

HB

13

SFIN

FILE

SENATE FINANCE COMMITTEE REPORT

DATE: 4/27/07

FURTHER:

DATE TURNED IN TO OFFICE: 3-28-08

Finance Committee considered CS FOR HOUSE BILL NO. 13(FIN)

HB 13 RETIREMENT SYSTEM LIABILITY/BONDS/CORP.

"An Act relating to prepayments of accrued actuarial liabilities of government retirement systems; relating to the Alaska Municipal Bond Bank Authority, the Alaska Housing Finance Corporation, and the state bond committee; establishing the Alaska Pension Obligation Bond Corporation; permitting the Alaska Municipal Bond Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, and the Alaska Pension Obligation Bond Corporation to assist state and municipal governmental employers by issuing bonds, notes, commercial paper, or other obligations to enable the governmental employers to prepay all or a portion of the governmental employers' shares of the unfunded accrued actuarial liabilities of retirement systems; authorizing a governmental employer to issue obligations to prepay all or a portion of the governmental employer's shares of the unfunded accrued actuarial liabilities of retirement systems and to enter into a lease or other contractual agreement with a trustee, the Alaska Municipal Bond Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, or the Alaska Pension Obligation Bond Corporation in connection with the issuance of obligations for that purpose, and relating to those obligations; relating to revision of the employer contribution rate in connection with financed prepayment of unfunded accrued actuarial liabilities of government retirement systems; and providing for an effective date."

and recommends:

- be replaced with SCS or CS CS HB 13 (FIN)
- adopt previous SCS or CS _____ (_____)
- attached amendment(s)
- adopt _____ Letter of Intent
- further referral to _____ Committee

SENATE BILL:	
<input type="checkbox"/> Same Title	
<input type="checkbox"/> New Title	
<hr/>	
HOUSE BILL:	
<input type="checkbox"/> Same Title	
<input type="checkbox"/> Technical Title Change	
<input checked="" type="checkbox"/> New Title w/ SCR # _____	

NEW FISCAL NOTE(S):

PREVIOUS FISCAL NOTE

Department	Date	Fiscal	Indet.	Zero	FN#
REV	7/6/08		✓		
ADM	12/3/07			✓	

Department	Date	Fiscal	Indet.	Zero	FN#

APPROPRIATION - no fiscal note

SIGNATURES AND RECOMMENDATIONS:	PRINTED LAST NAME	DO PASS	DO NOT PASS	NO REC	AMEND
	Elton	✓			
	Thomas	✓			
	Olson			✓	
CO-CHAIR:	Hoffman	✓			
CO-CHAIR:	Stern	✓			

FISCAL NOTE

STATE OF ALASKA
2008 LEGISLATIVE SESSION

Fiscal Note Number: _____
Bill Version: CSHB 13(FIN)
() Publish Date: _____

Identifier (file name): HB013CS(FIN)-DOA-DRB-12-03-07 Dept. Affected: Administration
Title: An Act relating to prepayments of accrued actuarial liabilities of RDU Centralized Administrative Services
government retirement systems and establishing the AK Pension Obligation Bond Corp. Component: Retirement and Benefits
Sponsor: Rep. Hawker, Fairclough, Kelly, Roses, Dahlstrom, Johnson, Johansen, Lynn, LeDoux
Requester: Senate Finance Component Number: 64

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

	Appropriation Required	Information						
		FY 2009	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
OPERATING EXPENDITURES								
Personal Services	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Travel	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Contractual	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Supplies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equipment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Land & Structures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants & Claims	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Miscellaneous	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CHANGE IN REVENUES ()	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1003 GF Match	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1004 GF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1005 GF/Program Receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1037 GF/Mental Health	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Interagency Receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2008) cost: _____

POSITIONS

Full-time	0	0	0	0	0	0	0	0
Part-time	0	0	0	0	0	0	0	0
Temporary	0	0	0	0	0	0	0	0

ANALYSIS: (Attach a separate page if necessary)

This bill creates the Pension Obligation Bond Corporation for the purpose of issuing pension obligation bonds to allow state and municipal employers to prepay unfunded accrued actuarial liabilities of the retirement systems. The division anticipates no additional operating or personnel costs to process any transactions that may occur as a result of passage of this bill.

Sec. 24.08.036. Fiscal notes on bills affecting state retirement systems. Before a bill which would have an effect on the retirement systems of the state is reported to the rules committee, there shall be attached to the bill an analysis of the long-term and short-term costs to the state if the bill is adopted, as well as the impact of the bill on the actuarial soundness of the fund. The analysis is in addition to the fiscal note requirements of AS .08.035.

Prepared by: Patrick Shior, Director
Division: Retirement and Benefits
Approved by: Annette Kreitzer, Commissioner
Department of Administration

Phone 465-4817
Date/Time 12/3/07 12:00 AM
Date 12/4/2007

FISCAL NOTE

STATE OF ALASKA
2008 LEGISLATIVE SESSION

Fiscal Note Number: _____
Bill Version: CSHB 13
() Publish Date: _____

Identifier (file name): CSHB13(FIN)-DOR-TRE-2-6-08 Dept. Affected: Revenue 04
Title: Retirement System Liability/Bonds/Corp. RDU: Taxation and Treasury
Component: Treasury
Sponsor: Representative Hawker
Requester: Senate Finance Component Number: 121

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

	Appropriation Required	Information						
		FY 2009	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
OPERATING EXPENDITURES								
Personal Services								
Travel								
Contractual								
Supplies								
Equipment								
Land & Structures								
Grants & Claims								
Miscellaneous								
TOTAL OPERATING	*		*	*	*	*	*	*

CAPITAL EXPENDITURES								
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CHANGE IN REVENUES ()								
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts								
1003 GF Match								
1004 GF								
1005 GF/Program Receipts								
1037 GF/Mental Health								
Other Interagency Receipts								
TOTAL	*		*	*	*	*	*	*

Estimate of any current year (FY2008) cost: 0.0

POSITIONS

	0	0	0	0	0	0	0
Full-time							
Part-time							
Temporary							

ANALYSIS: (Attach a separate page if necessary)

The bill expands the powers of the Alaska Municipal Bond Bank Authority (Bond Bank) and the State Bond Committee (SBC) and creates the Pension Obligation Bond Corporation (POBC) for the purpose of issuing obligations to provide funds to prepay unfunded accrued actuarial liabilities of the retirement systems. The premise of undertaking this type of transaction is borrowing at rates that are at least 1.5% lower than the actuarial assumed rate of return on the pension funds (8.25%).

The fiscal note is indeterminate in cost as it is uncertain how or if a transaction will develop if the legislation is passed. If a transaction is undertaken it is likely that it will be of considerable size, up to several billion dollars, and occur in FY 2008. Contractual costs include rating agency fees, financial advisor, bond counsel, printing, cusip service, underwriting, & other miscellaneous costs would need to be funded in the year of issuance as well as ongoing costs for administrative monitoring and cost of contractors over the life of the bonds.

Prepared by: Brian C Andrews
Division: Revenue / Treasury
Approved by: Jerry Burnett
Department of Revenue

Phone 907 465-3669
Date/Time 2/6/08 12:00 AM
Date 2/6/2008

SENATE CONCURRENT RESOLUTION NO.
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-FIFTH LEGISLATURE - SECOND SESSION

BY THE SENATE FINANCE COMMITTEE

Introduced:
Referred:

A RESOLUTION

1 Suspending Rules 24(c), 35, 41(b), and 42(e), Uniform Rules of the Alaska State
2 Legislature, concerning House Bill No. 13, relating to prepayments of accrued actuarial
3 liabilities of government retirement systems; relating to the Alaska Municipal Bond
4 Bank Authority; permitting the Alaska Municipal Bond Bank Authority or a subsidiary
5 of the authority to assist state and municipal governmental employers by issuing bonds,
6 notes, commercial paper, or other obligations to enable the governmental employers to
7 prepay all or a portion of the governmental employers' shares of the unfunded accrued
8 actuarial liabilities of retirement systems; authorizing a governmental employer to issue
9 obligations to prepay all or a portion of the governmental employer's shares of the
10 unfunded accrued actuarial liabilities of retirement systems and to enter into a lease or
11 other contractual agreement with a trustee or the Alaska Municipal Bond Bank
12 Authority or a subsidiary of the authority in connection with the issuance of obligations
13 for that purpose, and relating to those obligations; and providing for an effective date.

1 **BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

2 That under Rule 54, Uniform Rules of the Alaska State Legislature, the provisions of
3 Rules 24(c), 35, 41(b), and 42(e), Uniform Rules of the Alaska State Legislature, regarding
4 changes to the title of a bill, are suspended in consideration of House Bill No. 13, relating to
5 prepayments of accrued actuarial liabilities of government retirement systems; relating to the
6 Alaska Municipal Bond Bank Authority; permitting the Alaska Municipal Bond Bank
7 Authority or a subsidiary of the authority to assist state and municipal governmental
8 employers by issuing bonds, notes, commercial paper, or other obligations to enable the
9 governmental employers to prepay all or a portion of the governmental employers' shares of
10 the unfunded accrued actuarial liabilities of retirement systems; authorizing a governmental
11 employer to issue obligations to prepay all or a portion of the governmental employer's shares
12 of the unfunded accrued actuarial liabilities of retirement systems and to enter into a lease or
13 other contractual agreement with a trustee or the Alaska Municipal Bond Bank Authority or a
14 subsidiary of the authority in connection with the issuance of obligations for that purpose, and
15 relating to those obligations; and providing for an effective date.

SENATE CS FOR CS FOR HOUSE BILL NO. 13(FIN)
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-FIFTH LEGISLATURE - SECOND SESSION

BY THE SENATE FINANCE COMMITTEE

Offered:

Referred:

Sponsor(s): REPRESENTATIVES HAWKER, Fairclough, Kelly, Roses, Dahlstrom, Johnson, Johansen, Lynn, LeDoux

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to prepayments of accrued actuarial liabilities of government
2 retirement systems; relating to the Alaska Municipal Bond Bank Authority, the Alaska
3 Housing Finance Corporation, and the state bond committee; establishing the Alaska
4 Pension Obligation Bond Corporation; permitting the Alaska Municipal Bond Bank
5 Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance
6 Corporation, the state bond committee, and the Alaska Pension Obligation Bond
7 Corporation to assist state and municipal governmental employers by issuing bonds,
8 notes, commercial paper, or other obligations to enable the governmental employers to
9 prepay all or a portion of the governmental employers' shares of the unfunded accrued
10 actuarial liabilities of retirement systems; authorizing a governmental employer to enter
11 into a lease or other contractual agreement with a trustee, the Alaska Municipal Bond
12 Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing

1 Finance Corporation, the state bond committee, or the Alaska Pension Obligation Bond
2 Corporation in connection with the issuance of obligations by a state entity for the
3 purpose of prepaying all or a portion of the governmental employer's share of the
4 unfunded accrued actuarial liabilities of retirement systems, and relating to those
5 obligations; relating to revision of the employer contribution rate in connection with
6 financed prepayment of unfunded accrued actuarial liabilities of government retirement
7 systems; and providing for an effective date."

8 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

9 * Section 1. AS 14.25.070 is amended by adding new subsections to read:

10 (d) All or a portion of the employer's share of any accrued actuarial liability to
11 the plan may be prepaid in a lump sum. The commissioner of administration may, by
12 regulation, establish a minimum amount for the lump sum payment of a portion. The
13 administrator shall charge to the employer appropriate and reasonable administrative
14 costs to the plan attributable to a lump sum payment that are not greater than
15 administrative costs applied to other employer contributions. If an employer is
16 grouped with any other employer in accounting for contributions, the lump sum
17 payment for the employer shall be accounted for separately in accordance with
18 regulations adopted by the commissioner. The regulations must provide for crediting
19 to each lump sum payment account all earnings and losses received from investment
20 of that payment. The lump sum payment shall be used solely to offset contributions
21 under this section required of the employer for which the payment was made, taking
22 into account earnings and losses from its investment. A lump sum payment made by or
23 on behalf of an employer under this subsection, together with all earnings and losses
24 from investment of that payment, may not be considered in calculating that employer's
25 share of any discretionary payment authorized by the state that benefits multiple
26 employers.

