OAKLAND'S $860 MILLION CRISIS: UNFUNDED RETIREE HEALTHCARE

EXECUTIVE SUMMARY

Years ago, Oakland city leaders made a commitment to provide healthcare benefits to their employees after they retire. Like many other public agencies, Oakland now faces a fiscal crisis because elected officials did not understand the implications, including future costs, of the promises they were making. The cost of retiree healthcare benefits, better known as Other Post Employment Benefits (OPEB), coupled with skyrocketing pension costs, are starting to undermine the fiscal health of the city.

Instead of putting enough money away to fund future healthcare benefits for active employees, Oakland chose to pay only current costs of retiree healthcare as billed. The result is that related debt increases by more than $40 million annually. As of fiscal year 2016, the city's total liability for future OPEB costs reached a staggering $860 million. By using this deferred payment process, elected officials are leading the city toward service insolvency.

To address this problem, the city should have paid approximately $75 million in 2017, yet the city only budgeted $27 million to pay the benefits it owed that year, along with $20 million to partially fund future benefits in the 2017-2019 proposed budgets. To put this in perspective, the shortfall of nearly $40 million each year equals the total budgets for all city libraries along with parks and recreation, or the equivalent of the cost of nearly 200 police officers or firefighters. While the city established a trust in 2004 to begin to pre-fund OPEB, the trust has not been sufficiently funded (3% of total liability) and has failed to address the massive obligation.

The Grand Jury is concerned that, without radical changes, the city will never be able to pay for what it promised.

The Grand Jury is concerned that, without radical changes, the city will never be able to pay for what it promised. This dilemma is already starting to crowd out essential government services. City revenues are growing at a much slower pace (traditionally, 2% annually) than projected spending. The city has no new revenue source to keep up with the exploding annual costs of healthcare let alone to address the $860 million unfunded liability already accumulated. In 2007, the city spent $10 million to pay healthcare benefits for current retirees. By 2027, the projected annual cost will be more than $67 million, and the unfunded OPEB liability will likely have increased by another half-billion dollars.

Elected officials are leading the city toward service insolvency.

Solutions are complicated. Many cities facing similar issues, like Concord and Sausalito, have cut back on these benefits or converted their OPEB into defined contribution programs. Some like Santa Cruz have asked employees to contribute more to the costs of the programs. Public agencies like BART and the Alameda County Water District have taken aggressive approaches to prefund healthcare benefits. Finally, in cities like Vallejo, Stockton, and San Bernardino, unfunded OPEB obligations were a significant contributing factor in their bankruptcies.

At this point, Oakland's unfunded liability of nearly one billion dollars is too large to tackle without using a combination of solutions, yet the city currently has no viable plan in place. Without leadership to address the issue, Oakland is adding $40 million to its liability each year and will shortly face increasing cuts to essential government services. The city must immediately develop a long-term, multifaceted plan to address OPEB, or accept that municipal bankruptcy is an option in the future.

