

**ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS**

Anchorage, Alaska

July 14, 2005

12:01 p.m.

MEMBERS PRESENT

Representative Bruce Weyhrauch, Chair
Representative Norman Rokeberg
Representative Paul Seaton (via teleconference)
Representative Peggy Wilson (via teleconference)
Representative Max Gruenberg
Representative Carl Moses

MEMBERS ABSENT

Representative Ralph Samuels

OTHER LEGISLATORS PRESENT

Representative Carl Gatto (via teleconference)
Representative Ethan Berkowitz
Representative David Guttenberg
Representative Kurt Olson

COMMITTEE CALENDAR

REVIEW OF THE PUBLIC EMPLOYEES RETIREMENT SYSTEM (PERS) AND
TEACHERS RETIREMENT SYSTEM (TRS)

- HEARD

PREVIOUS COMMITTEE ACTION

No previous action to report

WITNESS REGISTER

DON GRAY

Fairbanks, Alaska

POSITION STATEMENT: Testified during the review of the Public
Employees' Retirement System (PERS) and the Teachers' Retirement
System (TRS).

SUJIT M. CANAGARETNA, Senior Fiscal Analyst

Southern Legislative Conference of the Council on State Governments

Atlanta, Georgia

POSITION STATEMENT: Testified on behalf of the council on issues related to state retirement systems.

REPRESENTATIVE MIKE KELLY

Alaska State Legislature

Juneau, Alaska

POSITION STATEMENT: Asked questions during the review of the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS).

TOMAS H. BOUTIN, Deputy Commissioner

Office of the Commissioner

Department of Revenue (DOR)

Juneau, Alaska

POSITION STATEMENT: Testified during the review of the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS).

JOSEPH ESUCHANKO, President

Actuarial Service Company, P.C. (ASC)

Troy, Michigan

POSITION STATEMENT: Testified on behalf of ASC and answered questions during the review of the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS).

SENATOR HOLLIS FRENCH

Alaska State Legislature

Juneau, Alaska

POSITION STATEMENT: Asked questions during the review of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS).

MELANIE MILLHORN, Director

Health Benefits Section

Division Of Retirement & Benefits

Department of Administration (DOA)

Juneau, Alaska

POSITION STATEMENT: Testified on behalf of the division and answered questions during the review of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS).

KEVIN BROOKS, Deputy Commissioner

Office of the Commissioner

Department of Administration (DOA)
Juneau, Alaska

POSITION STATEMENT: Offered a remark during the review of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS).

DAVID TEAL, Legislative Fiscal Analyst
Legislative Finance Division
Alaska State Legislature
Juneau, Alaska

POSITION STATEMENT: Testified during the review of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS).

ACTION NARRATIVE

CHAIR BRUCE WEYHRAUCH called the House Special Committee on Ways and Means meeting to order at [12:01:27 PM](#). Representatives Weyhrauch, Moses, Wilson (via teleconference), and Seaton (via teleconference) were present at the call to order. Representatives Rokeberg and Gruenberg arrived as the meeting was in progress. Representatives Gatto (via teleconference), Berkowitz, Kelly, Guttenberg, and Olson, and Senator French were also in attendance.

OVERVIEW(S)

Review of the Public Employees Retirement System (PERS) and Teachers Retirement System (TRS)

CHAIR WEYHRAUCH announced that the only order of business was the review of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS). He relayed the agenda for the meeting and the names and affiliations of invited speakers; noted that the committee would accept brief public comment before taking an at-ease until approximately 1:30 p.m., but that the remainder of the testimony - from the invitees - would be occurring when the committee reconvenes; and assured members and other present that the public will have numerous opportunities during future hearings to provide testimony. He indicated that the committee, through hearings on this issue, would be attempting to refine some of the committee objectives and bring some legislation to the body in the upcoming session; to consider a plan for addressing the unfunded liability; and to refine any objectives regarding issues of appropriations, policy changes, actuarial analyses, or pension revenue bonds.

12:09:06 PM

DON GRAY (ph) suggested that he can offer a two-fold perspective on the issues because he is currently a beneficiary in TRS, having taught for 23 years, and he has also recently retired from a brokerage firm after 11.5 years. Regarding the \$5.7 billion shortfall, he said the problem is more than the fact that the mortality tables were outdated; the actuary gave advise to the state that was not accurate, which resulted in the state's reducing the amount of the employer contribution in the late 80s/early 90s. He mentioned a press release from [Mercer Human Resources], dated July 5, which he said looks as though "they are positioning themselves to market benefit plans and to sell what looks like a modified annuity program to retirees." He said the trend is "away from a fixed benefit retirement plan." He stated concern that [the actuary's] estimates on health care costs were inaccurate. He said he hopes the committee is able to evaluate the huge amount of data before it.

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CHAIR WEYHRAUCH in response to further questions, again outlined the committee's agenda for the meeting, and offered assurance that the public would have numerous opportunities during future meetings to provide testimony.

12:15:00 PM

The committee took an at-ease from 12:15 p.m. to 1:35 p.m.

1:35:27 PM

CHAIR WEYHRAUCH again outlined the committee's agenda for the meeting.

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SUJIT M. CANAGARETNA, Senior Fiscal Analyst, Southern Legislative Conference of the Council on State Governments, relayed that his remarks would deal with the challenges confronting public retirement systems in recent years. He said he would draw upon his research in preparing a 50-state review of the nation's public retirement system, published in October 2004, as well as his ongoing study of this issue. He continued as follows:

Part one: Any discussion of the financial position of public retirement systems has to be placed in the context of the overall health of state finances. States are finally seeing improved revenue numbers, and for the just-concluded fiscal year 2005, revenues exceeded original budget projections in 42 states, while three others met their targets. Revenue in only five states came in below projections. Sales, corporate, and personal income tax flows have all performed admirably. This is a marked improvement from the prior four years when states battled a fiscal downturn termed the worst in six decades. Since fiscal year 2001, states closed a cumulative budget gap that surpassed \$235 billion, by adopting a range of difficult choices.

While the revenue side of the balance sheet is now promising, unfortunately the expenditure side continues to pose serious dilemmas. After several years of flat growth, state spending grew by 6.6 percent in fiscal year 2005. The annual average since 1979 is 6.5 percent, even though the average over the last five years was only 3.9 percent. Health care costs lead the way here. And in the next decade, just as it has in the last five years, Medicaid is estimated to grow by 9-10 percent as year. In addition, expenses associated with education, included court-mandated costs, retirement systems, corrections, transportation, demographic changes, and infrastructure needs will continue to burden state budgets.

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MR. CANAGARETNA continued:

Part two: State retirement systems are one element in our nation's overall retirement architecture. There has been a great deal of discussion recently of the "graying" of American and the need to develop an infrastructure to absorb the retirement needs of all Americans. As [U.S.] Census Bureau figures indicate, the elderly population in every state will grow faster than the total population and seniors will outnumber school-aged children in 10 states in the next 25 years.

Financial planners often recommend a three-legged stool concept in planning for retirement. Each leg of the stool is supposed to represent a source of income in retirement, and the goal is to accumulatively attain a standard of living at least compatible to the one experienced prior to retirement. In this analysis, if the first leg of the stool is Social Security income, the other two legs of the stool refer to personal savings and pension income. Unfortunately, a closer view of national financial and demographic trends reveals that all three legs of this metaphorical retirement stool remain wobbly; a development that threatens to seriously jeopardize the retirement plans of the majority of Americans.