27 (e) If all or a portion of an employer's share of any accrued actuarial liability
28 to the plan is prepaid in a lump sum under (d) of this section, the administrator shall

1 calculate a revised employer contribution rate for that employer in recognition of that
2 prepayment not more than 30 days following the prepayment.

3 * Sec. 2. AS 18.56.010 is amended by adding a new subsection to read:

4 (g) The legislature finds that permitting the Alaska Housing Finance
5 Corporation to create a subsidiary to assist in the financing of prepayment of all or a
6 portion of a governmental employer's share of unfunded accrued actuarial liability of
7 retirement systems serves a public purpose in benefiting the people of the state. The
8 Alaska Housing Finance Corporation may act on behalf of the state and its people in
9 serving this public purpose for the benefit of the general public.

10 * Sec. 3. AS 18.56.086 is amended to read:

11 Sec. 18.56.086. Creation of subsidiaries. The corporation may create
12 subsidiary corporations for the purpose of financing or facilitating the financing of
13 school construction, facilities for the University of Alaska, facilities for ports and
14 harbors, prepayment of all or a portion of a governmental employer's share of
15 unfunded accrued actuarial liability of retirement systems, or other capital
16 projects. A subsidiary corporation created under this section may be incorporated
17 under AS 10.20.146 - 10.20.166. The corporation may transfer assets of the
18 corporation to a subsidiary created under this section. A subsidiary created under this
19 section may borrow money and issue bonds as evidence of that borrowing, and has all
20 the powers of the corporation that the corporation grants to it. However, a subsidiary
21 created for the purpose of financing or facilitating the financing of prepayment of
22 a governmental employer's share of unfunded accrued actuarial liability of
23 retirement systems may borrow money and issue bonds only if the state bond
24 rating is the equivalent of AA- or better and subject to AS 37.15.903. Unless
25 otherwise provided by the corporation, the debts, liabilities, and obligations of a
26 subsidiary corporation created under this section are not the debts, liabilities, or
27 obligations of the corporation.

28 * Sec. 4. AS 18.56.110(g) is amended to read:

29 (g) Notwithstanding AS 18.56.090(a)(11) and (a) of this section, the
30 corporation may not issue bonds in any 12-month period beginning after June 30,
31 1983, in an amount that exceeds the amount of bonds authorized to be issued during

1 the preceding period, unless a different amount is authorized by the legislature. This
 2 subsection does not apply to

3 (1) the issuance by the corporation of refunding bonds;

4 (2) [OR TO] the issuance by the corporation of bonds the proceeds of
 5 which are intended to be used to refinance mortgage loans held by the corporation; or

6 (3) the issuance by a subsidiary of the corporation of bonds to
 7 prepay all or a portion of a governmental employer's share of unfunded accrued
 8 actuarial liability of retirement systems if the board of the subsidiary first finds
 9 that the actuarially assumed rate of return on the funds managed by the Alaska
 10 Retirement Management Board is projected to exceed the true interest cost to be
 11 paid on the bonds by at least 1.5 percent annually.

12 * Sec. 5. AS 18.56.390 is amended by adding a new paragraph to read:

13 (14) "governmental employer" means the State of Alaska or a
 14 municipality or other state or municipal governmental entity within the state, including
 15 an agency, instrumentality, district, school district, public corporation, department,
 16 division, or other subdivision of the state or of a municipality, in its capacity as an
 17 employer.

18 * Sec. 6. AS 29.47 is amended by adding a new section to read:

19 Sec. 29.47.480. **Accrued actuarial liabilities of retirement systems.** (a) A
 20 municipality, or two or more municipalities jointly, may enter into a lease or other
 21 contractual agreement with a trustee, or the Alaska Municipal Bond Bank Authority or
 22 a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation,
 23 the state bond committee, or the Alaska Pension Obligation Bond Corporation in
 24 connection with the issuance of obligations by a state entity to prepay all or a portion
 25 of each participating municipality's share of the accrued actuarial liabilities of
 26 retirement systems. Obligations issued for purposes described in this subsection must
 27 be secured and payable as provided in the agreement or under an authorizing
 28 ordinance. The agreement or ordinance may provide for reserves and for protective
 29 covenants.

30 (b) Amounts paid by a participating municipality in connection with
 31 obligations issued by a state entity under this section, together with proceeds of the

1 obligations and interest or earnings, may be pooled into one or more funds or
 2 accounts, including one or more debt service funds. The assets in any of the funds or
 3 accounts may be pledged to the holders of the obligations.

4 (c) A municipality may enter into a funds diversion agreement with a state
 5 agency regarding payment of money on behalf of the municipality that may be applied
 6 to payments under a lease, other agreement, or obligation issued under this section.
 7 The funds diversion agreement must provide, subject to any conditions set out in the
 8 funds diversion agreement, that all or a portion of the funds otherwise payable to the
 9 municipality by the state agency shall be paid directly to the trustee, the Alaska Bond
 10 Bank Authority, or its subsidiary, a subsidiary of the Alaska Housing Finance
 11 Corporation, the state bond committee, or the Alaska Pension Obligation Bond
 12 Corporation, to satisfy, in whole or part, the municipality's payments under the lease,
 13 other agreement, or obligations. Nothing in this subsection or in a funds diversion
 14 agreement entered into under this subsection obligates the state or a state agency to
 15 pay any amount to or on behalf of a municipality that the municipality is not otherwise
 16 entitled to receive or to make any payments of principal or interest on the obligations.

17 (d) For purposes of this section, "obligations" means bonds, notes, commercial
 18 paper, certificates of participation, or other contractual obligations.

19 * Sec. 7. AS 36.30.850(b) is amended by adding a new paragraph to read:

20 (46) contracts of the Alaska Pension Obligation Bond Corporation
 21 under AS 37.16.010 - 37.16.900.

22 * Sec. 8. AS 37.15 is amended by adding new sections to read:

23 **Article 8. Pension Obligation Bonds.**

24 **Sec. 37.15.900. Bond authorization.** (a) For purposes of financing
 25 prepayment of all or a portion of a governmental employer's share of unfunded
 26 accrued actuarial liability of retirement systems, including the costs of issuance and
 27 administration, the issuance and sale of bonds of the state by the committee is
 28 authorized as provided in this section and AS 37.15.903 - 37.15.955, but only if the
 29 state bond rating is the equivalent of AA- or better. The net proceeds of the sale of the
 30 bonds remaining after payment of costs of issuance and administration shall be
 31 transferred to the commissioner of administration for the account of the governmental

1 employer whose share of unfunded accrued actuarial liability is to be prepaid for
2 application to that liability. Accrued interest paid on the bonds shall be paid into the
3 pension obligation bond redemption fund.

4 (b) The total unpaid principal amount of bonds, including refunding bonds,
5 but excluding refunded bonds, is limited as provided in AS 37.15.903. The bonds do
6 not constitute a general obligation of the state. Authorization by the voters of the state
7 or the legislature is not required.

8 (c) The committee may enter into agreements with other state agencies as
9 necessary or convenient to implement this section and AS 37.15.903 - 37.15.955.

10 (d) The committee may contract for the services of underwriters, paying
11 agents, trustees, bond printers, rating agencies, bond insurance, credit enhancement
12 providers, accountants, financial advisors, and bond counsel, and for other services as
13 are necessary to accomplish the bond issuance and sale.

14 **Sec. 37.15.903. Pension obligation bond limit.** The total unpaid principal
15 amount of bonds, including refunding bonds, but excluding refunded bonds, issued by
16 all state entities added together, for the purposes of financing prepayment of all or a
17 portion of a governmental employer's share of unfunded accrued liability of retirement
18 systems, may not exceed \$5,000,000,000.

19 **Sec. 37.15.905. Bond redemption fund.** (a) There is established a special fund
20 of the state, known as the pension obligation bond redemption fund, which is a trust
21 fund for paying and securing the payment of the principal of and interest and
22 redemption premium, if any, on the bonds, and which shall be at all times completely
23 segregated and set apart from all other funds of the state. The bond redemption fund
24 shall be drawn on only for the purpose of paying the principal of and interest and
25 redemption premium, if any, on the bonds, together with related trustee fees, if any.

26 (b) Money in the bond redemption fund may be invested in the same manner
27 and on the same conditions as permitted for investing of money belonging to the state
28 or held in the treasury under AS 37.10.070; however, the committee may agree with
29 the bondholders to further limit these investments. Earnings on investments must be
30 retained in the bond redemption fund.

31 (c) Separate accounts may be created in the bond redemption fund for the

1 purposes of paying and securing the bonds. The accounts may be combined for
2 purposes of investment and for financial support to achieve the purposes of
3 AS 37.15.910(c).

4 **Sec. 37.15.910. Bond terms.** (a) The bonds may be issued and sold at public
5 or negotiated sale in the manner, in the amounts or series, and at the time or times that
6 the committee determines. The bonds, or each series of them, shall be sold at the price
7 and on the terms, conditions, and covenants set by the committee after considering
8 market conditions. Interest rates may be fixed or variable.

9 (b) The bonds mature at the time or times fixed by the committee. The bonds
10 may be subject to redemption before their fixed maturities, as determined by the
11 committee, with or without a premium or premiums. The bonds may be in
12 denominations determined by the committee; may be issued in fully or partially
13 registered form; must be payable as to principal and interest at the place or places
14 determined by the committee; must be signed on behalf of the state in the manner
15 provided by the committee; and must be issued under and subject to the terms,
16 conditions, covenants, and protective features safeguarding payment of the bonds as
17 found necessary by the committee.

18 (c) If the committee finds it reasonably necessary, the committee may select a
19 trustee or trustees for the holders of the bonds, or any series of them, for the
20 safeguarding and disbursement of any of the money in the bond redemption fund or
21 for duties with respect to the enforcement, authentication, delivery, payment, and
22 registration of the bonds as the committee may determine. The committee shall fix the
23 rights, duties, powers, and obligations of the trustee or trustees.

24 (d) In its determination of all matters and questions relating to the issuance
25 and sale of the bonds and the fixing of their maturities, terms, conditions, and
26 covenants as provided in (a) of this section, the decisions of the committee shall be
27 those that are reasonably necessary for the best interests of the state and its inhabitants
28 and that will accomplish the most advantageous sale of the bonds. Decisions of the
29 committee, as expressed in a bond resolution, are final and are conclusively
30 considered to comply with the requirements of AS 37.15.900 - 37.15.955.

31 **Sec. 37.15.915. Bond resolution.** The committee shall authorize the issuance

1 of bonds by adopting a resolution and shall prepare all other documents and
2 proceedings necessary for the issuance, sale, and delivery of the bonds or any part or
3 series of them. The bond resolution must fix the principal amount, denominations,
4 date, maturities, manner of sale, place or places of payment, rights of redemption, if
5 any, terms, form, conditions, and covenants of the bonds or each series of them.

6 **Sec. 37.15.920. Enforcement by bond owner.** (a) The owner or owners of not
7 less than 10 percent of the aggregate principal amount of any series or issue of bonds
8 or the trustee for the owners of the bonds or any series of them may, by appropriate
9 proceedings in state court, require and compel the transfer, setting aside, and payment
10 of money and the enforcement of all of the terms, conditions, and covenants as
11 required and provided in AS 37.15.900 - 37.15.955, as appropriate, and the bond
12 resolution.

13 (b) A proceeding under (a) of this section may be commenced and conducted
14 only in the Superior Court for the State of Alaska, First Judicial District at Juneau.

