Date: September 2, 2009

To: Members of the California Legislature

From: Mac Taylor
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Subject: Pending Proposal Concerning Highway Patrol Officer Retiree Health Benefits Funding

On August 27, the administration presented to the Legislature a proposed addendum to the existing state employee labor agreement with Bargaining Unit 5 (California Highway Patrol [CHP] Officers). The proposal would amend the Public Employees' Medical and Hospital Care Act and increase state budgetary costs in some future years. Accordingly, as we advised the Joint Legislative Budget Committee (JLBC) last week, the proposal requires legislative approval. This letter provides our office's analysis of the proposal, similar to the analysis we routinely provide the JLBC with proposed labor agreements.

We understand that SB 519 (Ashburn) will be the vehicle for legislative consideration of the addendum. If the proposal is approved, it would mark the first time that the State of California and a group of its employees have begun to address unfunded liabilities for state employee retiree health benefits through establishment of a retiree health trust fund.

Extension of Rank-and-File Provisions to CHP Officer Supervisors Expected. Bargaining Unit 5, to which the proposed addendum applies, includes rank-and-file CHP officers. The administration controls most pay and benefits for state managers and supervisors. We understand that if the Legislature approves the proposed legislation related to the addendum, the administration will extend similar retiree health funding provisions to supervisors and managers of CHP officers, such as sergeants, lieutenants, and captains.

BACKGROUND

The proposal affects (1) the existing annual pay raise provisions incorporated in state law and the existing labor agreement with Unit 5 and (2) the method the state now uses to fund health benefits for retired CHP officers, their eligible dependents, beneficiaries, and survivors.

Existing Pay Raise Provisions

Automatic Pay Adjustments, Including 0.5 Percent Raise Scheduled in 2009-10. Along with judges, CHP officers are among the only state employees with an automatic annual pay adjustment process. Government Code Section 19827 requires that CHP officers receive an annual salary increase based on the agreed upon difference of (1) a weighted average of the compensation of officers employed by five specific, large local law enforcement agencies and (2) the weighted average compensation of a CHP officer. This requirement also is incorporated as part of the existing labor agreement between the state and Unit 5, which was ratified by the Legislature in 2006 and expires on July 2, 2010. The Department of Personnel Administration (DPA) posts results of the annual survey to determine this compensation difference at its web site. (For more information, see http://www.dpa.ca.gov/salaries/surveys/main.htm.) While DPA has not yet released the 2009 survey, it reports that Unit 5 members are due to receive a 0.5 percent salary increase effective July 2009.

Existing Retiree Health Benefits and Funding

Up to 100 Percent of Premiums Paid by State Upon Officers' Retirement. Like other state employees, CHP officers accrue eligibility during their working years to receive state-funded health benefits after retirement. Retiree health benefits are detailed in statute and generally are not addressed in bargaining units' labor agreements with the state. Section 22871 of the Government Code specifies that the full state contribution toward retirees' health care is the sum of (1) 100 percent of the weighted average health premiums for single enrollees in the four largest California Public Employees' Retirement System (CalPERS) health plans that enroll active state employees and (2) 90 percent of the additional weighted average health premiums for enrolled family members (when applicable) in the same four CalPERS health plans. Figure 1 shows estimated CalPERS premiums in 2010 for sample groups of retirees along with the maximum state contribution for their monthly premiums. In addition to plan premiums, CalPERS retirees and their dependents also pay deductibles, copayments, and similar charges.

Figure 1

Estimated State Contributions to Retiree Health Premiums in 2010

	Monthly Premium	Maximum State Contribution
Single Retiree Not Enrolled in Medicare		
Kaiser Permanente (Kaiser)	$495	$493
Blue Shield Access+	517	493
PERS Choice	487	493
Blue Shield NetValue	448	493
Single Retiree Enrolled in Medicare		
Kaiser	$298	$493
Blue Shield Access+	300	493
PERS Choice	356	493
Retiree With a Spouse or Domestic Partner Not Enrolled in Medicare		
Kaiser	$990	$936
Blue Shield Access+	1,034	936
PERS Choice	975	936
Blue Shield NetValue	896	936
Retiree With a Spouse or Domestic Partner (Both Enrolled in Medicare)		
Kaiser	$597	$936
Blue Shield Access+	599	936
PERS Choice	712	936

Note: Estimated Kaiser premiums are for in-state California enrollees. For Kaiser members residing out-of-state, premiums may be higher.

