" refers to providing eligible employees with a choice between receiving a lump-sum payment or keeping their defined benefit OPEB plan.
"Implied subsidy" occurs when a city's employee insurance pool requires higher insurance premiums because retirees participate in the same health plan as active employees and increase the overall cost of the insurance pool.
Sources: Cities' audited financial statements, Moody's Invertors Service

Pre-fund liabilities

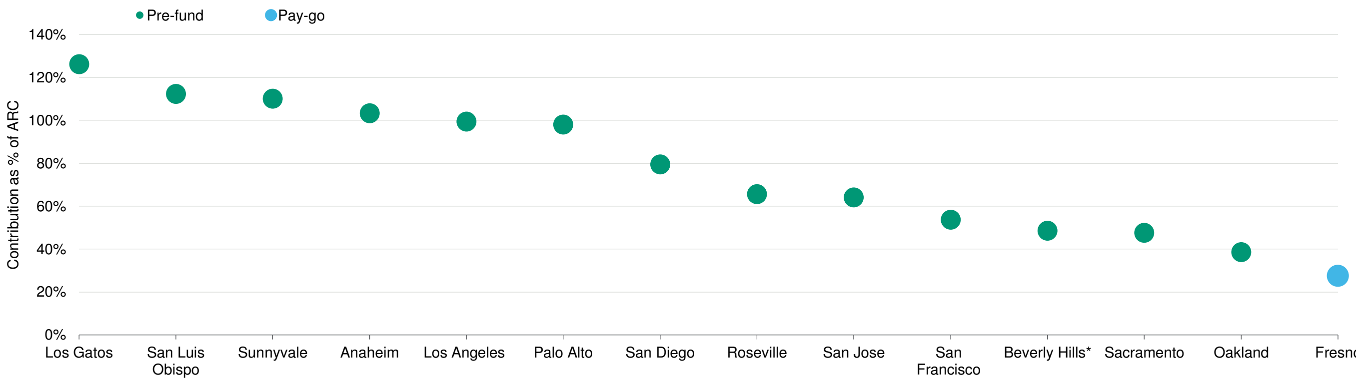
Unlike pensions, which are predominantly pre-funded, many local governments have historically funded OPEBs on a pay-as-you-go (pay-go) basis. Recently, an increasing number of California cities have begun to pre-fund their OPEB liabilities by building up assets in a trust. OPEB pre-funding typically requires higher near-term contributions than a pay-go approach, but better aligns government expenditures with benefit accruals and generally lowers long-term costs in nominal dollars.

Of the 15 California cities in our study, 13 exhibit some pre-funding of their OPEB liabilities (see Exhibit 2). Los Angeles (Aa2 stable) has pre-funded its OPEB program since the 1980s, while the other 12 have begun pre-funding in the last decade. Some of these cities have pre-funded via ad hoc payments using operating surpluses or one-time revenues, while others have instituted specific funding policies or goals. For example, San Luis Obispo (Aa2) and Anaheim (Aa2 stable) have established policies to fund the annual required contribution (ARC). The ARC is a funding level that, if paid on an ongoing basis, is projected to annually cover OPEB service costs (i.e., current-year benefit accruals) and amortize unfunded actuarial accrued liabilities (UAAL) over a period not to exceed 30 years.

The ARC, which has been recently retired as an accounting concept, is an imperfect measure of contribution strength because of wide flexibility and variation in numerous important actuarial assumptions. Nonetheless, higher contributions against the ARC can provide a rough indication of the magnitude of pre-funding. Of the 15 cities in our study, only six have consistently pre-funded at or above the ARC level in recent years (see Exhibit 2).