BACKGROUND

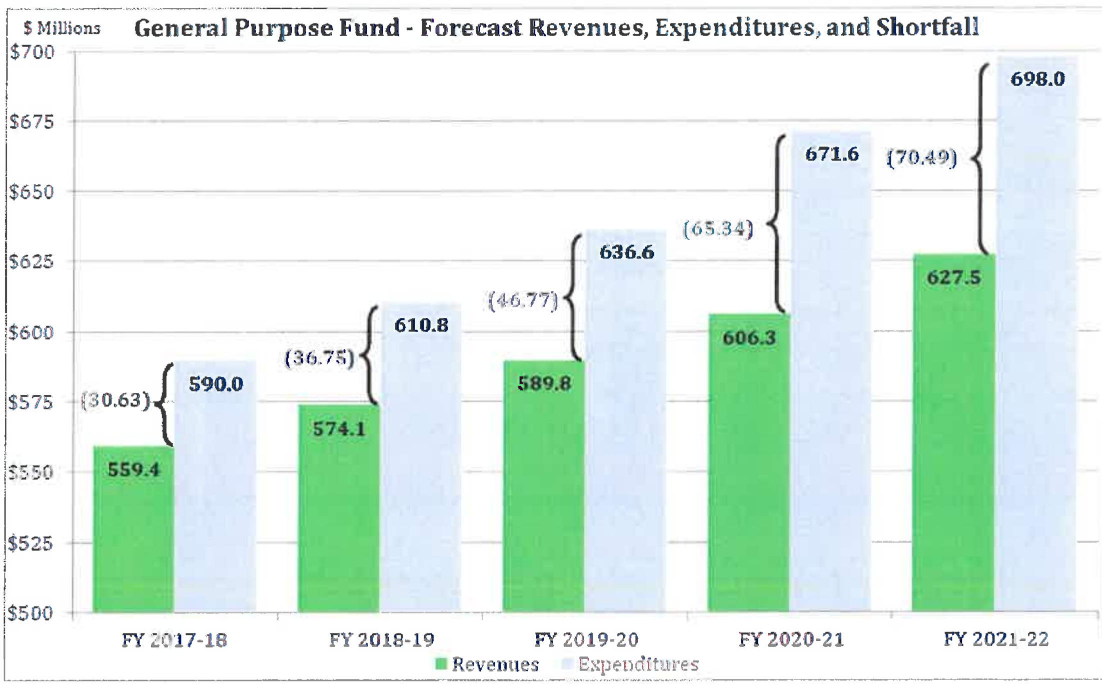
Oakland's City Budget

The city of Oakland adopts an annual budget that describes how the city will use public dollars to provide services to its residents. The budget identifies two principal types of data: projected revenues and planned expenditures. Revenues are divided into those that can be expended on general city activities and those that are restricted for specific purposes. Expenditures are classified as either restricted, meaning there is no discretion as to whether the city must pay them, or general purpose, those that are not legislatively or contractually mandated. The city council is legally required to submit a balanced budget annually: expenditures must match revenues.

Oakland's unfunded liability of nearly one billion dollars is too large to tackle without using a combination of solutions, yet the city currently has no viable plan in place.

Historically, general purpose fund revenue has grown at less than 2% annually. Consequently, to achieve a balanced budget, any expenses that grow at a faster annual compounded rate must be paid either from reserves or by reducing other general purpose fund expenses.

The chart below represents the city's five-year financial forecast related to city general purpose fund revenues and expenditures. It shows that city revenues are not keeping up with expenditures. The difference must be made up be either cuts in programs, increased taxes, or borrowing.