Medicare-Eligible Retirees Often Receive State Subsidy for Part B Premiums. For many retirees, the monthly state contribution is more than the plan's monthly premium. For such retirees enrolled in Medicare, CalPERS credits the difference between the two amounts up to the amount of the retirees' Medicare Part B (medical insurance) premiums to assist them with payment of those costs. For most people, Medicare Part B premiums in 2009 are $96 per month. Some state retirees—including some hired before 1986, when Medicare taxes became mandatory—are not eligible for Medicare. These retirees can remain in CalPERS' basic health plans.

Hire Date and Length of Service Determines if Retiree Receives Maximum Contribution. State law uses the term "vesting" to refer to the amount of time a person must be employed by the state to be eligible to receive the maximum state contribution toward retiree health premiums. Employees first hired by the state prior to January 1, 1985, are generally eligible to receive 100 percent of the maximum state contribution upon retirement, if they have worked for the state at least five years. Employees first hired between January 1, 1985, and January 1, 1989, typically receive 100 percent of the maximum state contribution only after working for the state for ten years. Employees in this group who retire with less than ten years of service generally have their state contribution reduced by 10 percent for each year of service under ten years. Employees first hired after January 1, 1989, generally receive no state contribution to retiree health benefits if they retire with fewer than ten years of service, 50 percent of the maximum state contribution if they retire with ten years of service, and, when they retire with over ten years of service, 50 percent plus an additional 5 percent of the maximum state contribution for each year of state service after the tenth year. Under this formula, state workers hired after January 1, 1989, generally will receive 100 percent of the maximum state contribution to retiree health benefits if they retire with 20 or more years of service. The state has instituted these vesting requirements over the years to reduce future retiree health benefit costs. The Governor proposed additional vesting requirements for future state hires as part of the 2009-10 budget process, but the final budget package included no changes.

State Now Funds Retiree Health Costs on "Pay-As-You-Go" Basis. Currently, the state—like most governmental employers throughout the U.S.—funds its retiree health benefits on a pay-as-you-go basis. This means that neither the state nor employees set aside any funds during employees' working lives to fund the retiree health benefits that they are earning during that time. As a result, very large unfunded accrued liabilities for retiree health benefits are reflected on the state's balance sheet. The Legislature directed the Controller to complete the state's first actuarial valuation of these unfunded liabilities in 2006. The most recently updated valuation shows that the state had a $48.2 billion unfunded liability for these benefits as of June 30, 2008.

Increased State or Employee Contributions Needed to Address Liabilities. According to the most recent valuation, the state currently contributes $1.36 billion to health benefits for its retirees (equivalent to 7.6 percent of current payroll for covered employees). The valuation estimates that the state would need to contribute an additional $1.32 billion per year (equivalent to an additional 7.4 percent of payroll for all covered employees) to fund retiree health benefits as they are accrued in future years and retire all existing unfunded liabilities within about 30 years. The unfunded liability for CHP officers and their supervisors and managers makes up $2.7 billion of the $48.2 billion in statewide unfunded retiree health benefits. Currently, the state contributes an estimated $77 million per year to the pay-as-you-go cost of retired CHP officers' health benefits. According to the most recent valuation, additional contributions from the state and/or employees totaling $52 million per year would be required to retire unfunded retiree health liabilities for CHP officers over the next three decades. (All of these figures are in current dollars and will grow with inflation over time.)