Exhibit 2

Majority of cities in study exhibit some pre-funding of OPEB programs to ward off budgetary challenges, though pre-funding levels vary
2013-17 average OPEB contribution as % of ARC



*Beverly Hills has set aside assets in a Employee Benefits Fund. Since this fund is not an irrevocable trust, the set asides are not reported as pre-funding above pay-go based on Governmental Accounting Standards Board (GASB) standards.
Exhibit includes 14 of the 15 cities in our study. Glendale is not included due to the elimination of its implied subsidy in 2016.
Sources: Cities' audited financial statements, Moody's Invertors Service

Increase employee contributions

Several cities have begun to require employees to make contributions (typically a specified percentage of salary) to offset a portion of OPEB costs. For example, San Jose has entered into agreements since 2009 with each of its bargaining units to increase existing and new employees' contributions toward OPEBs. Los Angeles has also increased cost sharing for both existing employees and new hires since 2011. Palo Alto implemented a plan with several of its unions in 2010 in which the city (90%) and its employees (10%) split the cost of the annual increases in medical premium costs. San Francisco's charter amendments approved by voters in 2009 (Proposition B) and 2011 (Proposition C) require all employees to contribute a specific percentage of pay to the city's OPEB trust. Roseville also requires employees hired after 2013 to set aside a portion of their annual salary in a retirement health savings account.

Cap or scale back benefits

Cities have also attempted to reduce OPEB costs through reducing benefit offerings. San Francisco created a lower-cost tier of OPEB benefits for new employees hired after January 2009, while Palo Alto capped the retiree healthcare premiums it pays every year. As of 2007, Palo Alto no longer pays the full premium under the most expensive medical plan option for employees retiring after 2007. Instead, the city's contribution is capped at the cost of the second most expensive plan. The maximum monthly amount of the medical plan premium subsidy for Los Angeles' general retirees and sworn retirees are determined annually by the Board of Administration of the Los Angeles City Employees' Retirement System and the Board of Fire and Police Pension Commissioners, respectively, at their discretion.

In 2017, San Jose approved an agreement with various employee groups that limits current and future retirees to the lowest cost health plan, which will be permanently set at the annual "silver" level under the Affordable Care Act. Los Gatos' collective bargaining process completed in the fall of 2018 reduced medical benefits for employees hired after October 2018 to the Public Employees' Medical & Hospital Care Act (PEMCHA)'s minimum plan. In fiscal 2019, Oakland also reached agreement with its sworn public safety unions to cap retiree medical benefits for existing employees and implement new, lower-cost tiers for employees hired after January 2019.

Restrict eligibility

Legal ability to reform benefits does not necessarily equate to political feasibility or willingness to cut existing employees' retiree benefits. As such, many local governments elect to eliminate or increase benefit eligibility criteria solely for new employees. For example, Anaheim stopped providing retiree healthcare benefits to general city employees hired after January 1996, and to police and fire staff hired after July 2001 and November 2001, respectively. Similarly, Sacramento (Aa2 stable) ended OPEB offerings to general employees hired after June 2012 and to police employees hired after September 2013. San Francisco and Palo Alto have increased the number of years new employees must work in order to qualify for retiree healthcare benefits.

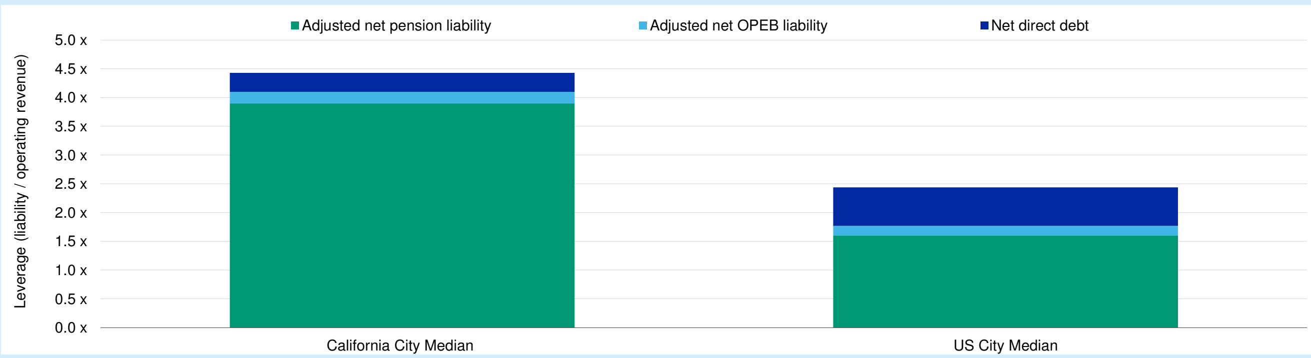
California local governments have more legal flexibility to change retiree healthcare plans than pension offerings

California cities have above-average leverage compared to national medians due to elevated pension burdens (see Exhibit 3). A number of decisions by the California Supreme Court, the state's highest court, have significantly curtailed governments' ability to reduce employee pensions. These judicial decisions collectively form the "California Rule," whereby governments cannot reduce pension benefits for retirees, nor can they prospectively reduce benefits for current employees, without an offsetting, comparable benefit.