15 **Sec. 37.15.925. Amounts required for payments.** The committee shall,
16 before June 30 of each year or from time to time within the year, as appropriate,
17 commencing with the year in which the bonds are issued, certify to the commissioner
18 of revenue and the commissioner of administration the amounts required in the current
19 fiscal year and the next ensuing fiscal year by the bond resolution or resolutions to be
20 paid from the general fund into the bond redemption fund and to be paid into and
21 maintained in any reserve fund or account or other fund or account created by the
22 bond resolution or resolutions, and shall also certify to the commissioners the last date
23 or dates on which payments may be made.

24 **Sec. 37.15.930. Purposes and sufficiency of revenue.** The proceeds of bonds
25 may be used for the purposes described in AS 37.15.900(a), as appropriate. Bonds
26 may not be issued unless the committee first finds that the actuarially assumed rate of
27 return on the funds managed by the Alaska Retirement Management Board is
28 projected to exceed the true interest cost to be paid on the bonds by at least 1.5 percent
29 annually.

30 **Sec. 37.15.935. Refunding.** (a) The committee may refund the bonds or any
31 part of them at or before their maturities or redemption dates by the issuance of

1 refunding bonds of the state if the state bond rating is the equivalent of AA- or better
2 and if, in the opinion of the committee, refunding is advantageous to and in the best
3 interest of the state and its inhabitants.

4 (b) The issuance of refunding bonds need not be authorized by the voters of
5 the state or by an act of the legislature. The committee shall adopt the resolution or
6 resolutions and prepare all other documents and proceedings necessary for the
7 issuance, exchange or sale, and delivery of the refunding bonds. All provisions of
8 AS 37.15.900 - 37.15.955 are applicable to the refunding bonds and to the issuance,
9 sale, or exchange of them, except as otherwise provided in this section.

10 (c) Refunding bonds may be issued in a principal amount sufficient to provide
11 money for the advance or current refunding of all bonds to be refunded and interest on
12 the refunded bonds and, in addition, for the payment of all costs of issuance and
13 administration of the refunding bonds. These expenses also include the difference in
14 amount between the par value of the refunding bonds and any amount less than par for
15 which the refunding bonds are sold; the premium, if any, necessary to be paid to call
16 or retire the outstanding bonds and the interest accruing on them to the date of the call
17 or retirement; and other of these costs. The committee is authorized to incur expenses
18 to carry out this section.

19 (d) The committee may contract with a refunding trustee to hold the proceeds
20 of refunding bonds in trust until the proceeds, together with earnings on the proceeds,
21 are applied to pay the principal of, premium, if any, and interest on the bonds to be
22 refunded. Until the refunding bond proceeds are applied, the proceeds may be invested
23 in direct obligations of, or obligations guaranteed by, the United States or an agency or
24 corporation of the United States whose obligations constitute direct obligations of, or
25 obligations guaranteed by, the United States.

26 **Sec. 37.15.940. Bonds as legal investments.** The bonds are legal investments
27 for all banks, trust companies, savings banks, savings and loan associations, and other
28 persons carrying on a banking business, all insurance companies and other persons
29 carrying on an insurance business, and all executors, administrators, trustees, and other
30 fiduciaries. The bonds may be accepted as security for deposits of all money of the
31 state and its political subdivisions.

1 **Sec. 37.15.945. Statutory construction.** AS 37.15.900 - 37.15.955 shall be
2 liberally construed to carry out the purposes for which they were enacted.

3 **Sec. 37.15.950. Regulations.** The committee may adopt regulations necessary
4 to implement the provisions of AS 37.15.900 - 37.15.955.

5 **Sec. 37.15.955. Definitions.** In AS 37.15.900 - 37.15.955,

6 (1) "bond redemption fund" means the pension obligation bond
7 redemption fund established in AS 37.15.905;

8 (2) "bond resolution" means a resolution or resolutions adopted by the
9 committee under AS 37.15.915 authorizing the issuance of bonds;

10 (3) "bonds" means the pension obligation bonds authorized in
11 AS 37.15.900 - 37.15.955;

12 (4) "committee" means the state bond committee created in
13 AS 37.15.110 or any other committee, body, department, or officer of the state that
14 succeeds to the rights, powers, duties, and obligations of the state bond committee by
15 law;

16 (5) "costs of issuance and administration" means all costs associated
17 with issuance and administration of pension obligation bonds and refunding bonds,
18 including costs of bond printing, official statements, financial advisors, travel costs,
19 rating agencies, bond insurance, letters and lines of credit for credit enhancement,
20 underwriters, legal services, paying agents, bond registrars, bond and escrow trustees,
21 arbitrage rebate, and all other costs, including administrative costs, both direct and
22 indirect.

23 * **Sec. 9.** AS 37 is amended by adding a new chapter to read:

24 **Chapter 16. Alaska Pension Obligation Bond Corporation.**

25 **Sec. 37.16.010. Alaska Pension Obligation Bond Corporation.** There is
26 established the Alaska Pension Obligation Bond Corporation. The corporation is a
27 public corporation and government instrumentality in the Department of Revenue
28 managed by a board of directors. The purpose of the corporation is to finance
29 prepayment of all or a portion of a governmental employer's share of unfunded
30 accrued actuarial liability of retirement systems.

31 **Sec. 37.16.020. Board of directors.** The directors of the corporation are the

1 commissioner of commerce, community, and economic development, the
 2 commissioner of administration, and the commissioner of revenue. If a director is
 3 absent or otherwise unable to act, the director's designee in the department shall act as
 4 a director of the corporation in the director's place.

5 **Sec. 37.16.030. Bond authorization.** (a) For purposes of financing
 6 prepayment of all or a portion of a governmental employer's share of unfunded
 7 accrued actuarial liability of retirement systems, including the costs of issuance and
 8 administration, the issuance and sale of bonds by the corporation is authorized as
 9 provided in this section and AS 37.16.040 - 37.16.900, but only if the state bond rating
 10 is the equivalent of AA- or better. The net proceeds of the sale of the bonds remaining
 11 after payment of costs of issuance and administration shall be transferred to the
 12 commissioner of administration for the account of the governmental employer whose
 13 share of unfunded accrued actuarial liability is to be prepaid for application to that
 14 liability. Accrued interest paid on the bonds shall be paid into the reserve fund.

15 (b) The total unpaid principal amount of bonds, including refunding bonds,
 16 but excluding refunded bonds, is limited as provided in AS 37.15.903. The bonds do
 17 not constitute a general obligation of the state. Authorization by the votes of the state
 18 or the legislature is not required.

19 (c) The corporation may enter into agreements with other state agencies as
 20 necessary or convenient to implement this section and AS 37.16.040 - 37.16.900.

21 (d) The corporation may contract for the services of underwriters, paying
 22 agents, trustees, bond printers, rating agencies, bond insurance, credit enhancement
 23 providers, accountants, financial advisors, and bond counsel, and other services as are
 24 necessary to accomplish the bond issuance and sale.

25 **Sec. 37.16.040. Reserve fund.** (a) The corporation may establish and maintain
 26 a special fund called the Alaska Pension Obligation Bond Corporation reserve fund in
 27 which there shall be deposited or transferred

28 (1) all money appropriated by the legislature for the purpose of the
 29 fund in accordance with the provisions of (g) of this section;

30 (2) all proceeds of bonds required to be deposited in the fund by terms
 31 of a contract between the corporation and its bondholders or a resolution of the

1 corporation with respect to the proceeds of bonds;

2 (3) all other money appropriated by the legislature to the reserve fund;
3 and

4 (4) any other money or funds of the corporation that it decides to
5 deposit in the fund.

6 (b) Subject to the provisions of (h) of this section, money in the reserve fund
7 shall be held and applied solely to the payment of the interest on and principal of
8 bonds of the corporation as the interest and principal become due and payable to the
9 retirement of bonds, or to the payment or prepayment of a portion of the participating
10 governmental employer's share of the accrued actuarial liabilities of retirement
11 systems. Money may not be withdrawn if a withdrawal would reduce the amount in
12 the reserve fund to an amount less than the required debt service reserve except for
13 payment of interest then due and payable on bonds and the principal of bonds then
14 maturing and payable and for the retirement of bonds in accordance with the terms of
15 a contract between the corporation and its bondholders and for which payments of
16 other money of the corporation is not then available.

17 (c) Money in the reserve fund in excess of the required debt service reserve as
18 defined in (b) of this section, whether because of investment or otherwise, may be
19 withdrawn at any time by the corporation to pay or prepay a portion of participating
20 governmental employer's share of the accrued actuarial liabilities of retirement
21 systems or transferred to another fund or account of the corporation subject to the
22 provision of (h) of this section.

23 (d) Money in the reserve fund may be invested in the same manner and on the
24 same conditions as permitted for investment of funds belonging to the state or held in
25 the treasury under AS 37.10.070; however, the corporation may agree with the
26 bondholders to further limit these investments.

27 (e) For purposes of valuation, investments in the reserve fund shall be valued
28 at par or, if purchased at less than par, at cost unless otherwise provided by resolution
29 of the corporation. Valuation on a particular date shall include the amount of interest
30 then earned or accrued to that date on the money or investments in the reserve fund.

31 (f) Notwithstanding any other provision of this chapter, bonds may not be

1 issued by the corporation unless there is in the reserve fund the required debt service
2 reserve for all bonds then issued and outstanding and for the bonds to be issued;
3 however, the corporation may satisfy this requirement by depositing as much of the
4 proceeds of the bonds to be issued, on their issuance, as is needed to meet the required
5 debt service reserve. The corporation may at any time issue its bonds or notes for the
6 purpose of increasing the amount in the reserve fund to the required debt service
7 reserve, or to meet whatever higher or additional reserve that may be fixed by the
8 corporation with respect to the fund.

9 (g) To assure the maintenance of the required debt service reserve in the
10 reserve fund, the legislature may appropriate annually to the corporation for deposit in
11 the fund the sum, certified by the chair of the corporation to the governor and to the
12 legislature, that is necessary to restore the fund to an amount equal to the required debt
13 service reserve. The chair annually, before January 30, shall make and deliver to the
14 governor and to the legislature a certificate stating the sum required to restore the fund
15 to that amount, and the certified sum may be appropriated and paid to the corporation
16 during the then current state fiscal year. Nothing in this subsection creates a debt or
17 liability of the state.

18 (h) All amounts received because of money appropriated to the reserve fund
19 shall be held and applied in accordance with (b) of this section.

20 (i) All references to the reserve fund in this section include special accounts
21 within the reserve fund that may be created by the corporation to secure the payment
22 of particular bonds.

23 (j) The commissioner of revenue may, subject to appropriation, lend surplus
24 money in the general fund to the corporation for deposit to any account in the reserve
25 fund in an amount equal to the required debt service reserve. The loans shall be made
26 on the terms and conditions that may be agreed on by the commissioner of revenue
27 and the corporation, including, without limitation, terms and conditions providing that
28 the loans need not be repaid until the obligations of the corporation secured and to be
29 secured by the account in the reserve fund are no longer outstanding.

30 (k) In this section, "required debt service reserve" means, on the date of
31 computation, the amount required to be on deposit in the reserve fund as provided by

1 resolution of the corporation.

2 **Sec. 37.16.050. Bond terms.** (a) The bonds may be issued and sold at public
3 or negotiated sale in the manner, in the amounts or series, and at the time or times that
4 the corporation determines the bonds, or each series of them, shall be sold at the price
5 and on the terms, conditions, and covenants set by the corporation after considering
6 market conditions. Interest rates may be fixed or variable.

7 (b) The bonds mature at the time or times fixed by the corporation. The bonds
8 may be subject to redemption before their fixed maturities, as determined by the
9 corporation, with or without a premium or premiums. The bonds may be in
10 denominations determined by the corporation; may be issued in fully or partially
11 registered form; must be payable as to principal and interest at the place or places
12 determined by the corporation; must be signed in the manner provided by the
13 corporation; and must be issued under and subject to the terms, conditions, covenants,
14 and protective features safeguarding payment of the bonds as found necessary by the
15 corporation.

