

POST EMPLOYMENT HEALTH CARE BENEFITS TASK FORCE

CITY OF DULUTH, MINNESOTA

FINAL  
REPORT

PRESENTED TO THE CITY COUNCIL AND ADMINISTRATION

DECEMBER 12, 2005

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EXECUTIVE SUMMARY

The Governmental Accounting Standards Board in its Statement #45 (GASB #45) has prescribed new accounting and financial reporting by employers for Post Employment Benefits other than Pensions (OPEB), effective with fiscal year 2007 for the City of Duluth. By far the largest impact of GASB #45 for the City will result from post employment health care plans which Duluth has in place for its present retirees, and which have been promised to its active employees upon their retirement. Generally, the City provides free health care insurance coverage to employees, their spouses and their dependents, after retirement, except for Medicare premiums which are paid by the retiree.

Costs to the City of providing this coverage have soared in recent years due to medical cost inflation, an aging population, the increasing ratio of retirees to active employees (more than one to one), and higher utilization of medical services, among other factors. Consequently, the liability accruing to the City has grown completely beyond what the City anticipated in earlier years, and has created a financial “black hole” that must be dealt with.

The City Council of Duluth appointed a special Task Force in August 2005 to study the problems associated with Post Employment Benefits other than Pensions (OPEB) and the implementation of GASB #45, to arrive at findings and recommendations based on this study, and to present these to the City Council and the Administration. This document prepared by the Task Force is in answer to the action of the City Council in August. In it, the Task Force lays out the problems in detail, and recommends a combination of actions that will reduce costs as much as feasible and fund the Annual Required Contribution (ARC) to an irrevocable Trust such that the Actuarial Accrued Liability (AAL) now existing will be amortized over thirty years, and the future annual medical claims against the Trust assets will be met.

By agreement between Task Force members, the cumulative dollar impact of the following recommendations MUST be sufficient to fully fund current and future costs, as defined in the last sentence of the paragraph above. The Task Force considered partial funding over the next 30 years (past practice has been to pay only current bills), but rejected that approach, feeling that it’s high time that post employment health care costs NOT be deferred, ignored or in other ways avoided. The pay-as-you-go model used for the past 22 years is defunct and needs to be replaced by the realism of recognizing (as required by GASB #45) and funding promises at the time liabilities are incurred.

The following pages of this Final Report represent the detailed findings and recommendations of the Task Force, for the Council’s and Administration’s consideration and action. A summary of recommendations is shown on pages 2 and 3. The Task Force wishes to thank all those who, through interviews, written suggestions, or in other ways, contributed to the completion of this report on a timely basis.

## SUMMARY OF RECOMMENDATIONS

More on Page

1. Establish through negotiations between City and active employees revised cost sharing for health care expenses/insurance, which lowers the City's share, and work towards offering a defined contribution plan 5 & 6
2. Modify the defined benefit health care plans provided to retirees to the same such plans in effect from time to time for active employees, to permit competitive bidding among providers of fully insured plans 7 & 8
3. Change all eligible post-64 retirees to a fully insured "cost product" as permitted by plan design, to immediately reduce Actuarial Accrued Liability (AAL) by up to \$65 million, or 23 % 8 & 9
4. If retirees refuse to accept Recommendations 2 and 3, the City should seek a Declaratory Judgment from the District Court to either confirm or reject its right to implement Recommendations 2 and 3 8, 24 - 26
5. Increase all utility rates (gas, water, sewer and storm sewer) to fully fund the Annual Required Contribution (ARC) attributable to utility operations, beginning not later than July 2006 or earlier if possible; amounting to a rate increase of 4 - 5% 9
6. Recover from Job Training Staff funding agencies the cost of health insurance premiums, which are currently being absorbed by the City 10
7. Reduce the cost of health care administration/stop loss by Blue Cross Blue Shield and the City, which does not appear to be competitive 12 & 13
8. Establish a drug importation program for actives and retirees, utilizing the models in existence, saving about 25% of City's prescription drug costs 13 & 14
9. Establish health care cost internal audit function in City Hall, and hire an experienced person or persons who should save the City multiples of their salary; also engage independent auditor to audit health care expenses annually 14
10. Set up an irrevocable Trust to receive all health care receipts, make all health care payments, and invest Trust fund balances; appoint Trustees to be responsible for all decisions required under the Trust Agreement 14 & 15
11. City Administration should be charged with responsibility to seek savings in health care costs, over and above or as alternatives to, those recommended in the Report, and report annually on its efforts to the Council and the taxpayers of Duluth 16

12. Use portion of annual income accruing to the Community Investment Trust to assist in funding Annual Required Contribution (ARC), beginning as soon as possible, but not later than January 2007 17
13. Increase Payment In Lieu Of Property Taxes (PILOT) by utilities to City, for the benefit of funding the Annual Required Contribution (ARC), starting no later than 2007 17 &18
14. Phase in an increase in the City’s portion of property taxes over a 4-year period, as the last piece in the funding puzzle 20
15. If the above Recommendations are not or cannot be implemented and if the recommended funding of the Annual Required Contribution (ARC) is not substantially implemented, then the City will likely face bankruptcy. Accordingly, the City should promptly retain counsel experienced in municipal reorganization to give it advice regarding this alternative and the steps the City needs to take now to protect its Citizens should bankruptcy happen in the future

## DISCUSSION, FINDINGS, AND RECOMMENDATIONS

### HOW WE GOT TO WHERE WE ARE

It would be difficult, if not impossible, to overstate the financial crisis looming for the City of Duluth. As of January 1, 2005, the City faces an unfunded Actuarial Accrued Liability (AAL) of \$279.9 million arising from vested post employment health care benefits for its retirees and current active employees. This amounts to about \$3,300 for every man, woman and child who is a citizen of the City. In addition, the City has the knowledge of another \$82 million as a future obligation attributable to future service by employees under current health care plans. And, these amounts are the present value, in today's dollars, of promises made by the City. The actual dollar costs to be incurred by citizens in future years will likely be several times these amounts; upwards of \$1 billion dollars. Also, it will likely be fiscal 2007 before many of the following recommendations can be implemented, which means that the \$279.9 million will increase before any corrective action can be taken. The 2005 Annual Required Contribution (ARC) relating to this Actuarial Accrued Liability (AAL) is \$26.0 million; the annual cost of amortizing the AAL over a 30 year period plus the "Normal Cost" of one additional year's entitlement for active employees. From this amount, the actual amount paid out for medical claims may be deducted, in the amount of \$6.8 million for 2005, leaving a Net Post Employment Benefits other than Pensions (Net OPEB) of \$19.2 million. This is the additional amount required to fully fund past and current promises for year 2005, were GASB #45 effective this year, and would be the Task Force's recommended amount to be irrevocably committed to a Trust. Although GASB #45 is not required to be implemented by the City until fiscal 2007, the Net OPEB for 2005 is an undeniable predictor for 2007 of what the number will be two years from now except that 2007 will be higher because little funding progress is expected for 2006.

This is an unsustainable burden on the City's taxpayers. The granting of free medical coverage for retirees beginning in 1983 has turned into a disaster for the City, totally unforeseen by those who entered into making that decision 22 years ago. At that time, Councilor Meg Bye spoke and voted against the enabling resolution, feeling that the City was trading in a given, known quantity (a bank where unused sick leave days were accumulated, converted to dollars, and used after retirement to pay medical insurance premiums), for an unknown quantity that would most likely have higher costs in the future. Councilor Bye's concerns notwithstanding, the resolution passed 7-2, driven by a desire to eliminate the unused sick leave bank so that the liability would not show up on the City's books under accounting rules in effect at that time. As we now know, that trade-off couldn't have been worse from the City's standpoint. We now have a \$279.9 million unfunded liability, still on the rise, to wrestle with and somehow solve. Even the City's harshest 1983 critics of the benefit trade-off agreed to at that time would almost certainly not have come close to guessing a number this exorbitantly high 22 years hence. The "problem" of booking unused sick leave was reportedly a dollar issue of a million or two in 1983, less than one percent of the current problem.