Exhibit 3

California cities have above-average total leverage (debt, pension and OPEB combined)

Moody's-rated cities



Sources: Cities' audited financial statements, Moody's Investors Service

While more moderate than pension burdens, OPEB liabilities add to California cities' total leverage. Unlike pensions, OPEB promises do not usually carry such strong legal protections unless a government is found to have granted a contractual right to the benefits. As the numerous examples in this report demonstrate, cities can often modify OPEB benefits for existing employees through the collective bargaining process. But political feasibility (i.e, opposition from unions and other constituencies) may not be the same as legal flexibility.

Introduce defined contribution retiree health plans

Compared to defined benefit OPEB plans, defined contribution plans reduce governments' risks associated with rising healthcare costs and investment volatility. Under a defined contribution plan, cities contribute a defined amount towards an employee's OPEB plan annually, but have no additional responsibility for retiree health benefits, even if assets set aside end up amounting to less than the cost of those benefits.

Several California cities have begun to offer defined contribution plans in recent years. For example, employees hired after 2009 by San Diego are only offered defined contribution OPEB plans. As of fiscal year-end 2017 (June 30, 2017), more than half of the members in San Diego's OPEB program are part of defined contribution plans. San Jose offers defined contribution retiree health plans to general staff hired after September 2013, police staff after August 2013, fire staff after January 2015, as well as certain employees hired after June 2017. Similarly, Beverly Hills (Aaa) only offers defined contribution retiree health plans to general employees hired after January 2010 and safety employees hired after July 2012. All employees in Roseville hired after January 2014 are also only offered defined contribution plans.

Other approaches

» **"Un-blending" medical insurance premium rates:** In 2016, Glendale transitioned retirees from city-sponsored plans into healthcare benefit exchange services. This allowed the city to separate medical insurance premium rates for active employees from retired employees, effectively eliminating the city's "implied subsidy." An OPEB implied subsidy occurs when a city's employee insurance pool generates higher insurance premiums because retirees participate in the same health plan as active employees and increase the overall cost of the insurance pool.

» **Buy out retiree benefits:** In 2010, Beverly Hills created an Alternative Retiree Medical Plan (ARMP), a voluntary plan that allows eligible employees to choose a lump-sum payment instead of their current defined benefit OPEB plan. About 58% of the eligible workers opted into the program, allowing the city to reduce its exposure to future healthcare cost inflation.

Few California cities have markedly reduced OPEB liabilities to date as savings take years to materialize

Few cities in our 15-city study have demonstrated meaningful success in reducing OPEB liabilities to date. That is because most cost-containment strategies implemented thus far apply to new employees and take decades to produce material cost reductions. Glendale, however, has significantly reduced its OPEB liabilities. By eliminating the implied subsidy for all current and future retirees, the city reduced its unfunded actuarial accrued liability (UAAL) to $16 million in 207 from $191 million in 2011.

San Jose, San Francisco, Sacramento, Los Gatos and Roseville all report some declines in their OPEB liabilities over a five-year period through 2017, although some of the reductions are attributable to increases in valuation discount rates, making it difficult to separate the effects of their OPEB benefit reforms from changes in actuarial assumptions (see Exhibit 4). Sunnyvale also made progress in reducing its unfunded OPEB liability to $86 million in 2017 (0.5x operating revenues) from $106 million in 2010 (0.9x operating revenues) when assuming a constant discount rate over these valuation dates.

