

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

September 8, 2005

1:01 p.m.

MEMBERS PRESENT

Representative Bruce Weyhrauch, Chair
Representative Norman Rokeberg
Representative Paul Seaton
Representative Peggy Wilson
Representative Max Gruenberg

MEMBERS ABSENT

Representative Ralph Samuels
Representative Carl Moses

OTHER LEGISLATORS PRESENT

Representative John Coghill
Representative David Guttenberg
Representative Jay Ramras
Representative Carl Gatto
Representative Mike Kelly
Representative Kurt Olson

COMMITTEE CALENDAR

PERS/TRS FUNDING SHORTFALL ISSUES

- HEARD

PREVIOUS COMMITTEE ACTION

No previous action to report

WITNESS REGISTER

MELANIE MILLHORN, Director
Health Benefits Section
Division of Retirement & Benefits
Department of Administration
Juneau, Alaska

POSITION STATEMENT: Testified on behalf of the division.

DAVID TEAL, Legislative Fiscal Analyst

Legislative Finance Division
Legislative Agencies & Offices
Juneau, Alaska

POSITION STATEMENT: Testified during the discussion of PERS/TRS shortfall issues.

GARY HUTCHISON
Fairbanks, Alaska

POSITION STATEMENT: Testified on behalf of himself to recommend a change to the [Alaska State] Constitution.

CHARLES GALLAGHER, Chair
Retired Public Employees of Alaska
Northern Region Chapter
Ester, Alaska

POSITION STATEMENT: Testified on behalf of himself during the discussion of PERS/TRS shortfall issues.

DORIS ROBBINS, Member
Retired Public Employees of Alaska (RPEA)
Fairbanks, Alaska

POSITION STATEMENT: Testified during the discussion of PERS/TRS shortfall issues.

RICHARD SOLIE, Ph.D.
Fairbanks, Alaska

POSITION STATEMENT: Offered comments during the discussion of PERS/TRS shortfall issues.

JEFF JOHNSON
Fairbanks, Alaska

POSITION STATEMENT: Testified during the discussion of PERS/TRS shortfall issues.

BILL BJORK, President
NEA-Alaska
Anchorage, Alaska

POSITION STATEMENT: Testifying on behalf of NEA-Alaska, offered advise during the discussion of PERS/TRS shortfall issues.

WAYNE HEIMER
Fairbanks, Alaska

POSITION STATEMENT: Testified on behalf of himself to make a suggestion during the discussion of PERS/TRS shortfall issues.

DON GRAY
Fairbanks, Alaska

POSITION STATEMENT: Testified on behalf of himself during the discussion of PERS/TRS shortfall issues.

V. K. LAHDENPERA
Anchorage, Alaska

POSITION STATEMENT: Testifying on behalf of herself, offered comments during the discussion of PERS/TRS shortfall issues.

KEVIN RITCHIE
Alaska Municipal League
Juneau, Alaska

POSITION STATEMENT: Testified on behalf of the AML during the discussion of PERS/TRS shortfall issues.

ACTION NARRATIVE

CHAIR BRUCE CHAIR WEYHRAUCH called the House Special Committee on Ways and Means meeting to order at [1:01:36 PM](#). Present at the call to order was Representative Weyhrauch. Representatives Rokeberg, Seaton, Wilson, and Gruenberg joined the meeting via teleconference as it was in progress.

DISCUSSION OF PERS/TRS SHORTFALL ISSUES

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CHAIR WEYHRAUCH announced that the only order of business was the discussion of PERS/TRS shortfall issues. He said that presently there is approximately a \$5.7 billion unfunded liability and a question regarding what that means to both the systems, those in them, and those retired from them. He clarified that the purpose of the hearing was not to delve into policy debates over whether there should be a defined benefit or defined contribution plan; that policy decision has already been made by the legislature. He said the House Special Committee on Ways and Means will be looking at the financial implications related to the unfunded liability and what, if anything, the legislature should do about it. He said the committee will hear public testimony and then decide whether there are a range of options to present to the legislature to address the unfunded liability. He reviewed that at the last hearing, the committee did not take public testimony, but heard from recognized experts on state retirement systems to place Alaska's system in the context of the national perspective. He offered a brief history of the House Special Committee on Ways and Means and noted that "this kind of a hearing fits within the strategic context" of the committee.

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MELANIE MILLHORN, Director, Health Benefits Section, Division of Retirement & Benefits, Department of Administration, referred to a memorandum in the committee packet, dated September 7, 2005, which she said shows the response of the division to questions posed by Chair Weyhrauch. The first question asks what the present amount of the unfunded liability is for PERS and TRS. As of the draft valuation of June 30, 2004, the unfunded accrued liability for PERS is \$3.4 billion and \$2.4 billion for TRS. The total unfunded liability, as previously mentioned, is \$5.7 billion. She noted that it takes the actuary six months to conduct a complete valuation on each of the systems. The valuation for a one-year period ending June 30, 2005, was available for dissemination in draft form as of April 2006. She noted that the information was reviewed by the PERS and TRS Boards in March, but the valuations were not finalized; therefore, they are still in draft form.

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REPRESENTATIVE DAVID GUTTENBERG, Alaska State Legislature, asked if the state is still retaining the services of Mercer [Human Resource Consulting] as its actuary.

MS. MILLHORN answered yes; however, she noted that the division went out for a request for proposal (RFP) for actuarial services, and expects to award a contract for actuarial services based on the successful bidder sometime in October. She estimated that there are five actuarial firms that have a national reputation for working with government pension plans; and out of those five national firms, the state received proposals from four.

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MS. MILLHORN referred to the second question in the memorandum, which asks about the definition of the term "unfunded liability" and how it differs from "deficit" or "debt." She defined unfunded liability as "the excess of the accrued liability over the assets of the plan at the valuation date." She explained that a deficit is simply "the amount by which a sum of money falls short of what is necessary," while a debt is "the amount that is promised and is owed." The question also asks how the unfunded liability is calculated and whether it is likely that the events on which the calculation is based will occur. Ms.

Millhorn said the actuary goes through a detailed process in determining what the accrued liability is for future obligations of the system. She noted that the valuation reports back to 1976 are available on line.

MS. MILLHORN stated that the valuation itself sets out the assumptions that underlie the valuation. She said it's important to remember this is an annual process whereby the system is evaluating and telling policy makers exactly what the status is of the retirement system. She described the process as "a snapshot in time." The valuation reveals "what your future obligation is for these members as of that date." She added that it's also important to remember that valuations are subject to change year after year.

MS. MILLHORN said that an important component of the valuation report is that it sets out and determines what the accrued liability is by comparing the assets of the system to the liabilities and thus establishing the employer contribution rate or the amount the system needs to collect from the employers in order to pay for promised benefits for its members. If the system has accrued liability that is higher than the valuation of the assets, the result is an unfunded liability. That unfunded liability for the system, as of that point in time, is then amortized over a 25-year period to pay off the unfunded liability. Based on the information as of June 30, 2004, the actuary recommended that the PERS employer contribution rate be set at 28.19 percent and the TRS employer contribution rate be set at 41.78 percent. If the board were to have approved those recommendations, then those rates would have been set in place for the next 25 years. Ms. Millhorn noted that there are two components to the employer contribution rate: the normal cost rate and the past service rate.

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MS. MILLHORN, regarding the likelihood of the events on which the calculation is based occurring, indicated that coming into play are economic and demographic assumptions. She said those assumptions are in place in order to pay for the future obligations; however, it is also known that those assumptions may change over time. For example, she noted, the medical cost trend was reset in 2002 after a valuation. She said a new mortality table was in place as of 2000. The targets are made by the actuary with the best estimates that are available.

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MS. MILLHORN turned to the third question in the memorandum, which asks what the liability means in general and, in particular, for: state finances, credit rating, additional appropriation, retirees, current employees, and payment of medical and pension benefits. She noted that attached to the pages of information provided by the division is a one-page chart that shows the increase in the employer contribution rate from fiscal year (FY) 06-09 for five different categories: the State of Alaska, the University of Alaska, the school districts, the municipalities, and a total for all categories. For example, she said, the increase to the State of Alaska in FY 06 is \$40 million, for a total of \$142 million.

