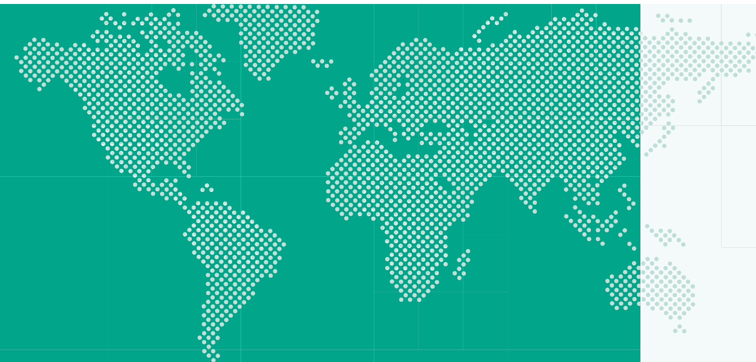

ABOUT ORRICK

For the past decade, Orrick has ranked number one in the country as bond counsel and as underwriter's counsel, averaging a combined market share of over 12.5 percent of all municipal debt obligations issued each year. Orrick was a pioneer in pension obligation bonds and has handled more pension obligation bonds as bond counsel than any other firm. Similarly, it is in the forefront of bond financing of other post-employment benefits (OPEB). Orrick's Public Finance, Tax and Employee Benefits attorneys have undertaken extensive research to develop legal theories and financial structures suitable for OPEB funding by a broad range of public entities. Orrick's Public Finance attorneys are located in San Francisco, Los Angeles, Sacramento, New York, Seattle, Portland and Washington, D.C. From these offices, Orrick serves as bond counsel for issuers in more than 40 states, several territories and other countries.

For additional information about our public finance practice, please visit our website at www.orrick.com or contact us at publicfinance@orrick.com.

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OTHER POST-EMPLOYMENT BENEFITS

The Next Big Financial, Disclosure, Accounting and Public Relations Challenge Affecting State and Local Governments

Fourth Edition (2008)

Roger L. Davis

ORRICK

Accounting Change

OPEB refers to "other post-employment benefits," meaning other than pension benefits. OPEB consist primarily of health care benefits, and may include other benefits such as life insurance, long term care and similar benefits. Until now, these benefits have generally been administered on a pay-as-you-go basis and have not been reported as a liability on municipal financial statements.

GASB 45

GASB 45 will require municipalities to account for OPEB liabilities much like they already account for pension liabilities, generally adopting the actuarial methodologies used for pensions, with adjustments for the different characteristics of OPEB and the fact that most municipalities have not set aside any funds against this liability. Unlike GASB 27, which covers accounting for pensions, GASB 45 does not require municipalities to report a net OPEB obligation at the start.

ANNUAL REQUIRED CONTRIBUTION (ARC) AND NET OPEB OBLIGATION (NOO)

Under GASB 45, based on an actuarial valuation, an annual required contribution (ARC) is determined for each municipality. The ARC is the sum of (a) the normal cost for the year (the present value of future benefits being earned by current employees) plus (b) amortization of the unfunded actuarial accrued liability (benefits already earned by current and former employees but not yet provided for) (UAAL), using an amortization period of not more than 30 years. If a municipality contributes an amount less than the ARC, a net OPEB obligation (NOO) will result, which is required to be recorded as a liability on its financial statements.

Note that the UAAL will be much greater than the NOO. Although not required to be treated as a liability on financial statements, the UAAL will likely appear in a related footnote and be disclosed in connection with the municipality's bond or note offerings.

Some actuaries have estimated that for many municipalities the ARC may be 5 to 10 times higher than current pay-as-you-go expenses. However, after a period of years, because of factors such as increasing number of retirees and inflation in health care costs, pay-as-you-go costs are expected to far exceed the ARC. GASB 45 does not require that the unfunded liability actually be amortized, only that the municipality account for its unfunded accrued liability and compliance in meeting its ARC.

An actuarial valuation is required every 2 years for OPEB plans with more than 200 members, or every 3 years if there are less than 200 members.