The unfunded liability's gigantic size has been principally driven in the past few years by the massive increase in medical costs coupled with longer life expectancy for retirees. As of January 1, 1998, the present value of retiree medical plans' obligations for current and future retirees was calculated by the actuaries to be \$34.2 million. While a large sum, if funding had begun at that time, the City would now have a sizeable trust fund in place and be on the road to beginning to solve the problem. Unfortunately, the City Administration and the Council did not address the issue at that time. Four years later, on January 1, 2002, the present value of these current and future obligations had risen to \$178.5 million, more than a five-fold increase. How can that be? The City's health care plan liabilities in the future are largely the result of the trend in medical costs coupled with longer life expectancy; the cost trend for medical services since 1998 even to this day has been double-digit, and retirees are clearly living longer. In 1998 medical cost inflation was, based on past history, predicted to rise by 5% annually, vastly underestimating the actual inflation that has occurred since then or the trend expected for the next several years. The Administration and Council became acutely aware of the problem over the past several years, but until very recently no concrete actions were taken. Now, three years later, as of January 1, 2005 the present value of the City's accrued liability obligation has grown by over \$100 million, to a gigantic \$279.9 million. It's enough to make Duluth citizens throw up their hands and give up (or move out of town!).

#### WHAT WE NEED FROM ACTIVE EMPLOYEES

But, giving up won't solve the problem. Somehow, long term solutions must be found that puts this huge financial gorilla into a cage. As a continuation of steps already taken in past negotiations, labor contract eligibility periods for entitlement to future benefits should be lengthened further and new cost saving measures should be introduced over time. Mayor Bergson and the Supervisory Union recently reached agreement such that new hires after the end of 2005 would not be eligible for present health care benefits upon their retirement. The impact of this agreement (now withdrawn) on the City's Actuarial Accrued Liability (AAL) and Annual Required Contribution (ARC) was/is unclear. However, it does not appear that the withdrawn agreement would have funded much of the share of ARC ascribed to supervisory employees; over time, additional steps would need to be taken.

The Task Force recommends serious negotiations by the City and its five Unions to deal with the skyrocketing liabilities under the current defined benefit health care plans, and implement actions that move towards a more affordable defined contribution plan. The Task Force acknowledges and believes that most health care benefit plans in the country are moving toward a defined contribution approach in place of the existing defined benefit concept. Under a defined contribution plan, the City would irrevocably fund each year on a formula basis that year's obligation, after which there would be no further obligation of the City for that year (and hence there would be no new unfunded liability for that year in future years). The dollars placed in Trust would earn returns to at least partially offset future inflation in medical costs.

The Unions have proposed in recent years several very substantial cost saving measures, including HMOs and fully insured post employment health care coverage. These proposals would restrict the insured's choices in the future. As examples of how the City and Unions might proceed, the City could fund a percentage of an employee's salary. Or, a health savings account such as an HRA, HSA or similar financing vehicle might be workable, funded in a similar fashion. In any case, pre-tax employee dollars might be part of the overall funding. Another possible approach is the crediting of unused sick leave days for use after retirement to pay medical premiums (similar to the City plan pre-1983). Or, a cafeteria plan encompassing several approaches might be used. Funds from these sources would be used to pay post employment health care costs for retirees until the fund balance for that employee was exhausted. This would be a plan similar to those now existing at St. Louis County and ISD 709. These examples are just that, examples, and should not be construed as recommended bargaining proposals. The Task Force's role is to provide an overall set of solutions, and leave specific bargaining to the responsible parties. It does not intend to advantage or disadvantage any particular party at the table.

The Task Force believes longer term solutions are achievable if good faith exists among all parties to be a part of the solution. The Task Force further believes that a net reduction for active employees in the Actuarial Accrued Liability (AAL) and the Annual Required Contribution (ARC) of at least \$29 million and \$2.7 million, respectively, is achievable with a well thought-out plan for post employment health care coverage. These figures are based on the assumption that, after all negotiations are concluded, 20% of the AAL and ARC relating to active employees can be eliminated or shifted from the City's responsibility, leaving 80% to be borne by the City. This percentage is generally consistent with cost sharing between the insured and the insurer in many sectors today, and would not place the City at a disadvantage when competing with other entities and their treatment of existing employees.

The increasing liabilities from existing defined benefit plans can be put in check by limiting existing plans to current retirees and older active employees, negotiating cost savings with all active employees, offering more cost effective coverage for new hires, and working cooperatively to phase in a defined contribution plan over a period of several years.

#### IS FREE MEDICAL FOR LIFE SUSTAINABLE?

The provision of free medical coverage for life to retirees, their spouses, as well as any dependents, is simply not sustainable in its present form by the City. While agreements were no doubt made in good faith by all parties, until recently no one foresaw the edge of the financial cliff which the City was approaching. Actual future circumstances were not dreamed of by anyone, so it can be said that there was not a meeting of the minds by those negotiating: they were all working with vastly erroneous assumptions. City workers and retirees cannot and do not live in a vacuum, but rather in the real world.

With corporate bankruptcies all around, and with others threatened, these employees and retirees must realize that the good old days of free medical cannot be sustained currently.

In the most recent example of reality setting in, the employees and retirees of General Motors, who have had health care benefits available to them at little or no cost, have seen the handwriting on the wall. They have made concessions which all hope will help GM stave off bankruptcy, not a sure thing by any means.

For those firms in bankruptcy, like Northwest Airlines, the economic future for their workers and retirees is highly uncertain. Without doubt, any health care cost coverage that is made available free or at very low cost to workers and retirees will not survive the bankruptcy court without substantial changes which will require employees to pay a much larger part of the overall cost, if in fact medical coverage is offered at all after retirement.

No one wants the City to go into bankruptcy, but that is a real possibility unless long term solutions are found. And if that were to happen, all bets would be off as to who gets what. The Task Force strongly encourages and recommends that workers and retirees join in the effort to bring about a long term solution, in their own self-interest as well as in the interest of the Duluth citizenry.

#### WHAT ABOUT THE COUNTY AND THE SCHOOL DISTRICT?

Not all governmental units in this area face the City's dilemma, at least not to the same degree. St. Louis County, in its published financial statements as of June 30, 2005, claims to have funded 100% of its responsibility for current retirees' current and future health care premiums, and 5/9 of the County's obligation which will ultimately be required after retirement for current active employees. It also states that this portion will be fully funded in another four years. The County utilizes an unused sick leave bank approach to providing health care benefits to retirees, similar to that used by the City prior to 1983, plus a years-of-service credit. Under this approach, when the unused sick leave and years-of-service credits run out, individual retirees pay 100 percent of their medical insurance premiums. The Duluth School District also uses a similar approach, and is reported to have a minor unfunded liability problem when compared to that of the City. Some Mesabi Iron Range municipalities and schools are believed to have a problem similar to that of Duluth, in proportion to their population. But, on the local scene, whether through good luck or good planning, it appears that both the County and the School District will not suffer severe hardship because of health care promises to actives and retirees. Bringing that status to the City over the longer term is the mission of the Task Force, as was assigned to it by the City Council.

#### WHAT'S NEEDED FROM RETIREES

If City retirees were to agree to modifications in health care plans that would reduce the City's costs by 20%, the same reduction as the Task Force has recommended for active employees, the unfunded Actuarial Accrued Liability (AAL) obligation of the City would decline by an additional \$27 million, leaving \$223.9 million as the City's net responsibility after recognizing the liability borne by active employees and retirees. The Annual Required Contribution (ARC) for the City would go down to \$20.8 million and

the Net Post Employment Benefits other than Pensions (Net OPEB) would be reduced to \$15.4 million. The funding of this Net OPEB amount needs to be solved by the City through a combination of cost savings, revenue enhancements and tax increases. If the employees and retirees agree to their share of cost reductions for the City (totaling \$3.0 million of Net OPEB, as shown in the table on page 21), then they and the City, working together, will have provided impetus for a total solution.

Unless retirees agree to voluntarily help solve the problem with substantial cost reductions for the City, the Task Force recommends that the City seek a Declaratory Judgment from the District Court which seeks to determine whether it has the right to provide health care coverage for retirees under the same health care plan or plans as are currently in effect for active employees, or whether instead it is required to provide such coverage under the plan or plans in effect at the time of their individual retirement. Note: the City's plan or plans are supplemental to Medicare, and would result in retirees receiving the same benefits from the combination of the City plan or plans and Medicare, as they would have received were they still active employees. The issues involved in seeking a Declaratory Judgment are discussed further in the Section DECLARATORY JUDGMENT which follows later in this Final Report.