As states emerge from the recent financial downturn, policymakers now face the daunting challenge of dealing with weaknesses in public retirement systems. These public retirement systems are underfunded at a time when the first wave of the nation's Baby Boomers is rapidly approaching retirement.

As mentioned, other areas of the nation's retirement remain extremely shaky, as well. Specifically, the precarious financial position of corporate pension plan and the federal pension benefit guarantee corporation. The looming shortfall is expected in social security and Medicare in coming decades and the low personal savings rates of most Americans, coupled with higher rates of consumer and household debts.

MR. CANAGARETNA read further from his written testimony as follows:

Part three: The employee retirement systems of state and local governments remain a critical component of our nation's government sector. Not only do these retirement systems cover millions of public sector employees and provided current and future income for these retirees and employees, they contain significant investment holding, as well.

After suffering steep losses—losses from which these public pension plans continue to reel—during the economic downturn of the early years of this decade and during the 2000-2002 stock market collapse, finally, most plans are seeing positive returns.

Based on the latest federal data, the cash and investment holdings of state and local government employee retirement systems cumulatively reached \$2.2 trillion in 2003, a very slight increase - \$14 million - over the prior year.

Just a decade ago, in 1993, total cash and investment holdings in these public pension plans amounted to about \$921 billion. Propelled by the tremendous gains in equity investments in the late 1990s, these holdings accelerated to about [\$2.2] trillion by 2000 and have continued to hover at that level for the past four years. During the recent fiscal downturn, a number of state and local governments slashed their regular contributions to their pension funds in order to balance budgets. For instance, North Carolina withheld \$144 million in payments in 2002 and Texas cut its contribution to the Teacher Retirement System from 7.3 percent of employee pay to 6 percent. In Illinois, until 1995, the state's contribution to its pension funds was subject to an annual appropriation by the legislature; yet, in the last decade, Illinois lawmakers failed to allocate sufficient funds to cover liabilities. Since 1996, New Jersey contributed virtually nothing to its public employee retirement plan.

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MR. CANAGARETNA continued:

My ongoing review of public retirement plans reveals several trends. First, the increasing move by these plans to invest in nongovernmental securities - such as corporate bonds, stocks and foreign investments - away from government securities - such as U.S. Treasury bills. In fact, in 1993, public plans only had 62 percent of their total cash and investment holdings in nongovernmental securities; ten years later in 2003, this percentage had ballooned to 77 percent. Several states made statutory changes to allow their pension plans to invest more heavily in the market; Georgia approved an increase from 50 percent to 60 percent and South Carolina Senate approved an increase from 40 percent to 70 percent. Second, in the last few years, payments from these

retirement plans have far outpaced receipts into the plans. For instance, between 2000 and 2001, payments increased by 12 percent while receipts shrank by 59 percent. Similarly, between 2001 and 2002, payments expanded by 9 percent while receipts dwindled by 105 percent. A significant portion of these payments are related to health care expenditures, a spending category that has experienced substantial growth in recent years.

Third, given the spate of accounting and corporate scandals and the significant losses experienced by these public retirement systems, there is a great deal more activism on the part of the boards overseeing these plans and state lawmakers to monitor more closely the performance and management of their retirement plans. Fourth, a number of research studies indicate that in the last few years, a vast majority of these public pension plans were underfunded to varying degrees, ... [for example], assets were less than their accrued liability. The further a plan's funding level is below 100 percent, the greater the contributions required to finance its unfunded liability. For instance, according to the October 2004 Southern Legislative Conference pension report, 73 percent, or 68 of the 93 plans for which information was secured, were unfunded to varying degrees. Then, according to the latest (2005) Wilshire Report on 125 state retirement systems, the actuarial value funding ratio of plans declined from 103 percent in 2000, to 85 percent in 2004. Finally, according to the latest - April 2005 - survey of 103 plans by the National Association of State Retirement Administrators (NASRA), the average funding level stood at 89 percent with a cumulative unfunded liability of \$267 billion.

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Fifth, the chilling effect of a Governmental Accounting Standards Board (GASB) ruling released last August on already teetering public pension plans. GASB is the independent standard-setter for 84,000 state and local government entities. According to this ruling, state and local governments have to place a value on "other post-employee retirement benefits" - consisting mostly of health care - they promise to

employees. They will also have to record as an expense the amount - the annual required contribution - they would need to stash away to fully fund this long-term liability over 30 years. While the private sector has had similar rules since 1992, for the public sector, implementation will be phased in beginning December 15, 2006. Given the huge spikes in healthcare costs expected in upcoming years, the explosion in unfunded liabilities as a result of this ruling promises to be most alarming.

MR. CANAGARETNA paraphrased his written testimony further:

Part five: In responding to the growing crisis associated with unfunded pension liability, lawmakers have pursued various strategies to bolster the finances of these systems. Pension Obligation Bonds: One strategy adopted by states and localities in the last decade or so involves issuing pension obligation bonds. Given their increasing fiscal problems, several states and localities opt to issue debt to raise money to plough into their pension systems and pay off, in a lump sum in today's dollars, their unfunded liabilities. The fact that interest rates have been at historically low levels recently and the fact that raising taxes continues to be politically radioactive, the opportunity to raise funds via enhanced borrowing quickly loomed as an attractive strategy. A further twist to this approach surfaced in California where an effort was made by both Governors Davis and Schwarzenegger in 2003 and 2004 to issue pension obligation bonds to even pay for the state's annual retirement contribution. Formerly, the trend had been to completely retire the state's unfunded liability portion not just pay for an annual contribution. Some of the states that pursued pension obligation bond strategy recently to replenish their pension plans include California - \$2 billion, Illinois - \$10 billion, Kansas - \$500 million, Oregon - \$2 billion, and Wisconsin - \$1.8 billion. In June 2005, West Virginia voters, in a special election, rejected Governor Manchin's efforts to issue \$5.5 billion in bonds to bolster his state's ailing pension plans.

In selling these bonds, states are counting on the interest payable on the bonds being less than their pension investment earnings. Another advantage is that states experience immediate budget relief because their current-year contributions to a pension plan can be secured from the proceeds of the bond issue. On the flip side, there is always the possibility that the market may not generate the returns to cover the interest rate. Furthermore, once a state issues a bond, it is locked into paying the debt whereas the state has much more flexibility in deciding on future pension contributions, including size, rate, and regularity.

New Jersey's experience in 1997 offers a cautionary tale for states mulling the pension obligations bonds option. Then-Governor Christine Todd Whitman led an effort that resulted in the state issuing \$2.8 billion in bonds that promised to pay off its unfunded pension liability, solve all of its pension problems for the next 36 years, make the state's contributions to the plan for that year, and free up \$623 million for tax cuts. The state banked on getting returns exceeding 7.6 percent, the interest it was paying on the bonds. For the first few years, while the economy surged ahead and the stock market roared, the gamble appeared to have paid rich dividends. Then, the economy slumped and the stock market collapsed, resulting in a severe drop in investment earnings. By mid-2003, even after the stock market had recovered, the state only saw returns of 5.5 percent, significantly lower than the required 7.6 percent. In 2003, New Jersey paid \$163 million in debt service costs for the bonds and these costs will soar to as high as \$508 million annually by 2022. The state will also have to inject \$750 million in contributions to the state pension plan over the next five years. Consequently, the state's costs, including interest, will escalate to \$10.3 billion. The city of Pittsburgh also suffered a fate similar to New Jersey's with its ill-timed pension bond offering in the late 1990s.

