

**MINUTES**  
**SENATE FINANCE COMMITTEE**  
**February 2, 2007**  
**9:01 a.m.**

**CALL TO ORDER**

Co-Chair Bert Stedman convened the meeting at approximately [9:01:01 AM](#).

**PRESENT**

Senator Lyman Hoffman, Co-Chair  
Senator Bert Stedman, Co-Chair  
Senator Charlie Huggins, Vice Chair  
Senator Kim Elton  
Senator Joe Thomas  
Senator Donny Olson  
Senator Fred Dyson

**Also Attending:** SENATOR GARY STEVENS; REPRESENTATIVE MIKE HAWKER; ANNETTE KREITZER, Commissioner, Department of Administration; MELANIE MILLHORN, Director, Division of Retirement and Benefits, Department of Administration; CHARLENE MORRISON, Chief Financial Officer, Division of Retirement & Benefits, Department of Administration;

**Attending via Teleconference:** There were no teleconference participants.

**SUMMARY INFORMATION**

The Committee received a presentation from the Department of Administration overviewing the State's public retirement systems.

[9:02:30 AM](#)

^PERS/TRS Overview & Update#

Co-Chair Stedman announced that this meeting would be the first of several addressing the pension liability challenges facing the State. It would provide "background" information related to

the Public Employees Retirement System (PERS) and Teachers Retirement System (TRS) issues.

9:03:04 AM

Co-Chair Stedman recognized that retirement and benefit concerns are typically handled in the Operating Budget, which Co-Chair Hoffman is charged with in this year. However, Co-Chair Hoffman had delegated this aspect of the Operating Budget to Co-Chair Stedman.

Co-Chair Stedman told that the concerns related to the retirement systems were significant and would be addressed as clearly and with as much information as possible. He anticipated the Committee would be attending to these issues for several weeks, and would eventually produce a "clean-up bill" to SB 141, the PERS/TRS legislation passed by the 24th Legislature. The Alaska Retirement Management Board (ARMB) would assist in the process.

9:05:13 AM

ANNETTE KREITZER, Commissioner, Department of Administration, introduced herself as the Commissioner Designee for the Department, explaining that she had not yet been confirmed by the legislature. She reported that the goal of the presentation was to ensure all Members were equipped with an adequate understanding of the conditions that led to the current situation, and to review the objectives and components of SB 141.

9:06:29 AM

MELANIE MILLHORN, Director, Division of Retirement and Benefits, Department of Administration, instructed Committee members that the final page, page 7, of the presentation, titled "Department of Administration, Financial Overview, PERS and TRS, Senate Finance" [copy on file] dated February 2, 2006, would be referenced throughout the presentation.

9:07:24 AM

Ms. Millhorn noted three areas to be covered in the presentation: protections established by SB 141, current

financial reports for PERS/TRS, and the financial summary on the last page.

Ms. Millhorn emphasized the unique situation the retirement systems were in, as they had had three separate financial reports prepared during 2006. Typically, only an actuarial valuation report would have been prepared, but as a result of the trio of studies conducted, three different rates were produced. The three reports were the actuarial report as of June 30, 2005, a level dollar amortization schedule, and the experience study for PERS and TRS. Ms. Millhorn also referred to the "experience study" as the "actuarial experience analysis" throughout her testimony and presentation. All of the detailed financial reports that would be discussed are available on the Division of Retirement and Benefits webpage.

[9:09:53 AM](#)

Ms. Millhorn directed attention to page 3 of the handout, and informed that SB 141 established the ARMB under AS 37.10.210. The ARMB assumed the function of three separate boards that had previously governed the dealings of the retirement systems. The Senate Finance Committee of the 24th Legislature had decided to consolidate the separate boards, the Public Employees' Retirement Board (PERB), the Teachers' Retirement Board, and the Alaska State Pension Investment Board (ASPIB), into one entity.

[9:10:52 AM](#)

Ms. Millhorn explained that the ASPIB had handled the investment functions of the State pension fund. PERB and TRB dealt with the liabilities and appeals of the different boards.

[9:11:48 AM](#)

Ms. Millhorn mentioned that the ARMB consisted of nine trustees, including Commissioner Kreitzer.