#### WHY HASN'T THE CITY USED A FULLY INSURED PLAN FOR RETIREES?

The Task Force met with both Blue Cross Blue Shield and Medica, in trying to understand the health care situation and where the City should go in the future. Medica has proposed a fully insured product for those retirees 65 and above (eligible for Medicare), which would replace the current self insured plan administered by BCBS. The fully insured approach would use a community-based health risk rating, as opposed to a risk assessment using only the City's retiree base. This is believed to be favorable to the City and would help spread some of the costs over a larger base, including the cost of administration. The fully insured approach also introduces federal subsidies into the equation of who pays what, thus lowering the City's cost. Recent trending of premiums charged by Medica appears very favorable when compared to the current City's self-insured approach to insuring the health care costs for retirees. While there are no guarantees with respect to future cost trends for the fully insured product, Medica has provided what its actuary believes to be the savings available through their product. The Task Force is aware that several other insurance carriers would likely have interest in bidding on a post-64 retiree plan or plans. The City's actuary, Van Iwaarden, has addressed this issue, and using some of the basic data supplied by Medica, has computed that cost savings to the City result in an overall present value of \$64.8 million with the fully insured plan. This would be the gross beneficial effect upon the Accrued Actuarial Liability (AAL), a 23% reduction! The net effect would be a reduction in the City's AAL of \$52 million, after adjustment to credit employee and retiree assigned responsibility for AAL, in the amount of \$13.0 million. After giving effect to employee and retiree sharing of AAL costs and the net effect of a fully insured plan for retiree health care costs, the City's net AAL is reduced to \$172.1 million, from \$223.9 million.

In order for competitive bidding to be effective for a fully insured plan for Medicare-eligible retirees, the number of plans offered must be brought down. Medica, for one,

cannot or will not bid on a multiplicity of plans. It is believed that other potential providers would reach the same conclusion. Therefore, the number of plans available for retirees must be drastically reduced. As discussed above, the Task Force recommends that all eligible post-64 retirees be placed on health care plans currently in effect for active employees. This is a critically important step to be taken by the City to take advantage of savings available under fully insured plans which can be competitively bid. Again, the Task Force strongly recommends the City seek if necessary the Declaratory Judgment outlined above, as well as later in this Report, to determine its contractual rights and obligations, in order to obtain such savings. The City cannot afford to be passive on this issue and allow tens of millions of dollars of savings available through competitive bidding to go unclaimed. Absolutely all necessary steps must be taken to make such bidding a reality.

Incidentally, the Duluth School District ISD 709 recently switched to a fully insured approach for post-64 retirees, which is expected to produce large savings for the District. The City clearly needs to follow their lead in the interest of taxpayers.

In following sections of this report, it is assumed that the savings from the above described competitive bidding process are fully realized, inasmuch as those savings affect dollars of AAL, ARC and Net OPEB assigned to various functions. The tables on pages 21 and 22 show such assignment, with and without competitive bidding, which illustrates the critical impact of such bidding on costs to be borne by taxpayers.

#### ENTERPRISE FUND RESPONSIBILITY

The City operates four Enterprise activities which fall under the general heading of utilities (gas, water, sewer and storm sewer). GASB #45 financial and accounting standards are applicable to the Enterprise activities, and rates should be set to recover current Normal Costs of health care plans relating to Enterprise employees, plus the amortization of the Enterprise Accrued Actuarial Liability (AAL) over 30 years.. The Annual Required Contribution (ARC) for the Enterprise Funds to fund current costs and amortize past costs, would be about \$4.0 million annually, which would amortize the \$43 million of AAL assigned to the Enterprises over 30 years and provide for recovery of annual Normal Costs for Enterprise active employees. The Net Post Employment Benefits other than Pensions (Net OPEB) for the Enterprise activities is estimated at \$3.0 million. Assigning responsibility for these costs to the utilities would require an increase of 4-5% in rates for the various utilities within the Enterprise family. The Task Force recommends that utility rates be increased by 4-5% as soon as possible and these funds be irrevocably committed to a Trust fund, in order to begin the funding process. The Task Force is well aware that natural gas prices have risen substantially over the past few months, and that this increase would further increase the cost burden on customers. Nevertheless, if the problem is to be solved, all utility customers need to participate, just as the Task Force expects the City's actives and retirees to participate in bringing about a solution. If Enterprise activities are not charged with cost recovery for Net OPEB relating to their activities, then others will need to bear more than their fair share, which is not a defensible situation.

## INDEPENDENT AGENCY RESPONSIBILITY

Three agencies have employees who are covered by the City's health care plans, for both active and retired employees, namely the DECC, the Airport Authority and the HRA. The Task Force was concerned that some of the cost of such plans relative to these agencies might not be fully billed by the City to such Agencies. The City Administration states that all such health care plan costs for both active and retired employees of these agencies, are billed in accordance with rates as established by Blue Cross/Blue Shield and approved by the Insurance Committee of the City. While the Task Force encourages the City Administration to continue to review this matter to be sure there are no subtle subsidies running from the City to one or more of the Agencies, it is the Task Force's conclusion that the Agencies are not vehicles for recovery by the City of health care costs over and above those presently being collected. Hence, extension of health care plans to employees and retirees of these agencies has no impact upon the Accrued Actuarial Liability (AAL) and Annual Required Contribution (ARC) as established by the actuary. The Task Force has not determined if any or all of these agencies have unfunded liabilities for health care plans, and suggests that the governing bodies and administrators of the agencies promptly determine whether unfunded liabilities exist, and if so, the size of those liabilities. Based on preliminary information the Task Force has received, it seems quite certain that at least some of the agencies have unfunded liabilities, and do/may not know the extent of these liabilities. The Task Force believes the agencies are subject to GASB #45 for financial reporting and accounting purposes.

## SUBSIDY FOR JOB TRAINING STAFF

The Task Force understands that the direct salary costs of certain training staff are funded by St. Louis County and other non-City sources. However, the overhead costs for such employees, including health care costs, are borne by the City, without recovery from the sources bearing the direct salary costs. There are currently about 30 City workers engaged in Job Training activities, and it is assumed that there are existing retirees related to Job Training, in the same proportion that exists in the general City active and retiree population. It is thus inferred that an Accrued Actuarial Liability (AAL) responsibility of \$4.0 million and an Annual Required Contribution (ARC) of \$0.4 million is the magnitude of the City support for job training staff whose base salaries are paid by others. The Task Force recommends that the City seek recovery of these costs from the County and the other funding agencies and entities.

## COSTS ASSIGNED TO GENERAL FUND ACTIVITIES

If the recommendations outlined above are followed and adopted, the unfunded liability is reduced to \$125.1 million, which in one way or another, will need to be funded through the General Fund by a combination of cost reductions and new dollars from funding sources. The Annual Required Contribution (ARC) associated with this liability is \$11.6 million, and the Net Post Employment Benefits other than Pension (Net OPEB) relating to General Fund activities is \$8.4 million (see table on page 21). This amount should be handled through cost reductions other than through employee and retiree participation in finding solutions, and through additional funding sources.

## LET'S DISCUSS BRIEFLY THE ACTUARIAL REPORT

It is not the purpose of the Task Force to discuss in detail the actuarial study which has identified current estimates of the Actuarial Accrued Liability (AAL), Annual Required Contribution (ARC) and Net Post Employment Benefits other than Pension (Net OPEB) faced by the City. The actuary, Van Iwaarden Associates, has made the calculations in accordance with standards in the actuarial field. GASB #45 requires that an actuarial update be prepared every two years, and the liabilities and contributions shown in the above paragraphs will undoubtedly change over time. In the near term they will undoubtedly increase, prior to the time funding is put in place. Even after funding takes place, the AAL, ARC and Net OPEB will be revised every two years to reflect the then current new set of assumptions and calculations. The Task Force believes, however, that the City is not likely to face another order of magnitude change in the future as happened in the period 1998-2005 (assuming funding is not delayed), and that if cost reduction and funding plans can be put in place over the next year for amortizing the AAL over 30 years and funding the ARC annually starting primarily in 2006 and 2007, future changes will be more of the fine tuning variety as opposed to wholesale changes. But, if such plans are not put in place, AAL, ARC and Net OPEB will inevitably grow to even more monstrous proportions.

### WHY NOT JUST DO NOTHING?

Some might question what happens if nothing is done. In short, the Accrued Actuarial Liability (AAL), Annual Required Contribution (ARC) and Net Post Employment Benefits other than Pensions (Net OPEB) keep growing until the huge numbers would force the City into bankruptcy. The Task Force most strongly and vehemently states that continuing to do nothing is irresponsible and cannot be condoned.

Some might also wonder if the prescribed accounting treatments of GASB #45 need to be followed by the City. While the Task Force members are not CPAs, we believe that the State of Minnesota Auditor would not accept financial statements of the City which are not in accord with GASB pronouncements. Nor do we believe that buyers of the City's bonds in the future would accept anything other than compliance with accounting and financial reporting requirements prescribed by GASB. Therefore, there is really no realistic option or alternative in that regard, except to comply with GASB #45 as well as its other Statements that apply to governmental units like the City.