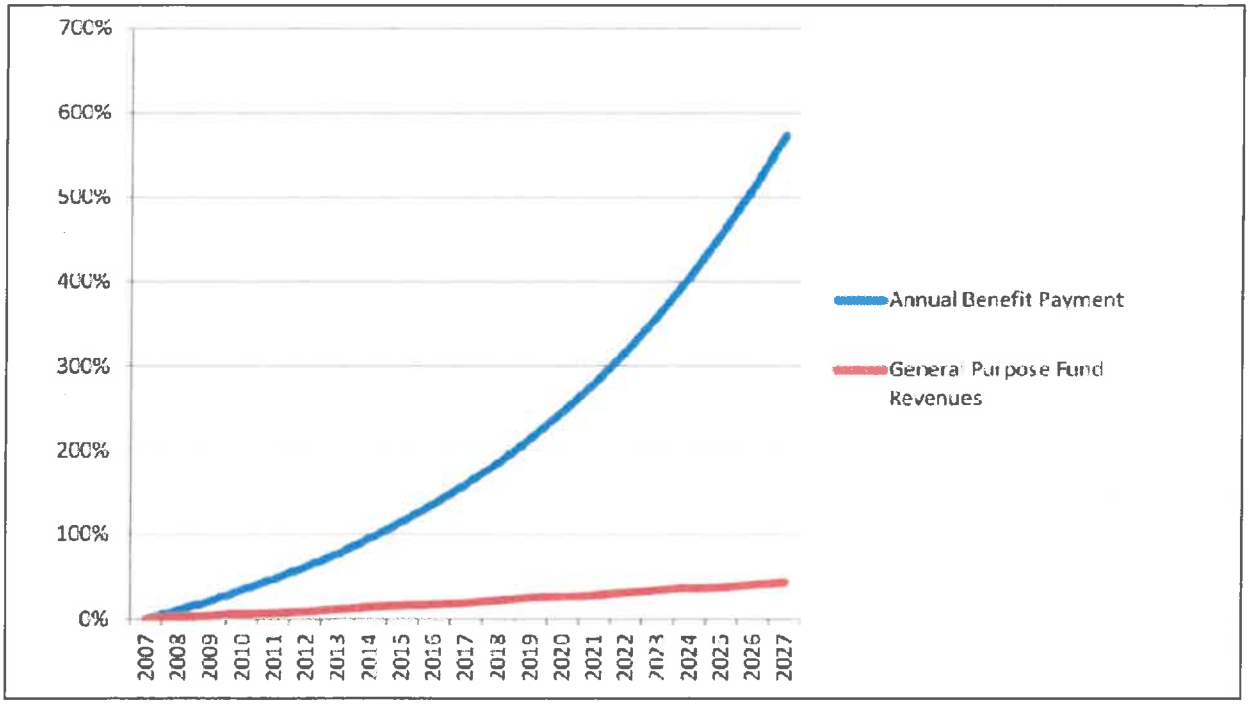


Source: City of Oakland Five-Year Financial Forecast, FY 2017-18 – FY 2021-22

The city of Oakland's five-year forecast has already acknowledged a growing gap in general purpose revenues and expenses. One alarming example of this projected budget shortfall is the disproportionate and rapidly increasing OPEB/retiree healthcare cost.

The city spent $10 million in FY 2006-2007, $26 million in FY 2016-2017, and is projected to spend $67 million in FY 2026-2027 on healthcare benefit payments for those currently retired ("pay-as-you-go"). These costs have been growing at a compounded rate of about 10% per year. This is more than five times the growth of general purpose fund revenues.

The chart below best illustrates this growing gap (shown compounded annually):



There are only two categories of general purpose fund expenses in Oakland's budget that are large enough to cut in order to provide sources for paying the growing OPEB costs: (1) operations and maintenance, representing 17% of 2017-18 budgeted general purposes fund expenses, and (2) salaries, representing 45% of those expenses.

City Employees Entitled to Healthcare Benefits

For decades, city leaders have been negotiating agreements with labor organizations that promised to pay a portion of the cost of health insurance premiums for most classes of retired city employees. Benefits are based on age, years of service and class of employee. Employees' rights to these benefits are vested after five years of service, but the employee must retire directly from the city of Oakland to be eligible. The city's contribution on behalf of miscellaneous employees (not police or fire) can reach a maximum of approximately $580 per month. The cost for retired firefighters with a full-family plan can top out at about $19,968 per year, and at $18,996 annually for retired police officers.

The city currently has approximately 6,000 participants in the OPEB program. They include active employees who are vested to get OPEB benefits when they retire, and former employees who are currently receiving the benefit. As of July of 2015, a total of 1,963 retirees, 399 disabled retirees, and 241 spouse survivors of retirees are collecting benefits.

INVESTIGATION

The Grand Jury began its examination of this public finance crisis after receiving a complaint that elected officials in Oakland were not taking seriously an unfunded retiree health care liability that is approaching one billion dollars and growing exponentially. The Grand Jury inquiry focused on whether the city can pay for the health care benefits it has promised its retired workers, and, ultimately, whether the city's forecasted long-term revenue can keep up with long-term expected health care expenditures. Unfortunately, like those who have conducted similar investigations in other cities, what we found was of great concern.

The retiree healthcare benefits promised to city employees have been chronically underfunded, and the deficit is growing annually.

During the investigation, the Grand Jury heard testimony from a number of witnesses, including current and former city of Oakland employees, elected public officials, and statewide experts in municipal finance. The Grand Jury also reviewed the city of Oakland five-year budget forecasts, Oakland's annual budgets, past consolidated annual financial reports, staff reports to Oakland City Council, the city's bi-annual actuarial reports, and studies from the League of California Cities and other public agencies.

Discovering the Unfunded Liability (GASB 45)

In 2004, the Government Accounting Standards Board (GASB) issued a new rule requiring government agencies to report their future OPEB liabilities every two years. The reporting requirement was a victory for transparency. It began a conversation about the looming debt created when elected leaders made generous contractual promises to pay retirees healthcare benefits without a complete understanding of the costs associated with those promises or whether the benefit packages were sustainable.

Unfortunately, while the new reporting rules required public entities to disclose their long-term unfunded liabilities/debt, those agencies were not required to change the methods used to fund the benefits.