[9:12:08 AM](#)

Ms. Millhorn continued that SB 141 contained "important protections" found in AS 37.10.220., including a requirement that an experience study be conducted not less than once every four years, and that health care costs be reviewed annually by the State's contracted actuary. This is important as healthcare

assumptions are one of the largest contributors to the unfunded liability costs.

[9:12:44 AM](#)

Ms. Millhorn added that SB 141 also called for actuarial assumptions to be reviewed by a separate, independent actuary, and required an independent audit to be conducted on the actuary at least once every four years.

[9:13:23 AM](#)

Ms. Millhorn informed that the most recent independent audit was performed in 2002 and resulted in dramatic increases to the unfunded liability. That audit was referred to as a "limited scope audit", which is different from a full scope audit in that it does not provide for replication testing.

[9:14:09 AM](#)

Ms. Millhorn anticipated that the independent audit of the State's consultants carried out every four years would reduce the "shock factor" that accompanied the valuations for 2002 and 2005.

[9:14:38 AM](#)

Ms. Millhorn turned attention to page 4 of the handout, which contained the following information.

#### Actuarial Valuation Results

In November 2005 Buck Consultants was awarded contract to provide professional actuarial services to the Division of Retirement and Benefits.

In March of 2006 Buck performed a replication and actuarial review of methods and assumptions used by Mercer in the June 30, 2004, valuations. Correction of errors discovered in the replication process were incorporated into the June 30, 2005, valuation reports for PERS and TRS. Principal replication findings are summarized as follows:

- ❖ Did not find significant errors or concerns regarding *pension* liabilities for PERS or TRS.

- ❖ Found several items in replication process where Mercer failed to properly value medical liabilities for PERS. This resulted in approximately \$399 million underestimate for PERS medical liabilities.

Based on the valuation results, the increase to the employer contribution rates for FY08 and FY07 are as follows:

	<u>FY07</u>	<u>FY08</u>
PERS	28.19%	35.51%
TRS	41.78%	42.26

Ms. Millhorn commented that prior to November 2005, Mercer Human Resource Consulting had been the State's actuary for the PERS and TRS retirement systems for 29 years. She stated the purpose of an actuary evaluation was to measure the accrued liabilities for the retirement system, and compare that to the system's assets to determine the funding ratio for the system. This also determines the employer contribution rate for the year.

Ms. Millhorn reported that the replication study performed by Buck Consultants in March of 2006 was an attempt to certify the older data they would inherit from Mercer. In order to accept Mercer's body of work, the data must be reproduced with results within one to three percent of the original figures.

[9:17:05 AM](#)

Ms. Millhorn told that Buck found major errors in the medical component of Mercer's work, and the variation in medial liabilities was 5.8%, resulting in a rejection of the Mercer data. Investigation revealed that Mercer had made medical coding errors and had not properly applied the statute provisions.

[9:18:36 AM](#)

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Level Dollar Amortization Schedule

At the request of the ARMB, Buck Consultants calculated FY08 rates based on a level dollar amortization of the unfunded liability for the PERS and TRS. The current

funding policy adopted in 2002 amortizes the initial unfunded liability and the change in the unfunded liability in subsequent years over a fixed 25-year period, using a 4.25% payroll growth assumption.

The plan is now closed to new members so it is appropriate to not use a 4.25% payroll growth assumption. The ARMB adopted the rates developed using the level dollar amortization method.

Two important points:

- ❖ Closing the defined benefit plans to new members does not increase the liability to the plans
- ❖ Adopting the level dollar amortization schedule does not increase the unfunded liability to the plans

What does not using the payroll growth factor do?

- ❖ Removing the payroll growth factor acts to increase the contribution rates for FY08. However, according to Buck it will result in a lower contribution schedule in future years.

PERS

FY07: 28.19%

2005 Valuation FY08: 32.51%

Level Dollar Amortization FY08: 39.76%

TRS

FY07: 41.78%

2005 Valuation FY08: 42.26%

Level Dollar Amortization FY08: 54.03%

Ms. Millhorn summarized the information on page 5, and mentioned that detailed minutes of the ARMB meeting are available at the Department of Revenue, Division of Treasury webpage. She noted that lower long-term contribution rates are achieved by paying more into the fund through the current higher rates to reduce the interest paid on the unfunded liabilities.