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MS. MILLHORN said, "The projection is that this increments up by 5 percentage points per year. And it's important to note when we're talking about an increase in 5 percentage points that that is additive, which means the employer contribution rate for FY 06 for PERS, set at 16.77 [percent], when ... adopted at a 5 percent increase - 5 percentage points - ... means that that rate goes to 21 percent."

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REPRESENTATIVE GUTTENBERG asked for an idea of what other changes occurred, including what assumptions have changed.

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MS. MILLHORN noted that the valuation of 2002 was a "pretty dramatic change for the system." She said there were some changes in assumptions and there were some experiences that were taken into the system as of that valuation for 2002 that included a change in the medical cost trend and the actual experience as a result of medical costs for the system during that one-year period. She offered further details:

There was a projection in place that indicated that the medical costs were at 8 percent and then that would decrement down to the next 9-year period, or so. And when they reset that, they recognized that the actual experience for the system, year after year, was closer to 9-10 percent, and so they reset the medical trend to 12 percent for the next 3 years, followed by a decline in that medical cost trend. And ... those

two factors added together for that valuation in 2002 added 10 percent to the employer contribution rate in one year for PERS and TRS.

MS. MILLHORN said a recommendation based upon a valuation by Milliman, the auditor of the system, was that the actuarial valuation system itself needed to be changed. She indicated the change was recommended "because they used a corridor method." She explained that the corridor method "looks at a band that surrounds your assets." It was determined that that band was too narrow. The recommendation was to use an "asset smoothing method," which she explained takes in the gains and losses to a system in a 5-year period. The method is designed to "take the volatility out of spikes in your employer contribution rate." In order to make that change, it was necessary to "reset to the market value of assets," which recognized all the losses for PERS and TRS in a one-year period. It added \$1 billion to PERS and about \$600 million to TRS.

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MS. MILLHORN, regarding credit rating, said she believes the Department of Revenue should address that question.

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MS. MILLHORN, in regard to additional appropriation, noted that in accordance with SB 141, the [Alaska Retirement Management (ARM) Board] will come up with short- and long-term solutions to deal with the unfunded liability. That board will be "constituted" in October, will meet, and will provide a report to the legislature regarding its recommendation associated with additional appropriation. With regard to retirees, she said the liability has no impact. She said, "Those benefits are constitutionally protected under the Alaska [State] Constitution, Article 12, Section 7. She said that has been tested and upheld in the court system. Those benefits cannot be diminished, nor impaired; it's a contractual relationship that exists.

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REPRESENTATIVE WILSON asked what happens to the state and the system when people retire early.

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MS. MILLHORN asked for clarification as to whether Representative Wilson was referring to those who retire through a retirement incentive program (RIP) or when an employee chooses to retire earlier.

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REPRESENTATIVE WILSON answered both.

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MS. MILLHORN noted that the state has offered multiple RIPs. She said:

We have not actually calculated that to determine what the impact is, but we do know - based on the most recent analysis prepared in response to House Bill 329, which was a RIP bill - ... that due to rising health care costs, it is exceedingly difficult for the ... system to actually find a savings in order to let the individual retire early. It's designed to give the individual three years of service, so long as the individual and the employer make contributions that result in a savings. And we found that when that was analyzed in relation to House Bill 329, that the costs were prohibitive to allow an individual under those circumstances. You almost had to delete the position in order to realize a savings. ... It was very difficult to go back and peg that savings to the system. So, ... in a situation where there may have been a projection that there would be a savings, because you can go in and replace the position or have the higher advance step placement later on, it may diminish, erode, or change the initial projections upon which you thought you were going to have a savings but it didn't ultimately materialize into a savings.

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REPRESENTATIVE WILSON offered a case in point: She said when someone retires early from the school system and is replaced by someone new at a lower pay scale, initially it saves the school money. However, because of the guarantees of the retirement program, what happens is that the person who retired two years early is not paying into the system for those two years.

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MS. MILLHORN, in response to the second part of Representative Wilson's original question, said if a person chooses to retire early, that is calculated as part of the process. When a person chooses to retire early, he/she takes an actuarial reduction in his/her benefit, which is not anticipated to result in an unfunded liability to the system.

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MS. MILLHORN returned to her review of the questions from the memorandum, specifically the question related to what the liability means for current employees. She said, "It's not a direct impact for our current employees; however, employers do have increases in the employer contribution rates and that has fiscal impact for their budget." Regarding the payment of pension and medical benefits, Ms. Millhorn said retirees will continue to receive them.

MS. MILLHORN addressed the fourth question in the memorandum, which asks when the unfunded liability began and over what period of time it has existed. She said although it is difficult to pinpoint a specific period of time, there are known occurrences that happened with the system that are contributing factors toward the unfunded liability. For example, medical assumptions were too low for a period of time, a problem that was remedied in 2002, which had the consequence of increasing the employer contribution rate dramatically. She said that beginning in 1997, for approximately a seven-year period, the employer contribution rate was lowered because of surpluses in the system, resulting in a \$460 million savings to the employer, with a realized savings of approximately \$360 million due to an increase in wages.

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REPRESENTATIVE GUTTENBERG noted that almost every state in the country has problems with its public employee retirement system. He asked specifically, if assumptions being made incorrectly or too low is a problem unique to Alaska.

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MS. MILLHORN responded by naming two issues common among all the retirement systems: loss of investment income during the three-year bear market in the early 2000s and rising health care

costs. Many of the pension systems enhanced their benefits substantially during that bear market. She stated that the actuarial analysis information that was provided in January 2005 takes the unfunded liability at the \$5.7 billion amount. She continued:

The plan changes that you're speaking to represent \$500 million out of the \$5.7 billion. And out of that, ... \$400 million is attributed to ad hoc [post retirement pension adjustment (PRPAs)]. And that leaves you with \$100 million in unfunded liability through plan changes with the legislature. And so, my analysis is that the legislature has been very judicious in not having that be one of the primary factors. And it's a very small factor associated with the unfunded liability.

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REPRESENTATIVE ROKEBERG asked if the teachers under TRS are also constitutionally guaranteed their retirement benefits.

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MS. MILLHORN answered yes.

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MS. MILLHORN, in response to follow-up questions, explained that beginning in 97-98, there were surpluses in the system that allowed the employer contribution rate to be lowered, and she confirmed that those surpluses lasted for seven fiscal years.

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REPRESENTATIVE ROKEBERG said he would like a follow-up showing those amounts and the impacts to the state budget.

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MS. MILLHORN said she would provide that information.

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MS. MILLHORN returned to the memorandum and question six, regarding the division's position on the unfunded liability. She reminded the committee that there are three primary factors

that contribute to the system's unfunded liability: rising health care costs, loss of invest income, and change in actuarial assumptions to better reflect changing information. She mentioned a "sensitivity analysis," which she said is information obtained through the valuations and in regard to the investment returns. She said it is shown at the back of the previously mentioned presentation material from the division. She said a sensitivity analysis doesn't necessarily look at just the system's assumption; it tests variables to look at the sensitivity associated. For example, two assumptions have a high level of sensitivity: the investment return and the medical cost. She said the information in the handout isolates the investment return into three specific categories and looks at what the employer contribution rate is as a result of that isolation. Those three categories are: base case, at 8.25 percent; optimistic, at 9 percent; and pessimistic, at 7.5 percent. She offered further details.

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MS. MILLHORN indicated that the following two charts show "what that represents in a change to the contribution rate for employers over that 25-year amortized period," for PERS and TRS, respectively. The last page of the handout shows [the hypothetical effect of changes in liabilities and assets]. It shows that a 5 percent liability increase will increase the employer contribution rate 3.4 percent for PERS and 4.7 percent for TRS, while a 5 percent market asset decrease will decrease the employer contribution rate .3 percent for PERS and .5 percent for TRS. She stated that an increase in liabilities has a far greater impact on the employer contribution rate than a change in the net assets. She stated her understanding that there was information available to committee members from the actuary as of July 14. In response to a request from the chair, she said she would provide that information to the committee. She said it shows the change in net assets and liabilities for PERS and TRS for the last 10 years, and it ties back to the \$5.7 billion in unfunded liability.