Accounting for OPEB Costs

In June of 2006, Oakland hired an outside consultant to conduct actuarial studies relating to its OPEB obligation. Findings from the study were presented to the city council in October 2007.

The report dropped a number of fiscal bombshells. First, it let the city council and public know that the city funded OPEB differently than the way it funded its employee pensions. Rather than putting aside money to pay future retiree healthcare benefits as they were accruing, the city used the pay-as-you-go method to defer the costs until after the employees retired.

By contrast, the California Public Employees' Retirement System (CalPERS) requires public agencies to contribute to pensions when they are earned – while the employee is still working – and Oakland makes its required payments each year. CalPERS holds the money it receives in trust, investing it until the employee retires and begins collecting the pension. The investment income helps pay for the overall cost of the benefit.

Oakland's failure to take the tough steps necessary to address the problem has pushed its budget to the straining point, even in this period of relative economic prosperity.

The second revelation uncovered by the 2006 actuarial report was that the city had already accrued a massive liability of $524 million because it had not prefunded OPEB in the past. At that time, the city was paying about $10 million annually for current retiree health benefits. The actuaries determined that the city would have to contribute an additional $30 million every year for 20 years to pay down the unfunded portion of the benefits already earned. The extra amount the city would have to pay was nearly equivalent to the amount it was spending on the parks and recreation department and libraries combined.

With 3,640 active employees and 2,410 retirees in 2006, coupled with rapidly increasing costs of healthcare, the actuaries showed that the city's liability would grow exponentially as more retirees enter the pool if the city continued on its pay-as-you-go approach. Ultimately, however, city leaders took no action other than ordering further study of the problem and potential solutions.

The Grand Jury found no evidence that the city ever followed up with the promised study.

In short, the 2006 actuarial report showed that the city was locked into a very expensive long-term benefit for retired city workers that it ultimately could not afford if it continued down the pay-as-you-go path, but the city council chose to "kick the can" down the road rather than figuring out a responsible way to alter those benefits or to fund them sufficiently.

Establishment of Trust Fund: Oakland's Response

In 2010, the Finance and Management Agency for the city of Oakland recommended that the city "address its OPEB liabilities by implementing a prefunding mechanism, or dedicated trust, to decrease the required funding." Heeding that recommendation, Oakland established an irrevocable OPEB trust fund in 2014. City council put $3.9 million into the account in November 2016, and pledged to add another $20 million in the 2017-2019 bi-annual budget. As of September of 2017, the trust fund balance was just over $15 million, representing just 2% of the unfunded liability.

While this was a step in the right direction, it was not nearly enough to make a meaningful dent in the unfunded OPEB liability. Anything less than a $50 million annual contribution to the trust ends up increasing the total liability rather than amortizing it. Unfortunately, annual contributions in that amount are just not possible. Revenue forecasts indicate that Oakland's general purpose fund revenue will increase at a far lower rate than its general purpose fund expenses, particularly as CalPERS increases Oakland's annual required contributions for employee pensions, and increasing health care costs cause huge annual increases to the "pay-as-you-go" amounts. Oakland needs to look at other ways to address the problem.

2016 OPEB Actuarial Study

In the 2016 actuarial study, it was reported that, as of July 2015 (FY 2015-2016), the city's unfunded OPEB liability had ballooned to $860 million. It concluded that, instead of making pay-as-you-go payments (which by then had reached about $26 million annually), Oakland should have been making annual payments of $74.1 million.

Moody's Credit Challenge

In early 2017, a credit opinion from Moody's called Oakland's pension-driven budget pressures "significant." The report concluded that Oakland's largely unfunded OPEB liability of

$860 million constitutes an exceptionally high 238% of covered payroll. These facts could lead to a downgrade of the city's bond ratings, making it more expensive for the city to borrow money.

Oakland's OPEB Funding Structure

Many public agencies throughout the state, like Orange County, fund their healthcare using cafeteria-style plans, where the amount the employer pays for the employee's health insurance is deducted from the employee's gross income and used exclusively for that purpose. Because Oakland police and fire health plans are not funded through cafeteria plans, state law requires that active and retired health benefit packages be identical. For this reason, OPEB plans for Oakland public safety retirees are more expensive. Many of these employees – those hired before state pension reform in 2013 – can retire as early as age 50, when they may still have young families, requiring the city to make full contributions of $1,500 to $1,600 per month until the beneficiary enrolls in Medicare or there is a change in status of dependent or spouse. If the city establishes a cafeteria-style healthcare funding plan for all active employees, there would be no state mandate that the benefits for retirees be identical to those provided to active employees, and this issue would be a subject for negotiation with labor unions.

