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Metro

FINANCE AND BUDGET COMMITTEE
FEBRUARY 14, 2006

SUBJECT: GASB 45 IMPLEMENTATION

ACTION: ADOPT RESOLUTION CREATING AN OPEB TRUST

RECOMMENDATION

A. Adopt a resolution authorizing the creation of an Other Post Employment Benefits Trust (OPEB), Attachment A.

B. Authorize the deposit of monetary assets on hand at June 30, 2007, that are restricted for the payment of retiree medical benefits into the OPEB trust.

C. Approve the OPEB funding strategy, "pay-as-you-go" basis, for FY08, 09 and 10 budget planning parameters as described in Attachment B.

ISSUE

Government Accounting Standards Board Statement 45 (GASB 45) is the new accounting standard affecting governmental employers who provide retirees other post employment benefits (OPEB) such as medical, dental and life insurance. It does not apply to pension benefits. While GASB 45 does not mandate a "funding strategy" to provide the future benefits, a governmental entity that contributes amounts less than actuarially required will be required to report such shortfalls as a liability on their financial statements and this liability could become a bond ratings factor.

POLICY IMPLICATIONS

GASB 45's basic concept is to recognize the cost of an employee's OPEB during the period of service. As defined in the standard, a significant expense recognizing the past and future costs of providing OPEB benefits is required to be recorded annually. In the case of our defined benefit plans, this annual cost is the actuarially required contribution (ARC).

The funding strategy to minimize future ARCs would be to set aside cash in the amount of the ARC each year into an irrevocable trust. Monies in the trust could then only be used for OPEB purposes. The trust assets would have to be legally protected from creditors and the Board would have no further discretion over the use of those assets. The Board resolution creating the trust also allows the trust fund assets to be invested in a broader range of securities than is permitted under the Metro Investment Policy that is constrained by State law. Like our pension fund assets, the monies will be invested in equity securities and longer term fixed income bonds and, accordingly, will be expected to generate greater investment income that can be used to offset OPEB costs.

The recommended actions authorize Metro to take the first steps toward a funding strategy aimed at mitigating the high expense of OPEB benefits by creating the irrevocable OPEB trust, making an initial deposit and partial payments against the ARCs for the next three years. The determination to actually deposit some or all of the ARCs in future years will be addressed in each year's annual budget process.

ALTERNATIVES CONSIDERED

Continue the existing practice of restricting the OPEB assets. This alternative is not recommended since the creation of the trust and deposit of the assets into it allow the monies to be invested to yield higher returns and those returns will meet GASB 45's requirements for reducing future OPEB expenses on a generally accepted accounting principles (GAAP) basis.

DISCUSSION

Funding strategies affect the computation of future ARCs and future amounts of budgetary resources required depending on how much and what types of financing procedures are implemented. The impacts of the funding strategy adopted will be reflected in our audited financial statements and may affect the perception of those who read them.

In anticipation of the July 2008 implementation requirement, we engaged Mercer Human Resource Consulting to provide a detailed report for "Planning for GASB 45 Reporting and Related Issues." Mercer prepared an actuarial analysis of the FY05 OPEB obligation. They estimated the present value of future OPEB benefits to be $937 million. Mercer found that the ARC expense for FY05 would have been $68 million. Our budgeted cost, "pay-as-you-go" basis, in FY05 for these retiree benefits was $11 million.

The ARC is the cost of benefits earned by current employees during the period plus the amortization of unfunded past liabilities for both current and future retirees. Funding the ARC would require substantially more cash resources than anticipated in the 10-Year Forecast presented to the Board in October 2006. Our current practice is to budget, i.e. set aside cash, for the present value of future benefits for only the employees who are projected to retire in the budget year. Under this practice, approximately $135 million will have accumulated by June 30, 2007.

Retaining a pay-as-you-go strategy without a funded trust would result in significantly higher future ARCs since there would be no monies on deposit to earn interest to offset future costs. The entire liability would be disclosed in the financial statements as "unfunded" unless monies are deposited into an OPEB trust.

Mercer has been engaged to perform the GASB 45 required actuarial study based on our employee and retiree population as of January 1, 2007. Mercer will provide its report by summer 2007 in time for our accounting implementation. However, we will need to develop FY08 budget parameters before the report can be completed.

We will implement all of the accounting requirements of GASB 45 so that our financial statements will continue to be in full compliance with GAAP.