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REPRESENTATIVE GRUENBERG directed attention to the division's answer to question six on the memorandum. He said very little has been discussed relating to how to contain the cost of health care. He noted that a number of insurance companies maximize the amount that they will pay per procedure. He asked if the

state's actuary has looked at the actuarial effect of instituting more stringent reimbursement rates.

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MS. MILLHORN said medical benefits for members are protected under the Alaska State Constitution; therefore, the state must be careful about any changes it makes. The court ruled that changes can be made; however, any decreases to benefits must be met with corresponding increases. She noted that in 1999, the plan changed nine different elements of the retirees' medical plan. She offered examples. A lawsuit was brought forward as a result of those changes. That particular lawsuit was remanded for further analysis before the [Alaska] Superior Court. She said the division talks to the Department of Law before making any changes, to make sure it is in compliance with the court ruling.

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REPRESENTATIVE GRUENBERG said Ms. Millhorn has mentioned having preferred providers. He asked, "Do you have a legal opinion that says that would be such a change?"

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MS. MILLHORN responded that currently the division is contemplating that particular initiative. She said that after conferring with the Department of Law, it does not appear to be problematic. She said, "We are vigorously ... pursuing anything that we can do that would not impinge on that particular lawsuit, and we continue to make those efforts and look at those particular initiatives." She explained that Commissioner Matiashowski has charged the division with looking at all possibilities for cost containment, and as part of that initiative, the division had positive open enrollment for the active employees, asking that documentation be provided that supports that all members are eligible "for our 125 qualified plans." She said it was found that about 10 percent of the population did not provide the documentation. She reported that the realized savings to the active plan is projected to be about \$3 million annually. She said, "We are underway right now to go through that very same process with our retirees." She said national auditing firms have determined that up to 15 percent of individuals will not be able to support that they are eligible for benefits under a plan during an open enrollment, and the projection is that the savings based on that percentage would be

approximately \$16 million annually. She added that SB 141 tasked the division to provide the legislature with report on all cost initiatives.

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REPRESENTATIVE GRUENBERG expressed concern that the state may be denying some people coverage when they clearly ought to be covered. He said for example that he has a foreign-born son, and "we had a devil of a time getting some documentation to support that Daniel was eligible." He suggested that that may be an issue to cover at a future hearing. He said his question had been in regard to the preferred provider list. He said he also is concerned with the increasing cost of [medical] care. He asked if there may be some way to put a cap on the amount the state will pay for the same service. He suggested, "That's not denying anyone a benefit; it's simply capping a cost."

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MS. MILLHORN responded that she had spoken to Chair Weyhrauch outside of the hearing to discuss putting together some information for the next House Special Committee on Ways and Means meeting to address this issue. Regarding putting a limitation on particular costs for procedures, she said she would want to talk to the Department of Law to find out if that would be an issue.

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REPRESENTATIVE GRUENBERG said he wants that issue addressed and would like to invite the Department of Law to the table. He said he would also like to address whether people are being denied because they can't come up with paperwork.

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MS. MILLHORN stressed that the division has not denied anyone who can't provide paperwork but is eligible; it works with them on a case-by-case basis. She said the intent is not to penalize people.

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REPRESENTATIVE GUTTENBERG asked what is being done nationally to control costs, without changing benefits. He said he would like

Ms. Millhorn to address that question at the next committee meeting.

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CHAIR WEYHRAUCH requested that Representative Guttenberg refine his question and submit it to the committee. He said the committee is looking at these issues with a "macro view", rather than with a "micro view."

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REPRESENTATIVE GUTTENBERG indicated that working on medical cost control may help with [the unfunded liability].

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MS. MILLHORN directed attention to question 8 in the memorandum, which asks when the legislature has to fund the liability or when it will face a cash flow problem. She said a 5-percentage point increase, in and of itself, creates fiscal problems for employers. She said it is expected that those rates will continue to rise until they reach that calculated rate. She explained, "Every year that you're not at the calculated rate recommended by the actuary it has the impact of adding additional liabilities to the system."

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CHAIR WEYHRAUCH asked what the effect of a cap would be on the employer contribution rate.

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MS. MILLHORN reminded the committee that regulation AAC.35.900 was enacted in 1991 at the request of the Municipality of Anchorage to cap the PERS employer contribution rate at a 5 percentage point increase or decrease in any one year. She explained that SB 141 supersedes that regulation; therefore, AAC.35.900 does not exist any longer and it will be up to the Alaska Retirement Management Board "to make a determination about employer contribution rates going forward." In response to Chair Weyhrauch's question, she said if the employer contribution rate was capped at 3 percent, additional liabilities would be added to the system, because the state would be "pushing and deferring liabilities into the future." She stated, "In the last two valuation periods, those

contributing factors that built on the 2002 valuation can ... primarily be attributed to not being at the calculated rate and a rise in the health care cost. Those are really the two factors that bring the 24.91 [percent] to 28.19 [percent] and 35 [percent] for ... [TRS] to 41 [percent]."

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REPRESENTATIVE WILSON asked what happens if a municipality cannot pay its part for one reason or another. She asked if the state would be responsible.

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MS. MILLHORN answered that the system would not get the contribution that it needs and the cost to the employer would increase. When an employer terminates its participation agreement with the retirement system, the retained actuary looks at each individual member and provides options to all the members to either vest in the system or refund out of it. At the end of that election process by the members, a termination report is generated that goes to the employer. She said the employer is presented with a bill for payment. Ms. Millhorn said the division works with those employers to set up a repayment schedule.

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REPRESENTATIVE WILSON asked who is ultimately responsible.

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MS. MILLHORN responded that if the employer truly cannot pay, the employee would still be provided with the benefits. That cost would be absorbed by the retirement system.

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CHAIR WEYHRAUCH clarified that Representative Wilson's question is in regard to who would be legally responsible.

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MS. MILLHORN said the State of Alaska would have a cause of action and would pursue payment from that particular employer.

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REPRESENTATIVE ROKEBERG, regarding the 5 percent cap repeal in SB 141, asked if Ms. Millhorn is indicating that there would be "no grandfathering and/or cap that relates to the unfunded liability for Tiers I, II, and III."

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MS. MILLHORN answered yes. In response to a follow-up question from Representative Rokeberg, she explained that the procedure for PERS is now and will continue to be to receive a recommendation for the employer contribution rate. She continued:

They set that rate as an average calculated percentage amount. They don't apply an individual employer contribution rate to the 155 employers for PERS; they adopt an average calculated rate. And for ... TRS, they have a single rate that is the rate used for all ... TRS employers.

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REPRESENTATIVE ROKEBERG said he thinks the committee should look into this issue further.

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REPRESENTATIVE SEATON mentioned accrued liability charts and said he would like clarification at the next meeting on whether that is in regard to a projected unfunded liability.

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MS. MILLHORN returned to the memorandum and question nine, which asks whether the legislature should worry about the liability or whether it will fix itself. She said there are three available levers to improve the funding status for the system: to experience higher investment returns than projected for some period of time; to reduce the benefit costs; or to receive a cash infusion in order to reduce or eliminate the unfunded liability.

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REPRESENTATIVE GRUENBERG noted for the record that any time benefit costs are reduced, it is important to take care that the

benefits are not reduced, because that would be unconstitutional.

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MS. MILLHORN concurred.