Effective Date

Although GASB 45 encourages earlier adoption, implementation is required by the following dates, based on the size of government measured by annual revenue:

ANNUAL REVENUE	EFFECTIVE FOR FISCAL YEAR BEGINNING AFTER:
Greater than $100 million	December 15, 2006
Between $10 million and $100 million	December 15, 2007
Less than $10 million	December 15, 2008

OPEB Options

Municipalities have a number of options to consider in developing an OPEB strategy or otherwise addressing their OPEB liability, such as:

REDUCE OPEB OBLIGATION

Unlike pensions, which municipalities are required to provide to their employees as a matter of law in most states, state law generally does not impose on municipalities the obligation to provide OPEB. Instead, the OPEB obligation usually arises purely by action of the municipality, whether by collective bargaining agreement, MOU, other employee contract, ordinance, resolution, board policy or even just past practices. Many of these are subject to renewal, renegotiation, change or termination. In some cases, municipalities have been careful to describe all of its OPEB obligations as discretionary and/or subject to change or discontinuation. However, while the ability to change or discontinue OPEB for future employees should be an option in most cases, the ability to change or discontinue OPEB with respect to retired or current employees may vary from state to state, depending on the degree to which the courts in a particular state treat OPEB, even if not vested by express contractual terms, as not subject to unilateral change by the municipality on the theory that they are "fundamental benefits," "inducement to remain employed," "elements of compensation contractually vested in accordance with their terms upon acceptance," "earned by remaining employed" or similar theory and on the particular facts pertaining to the municipality, its employees and its OPEB. This is an evolving area of the law, and while it evolves, most municipalities are expected to assume OPEB are discretionary and try to preserve the option to reduce them.

Other approaches to reducing the municipality's OPEB liability include charging or increasing premiums charged to employees and retirees, charging higher premiums to retirees than current employees (eliminating or reducing an implicit subsidy that GASB 45 requires being included in OPEB liability), increasing the length of time employees must work to be eligible, capping employer's total exposure, treating new employees less favorably than existing and prior employees, and/or shifting in whole or part to a defined contribution instead of defined benefit plan.

CONTINUE PAY-AS-YOU-GO

In the short run this is the simplest and cheapest option. However, at some point in the future pay-as-you-go will become much more expensive than the ARC or fixed bond payments. Pay-as-you-go will result in an annually increasing NOO for GASB 45 purposes, and higher OPEB UAAL and ARC amounts due to the inability to apply a higher investment return assumption to the calculation of these amounts that would be available under an even partially funded trust program; and may become a ratings factor (for example, Fitch Ratings has commented that "an absence of action taken to fund OPEB liabilities or otherwise manage them will be received as a negative rating factor").

BUY-OUT OPEB

Another option is to buy out OPEB from employees and/or retirees, using any available moneys or bond proceeds. This could take the form of funding a union trust in return for the union assuming OPEB responsibilities or offering a cash settlement to individual employees/retirees to give up any claim to OPEB.

UNDERTAKE A FUNDING PROGRAM, recently recommended by the California Public Employee Post-Employment Benefits Commission. Funding vehicles include:

1. Special reserve or other dedicated fund within the treasury of the municipality. However, contributions to such an internal fund will generally not qualify as contributions toward the ARC nor as plan assets for GASB 45 purposes, which require an irrevocable contribution to a trust or equivalent arrangement protected from creditors and dedicated solely to providing benefits to retirees and beneficiaries in accordance with the terms of the OPEB plan. Therefore, an internal special reserve or similar fund will still be considered pay-as-you-go for GASB 45 purposes, and, in calculating the OPEB UAAL and related ARC, the investment return assumption applicable to deposits in such fund will likely be based on the municipality's return on its general (largely short-term) investments (roughly 3–4% today) compared to the much higher investment return assumption (7% to 8%) used by pension funds, especially if large and diversified. The investment return assumption is the equivalent of a discount rate used in present valuing future OPEB payments, and the foregoing difference in investment return assumptions will make a very significant difference in OPEB UAAL and ARC amounts (in some cases cutting them in half). Therefore, most municipalities choosing to undertake an OPEB funding program will use an OPEB trust of some kind. Some may use the special reserve fund option temporarily until a suitable OPEB trust is available.

2. OPEB Trust. Funding may consist of just the ARC or a larger portion of the UAAL, for which purpose the municipality may choose to use OPEB Bonds. See below for a discussion of OPEB trusts and OPEB bonds.

3. Insurance. Note that most of the same objectives could be achieved by purchasing insurance for future OPEB obligations, but such long-term insurance is not currently available and cost and availability seem likely to continue to foreclose or severely limit this option.

OPEB Trusts

GASB 45 does not require OPEB liabilities to be funded or, if funded, by funding an irrevocable trust of some kind. However, as explained above, the existence of GASB 45 creates strong incentives to establish such a trust.

TYPES OF OPEB TRUSTS

The following types of OPEB trusts are each named for the section of the Internal Revenue Code from which they derive their exemption from federal income tax.