PROPOSAL

Agreement Does Not Change CHP Officer Retiree Benefits

Proposed Agreement Deals With Funding of Retiree Health Benefits Only. The proposed agreement between the state and Bargaining Unit 5 would *not* change existing retiree health benefits for CHP officers. Those benefits are established in state laws that would be unaffected by the proposal. Instead, the agreement alters only the method of funding those benefits, as described in more detail below. Furthermore, other provisions of state law specify that establishment of a retiree health benefit trust fund with CalPERS, such as that proposed in the agreement, does not in and of itself "create, change, or vest" existing obligations established under other contracts or laws. The agreement specifies that future state contributions to the proposed CHP officers' retiree benefit trust fund could be taken into account in future annual salary surveys "if mutually agreed" in a future labor agreement.

New CHP Officer Account in CalPERS Retiree Health Trust Fund

Legislature Has Authorized Several Retiree Health Trust Funds. Upon CalPERS' decision to establish a retiree health prefunding trust, the Legislature approved Chapter 318, Statutes of 2007 (AB 554, Hernandez), to clarify the system's authority to establish a fund. Pursuant to Chapter 318 and CalPERS regulations, the state, as well as local governments, may file a resolution with the system to participate in the trust fund and must sign a contract with the system to that effect. Participating governments then periodically deposit funds—the amounts of which are specified by the governments themselves—to the trust fund, and CalPERS invests the funds. The system periodically disburses trust fund moneys to the credit of participating governments to cover eligible retiree health costs and deducts funds necessary to cover administrative costs. Pursuant to Chapter 318, a public employer's actions to enroll in CalPERS' retiree health benefits trust—now known as the California Employers' Retiree Benefits Trust (CERBT)—does not "create, change, or vest the obligations of an employer… that were created under any other contract, law… or similar actions." As of July 27, 2009, CalPERS reports that 200 local public agencies (including 10 counties, 65 cities or towns, and 17 schools or county offices of education) have enrolled with the trust fund. The CERBT's market value as of June 30, 2009, was $842 million. In addition to its authorization of CERBT, the Legislature also authorized county retirement systems (known as "1937 Act" systems) to establish similar retiree health trust funds. Senate Bill 11 (Negrete McLeod) seeks to clarify the 1937 Act provisions to allow the San Bernardino County Retirement System to accept retiree health trust fund deposits from essentially *any* local public entity in California. The Governor vetoed a similar bill and many other bills in 2008, citing the Legislature's delay in approving the 2008-09 state budget. Senate Bill 11 passed the Senate on May 6, 2009, and passed the Assembly on August 20, 2009. It now awaits action by the Governor.

Benefit Trust Account for CHP Officers Would Be Established at CalPERS. Under the proposed agreement, funds contributed by the state and CHP officers would be deposited into CERBT, according to the administration. Funds directed to CERBT could only be used to fund health benefits for CHP officer retirees and their eligible dependents, beneficiaries, and survivors. Unlike certain employee pension contributions, such funds would never be refundable to a CHP officer or his or her beneficiary or survivor.

Portions of 2009 and 2010 Officer Raises Would Be Directed to Trust Fund

July 2009 Raise Would Be Directed to Proposed Retiree Health Fund. According to administration officials, CHP officers, their supervisors, and managers have not yet begun to receive the 0.5 percent salary increase they are otherwise due under state law and the existing Unit 5 labor agreement. Under legislation to implement the proposed agreement, the 0.5 percent raise that CHP officers otherwise would have received beginning July 1, 2009, would be directed to the CHP officers' account in CERBT beginning upon establishment of the account. This 0.5 percent employees' contribution to CERBT would be permanent and ongoing.

Additional 0.5 Percent of CHP Officer Pay to Go to Fund Beginning in January 2010. We understand that the administration proposes to have the Unit 5 proposal approved in legislation requiring a majority vote. Under the draft legislation, CHP officers would contribute an additional 0.5 percent of their base pay to the proposed CHP officer retiree health trust fund following the effective date of this legislation and ratification by Unit 5 members—presumably on or about January 1, 2010. The total monthly contributions to CERBT by officers at that time would be 1 percent of CHP officer pay. This additional contribution also would be permanent and ongoing.