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DAVID TEAL, Legislative Fiscal Analyst, Legislative Finance Division, Legislative Agencies & Offices, said he would be speaking in regard to a seven-page handout with charts [included in the committee packet]. He said that while meeting with Chair Weyhrauch the week before, he was shown an article from a Nebraska newspaper regarding that state's pension funds. He said Chair Weyhrauch asked him to create a similar chart for the State of Alaska. That chart is shown on page one of the handout. He said the gist of the article is in the following statement: "Like many public pensions, benefits tend to increase when the fund is flush; contributions go up when shortfalls occur." The bottom of the graph shows a number of actions that [Nebraska] took: lowering the retirement age; increasing cost of living benefits; and changing to an early retirement. He said, "They're blaming that for the problems they're now facing with unfunded liability." The good news, Mr. Teal said, is that Alaska did not really modify its programs." The bad news, he noted, is shown on page 2 of the charts, where Alaska is shown to look as bad or worse than Nebraska. He suggested that the \$5.7 billion unfunded liability can be thought of in terms of being twice the amount of the annual state budget, or one-quarter of the permanent fund; it's a lot of money.

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MR. TEAL said some questions to ask are: why is there a problem when the state didn't do anything wrong; what actions could the state take; and what will happen if the state does nothing? He said he thinks the chart is too simple. Pensions are long-term issues, he said, and "it's better to avoid snap decisions on long-term issues." He said that is not political advice, it's just a realization that small differences compound over time, or, conversely, the impact of changes takes a long time to materialize.

MR. TEAL said Ms. Millhorn discussed the reasons for the gap's existence, including market returns, life expectancy, and

medical costs. He directed attention to page 1 of the charts. He indicated that Nebraska decided to change its assumptions on market returns. The chart shows assets increasing but also a jump in benefits. Alaska's chart shows both, he said.

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MR. TEAL said discussion has taken place regarding the dangers of making decisions about knowing exactly "where we are" and what the projections are on cash flow. He said the question is whether the system is increasing its asset base or if the problem is being compounded now by annual payouts that exceed cash inflow, thus increasing the size of the liability. He recommended looking at a chart that looks at the future, complete with the impact of "modifying those assumptions and taking action or not taking action." He indicated it would be helpful to know whether the state faces an actual crisis or just a potential liability that will hit some date in the future. He continued:

Describe the consequences of delaying; convince me that this issue is not the same as hearing the Constitutional Budget Reserve will be gone in two years, every single year for the past decade. Because that's ... what we have heard there, and how do we know that this isn't the same thing?

MR. TEAL noted that at the last meeting, the committee heard that unfunded liability is a nationwide problem, and it also heard a list of things that other states are doing about it. He said the legislature can copy those other states or stumble upon a solution of its own. However, he said he agrees with Chair Weyhrauch that there is a better chance of success if the legislature really understands the problem, the impact, and the pros and cons of each potential action.

MR. TEAL noted that Representative Weyhrauch also asked him to provide more detail on the resources available to address the problem. Specifically, given the price of oil, what the limitations are on the actions that are faced because the state has or doesn't have the money to address it. He opined that the Division of Retirement and Benefits is in a much better position than he is to talk about issues of sensitivity. He said Chair Weyhrauch asked him to look at the overview of the budget; a little more than just PERS, it's a kind of "heads-up" on what the Legislature may face when it returns to Juneau in January.

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He directed attention to page 3, which shows a fiscal summary. He continued:

That circled number on line 29 of the [FY] 06 budget shows that we've got a \$2.6 billion budget, and that gives us a surplus on line 30 of about \$40 million. But there's a footnote there, and that's oil at \$38 in footnote 1. And in particular, look at footnote 4 that says FY 06 appropriations for formula programs excludes \$414 million that went to public education. ... That's because that appropriation for education crossed fiscal years and ... doing that distorts year-to-year comparisons. If we were to adjust for that, the budget is actually at \$3 billion. The next chart on page 4 is a chart that is on our web site. Typically, what that shows, is the fiscal gap and then, at the type of various prices of oil, you can see that at \$38 that gap begins to turn into a surplus appearing at the top of the chart. At \$38 we breakeven [with] no gap [or]... surplus. The current price of oil is \$57 and change. That's noted on the charts, and that shows a surplus there of \$1.1 billion for FY 06.

Page 5 shows a revised fiscal summary, and this is the response to that ... fiscal note on the traditional summary - footnote 4. The danger there is that, as I said, the FY 06 budget's really understated by \$400 million, and if not for the use of that '05 surplus we would be at \$3 billion [with] break-even oil prices of \$44. And the danger here is that we are not really looking at '06 anymore, we're looking at FY 07, and it's this \$3 billion budget that's going to be the base for the '07 budget - not the \$2.6 billion that (indisc.) in the fiscal summary.

So, what I did then was prepare another break-even chart at a \$3.5 billion budget. You can argue about when we're going to hit \$3.5 billion, whether it is '07, or '08, or '09, or 2010, but we will get there soon, and you can see on this chart that the breakeven point is \$53 a barrel, and that \$57, where we are at right now, wouldn't give us much of a surplus - about \$250 million, which comes and goes real quickly in a volatile oil market.

2:39:34 PM

MR. TEAL continued:

[Chair Weyhrauch] also asked me to talk about supplemental bids, because the idea was how much money those high oil prices in '06 leave us to address the PERS/TRS issue. This is very rough; [the Office of Management & Budget (OMB)] and the departments are not really willing to talk about "supplementals" at this time of year, but we've got some guesses. One is the Federal Medicaid Matching Percentage (FMAP). They told us last year [that] our Senators would try to fix it, and then [they] argued that everything that we know from the national perspective is that we wouldn't get that money. I think we can now admit that that money is not on the way; it's going to cost \$55 million in the supplemental bill. Average Medicaid supplementals in the past 5 years have been about \$23 million; it wouldn't surprise me if we get another supplemental from Medicaid in that neighborhood.

The Marine Highway System [is] another source of supplemental needs. Partly because of fuel, and partly because of ... changes in ... underfunding, \$20-25 million may go there. Fire suppression was [a] huge supplemental last year, about \$40 million. Fire season's bad this year, as well, but many of those fires are on Federal land this year, and we may get away with no supplemental for fire suppression. But typically, we'll have about \$75 million a year for other purposes, or other supplemental needs. I'm looking at a \$150-200 million supplemental budget request.

... So, what we're looking at here is a true FY 06 surplus of about \$500 million We will have cash, but a lot of that - \$400 million of it - is carried forward from last year. So, [the] bottom line is, you'll have about \$900 million on the table available for purposes other than this \$150-200 million supplemental. And looking to '07, as I said the critical point there is that the starting point of the '07 budget will be the \$3 billion spent in '06 after adjusting for that '05-'06 crossover. The '07 budget's likely to see increases from that point as always: the FMAP will jump to about \$75 million a

year, beginning in '07; the state PERS rate increase will cost another \$25 million or so, in general funds; if the legislature again decides to fund PERS for school districts, that's another \$40 million; and if they give the same sort of increase that they gave school districts last year, you're looking at \$80 million. So, we're up somewhere between [a] \$140-180 million increase on just those items for '07.

[2:42:36 PM](#)

MR. TEAL, in response to a question from Representative Gruenberg, said Medicaid will probably increase as well; it has been increasing at about the rate of 14 percent a year on a \$600 million budget. He continued as follows:

In addition to that, dividends from Alaska Housing [Finance Corporation (AHFC)] are down [and] school debt is up, so I wouldn't be at all surprised to see a \$3.2 or even a \$3.3 billion budget in '07. On the other hand, the Capital Budget in '06 was at a little over \$300 million and if the legislature chose to go back to a more normal capital budget of \$100-150 million, there is some potential for reduction there.

But getting back to the retirement system and how this plays, on this break-even chart you've got \$3.5 billion. You've got oil at \$53; \$57 - [that's] break-even there. Where we are in '07 and in the future all depends on oil. The forecast is now ahead that occurs in October and the numbers will be [released], probably in December. But I don't expect an oil forecast above \$50. And that supports a spending plan of about \$3.3 billion, which ... as I just said, wouldn't be a surprise.