16 (c) If the corporation finds it reasonably necessary, the corporation may select
17 a trustee or trustees for the holders of the bonds, or any series of them, for the
18 safeguarding and disbursement of any of the money in the bond reserve fund or for
19 duties with respect to the enforcement, authentication, delivery, payment, and
20 registration of the bonds as the corporation may determine. The corporation shall fix
21 the rights, duties, powers, and obligations of the trustee or trustees.

22 (d) In its determination of all matters and questions relating to the issuance
23 and sale of the bonds and the fixing of their maturities, terms, conditions, and
24 covenants as provided in (a) of this section, the decisions of the corporation shall be
25 those that are reasonably necessary for the best interests of the state and its inhabitants
26 and that will accomplish the most advantageous sale of the bonds. Decisions of the
27 corporation, as expressed in a bond resolution, are final and are conclusively
28 considered to comply with the requirements of this chapter.

29 **Sec. 37.16.060. Bond resolution.** The corporation shall authorize the issuance
30 of bonds by adopting a resolution and shall prepare all other documents and
31 proceedings necessary for the issuance, sale, and delivery of the bonds or any part or

1 series of them. The bond resolution must fix the principal amount, denominations,
2 date, maturities, manner of sale, place or places of payment, rights of redemption, if
3 any, terms, form, conditions, and covenants of the bonds or each series of them.

4 **Sec. 37.16.070. Enforcement by bond owner.** (a) The owner or owners of not
5 less than 10 percent of the aggregate principal amount of any series or issue of bonds
6 or the trustee for the owners of the bonds or any series of them may, by appropriate
7 proceedings in state court, require and compel the transfer, setting aside, and payment
8 of money and the enforcement of all of the terms, conditions, and covenants as
9 required and provided in this chapter, as appropriate, and the bond resolution.

10 (b) A proceeding under (a) of this section may be commenced and conducted
11 only in the Superior Court for the State of Alaska, First Judicial District at Juneau.

12 **Sec. 37.16.080. Purposes and sufficiency of revenue.** The proceeds of bonds
13 may be used for the purposes described in AS 37.16.030(a), as appropriate. Bonds
14 may not be issued unless the corporation first finds that the actuarially assumed rate of
15 return on the funds managed by the Alaska Retirement Management Board is
16 projected to exceed the true interest cost to be paid on the bonds by at least 1.5 percent
17 annually.

18 **Sec. 37.16.090. Refunding.** (a) The corporation may refund the bonds or any
19 part of them at or before their maturities or redemption dates by the issuance of
20 refunding bonds of the corporation if the state bond rating is the equivalent of AA- or
21 better and if, in the opinion of the corporation, refunding is advantageous to and in the
22 best interest of the state and its inhabitants.

23 (b) The issuance of refunding bonds need not be authorized by the voters of
24 the state or by an act of the legislature. The corporation shall adopt the resolution or
25 resolutions and prepare all other documents and proceedings necessary for the
26 issuance, exchange or sale, and delivery of the refunding bonds. All provisions of this
27 chapter are applicable to the refunding bonds and to the issuance, sale, or exchange of
28 them, except as otherwise provided in this section.

29 (c) Refunding bonds may be issued in a principal amount sufficient to provide
30 money for the advance or current refunding of all bonds to be refunded and interest on
31 the refunded bonds and, in addition, for the payment of all costs of issuance and

1 administration of the refunding bonds. These expenses also include the difference in
2 amount between the par value of the refunding bonds and any amount less than par for
3 which the refunding bonds are sold; the premium, if any, necessary to be paid to call
4 or retire the outstanding bonds and the interests accruing on them to the date of the
5 call or retirement; and other of these costs. The corporation is authorized to incur
6 expenses to carry out this section.

7 (d) The corporation may contract with a refunding trustee to hold the proceeds
8 of refunding bonds in trust until the proceeds, together with earnings on the proceeds,
9 are applied to pay the principal of premium, if any, and interest on the bonds to be
10 refunded. Until the refunding bond proceeds are applied, the proceeds may be invested
11 in direct obligations of, or obligations guaranteed by, the United States of an agency or
12 corporation of the United States whose obligations constitute direct obligations of, or
13 obligations guaranteed by, the United States.

14 **Sec. 37.16.100. Bonds as legal investments.** The bonds are legal investments
15 for all banks, trust companies, savings banks, savings and loan associations, and other
16 persons carrying on a banking business, all insurance companies and other persons
17 carrying on an insurance business, and all executors, administrators, trustees, and other
18 fiduciaries. The bonds may be accepted as security for deposits of all money of the
19 state and its political subdivisions.

20 **Sec. 37.16.110. Debt service repayment contracts.** The corporation shall
21 enter into contracts with governmental employers for the purpose of recouping
22 amounts paid as debt service on bonds issued by the corporation for the benefit of
23 governmental employers. The corporation may pledge the revenue of the contracts as
24 security for the bonds issued by the corporation.

25 **Sec. 37.16.800. Statutory construction.** This chapter shall be liberally
26 construed to carry out the purposes for which it was enacted.

27 **Sec. 37.16.810. Regulations.** The corporation may adopt regulations necessary
28 to implement the provisions of this chapter.

29 **Sec. 37.16.900. Definitions.** In this chapter,

30 (1) "bond resolution" means the resolution or resolutions adopted by
31 the corporation under AS 37.16.060 authorizing the issuance of bonds;

1 (2) "bonds" means the pensions obligation bonds authorized in this
2 chapter;

3 (3) "corporation" means the Alaska Pension Obligation Bond
4 Corporation created in AS 37.16.010;

5 (4) "costs of issuance and administration" means all costs associated
6 with issuance and administration of pension obligation bonds and refunding bonds,
7 including costs of bond printing, official statements, financial advisors, travel costs,
8 rating agencies, bond insurance, letters and lines of credit for credit enhancement,
9 underwriters, legal services, paying agents, bonds registrars, bond and escrow trustees,
10 arbitrage rebate, and all other costs, including administrative costs, both direct and
11 indirect;

12 (5) "reserve fund" means the Alaska Pension Obligation Bond
13 Corporation reserve fund established in AS 37.16.040.

14 * Sec. 10. AS 39.35.100(b)(3) is amended to read:

15 (3) A separate account for each employer shall be maintained. The
16 account shall be credited with contributions made by or on behalf of the employer.
17 Except as provided in AS 39.35.270(d), this [THIS] account shall be charged with
18 the employer's actuarial charge for pension, death benefits, and other benefits paid
19 under this plan to or on behalf of the employee of the employer. Except as provided
20 in AS 39.35.270(d), after [AFTER] an allowance for interest credited to employee
21 contribution accounts and employee savings accounts, the investment income of the
22 pension fund shall be allocated to the retirement reserve account and to each employer
23 asset share account according to the ratio that the average of the assets in the account
24 as of the beginning and as of the end of the fiscal year bears to the total of the average
25 balance of the retirement reserve account and all employer accounts.

26 * Sec. 11. AS 39.35.100(b)(4) is amended to read:

27 (4) An expense account shall be maintained for the plan. Except as
28 provided in AS 39.35.270(d), this [THIS] account shall be charged with all
29 disbursements representing administrative expenses incurred by the plan. At the end of
30 the year, the expense account shall be allocated to each employer in accordance with
31 (3) of this subsection. Expenditures from this account shall be included in the

1 governor's budget for each fiscal year and are subject to approval by the legislature.

2 * Sec. 12. AS 39.35.270 is amended by adding new subsections to read:

3 (d) All or a portion of the employer's share of any accrued actuarial liability to
4 the plan may be prepaid in a lump sum. The commissioner may, by regulation,
5 establish a minimum amount for the lump sum payment of a portion. The
6 commissioner shall charge to the employer appropriate and reasonable costs to the
7 plan attributable to a lump sum payment that are not greater than administrative costs
8 applied to other employer contributions. If a lump sum payment is made, the payment
9 shall be accounted for separately in accordance with regulations adopted by the
10 commissioner. The regulations must provide for crediting to each lump sum payment
11 account all earnings and losses received from investment of that payment. The lump
12 sum payment shall be used solely to offset contributions under this section required of
13 the employer that made the payment or on whose behalf the payment was made,
14 taking into account earnings and losses from its investment. A lump sum payment
15 made by or on behalf of an employer under this subsection, together with all earnings
16 and losses from investment of that payment, may not be considered in calculating that
17 employer's share of any discretionary payment authorized by the state that benefits
18 multiple employers.

19 (e) If all or a portion of the employer's share of any accrued actuarial liability
20 to the plan is prepaid in a lump sum under (d) of this section, the administrator shall
21 calculate a revised employer contribution rate for that employer in recognition of that
22 prepayment not more than 30 days following the prepayment.

23 * Sec. 13. AS 44.85.010 is amended to read:

24 Sec. 44.85.010. Legislative policy. (a) It is the policy of the state to

25 (1) [TO] foster and promote by all reasonable means the provision of
26 adequate capital markets and facilities for borrowing money by municipalities in the
27 state to finance capital improvements or for other authorized purposes, to assist these
28 municipalities in fulfilling their capital needs and requirements by use of borrowed
29 money within statutory interest rate or cost of borrowing limitations, to the greatest
30 extent possible to reduce costs of borrowed money to taxpayers and residents of the
31 state, and equally to encourage continued investor interest in the purchase of bonds or

1 notes of municipalities as sound and preferred securities for investment;

2 (2) [TO] encourage municipalities to continue their independent
3 undertakings and financing of capital improvements and other authorized purposes
4 and to assist them by making capital funds available at reduced interest costs for
5 orderly financing of capital improvements and other purposes especially during
6 periods of restricted credit or money supply, particularly for those municipalities not
7 otherwise able to borrow for capital needs;

8 (3) [TO] assist municipalities to provide for adequate insurance
9 coverage by authorizing the Alaska Municipal Bond Bank Authority to issue
10 negotiable or nonnegotiable revenue bonds, notes, or certificates of participation either
11 directly or through an entity it may create for the purpose of providing a self-insurance
12 program for municipalities or municipal joint insurance arrangements organized under
13 AS 21.76;

14 (4) assist governmental employers to prepay all or a portion of
15 their share of unfunded accrued actuarial liabilities of retirement systems in an
16 effort to reduce their costs of satisfying their contractual obligations to provide
17 retirement and other benefits to public employees through the issuance of bonds,
18 notes, commercial paper, or other obligations by the bond bank authority or by a
19 subsidiary corporation created by the bond bank authority under AS 44.85.085,
20 but only if the state bond rating is the equivalent of AA- or better; this assistance
21 is limited as provided in AS 37.15.903.

22 (b) The legislature further declares that

23 (1) the exercise of the powers of the state in the interest of its
24 municipalities and in the interest of public employees of the state and of its
25 municipalities is required to further and implement the policies declared in (a) of this
26 section by authorizing the creation of a state bond bank authority as a body corporate
27 and politic that will have full powers to borrow money and to issue its bonds and notes
28 to make capital funds available for borrowing by municipalities and for borrowing
29 by or on behalf of governmental employers, by authorizing governmental
30 employers to contract with the bond bank authority or with a subsidiary created
31 under AS 44.85.085 for the purpose of reducing future costs of providing

1 retirement and other benefits to employees, and by granting broad powers to the
 2 bond bank authority to carry out the declared policies, which are in the public interest
 3 of the state and its taxpayers and residents;

4 (2) state funds should be applied or authorized to be paid to a state
 5 bond bank authority only to provide adequate assurance and security to the holders of
 6 the bonds or notes of the bond bank authority;

7 (3) the bond bank authority should conduct its operations to provide
 8 the lowest rates in terms of borrowing to municipalities as is consistent with a self-
 9 supporting operation with no expectation of subsidization with state funds; the
 10 legislature does not intend that the bond bank authority be utilized as a means to
 11 finance municipalities beyond their capability to meet repayment schedules and debt
 12 service requirements of bonds or notes;

13 (4) the bond bank authority or its subsidiary should conduct its
 14 operations to provide the lowest rates in terms of borrowing to governmental
 15 employers under AS 44.85.085 and 44.85.086 as is consistent with a self-
 16 supporting operation with no expectation of subsidization with state funds; the
 17 legislature does not intend that the bond bank authority or its subsidiary be
 18 utilized as a means to finance governmental employers under AS 44.85.085 and
 19 44.85.086 beyond their capability to meet repayment schedules and debt service
 20 requirements of bonds, notes, commercial paper, or other obligations to the bond
 21 bank authority or its subsidiary.