Exhibit 4

California cities in study show mixed results in attempts to curb OPEB liabilities

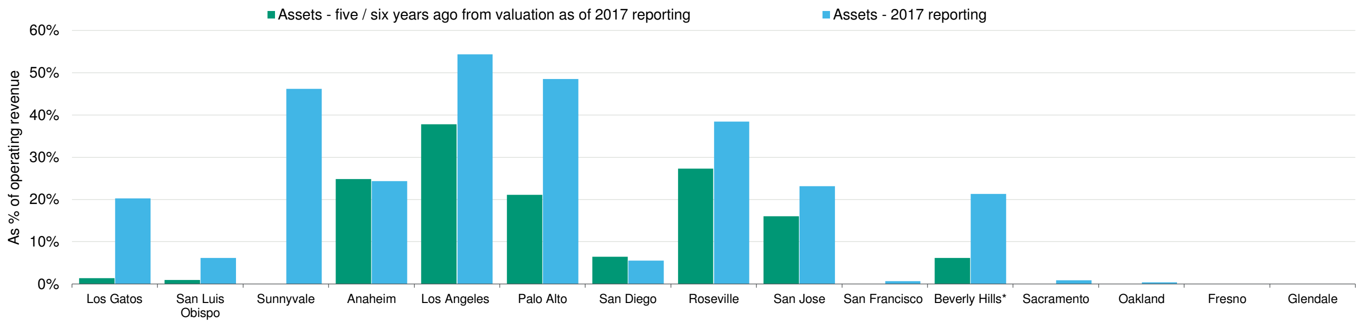
	Prior actuarial valuation						Actuarial valuation as of 2017 audit						Five-year change	
City	Year	Discount rate	AAL ($M)	Assets ($M)	UAAL ($M)	UAAL / operating revenue (valuation year)	Year	Discount Rate	AAL ($M)	Assets	UAAL ($M)	UAAL / operating revenue (valuation year)	UAAL (% change)	UAAL / operating revenue
Glendale	2011	4.50%	$ 191	$ -	$ 191	0.72	2017	3.58%	$ 16	$ -	$ 16	0.06	-91.6%	-0.66
San Jose	2011	5.70 - 6.10%	1,896	166	1,730	1.67	2016	5.90 - 6.60%	1,371	310	1,061	0.79	-38.7%	-0.88
Sunnyvale	2010	6.50%	106	-	106	0.91	2016	6.50%	158	73	86	0.54	-18.8%	-0.36
San Francisco	2008	4.25%	2,582	-	2,582	0.90	2014	4.50%	2,391	27	2,364	0.56	-8.5%	-0.34
Fresno	2012	4.00%	116	-	116	0.38	2017	3.00%	107	-	107	0.32	-7.0%	-0.06
Sacramento	2009	4.25%	318	-	318	0.67	2015	4.50%	307	5	302	0.59	-4.8%	-0.07
Los Angeles	2012	7.75%	4,356	2,262	2,094	0.35	2017	7.25%	5,782	3,637	2,145	0.32	2.4%	-0.03
Beverly Hills*	2009	5.00%	58	10	48	0.29	2015	4.00%	99	46	54	0.25	12.0%	-0.05
San Diego	2012	7.06%	430	81	349	0.28	2017	6.73%	520	90	430	0.27	23.3%	-0.01
Anaheim	2010	7.75%	212	64	148	0.58	2015	7.28%	271	80	191	0.58	29.4%	0.01
Palo Alto	2009	7.75%	130	25	105	0.90	2015	7.25%	235	79	156	0.96	48.7%	0.06
Oakland	2010	4.00%	521	-	521	0.83	2015	4.00%	863	3	860	1.10	65.1%	0.26
San Luis Obispo	2009	7.75%	5	1	4	0.07	2015	7.00%	13	5	8	0.12	99.3%	0.05
Discount rate varies substantially from time to time for the following, so changes in AAL & UAAL are partly attributable to valuation assumption changes														
Los Gatos	2010	5.25%	18	-	17	0.55	2015	7.25%	21	8	13	0.31	-26.3%	-0.24
Roseville	2009	4.25%	180	34	146	1.45	2015	6.50%	206	54	153	0.99	4.4%	-0.46