[9:22:26 AM](#)

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Actuarial Experience Analysis

Buck Consultants completed the actuarial experience analysis in October 2006. Purpose of actuarial experience study is to compare actual plan experience with actuarial assumptions used in the valuation. The experience study looked at the five year period from 2001 through 2005.

(1) Actuary will recommend changes to assumptions if sufficient data is available that shows material difference between expected and actual experience.

(2) Future experience is likely to be different given recent trends.

Several of the assumptions include: investment return, healthcare, mortality, retirement, salary, Alaska residency, actuarial cost method, and disability.

To get an understanding of the impact of the revised assumptions and actuarial methods, Buck recalculated FY08 rates using the revised assumptions and actuarial methods. The results are summarized below.

PERS

2005 Valuation FY08: 32.51%

Level Dollar Amortization FY08: 39.76%

Actuarial Experience Study FY08: 46.64%

TRS

2005 Valuation FY08: 42.26%

Level Dollar Amortization FY08: 54.03%

Actuarial Experience Study FY08: 59.56%

The ARMB adopted the recommendations by Buck, which had been reviewed by GRS (second actuary) and determined to be reasonable. The revised assumptions and actuarial methods will be incorporated into the June 30, 2006, actuarial valuation reports.

Ms. Millhorn told that an experience study should be conducted every three to six years, and is called for every four years by the Department. The study compares actual plan experiences with the actuarial assumptions, and recommends changes.

[9:24:14 AM](#)

Ms. Millhorn located the assumptions in section 2.3 of the aforementioned valuation report, and provided examples of the assumptions.

[9:24:57 AM](#)

Ms. Millhorn informed that the experience report was prepared to assist the ARMB in understanding the impacts of the assumptions and the recommended changes.

Ms. Millhorn specified that the assumption recommendations used the June 30, 2005 valuation, and summarized the anticipated changes.

[9:26:03 AM](#)

Ms. Millhorn remarked that those assumptions would be incorporated into the June 2006 valuation, which had not yet been completed.

[9:26:22 AM](#)

Ms. Millhorn spoke to the most recent prior study conducted by Mercer in 2002. That study canvassed only the past two years of data, and it was believed that that amount of time was insufficient to analyze trend changes that would influence assumption changes.

[9:27:25 AM](#)

Page 7

Alaska Public Employees' and Teachers' Retirement System  
Earnings - Actuarial Rate - Employers Rates - Funding  
Ratios

[Chart listing Actual Investment Return and Actuarial Investment Return, Unfunded Liability in billions, Average Calculated Rate and Board Adopted Rate, Funding Ratio - Assets\Liabilities Total Benefits, and Total Employer Contribution Amount in Millions for Valuation Years FY 01 through FY 05 and Employer Contribution Fiscal Years FY 04 through FY 08 for the PERS and TRS systems.]

Ms. Millhorn reviewed the summary chart, and stated that projections of an unfunded liability of approximately \$10 billion are based on the fact that the actuarial evaluation as of June 30, 2006 had not been reviewed.

[9:29:41 AM](#)

Ms. Millhorn referred to the "shock factor" associated with the recent reports on the retirement systems, and explained that reports will be conducted frequently to avoid unanticipated "surprises". She exemplified the results of a limited scope audit carried out in 2002, which increased the Average Calculated Rate for PERS from 6.77 percent to 24.91 percent in one valuation year. During the same time period, the TRS Average Calculated Rate increased from 14.44 percent to 35.57 percent.

[9:31:21 AM](#)

Ms. Millhorn addressed the decline in the funding ratio as the total employer contribution rate increased from \$105.6 million in FY 01 to an estimated \$676.8 million in FY 08 in PERS. The TRS employer contribution rate increased from \$68.7 million to \$351.7 during the same time period.

[9:32:50 AM](#)

Co-Chair Stedman summarized that five years ago the State contribution was approximately \$170 million per year. The current annual contribution by the State exceeds \$1 billion.