### WHAT WILL THE BOND RATING AGENCIES DO?

The City has recently had its bond ratings upgraded by Moody's and Standard & Poor's from A1 and A+, to Aa3 and AA-, respectively. Everything within reason should be done to hold onto these ratings. A solid bond rating is important for future borrowing costs and the marketability of the City's bonds in the market place. For example, the City has \$20-30 million in bonding planned for 2006, for both refinancing existing debt and for new dollars. The City's ratings at the current level are supported in no small part by the balance in the Community Investment Trust (Casino revenues to the City), which

tends to be viewed by the rating agencies as an offset to some of the negatives of the City, like slow growth, low property tax base, etc. The impact of GASB #45 has not yet been shown on the books of the City, and although the rating agencies are aware in general of the unfunded accrued liability (and probably of the Net Post Employment Benefits other than Pensions (Net OPEB)) relating to retiree health care benefits, when these numbers are shown on the books for the first time for fiscal 2007, it is only reasonable to expect that their concerns will be heightened. It is therefore critically important that the Community Investment Trust be maintained at or increased from its current level, except for any annual revenues from the Casino dedicated to funding the Net OPEB and reducing the Actuarial Accrued Liability (AAL). The Task Force believes such action by the City would be viewed positively by the rating agencies.

#### WHAT CAN BE DONE TO REDUCE COSTS?

The Task Force now wishes to discuss and deal with the Net Post Employment Benefits other than Pensions (Net OPEB) unfunded balance of \$8.4 million (see table on page 21), to be addressed through impacts on the City's General Fund, a combination of cost reductions and additional revenue. Let's look at cost reduction first.

#### LET'S START WITH COSTS OF ADMINISTRATION

First, the Task Force believes that administrative costs, both in house as well as those passed through to the City by Blue Cross Blue Shield, can and should be reduced. One step needed to assist in that regard, is to minimize the number of plans in existence. There are 90 groups out there, who receive service under 4 primary plans for actives and 7 primary plans for retirees. As explained earlier in this Report, this number of plans has made competitive bidding virtually impossible for post-64 retirees' health care insurance. In addition, the Task Force believes the multiplicity of plans and groups has resulted in a lack of oversight in administration of plans and groups. There are simply too many plans and groups in existence to effectively administer.

Steps need to be taken now to reduce the number of plans (and groups, to the extent that their existence increases administrative costs), including the possibility of offering slight inducements to participants in order to gain their acceptance.

The Task Force believes that the number of plans can be reduced to two plans in the near future, and longer term, to one plan. This comment applies to both active employee plans and to retiree plans. This is essential for cutting into the \$1.5 million or so of administrative/stop loss costs being reimbursed by the City to the Blues and being incurred in-house by the City in its HR Department. The Task Force believes that, as a goal, approximately \$500,000 annually can be cut through this approach. Competitive bidding may be required to reduce the external costs now being paid to the Blues. It is reported that St. Louis County is paying about \$750,000 to the same external provider for administrative services, compared to the \$1.3 million the City pays to the Blues, including stop loss. This may be somewhat of an apples and oranges comparison because there are differences in stop loss coverage, and the Task Force is not in a position to

address the broad question of City vs. County comparisons in detail. However, it's hard to imagine that the County, with twice as many employees as the City, should be able to get by for much less than the cost to the City for administration of medical plans.

Over the past years, the Unions have made several constructive suggestions for health care cost containment, many of which are included in whole or in part as recommendations for adoption by the Task Force in this report. It appears that little has been done by the City to respond to or implement these suggestions, which has discouraged cooperation by actives and retirees. The Task Force is very hopeful that, in the future, worthwhile suggestions by the Unions are acted upon and implemented. Their cooperation and support is critically important to the issues addressed in this Report.

The Task Force has heard many horror stories from employees and retirees concerning what they viewed as poor practice by the City with respect to medical plans. These stories involved such topics as dead people being on the medical insurance rolls (such as spouses of retirees), employees with two spouses (the current spouse AND a former spouse) covered under the plans, Medicare not being the primary insurer for those 65 or over, but rather that the Blues are the primary insurer in some cases, annual deductibles not being collected by the City when they are owed by actives and retirees, lack of diligence in pursuing cost containment such as not auditing payments to medical providers, lack of diligence in pursuing disability treatment from Medicare for certain employees and, instead, paying those costs out of the City coffers, and many other such claims. While the Task Force takes some comments skeptically, a number of them ring true due to being repeated and backed up with what seems to be credible information.

The Task Force believes that the previous and current Administrative Assistants, Mr. Winson and Dr. Almanza, were and are aware of some or all of these issues, and they did indicate to the Task Force their intention of resolving them. It is with this belief that the Task Force assumes savings of \$500,000 as a proxy for the actual savings Dr. Almanza, Mr. Meier and the HR Department will arrive at after the issues have been effectively addressed.

#### IMPORTATION OF PRESCRIPTION DRUGS SHOULD BEGIN

Everyone who lives on planet earth knows of the huge cost of prescription drugs, which continues to escalate in spite of efforts at cost containment. Drug importation is seen by the Task Force as an additional means of cost savings. The City of Springfield, MA has been engaged in such a program for several years, reportedly saving that City many millions of dollars. Governor Pawlenty, Congressman Gutknecht, and MN Attorney General Hatch have also been promoting the idea within the State of Minnesota. The Minnesota Citizens Federation NE (formerly the Senior Federation of NE MN) met with the Task Force and made a presentation on means of obtaining savings through drug importation.

While the Task Force is not able to work out the details of such a plan in the time it was

allotted, it is believed that substantial savings from such a plan are available and achievable. The challenge will be in how to encourage retirees and actives of the City to participate in such a program when offered. Perhaps the waiving of co-pays or other financial inducements will be necessary in order to provide the size of financial incentives needed to encourage participation, which would still result in substantial savings for the City. The Task Force assumes that savings of \$800,000 annually can be achieved, and probably more, through an effective program of drug importation, and strongly recommends that the City look to the Springfield, MA model as well as models for Minnesota which the Minnesota Citizens Federation NE has researched, in arriving at a program.

It is also recommended that the City work with local pharmacists in inviting them to come up with a program that will approach or equal the savings to be gained by importation. Buying local should always be considered, assuming costs are approximately equal as between the local providers and those external to the City.

#### THE CITY NEEDS A MEDICAL COST INTERNAL AUDITOR

The Task Force also believes that a staff person or persons with ability and experience should be employed by the City, whose job it is to make sure that, within the medical insurance arena, all rules are followed, deductibles and co-pays are collected, medical bills are reviewed (and also reviewed by the recipient of the service or procedure) for accuracy to prevent overcharging, and the like. In addition, this person would perform operational audits, defined as seeking ways to improve the efficiency of health care plan internal operations within City Hall. The Task Force has the distinct and uncomfortable feeling, after listening to some of those interviewed, that administration has not been handled as well as it should be, and that such a staff person or persons would produce a multiple of their salary cost in savings for the City.

It appears obvious to the Task Force that, over past years, the ball has been dropped by City Administrations. For example, enhancements have been passed through to retirees (such as increasing lifetime caps, etc.), while increased costs that were passed through to actives (such as higher drug co-pays) have not been passed through to retirees. Whether or not an internal auditor would or could deal with this practice, which is so completely adverse to the City's financial interest, may be open to question. But, certainly SOMEONE in City Hall should have had the intestinal fortitude to say "Wait a minute, this is wrong!" A worth while internal audit function would be apt to address such situations.

The Task Force also recommends that an independent audit be performed annually by a fully qualified medical expense auditing firm, to assure compliance with medical plan rules and regulations, and to assure that the City is not paying unnecessarily for items which are duplicative, excessive, the responsibility of others, and the like. The Task Force believes that this step, coupled with establishing the medical internal audit function described in the previous paragraph, will greatly improve medical plan cost effectiveness.

## AN IRREVOCABLE TRUST FUND NEEDS TO BE FORMALLY ESTABLISHED

While GASB #45 does not require that funds committed to fund Annual Required Contribution (ARC) be irrevocably placed in a Trust which can only be used to pay health care claims, the Task Force cannot imagine the City or its employees and retirees not wanting to do so. In fact, we believe that employees and retirees, as well as the citizens and taxpayers, will insist upon setting up such a Trust. Otherwise, future decision makers may raid the dollars set aside for retiree health care benefits. No such opportunity or temptation should be offered or made available to those decision makers.