1. 401(h) account. This is a separate account in a tax-qualified pension fund for health benefits of retirees, their spouses and dependents. The aggregate actual contributions to this account cannot exceed 25% of the total actual contributions to the pension fund (other than contributions to fund past service credits) after the date on which the account is established. This limitation could present a problem for some municipalities' OPEB funding strategies, unless either the 401(h) account has been a component of the pension fund for a substantial period or the municipality is going to fund the applicable pension benefits component of the fund at three or more times the amount at which it is going to fund the 401(h) account component. Amounts in a 401(h) account may not be used for or diverted to any other purpose, including pension income benefits.

2. 115 trust. This type of trust is considered exempt from federal income tax either because it is an "integral part" of a single governmental entity or because it serves an "essential governmental function" of one or more governmental entities. This is the type of trust most municipalities are likely to use, whether alone or in combination with other municipalities. Even pension systems may choose the 115 trust for its much greater flexibility over the 401(h) account, as CalPERS, for example, has done.

3. 501(c)(9) trust. Also known as a "voluntary employees' beneficiary association" ("VEBA") trust, this is the primary vehicle used by the private sector for funding health benefits. Among the requirements are that membership be voluntary (which is deemed satisfied if mandated by collective bargaining agreement or if membership imposes no detriment and is required of all employees), and that the trust be controlled by its membership (which can be satisfied if the membership, directly or through representatives, designates the trustee or trustees who control(s) the trust, or if the trustee(s) are designated pursuant to a collective bargaining agreement). Because the form and operation of VEBA trusts are so well developed in the private sector, some municipalities may elect to adopt this model (or borrow from it in establishing a 115 trust), particularly if it arises out of bargaining with unions.

CHARACTERISTICS OF OPEB TRUSTS

To accomplish the goals for which OPEB trusts are created, they generally will be designed to satisfy at least the following three conditions:

1. Exemption from federal income tax. In addition to income on investment of trust assets being exempt from income tax (as described above), contributions to the trust must not be treated as income to the employee or retiree (in each case under federal and state income tax laws).

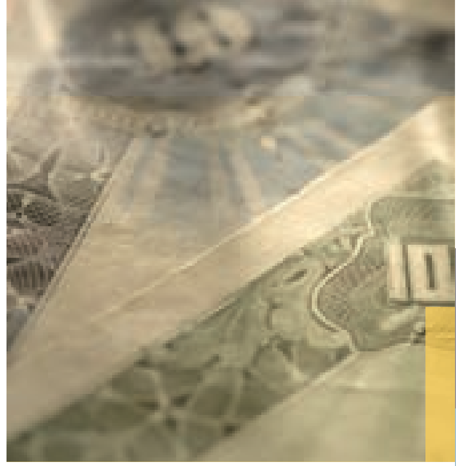
2. Qualified trust for GASB 45 purposes. For contributions and deposits to count for GASB 45 purposes, they must be irrevocable, protected from creditors of the municipal employer and dedicated solely to providing benefits to retirees and beneficiaries in accordance with the OPEB plan.

3. Broad investment powers, including equities. In order to be entitled to use the higher investment return assumption in calculating the UAAL and ARC and perhaps actually to earn a higher rate of return, the trust must be able to invest in a broader range of investments than those to which municipal funds are generally restricted, including equities. Some states already have specific legislation broadening the scope of permitted investment by OPEB trusts. However, a number of states, including some of those with specific legislation, have restrictions on investment in equities embedded in their state constitutions. As a result, in some states, it may be necessary to conclude that the OPEB trust is a pension or retirement fund within the meaning of any applicable exception to the restrictions otherwise applicable to the investment of municipal funds or that the OPEB trust is sufficiently separate from the municipality to not be included among the types of entities covered by state statutory (or, in some cases, constitutional) investment restrictions.

4. Single or multiple employer trusts. An OPEB trust may be a single employer trust established by and for a single municipality or a multiple employer trust established by a pension system or by an association or other collection of municipalities for membership by any interested municipality or by specific categories (such as, cities, counties, school districts, etc.)

DOUBLE TRUST STRUCTURES

If a municipality's OPEB obligations are eliminated or fixed below the level that can be handled by its OPEB trust, the excess money can usually be returned to the municipality. In order to get the trust moneys back under other circumstances or to manage when and how much is applied to OPEB obligations each year for budget or cash flow management purposes, some municipalities are using a double trust structure. One trust would be the irrevocable OPEB trust described above, and the other would be an intermediate trust from which the municipality can direct when and how much is transferred to the OPEB trust. The intermediate trust may be revocable (permitting the municipality to direct transfers to non-OPEB purposes or to its general fund under certain circumstances) or irrevocable (dedicated solely to funding the OPEB trust so long as there is an unfunded liability but not subject to a specific funding schedule).