MR. TEAL noted that there is a summary of the oil price information on page 7, which shows general fund expenditures for FY 06 at \$3 billion, with an increase of \$200 million per year. The page also shows how much revenue the state would have at various prices per barrel; it computes the surplus by subtracting the expenditures and revenues, and shows the cumulative surplus. He continued:

You can see that we've got deficit through 2010, even ... with oil at \$50. So, you need \$50 oil just to break even in '07 through ['10]. At \$55 a barrel, you

show a cumulative surplus out there, but you're back to an annual deficits by 2010, meaning that you're on the downslide again. ... The Chairman asked me about a fiscal plan, specifically the role that this unfunded liability may play in that plan, and whether there is any money to reduce the unfunded liability if you choose to do so. ... If you look at the \$55 scenario, you'll see that there's a surplus in '07 of \$418 million, which combined with the surplus through '06 of a little over a billion, gives you about \$1.5 billion on the table.

[2:47:04 PM](#)

MR. TEAL said one option would be to spend all the money at once; however, he opined that that would not be "much of a fiscal plan." He explained that a fiscal plan generally involves not spending money "in some fashion." He cited the following options "in order of declining flexibility," as follows: depositing the money to the permanent fund, making it untouchable forever; letting it fall to the [capital budget reserve (CBR)]; putting the money towards retirement, where it would roll to the distant future; or putting the money in a public education fund. He recommended the latter. He explained:

[It's] not ... because it costs us any money or saves us any money; it just takes the money off the table very early in the process and moves the decision to the full FY 07 process. So ..., rather than going through this abbreviated supplemental process, where the scrutiny is limited, you would put money in the education fund, freeing up that billion dollars, or so You could then spend it in the '07 budget process. Same amount of money - it just would, in theory ..., be given more scrutiny. Even with this, you could pay up to \$1.5 billion of the unfunded liability of the retirement system in '07.

MR. TEAL said the state does have money to address the problem and, although not filling the whole gap, to make significant progress.

MR. TEAL said the question then becomes whether the state should fund some of the unfunded liability, how much it should fund, and what impact it would have on various interest groups.

[2:50:43 PM](#)

MR. TEAL observed that the state's liability equals only about half of the system's liability; therefore, of the \$5.7 billion unfunded liability, approximately \$3 billion is the state's. The other \$3 billion of liability belongs to the cities, communities, and school districts. He said that none of these entities would ever get a bill for the \$5.7 billion. He explained:

By that I mean, it doesn't come due in 2017, or 2033, or pick your date out there, because the way the system works is that the rate increase is designed to eliminate that unfunded liability in 25 years, meaning that you don't have to do anything about it except pay the rate increases, and your problem is solved.

So then, the primary reason to be concerned about solutions other than rate increases is that those increases are unacceptable or unaffordable.

MR. TEAL said the task force needs to clarify whether [the state] is looking for a solution to the PERS/TRS system-wide problem - the full \$5.7 billion, or is simply looking at the problem from the state's perspective, saying, "We've got ... \$3 billion of this unfunded liability." He said the next step is to decide whether rate increases are an acceptable solution. He continued:

If the focus is the state, I think the rate increases are an acceptable solution. You just increase the operating budget [and] the money comes from various fund sources. ... The critical thing here is that as you saw last year, the state's liability was about \$50 million. The general fund portion of that was only \$25 million. The other portion comes from federal and other funds. Now, if we took that \$3 billion liability and closed it, making a \$3 billion cash injection, you'd be spending \$3 billion worth of federal general funds to fix the problem. You'll pay for it in rates, in which case the state pays half, and federal and other sources pay the other half. So, I guess I would say, "Why would you want to fix the problem with the infusion of general funds? It costs you twice as much than if you just let it ride."

[2:54:02 PM](#)

MR. TEAL continued:

Teachers are now negotiating for pay increases, but the districts look at it this way: each teacher just costs us an additional 5 percent because of this benefit increase, and we can't afford to increase take-home pay in addition to this 5 percent. And then you've got education advocates saying, "Thank you for funding education, but not enough of it went to the classroom." The trouble here is that everybody's right, and in this case, it ... may make more sense to pay off that unfunded liability up front in order to keep rate increases down so the districts aren't faced with ... the employment dilemma they've got right now.

MR. TEAL said he doesn't understand how any employer can have a benefit rate of 50 percent; he/she cannot be competitive because the employees cost too much. He noted that, arguably, the state is not responsible for communities in the same direct manner as for school districts. He stated that he sees the unfunded liability "entering the budget state ... at school districts and communities." The question, he added, is whether the state wants to "prefund them." The unfunded liability cannot be escaped. He explained:

... If you use this ... surplus and put it towards retirement or some other program that's going to cost you now or cost you later, what you're doing is spending the surplus now and reducing future budgets instead of increasing them. So, I guess my recommendation is that when a surplus exists, use it.

[2:56:55 PM](#)

CHAIR WEYHRAUCH asked, "That means not having any lapse into the CBR?"

[2:57:05 PM](#)

MR. TEAL responded that he would recommend "prefunding" the school districts, and perhaps the communities. He added, "As I said, you've got no direct liability for communities, but of course, who is it you represent?" He said communities are far less able to afford the 5 percent increases.

[2:57:41 PM](#)

REPRESENTATIVE GUTTENBERG asked if there is a way to "get into ... PERS where you just address the municipalities' employees."

[2:57:56 PM](#)

MR. TEAL answered yes. He surmised that the logic is that with the high prices of oil, the primary impact on the state is surplus revenue. He noted that [the Department of Transportation & Public Facilities (DOT&PF)], the University [of Alaska], [and the Alaska State] Troopers are hit with higher fuel bills, "but that's far outweighed by the revenue increase." He said high oil prices don't add any revenue to the communities, but certainly cost them money. He stated:

That's the only logic I have for saying the communities are the ones that need the money and don't have the revenue sources. The state has the revenue sources, and your question in January [was], "Are you going to share with the communities?"

I don't have any answers, here. ... We're certainly willing to work with [the Division of] Retirement & Benefits and work with you to try to find the answers, but \$5.7 billion's a lot of money. We don't have it all now and, even if we did, there are other things to spend the money on.

[2:59:36 PM](#)

REPRESENTATIVE WILSON asked if the responsibility of the state would be that if it bailed out some entities it would have to bail out others.

[3:00:11 PM](#)

MR. TEAL replied that he doesn't have an answer to that question. He suggested that the director of the Division of Retirement & Benefits may have a better sense of what the state's liability would be.

[3:00:47 PM](#)

REPRESENTATIVE GATTO stated his understanding that Orange County, California, filed for bankruptcy and he suggested that some boroughs in Alaska may file for bankruptcy.

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REPRESENTATIVE ROKEBERG asked if it is true that historically the state has not provided general fund monies for TRS liabilities "as separate line item" or if it is "typically used in the foundation formula."

3:02:06 PM

MR. TEAL responded:

Technically, you didn't address the TRS liability - you didn't give the school districts money - but ... certainly you knew that their liability was \$40 million and that the increase in the base student allocations ... was designed to pay \$40 million to cover their PERS liability and then another \$40 million on top of that. ... I guess the answer is [that] they didn't have to spend money on TRS - the new money that they got in formula - but effectively there's nothing else they can do. They had to pay their bill for retirement, and you gave them money that they could spend on anything. So, it's pretty hard to say which dollar precisely was used to pay the pension liability.

You also gave money to communities. And there's a difference here, because with the communities, you gave that money directly to retirement and benefits and said the money was intended to reduce their contributions that year. ... I think most of the communities did accept their 5 percent increase and so didn't get any windfall. But I know that Juneau is one community that said, "Great, our increase is paid; we just got a \$1.3 million windfall." ... They didn't use it to pay down their pension.

MR. TEAL, in response to a remark by Representative Rokeberg, indicated that the amount that Juneau received was \$18 million.

REPRESENTATIVE ROKEBERG asked, "In your recollection, is that unusual; have we ever done that before?"

MR. TEAL responded, "Never directly, because we've never had increases in rates like this." He said it doesn't matter whether the money is slated as paying for a portion of a

community's pension liability or is labeled community assistance - a dollar is a dollar.

[3:05:13 PM](#)

REPRESENTATIVE ROKEBERG directed attention to a spreadsheet attached to a September 7 [2005] letter from Melanie Millhorn [included in the committee packet, showing the increases in and total for the composite employer contributions]. He noted that the cumulative total for FY 06 is \$386.5 million and \$716.6 million for FY 09. He asked if it would be a correct assumption to say "that delta - the differential there - would be the amount of unfunded liability for ... the next three fiscal years."