[9:33:33 AM](#)

Co-Chair Stedman asked Ms. Millhorn to explain the "lag time" between the end of the fiscal year and the implementation of the ARMB-set rates for the following period.

[9:33:47 AM](#)

Ms. Millhorn told that questions regarding the "lag period" involved in the determination of the employer contribution rate are common. She informed that at the end of the fiscal year, the Division provides Buck Consultants with information on all of the members enrolled in PERS and TRS. The data is transmitted in September or October, and the consultants analyze the data to

prepare the employer contribution rate for the following fiscal year. The rate for the ensuing fiscal year is typically available in March or April.

Ms. Millhorn acknowledged that the consultants' timetable does not allow for legislative consideration of the employer contribution rate when budgeting for the following fiscal year. Therefore, there is approximately a two year lag period between the consultants' analysis and that data impacting the budget process.

[9:36:04 AM](#)

Co-Chair Stedman commented that the asset-to-liability ratio indicated that the systems were fully funded in 2001, and the State had not revised the information to reflect the fiscal realities. The 100 percent funding ratio would not exist if the ratio was restated retroactively.

[9:37:19 AM](#)

Co-Chair Stedman informed that the Committee had not deemed it necessary to finance a restatement of the funding ratio, but stressed that the "big reduction" reflected in the chart did not occur in a single year.

[9:37:30 AM](#)

Co-Chair Stedman referred to page 5 of the presentation, and reiterated that closing the defined benefits plan to new members would not increase the unfunded liability of the plan. This would be addressed further by the Department at a later date. The adoption of a level dollar amortization schedule would also be considered in future meetings.

[9:38:42 AM](#)

Co-Chair Hoffman spoke to the third point bulleted on page 5, which forecast a lower employer contribution schedule in the future. He asked if the Department was aware of a timeframe for the rate reduction and asked the amount of the reduction.

[9:39:13 AM](#)

Ms. Millhorn replied that a schedule had not yet been prepared, but would be requested from Buck Consultants. Section 1.5 of the current valuations provide that the information will be produced for the projected 25 year period.

[9:40:02 AM](#)

Co-Chair Hoffman found such a reduction "hard to predict" and suggested that the rate may increase if a large proportion of State employees who are members of the defined benefits system remain in State employment.

[9:40:43 AM](#)

Ms. Millhorn agreed that the Department needed to provide more discussion on that issue. She expressed that the unfunded liability is currently fixed in the defined benefit plan. Use of the level dollar amortization schedule allows the employer to "liquidate" the unfunded liability debt, as it is not driven by employee contributions.

[9:41:33 AM](#)

Co-Chair Stedman asked Ms. Millhorn to define "level".

[9:41:38 AM](#)

Ms. Millhorn explained that a level dollar amortization does not include a growth factor.

[9:41:49 AM](#)

CHARLENE MORRISON, Chief Financial Officer, Division of Retirement & Benefits, Department of Administration, elaborated that a level dollar amortization means that the amount of amortization in any given year is the same dollar amount. It does not assume that increased employment rates will translate into increased contribution amounts.

[9:42:17 AM](#)

Co-Chair Stedman clarified that the contributions mentioned would be employer contributions.

[9:42:21 AM](#)

Ms. Morrison affirmed.

[9:42:30 AM](#)

Co-Chair Stedman asked for that information in the form of a table in forthcoming presentations.

[9:42:45 AM](#)

Co-Chair Hoffman asked if the funding ratios listed on page 7 were calculated after the employer contributions were made.

[9:43:19 AM](#)

Ms. Millhorn responded that the funding ratios were based on the valuation reports, not the experience study.

[9:43:45 AM](#)

Senator Elton asked when the Department would request a contribution schedule from Buck Consultants, and when they expected such a schedule to be produced.

[9:44:15 AM](#)

Ms. Millhorn replied that the Department would make the request to Buck Consultants in the current week, and at that time would ask for an estimate of the completion date as well as the anticipated cost of the study.

[9:44:32 AM](#)

Senator Elton asked if Ms. Millhorn could estimate the date that schedule would be available.

[9:44:52 AM](#)

Ms. Millhorn was unsure, but would inform the Committee when she knew.