Retirees, in particular, should insist that promises for post employment health care coverage “from here on out” be irrevocably funded in exchange for concessions granted and agreements made in good faith. It should also be noted that, from a financial reporting standpoint, GASB does not allow recognition of funding simply by “earmarking” or in other non-firm ways identifying the source of funding for Net Post Employment other than Benefits (Net OPEB). In order to obtain recognition of funding for financial reporting purposes, funds must be irrevocably committed.

The Task Force envisions a Trust with a board of trustees who operate and control the Trust for its intended purpose. Although the Trust will start with small dollars, over time these dollars will build up as funding occurs each year which is in excess of that year’s medical claims (which the Task Force is confident will be each and every year if the recommendations herein are implemented). At some future time not too far off, the Task Force believes the Trustees will engage professional investment guidance to assist with such matters as asset allocation, types and amounts to be invested in various financial vehicles, and other duties normally performed by trustees for institutions such as foundations. Perhaps the Trust will be able to operate as a branch of PERA, thus utilizing the PERA model for investment decision making as well as mirroring PERA actual investments. The Task Force recognizes that legislation by the Minnesota Legislature may be needed to allow the City to utilize investment strategies similar to those used by PERA, or to engage PERA to handle the City’s Trust funds. It is believed that such an approach would be highly cost effective, as PERA currently operates with low costs as compared to private investment managers. PERA also invests in a balanced manner and uses an asset allocation process to decide where funds should be invested. For example, it might use an asset allocation of 50% equities, 40% fixed income, and 10% cash. This approach would lend itself to achieving an overall annual return in the 7-8% range as an average over a period of years. By contrast, the City is currently very limited in its choice of investment alternatives, being primarily limited to government fixed income obligations or cash, which are currently yielding an overall return in the vicinity of 4%. It does not require a lot of imagination to realize that the higher potential return with PERA would be to the substantial advantage of the City and the parties at interest with respect to funding the Actuarial Accrued Liability (AAL) and Net Post Employment Benefits other than Pensions (Net OPEB).

The Task Force believes in rigorous and complete assumption of duties by the trustees in accord with a formal Trust document to be written, and annual reporting by such trustees

to the City, employees of the City and its retirees, and taxpayers. The trustees should be fully independent to pursue duties assigned to them by the Trust Agreement without any undue influence which might be attempted by interested parties.

#### OTHER COST SAVING POSSIBILITIES?

The City Administration and dedicated union employees are in the best position to seek other cost savings which only they can uncover due to intimate familiarity with City operations. To facilitate this process, the City must open up the flow of information between itself, the insurance carriers, and the public. Given the still very large Actuarial Accrued Liability (AAL), Annual Required Contribution (ARC), and Net Post Employment Benefits other than Pensions (Net OPEB), even after the reductions in these numbers as shown above, the Task Force and the citizens and taxpayers of Duluth will have to rely on the Administration with the oversight and assistance of the City Council to make further reductions whenever and wherever possible. The Task Force recommends that the City Administration report annually to the Council and the taxpayers of Duluth on the results of its efforts to uncover additional or alternate cost reductions and savings.

The next paragraphs of this report will deal with raising more dollars, where every effort must be made to avoid placing an undue burden on the taxpayers. Hence, it becomes the duty of the City's decision makers to replace as many dollars on the revenue raising side as possible with dollars saved on the cost side of the equation.

#### WOULD ASSET SALES BE PRODUCTIVE?

The Task Force reviewed briefly the possibility of selling City assets to help fund the Actuarial Accrued Liability (AAL). A list of City owned assets was made available from the Administration, not including the Enterprise Funds assets. After reviewing this list and discussing it with the Administrative Assistant at the time, Mr. Winson, the Task Force concluded that there are apparently few assets that can be spared and none that would raise significant dollars if sold. Much of the City's assets are tied up in parks and other public land, street and highway rights-of-way, parking ramps, etc. On the surface, it seems very unlikely that more than one or two million dollars could be raised to fund the AAL. While the Task Force encourages the Administration to sell any property no longer needed, and if possible devote the funds raised to the Trust to be established to fund retiree health care costs, it has not assumed any dollars to be available as a result of such sale.

#### SHOULD THE GAS UTILITY BE SOLD?

One, or possibly two, of the Enterprise Funds utilities would have significant market value (gas utility and water utility). The utility with the most value would be the gas utility, which would very likely set off spirited bidding if offered for sale. No effort was made to evaluate the cash flow that might be available to the City, after retirement of associated utility bonds, selling expense, and the like, but it would likely be in the tens of millions of dollars. So, why not sell the gas utility? The gas utility is a going concern for

the City, an enterprise that will continue to be of increasing value to the City with the passage of time. It's a going concern in the business sense. To use an old metaphor, selling it would be to consume the seed, rather than just the crop the seed produces. Aside from the questionable proposition of selling an earning asset, it seems doubtful to the Task Force that the citizens of Duluth, to say nothing of the Council or the Mayor, would have interest in selling the gas utility. Several years ago the idea of selling the gas utility to Minnesota Power was suggested. In spite of MP's strong reputation for low rates and good service, a substantial public outcry in opposition was heard. If the Task Force is wrong and there is such an appetite to sell, then the Task Force would suggest the engagement of investment banking professionals and legal counsel to advise the City on such a sale, in order that maximum cash benefits may be obtained for the benefit of reducing the Actuarial Accrued Liability (AAL) and funding the Annual Required Contribution (ARC).

#### SHOULD THE FOND-DU-LUTH REVENUES BE TAPPED?

The Community Investment Trust has a budgeted balance at the end of 2005 of \$53.2 million, compared to a beginning balance for the year of \$49.0 million. Budgeted revenues for 2005 are \$7.8 million and budgeted expenditures are \$3.6 million, for a net increase in the budgeted balance over the one year period of \$4.2 million. The Task Force has discussed earlier herein the importance of maintaining and increasing the balance in the Trust, in order to keep the City's current bond ratings secure. The Task Force knows that there are many temptations regarding spending of the Trust's dollars, for many worthwhile purposes. And there have been several approved uses of funds for projects other than street improvements, such as for the Kroc Center. Nevertheless, the Task Force encourages the City in the future to use current revenues, to the extent they are not already committed, or dedicated to street improvements, or to build up the Trust balance, to help fund the Net Post Employment Benefits other than Pensions (Net OPEB) and reduce the Actuarial Accrued Liability (AAL). The Task Force has assumed that the City agrees with this priority, and that dedicating \$2 million per year to funding the Net OPEB would be of utmost priority. The tables included at the end of this narrative include this \$2 million funding source.

#### UTILITY PAYMENTS IN LIEU OF PROPERTY TAXES

The City collects fees annually from its gas utility to the tune of 7% of revenues as Payments In Lieu Of Taxes (PILOT). This amount is to make up for what would be collected, primarily property taxes, if these utilities were owned in the private sector. The amount collected in 2005 from the gas PILOT is \$3.2 million, and thus for every 1% increase in the fee, the City could receive an additional \$0.45 million annually. The water utility does not pay a PILOT currently nor do the sewer utilities. The steam cooperative also pays a PILOT of 2% of revenues, which amounts to about \$80,000 for 2005, or \$40,000 per percent of PILOT.

The Task Force has reviewed a gas, water and sewer billing comparison for utility rates

in Superior and Cloquet, as compared to those in Duluth. The Task Force believes that a 1% increase should be made effective for the gas PILOT, moving it from 7% to a new rate of 8% (produces \$450,000 annually). Further, the steam cooperative PILOT should also be increased by 6%, to an overall rate of 8% (same as gas utility). This produces \$240,000 additionally for the City. Finally, the Task Force recommends that a PILOT be approved for both water and sewer utilities (but not including the storm water fund), at a rate of 8% (same as for the gas utility), which produces about \$2.0 million annually. The billing comparison, included in the Appendices, indicates that these increases are not excessive and will not make rates uncompetitive. This action would produce in total an additional \$2.7 million to apply against the Net Post Employment Benefits other than Pension (Net OPEB) balance to be funded. As in the case of the prior discussion in this Report of the Enterprise Funds paying their fair share of the Net OPEB, the payment of the PILOT protects those citizens and taxpayers of the City who do not enjoy these utilities from being forced to subsidize them.

#### ARE UTILITY RATES WHERE THEY SHOULD BE?

As mentioned above, the Task Force has looked into the level of gas, water and sanitary sewer utility rates when compared to those in surrounding communities. Previous recommendation #5 for funding the utilities' Annual Required Contribution (ARC) through rates has been taken into account. Although the 1% increase outlined above for gas customers, coupled with the 4-5% increase resulting from Recommendation #5 and the rapid increase in purchased natural gas, would amount to a very sizeable overall billing increase, it should be remembered that gas rates are going up in competing surrounding communities as well. The steam utility customers should be able to absorb the 6% increase, while noting that the source of their heat (coal) is escalating much less rapidly than if they were burning natural gas in their boilers. Water and sanitary sewer rates are fully competitive and can absorb the 8% PILOT increase along with the 4-5% increase in Recommendation #5, which amounts to a total increase of about \$4.00 per month for the average City residential water and sewer customer.