[3:06:44 PM](#)

MR. TEAL answered that the unfunded liability is \$5.7 billion. He added, "This is simply the amount that would be generated by the capped rate increase."

[3:07:01 PM](#)

REPRESENTATIVE ROKEBERG observed that the spreadsheet shows a projected \$330 million increase in the cumulative total for the next three years, beginning in FY 06.

[3:07:58 PM](#)

MR. TEAL confirmed that Representative Rokeberg's observation was correct.

[3:08:10 PM](#)

REPRESENTATIVE ROKEBERG said it would be interesting to "see ... where we have to be [for] the out years to get the balance."

[3:08:49 PM](#)

REPRESENTATIVE MIKE KELLY, Alaska State Legislature, said he would like to see the shortfall shown in another column. He noted that the legislature has been told that one factor that has not been incorporated into the actuarials regarding the retirement system is that [life expectancies will continue to increase], and that factor could add to the unfunded liability. He asked Ms. Millhorn for her opinion.

3:10:03 PM

MS. MILLHORN said the actuarial assumptions will be reviewed. She said the current mortality table in use is from 1996 and has some built in projections; however, the actuary has indicated that there is a 2000 mortality table available.

3:11:30 PM

MR. TEAL clarified that the numbers on the chart usually understate the money needed to close the gap. He noted that Ms. Millhorn had referred previously to a sensitivity chart which shows a 5 percent liability increase and 3.4 [percent] impact on rates, versus a market asset decrease. He explained:

What that means is that putting money into the system has a lot less impact than changing your benefit payout It's the benefit side that ... hits you on just your sensitivity analysis, which we can see in bits and pieces, and which I would like to see as an extension of chart two saying: "I want to take this thing out - it's 5.7 now. Given your assumptions, what would that liability be next year, next year, next year?" The sensitivity analysis they've given you so far just says, "What's the impact on the rate?" That's not enough for me to make a decision, because I don't know whether that rate goes for 25 years and what it does. Do we then still close the unfunded liability at 25 years? I think there's a lot of information that you could get, or should get from the actuary before you really decide what to recommend to the full legislature.

3:15:07 PM

REPRESENTATIVE SEATON said he thinks everyone needs to understand that the \$5.7 billion is the present dollar value of the schedule of anticipated payments to be made for benefits. That schedule of payment, he said, is "\$15.6 unfunded." He continued:

I think it's really imperative that people realize that the present dollar cost is the calculation from the schedule of payments that we'll have to make to retirees, and also everyone should realize that about 75 percent of all the benefits that are going to be paid out are not from deposit money that we get and

collect, but is scheduled on the growth of that asset base. So, if our asset base is underfunded, then it's not growing, and that's got to pay ... three-quarters of all the benefits in the future. So, ... it becomes a very sticky problem to be carrying a large unfunded liability, not just because it's unfunded liability, but because it's not growing to make those payments.

[3:17:54 PM](#)

REPRESENTATIVE ROKEBERG expressed his appreciation to Mr. Teal for "coming back and helping make the point I wanted to make." He said he has seen other charts better than the one being discussed, which made the distinction between the various entities that had the unfunded liabilities and "where they may fall." He indicated that Representative Seaton's information "makes an interesting point that we need to focus on in terms of public policy formation." He stated that there are four distinct elements that make up the unfunded liability for the state and each one calls for different policy decisions. He added, "And I think that that's important ... when we talk about this \$5.7 billion that we think of it in terms of the categories and the entities that have that liability, which I don't believe is ... 100 percent the province of the state general fund to fix. And as a result I think that we need to keep that in mind when we discuss this in terms of our own policy discussion." He said he would like to see an updated chart with more current information regarding the accrued unfunded liabilities. Furthermore, he said he would like to know about any other sensitivity adjustments before the legislature makes any policy call. He concluded:

It's troublesome for me right now, for example, in the Anchorage area to have all our teachers under the cloud of a possible strike here, when in fact there's been absolutely almost no discussion publicly about this extraordinary amount of the money that the state ... is putting into the Anchorage School District right now. It's like an assumption that this is a given for the future, and I ... think we're doing a disservice to the public right now when we don't talk about this in the proper context.

[3:21:33 PM](#)

GARY HUTCHISON noted that he is a resident of Fairbanks who has been a practicing certified public accounting (CPA) for 30

years, providing services to municipalities under government accounting and government auditing standards. He revealed his background as the current presiding officer of the Fairbanks North Star Borough, and as one who has served on the assembly for six years; however, he specified that he was not testifying on behalf of the borough or the assembly.

MR. HUTCHISON offered suggestions for dealing with the deficiency. He stated that he understood Mr. Teal to have said that the surplus from the higher oil prices will not be sufficient to eliminate the deficiency. He said that is a significant point that underscores the need for the ability to change benefits. The Alaska State Constitution and the supreme court interpretation of it prohibits the adjustment of benefits of current employees, he said; therefore, he recommended that the constitution be changed "to eliminate the effect of that supreme court decision." He said if people work longer, benefits would be more affordable.

[3:24:05 PM](#)

MR. HUTCHISON said his second suggestion would be to have large funds contributed into the PERS/TRS retirement systems soon. He said, "If we could get a constitutional amendment so that you had some flexibility in adjusting benefits, you'd have a new basis for an actuarial calculation." He said surpluses should not be spent on the general fund and should not be allowed to go in the CBR; they either should be put into PERS/TRS or into a fund that the legislature can access with a 51 percent vote.

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MR. HUTCHISON said he thinks more needs to be known regarding "why we are where we're at." He said he was puzzled in the past that the projected cost increases for the [state's] retirement program were "flat" when other [private] businesses were incurring increases in health costs of 15-30 percent. He remarked, "That went on for years and I used to think ..., 'Boy, they must have a wonderful system here that contains costs.'" He added, "Of course, we see now that that's not the case." He said it's important to know why those assumptions were wrong, and the legislature should know whether or not controls need to be put in place to ensure that the best estimates from actuarial calculations are used, rather than the most favorable ones.

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CHARLES GALLAGHER, Chair, Retired Public Employees of Alaska, Northern Region Chapter, stated that when he looked at his PERS retirement account and compared it to his [Supplemental Benefits System (SBS)] account, he realized that his PERS funds had been used for the past 25-30 years that he worked for the state in order to accommodate the needs of the tax payers in the 90s. He explained that his PERS funds were accumulated at the rate of 2.3 percent, whereas his SBS was often accumulating at the rate of 18 percent, which is what allowed him to retire. He said he mirrors Mr. Teal's recommendation that "this be forward-funded into an Escrow account in order to accommodate the needs of what could be coming up in the next two years." He also agreed with Mr. Teal that the reason the money should be in the Escrow account is "to allow a little bit more time in the situation to develop."

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DORIS ROBBINS, Member, Retired Public Employees of Alaska (RPEA), testifying on behalf of RPEA, revealed that she is retired from the Department of Labor. She said RPEA has been working actively with its members to help reduce the cost of health care. For example, many members have taken generic drugs whenever possible and changed to mail order prescription in order to save the system money. She stated that she feels like the real problems have been ignored "at this point." She said, "This is the kind of investigation that should have been done before a bill was passed without it being thoroughly analyzed. So, now I hope you will go back, ... follow up on these things, and try to find a solution." She said she contracted with the state for retirement and benefits, thus, they are guaranteed by the Alaska State Constitution, and she expects them to be honored. She suggested that perhaps the current higher price of oil will help the problem.