22 * Sec. 14. AS 44.85.080 is amended to read:

23 Sec. 44.85.080. Powers of bond bank authority. The bond bank authority
 24 may

- 25 (1) sue and be sued;
- 26 (2) adopt and alter an official seal;
- 27 (3) make and enforce bylaws and regulations for the conduct of its
 28 business and for the use of its services and facilities;
- 29 (4) maintain an office at any place in the state;
- 30 (5) acquire, hold, use, and dispose of its income, revenue, funds, and
 31 money;

1 (6) acquire, rent, lease, hold, use, and dispose of other personal
2 property for its purposes;

3 (7) subject to AS 44.85.100(b), borrow money and issue its negotiable
4 bonds or notes and provide for and secure their payment, provide for the rights of their
5 holders, and purchase, hold, and dispose of any of its bonds or notes;

6 (8) fix and revise from time to time and charge and collect fees and
7 charges for the use of its services or facilities;

8 (9) accept gifts or grants from the United States, or from any
9 governmental unit or person, firm, or corporation, carry out the terms or provisions or
10 make agreements with respect to the gifts or grants, and do all things necessary,
11 useful, desirable, or convenient in connection with procuring, accepting, or disposing
12 of the gifts or grants;

13 (10) do anything authorized by this chapter, through its officers,
14 agents, or employees or by contracts with a person;

15 (11) make, enter into, and enforce all contracts necessary, convenient,
16 or desirable for the purposes of the bond bank authority or pertaining to a loan to a
17 political subdivision, a purchase or sale of municipal bonds or other investments, or
18 the performance of its duties and execution of any of its powers under this chapter;

19 (12) purchase or hold municipal bonds at prices and in a manner the
20 bond bank authority considers advisable, and sell municipal bonds acquired or held by
21 it at prices without relation to cost and in a manner the bond bank authority considers
22 advisable;

23 (13) invest funds or money of the bond bank authority not required at
24 the time of investment for loan to political subdivisions for the purchase of municipal
25 bonds, in the same manner as permitted for investment of funds belonging to the state,
26 except as otherwise provided in this chapter;

27 (14) prescribe the form of application or procedure required of a
28 political subdivision for a loan or purchase of its municipal bonds, fix the terms and
29 conditions of the loan or purchase, and enter into agreements with political
30 subdivisions with respect to loans or purchases;

31 (15) render services to a political subdivision in connection with a

1 public or private sale of its municipal bonds, including advisory and other services,
2 and charge for services rendered;

3 (16) charge for its costs and services in review or consideration of a
4 proposed loan to a political subdivision or purchase by the bond bank authority of
5 municipal bonds of the political subdivision, whether or not the loan is made or the
6 municipal bonds purchased;

7 (17) fix and establish terms and provisions with respect to a purchase
8 of municipal bonds by the bond bank authority, including date and maturities of the
9 bonds, provisions as to redemption or payment before maturity, and any other matters
10 that [WHICH] in connection with the purchase are necessary, desirable, or advisable
11 in the judgment of the bond bank authority;

12 (18) procure insurance against any losses in connection with its
13 property, operations, or assets in amounts and from insurers as it considers desirable;

14 (19) to the extent permitted under its contracts with the holders of
15 bonds or notes of the bond bank authority, consent to modification of the rate of
16 interest, time and payment of installment of principal or interest, security or any other
17 term of a bond or note, contract or agreement of any kind to which the bond bank
18 authority is a party;

19 (20) by regulation, create a new entity or new entities for the purpose
20 of issuing negotiable or nonnegotiable revenue bonds, notes, or certificates of
21 participation to finance a self-insurance program for municipalities or municipal joint
22 insurance arrangements organized under AS 21.76 or to provide assistance to
23 governmental employers under AS 44.85.085(a); the powers, duties, and
24 membership of the new entity or entities shall be limited to the powers, duties, and
25 membership of the authority and stated in the regulation; the new entity or entities
26 shall each be a public corporation and an instrumentality of the state with the same
27 legal existence and continuing succession as the bond bank authority; and

28 (21) do all acts and things necessary, convenient, or desirable to carry
29 out the powers expressly granted or necessarily implied in this chapter.

30 * Sec. 15. AS 44.85 is amended by adding new sections to read:

31 Sec. 44.85.085. Creation of subsidiary corporation. (a) The bond bank

1 authority may create one or more subsidiary corporations for the following purposes:

2 (1) providing financial and other assistance to governmental employers
3 to enable the governmental employers to reduce their costs of providing retirement
4 and other benefits to their employees by prepaying all or a portion of their shares of
5 the unfunded accrued actuarial liabilities of retirement systems;

6 (2) receiving payments and providing servicing for payments to or
7 from participating governmental employers; and

8 (3) performing other duties and providing other services as the
9 subsidiary corporation considers necessary or desirable to further the purposes set out
10 in (1) and (2) of this subsection.

11 (b) The bond bank authority may incorporate under AS 10.20.146 - 10.20.166
12 a subsidiary corporation created under (a) of this section. The bond bank authority
13 may transfer assets of the bond bank authority to the subsidiary corporation and may
14 agree to secure bonds, notes, commercial paper, or other obligations of the subsidiary
15 corporation with a reserve fund established under AS 44.85.270.

16 (c) A subsidiary corporation created under (a) of this section may, if the state
17 bond rating is the equivalent of AA- or better, and subject to AS 37.15.903, borrow
18 money and issue bonds, notes, commercial paper, or other obligations as evidence of
19 that borrowing and may have all the powers of the bond bank authority that the bond
20 bank authority grants to it. The provisions of AS 44.85.130 - 44.85.170 and 44.85.270
21 - 44.85.390 apply to the subsidiary corporation and to bonds, notes, commercial paper,
22 or other obligations issued by the subsidiary corporation. Unless otherwise provided
23 by the bond bank authority, the debts, liabilities, and obligations of the subsidiary
24 corporation are not the debts, liabilities, or obligations of the bond bank authority.

25 (d) The staff of the bond bank authority serves as staff of a subsidiary
26 corporation created under (a) of this section. The bond bank authority shall determine
27 the membership or the process for selecting the membership of the board of directors
28 of the subsidiary corporation. The bond bank authority may permit some or all of its
29 directors to serve on the board of directors of the subsidiary corporation.

30 **Sec. 44.85.086. Powers of subsidiary corporation.** A subsidiary corporation
31 created under AS 44.85.085 has the following powers in addition those granted to it

1 under AS 44.85.085(c):

2 (1) to make loans to and enter into contracts with governmental
3 employers;

4 (2) to incur debt, subject to AS 37.15.903, in furtherance of its
5 purposes, in the form of bonds, notes, commercial paper, or other obligations as the
6 subsidiary corporation considers appropriate, but only if the state bond rating is the
7 equivalent of AA- or better;

8 (3) to secure its debt with a pledge of any assets that are available to
9 the subsidiary corporation for the purpose, including identified revenue and
10 contractual payments from participating governmental employers, and the general
11 assets and revenue of the subsidiary corporation; and

12 (4) to enter into contracts with underwriters, bond counsel, financial
13 advisors, accountants, actuaries, and other contractors to provide assistance as the
14 subsidiary corporation considers desirable to accomplish its purposes.

15 * Sec. 16. AS 44.85.100(b) is amended to read:

16 (b) The bond bank authority shall include in the report required by (a) of this
17 section an estimate of the amount of revenue bonds of the bond bank authority to be
18 issued during the fiscal year following the fiscal year in which the report is submitted.
19 Other than refunding bonds and other than bonds, notes, commercial paper, or
20 other obligations issued under AS 44.85.086 and 44.85.180(a)(5), the [THE] bond
21 bank authority may not issue revenue bonds [, OTHER THAN REFUNDING
22 BONDS,] in excess of \$75,000,000 during any fiscal year beginning after June 30,
23 1981, unless the legislature, by law, approves the estimate required by this subsection
24 for that fiscal year.

25 * Sec. 17. AS 44.85.180(a) is amended to read:

26 (a) Subject to AS 44.85.100(b), the bond bank authority may issue its bonds or
27 notes in principal amounts that it considers necessary to provide funds for any
28 purposes under this chapter, including

29 (1) the purchase of municipal bonds;

30 (2) the making of loans through the purchase of municipal bonds,
31 notes, or certificates of participation secured by an agreement between the bond bank

1 authority and a municipality or a municipal joint insurance arrangement organized
2 under AS 21.76;

3 (3) the payment, funding, or refunding of the principal of, or interest or
4 redemption premiums on, bonds or notes issued by it whether the bonds or notes or
5 interest to be funded or refunded have or have not become due;

6 (4) the establishment or increase of reserves to secure or to pay bonds
7 or notes or interest on bonds or notes and all other costs or expenses of the bond bank
8 authority incident to and necessary or convenient to carry out its corporate purposes
9 and powers;

10 (5) assisting governmental employers to prepay all or a portion of
11 their share of the unfunded accrued actuarial liabilities of retirement systems,
12 with security as the bond bank authority considers reasonable; however, to carry
13 out this paragraph, bonds and other obligations may only be issued if the state
14 bond rating is the equivalent of AA- or better; bonds issued under this paragraph
15 are subject to AS 37.15.903.

16 * Sec. 18. AS 44.85.180(c) is amended to read:

17 (c) Notwithstanding the provisions of (a) and (b) of this section, the total
18 amount of bond bank authority bonds and notes outstanding at any one time [,
19 EXCEPT BONDS OR NOTES ISSUED TO FUND OR REFUND BONDS OR
20 NOTES,] may not exceed \$750,000,000. This subsection does not apply to

21 (1) bonds or notes issued to fund or refund bonds or notes;

22 (2) bonds, notes, commercial paper, and other obligations issued
23 under AS 44.85.086 or 44.85.180(a)(5).

24 * Sec. 19. AS 44.85.410 is amended by adding a new paragraph to read:

25 (8) "governmental employer" means the State of Alaska or a
26 municipality or other state or municipal governmental entity within the state, including
27 an agency, instrumentality, district, school district, public corporation, department,
28 division, or other subdivision of the state or of a municipality, in its capacity as an
29 employer.

30 * Sec. 20. This Act takes effect immediately under AS 01.10.070(e).

Page 2 amended 03-LS0084NK

CS FOR HOUSE BILL NO. 13(FIN)

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FIFTH LEGISLATURE - FIRST SESSION

BY THE HOUSE FINANCE COMMITTEE

Offered: 4/23/07

Referred: Rules

Sponsor(s): REPRESENTATIVES HAWKER, Fairclough, Kelly, Roses, Dahlstrom, Johnson, Johansen, Lynn, LeDoux

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to prepayments of accrued actuarial liabilities of government
2 retirement systems; relating to the Alaska Municipal Bond Bank Authority, the Alaska
3 Housing Finance Corporation, and the state bond committee; establishing the Alaska
4 Pension Obligation Bond Corporation; permitting the Alaska Municipal Bond Bank
5 Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance
6 Corporation, the state bond committee, and the Alaska Pension Obligation Bond
7 Corporation to assist state and municipal governmental employers by issuing bonds,
8 notes, commercial paper, or other obligations to enable the governmental employers to
9 prepay all or a portion of the governmental employers' shares of the unfunded accrued
10 actuarial liabilities of retirement systems; authorizing a governmental employer to issue
11 obligations to prepay all or a portion of the governmental employer's shares of the
12 unfunded accrued actuarial liabilities of retirement systems and to enter into a lease or

1 other contractual agreement with a trustee, the Alaska Municipal Bond Bank Authority
 2 or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance
 3 Corporation, the state bond committee, or the Alaska Pension Obligation Bond
 4 Corporation in connection with the issuance of obligations for that purpose, and relating
 5 to those obligations; relating to revision of the employer contribution rate in connection
 6 with financed prepayment of unfunded accrued actuarial liabilities of government
 7 retirement systems; and providing for an effective date."