[9:44:58 AM](#)

Co-Chair Stedman expected matters concerning the proposed natural gas pipeline to dominate latter Committee meetings, and

indicated that the Committee would strive to address the retirement systems in a timely fashion. He requested the information from the Division of Retirement and Benefits be distributed to Members as soon as possible. If the cost of the studies was an issue, he and Co-Chair Hoffman would address the funding.

[9:45:47 AM](#)

Senator Elton assumed that the cost of funding the requests of Buck Consultants would not be general fund dollars, but rather PERS/TRS funds.

[9:46:01 AM](#)

Ms. Millhorn affirmed, stating that the studies are paid for using the retirement system trust funds.

[9:46:39 AM](#)

Senator Elton referred to page 6 of the handout, and asked what assumptions Buck Consultants used for future investment returns, and how poor returns would affect the experience analysis assumptions.

[9:47:44 AM](#)

Ms. Millhorn responded that Buck Consultants conducts thorough analysis on investment rate return, as a lower assumption rate drives up the liabilities. The ARMB sets asset allocations for the retirement system, and that is the figure that Buck utilizes to determine the needed investment return. Detailed information was available.

[9:48:47 AM](#)

Co-Chair Stedman informed that both the ARMB and the Alaska Permanent Fund Board would appear before the Committee.

[9:49:06 AM](#)

Senator Elton opined that it would be of benefit to the Committee to examine the normal cost rate in comparison to the average calculated rate.

[9:49:33 AM](#)

Ms. Millhorn stated that that information is available and would be provided.

[9:49:37 AM](#)

Senator Huggins inquired how Alaska's funding ratio compared to other similarly situated states.

[9:50:06 AM](#)

Ms. Millhorn responded that she must to examine the most recent information provided by other states to make such a comparison. She noted that a comparison can be difficult as some states either do not provide health care to their members, or do not prefund health care costs in the pension system.

[9:50:55 AM](#)

Senator Huggins asked for a brief explanation of the implications of prefunding.

[9:51:08 AM](#)

Ms. Millhorn informed that the Governmental Accounting Standards Board (GASB) ruled in 2005 that beginning in 2007, retirement pension systems' post-employment health care must be accounted for on an accrual basis.

Ms. Millhorn spoke to a report prepared in 2003 by Workplace Economics that analyzes the health care costs to pensions systems. The report indicates that there are 11 other pension systems that prefund health care costs, which the PERS/TRS systems began doing in 1976. Systems that do not prefund have even more drastic unfunded liabilities. California, for example, is facing \$40 to \$70 billion in unfunded liability as a result of not accounting for these pension costs.

[9:53:06 AM](#)

Senator Huggins shared that he had benefited from learning of other state's experiences in tackling their pension problems while at a conference in Hawaii.

[9:53:40 AM](#)

Senator Thomas referred to the provision put into place by SB 141 that required an experience analysis be conducted "not less than once every four years," and asked what the previous practice had been.

[9:54:03 AM](#)

Ms. Millhorn responded that the prior statutory requirement was once every six years for the PERS retirement system.

[9:54:08 AM](#)

Senator Thomas asked when the last experience analysis had been conducted.

[9:54:14 AM](#)

Ms. Millhorn stated it was performed in 2000.

Senator Thomas asked the time frame that analysis covered.

Ms. Millhorn informed it pertained to the years of 1999 and 2000.

[9:54:37 AM](#)

Senator Thomas characterized that investment period as "horrendous," yet noticed that the information on page 7 of the handout reflected negative unfunded liability amounts for the fiscal years of 2001 and 2002. He asked if there was any attention directed towards the trend at that time.

[9:54:54 AM](#)

Ms. Millhorn clarified that Senator Thomas was referring solely to the investment returns, and told that she was not in her position at that time. Nonetheless, she characterized the investment returns as "alarming". She advised the Committee to discuss this subject further with the ARMB.

[9:55:40 AM](#)

Co-Chair Stedman added that the Committee's "historical file" could produce the allocation of the liability for investment performance, change in health care assumptions, and policy changes implemented by the legislature. This would illustrate factors that contributed to the current situation.

#

**ADJOURNMENT**

Co-Chair Bert Stedman adjourned the meeting at [9:57:10 AM](#)