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October 22, 2014

Personal and Confidential

Ms. Barbara Michalowski
Town Treasurer
Town of Topsfield
8 West Common Street
Topsfield, MA 01983

Re: GASB 45 – Summary of Results

Dear Ms. Michalowski

The purpose of this letter is to summarize our actuarial valuation of the Town of Topsfield Other Postemployment Benefits Plan (the "Plan") for the fiscal year ending June 30, 2014 in accordance with Statement No. 45 of the Governmental Accounting Standards Board ("GASB 45").

<u>What caused plan liabilities to change from FY 12 to FY 14?</u>

Plan experience was far more favorable than expected due to changes in the Medicare integrated plan (Medex III to Medex II) -premiums decreased ($276.73 / month vs expected $809.38 / month) and non-Medicare integrated plan premiums increasing less than the expected 15% increase over the two year period resulting in a $12.7 million in liabilities. This was somewhat offset by the introduction of a more conservative mortality table and the inclusion of the ACA excise tax. The actuarial experience gain is amortized into the annual OPEB costs over a 30-year period. The net impact of plan experience is a decrease in the annual OPEB cost.

Over the two year period, the Actuarial Accrued Liability ("AAL") went from $22,221,197 as of July 1, 2011 to $15,141,371 as of July 1, 2013 for a decrease of $7,079,826. During that same period the Annual OPEB Cost went from $2,619,276 to $1,641,184 for a decrease of $978,092. As you continue to recognize more of the AAL at the time of adoption of GASB 45 onto your financial statements and factor in plan experience you can expect your OPEB obligation to increase. The Town's OPEB obligation increased from $6,785,461 as of June 30, 2012 to $10,128,161 as of June 30, 2014 for a total change of $3,342,700.

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<u>What is the value of benefits accrued to date? How much is accrued each year?</u>

As of July 1, 2013, the Plan had accrued benefits (medical & life insurance) of approximately $15,141,371. The Plan has a "normal cost" or benefits accruing during the year of approximately $798,539. Additionally, the Plan must amortize the accrued benefits in place at adoption of GASB 45 over a period of not more than 30 years. Given a 30 year amortization period for the obligation at adoption, the continuing annual amortization payment is $1,235,630. In combination with the normal cost and interest to the end of the plan year and required adjustments to the ARC, the OPEB expense is $1,641,184 which exceeds the expected pay-as-you-go cost of $301,484 plus contributions to an OPEB Trust of $100,000 by $1,239,700 . A key issue to remember is that this is a "non-cash" charge and does not require pre-funding like a pension plan.

<u>What are the key assumptions used to estimate a $15,141,371 liability?</u>

While there are a number of assumptions used to estimate plan costs and liabilities, the most important are future increases in medical care costs and the likelihood of participants retiring when they are eligible. Unlike a pension plan where a participant receives a reduced benefit for early retirement, a participant in a retiree welfare plan will actually receive a higher benefit by retiring early (more years of benefits to be received plus more years before Medicare). A key issue to keep in mind is that participant behavior (as far as retirement is concerned) is affected by many factors including the economy, personal health and work satisfaction.

For this valuation we have recognized medical premiums as of the 2015 fiscal year. For years beyond the 2015 fiscal year, medical care costs are assumed to increase by 5.0% per year. If costs increase at rates higher than assumed, plan liabilities will escalate while costs less than those assumed will yield lower liabilities in the future.

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What are some key plan metrics?

While an actuarial valuation under GASB 45 can be very complex with many variables, we find it helpful to look at several key metrics shown below to better allow you to manage your plan.

Representative Plan Statistics

	July 1, 2013	July 1, 2011
Total Accumulated Postretirement Benefit Obligation	15,141,371	22,221,197
Per Eligible Active Plan Participant	68,308	89,282
Per Retiree/Spouse Plan Participant	58,930	84,850
Total Annual Normal Cost (annual benefit accrual)	798,539	1,415,431
Per Eligible Active Plan Participant	4,899	8,527
Expected Employer Share of Retiree Costs	301,484	388,447
Per Retiree/Spouse Plan Participant	4,434	4,454
Unfunded Actuarial Liability as a % of Payroll	N/A	284.20%
Average Annual Medical Plan Premium (Single Coverage)	7,993	N/A
Average Annual Medical Plan Premium (Family Coverage)	25,642	N/A
2018 Excise Tax Thresholds		
Annual Medical Plan Premium (Single Coverage)	10,200	
Annual Medical Plan Premium (Family Coverage)	27,500	

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One item to consider when looking at the design of your medical plans is the upcoming "Excise Tax" under the Affordable Care Act in 2018. Given your premiums through the 2015 fiscal year and the excise tax threshold, your single premiums are within 27.61% of the excise tax and your family premiums are within 7.25% of the excise tax. Once the excise tax is reached, the plan will owe a 40% tax on amounts that exceed the tax threshold.

Impact of Patient Protection and Affordable Care Act ("PPACA") Excise Tax

Under the Patient Protection and Affordable Care Act ("PPACA"), an excise tax will be imposed for tax years beginning after December 31, 2017 for high cost employer sponsored health coverage. The law specifies a 40% excise tax to be paid by the provider of such coverage of the excess value beyond a basic dollar amount plus an additional "kicker" for qualified retirees or those engaged in a high risk profession. The basic dollar amount for 2018 is $10,200 for single coverage and $27,500 for family coverage and the "kicker" amount for 2018 is $1,650 for single coverage and $3,450 for family coverage.