8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

9 * Section 1. AS 14.25.070 is amended by adding new subsections to read:

10 (d) All or a portion of the employer's share of any accrued actuarial liability to
 11 the plan ^{may} be prepaid in a lump sum. The commissioner of administration may, by
 12 regulation, establish a minimum amount for the lump sum payment of a portion. The
 13 administrator shall charge to the employer appropriate and reasonable administrative
 14 costs to the plan attributable to a lump sum payment that are not greater than
 15 administrative costs applied to other employer contributions. If an employer is
 16 grouped with any other employer in accounting for contributions, the lump sum
 17 payment for the employer shall be accounted for separately in accordance with
 18 regulations adopted by the commissioner. The regulations must provide for crediting
 19 to each lump sum payment account all earnings and losses received from investment
 20 of that payment. The lump sum payment shall be used solely to offset contributions
 21 under this section required of the employer for which the payment was made, taking
 22 into account earnings and losses from its investment. A lump sum payment made by or
 23 on behalf of an employer under this subsection, together with all earnings and losses
 24 from investment of that payment, may not be considered in calculating that employer's
 25 share of any discretionary payment authorized by the state that benefits multiple
 26 employers.

27 (e) If all or a portion of an employer's share of any accrued actuarial liability
 28 to the plan is prepaid in a lump sum under (d) of this section, the administrator shall

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

MEMORANDUM

March 26, 2008

SUBJECT: Pension obligation bonds (CSHB 13(FIN),
Work Order No. 25-LS0084K)

TO: Senator Bert Stedman
Co-Chair of Senate Finance Committee
Attn: Darwin Peterson

FROM: Tamara Brandt Cook *TBC*
Director

Does CSHB 13(FIN), authorizing entities of the state and municipalities to issue pension obligation bonds, pose constitutional or other legal problems?

There are provisions of the state constitution that may limit the uses of this legislation. Mechanisms that have worked in other states to fund pension liability through pension obligation bonds may be difficult to apply in Alaska because of Art. IX, sec. 7 (prohibition against dedicated funds), sec. 8 (state debt), sec. 9 (local debts), sec. 11 (exceptions to restrictions on acquisition of debt), and sec. 13 (money must be appropriated). The Alaska Supreme Court has noted, for example, that the prohibition against dedicating state funds is found only in the constitutions of Alaska and Georgia. (*Myers v. Alaska Housing Finance Corp.*, 68 P.3d 386 (Alaska 2003)). There is at least a slight chance that the prohibition against dedicated funds applies to municipalities as well as to the state. (*Fairbanks v. Convention and Visitors Bureau*, 818 P.2d 1153, 1158, footnote 7 (Alaska 1991) declining to address the question of whether the prohibition against dedicated funds applies to political subdivisions)

Under the state constitutional provisions noted, it is not clear to me how certain provisions of CSHB 13(FIN) are to be applied. Under sec. 37.15.905 the state bond committee may "obligate and bind the state to set aside and pay into the bond redemption fund. . . ." If this is subject to appropriation, in what sense is the state bond committee obligating and binding the state? Likewise, amounts required for bond payments under the terms established by the bond resolution (secs. 37.15.925 and 37.16.060) could be subject to appropriation despite the fact that the language of the bond resolution may not indicate that. Since the pension obligation bonds will not constitute debts of the state under art. IX, sec. 8, it is unlikely that the state will, as a matter of constitutional law, be liable for bond payments to bond holders (see secs. 37.15.920 and 37.16.070), although the state could find itself liable for damages to bond holders if they are misled on this point. Art. IX, sec. 11 only permits "the issuance of revenue bonds by a public enterprise

Senator Bert Stedman

March 26, 2008

Page 2

or public corporation of the State or a political subdivision, when the only security is the revenues of the enterprise or corporation."

Under sec. 37.16.110 the Alaska Pension Obligation Bond Corporation is permitted to "enter into contracts with governmental employers for the purpose of recouping amounts paid as debt service on bonds issued by the corporation for the benefit of governmental employers." The corporation is then authorized to pledge the revenue of the contracts as security for the bonds. If payments by the state on the contracts are not subject to appropriation, there will be an issue under Art. IX, sec. 7 (prohibition against dedicated funds) and sec. 13 (appropriation requirement). If payments by municipalities are not subject to local budget and appropriation processes, the contracts themselves could constitute an unconstitutional municipal debt under sec. 9. While it is clear that sec. 9 applies to municipal bonds, the court has left open the possibility that other types of debt, in addition to bonds, might be subject to that provision. (Chefornak v. Hooper Bay Construction Co., 758 P.2d 1266 (Alaska 1988)) The court stated at pages 1269 and 1270, emphasis added:

Thus, we think it clear that the framers of our constitution intended section 9 to restrict a municipality's ability to voluntarily borrow funds or issue bonds. ... We conclude that the restrictions on contracting debt contained in article IX, sec. 9 are applicable only where a political subdivision has endeavored to borrow money, via the issuance of bonds or other paper indebtedness.

Understand that I am not calling the constitutionality of sec. 37.16.110 into question, but, rather pointing out that the contracts for recouping debt service may, as a practical matter, constitute only a limited form of security for the pension obligation bonds because they may have to include a nonappropriation clause.

Indeed, I stress that the provisions of CSHB 13(FIN) can be applied in ways that do not raise constitutional issues. My conclusion is only that the constitutional limits on acquiring state and municipal debt, coupled with the prohibition against dedicating funds and the appropriation requirement, may make pension obligation bonds in this state more difficult to issue and market and, thus, less useful than those types of bonds have been in other states. Some methods of creative financing have, in fact, been upheld by the court in Alaska, although the facts involved in those instances do not appear to be directly applicable to the pension obligation bond situation under CSHB 13(FIN). (Carr-Gottstein Properties v. State, 899 P.2d 136 (Alaska 1995) involving the issuance of certificates of participation for a capital project where the state lease payment obligation was subject to appropriation; Mvers v. Alaska Housing Finance Corp., 68 P.3d 386 (Alaska 2003) involving the sale of a present interest in a tobacco litigation settlement revenue stream)

TBC:lmb

08-166.lmb

*corrected
(by legal
staff)*

*Adopted
as corrected*

AMENDMENT

7

OFFERED IN THE SENATE

BY SENATOR STEDMAN

TO: CSHB 13(FIN)

- 1 Page 1, lines 10 - 12:
- 2 Delete "to issue obligations to prepay all or a portion of the governmental
- 3 employer's shares of the unfunded accrued actuarial liabilities of retirement systems
- 4 and"
- 5
- 6 Page 2, line 4:
- 7 Delete "for that purpose"
- 8 Insert "by a state entity for the purpose of prepaying all or a portion of the
- 9 governmental employee's share of the unfunded accrued actuarial liabilities of
- 10 retirement systems"
- 11
- 12 Page 4, lines 15 - 18:
- 13 Delete "A municipality, or two or more municipalities jointly, may issue obligations to
- 14 prepay all or a portion of each participating municipality's share of the accrued actuarial
- 15 liabilities of retirement systems."
- 16
- 17 Page 4, line 22, following "obligations":
- 18 Insert "by a state entity"
- 19
- 20 Page 4, line 29, following "issued":
- 21 Insert "by a state entity"

adopted

25-LS0084\K.4
Cook
3/25/08

AMENDMENT

3

MAR 25 2008

OFFERED IN THE SENATE
TO: CSHB 13(FIN)

BY SENATOR STEDMAN

- 1 Page 6, lines 15 - 17:
- 2 Delete "The committee, on behalf of the state, may obligate and bind the state to set
- 3 aside and pay into the bond redemption fund, on a monthly or other periodic basis."

3/27/08 Andrews

State of Alaska

Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS)

Cash Contribution and Pension Obligation Bond Analysis
Version 4 - Prepared March 13, 2008

	Input
Pension Obligation Bond Interest Rate:	5.25%
Growth Rate of POB Payments:	4.00%
Present Value Interest Rate:	8.25%
Cash Contribution < \$1B (\$ in millions):	\$ 450

March 27, 2008

**Public Employees' Retirement System
Cash and Pension Obligation Bond Analysis
Actual June 30, 2006 Valuation Results**

Pension Obligation Bond Interest rate: 5.25%
 Projected FY09 Salary (in thousands): \$1,877,510
 Unfunded Liability at June 30, 2006 (in thousands): \$5,347,505

Employer Contribution Rate as a Percent of Payroll

POB Amount \$	Pension Obligation Bonds (in billions)												
	Percent of Unfunded Liability												
% of Unfunded	0%	9%	19%	28%	37%	47%	56%	65%	75%	84%	94%	103%	112%
\$ -	35.22%	34.03%	34.04%	33.45%	32.86%	32.26%	31.67%	31.08%	30.49%	29.90%	29.31%	28.72%	28.13%
\$ 0.45	33.53%	32.94%	32.34%	31.75%	31.16%	30.57%	29.98%	29.39%	28.80%	28.21%	27.62%	27.03%	
\$ 1.0	31.46%	30.87%	30.28%	29.69%	29.09%	28.50%	27.91%	27.32%	26.73%	26.14%	25.55%		
\$ 1.5	29.58%	28.99%	28.40%	27.81%	27.21%	26.62%	26.03%	25.44%	24.85%	24.26%			
\$ 2.0	27.70%	27.11%	26.52%	25.93%	25.33%	24.74%	24.15%	23.56%	22.97%				
\$ 2.5	25.82%	25.23%	24.64%	24.05%	23.45%	22.86%	22.27%	21.68%					
\$ 3.0	23.94%	23.35%	22.76%	22.16%	21.57%	20.98%	20.39%						
\$ 3.5	22.06%	21.47%	20.88%	20.28%	19.69%	19.10%							
\$ 4.0	20.18%	19.59%	19.00%	18.40%	17.81%								
\$ 4.5	18.30%	17.71%	17.12%	16.52%									
\$ 5.0	16.42%	15.83%	15.24%										
\$ 5.5	14.54%	13.95%											
\$ 6.0	12.66%												

Savings on Employer Contribution Rate

POB Amount \$	Pension Obligation Bonds (in billions)												
	Percent of Unfunded Liability												
% of Unfunded	0%	9%	19%	28%	37%	47%	56%	65%	75%	84%	94%	103%	112%
\$ -	0.00%	0.59%	1.16%	1.77%	2.36%	2.96%	3.55%	4.14%	4.73%	5.32%	5.91%	6.50%	7.09%
\$ 0.45	1.69%	2.28%	2.88%	3.47%	4.06%	4.65%	5.24%	5.83%	6.42%	7.01%	7.60%	8.19%	
\$ 1.0	3.76%	4.35%	4.94%	5.53%	6.13%	6.72%	7.31%	7.90%	8.49%	9.08%	9.67%		
\$ 1.5	5.64%	6.23%	6.82%	7.41%	8.01%	8.60%	9.19%	9.78%	10.37%	10.96%			
\$ 2.0	7.52%	8.11%	8.70%	9.29%	9.89%	10.48%	11.07%	11.66%	12.25%				
\$ 2.5	9.40%	9.99%	10.58%	11.17%	11.77%	12.36%	12.95%	13.54%					
\$ 3.0	11.28%	11.87%	12.46%	13.06%	13.65%	14.24%	14.83%						
\$ 3.5	13.16%	13.75%	14.34%	14.94%	15.53%	16.12%							
\$ 4.0	15.04%	15.63%	16.22%	16.82%	17.41%								
\$ 4.5	16.92%	17.51%	18.10%										
\$ 5.0	18.80%	19.39%	19.98%										
\$ 5.5	20.68%	21.27%											
\$ 6.0	22.56%												

Data, Assumptions, Methods and Plan Provisions

Results are based on actual 6/30/06 valuations

Percent of pay calculation based on total payroll and amounts use projected FY09 payroll

Cash contribution and pension obligation bonds are receivable as of the valuation date

Total cash and pension obligation bonds are not to exceed the total unfunded accrued liability

All other data, assumptions, methods, and plan provisions are the same as those described in the June 30, 2006 valuation report

The above contribution amounts and rates are for illustrative purposes only. The actual rates and amounts will incorporate the delay between the valuation date and the deposit of the bonds and the cash contribution.