Data reflects cities' governmental activities only.
"AAL" stands for "actuarial accrued liability," which is the total liability on a reported basis. UAAL, which is AAL less assets, is the reported unfunded liability.
*Beverly Hills has assets in a non-irrevocable OPEB special reserve, which is incorporated in the calculation of assets and UAAL for the purpose of our analysis
Sources: Cities' audited financial statements, Moody's Investors Service

As seen in Exhibit 5, the majority of issuers in our study have accumulated more assets in recent years through pre-funding. For example, Sunnyvale has set aside $72.8 million in assets (46.2% of operating revenues) to its OPEB trust over a five-year period. Nonetheless, even with pre-funding, unfunded OPEB liabilities may continue to rise due to backloaded amortization, investment performance, actuarial assumption changes or a combination of these factors. Los Angeles, Anaheim and San Luis Obispo have all contributed at their respective ARC levels but still reported rising unfunded liabilities.

Exhibit 5

Majority of issuers in study have accumulated more assets in recent years through pre-funding



Data reflects cities' governmental activities only.
*Beverly Hills has assets in a special reserve, which is incorporated in the calculation of assets for the purpose of our analysis.
Sources: Cities' audited financial statements, Moody's Investors Service

GASB 75 provides greater detail on OPEB liabilities; Moody's additionally makes adjustments to reported OPEB liabilities to improve comparability across governments

Beginning with fiscal 2018 audits, many governments began reporting OPEB liabilities under new Governmental Accounting Standards Board (GASB) Statements 74 and 75. Key updates of the new standards include:

- OPEB liabilities will appear on cities' statements of net position, rather than in the notes of financial statements
- Similar to pensions, OPEB discount rates used under GASB 75 are linked with expected investment returns and projected asset solvency. While discount rate rules are identical for pensions and OPEBs, GASB OPEB discount rates will tend to be lower in practice because of widespread lack of material pre-funding
- Disclosure of the sensitivity of the reported liability to a change in the discount rate and healthcare cost trend rate
- Reporting on proportionate shares of multiple-employer cost-sharing OPEB plans

Discount rate adjustments to reported OPEB liabilities, using a high-grade corporate bond index, greatly improve comparability of OPEB liabilities with pensions and across governments. For example, Los Angeles reported approximately $2.2 billion in governmental net OPEB liabilities in fiscal 2018 (ended June 30, 2018), based on a reported discount rate of 7.25% (see Exhibit 6). Applying a high-grade corporate bond index as a discount rate, 3.87% as of June 2017, the city's unfunded OPEB liability was $5.5 billion. On the other hand, Oakland reported nearly $840.7 million in governmental net OPEB liabilities in fiscal 2018 using a discount rate of 3.58%, since it only has a modest amount of assets set aside. The city's unfunded OPEB liability is slighty lower at approximately $804.2 million under our adjustments.

Exhibit 6

Adjustment to reported OPEB liabilities allows greater comparability among issuers
(Amount in thousands)

	City of Los Angeles		City of Oakland	
	Reported	Moody's adjusted	Reported	Moody's adjusted
Measurement date	6/30/2017	6/30/2017	6/30/2017	6/30/2017
Discount rate	7.25%	3.87%	3.58%	3.87%
Total OPEB liability	$5,831,262	$9,199,374	$840,690	$804,243
Reported asset	$3,674,158	$3,674,158	$4,259	$4,259
Funded ratio	63.0%	39.9%	0.5%	17.5%
Net OPEB liability	$2,157,104	$5,525,216	$840,690	$804,243
Net OPEB liability as % of operating revenue	30.7%	78.7%	83.4%	79.8%

