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[California Cities Strained by Retiree Health: Muni Credit.]

The Los Angeles Unified School District, the nation's largest outside New York City, owes so much for retiree health care that paying off its debt would cost $17,500 for each student — and there are 640,000 of them.

Local governments typically haven't been punished by investors for underfunding retiree health care and insurance, unlike pensions. Investors believe that, in a pinch, the governments can walk away from the obligations, said Michael Ginestro, head of fixed-income research for Bel Air Investment Advisors LLC, which manages $2.8 billion in Los Angeles.

A group of California state court decisions have upended that assumption, treating "other post-employment benefits," or OPEB, as vested rights that can be changed only through contract negotiations. The decisions threaten to add to the fiscal strains of cities and counties whose pension obligations are already putting pressure on their creditworthiness.

"If push comes to shove, they can be impaired," Ginestro said. "It is a big concern. One of the things we look at is whether they're addressing it with a reserve. If not, it's a credit negative."

U.S. states have $529 billion in unfunded liabilities for non-pension retirement benefits, down 3 percent in two years, Standard & Poor's said in a November 2013 report. The states have $833 billion in unfunded pension liabilities and $488 billion in tax-supported debt such as bonds, according to the report.

Mixed Signals

California courts, in four separate cases, have differed on how much leeway public agencies have in changing retiree health-care and insurance benefits.

The California Supreme Court ruled in 2011, in a case in which Orange County retirees had sued to keep their health insurance premiums pooled with those of active workers, that it was possible for a county to be bound by implied contract terms involving health benefits for retirees.

In Los Angeles, Superior Court Judge Luis A. Lavin in September blocked the city from threatening to freeze the health-care subsidies of retirees unless their unions agreed to an employee contribution of 4 percent. The judge said workers had a vested right to the health insurance premium subsidy.

Voter Approved

In San Jose, Superior Court Judge Patricia Lucas issued a tentative decision on Dec. 19 striking down part of a voter-approved overhaul of public worker retirement benefits.

Unfunded pension liabilities are the responsibility of the city, the judge said, barring San Jose from demanding higher employee contributions. However, she ruled that the city can require employees to contribute to unfunded retiree health care liabilities. The judge said city employees had a vested right to pay no more than 50 percent of the costs of retiree health care, according to the ruling.

On Dec. 26, the California Court of Appeal in San Diego upheld a lower court's ruling that the city could cap its contribution to health care premiums of retired police officers because it wasn't a vested benefit.

"Retiree health is not a benefit under the retirement system; it is an employment benefit that is renegotiated every few years by the city's labor organizations and the city," the appellate court said in a unanimous decision.

The decision may reduce San Diego's unfunded liability for the benefits by 31 percent, to $969 million from $1.4 billion, Moody's Investors Service said in a Jan. 9 note.

Challenge Assumption

The Los Angeles decisions directly affected a small number of workers. Its effect was broader, Fitch Ratings said in an October note, by challenging the assumption that retiree health care is more flexible than pensions.

"This decision shows that enacted pension and OPEB reforms could be successfully challenged in court and other forums," Fitch analyst Jessalyn Moro wrote of the Los Angeles ruling, concluding that the ruling could harm the credit of numerous local governments.

The growing health-care liabilities should concern investors, said Scott Minerd, global chief investment officer of Guggenheim Partners in Santa Monica, California.

It's often difficult for municipal investors to determine how much local governments owe, because unlike pensions, there's no standard for how to report the retiree health liabilities, Minerd said.

"There are a lot of liabilities piling up that are going to have to be paid," Minerd said by telephone. "Something will have to be done akin to Proposition B in San Diego."

Rolled Back

Voters in California's second-largest city in 2012 rolled back retirement benefits by placing new non-police employees in 401(k)-style plans and by limiting San Diego's contribution to retirement benefits.

Two years earlier, San Diego froze its contribution for retiree health care, prompting a lawsuit from former employees. A state court judge ruled that unlike pensions, retiree health care can be modified without a vote of current and retired workers.

The Los Angeles school district, with $7 billion in operating funds, is paying $50.6 million to partially pre-pay retiree health care this year. It projects that cost will grow to $75.9 million next year and $113.9 million in the school year ending in 2016. The district expects to pay about $305.4 million this year toward pensions.

The school system has an unfunded liability for OPEB of $11.2 billion over 30 years, according to its 2012 annual report. In November, the school board established a trust fund for retiree health care, said Gayle Pollard-Terry, a spokeswoman.

Liabilities Fall

Contra Costa County, east of San Francisco, is being sued after reducing unfunded retiree health liabilities to $1.02 billion in 2010. The plan's assets covered just 6.3 percent of expected costs, according to an annual report.

The liabilities fell from $2.57 billion in 2006 after the county stopped offering retirement health care to new employees, said David Twa, the county administrator. The county also capped its contribution to health insurance, drawing a lawsuit from retirees that’s pending, Twa said.

The county’s unfunded liability for retiree health care is about half the total for pensions, he said.

“It is a risk,” Twa said. “We’re trending in the right direction. We have a long way to go.”

Court rulings in retiree health care cases will be critical to the fiscal health of California cities and counties, said Arthur Hartinger, a principal at Meyers Nave Riback Silver & Wilson in Oakland, California, who has represented cities in lawsuits over retirement guarantees.

Many local governments underestimated costs of both pensions and retiree health care, leading to shortfalls in plans and costs that eat into law enforcement and other public services, he said

“It all comes down to what obligations were granted in the first place,” Hartinger said in a telephone interview.

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