**Public Employees' Retirement System
Cash and Pension Obligation Bond Analysis
Actual June 30, 2006 Valuation Results**

Pension Obligation Bond interest rate: 5.25%
 Projected FY09 Salary (in thousands): \$1,877,510
 Unfunded Liability at June 30, 2006 (in thousands): \$5,347,500

Annual FY09 Employer Contribution Amount (in millions)

POB Amount % of Unfunded	Pension Obligation Bonds (in billions) Percent of Unfunded Liability													
	0%	9%	19%	28%	37%	47%	56%	65%	75%	84%	94%	103%	112%	
\$ -	\$ 661.3	\$ 650.2	\$ 639.1	\$ 628.0	\$ 616.9	\$ 605.7	\$ 594.6	\$ 583.5	\$ 572.5	\$ 561.4	\$ 550.3	\$ 539.2	\$ 528.1	
\$ 0.45	\$ 629.5	\$ 618.5	\$ 607.2	\$ 596.1	\$ 585.0	\$ 574.0	\$ 562.9	\$ 551.8	\$ 540.7	\$ 529.6	\$ 518.6	\$ 507.5		
\$ 1.0	\$ 590.7	\$ 579.6	\$ 568.5	\$ 557.4	\$ 546.2	\$ 535.1	\$ 524.0	\$ 512.9	\$ 501.9	\$ 490.8	\$ 479.7			
\$ 1.5	\$ 555.4	\$ 544.3	\$ 533.2	\$ 522.1	\$ 510.9	\$ 499.8	\$ 488.7	\$ 477.6	\$ 466.6	\$ 455.5				
\$ 2.0	\$ 520.1	\$ 509.0	\$ 497.9	\$ 486.8	\$ 475.6	\$ 464.5	\$ 453.4	\$ 442.3	\$ 431.3					
\$ 2.5	\$ 484.8	\$ 473.7	\$ 462.6	\$ 451.5	\$ 440.3	\$ 429.2	\$ 418.1	\$ 407.0						
\$ 3.0	\$ 449.5	\$ 438.4	\$ 427.3	\$ 416.1	\$ 405.0	\$ 393.9	\$ 382.8							
\$ 3.5	\$ 414.2	\$ 403.1	\$ 392.0	\$ 380.8	\$ 369.7	\$ 358.6								
\$ 4.0	\$ 378.9	\$ 367.8	\$ 356.7	\$ 345.5	\$ 334.4									
\$ 4.5	\$ 343.6	\$ 332.5	\$ 321.4	\$ 310.2										
\$ 5.0	\$ 308.3	\$ 297.2	\$ 286.1											
\$ 5.5	\$ 273.0	\$ 261.9												
\$ 6.0	\$ 237.7													

Savings on Annual FY09 Employer Contribution Amount (in millions)

POB Amount % of Unfunded	Pension Obligation Bonds (in billions) Percent of Unfunded Liability													
	0%	9%	19%	28%	37%	47%	56%	65%	75%	84%	94%	103%	112%	
\$ -	\$ -	\$ 11.1	\$ 22.2	\$ 33.3	\$ 44.4	\$ 55.5	\$ 66.7	\$ 77.8	\$ 88.8	\$ 99.9	\$ 111.0	\$ 122.1	\$ 133.2	
\$ 0.45	\$ 31.8	\$ 42.8	\$ 54.1	\$ 65.2	\$ 76.3	\$ 87.3	\$ 98.4	\$ 109.5	\$ 120.6	\$ 131.7	\$ 142.7	\$ 153.8		
\$ 1.0	\$ 70.6	\$ 81.7	\$ 92.8	\$ 103.9	\$ 115.1	\$ 126.2	\$ 137.3	\$ 148.4	\$ 159.4	\$ 170.5	\$ 181.6			
\$ 1.5	\$ 105.9	\$ 117.0	\$ 128.1	\$ 139.2	\$ 150.4	\$ 161.5	\$ 172.6	\$ 183.7	\$ 194.7	\$ 205.8				
\$ 2.0	\$ 141.2	\$ 152.3	\$ 163.4	\$ 174.5	\$ 185.7	\$ 196.8	\$ 207.9	\$ 219.0	\$ 230.0					
\$ 2.5	\$ 176.5	\$ 187.6	\$ 198.7	\$ 209.8	\$ 221.0	\$ 232.1	\$ 243.2	\$ 254.3						
\$ 3.0	\$ 211.8	\$ 222.9	\$ 234.0	\$ 245.2	\$ 256.3	\$ 267.4	\$ 278.5							
\$ 3.5	\$ 247.1	\$ 258.2	\$ 269.3	\$ 280.5	\$ 291.6	\$ 302.7								
\$ 4.0	\$ 282.4	\$ 293.5	\$ 304.6	\$ 315.8	\$ 326.9									
\$ 4.5	\$ 317.7	\$ 328.8	\$ 339.9	\$ 351.1										
\$ 5.0	\$ 353.0	\$ 364.1	\$ 375.2											
\$ 5.5	\$ 388.3	\$ 399.4												
\$ 6.0	\$ 423.6													

Data, Assumptions, Methods and Plan Provisions

Results are based on actual 6/30/06 valuations

Percent of pay calculation based on total payroll and amounts use projected FY09 payroll

Cash contribution and pension obligation bonds are receivable as of the valuation date

Total cash and pension obligation bonds are not to exceed the total unfunded accrued liability

All other data, assumptions, methods, and plan provisions are the same as those described in the June 30, 2006 valuation report

The above contribution amounts and rates are for illustrative purposes only. The actual rates and amounts will incorporate

the delay between the valuation date and the deposit of the bonds and the cash contribution

**Public Employees' Retirement System
Cash and Pension Obligation Bond Analysis
Actual June 30, 2006 Valuation Results**

Pension Obligation Bond interest rate: 5.25%
 Projected FY09 Salary (in thousands): \$1,877,510
 Unfunded Liability at June 30, 2006 (in thousands): \$5,347,505
 Interest Rate for Present Value: 4.09%

Present Value of Savings on Employer Contribution Amount (In millions)

POB Amount % of Unfunded	Pension Obligation Bonds (In billions) Percent of Unfunded Liability												
	\$ - 0%	\$ 0.5 9%	\$ 1.0 19%	\$ 1.5 28%	\$ 2.0 37%	\$ 2.5 47%	\$ 3.0 56%	\$ 3.5 65%	\$ 4.0 75%	\$ 4.5 84%	\$ 5.0 94%	\$ 5.5 103%	\$ 6.0 112%
Cash (in billions)	\$ -	\$ 186.5	\$ 373.0	\$ 559.4	\$ 745.9	\$ 932.4	\$ 1,118.9	\$ 1,305.4	\$ 1,491.9	\$ 1,678.4	\$ 1,864.9	\$ 2,051.4	\$ 2,237.9
\$ 0.45	\$ 492.0	\$ 1,014.5	\$ 1,537.0	\$ 2,059.5	\$ 2,581.9	\$ 3,104.4	\$ 3,626.9	\$ 4,149.4	\$ 4,671.9	\$ 5,194.3	\$ 5,716.8	\$ 6,239.3	\$ 6,761.8
\$ 1.0	\$ 1,093.4	\$ 1,615.9	\$ 2,138.3	\$ 2,660.8	\$ 3,183.3	\$ 3,705.8	\$ 4,228.2	\$ 4,750.7	\$ 5,273.2	\$ 5,795.7	\$ 6,318.2		
\$ 1.5	\$ 1,640.1	\$ 2,162.5	\$ 2,685.0	\$ 3,207.5	\$ 3,730.0	\$ 4,252.5	\$ 4,774.9	\$ 5,297.4	\$ 5,819.9	\$ 6,342.4			
\$ 2.0	\$ 2,186.7	\$ 2,709.2	\$ 3,231.7	\$ 3,754.2	\$ 4,276.7	\$ 4,799.1	\$ 5,321.6	\$ 5,844.1	\$ 6,366.6				
\$ 2.5	\$ 2,733.4	\$ 3,255.9	\$ 3,778.4	\$ 4,300.9	\$ 4,823.3	\$ 5,345.8	\$ 5,868.3	\$ 6,390.8					
\$ 3.0	\$ 3,280.1	\$ 3,802.6	\$ 4,325.1	\$ 4,847.6	\$ 5,370.0	\$ 5,892.5	\$ 6,415.0						
\$ 3.5	\$ 3,826.8	\$ 4,349.3	\$ 4,871.8	\$ 5,394.2	\$ 5,916.7	\$ 6,439.2							
\$ 4.0	\$ 4,373.5	\$ 4,896.0	\$ 5,418.4	\$ 5,940.9	\$ 6,463.4								
\$ 4.5	\$ 4,920.2	\$ 5,442.7	\$ 5,965.1	\$ 6,487.6									
\$ 5.0	\$ 5,466.9	\$ 5,989.3	\$ 6,511.8										
\$ 5.5	\$ 6,013.5	\$ 6,536.0											
\$ 6.0	\$ 6,560.2												

Data, Assumptions, Methods and Plan Provisions

Results are based on actual 6/30/06 valuations

Percent of pay calculation based on total payroll and amounts use projected FY09 payroll

Cash contribution and pension obligation bonds are receivable as of the valuation date

Total cash and pension obligation bonds are not to exceed the total unfunded accrued liability

All other data, assumptions, methods, and plan provisions are the same as those described in the June 30, 2006 valuation report

The above contribution amounts and rates are for illustrative purposes only. The actual rates and amounts will incorporate the delay between the valuation date and the deposit of the bonds and the cash contribution.