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MS. ROBBINS said part of the underfunding problem occurred when retirement incentive programs (RIPs) took place in the past without the funding for them being put into the system at the time. She said she was told that when an employee retired early [through a RIP], "that money would be put into the system, which would make up the difference from what they would have made, perhaps at their higher range, and then a lower new employee would have come in and taken that job and been paid a lesser rate." She suggested what may have happened is that sometimes those positions were rewritten at a higher grade and given

higher salaries. She asked the committee to look into that. She said the health care problem is nationwide and "we need to encourage our people in [Washington] D.C. to work on that." She noted that drug companies are making more than Wall Street or, for that matter, anyone else in the whole world. She said there has been discussion about a health maintenance account that was put forth by Aetna; it's a program that has been used across the country. She said although it costs something to start up, getting people to get regular health checks saves money in the long run, because it can prevent the higher cost of emergency care. She said she works on a committee that is studying ways to solve the problem of health care costs, and she told the committee she is glad to see the legislature taking a positive approach "to actually do something about the problem."

[3:32:59 PM](#)

RICHARD SOLIE, Ph.D., stated his understanding that the primary purpose of the hearings is to address the unfunded liability. He noted that he had prefaced his written testimony [included in the committee packet] with some recommended changes to the retirement plan adopted through SB 141. He said he thinks it was at least implied by a number of legislators that there would be further examination of that plan before its effective date of FY 06, and he urged the committee not to "overlook that aspect."

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CHAIR WEYHRAUCH clarified, "While the major thrust of this committee was to look at the unfunded liability and address that, it was not to overlook potential recommendations for change if they were constructive and something we could recommend to the legislature."

[3:34:25 PM](#)

DR. SOLIE, regarding the funding shortfall, opined that the ultimate shortfall will turn out to be significantly larger than the \$5.7 billion estimate in the 2004 actuarial reports from Mercer Human Resource Consulting. He explained that in the 2004 report, the actuary continued to make assumptions that were similar to those that led to the previous understatement of the liability. He named three assumptions:

First [is] the continued underestimate of future health care inflation. And as I indicated in my written testimony, their assumptions dropped that

inflation trend down to 5 percent by FY 14, and we have an experience that goes back to FY 78, showing an average of 10 percent a year. And I think it is incumbent on us to make sure that we don't use an unrealistic assumption there and get ourselves back in the same jam.

[Second, is the] continued reliance on the outdated life expectancies and the mortality data. The ... long-established trend line shows life expectancies increasing at about two years per decade - that's life expectancy at birth - and yet Mercer continues to use outdated data in that regard.

... A third thing is that I think we're using an unrealistically high assumption regarding investment returns. Now unless these assumptions are corrected, any action that the legislature takes to cover the funding shortfall could fall billions of dollars short of actually dealing with the problem. And I think the very difficult decisions that the legislature has to face in this upcoming session will be multiplied greatly if you have to come back and face a similar problem a few years down the line.

So, I would urge you to press very hard to make sure those assumptions are as realistic as possible and that the true nature of the problem is truly understood at the time when the issues are dealt with.

[3:37:22 PM](#)

DR. SOLIE stated that he has no special knowledge in regard to covering the unfunded liability, thus his comments would be made as "an ignorant citizen." He stated his belief that the onus should be on the State of Alaska, and a significant portion of the surplus resulting from high oil prices, for example, should be "considered for application to that." He said that at the same time he thinks some added cost can and probably should be borne by employers. He said he is not certain [how much] that should be, but suggested that one starting point may be the level of increases that have already been put into place.

DR. SOLIE said he thinks consideration should be given to pension obligation bonds (POBs); however, he said their potential negatives should be weighed carefully along with the potential positives of savings. If POBs are to be part of

package, he stated, the sooner a decision is made, the better, because interest rates are going up and the advantage that might be gained through the use of POBs will disappear. Beyond that, he said that he is afraid consideration may have to be given to drawing on the permanent fund; although he said Mr. Teal's suggestion to extend payments "on the state side out for an indefinite period of time" may be the best solution. Mr. Solie stated:

If it's determined that the permanent fund has to be capped - either in terms of the earnings or conceivably in terms of the corpus of the permanent fund - certainly considerable effort is going to have to be undertaken to inform and convince the general public, because to tap the earnings is going to require courage on the part of the legislature, but I think will only exist if the public supports it. To tap the principal, of course, is going to require a change in the [Alaska State] Constitution [and] a vote of the people, and that would require significant public information."

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DR. SOLIE said in that regard he thinks it might be helpful to obtain a decision of ruling from the Alaska Supreme Court as to what the actual obligation is of the State of Alaska with respect to the pension obligations. He referred to previous discussion about who would pick up the bill if a municipality were to fail to pay and go bankrupt.

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JEFF JOHNSON said he is long-term resident of Alaska who has practiced as a certified public accountant (CPA) for 30 years, including auditing and advising on defined benefit, defined contribution, and health plans. He revealed that he is also a member of the Fairbanks City Council. Regarding the \$5.7 billion unfunded liability, he said, "As we address that problem, we, as council members and as legislators, are unable to pay a bill that's accrued for past benefits, and that we think future generations further than 25 years out - unborn children - will have better economic means to pay these bills." Mr. Johnson said a projection is needed to find out what the result of a continued incremental increase of 5 percent would be. He said:

Because the interest on [\$5.7 billion] to roughly 8 percent of that could be \$400-500 million, we know we're going negative - we're not going positive. So, we're over \$6 billion dollars right now, assuming all the actuarial assumptions are correct, and I totally agree with Dr. Solie - we know when they're not correct. So, we're probably closer to \$7 billion right now.

[3:42:53 PM](#)

MR. JOHNSON stated his understanding that the CBR currently amounts to \$2 billion. He asked what the payments paid by the State of Alaska would have been from '95 forward if the state had implemented the correct assumptions back in the early 90s. He stated his belief that that number would probably be \$1 billion. He clarified, "So, would we really have \$2 billion in the constitutional budget reserve right now? No, we would have had to spend that money already had we used correct assumptions ten years ago." Part of the CBR exists, he said, because the state underfunded PERS and TRS in the past.

MR. JOHNSON mentioned a large pension plan in Alaska that is being paid off in 15 years compared to the State of Alaska that will be paying for 30-40 years. If the state were to pay off the unfunded liability through financing and did so over 15 years, he said, the premium would be approximately \$309 million a year. He continued:

If the bill was only \$5 billion, we could pay this off in 15 years, if we slammed. Now I know the bill is more than \$5 billion, but the concept of the difference between 6 percent and 8.25 - it's about \$50 million. So, there's a lot of risk with pension obligation bonds, but if you believe it, and we research it, and we say it works, we save \$700 million for the State of Alaska over 15 years - and that's a gross number, not a preset value.

MR. JOHNSON indicated that if the contributions to municipalities and school districts were frozen at 20 percent, then those entities would know that "the state's going to take care of the big picture" and would be able to set a budget. He said a plan was put together with actuarial benefit assumptions made 25 years ago [that] were erroneous, yet they were the best assumptions known at the time. The volatility of the plan dictates that there will be major changes. He said, "These

changes have all been economically disastrous for the state right now." He continued:

The City of Fairbanks ... signed on and said, "Hey, ... join this, it's a great program, and send us 10 percent, roughly, a year, [or] 15 percent and life is good." Our projected PERS rate right now, if we want to pay our bill off in 25 years - this is the rate established two years ago - is 100 percent. We have to pay 100 percent of our eligible employees right now - that's our burden, just for PERS, but when we signed on, everyone really felt that the cost would be closer to 10 or 15 percent. So, I believe it is a state problem.

[3:48:02 PM](#)

BILL BJORK, President, NEA-Alaska, noted that he submitted written testimony [included in the committee packet]. He emphasized that NEA-Alaska believes that the first critical step is to well define the magnitude of the problem and that an independent actuary is needed to review the current retirement systems to determine what actuarial assumptions ought to be applied. He noted that the actuary retained by Legislative Council, Joseph Esuchanko, had testified during a previous hearing and much of his information was illustrative.

MR. BJORK reviewed that the assumption that Mercer Human Resources Consulting applied is a 3.5 percent rate of inflation. Alaska's experience over any 10-year period is 2.6 percent. The permanent fund, which he said is well respected for good management, uses a 3 percent inflation figure, as does the Governor's office. He noted that the difference between a 3 percent and 3.5 percent is huge; a half a percent over 30 years is \$1 billion. He said it is vital that everyone agrees on what rates to apply.