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MR. CANAGARETNA introduced the concept of "trimming benefits." He continued paraphrasing his written testimony as follows:

Several strategies crop up under this category:

[1] Moving workers hired in the future to 401(k)-style investment accounts away from the current format of a guaranteed pension based on years of service and high salary. California Governor Schwarzenegger advocated this measure, but has since backed off from pursuing it given the howls of protest. Governor Sanford in South Carolina has also advocated this approach along with Governor Romney in Massachusetts and Speaker DeRoche in Michigan.

[2] Linking the annual increases in retirees' pensions to cost-of-living increases based on the Consumer Price Index as opposed to an automatic percentage increase. The governors in Illinois and Rhode Island both advocate this approach along with a New Hampshire House Committee.

[3] Capping the amount that end-of-career raises would contribute to a teacher's pension. In Illinois, the governor proposed restricting big raises teachers might receive towards the end of their careers, a step, he contends, inflates their pensions and adds to overall retirement debt.

[4] Adjusting the age at which employees are paid full benefits. In Illinois, an individual who worked at least eight years for the state can retire with full benefits at age 60; the governor wants to raise the age to 65. He also proposes changing - from 60 to 65 - the age at which state employees with 35 years service can retire with full benefits. Similarly, in Rhode Island, the governor sought to limit pensions to only those who are 65 and who have worked at least 10 years, or those aged 65 and up, and who have worked at least 30 years. Texas passed legislation that would require educators to be at least 60 before retiring with full benefits. Louisiana [proposed] pushing the age at which teachers can get retirement benefits to 60; currently they can retire at 55 after 25 years or at any age after 30 years.

[5] Reducing the percentage of pay a retiree gets for each year of work. According to a Rhode Island proposal, the maximum pension for a retired state

worker or teacher would drop from 80 percent of an employee's three-year salary average after 35 years work to 75 percent after 38 years.

[6] Eliminating programs like the Deferred Retirement Option Plan, or DROP, which allows state workers with 30 years on the job to continue working up to three years, for instance, while escrowing their retirement benefits at a guaranteed rate of return. A number of states and localities suffered huge financial setbacks recently since they had entered into these DROPs during the 1990s. When the economy nosedived and stock market buckled, these guaranteed rates were significantly more than what the public pension plans were generating in earnings.

[7] Ending lucrative retirement plans where certain state employees serve a brief period in select positions and secure a significant boost in pension income. Missouri recently eliminated its administrative law judge retirement system which allowed this practice. A Louisiana lawmaker proposed halting the practice of granting new retirement breaks through special interest legislation. He cited recent bills to boost the retirement pay of nine members of the State Police, a single judge, and 500 workers at the Legislature.

[8] Placing salary caps on state and local government retirees who return to work in government jobs. New Mexico enacted such legislation.

[9] Debating the ability of public sector plans to continue offering lucrative healthcare options to retirees. In North Carolina and Michigan, currently, any state employee who puts in five years of service becomes eligible to receive free retiree health insurance for life.

[10] Prohibiting school districts in Texas from offering early retirement incentives.

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MR. CANAGARETNA continued:

Increasing costs: Minnesota proposed ... increased pension contributions by public workers as well as cities and counties. A proposal in Texas required ... retired teachers to pay more in health care premiums. Kentucky sought to increase the cost of retiree health care benefits too. Louisiana proposed increasing worker contributions to their retirement pay from 7.5 percent of salary to 8 percent. Nevada proposed ending benefit subsidies for future state retirees while both Arkansas and South Carolina required higher retirement premiums from workers.

Consolidating boards: West Virginia teachers will decide by 2006 whether to merge their two retirement systems to create greater efficiencies. Louisiana explored creating a single administrative board to oversee its retirement programs for teachers and state employees while Minnesota sought to merge the troubled Minneapolis teachers' pension fund with the larger, statewide fund. In Vermont, the governor and lawmakers agreed to combine the funds of its three state retirement systems for investment purposes.

Guaranteed returns: In a contrarian approach that has hailed it as the first pension fund in the United States to do so, Maine adopted a strategy known as matching, ... [for example], deliberately aiming for low, but guaranteed investment income to pay for the retirement benefits of its workers. In 2003, Maine put a third of its assets into very conservative bonds. The bonds pay a low interest rate, but their values will rise or fall in conjunction with the value of the pensions the state must pay its retirees, regardless of the trajectory of the markets.

Unorthodox investments: The Retirement System of Alabama embarked on a series of unorthodox investments that enabled the fund to progress from \$500 million in assets in 1973 to \$26.6 billion in assets in 2004. Some of these acquisitions include New York City real estate, media outlets - television [and] newspapers, hotels, a cruise ship terminal, golf courses, and most recently, becoming the largest stakeholder of U.S. Airways. Similarly, Massachusetts is considering a proposal to open the state's \$36 billion public

employee pension fund to all state residents for investment purposes.

In conclusion, almost every state continues to be plagued by unfunded pension liabilities, yet another force pummeling state finances warily recovering from the recent downturn. While in certain instances the weakened pension outlook was the result of states skipping their required contributions, the severity of the recent fiscal downturn, demographic changes, and the steep rise in healthcare costs are factors, too. The implementation of the previously mentioned GASB ruling could propel unfunded pension liability levels to new heights beginning in December 2006, a trend that could damage state bond ratings. Yet, the "graying" of America, the fact that states will have more retirees living longer in the coming years, and the ability of the public sector to attract quality employees in an era of dwindling retirement benefits, requires innovative solutions. Further complicating the public pension outlook is the fact that the financial viability of the other elements of our retirement infrastructure remains shaky too. Ensuring both the short-term and long-term financial viability of the different elements in America's retirement systems, both private and public, remains of paramount importance. In fact, first resuscitating and then sustaining the financial health of our different retirement income flows provides the underpinnings for the foundation of the United States as an economic, political, and military powerhouse in the global context.

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CHAIR WEYHRAUCH asked whether the GASB ruling is mandatory and if Alaska, or any other state, has any legal liability for failure to comply with the ruling.

MR. CANAGARETNA said the GASB ruling will call for all state and local governments to fall in compliance. He said there will be a phasing process of over three years, based upon "the revenues of the particular entity." He said he doesn't know the answer to Chair Weyhrauch's question regarding legal liabilities, but he offered to find out.

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MR. CANAGARETNA, in response to a request for clarification from Representative Rokeberg, stated that the new GASB rule will compel all 84,000 state and local government entities to put a value on the other post-employee retirement benefits, which is mostly health care. He explained, "In other words, they will have to record, as an expense, the annual required contribution for the amount they will need to assign or put away to fund this long-term liability fully for the next 30 years." He said actuaries estimate that this contribution could be 5-10 times the current annual outlay for retirees' health care. He said examples are available.

REPRESENTATIVE ROKEBERG offered his understanding that Alaska is in conformance with [the GASB] rule, but he wants to ensure that's true, "by definition."

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REPRESENTATIVE ROKEBERG asked whether there are any "good news" stories regarding the use of the Pension Obligation Bond (POB).

MR. CANAGARETNA answered yes. He said the low interest rate environment makes [using the POB] an attractive strategy. A number of states have experienced successful bond issues. He offered examples.

CHAIR WEYHRAUCH opined that it's a matter of timing.