July 2010 Raise Up to 2 Percent Would Be Directed to Retiree Health Fund. Under the proposed legislation, the raise that CHP officers are due to receive under state law and the existing labor agreement on July 1, 2010—up to a maximum of a 2 percent raise—would also be directed to the CHP officers' account in CERBT. These additional contributions also would be permanent and ongoing and would take the amount of employee contributions to the account up to as much as 3 percent of CHP officer pay. Because of the strained fiscal condition of the local agencies to which CHP officers' pay is compared in the annual salary survey, it is likely that the raise due CHP officers on July 1, 2010, will be less than 2 percent. If so, the total amount of employee contributions to the account would be less than 3 percent of pay. If the July 1, 2010, raise, for example, would have been 1 percent, the employee contributions to the CHP officer trust fund account as of that date would be 2 percent of pay: the 1 percent provided as of January 1, 2010, and an additional 1 percent effective on July 1, 2010.

Employee Contributions Beginning July 2010 Would Be Up to $19 Million Per Year. Under current pay levels, each 1 percent of CHP officer pay (including supervisors and managers) totals about $6.3 million—essentially all of which is paid from the Motor Vehicle Account (MVA), which supports most CHP operations. Therefore, the maximum amounts that would be directed by employees to the CHP officers' retiree health account beginning July 2010 would be about $19 million per year.

Raises in 2009 and 2010 Would Not Count as "Final Compensation" for Pensions. Under the proposed legislation, the portion of the raises CHP officers otherwise would receive on July 1, 2009, and July 1, 2010, and that are directed to CERBT will *not* be included in the calculation of officers' final annual compensation for CalPERS pension purposes. In other words, CHP officers retiring in the future will receive a lower CalPERS monthly pension payment than otherwise would have been the case. An actuarial analysis of the effects of this provision on state costs is not available.

New State Contributions Would Be Required Beginning in 2012-13

New State Funding Commitment Would Begin on July 1, 2012. Under the proposed legislation, the state would have a new, permanent, and ongoing budgetary obligation to contribute to the CHP officers' retiree health account beginning on July 1, 2012. Effective on that date, the state must match officers' contributions, which could be up to 3 percent of pay. State contributions most likely will be somewhere between $10 million and $20 million per year as of 2012-13.

Employee and Employer Contributions Beginning in 2012-13 of Up to $40 Million Per Year. Under the provisions of the addendum and the proposed legislation, employees already would be contributing up to 3 percent of their pay to the new CHP officers account in CERBT in 2012-13, and the state would initiate matching contributions to the account as of that time. Accordingly, total contributions to CERBT for CHP officers' retiree benefits would be up to 6 percent of their pay beginning in 2012-13—somewhere around $40 million per year. On the other hand, total contributions (employer and employee) could be as little as 2 percent of pay beginning in 2012-13 (and under $15 million per year) if CHP officers are eligible to receive a minimal raise or no raise in 2010. In either event, the combined employee and employer contributions would most likely be insufficient to cover the estimated $52 million annual contribution needed to retire unfunded CHP officer retiree health liabilities within the next three decades.

LAO Comments

Administration and Union Should Be Commended for This Major Step

First State Employee Agreement to Propose Funding Retiree Health Liabilities. The Legislature first expressed its concern about unfunded retiree health liabilities in 1988 with the passage of a measure that attempted to prod CalPERS into establishing a retiree health prefunding trust. Alarmed by the magnitude of the state's unfunded retiree health liabilities, our office proposed beginning to set aside funds to address these future costs in February 2006 with release of our report, *Retiree Health Care: A Growing Cost* *for Government*. The Controller released the first valuation of state retiree health liabilities in 2007 and called for a prefunding plan for the benefits. A bipartisan commission appointed by legislative leaders and the Governor proposed the beginning of such funding in January 2008. With this agreement, the administration has come to terms with a state employee union to propose a specific method of beginning to fund a small portion of the state's unfunded liabilities for the first time. We commend both parties for this important step to try to put state employee benefits and their costs on a sounder long-term financial footing.