OPEB Bonds

ADVANTAGES/DISADVANTAGES

The benefits of OPEB bonds are essentially the same as for pension obligation bonds (POBs), including interest rate savings (comparing bond interest costs against the investment return assumption/discount rate used in calculating the UAAL and ARC), arbitrage (see below), budget relief (compared to the ARC alternative), labor relations, and better than alternative strategies. Additional benefits pertaining to or receiving more emphasis as applied to OPEB bonds include the following:

1. *Reducing the OPEB UAAL and ARC:* which results from funding a qualified trust entitled to use a higher investment return assumption (discount rate on future OPEB payments) than pay-as-you-go or funded internal reserve fund plans. This, in turn, also reduces the political burden of reporting a higher UAAL and the political and financial burden of budgeting for a higher ARC.

2. *Lowering long-term cost of OPEB.* While debt service on OPEB bonds (like the ARC) will generally be higher than pay-as-you-go costs for the first few years, pay-as-you-go costs (and resulting ARC costs) are likely to increase sharply, and after a few years exceed the cost of debt service and continue to grow thereafter.

3. *Potential arbitrage opportunity,* if not only the investment return assumption but also the actual investment return earned by the OPEB trust exceeds the yield on the bonds. An informal 2004 study of POBs concluded that 84% of POBs were in a positive arbitrage position and another 7% were at breakeven, notwithstanding substantial decline in stock market values in 2000-2002. Even measured as of the least favorable time in the stock market, late 2002, only 34% were in a negative arbitrage position, most of which were less than four years old and were positive just two years later.

4. *Reducing public pressure* to reduce or discontinue OPEB benefits, which may result from publication of this substantial "new" unfunded liability, particularly in context of the growing debate over pension reform occurring in some states.

5. *Credit rating protection.* A January 2008 Standard & Poor's report warns that if governments put off for too long addressing OPEB liabilities, they could pose a credit risk. Several rating agencies will be evaluating a municipality's strategy for managing its OPEB liability. A couple of rating agencies have indicated that OPEB bonds, properly used, will be considered a positive favor in a municipality's general credit evaluation.

The possible disadvantages of OPEB bonds are also the same as for POBs, including replacing potentially negotiable or discretionary OPEB obligations with immutable bond obligations, the concentration of investment risk through lump sum deposit compared to spreading market timing risks by making ARC deposits annually, and possible negative arbitrage if the return on OPEB investments falls and stays below the interest cost of the OPEB bonds (including any refunding bonds).

TYPES AND LEGAL AUTHORITY

Legal authority for OPEB bonds will vary from state to state and, within states, by type of entity. For example:

1. General obligation bonds
2. Obligations imposed by law (OPEB variation, see discussion below)
3. Appropriation contingent bonds
4. Asset-strip lease-back financing
5. Revenue bonds (enterprise special districts and authorities)
6. Trust obligations

The "obligations imposed by law" theory used in California and some other states to support POBs may not be as easily applied to OPEB and, even if it or a variation we have developed were to be applied, some municipalities consider OPEB to be discretionary or negotiable, and may not want to impair that position by declaring them in court to be "obligations imposed by law." For those situations, we have developed alternative legal structures, which avoid that problem.

TAXABLE

Just like POBs, interest on most variations of OPEB bonds will be included in gross income for federal income tax purposes, although they will usually be exempt from income taxes of the state in which the issuer is located.

FEDERAL REIMBURSEMENT ISSUES

Certain costs (including OPEB) of state and local governments in administrating programs under grants from or contracts with the federal government are eligible for reimbursement from the federal government pursuant to Office of Management and Budget Circular A-87. Issuers will want to be comfortable that the federal government will treat debt service on OPEB bonds (like they have generally for POBs) as the surrogate for the obligations funded with the bonds and will continue to reimburse its allocable share.

ADDITIONAL INFORMATION

At the beginning of 2005, Orrick formed an OPEB task force composed of public finance, tax and employee benefit lawyers to research and develop strategies to help municipalities to address this new challenge.

We invite you to discuss these OPEB matters with us further by contacting Roger Davis (at 415-773-5758 or rogerdavis@orrick.com) or other members of Orrick's OPEB task force.