MR. CANAGARETNA concurred. In terms of raw numbers, he said Illinois' unfunded liability is the largest in the country; therefore that state had to pursue [the POB] option just to buttress its pension fund. New Jersey was not so lucky. He said, "That's something that states have to ponder and ... do their own risk-benefit analysis and come up with a strategy that they feel is most appropriate to their own means." He said although there have been bad outcomes, the last couple of years have seen some pretty positive developments on that front.

CHAIR WEYHRAUCH noted that Mr. CanagaRetna used the term "infrastructure." He asked, "In these states that have large, unfunded pension obligations and liabilities, [have] their been instances where their state's overall credit rating has taken a hit because of that liability?"

MR. CANAGARETNA answered yes. He said one of the reasons that that Illinois had to go ahead with its bond offering was to

ensure that its credit rating didn't continue to suffer as a result of the state's huge, unfunded liability. He noted, "Just yesterday, South Carolina's rating was lowered, mainly because ... the unemployment rate ... has been persistently high - much higher than the national average, which is very unusual for a state like South Carolina which, in the late 90s, did exceptionally well in terms of generating employment." He said rating agencies bring about their own set of demands on state budgets, and states are pretty quick to react to possible downgrades.

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REPRESENTATIVE MIKE KELLY, Alaska State Legislature, referred to Mr. CanagaRetna's comments regarding the GASB-driven approach, which he said is different than the [National Association of State Retirement Administrators (NASRA)] graph that indicates the funding of states. He surmised that [the NASRA graph] must be "without any medical component."

MR. CANAGARETNA confirmed that the NASRA chart that the committee has is "without the impact of the GASB ruling coming into play."

REPRESENTATIVE KELLY asked, "Isn't it folly to pay much attention to the NASRA numbers as compared with yours?"

MR. CANAGARETNA said the GASB numbers are just now becoming an issue that people are talking about. He stated, "So, the NASRA numbers are accurate as it is, but obviously factoring in the GASB ruling, it'll be a whole different picture."

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TOMAS H. BOUTIN, Deputy Commissioner, Office of the Commissioner, Department of Revenue (DOR), stated that the Division of Treasury in DOR is the contractor for the pension fund fiduciary for the Alaska State Pension Investment Board (ASPIB). He noted that some pension fund responsibilities are in a transition phase due to SB 141, given the expectation that the bill will be transmitted to the governor and signed into law. On September 30, ASPIB will sunset and be replaced on October 1 by the Alaska Retirement Management Board, which will become the fiduciary.

MR. BOUTIN noted that ASPIB is by far the largest client of the Treasury Division. As of May 31, the Treasury Division managed

\$20.3 billion, of which \$12.6 billion was in PERS, TRS, Judicial Retirement, and Military Retirement funds. Of that amount, about \$2 billion is managed internally, all in fixed income, meaning that state investment officers buy and sell securities every trading day, and the bulk of the money is managed by so-called external managers - private money management firms hired by the fiduciaries. The department manages those contracts on a day-to-day basis for ASPIB and provides custodial, governance, and compliance services to the board.

MR. BOUTIN said the asset allocation decided by the fiduciary has a specific and predictable amount of volatility or risk. Judging results over any short term could lead to conclusions that do not properly account for that risk. Over the long term, investment returns have exceeded both the target returns for the asset mix selected by the fiduciary and the rate of return assumed by the actuary. Mr. Boutin noted that for calendar year 2004, Institutional Investor magazine selected ASPIB as one of the top three public pension plans in the nation.

MR. BOUTIN stated his understanding that the House Special Committee on Ways and Means will be conducting a series of meetings around the state regarding the issue of PERS and TRS. He said he doesn't know to what degree the committee would like to examine investment results, practices, trends, and outlook; however, he made available to the committee all of the resources at DOR. For example, he said he, the chief investment officer, and the state investment officers could present any detail of investment numbers the committee desires, including how managers are hired and fired by the fiduciaries, how investment managers are selected to be entrusted with the hundreds of millions of dollars that the typical investment management firm manages.

MR. BOUTIN said ASPIB has allocated assets to investments in real estate, agricultural land, hedge funds, private equity, high yield bonds, and mainstream equity and fixed income investment classes and styles. He said the investment consultant, Callan and Associates, could present the ASPIB results "in the context of Callan's data base that is the universe of public and private pension plans.

MR. BOUTIN said the state comptroller is responsible for compliance, governance, and investment accounting, and he suggested a presentation on those topics may be of interest to the committee. He stated that three years ago, ASPIB contracted with a firm to provide a fiduciary audit of investment practices. That firm came up with 85 recommendations, and the

board has now dealt with all the recommendations. A presentation on that fiduciary audit would be another subject for a possible presentation.

MR. BOUTIN noted that the department is also responsible for state debt management, and he suggested the committee may want to have some information regarding how the pension liabilities are viewed in relation to other liabilities such as debt. Furthermore, the department could also offer a perspective on pension obligation bonds, although it has no experience with issuance of those bonds. Mr. Boutin said one final idea for the committee to consider is to come visit the Treasury Division to meet the fixed income traders and the other state investment officers, as well as those working in accounting and cash management.

MR. BOUTIN, in conclusion, offered some numbers related to investments. He noted that in fiscal year (FY) 04, PERS investments generated a 15.08 percent rate of return compared with 3.67 percent in 2003, while TRS investments generate a 15.09 percent rate of return compared with 3.68 percent in 2003. The PERS and TRS annualized rates of return were 4.09 percent over the last three years and 3.29 percent over the last five years. FY 05 numbers are not yet available, he said.

MR. BOUTIN, regarding asset allocations, noted that during FY 04, both PERS and TRS asset allocations were 40.4 percent domestic equities, 17.9 percent international equities, 27 percent domestic fixed income, 3.6 percent international fixed income, 7.8 percent real estate, and 3.3 percent alternative investments.

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CHAIR WEYHRAUCH relayed that the committee would appreciate information detailing how the current unfunded liability came about and what strategic approach is the Department of Revenue advising the new Alaska Retirement Management Board to address it. He said he would also like to know what involvement is necessary from the legislature. He said, "I think to the extent that we work in close partnership with the administration, the more productive our results can be."

MR. BOUTIN agreed to research those issues and provide information to the committee. He stated that over the long term, the investment returns have exceeded both the target returns and the actuarial assumptions; the asset allocation that

the fiduciary has selected carries with it a risk of a variation in returns from year to year, including losses, which demands a long-term perspective.

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REPRESENTATIVE ROKEBERG asked what the administrative branch's policy is regarding the recently passed [SB 141] and "its relationship to the legislature in the next session."

MR. BOUTIN relayed that the Treasury Division and the Office of the Commissioner in the Department of Revenue and the Office of the Commissioner and the Division of Retirement & Benefits in the Department of Administration are meeting almost weekly to address the implementation of SB 141, and reports are made to the cabinet regarding "where we are in that implementation." He said there are certain "things" that are needed from the Pension Investment Board for the implementation of SB 141. He said the expectation is that SB 141 will be signed into law.

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REPRESENTATIVE KELLY said he would like to hear from Mr. Boutin regarding options other than pension obligation bond (POB) approach.

MR. BOUTIN mentioned possible solutions that have been discussed, including leveraging, POBs, and alternative options. He indicated that the Treasury Division has decided that if one day there is a fiduciary that wants to use leverage, the division could come up with more appropriate increments and lower-cost ways to borrow money.