The Task Force firmly believes the PILOT increases are reasonable and will help to forestall placing an undue burden upon the local property tax base.

#### MAYBE WE SHOULD ASK THE MN LEGISLATURE FOR HELP!

If at all possible, the City should fully fund the Annual Required Contribution (ARC), or even over fund ARC if possible, in order to get its financial house in order as soon as reasonably possible. The only two known remaining sources to accomplish this are the Minnesota Legislature and local taxation (and it should be remembered that any "slippage" with respect to previously outlined solutions to the problem will fall to the local tax bottom line – the solutions outlined in the remainder of this report). As to the Minnesota Legislature, it is believed that, although Minneapolis and St. Paul do not have as significant a level of Actuarial Accrued Liability (AAL) relating to post retirement medical costs as does Duluth, proportional to their size, the Minneapolis school district

reportedly has a huge unfunded pension liability, which it may attempt to solve through the Minnesota Legislature. The Task Force is unable to assess the prospects for success by the Minneapolis School District for getting money from the State, but Duluth should remain aware of what's happening with the Minneapolis request, if it materializes, and be prepared to seek similar help for its AAL relating to retiree health care costs. Such funding may not be available, especially if most other municipalities, school districts and counties, do not have the problem to the same degree. But, stranger things have happened and the City should be prepared to move if the opportunity arises. No revenues from the State have been assumed for purposes of the Task Forces mission.

#### SHOULD THE CITY BOND TO FUND THE AAL AND ARC?

The Task Force believes the answer to that question is "No". Some of the potential benefits of bonding would be to take advantage of current low interest rates, which would be lower than the 4.5% rate used by the actuary and would produce a modest net benefit gain for the City. Partial funding of the Actuarial Accrued Liability (AAL) and pre-funding the Net Post Employment Benefits other than Pensions (Net OPEB) for several years would quickly create a sizeable Trust which could be managed professionally (as detailed earlier) and probably yield higher investment returns than the cost of funds borrowed and the 4.5% discount rate. Another advantage might be that, if level debt amortization were used for a bond issue or issues, it would in effect be a forced method of funding, since the City would in all likelihood pay its principal and interest payments to the bondholders on a timely basis.

On the other hand, it's unclear that the City could issue enough bonds to fund a major portion of AAL without interfering with its bonding plans for other projects now on the drawing boards. It is also unclear as to what authority would permit such bonding, and the nature of the bonds (general obligation or some other form of bond) to be issued. And, of course, the sources of bond payments would still fall back on most if not all of the sources outlined above. Finally, depending upon the amortization schedule of such bonds, issuance of bonds for partial AAL funding and pre-funding of the Net OPEB would again defer to future citizens at least a portion of costs that should be paid by today's citizens; putting off until tomorrow what should be taken care of today. There has already been too much deferred funding (actually, lack of funding), without adding to the current balance of obligations.

Therefore, the Task Force does not recommend bonding to partially fund AAL, and pre-fund the Net OPEB for several years. If City leaders nevertheless choose to follow such a path, then the impact on bond ratings and other City projects should be carefully studied before such decision is finalized.

#### SHOULD SALES TAXES BE INCREASED?

The Task Force believes that raising sales taxes to solve the problems outlined in this Final Report would not be feasible. First of all, the Minnesota Legislature would need to pass enabling legislation for that to be possible, which they would be unlikely to do

because the City already has an overall sales tax higher than in most other communities in the state. Secondly, the DECC Board and the City are anticipating asking for an increase in sales taxes in order to help fund the new hockey arena envisioned as part of an enhanced facility at the DECC. It would seem counter productive to jeopardize the DECC's chances of success by recommending what would be, in effect, a competing proposal by the Task Force. Therefore, the Task Force does not recommend an increase in the local sales tax as a means of funding current or accrued employee health care benefits and liabilities.

#### THE REVENUE SOURCE OF LAST RESORT: LOCAL PROPERTY TAXES

This leaves local taxation as the last known significant source of funds. Local tax revenues must be the shock absorber of last resort, since there is no one else to go to. The Task Force has tried to solve the City's problem by parceling out the responsibility (some might say the pain) for funding the Net Post Employment Benefits other than Pensions (Net OPEB) among all constituencies: tax payers, utility customers, other users of casino revenues, employees and retirees. And to the extent that the recommendations made earlier herein are ignored, then taxes will necessarily have to fill in the gap thus created. As mentioned at the outset of this Report, the Task Force is firmly resolved that the Net OPEB should be fully funded each and every year beginning in 2007. To fund less than all of the Net OPEB is to continue the sins of the past and expect future citizens of Duluth to pay for today's promises and commitments. No one is expected to bear an unreasonable burden, if all participate and pick up their share.

As a result of all the recommendations to this point in the Final Report, the local property tax is left with the burden of coming up with \$2.4 million annually (as already mentioned, it is assumed that increasing the City Sales Tax would not be attractive or even legislatively possible). The tables following the narrative of this Report show the derivation of this amount. The Task Force believes that a one time increase in the City portion of local property taxes of \$2.4 million, amounting to a 30-40% increase in the City portion of local taxes which would be made available for retiree health cost purposes, if done in a single year, would be excessive. Rather, the Task Force recommends that, for 2007, the City's portion of the local property tax bite (attributable to funding the Net OPEB) be increased 8-9% per year, for a period of 3 or 4 years. This will smooth the impact and would amount to about a 1.25-1.5% increase each year in terms of the homeowner and business establishment's total tax bill from the City, the Duluth School District and St. Louis County.

#### OTHER IDEAS?

The Task Force may have missed an opportunity to reduce post employment health care costs, or to find new revenues to support reasonable benefit levels. The Task Force encourages the Administration and The Council to pursue any other avenues that appear promising. We would be happy to pursue such ideas if requested to do so.

## SUMMARY OF THE NUMBERS

The Task Force has imposed many numbers on the reader in the previous sections of this Final Report. Following is a summary of numbers established and discussed above:

### SUMMARY OF ESTIMATED ACTUARIAL ACCRUED LIABILITY (AAL), ANNUAL REQUIRED CONTRIBUTION (ARC), AND NET POST EMPLOYMENT BENEFITS OTHER THAN PENSIONS (NET OPEB):

ASSUMING FULLY INSURED HEALTH CARE PLANS' EFFECTIVE BIDDING  
Dollars in Millions

Description of Event or Action to be Taken	AAL	ARC	Net OPEB
January 1, 2005 Unadjusted Balances, per Van Iwaarden Actuarial Report	\$ 279.9	\$ 26.0	\$ 19.2
Effective bidding for Post 64 insurance	64.8	6.0	4.4
Remainder of costs	215.1	20.0	14.8
Active Employees' Responsibility	22.3	2.1	1.6
Retired Employees' Responsibility	20.7	1.9	1.4
Net City Responsibility	172.1	16.0	11.8
Enterprise (Utility) Activities	43.0	4.0	3.0
Agency Activities	0	0	0
Training Staff Health Care Costs	4.0	0.4	0.4
Net City General Fund Responsibility	125.1	11.6	8.4
Cost Reduction Activities:			
Administration Improvements		0.5	0.5
Drug Importation		0.8	0.8
Net General Fund Resp. after Cost Reductions		10.3	7.1
Revenue Enhancements:			
Fond-Du-Luth Casino Funding		2.0	2.0
Utilities' PILOT Fee Increase		2.7	2.7
Local Property Taxes		2.4	2.4 *
Final Funding Result		3.2	0.0

\*Takes 4 years to reach this number, at tax increase of \$0.6 million per year for 4 years; may be necessary to extend to a fifth year in order to offset the under funding in years 1 through 3.