FINANCIAL IMPACT

Approval of the OPEB funding strategy, Attachment B, and the expected higher investment returns through the OPEB trust will reduce the deficit projected in the 10-Year Forecast by $5 million for FY08 through FY10. Trust set up and ongoing administrative costs, i.e., investment advisor fees, investment management fees, legal, etc., will be more than covered by the higher investment earnings.

ATTACHMENTS

A. Resolution
B. Funding Strategy

Terry Matsumoto
Chief Financial Services Officer and Treasurer

Roger Snoble
Chief Executive Officer

Attachment A

RESOLUTION AUTHORIZING AN OPEB TRUST

WHEREAS, pursuant to collective bargaining agreements and Board policy, the Los Angeles County Metropolitan Transportation Authority ("Metro") makes monthly contributions for retiree medical benefits for eligible retirees and their dependents; and

WHEREAS, effective for fiscal years beginning after December 15, 2006, GASB 45, a new accounting standard, will require Metro to account for its unfunded actuarial accrued liability attributable to retiree medical benefits; and

WHEREAS, Metro's current practice has been to budget and set aside cash in its Enterprise Fund for the present value of future benefits for only the employees who are projected to retire in the budget year; and

WHEREAS, under this funding practice, Metro will have accumulated approximately $155 million by June 30, 2007 for retiree medical benefit obligations; and

WHEREAS, the investment options for Metro Enterprise Funds are restricted by state law and Metro's Investment Policy, but without these restrictions, investment earnings could be 2-3% greater by investing in equities and longer term fixed income bonds; and

WHEREAS, the 2-3% difference in expected investment returns will make a very significant difference in reducing Metro's unfunded actuarial accrued liability and annual required contributions under GASB 45; and

WHEREAS, Metro wants to create an OPEB trust pursuant to Internal Revenue Code ("IRC") section 115 to use a higher investment return assumption in calculating the unfunded actuarial accrued liability and annual required contributions for retiree medical benefit obligations under GASB 45, and actually to earn a higher rate of return;

NOW, THEREFORE, the Metro Board of Directors hereby authorizes the Chief Executive Officer or his designee to take all necessary and appropriate steps to create and properly administer an IRC sec. 115 trust, including but not limited to executing a trust agreement, retaining an Actuary, selecting an institutional custodian to hold trust fund assets, utilizing an independent investment advisor to monitor fund performance, and appointing one or more trustees to manage the trust and select appropriate investment options. At a minimum, the OPEB trust must satisfy the following three requirements:

1. *Exemption from federal income tax.* Contributions to the trust and income on investment of trust assets shall not be treated as income to the employee or retiree in each case under federal and state income tax laws.

2. *Qualified trust for GASB 45 purposes.* Contributions to the trust shall be irrevocable, protected from Metro creditors and dedicated solely to

providing benefits to retirees and dependents in accordance with the applicable collective bargaining agreements and Metro policy.

3. *Broad investment powers, including equities.* The trust shall be able to invest in a broader range of investments than those to which general, governmental funds are restricted in California, including equities and longer term fixed income bonds.

Adopted this ______ day of __________________, 2007.

Attachment B

Funding Strategy

	OPEB Costs ($ millions)			
	FY08	FY09	FY10	Notes
ARC	70	70	70	A.
Prior Strategy	19	22	22	B.
New Strategy	18	19	21	C.
Deficit Reduction	1	3	1	D.

A. Extrapolated from the 2005 Mercer study. Amount is a rough order of magnitude estimate only.
B. Amount included in the October 2006 10-year forecast is the present value of future OPEB payments for employees estimated to retire during the budget year only.
C. The proposed strategy is to budget only the estimated actual payments for OPEB costs expected to be made during the budget year.
D. The amount saved is the present value of OPEB costs to be paid in future years.

The initial deposit of assets on hand at June 30, 2007, approximately $135 million, into the OPEB trust fund will be treated like an endowment, i.e., only the investment income will be used to pay for OPEB costs. The balance of OPEB costs will be funded from current year budget resources. Since the OPEB trust monies may be invested like a pension fund, investment earnings should be 2-3% greater than these monies now earn as Enterprise Fund assets restricted by the Metro Investment Policy. However, there will also be OPEB trust fund administrative expenses to be paid from the higher earnings. To be conservative, we will estimate that there is no net impact on the deficit of this endowment strategy until we have actual history.