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MR. BOUTIN, in response to comments from Representative Gruenberg, noted that issues pertaining to liability, including health care and actuarial assumptions are not within the purview of the Department of Revenue. He interpreted Representative Kelly to have said that "the map" doesn't fairly portray Alaska, because virtually all the states on it do not include health care in their actuarial calculation of liability, whereas Alaska does; therefore, it's like comparing apples and oranges. He noted that the State of Alaska has the highest credit ratings it has ever had. Each time state general fund credit ratings are reviewed, the pension liability is looked at and, at the current funding levels, the State of Alaska's pension situation is not a

concern to the credit rating agencies, particularly in light of the new GASB rule.

REPRESENTATIVE KELLY clarified that he had not intended to say that the map shows Alaska in better shape than it appears, but rather that the other states are portrayed inappropriately relative to the GASB ruling.

CHAIR WEYHRAUCH clarified for the record that the aforementioned map is from a Council and State Governments magazine; the same magazine in which Mr. CanagaRetna's article appeared.

REPRESENTATIVE GRUENBERG asked why the state should be concerned about the unfunded liability if the people who do the credit rating are not.

MR. BOUTIN prefaced his answer by saying that, as Deputy Commissioner for the Treasury Division, he does not have any advise to give regarding what the legislature should and should not be concerned about. Notwithstanding that, he said the credit rating agencies look at the entire mix of assets and liabilities and income outlook of any particular credit, and "they've used words for this administration, like 'strong fiscal management'" and are impressed with the resource drive of the administration. He said, "They mention the pension situation, but not in a negative way, when they write up the state's credit."

REPRESENTATIVE GRUENBERG noted that there are a number of municipalities across the state that are finding their pension liabilities and insurance costs so high that some of them are considering dis-incorporating "and taking other major steps." He asked Mr. Boutin for comment.

MR. BOUTIN offered, for example, that yesterday the Alaska Municipal Bond Bank approved purchase bonds from Petersburg and Haines, and it looks as though it will do so at its next meeting for the Northwest Arctic Borough. He said that resulted from an independent look at assets, liabilities, and future revenues of those three political subdivisions of the state.

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JOSEPH ESUCHANKO, President, Actuarial Service Company, P.C., relayed that he'd done a study for the Legislative Council. He noted that in its June 30, 2002, actuarial evaluation, Mercer Human Resource Consulting made some significant changes in the

methods and assumptions it was using and it has been relatively consistent in those assumptions for the next two years. He offered the following comparison of the years 2002-2004 as follows:

At June 30, 2002, the actuary projected the unfunded liability in '04 to be \$5.0 billion. A year later, with additional experience, they changed their projection to \$5.5 billion, and then when the June 30, [2004], report came out it was actually \$5.7 billion. In 2002, the actuary projected the 2005 liability to be \$5.1 billion. In 2003, they changed that projection to \$5.9 billion, and ... on June 30, 2004, they changed it again to \$6.2 billion.

MR. ESUCHANKO explained that he was not criticizing the changes; as an actuarial gets more experience and garners more information, it updates its information. He stated that he roughly estimates that on June 30, 2005, [the unfunded liability] will be \$6.6 billion, which includes PERS and TRS. Mr. Esuchanko continued with his comparison as follows:

In '02, the June 30, [2006], unfunded [liability] was projected to be \$5.1 billion. In '03 it was changed to \$6.1 billion. In '04 it was changed to \$6.7 billion.

MR. ESUCHANKO said his estimate for next year is \$6.9-\$7.7 billion, and he leans more toward the upper end of that range than the lower. He said the situation is getting worse compared to what the projections have been. He said that when he made his report to the Legislative Council, he noted that there are alternative ways to calculating the liability. Currently, it is calculated under a method called, "projected unit credit." He said that's a method that's only used by 11 percent of state plans, whereas about 75 percent use an "entry age normal" method. He said, "It means that we calculate liability from the time you're hired to 'til the time you retire, and we project it along a continuum, and we look at it at this point in time." Mr. Esuchanko said if a calculation were shown using that method there would be a better comparison to other states' systems when looking at their relative unfunded liabilities.

MR. ESUCHANKO said another method he suggested, which is not used often, is a "present value of accrued benefits." That method asks, "If the employee quits today, how much benefit has he earned?" A value is put on that figure and is compared with

the assets. By doing this there is an idea of whether the benefits that have been earned are being adequately funded.

MR. ESUCHANKO listed a fourth method as the "aggregate" method, which produces no unfunded liability. He explained, "What it does is it gives you a relatively large annual contribution, because it amortizes all the [unfunded liabilities], theoretically, over the work lifetime of your employees." He offered further details. He said some consideration should be given to "seeing what these answers look like." He continued:

As far as the future goes, the unfunded accrued liability is going to increase over the near future, as far as I can tell. Because you've put in a defined contribution plan, it will begin to level out, possibly with a small decline. And then, after your 25-year amortization period is up, it will then start to decline because you're fully amortized.

MR. ESUCHANKO, in response to a question from Representative Rokeberg, said he doesn't know why 25 years was chosen as the period of amortization. He continued:

One of the primary reasons for the increase in unfunded liabilities is the large cost of medical benefits. When I look at the actuary's June 30, [2004], evaluation, I see that 28 percent of the payments - the cash flow out of the fund - ... to retirees is for medical benefits. When I look at the accrued liability, 38 percent ... is for medical benefits. And when I look at the normal cost - the contribution for this year's accrual - 43 percent is attributable to medical benefits.

In 1999-2004, inflation increased 13.1 percent; wages increased 16.7 percent. ... These statistics are on a nationwide basis. The average medical premium increased 67.5 percent. The PERS/TRS medical premium increased 82.4 percent. Clearly medical growth is significantly greater than inflation, and it's becoming a larger and larger portion of the gross national product.

MR. ESUCHANKO turned to what can be done. He said the June 30, 2004, draft of the actuarial valuation came out in the spring of [2005]. He suggested that a full actuarial valuation as of June 30, 2005, be done as soon as possible, so that as the

legislative session begins in 2006, answers will be provided much sooner and a known problem can be addressed rather than a projection. From that, he said, the legislature will be able to determine the unfunded liability. Mr. Esuchanko suggested going one step further to "identify the sources"; discover how much of that unfunded liability is attributable to each individual tier and, within that, to each individual benefit. He said doing so will give the legislature a better picture of where things are.

MR. ESUCHANKO also suggested that the legislature perform various marginal analyses regarding, for example, the health trend rate, inflation assumptions, investment returns, and salary increases. Regarding the health trend rate - the actuary's assumption as to what health costs will do in the future - he stated his experience is that if health costs are just one percentage point higher than the actuary assumed, the accrued liability goes up by 8-12 percent. Regarding investment returns, he asked, "If 8.25 [percent] is the assumed rate of return, what happens if the real rate of return is 10 percent? ... How sensitive are the results to actual experience?"

MR. ESUCHANKO continued:

Then I'd like you to look at alternative actuarial funding methods and assumptions. ... Right now you're using projected unit credit; you may want to consider entry age normal, which is probably the only other one that I would suggest you consider. You're valuing assets in a very traditional way and I would suggest you stay with it. You've had experience studies done to see how your assumptions compare to actual experience and your assumptions are pretty much in line with experience, but this would be a good time to do a full experience study for a period of five or more years to see whether assumptions should be changed.