REVISED SUMMARY OF THE NUMBERS

WITHOUT FULLY INSURED HEALTH CARE PLANS' EFFECTIVE BIDDING

Description of Event or Action to be Taken	Dollars in Millions		
	AAL	ARC	Net OPEB
January 1, 2005 Unadjusted Balances, per Van Iwaarden Actuarial Report	\$ 279.9	\$ 26.0	\$ 19.2
Effective Bidding for Post 64 Insurance	0	0	0
Remainder of Costs	279.9	26.0	19.2
Active Employees' Responsibility	29.0	2.7	2.0
Retired Employees' Responsibility	27.0	2.5	1.8
Net City Responsibility	223.9	20.8	15.4
Enterprise (Utility) Activities	56.0	5.2	3.9
Agency Activities	0	0	0
Training Staff Health Care Costs	5.2	0.5	0.4
Net City General Fund Responsibility	162.7	15.1	11.1
Cost Reduction Activities:			
Administration Improvements		0.5	0.5
Drug Importation		0.8	0.8
Net General Fund Resp. after Cost Reductions		13.8	9.8
Revenue Enhancements:			
Fond-Du-Luth Casino Funding		2.0	2.0
Utilities' PILOT Fee Increase		2.7	2.7
Local Property Taxes		5.1	5.1*
Final Funding Result		4.0	0

\*Takes 4 years to reach this number, at tax increase of \$1.3 million per year for 4 years; may be necessary to extend a fifth year in order to offset the under funding in years 1 through 3.

## CONCLUSION

The Task Force members believe it has arrived at a responsible means of addressing the severe financial problems of the City, as laid out and discussed earlier in this report. Based on representations made by the Administration and the Council, the City's political leaders are deadly serious about solving the long festering and ballooning problem of funding post employment health care costs once and for all. The Task Force believes those representations, and pledges to assist in any way reasonably possible in bringing about meaningful and satisfactory resolution.

Respectfully submitted,

Post Retirement Health Care Benefits Task Force

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Arend J. Sandbulte, Chair

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Don L. Bye

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David W. Lindstrom

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John N. Nys

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Allan N. Winters

\*\* See page 26 for certain personal comments and reservations

## DETAILED DISCUSSION OF DECLARATORY JUDGMENT INITIATIVE

It has been consistently stated by representatives of the retirees, as well as some of the representatives of the active employees and of the City Administrative staff, that they believe retirees are entitled to have a health care benefit plan equivalent to the plan on their individual dates of retirement. It follows that to the extent that improvements have been made to those health insurance plans, that retirees are not entitled to those improvements. Further, it follows, if correct, that to the extent changes are made to the plans that increase the amounts payable by actives, such as drug co-pays, deductibles, or similar payments, that retirees are not required to pay these increased amounts. Finally, it means that, if these retirees and others are correct in their beliefs, the City must provide to each retiree a plan exactly equal to that in place on the date of their retirement.

This has led to the often repeated statement that the number of “plans” that are being administered by the City is in the neighborhood of 90 plans. According to BCBS, there are 90 “groups” in existence, but apparently there are far fewer plans inasmuch as several groups appear to be on the same “plan.”

In fact, it appears that there are in existence at this time a total of 4 primary health care plans for actives and 7 primary plans for retirees. In addition, there is in existence a practice in the City that anyone who claims that they are entitled to health care coverage not provided for by the existing plans, makes a claim against the City and the City after apparently little or no significant review, will pay those demands. The alleged existence of these 90 or so groups has made it difficult, if not impossible, for the City to have competitive bidding for its health care administration and has made it virtually impossible for Duluth to obtain a “fully insured” health care plan for post-64 retirees. Based on the information that the Task Force has learned, the unfunded accrued liability of the City could be reduced by almost \$65 million through a competitive bidding process.

The City Administration has received from outside counsel an opinion that the City could alter the terms of the retirees’ health care benefits either unilaterally or through collective bargaining. However, that outside legal opinion predates the recent Minnesota Supreme Court decision of Housing and Redevelopment Authority of Chisholm v. Norman. The Chisholm v. Norman case adopts the conclusion of an early Mower County case that:

“The retiree’s right to such benefits is vested for the life of the retiree and cannot be altered absent the retiree’s consent.”

While there are numerous contracts covering the City’s retirees over the last 22 years, they all appear to share the same basic language regarding retiree health care:

“ANY EMPLOYEE WHO RETIRES from employment with the City.....SHALL RECEIVE hospital-medical INSURANCE COVERAGE TO THE SAME EXTENT AS ACTIVE EMPLOYEES...” (emphasis added).

About the only evidence presented to the Task Force of the intent of the parties back in

1983 was the emphatic testimony of retirees that an employee would keep whatever insurance coverage was in effect on the employee's date of retirement.

That language has triggered at least two very different interpretations. The question is: active employees AS OF WHEN? Many would read the language to mean active employees currently, whenever the benefits accrue, or under labor contracts presently in effect. Another interpretation, strongly contended by some who were involved originally, is that it meant and means whatever insurance coverage, costs and payments that were or will be in effect on the date the individual retires.

Here is where the City administration of the benefit has completely broken down. Apparently the stated interpretation of active as of retirement date has been used to continue very low co-pay and very low deductibles, while the currently or fluid interpretation has been followed to add any increases in coverage or benefits as they have been negotiated in subsequent contracts.

It is almost incomprehensible that the City Administration(s) for twenty plus years would allow continued question and indecision, without determination and agreement, as to whether the City's responsibility was to provide each retiree with the exact same coverage as was in place on the date of retirement for the rest of that retiree's life, or to provide that retirees would continue to be covered but subject to any changes in coverage that might be negotiated into future contracts for unit employees.

If the City did not know what it negotiated in 1983, at some point it certainly should have found out, and it should have clarified the correct interpretation to be followed as soon as the City incurred the additional administration required under one interpretation, or substantial additional costs under the other interpretation.

Instead, the City has inconsistently followed both interpretations, often sparing retirees new costs but granting them added coverages and benefits as they were negotiated into subsequent contracts. The retirees, for their part, have accepted the changes. The Unions never negotiated the changes on behalf of the retirees. It has resulted in very substantial and needless cost to the City.

While the Task Force hopes that the present retirees will contribute to the resolution to the huge problem that the City now finds itself in, there may be some retirees who will be unwilling to agree to any change.

Given the substantial savings that are potentially available to the City (almost \$65 million), from shifting to a fully insured competitively bid plan, the Task Force has concluded that if retirees are unwilling to accept changes in their "plans" it will be necessary for the City to file an appropriate legal action for Declaratory Judgment seeking to have determined the City's rights and obligations under the collective bargaining agreements as they relate to retirees. This action will have to be initiated through the use of outside attorneys since the attorneys in the City Attorney's office are themselves entitled to retiree health care benefits.

Task Force member Don L. Bye's personal comments and reservations:

We came to this Task Force from very different paths. Initially it appeared that complete consensus would be virtually impossible. I applaud the other Task Force members for listening to and considering every point of view as expressed by others and among ourselves. I have signed the report as is because I agree with most all of the recommendations and acknowledge that it includes a number of amendments and compromises that I've requested or argued for.

The asterisks following my signature on page 23 above is because:

Even after amendment and compromise the report still, in my view, intrudes on bargaining relationship between the City and incumbent Unions.

Particularly, I do not subscribe to the mandate or supposition that the City must move to defined contribution plans. I do acknowledge the anecdotal evidence and contractual comparisons pushing in that direction.

Similarly, I do not subscribe to allocating the specific percentages of 80-20 and the correlative numbers, and assessing such cost contribution to both active and retired employees. It may end up that way, but that amount and that approach is not for us to mandate, direct, or even recommend, particularly as to active employees.

Given the law as it is today, and the facts as they exist today, I don't think we have sufficiently acknowledged the strong legal position of retirees in this matter.

I think our report is too soft on Blue Cross Blue Shield. I think they should be replaced or payments to them renegotiated and reduced drastically. And, as I'm bothered by the evidence that it's been difficult to pry basic cost and claim information from City administration, over the years, it's been even more so with the Blues.

Finally, and very likely due to time restraints, I don't think we have turned over the stones of costs and prices charged by providers, in an effort to get them down toward Medicare levels.

Overall, I can state that the other four Task Force members, at least, have done a tremendous job.

## ABOUT THE TASK FORCE

The Task Force was appointed by action of the Duluth City Council on August 1, 2005. Its assignment was to study the looming post retirement health care benefit cost issues, make findings associated with this topic, and provide a series of recommendations which would be actionable by the City Council and the Administration. A target date for completion of Task Force work was set for December 1, 2005. The Task Force agreed to serve without remuneration of any type, including food or beverages during meetings.