How Other Cities Are Responding to the Crisis

The Grand Jury heard that the city of Sausalito, admittedly a much smaller city than Oakland, addressed its OPEB problem by a dual-pronged program. It began by closing its defined benefits plan to newly hired employees and offered them instead a defined contribution plan. "Defined benefits" is where the employer promises to provide equivalent health insurance, e.g., to a basic Kaiser plan, and is obligated to pay the increased cost to purchase that type of plan even as premiums rise. "Defined contribution" is where the employer promises to pay a fixed amount annually toward the retiree's insurance costs, often with a cost-of-living rider.

Sausalito also offered a "buyout" plan to new or newer employees that offered an immediate cash payment of $1,000 per year for each year of employment in exchange for the employee waiving his or her right to post-employment health insurance. We learned that 50% of the eligible Sausalito employees took the buyout option.

Both of these changes required substantial negotiations with Sausalito's public employee unions. We heard that the city officials needed to lay all their cards on the table during negotiations, showing with incontrovertible evidence that the current system was not sustainable in the long run, and that Sausalito would be unable to pay its OPEB obligations in the future if changes were not made.

Some public agencies like BART and the Alameda County Water District have begun fully prefunding their OPEB costs. While this required massive investments by the organizations, they now have plans in place to erase their unfunded obligations. But, unlike Oakland, BART and the Water District do not have to go to the voters to raise revenue to pay for these initiatives – their boards can simply vote to increase rider fees and water rates.

In 2008, as a result of Grand Jury scrutiny, the city of Concord established a task force to address OPEB. As a result of the task force's recommendations, the city sat down with its labor organizations to craft a long-term plan that included material sharing by employees (14% at that time) of the cost of the program, and capping the benefits for existing employees. Prior to that, employees did not contribute to the cost. The city also established a trust and began to prefund its OPEB costs.

The city of Danville does not offer a traditional OPEB program and, therefore, has no unfunded OPEB liability. Instead, the city contributes to a health savings account, which in effect amounts to a defined contribution plan.

The city of Alameda appointed a task force in 2012 consisting of city officials, labor representatives and ordinary citizens to review Alameda's pension and OPEB obligations. After months of meetings, the task force submitted several recommendations regarding OPEB, none of which had unanimous support of all members:

- Modify vesting and eligibility rules for new hires beyond those made in 2011 in response to California's Public Employees' Pension Reform Act (PEPRA).
- Establish a 401(a)(h) plan in which all current employees are required to make contributions now for future health care. (New hires were already contributing to such a plan.)
- "Buy out" the benefit with a program giving employees the option to take cash or a tax-advantaged account in exchange for their defined benefit.
- Work with employee bargaining groups to negotiate down the liability.

In a follow-up report on OPEB liability in April 2015, Alameda staff, acknowledging that a multi-pronged approach was necessary and had to be coordinated with the city's bargaining units, discussed additional options to be considered along with those identified by the 2012 task force:

- Create a trust fund to pre-fund benefits.
- Budget more with existing funds to make payments above what is required under pay-as-you-go, with the excess going into the trust.
- Negotiate with labor for employees to contribute toward the cost of OPEB in exchange for the city making contributions toward pre-funding.
- Strengthen the tiered-benefit program that was created in response to PEPRA by making city contributions proportionate to the number of years of employment (so that the benefit would increase the longer the employee's years of service), and by lengthening the period before the benefit fully vested.
- Cap the city's medical contribution rate by changing to a defined contribution plan for new hires.
- Place further limits on spousal benefits. After PEPRA, spouses of employees hired after June 2011 were not eligible for OPEB. Staff suggested that it could modify OPEB benefits for spouses of pre-2011 hires by switching them to a defined contribution plan.