And then develop a strategic plan. Is there any way you can lower operating expenses? Is there any way you can increase net return on investments? Is there any way medical cost savings can be instituted? And is there any way you can reduce future pension payment, without violating the constitution - without taking away an employee's rights. As your committee continues through the summer and the fall, there are many things that I see that you can look at.

2:56:38 PM

CHAIR WEYHRAUCH asked if the legislature has purview over the various aforementioned methods or if they are recommendations from consultants that are adopted by the agency.

MR. ESUCHANKO offered his understanding that the actuary recommends the changes and then the pension board makes the final decision. He said the director of the Division of Retirement & Benefits would be able to further comment on that subject.

MR. ESUCHANKO, in response to Representative Gruenberg, agreed to submit his comments in writing. He said there are expansions of ideas that he could provide.

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SENATOR HOLLIS FRENCH, Alaska State Legislature, asked Mr. Esuchanko if the state would have been better off if it had been using the entry age normal method since 2002, for example.

MR. ESUCHANKO explained that if the entry age normal method had been used, the unfunded liability would be different than it is under projected unit credit, but "had you been using it consistently over the years, you still would have had increases in your unfunded liability."

SENATOR FRENCH asked, "Would it have been as large?"

MR. ESUCHANKO indicated that it may have been as large. He said what he sees could have been done differently is the projections. He said, "Certainly the actuary could not project in the mid-90s that there would be a stock market problem in 2000; so some of these things are impossible to predict." Nevertheless, he noted that what he has done is look back at the last three years to see what has actually happened to what's been projected. He said, "It seems obvious to me that experience is coming out different than the actuarial assumptions are determining, and possibly a change in assumptions could have been made that would have projected more accurately where you're going and allowed you to make an earlier change in your direction."

SENATOR FRENCH surmised that making a little change in the present could prevent problems in the future. He asked, "If we could go back to '02 and do it all over again with perfect

hindsight, wouldn't you have increased your contribution rate slightly then to avoid a big unfunded liability in the future?"

MR. ESUCHANKO answered, "With hindsight you would have, yes."

SENATOR FRENCH asked if medical costs caught Mr. Esuchanko's industry by surprise. He asked, "If I went back to 2002, wouldn't I find a whole bunch of articles in popular magazines and ... financial magazines about how medical costs are going to do nothing but ... increase?"

MR. ESUCHANKO answered as follows:

Within the actuarial profession it's fairly standard practice to assume over the past several years that health care costs would increase - let's pick a number - 12 percent over the next year, and then the following year drop that to 11 [percent], and then to 10, and then 9,8,7,6. Let's level [it off] at 5 [percent]. And the rationale is because medical expenses are becoming such a high portion of the [gross national product (GNP)] it can't go on at these 12 and 10 percent rates, so the actuary assumes it will eventually level off at 5 percent. The fact is, he was making those assumptions in 1992, and in 2002 he was making the same assumptions - 12 percent for the next year - and so each year you're showing losses. If you looked at some of these projections out into the future for inflation and medical expenses, then you might say that a better assumption is 12 percent per year for the next three years, 11 percent for the next three, and 5 percent for the next five, or something of that sort. ... We've got to think outside the box. The actuaries at Mercer have been making what I would call standard actuarial assumptions; there would be no criticism from the actuarial profession of the assumptions they are making

SENATOR FRENCH concluded, "I guess ... the common sense response to that is, 'How many years in a row can you be wrong before you decide you're wrong?'"

REPRESENTATIVE ROKEBERG asked Mr. Esuchanko to provide information to the committee regarding the cost of retaining his services again and to "break the cost out to how the scope of work can be defined in those discreet areas."

3:06:49 PM

MR. ESUCHANKO said his first recommendation would be an actuarial evaluation as of June 30, 2005, as soon as possible. He said the question would be whether Mercer or he performs the actuarial, or whether Mercer performs it and he performs it as a second opinion, which would significantly affect the fee quote.

REPRESENTATIVE ROKEBERG posited that that recommendation is helpful.

3:07:46 PM

REPRESENTATIVE ROKEBERG noted that the Security Exchange Commission (SEC) has recently criticized the conduct of actuarial firms. He asked Mr. Esuchanko to comment.

MR. ESUCHANKO explained that there are actuarial standards of practice and guidelines to professional practice of the Society of Actuaries and the American Academy of Actuaries. He stated that an actuary is supposed to be independent and objective in his/her work. He said he is sure there has been criticism of actuaries who find out what their client wants and make it happen; however, he said he thinks there are very few actuaries who actually do that.

CHAIR WEYHRAUCH surmised that sometimes that is not necessarily a bad thing. In other words, if a person wants to meet an objective, then the actuary would tell them how to get to that objective using certain assumptions.

MR. ESUCHANKO concurred. He proffered, "I think where the criticism would come in would be if the state would say, 'I know we've got this big unfunded liability but we can't afford it right now, we need an answer down here.'"

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REPRESENTATIVE GRUENBERG surmised that one of the items to consider is the dramatic rise in health care costs, and he asked whether there is "a branch of actuary science" that focuses on that issue.

MR. ESUCHANKO relayed that there is such a branch though it is not his specialty. In response to a follow-up question from Representative Gruenberg, he offered his understanding that the

rise in health care costs is in part due to the development and advertisement of "designer drugs." Generic drugs are not getting nearly the amount of use as the name brand drugs. There is a significant cost in developing drugs. He noted that a person in a certain state of health today is using significantly more medication than a person in the exact state of health was using 15 years ago. He offered another factor of rising health care costs as follows:

When a person is enrolled in a health plan where he or she contributes nothing, you've essentially given that person a free credit card: "Go to the doctor; charge it to my employer." And so the discipline to ... make conservative use of the physicians is lost with the free credit card concept.

MR. ESUCHANKO said there are other factors that he would be available to address if asked.

[3:14:05 PM](#)

MELANIE MILLHORN, Director, Health Benefits Section, Division Of Retirement & Benefits, Department of Administration (DOA), referred to a handout provided the committee entitled, "PERS and TRS Funding." She directed attention to page 2, which shows [earnings, actuarial rates, employer rates, and funding ratios] for PERS and TRS, separately. She said the actuarial valuation report itself is a report that is provided to the legislature each spring. It is important because it measures the assets and liabilities, provides the funding ratio, and, primarily, facilitates in determining what the employer contribution rate needs to be, "given the funding ratio and the promises of benefits to future members." Referring again to page 2 of the handout, she explained that "measurement year" is the actuarial valuation year. She said, "This is a four-year look-back with the most recent actuarial valuation that we have, which is in draft right now." The handout shows for PERS that the measurement year is fiscal year (FY) 01, which, Ms. Millhorn said, "sets the employer contribution rate as of FY 04." She noted that the actuarial investment return for PERS and TRS is 8.25 [percent]. The actual investment return was a negative 5.25 percent. She noted that the actual investment return for measurement years FY 02, 03, and 04 was negative 5.48 percent, positive 3.67 percent, and positive 15.08 percent, respectively.

MS. MILLHORN read the next line, which shows the cumulative dollar shortfall, the most recent being a shortfall of \$3.5

billion. The average calculated rate in the next row shows 6.77 percent under measurement year FY 01, which she said is an average taken from approximately 155 employers with their own contribution rates. She noted that, per regulation, that contribution rate can increase or decrease up to 5 percent in any one year. The contribution rate for measurement years FY 02, as recommended by the actuary, she noted, was 24.91 percent. She explained the reason that number is [typed in bold] is because she has other presentation material that goes back to that valuation and what happened during it to "get us to where we are right now." She read the average calculated rates for FY 03 and 04, which were 25.63 percent and 28.19 percent, respectively.