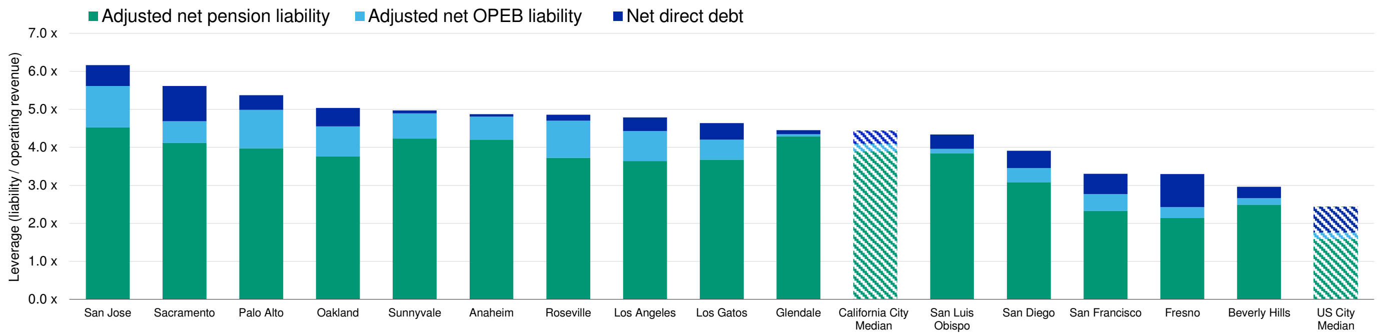
Data reflects cities' governmental activities only.
Sources: Cities' audited financial statements, Moody's Investors Service

Large OPEB burdens threaten to strain operating budgets

OPEBs are becoming a material source of balance sheet leverage for some cities, although the size of unfunded liabilities varies (see Exhibit 7). While more moderate than pension burdens, OPEB liabilities exceed debt burdens for the majority of cities in this study and add to total leverage. If left unaddressed, unfunded OPEB liabilities threaten to eventually settle as rising ongoing expenses.

Exhibit 7

OPEB burdens vary among cities and represent a material source of balance sheet leverage in some cases

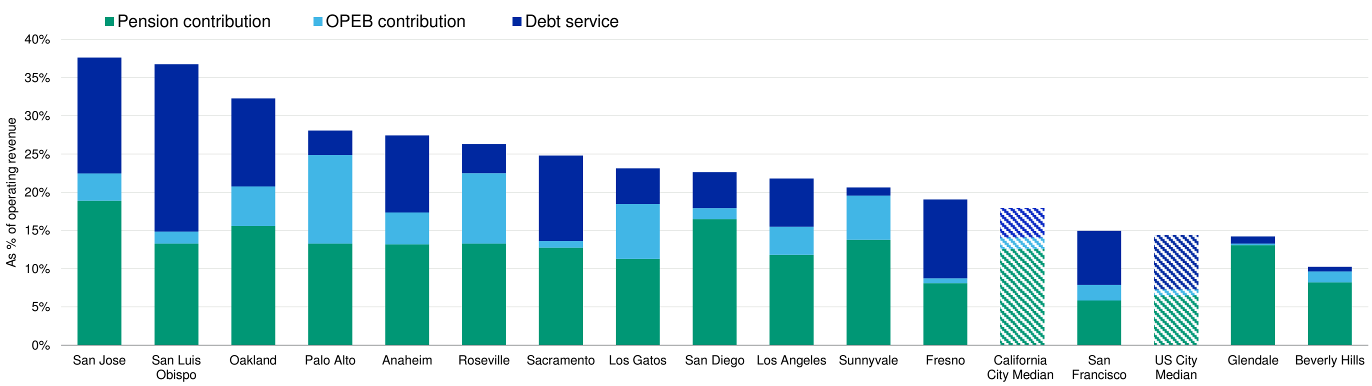


Fiscal year 2018 data except for San Francisco, which reflects 2017 data and includes reported net OPEB liability (assumed discount rate of 4.50% vs. 4.33% under our adjustments for the measurement date); governmental activities only.
Beverly Hills has assets in a special reserve, which is incorporated in the calculation of OPEB assets for the purpose of our analysis.
Median reflects Moody's-rated cities with fiscal 2018 data available to date
Source: Cities' audited financial statements, Moody's Investors Service

Unlike pensions, which are effectively annuities, OPEBs are mostly composed of retiree medical benefits subject to additional market variability such as healthcare cost inflation. As such, government budgets can be directly exposed to medical cost inflation and the pace at which employees decide to retire. Absent sustained revenue growth and/or benefit changes, rising OPEB costs along with pensions have the potential to meaningfully increase a government's fixed costs — the combination of debt service, pension contributions and retiree healthcare contributions. As seen in Exhibit 8, fixed costs represent a varying amount of governmental budgets, from roughly 10% of operating revenue (Beverly Hills) to over 37% of operating revenues (San Jose).