In September 2016, the OPEB Task Force of the League of California Cities issued a detailed report entitled "Retiree Health Care: A Cost Containment How-To Guide." After describing the OPEB problem, the task force discussed strategies California cities might employ to address it, including:

- Creating and funding an OPEB trust fund
- Changing benefits for existing employees
- Changing contributions to fixed amounts
- Limiting the duration of retiree medical benefits
- Closing the benefits to new employees
- Increasing vesting requirements
- Covering only retirees, not dependents
- Making city insurance secondary to other health insurance, such as veterans programs or coverage under a spouse's plan
- Buying down or buying out retiree benefits for current employees

- Changing health care plans
- Auditing retiree medical benefits
- Enrolling otherwise non-eligible retirees in Part A Medicare coverage
- Utilizing the federally subsidized prescription plan for Medicare retirees
- Buying down or buying out benefits for current retirees

CONCLUSION

Oakland's elected and appointed leaders are responsible for the welfare of their residents, for the stewardship of city finances, and for honoring or renegotiating the promises they and their predecessors made to public employees who serve the city.

The retiree health care benefits promised to city employees have been chronically underfunded, and the deficit is growing annually. Continuing the program of pay-as-you-go, without making a dent in the unfunded liability for future benefits, raises the prospect of massive budgetary cutbacks to programs deemed essential to the safety and welfare of its citizens.

These circumstances are not unique to Oakland, or even to the state of California, but Oakland's failure to take the tough steps necessary to address the problem has pushed its budget to the straining point, even in this period of relative economic prosperity. Moreover, other expensive issues, such as affordable housing, homelessness, decaying infrastructure, and more, are looming.

Inaction, or insubstantial action, on this matter is no longer tolerable. An economic downturn following years of growth will only make the problem worse. Failing to take bold action risks further cutbacks to essential and valued services like public safety, parks and libraries, and also risks worsening Oakland's bond ratings, imperiling its borrowing power, thus making Oakland a less desirable place to live and work. An informed community and courageous elected city officials must face this challenge head on to ensure a thriving and safe Oakland.

FINDINGS

Finding 18-1: The city of Oakland's current method of funding OPEB benefits underfunds its annual required contribution by at least $40 million.

Finding 18-2: The city of Oakland currently has no meaningful plan to address its $860 million unfunded OPEB liability, jeopardizing the city's long-term financial viability.

Finding 18-3: Rapidly increasing retiree health costs are squeezing city budgets and reducing funding for essential city services.

Finding 18-4: The city of Oakland has no revenue stream (anticipated revenue growth, new taxes or new bonds) sufficient to make payments that will amortize its unfunded OPEB liability over the next 20 or 30 years.

Finding 18-5: Solving Oakland's OPEB problem will require substantial political will and the cooperation of Oakland's bargaining units to make complex and unpopular structural changes to Oakland's retiree benefits program.

RECOMMENDATIONS

Recommendation 18-1: The city of Oakland must develop and implement a long-term comprehensive plan to address its $860 million unfunded OPEB liability.

Recommendation 18-2: Any long-term OPEB plan must include discussion of additional city funding and substantial structural change in benefits that are responsible for these growing liabilities.

Recommendation 18-3: The city of Oakland must develop a long-term cost-containment plan for OPEB that gives serious consideration to the options discussed by the League of California Cities and other California cities that have addressed this issue, including but not limited to:

- Capping or reducing premium contributions for current employees.
- Replacing defined benefits OPEB plans with defined contribution plans.

- Eliminating portions of the benefits, like dental and vision care.
- Limiting the length of medical coverage (e.g., to Medicare age).
- Eliminating or reducing coverage for spouses and children.

Recommendation 18-4: The city of Oakland must consider requiring current and future employees to share in paying for the cost of OPEB benefits.

Recommendation 18-5: City of Oakland staff must provide elected leaders and the public with clear and understandable reports, including graphs and charts, illustrating the impact of current OPEB funding decisions as well as the cumulative impact of deferred costs of these programs over a 15- to 20-year period.

Recommendation 18-6: The city of Oakland must decouple or separate the benefits offered to current public safety employees from those paid to retired police and firefighters, ending the pooling of active employees with retirees for rate setting.

RESPONSES REQUIRED

Oakland City Council
Findings 18-1 through 18-5
Recommendations 18-1 through 18-6

Mayor, City of Oakland
Findings 18-1 through 18-5
Recommendations 18-1 through 18-6