MS. MILLHORN, [in regard to the board adopted rates, which are shown on the next line down], said:

Right now, the board normally meets and sets a rate; they have not done that at this point in time, and it's expected that they will do that in October. But what the division has done during that intervening time period is we have advised all of our employers that they should anticipate, at a minimum, for budgetary purposes, up to a 5 percent increase. So, that communication was sent to the employers the very beginning part of June.

If the board adopts a 5 percent increase, that would represent 25 percent for FY 07. And if again they adopt another 5 percent increase, which is ... the expectation, it would be 26 percent. And the reason that is really, critically important is: For every year you do not contribute at the actuarial calculated rate, as recommended by the actuary, you're adding additional liability to your system.

MS. MILLHORN said the funding ratio [shown on the next line] for 2001 was 100.9 percent and dramatically changed to 75.2 percent for 2002. Currently the draft valuation shows the funding ratio at 70.2 percent.

MS. MILLHORN reviewed the numbers shown for corresponding categories in TRS. She highlighted that the actual investment returns for FY 01, 02, 03, and 04 were negative 5.35 percent, negative 5.49 percent, positive 3.68 percent, and 15.08 percent, respectively. She stated, "Currently, the shortfall (indisc. -- coughing) about \$3 billion for a total of \$5.7 billion as of the

valuation in draft for 2004." The recommendation from the actuary from the TRS 2002 valuation was 35.35 percent, she said. The funding ratio, she said, is 62.8 percent.

MS. MILLHORN said there are 3 primary drivers associated with the underfunded status: rising health care costs, loss of investment income, and change of assumptions. She directed attention to page 5, which she explained is a document directly from the actuarial valuation provided [June 30, 2002]. It shows that the contribution rate [from the prior year] was 6.77 percent and after adding all the variables, the contribution rate shows as 24.91 percent. Two of the factors shown, both health care related, add up to 10.66 percent. She noted that many of the factors listed on page 5 are a consequence of an audit that was conducted by Milliman USA in 2002. The purpose of the audit was to ensure that the actuarial condition of the system accurately measures the assets and the liabilities, and that the assumptions are reasonable in order to pay for promised future benefits. When that audit was conducted, the actuary made recommendations to change the health trend from 7.5 percent to 12 percent for the next three years, then grading down to 5 percent by FY 17.

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SENATOR FRENCH asked if that happened.

MS. MILLHORN said it did, adding that after the actuarial audit was conducted, all of the recommendations that were made by Milliman USA were adopted by Mercer Human Resource Consulting, and those changes were later adopted by the board to be included in "this actuarial valuation."

MS. MILLHORN, in response to a question from Representative Wilson, said that, unlike for PERS, there is not a regulation in place that sets the rate of increase or decrease for TRS; thus, the board recommends the employer contribution rate. She said that for about ten years the board had adopted an employer contribution rate that was fixed, but after a downturn in the market, the board recommended a 5 percent increase to the commissioner of the Department of Administration. In response to a follow-up question from Representative Wilson, she said the 5 percent limit for PERS was established in regulation.

REPRESENTATIVE WILSON-noting that ... knew it was inadequate, did they inform the legislature of that fact.

MS. MILLHORN, in response to another question from Representative Wilson, indicated that the final authority for changing the 5 percent amount rests with the commissioner.

REPRESENTATIVE WILSON pointed out that the commissioner may not know the need for the change if he/she is not informed.

MS. MILLHORN offered her recollection:

When the employer contribution rate was discussed at the last meeting and established increases at 5 percent, that was joint PERS/TRS meeting. And I recall that actually for [PERS], initially there was a recommendation for less than 5 percent, but ultimately 5 percent was adopted. And different employers come to those meetings and I do not recall that there was any testimony that indicated that it should be higher than the 5 percent, and it's my sense, if you will, that while [TRS] normally adopted a flat employer contribution rate, it appeared as if they were following suit ... with the board members for [PERS].

REPRESENTATIVE WILSON said she could understand "in the last couple years the hesitancy, especially for PERS, for municipalities, because they haven't been getting revenue sharing," but with regard to the major jumps in percentages that have shown historically, she said she wonders how that happened.

[3:31:20 PM](#)

REPRESENTATIVE ROKEBERG asked when the 2002 audit was made public.

MS. MILLHORN answered that the audit was conducted in October 2002, at which time the division received the report. She said, "Thereafter, that information was provided to the boards, and then ultimately incorporated into the valuation." She said the schedule for the valuation begins in September when the actuary receives the data file from the division, and the actuary spends from September until approximately December or January doing all the analyses necessary in preparation for the draft valuation to come out the first part of February to be submitted to the boards in March and to the legislature shortly after adopted by the boards.

MS. MILLHORN said the practice has been for the boards to look at the valuation report and then, after adopting it, a copy of that valuation "goes to the legislature; goes to the governor."

REPRESENTATIVE ROKEBERG surmised that if the report was received in October of 2002, it would have been available for the deliberations of the 2004 budget in "calendar 03." He said he is not frankly sure that the legislature was aware of that.

[3:33:12 PM](#)

MS. MILLHORN - noting that she was not present when this process happened - explained what would happen when an audit was completed:

That audit would be reviewed by the board and, after that point, they would make determinations about accepting the recommendation. Obviously Mercer did. They accepted the recommendations by Milliman, and the very next process would be that the board would receive that information. Thereafter, they would concur with that information, and then it would be incorporated into the valuation, which would then be received by the legislature. I'm not sure that there's an explicit process whereby any of the audits go to the legislature separately from the actuarial valuation.

REPRESENTATIVE ROKEBERG emphasized how important it is to him to be able to see the time line.

REPRESENTATIVE GRUENBERG asked Ms. Millhorn when [the Department of Administration] first became aware that the average calculated rate was increasing dramatically.

MS. MILLHORN estimated that the department would have become aware of it somewhere around December or January.

REPRESENTATIVE GRUENBERG noted that the effect of retirement incentive programs (RIPs) or rehiring retired employees has not yet been discussed, which are both issues that he thinks have contributed to the problem. He stated his concern that "this has gotten away from us" and he would like the committee to take a look cause and prevention, and would welcome Ms. Millhorn's advise.

REPRESENTATIVE ROKEBERG noted that the legislature has been accused of being part of causing the problem and he said he takes great exception to that, because most of the legislature was not even aware of the problem until most recently, but now is being told the information was available much sooner.

REPRESENTATIVE GRUENBERG said he is hoping to fix the problem rather than affixing blame.

CHAIR WEYHRAUCH concurred that that was the goal of the committee.

[3:40:26 PM](#)

MS. MILLHORN in summary, invited members to inform her division of ways in which it can help the legislature achieve its goals.

CHAIR WEYHRAUCH suggested that such a process might be time consuming but much needed, and expressed his hope that the cause of the problem can be discovered in order to come up with preventative measures for the future.

MS. MILLHORN relayed that the division's handout also provides details of the information she'd originally discussed, adding that similar material is available with regard to TRS, and that Mr. Boutin mentioned that there is material that discusses the change in net assets compared to the change in liabilities over a ten-year period. She said that information can be found in a two-page letter from Mercer Human Resource Consulting [attached to the report].

REPRESENTATIVE ROKEBERG said the asset methodology change, particularly the recognition of deferred losses, has had a substantial impact on the shortfall. He asked for clarification of the term, "corridor adjustments," and said he would like to know "what was done previously."