The Task Force met a total of 18 times in regularly scheduled weekly meetings. All of the meetings were open to anyone who wished to attend; no one was excluded to the best knowledge of Task Force members, other than during ONE brief executive session when confidentiality was required. The Task Force estimates that members spent a total of about 50 hours by each member in attending Task Force meetings, and in the range of 100 hours or more by each member in activity outside of these meetings. Therefore, it is estimated that at least 1,000 hours were invested in total by Task Force members in pursuing the assignment by the City Council. It is for this reason, among others, that members feel heavily invested in the Final Report and its implementation, and would be extremely disappointed to say the least if this Report were to simply be put on the shelf along with the myriad of special reports done on many subjects by various groups over the years. In fact, Task Force members pledge to do all in their power, within reason, to assure that the Report is considered very seriously and its recommendations implemented.

Task Force members and their credentials are as follows:

Arend J. (Sandy) Sandbulte -

Sandbulte is the Retired Chairman, President and CEO of Minnesota Power (now Allete). He is a native of Iowa and a graduate electrical engineer from Iowa State University in 1959, and holds an MBA from the University of Minnesota in the Twin Cities in 1966. After coming to Duluth in 1964 from Northern States Power in Minneapolis, he spent the next 31+ years with Minnesota Power in several executive positions, including VP-Corporate Planning, VP-Finance & CFO, Sr. VP of Finance & Administration and CFO, Executive VP-COO and CFO, and his final position of Chairman, President & CEO, until his retirement in 1996. He served on the MP board for 19 years, 1983-2002. He has been active over the years in many Duluth, state and national activities, including Chairman of the Duluth Area Chamber of Commerce, Board and Campaign Chair of United Way, Chair of the Board of Trustees of St. Scholastica, Chair of the board of St. Luke's Hospital, Chair of Lake Superior Center (GLA), UMD Business Person of the Year in 1995, Chair of State of MN Commission on Reform & Efficiency (CORE; appointed by Gov. Arne Carlson), Member of Executive Committee of the MN Business Partnership, Chair and Board member of Iowa State University Foundation, Chair of the National Association of Edison Illuminating Companies, Director and member of Executive, Audit (Chair) and Compensation (Chair) Committees of St. Mary Land & Exploration Company (a Denver-based oil and gas exploration and development

company). The College of St. Scholastica Sandbulte Chair of Business & Ethics was established in his honor in 1995, and he was also honored that year by receiving an honorary Doctorate of Humane Letters from St. Scholastica. In Financial World magazine's annual CEO of the year competition, he won second or third place awards in 1990, 1993 & 1994, and first place in 1995, for mid-sized electric power companies. He and his wife Verna have 4 children, and 14 grandchildren, 11 of which live in Duluth.

Don L. Bye -

Bye is a semi-retired lawyer and qualified mediator, who has practiced in the Duluth area for over 40 years. He earned an A.A. degree from Brainerd Junior College in 1955, a B.A. and a J.D. from the University of Minnesota in 1963, all with honors. In his years in Duluth he has served on Model City panels, Duluth School Location Committees and the Duluth Planning Commission. In the region Bye served as Chair of Arrowhead Food Bank, served on the Governor's Commission on Hunger, Chair of 11<sup>th</sup> District Bar Association, and started and chaired SHARE food drives. At the state level, he started Kid's Voting in Minnesota and served as the Duluth and Minnesota Chair. For 9 years Bye was on the Minnesota Public Employment Relations Board, and was the Chair for 5 years. He served two terms on the Minnesota Board of Legal Certification. Bye has also served on several Minnesota Bar Association Committees and task forces and as an officer of The Labor Law Section. He was also one of the initiators of National Bone Marrow Donor Registry. For a number of years Bye has been rated among Best Lawyers in America and Leading Lawyers in Minnesota. His legal practice focuses on Labor and Employment Law with an emphasis on the Public Sector, including legislative drafting and lobbying, contract negotiation, mediation, arbitration and court procedures. Bye has resided on the Duluth Central Hillside since 1963 and is married to wife Meg.

David W. Lindstrom -

Lindstrom was born in Pokegama, MN and raised in Rush City. He is a graduate of the University of Minnesota, Duluth with a Bachelor of Science Degree with a major in Social Studies. He was captain of the UMD MIAC championship football team and recipient of the UMD Outstanding Senior Athlete Award in 1961-62. Lindstrom was inducted into the UMD Athletic Hall of Fame in 1997. He spent several years as a high school teacher in Cambridge, Minnesota. He entered the insurance business in 1965 and is currently President of Lindstrom LTD, a firm specializing in employee benefits and personal insurance. The majority of Lindstrom LTD business is consulting with small to medium size businesses regarding their employee benefits, as well as with individuals about their insurance and investment needs. He is the past President of the Arrowhead Association of Life Underwriters (AALU), now known as the Arrowhead Association of Insurance and Financial Advisors (AAIFA). In 1974 he achieved the Charter Life Underwriter (CLU) designation. He has served on the Board of Trustees and Past President of St. Matthews Lutheran Church of Duluth. He is a member of the Duluth Superior Symphony Chorus, as well as a member of the UMD Bulldog Club Board of Trustees. Lindstrom and his wife Karen live in Duluth, have 4 children, 8 grandchildren and 2 great grandchildren. Son David works with his father at Lindstrom LTD.

John N. Nys -

Nys was born and raised in Duluth and graduated from Morgan Park High School. He graduated from Dartmouth College, magna cum laude and Phi Beta Kappa, in 1970 with a degree in Government with an emphasis in Urban Studies. He attended Stanford Law School where he was on the moot court board served as Managing Editor of the Stanford Journal of International Studies, graduating in 1973. After completing his obligation to the United States Navy as a JAG officer in 1974, he returned to Duluth and has been a practicing attorney with the Johnson Killen law firm, Duluth's oldest law firm, since that time. He is presently a "senior partner" in that firm focusing primarily in the area of business law. He has been active in the local (President in 1989) and Minnesota State (President in 1996) Bar Associations. He was also twice appointed by the Minnesota Supreme Court to serve on the Minnesota Lawyers Professional Responsibility Board. Nys has been active the community serving as Cubmaster (Pack 13 – Gary New Duluth), and as President of the Morgan Park – Smithville Community Club. The work he did restoring his home in Morgan Park, was featured on the segment in Bob Villa's "Restore American" TV program about Morgan Park. Nys and his wife Sandra have one son who lives in St. Paul and attends law school.

Allan N. Winters -

Winters grew up as the son of a Chief Petty Officer in the U.S. Navy, and lived in various locations in his youth. He settled in Duluth in 1968, and came to RJF Agencies, Inc. in January 2002 from the Holden Agency. He has 29 years of experience in the regional insurance industry, both on the insurance carrier side and on the agency side, and has won many honors and awards over the years, and has held many board positions. He was with Medica in the mid-to-late 1980s, where he managed the northern territory and established the first Medica office in Duluth. In 1990 he developed a Preferred Provider Organization (PPO) for the Superior medical providers and created a plan in partnership with Wisconsin Physician's Service (WPS). Once the provider contracting and plan creation was complete, he transitioned to WPS as the manager of the northern territory and opened an office in Duluth. During his first two years, Winters placed 25,000 members into their plans throughout the region. He added groups such as St. Luke's Hospital; City of Duluth: St. Scholastica College; City of Superior; Superior School District; Maple School District; Ashland School District; Hayward School District; Fleming Foods and many others. He worked seven years for WPS and their subsidiary EPIC Life. He moved back into the agent community eight years ago and has quickly become a significant marketing force in the region. During 2004 he wrote or consulted for colleges, school districts, health care organizations and private industry. Winters' abundance of experience has given him an intimate understanding of the regional political landscape – both on the employer side and the labor side. His knowledge, combined with his rapport with the key business and labor leaders, has won him the respect of groups on both sides of the table. Winters three daughters, ages 24, 21 and 17, live in Duluth.

## APPENDICES

Included are the following (for those receiving copy of the Final Report without Appendices, any or all are available upon request):

1. Copy of Power Point presentation to City Council on Dec. 12, 2005
2. GASB Statement #45
3. Van Iwaarden Actuarial Study
4. Listing of Interviews Conducted by the Task Force
5. Current and previous union proposals for cost reduction and efficiency
  
6. Moody's and Standard & Poor's Latest Bond Ratings for City of Duluth
7. Detailed summary of current health care plans now in existence
8. Drug Importation Possibilities (Minnesota Citizens Federation NE)
9. Savings Possibilities with fully insured coverage for retirees (Medica proposal for fully insured insurance coverage for post-64 retirees)
10. Listing of City Owned Assets
  
11. Casino annual revenues and Community Trust Fund (per City 2005 budget)
12. Utility Billing Comparisons (comparing Duluth to Superior and Cloquet)
13. Typical property tax impacts from Recommendation #14
14. Study prepared by St. Scholastica Students which highlighted issues and gave initial guidance to the Task Force work effort