The excise tax liability will vary significantly over time as it is highly leveraged with the basic amount increased with general CPI and medical costs increasing with medical trend (generally higher).For purposes of the fiscal year ending June 30, 2014 , the APBO for the excise tax is $332,996 and the increase in annual OPEB Cost is $39,978. As more regulatory guidance becomes available, the calculation of the excise tax liability will evolve.

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Liabilities & Benefit Payments in today's dollars

With the growth of medical care costs over time, the nominal accrued liabilities ("APBO") and benefit payments can appear daunting. However, it is important to remember that a dollar paid in the future is worth less than a dollar paid today. As such, another way to view the projected liabilities and benefit payments is in 2014 dollars so you can compare them to your current budget and ability to pay. As part of our analysis, we have developed projections of plan liabilities & expenses over the next 40 years assuming that the Town's benefit eligible active population remains constant (i.e., employees who terminate or retire are replaced). While the full 40 year projection in 2014 dollars in shown in the report, below are some selected years:

Fiscal Year	Number of Retirees, Spouses & Surviving Spouses	Present Value of Total Accumulated Postretirement Benefit Obligation ("APBO")	Present Value of Employer Share of Premiums / Claims including "implicit cost"
2014	68	15,141,371	301,484
2019	92	15,057,677	390,551
2024	120	16,392,135	491,901
2029	149	17,416,451	577,204
2034	166	18,465,413	619,404
2039	177	19,219,352	701,317
2044	185	19,888,713	726,749

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Looking at these liabilities and expenses over the next 40 years, we would offer the following highlights/observations:

- ✓ The present value of the Plan's APBO will reach their maximum in 2053 at $21.2 million ($97.9 million in 2053 dollars)
- ✓ The present value of the Plan's benefit payment will reach a peak of $780 thousand in 2053 ($3.60 million in 2053 dollars)
- ✓ The Plan will see the number of retirees & beneficiaries receiving benefits increase from 68 to a maximum of 194 in 2053 before beginning to decline.

We have an "unfunded liability". How do we fund it? Can we fund it?

The Plan currently has an unfunded liability of approximately $15,011,173 and this amount is expected to grow over time in the foreseeable future. While some municipal entities across America have chosen to fund this liability, over 95% are not currently dedicating funding to it. In order for funds to be considered as "plan assets", they must be placed in an irrevocable trust for this purpose. The State of Massachusetts has recently passed legislation allowing municipal entities to establish a trust for Other Than Postemployment Benefits ("OPEB") under M.G.L. Chapter 32B, Section 20 for purposes of accumulating assets to pre-fund the liabilities under GASB 45. To the best of our knowledge, Town of Topsfield has established an irrevocable trust for the purposes of prefunding liabilities under GASB 45.

How do we solve the "problem"? What can be done?

While you are more limited than Corporate America due to various statutory restrictions, you do have some options available to you to manage plan liabilities and "pre-fund" the liability.

Section 18 – as the Plan is already integrated with Medicare, there is no ability to reduce costs via that route.

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Change in cost sharing – You are currently charging retirees 33%-40% of premiums for their contribution. Under Massachusetts law, the maximum allowable contribution rate is 50% so you have the ability to increase retiree premiums. Beyond that, changing the underlying plan design is currently your only other alternative.

Pre-Funding – if you were to elect to "pre-fund" the OPEB expenses each year by contributing the entire Annual Required Contribution, you would be allowed to use a long-term interest rate based on your underlying investment policy. Assuming a balanced portfolio (50% equities & 50% fixed-income), you could discount plan liabilities at approximately 7.00% vs. the 4.00% used in our analysis. The impact of such funding would be to reduce disclosed plan liabilities to $9,502,835 and the annual OPEB Cost to $843,740. This would require additional funding of $423,808 in the first year which will increase by 0.00% per year until the plan reaches full funding. While this does not impact the ultimate cost of the plan, it would reduce disclosed liabilities and expenses.

In the report we have outlined several options for pre-funding (including pay-as-you-go, funding over 30 years and funding the annual normal cost):

- Pay-as-you-go – pay annual retiree premiums as they come due with little to no funding set aside in a trust.
- 30 year funding – the concept is to contribute to achieve full funding over a 30 year period.
- Funding annual normal cost – the concept is to fund the excess of the normal cost over current year benefit payments. This approach prevents the liability from growing in current dollars.

Please be aware the options presented represent a sampling of your options. The ultimate choice to fund, not to fund or the level of funding will depend on your circumstances. Should you decide that pre-funding is an appropriate option for you we would be happy to help you design a funding schedule that best fits your needs.

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How does GASB 45 impact our bond ratings or ability to raise cash?

In the short run, GASB 45 is unlikely to have any material impact on bond ratings. While S&P, Moody's & Fitch have all stated that they will reflect these figures in their ratings, the comparative financials to other municipal entities will be similar as they will have all adopted GASB 45. Over time, the outliers (those with very modest or very severe GASB 45 liabilities) are likely to see some benefit or harm to their ratings or financing operations.

Healthcare Reform in the United States – how does this impact our plan?

As noted earlier, the ultimate cost of the Plan is the premiums and benefits paid from the Plan less the contributions paid by retirees and their dependents. While you can slightly change participant contributions, the true costs of the Plan are the underlying costs of benefits and premiums. As such, if healthcare reform is successful in addressing the underlying cost issue, your Plan will benefit.

If you or your auditors have questions on this, feel free to give us a call.

Sincerely,

Parker E. Elmore, A.S.A., E.A., M.A.A.A.
President & CEO