MS. MILLHORN explained that the corridor adjustment method looks at a corridor above and below assets and makes a calculation based on that. She said the methodology does not work well when there is a downturn in the method. Furthermore, the corridor method has been described as complicated and difficult to understand. Milliman changed to the asset smoothing method, which is a common method used by pension systems. However, in order to make that change, it was necessary to "reset to market the fair value of assets." In order to take in losses, that

change represented a \$1 billion immediate recognition for PERS and \$866 million immediate recognition for TRS.

[3:47:02 PM](#)

REPRESENTATIVE GRUENBERG referred to page 3 and told Ms. Millhorn that he would appreciate any further identification the division could provide [explaining the causes of the deficit].

REPRESENTATIVE ROKEBERG asked whether there is an executive summary of the audit.

MS. MILLHORN said she would provide Representative Rokeberg with a copy of the audit.

REPRESENTATIVE ROKEBERG asked what the difference is between ad hoc [post retirement pension adjustment (PRPA)] and [Cost of Living Allowance (COLA)].

MS. MILLHORN said that the ad hoc PRPA is a benefit available to Tier I PERS and TRS members, and it is discretionary; it is based on the financial health of the system. She explained that COLA is available in statute and is based on residency and individual (indisc. - fade out).

REPRESENTATIVE ROKEBERG surmised that in the FY 02 budget the legislature appropriated \$20 million as an extra bonus to Tier I employees. He asked, "Is that at the discretion of the legislature to grant that, or what?"

MS. MILLHORN said that such is recommended by the PERS and TRS Boards and approved by the commissioner.

CHAIR WEYHRAUCH pointed out that the bonus to Tier I employees occurred at a time when the state was experiencing a \$2.4 billion shortfall.

MS. MILLHORN, in response to a question from Representative Rokeberg regarding a COLA lawsuit, relayed that Assistant Attorney General Neil Slotnick is handling that case. She said the case was heard by the superior court, which decided, against the State of Alaska, that "it was a violation of the constitution not to pay those individuals because they had decided to live in a high cost-of-living area." The case is being heard next in Alaska Supreme Court.

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REPRESENTATIVE GRUENBERG offered his understanding that the PRPA was based on litigation, too.

MS. MILLHORN concurred. She offered further details. In response to Representative Gruenberg, she said the PRPA is funded out of the pension system, not out of general funds. In response to a follow-up question from Representative Gruenberg, she said the Commissioner of the Department of Administration has not approved an ad hoc PRPA in the last three years, due to the funding of the system, and there has been no law suit brought forward.

REPRESENTATIVE GRUENBERG pointed out that the statute of limitations had not yet run out.

[3:55:51 PM](#)

KEVIN BROOKS, Deputy Commissioner, Office of the Commissioner, Department of Administration (DOA), noted that the recently passed SB 141 addresses many of the issues being raised.

[3:56:57 PM](#)

DAVID TEAL, Legislative Fiscal Analyst, Legislative Finance Division, Alaska State Legislature, regarding the shortfall, said he thinks the options are clear: reduce expenses or increase income. He said Mr. CanagaRetna's testimony provided a good starting point; a list of what other states have done to reduce expenses. He noted that Mr. Boutin had testified that the legislature can look at earnings in terms of increasing income. Mr. Teal said, "You may be able to increase earning, but I can tell you that I would be happy to have the returns that the pension funds have had on my personal account." He said he thinks contributions have not really been looked at yet - "the ability to address this through additional appropriations." He reminded the committee that the state has been running a deficit of approximately \$500 million a year, for the past decade. Although revenue in the state is promising, the expenditures are increasing faster than the revenue. The price of oil is high and likely to stay so. He said [FY] expenditures were approximately \$2.5 billion if you correct for crossing fiscal years and jumped to over \$3.2 billion in [FY] 06, which is an increase of more than 25 percent. He stated, "The outcome is likely that we simply fill the deficits that we faced in the past; I don't expect any surplus on a continuing basis."

MR. TEAL said that the good news is that the state has included health costs in its analysis, because it will not be affected by the GASB methodology change. Alaska is far from being short of cash like some states are. Nevertheless, the deficit of \$5.7 billion is not a small amount, particularly given that the projection is that it will increase as high as \$15 billion in the future. He noted that the deferred compensation plan that was recently adopted, by its nature eliminates unfunded liabilities. He said it is important to look at the trend, which, he suggested, illustrates that the situation has deteriorated. Nothing works every time and everywhere, but there are steps that can be taken. He said, "It's hard to see the results when something turns so slowly, but I'm just glad that you recognize that there is a problem and that it's better to turn slowly than not turn at all." He indicated that the Legislative Finance Division can offer assistance, but like the Division Of Retirement & Benefits, will need some direction from the legislature. He concluded, "Give us some direction, and we'll do the best we can."

[4:04:25 PM](#)

CHAIR WEYHRAUCH surmised that today's meeting offered the committee a chance to hear the different views of those who testified. He said that further meetings will focus on further refining the problem with the goal of arriving at solutions. He expressed appreciation to those who testified for providing the public with information regarding the unfunded liability, and he said he thinks there are many good ideas to derive from the public and special interest groups in the future.

REPRESENTATIVE GRUENBERG thanked the chair for addressing these issues in a bipartisan manner. He asked Chair Weyhrauch if he plans to conduct future hearings limiting the topic to the unfunded liability issue.

CHAIR WEYHRAUCH said that he does not want future meetings to denigrate into a critical process of "what we've done with respect to the policy decision and implementing the defined contribution plan." He said he would like to focus on making what has been recently adopted better. In response to another question from Representative Gruenberg, he indicated that he envisioned holding at least three more meetings before the start of the next legislative session.

REPRESENTATIVE ROKEBERG noting that he'd had discussions with Carol Comeau, Superintendent, Anchorage School District, and he

thinks school districts should be encouraged to participate in the process. He said he is particularly impressed with the methods that NEA has used for its health care cost containment. He said that is an issue that could be explored in a more formal manner with a greater degree of detail. He also suggested that Mr. Slotnick be invited to discuss issues such as the COLA case and ad hoc PRPA legal review and what the legislature can do to manage those issues. He characterized Mr. Teal's comment - that even with the surplus the state generates from oil revenue for the next ten years the state will still have a shortfall - as disturbing.

[4:12:43 PM](#)

REPRESENTATIVE WILSON suggested that having an idea ahead of time when future meetings might occur could facilitate members' ability to attend. Referring to the ratio of seniors to school age children, she said she would like to know the numbers for Alaska. Regarding a suggestion that permanent fund earnings be used, she pointed out that the pension is only for state employees, while the permanent fund earnings are spread across to all residents of the state; therefore, she warned that there could be an outcry in using those funds to solve the shortfall. She indicated that she thinks the legislature needs to look at the previously discussed methods and consider using more than one. She noted that Mr. Esuchanko had suggested a lot of possible ways to look at the situation and get information and facts, in order to proceed intelligently.

CHAIR WEYHRAUCH noted that the public employee unions, school districts, NEA, the municipalities through the Alaska Municipal League (AML), and other employers around the state have all offered to assist the committee as it deliberates on this issue and would certainly be invited to the discussion. He said more information would be garnered and more expertise would be sought to help advise the committee.

ADJOURNMENT

[4:16:46 PM](#)

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at 4:16 p.m.