Proposed Legislation Would Create New, Permanent State Funding Commitment

Retirement-Related Budgetary Commitments Generally Are Permanent in Nature. While the proposed legislation does not affect the health benefits of CHP officers or retired CHP officers, it would create a new budgetary commitment by the state to *fund* those benefits beginning in 2012-13. California case law makes clear that just as a public employer can create a contractual benefits commitment for public employees, it also can create a contractual funding commitment for those same benefits in statute. Senate Bill 519 contains language that might allow the state to alter this annual funding commitment through an agreement with Bargaining Unit 5. The legislation, however, contains no language allowing the Legislature to alter this funding commitment in the future unilaterally through legislation or the budget act. Accordingly, the Legislature should assume that, if it passes this agreement in its current form, it may be creating a contractual funding commitment that would be difficult or impossible to alter without offering a comparable and costly benefit in exchange. (These are the same general principles that courts cited in overturning the Legislature's unilateral withholding of $500 million of contributions from the California State Teachers' Retirement System in 2003-04.) Accordingly, this new funding commitment may further pressure the already-strained fiscal condition of the MVA, which funds most CHP and Department of Motor Vehicles operations, beginning in 2012-13. (Because the MVA generally funds CHP operations, we assume this new budgetary obligation would have little or no immediate General Fund impact.)

New Funding Arrangement Would Reduce State Liabilities and Costs Over Time. While the agreement may produce a new, added budgetary cost for the MVA beginning in 2012-13, these costs would most likely be more than offset over the long term (by perhaps a decade or two from now) by the savings that would result from investment returns generated by the new CHP officer retiree health account. The new funding commitment, however, may make the finances of the MVA less flexible in the near term. The Legislature should consider both the pros and cons of this arrangement when evaluating this proposal.

Little or No Consideration Apparently Given to Alternate Investment Providers

Administration Plan Would Place CHP Retiree Health Funds at CalPERS. The State Constitution authorizes public retirement boards, such as the CalPERS board of administration, to administer pension funds and invest in stocks and other vehicles to fund public pension liabilities. Under Proposition 162 (1992), public retirement boards have a great deal of independence from other elected officials, such as the Legislature, in their administration of pension investments and conduct of pension system operations. Chapter 318 specifies that CalPERS' administration of CERBT falls under the provisions of this section of the Constitution. (Comparable statutes authorizing county retirement systems to establish retiree health funds also specify that these funds fall under the same constitutional provisions.) In choosing to deposit CHP retiree health trust funds with CalPERS—and not with an alternative entity—the administration, therefore, has chosen *not* to pursue possible options that would place these funds with an organization over which the Legislature has more direct control. (As the funding and benefits administration functions for health plans are separate, there is little inherent reason why investment of the funds must be handled by the same entity—in this case, CalPERS—that administers the health benefits.)

Plan Includes No Competitive Bidding for Placement of the CHP Benefit Funds. Currently, CalPERS estimates on its Web site that the total annual administrative expenses for CERBT employers will be 20 to 50 basis points (equivalent to 0.2 percent to 0.5 percent of assets). The system states that this is a competitive administrative expense rate, compared with other providers of retiree health trust fund services. To our knowledge, however, neither the administration nor the association representing CHP officers has initiated a detailed request for proposal (RFP) process to determine if other public or private retirement investment providers could provide lower-cost, comparable investment services for the proposed CHP benefit trust fund. Among the entities that might wish to bid on such an RFP are the state's county retirement systems. For some time, we have noted that, upon beginning to fund the state's retiree health liabilities, the Legislature may wish to consider which of the many public and private investment providers would be best suited to invest state and employee/retiree funds for this purpose. Any arrangement that differs from that in the addendum may require additional negotiation between the administration and Bargaining Unit 5.

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