Exhibit 8

OPEB expenses add to a government's fixed costs, limiting financial flexibility



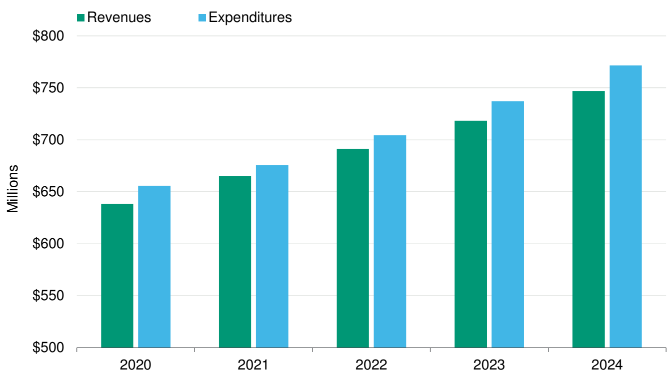
Fiscal year 2018 data except for San Francisco, which reflects fiscal 2017 data; governmental activities only.
Median reflects Moody's-rated cities with fiscal 2018 data available to date.
Source: Cities' audited financial statements; Moody's Investors Service

While pension contributions and debt service typically make up the bulk of fixed costs, OPEB contributions represent a sizable portion of Palo Alto's, Los Gatos' and Roseville's annual budgets, partly because they have been more aggressive in pre-funding OPEBs than cities funding at or just above pay-go (Oakland and Sacramento, for example). Overall, elevated fixed costs have the potential to limit budgetary flexibility, reduce funds for essential government services and hinder infrastructure investments.

If left unaddressed, unfunded OPEB liabilities can eventually translate to rising ongoing expenses. Oakland, for example, is forecasting a growing gap between recurring revenues and expenses in its latest financial projection (see Exhibit 9), as rapidly rising pension and OPEB expenses are forecast to outpace projected revenue growth. According to Oakland's OPEB actuarial valuation as of July 1, 2017, its pay-go OPEB cost is projected to grow to $50.3 million by fiscal 2027 (see Exhibit 10), roughly double the $26.0 million the city spent in fiscal 2017 on the line item. The city has historically funded its OPEB on a pay-go basis, and while it established an OPEB trust in fiscal 2014, actual pre-funding has been minimal until recently. The city made $10 million contributions on top of pay-go amounts in both fiscal 2018 and 2019, although these contributions still fall short of levels that prevent liability growth. The city also recently adopted a formal policy to contribute 2.5% of covered payroll ($10 million currently) to the irrevocable trust annually starting in fiscal 2020 until the trust is fully funded.

Exhibit 9

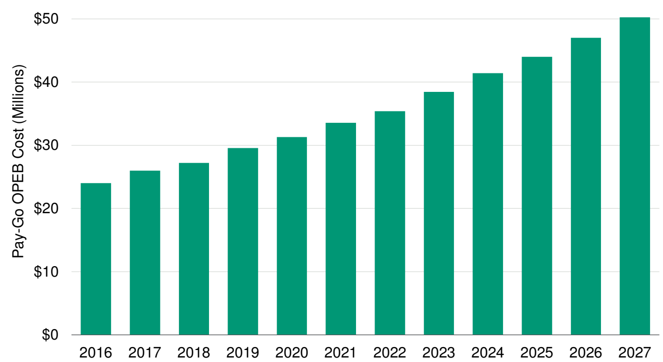
Oakland is forecasting a growing gap between recurring revenues and expenses in its latest financial projection...



Sources: City of Oakland, Moody's Investors Service

Exhibit 10

...partly because rapidly rising OPEB expenses are projected to outpace revenue growth



Sources: City of Oakland; Moody's Investors Service

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» FAQ: Wide differences in state retiree health spending and liabilities, December 19, 2017

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