MR. BJORK stated that wage growth is another issue. Mercer uses a 3.75-4.5 percent figure for wage growth, he said, but most employees in state government have experienced far less. Teachers' salaries, for example, "have grown by 1.36 percent per year over the last 17 years." The largest increase in salary, he noted, was 3.23 percent experienced "this last year." He said [NEA-Alaska] believes it ought to be decided which actuarial assumption is the correct one to apply.

MR. BJORK mentioned medical costs and said he agrees with Dr. Solie regarding the rate applied by Mercer after 2014. He said, "There just is virtually no basis in fact for annual increases dropping to 5 magically in 2014." He said Mr. Esuchanko recommended projecting at 7.5 percent. He added, "We've modeled it ourselves at 8 percent, annually. The assumptions used by the actuary "ought to be in line with Alaska reality," he said. He concluded:

We appreciate the information provided today on the liability associated with each tier in ... PERS and TRS I think that's illustrative look forward to the conversation at future meetings in that area.

In the area of medical costs, NEA-Alaska has some experience managing care. We believe that the medical system provided for our retirees is right for managed care - not reduction of benefits, but managed care. We know how to do it, and we could help in that area.

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REPRESENTATIVE GUTTENBERG noted that the committee is hearing challenges to Mercer's actuarial assumptions. He said he would like an oversight into what the next actuarial contract will be and what kind of controls will be built into it.

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WAYNE HEIMER, testifying on behalf of himself, told the committee that he is a retired wildlife biologist in Tier I of the retirement system. He surmised that the committee is trying to model a system, without knowing the assumptions. He expressed appreciation of the committee's work. He said it looks like the state is in trouble because it received bad assumptions in the past and the legislature must boldly do what it can. He stated his belief that not much can be done about the investment market, and he said he does not think it's practical to "dink too much with the existing benefits." He said he thinks that means the legislature must do something with "the cash infusion." He said he has heard some creative ideas from people who seem to know what they're talking about. He urged the committee to "look strongly at that cash infusion by whatever plan there is," and to be fair, wise, and prompt.

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DON GRAY, testifying on behalf of himself, stated that because of the passage of SB 141, new public service employees in PERS and TRS will not contribute to the pool of funds for earlier retirees starting July 1, 2006. Conversely, the employers in the State of Alaska, the boroughs, cities, and local school districts will still have the obligations that previously existed in the systems. He supported Mr. Teal's previous testimony regarding the advantage to paying down the unfunded liability sooner rather than later, because it "reduces the pain on school districts and municipalities, in particular." He made the assumption that that would also reduce "the pain" on local taxpayers. He continued:

Money is rather fungible; you can spend it in one part of a budget and save in another part of a budget. It does become a form of municipal revenue sharing, but one where the legislature can direct that public money is spent as intended and is not simply a windfall, as referred to earlier. As you indicated, it's pay now or pay later. If you postpone state payment, local taxpayers will feel the annual increased employer contribution rate. It's fair that the state prepays for borough employers, city employers, [and] local school districts, as well as the State of Alaska, and for school districts in unorganized boroughs where they're ... 100 percent state funded - not [funded] by local taxpayers.

MR. GRAY recalled that Dr. Solie had previously spoken to amending SB 141, so that the ability to recruit and retain future quality employees is addressed. He recommended Dr. Solie's letter dated August 17 be included in the committee packet. He noted that both city councilman, Jeff Johnson, and borough assembly chair, Gary Hutchison are CPAs, as well as elected public officials. He stated his belief that the opinions of those two men reflect both their professional and political perspectives, thus he asked the committee to "heed their comments." He again urged the committee to pay down the unfunded liability sooner rather than later.

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V. K. LAHDENPERA, testifying on behalf of herself, revealed that she is a second-generation Alaskan who has worked for 35 years as a public health nurse manager for the Municipality of Anchorage. She stated that she was opposed to parts of SB 141, and she requested a copy of Dr. Solie's letter. She indicated

that the results of SB 141 will be that the state will have a problem obtaining quality professionals. She explained that years ago the nurses employed by the state were the best paid, but now are the worst paid. The PERS benefit was a draw in the past, but now it's gone. She indicated that the state could find itself in big trouble during a natural disaster if it does not have enough qualified people in the public health system. She said after hearing Mr. Teal's testimony she is not sure any audit is necessary, because it is such an expense. She indicated that she thinks preventative medicine can reduce the cost of health care.

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MS. LAHDENPERA, regarding SB 141, said the average person is not versed in financial investments and it's costly to hire a financial advisor on a routine basis. She indicated that she hopes there could be options in the retirement plan regarding investments. She stated that she loved being a government employee, and she said she feels strongly that the legislature and the State of Alaska employees need to work closely together on the issue.

[4:04:32 PM](#)

KEVIN RITCHIE, Alaska Municipal League, expressed his appreciation of the committee's focus on the problem. He said that over the years, municipalities and school districts have met on a regular basis and will "continue to try to contribute positively to the process." He said AML agrees with Representative Rokeberg that each of the categories of employers needs to be looked at individually. He continued:

As ... [Mr.] Teal stated, the liability that's accrued to municipalities and school districts is \$3 billion - give or take - but ... [Ms.] Millhorn said and Representative Seaton emphasized [that] the 5 percent increase, which is very significant to municipalities, still isn't paying the bills. In other words, what the actuaries are seeing is that the average percent of salary paid by both municipalities and the state needs to be somewhere in the neighborhood of 40 percent. Going up 5 percent a year is not paying the bills, and the real costs are accruing because of essentially -- and I don't want to call it interest charges, but it works the same way. The liability that you see on the part of the municipalities - about

\$3 billion - the state is charging or adding to the liability of municipalities at the rate of 8.25 percent a year. So, in other words, on that \$3 billion, that's growing by about a quarter of a million dollars a year, because of that 8.25 percent loss of revenue that ... otherwise the state would get through investments if that money were actually there. So, in essence it's like a loan at 8.25 percent which is accruing interest at a very substantial rate.

To give you an idea of the quarter billion dollar increase in municipal liability each year: that's about 33 percent of all the property taxes collected by municipalities. So, you'd have to increase property taxes about 33 percent just to do an interest-only approach to the growing liability. So, it's a very significant issue for local taxpayers.

MR. RITCHIE, referring to Mr. Teal's previous comments regarding the state's present oil revenue boom, said:

While the state is accruing significant amounts of money every time the price of oil goes up, according to OMB several months ago, at least, there's about \$65 million for every \$1 increase. But according to the Institute for Social & Economic Research in the University of Alaska, Alaskans are using about 20 million barrels of oil per year. So, in essence, when the price of oil goes up one dollar, [it means] \$65 million dollars in new revenue to the state, but \$20 million of new increases to school districts, municipalities, families, [and] businesses. And of course, those costs are much higher in rural areas where the cost of oil and the cost of transportation are so much higher. So, that does expand the ... financial problem that municipalities are facing during the oil ... revenue boom.

[4:08:24 PM](#)

MR. RITCHIE echoed the sentiments of previous speakers that any changes to assumptions should be made known. He said if there's any possibility of constitutionally acceptable cost savings, that would be something that municipalities and school districts strongly support. Looking at POBs is a priority of municipalities, he said. He emphasized what some other speakers had said regarding acting sooner rather than later because of

rising interest rates. He said that certainly a "pay-down into the system" is a long-term benefit to all municipalities. He said he would like the committee to consider putting a cap on contributions by municipalities and school districts, "in that the bulk of the resource revenues obviously accrue to the state, not the municipalities or school districts." He said that might be a way of sorting out the liability in a way that's equitable and affordable for municipalities and school districts. He told the committee that finance directors and leaders have a lot of great information and ideas and could help define the municipal side and school district side of the financial issue for the committee.

[4:10:26 PM](#)

CHAIR WEYHRAUCH thanked the Fairbanks delegation, particularly Representatives Kelly, Ramras, Guttenberg, and Coghill, and all the people in Fairbanks who showed up to the meeting there.

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at [4:10:16 PM](#).