Teachers' Retirement System
Cash and Pension Obligation Bond Analysis
Actual June 30, 2006 Valuation Results

Pension Obligation Bond Interest rate: 5.25%
Projected FY09 Salary (In thousands): \$ 637,370
Unfunded Liability at June 30, 2006 (in thousands): \$ 3,088,151

Employer Contribution Rate as a Percent of Payroll

		Pension Obligation Bonds (in billions)								
		Percent of Unfunded Liability								
POB Amount \$		\$ -	\$ 0.5	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.5	
% of Unfunded		0%	16%	32%	49%	65%	81%	97%	113%	
	\$ -	44.17%	42.80%	41.43%	40.07%	38.70%	37.33%	35.96%	34.60%	
	\$ 0.45	39.46%	38.10%	36.73%	35.36%	33.99%	32.63%	31.26%		
	\$ 1.0	33.71%	32.35%	30.98%	29.61%	28.25%	26.88%			
	\$ 1.5	28.49%	27.12%	25.75%	24.39%	23.02%				
Cash (in billions)	\$ 2.0	23.26%	21.89%	20.53%	19.16%					
	\$ 2.5	18.03%	16.67%	15.30%						
	\$ 3.0	12.81%	11.44%							
	\$ 3.5	7.58%								

Savings on Employer Contribution Rate

		Pension Obligation Bonds (in billions)								
		Percent of Unfunded Liability								
POB Amount \$		\$ -	\$ 0.5	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.5	
% of Unfunded		0%	16%	32%	49%	65%	81%	97%	113%	
	\$ -	0.00%	1.37%	2.74%	4.10%	5.47%	6.84%	8.21%	9.57%	
	\$ 0.45	4.71%	6.07%	7.44%	8.81%	10.18%	11.54%	12.91%		
	\$ 1.0	10.46%	11.82%	13.19%	14.56%	15.92%	17.29%			
	\$ 1.5	15.68%	17.05%	18.42%	19.78%	21.15%				
Cash (in billions)	\$ 2.0	20.91%	22.28%	23.64%	25.01%					
	\$ 2.5	26.14%	27.50%	28.87%						
	\$ 3.0	31.36%	32.73%							
	\$ 3.5	36.59%								

Data, Assumptions, Methods, and Plan Provisions

Results are based on actual 6/30/06 valuations

Percent of pay calculation based on total payroll and amounts use projected FY09 payroll

Cash contribution and pension obligation bonds are receivable as of the valuation date

Total cash and pension obligation bonds are not to exceed the total unfunded accrued liability

All other data, assumptions, methods, and plan provisions are the same as those described in the June 30, 2006 valuation report

The above contribution amounts and rates are for illustrative purposes only. The actual rates and amounts will incorporate

the delay between the valuation date and the deposit of the bonds and the cash contribution.

Teachers' Retirement System
Cash and Pension Obligation Bond Analysis
Actual June 30, 2006 Valuation Results

Pension Obligation Bond interest rate: 5.25%
Projected FY09 Salary (In thousands): \$ 637,370
Unfunded Liability at June 30, 2006 (In thousands): \$ 3,088,151

Annual FY09 Employer Contribution Amount (In millions)

		Pension Obligation Bonds (In billions) Percent of Unfunded Liability								
POB Amount \$		\$ -	\$ 0.5	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.5	
% of Unfunded		0%	16%	32%	49%	65%	81%	97%	113%	
	\$ -	\$ 281.5	\$ 272.8	\$ 264.1	\$ 255.4	\$ 246.7	\$ 237.9	\$ 229.2	\$ 220.5	
	\$ 0.45	\$ 251.5	\$ 242.8	\$ 234.1	\$ 225.4	\$ 216.6	\$ 208.0	\$ 199.2		
	\$ 1.0	\$ 214.9	\$ 206.2	\$ 197.5	\$ 188.7	\$ 180.1	\$ 171.3			
	\$ 1.5	\$ 181.6	\$ 172.9	\$ 164.1	\$ 155.5	\$ 146.7				
Cash (In billions)	\$ 2.0	\$ 148.3	\$ 139.5	\$ 130.9	\$ 122.1					
	\$ 2.5	\$ 114.9	\$ 106.2	\$ 97.5						
	\$ 3.0	\$ 81.6	\$ 72.9							
	\$ 3.5	\$ 48.3								

Savings on Annual FY09 Employer Contribution Amount (in millions)

		Pension Obligation Bonds (In billions) Percent of Estimated Unfunded Liability								
POB Amount \$		\$ -	\$ 0.5	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.5	
% of Unfunded		0%	16%	32%	49%	65%	81%	97%	113%	
	\$ -	\$ -	\$ 8.7	\$ 17.4	\$ 26.1	\$ 34.8	\$ 43.6	\$ 52.3	\$ 61.0	
	\$ 0.45	\$ 30.0	\$ 38.7	\$ 47.4	\$ 56.1	\$ 64.9	\$ 73.5	\$ 82.3		
	\$ 1.0	\$ 68.6	\$ 75.3	\$ 84.0	\$ 92.8	\$ 101.4	\$ 110.2			
	\$ 1.5	\$ 99.9	\$ 108.6	\$ 117.4	\$ 126.0	\$ 134.8				
Cash (In billions)	\$ 2.0	\$ 133.2	\$ 142.0	\$ 150.6	\$ 159.4					
	\$ 2.5	\$ 166.6	\$ 175.3	\$ 184.0						
	\$ 3.0	\$ 199.9	\$ 208.6							
	\$ 3.5	\$ 233.2								

Data, Assumptions, Methods and Plan Provisions

Results are based on actual 6/30/06 valuations

Percent of pay calculation based on total payroll and amounts use projected FY09 payroll

Cash contribution and pension obligation bonds are receivable as of the valuation date

Total cash and pension obligation bonds are not to exceed the total unfunded accrued liability

All other data, assumptions, methods, and plan provisions are the same as those described in the June 30, 2006 valuation report

The above contribution amounts and rates are for illustrative purposes only. The actual rates and amounts will incorporate

the delay between the valuation date and the deposit of the bonds and the cash contribution

Teachers' Retirement System
Cash and Pension Obligation Bond Analysis
Actual June 30, 2006 Valuation Results

Pension Obligation Bond Interest rate: 5.25%
 Projected FY09 Salary (in thousands): \$ 837,370
 Unfunded Liability at June 30, 2006 (in thousands): \$ 3,088,151
 Interest Rate for Present Value: 4.09%

Present Value of Savings on Employer Contribution Amount (in millions)

POB Amount \$	Pension Obligation Bonds (in billions)								
	Percent of Unfunded Liability								
% of Unfunded	0%	16%	32%	49%	65%	81%	97%	113%	
\$ -	\$ -	\$ 125.9	\$ 251.8	\$ 377.7	\$ 503.5	\$ 629.4	\$ 755.3	\$ 881.2	
\$ 0.45	\$ 464.3	\$ 590.2	\$ 716.1	\$ 842.0	\$ 967.8	\$ 1,093.7	\$ 1,219.6		
\$ 1.0	\$ 1,031.8	\$ 1,157.7	\$ 1,283.6	\$ 1,409.4	\$ 1,535.3	\$ 1,661.2			
\$ 1.5	\$ 1,547.7	\$ 1,673.6	\$ 1,799.5	\$ 1,925.3	\$ 2,051.2				
\$ 2.0	\$ 2,063.6	\$ 2,189.5	\$ 2,315.4	\$ 2,441.2					
\$ 2.5	\$ 2,579.5	\$ 2,705.4	\$ 2,831.3						
\$ 3.0	\$ 3,095.4	\$ 3,221.3							
\$ 3.5	\$ 3,611.3								

Cash (in billions)

Data, Assumptions, Methods and Plan Provisions

Results are based on actual 6/30/06 valuations

Percent of pay calculation based on total payroll and amounts use projected FY09 payroll

Cash contribution and pension obligation bonds are receivable as of the valuation date

Total cash and pension obligation bonds are not to exceed the total unfunded accrued liability

All other data, assumptions, methods, and plan provisions are the same as those described in the June 30, 2006 valuation report

The above contribution amounts and rates are for illustrative purposes only. The actual rates and amounts will incorporate the delay between the valuation date and the deposit of the bonds and the cash contribution.

2/27
adopted, as amended

AMENDMENT

OFFERED IN THE SENATE
TO: CSHB 13(FIN)

BY SENATOR STEDMAN

1 Page 3, line 20, following ".":

2 Insert "However, a subsidiary created for the purpose of financing or facilitating
3 the financing of prepayment of a governmental employer's share of unfunded accrued
4 actuarial liability of retirement systems may only borrow money and issue bonds if the
5 state bond rating is AA- or better."

(the equivalent of AA-)

6
7 Page 5, line 26, following "37.15.555":

8 Insert ", but only if the state bond rating is AA- or better"

9
10 Page 8, line 26, following "if":

11 Insert "the state bond rating is AA- or better and if"

12
13 Page 11, line 2, following "37.16.900":

14 Insert ", but only if the state bond rating is AA- or better"

15
16 Page 15, line 14, following "if":

17 Insert "the state bond rating is AA- or better and if"

18
19 Page 19, line 12, following "AS 44 85.085":

20 Insert ", but only if the state bond rating is AA- or better"

21
22 Page 23, line 7, following "may":

23 Insert ", if the state bond rating is AA- or better."

1

2 Page 23, line 27, following "appropriate":

3 Insert ", but only if the state bond rating is AA- or better"

4

5 Page 25, line 1, following "reasonable":

6 Insert "however, to carry out this paragraph, bonds and other obligations may

7 only be issued if the state bond rating is AA- or better"

adopted

3/27

SENATE

MAR 24 2008

25-LS0084\K.2
Cook
3/25/08

AMENDMENT 2

OFFERED IN THE SENATE
TO: CSHB 13(FIN)

BY SENATOR STEDMAN

1 Page 3, line 19, following "may":

2 Insert "subject to AS 37.15.903,"

3

4 Page 6, line 2:

5 Delete "may not exceed \$5,000,000,000"

6 Insert "is limited as provided in AS 37.15.903"

7

8 Page 6, following line 10:

9 Insert a new section to read:

10 "Sec. 37.15.903. Pension obligation bond limit. The total unpaid principal
11 amount of bonds, including refunding bonds, but excluding refunded bonds, issued by
12 all state entities added together, for the purposes of financing prepayment of all or a
13 portion of a governmental employer's share of unfunded accrued liability of retirement
14 systems, may not exceed \$5,000,000,000."

15

16 Page 11, line 9:

17 Delete "may not exceed \$5,000,000,000"

18 Insert "is limited as provided in AS 37.15.903"

19

20 Page 19, line 12, following "AS 44.85.085":

21 Insert "this assistance is limited as provided in AS 37.15.903"

22

23 Page 23, line 7, following "may":

1 Insert ", subject to AS 37.15.903,"

2

3 Page 27, line 25, following "debt":

4 Insert ", subject to AS 37.15.903,"

5

6 Page 25, line 1, following "reasonable"

7 Insert "; bonds issued under this paragraph are subject to AS 37.15.903"

STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

SARAH PALIN, GOVERNOR

333 WILLOUGHBY, 11TH FLOOR
PO BOX 110400
JUNEAU, ALASKA 99811-0400
TELEPHONE: (907) 465-2301
FACSIMILE: (907) 465-2389

The Honorable Senator Bert Stedman, Co-Chair
The Honorable Senator Lyman Hoffman, Co-Chair
Senate Finance Committee
Juneau, AK 99801

cc Miles
Darwin

RECEIVED

MAR 11 2008

Dear Senator Stedman and Senator Hoffman,

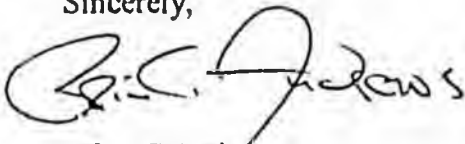
COPY

I appreciated you allocating time on February 29th for concluding my presentation on Pension Obligation Bonds (POBs). During the hearing, your committee requested information regarding the costs the State would incur as a result of POBs carrying a lower credit rating than the State's General Obligation credit rate.

Rating agencies consider debt obligations, such as POBs to be inherently riskier than general obligation bonds. The spread between these two types of bonds is about .15% or 15 basis points (bps). On a 2 billion dollar issuance the 15 bps would account for a difference of \$3 million. If we were able to do a \$2 billion POB transaction at a refinancing cost of 5.25%, versus our current cost of 8.25%, there would be a potential savings of 3% or \$60 million in the first year. Add to this the 15 bps we could gain if we are able to do the transaction at the State's general obligation credit rating, and the savings would potentially be 3.15% or \$63 million.

I have enclosed three recent communiqués for the investment banking community on this subject. If you have any questions please give me a call. I appreciate the attention you and the committee are giving to the matter of POBs and the retirement system's unfunded liabilities.

Sincerely,



Brian C. Andrews
Deputy Commissioner
Department of Revenue

CC: The Honorable Senator Charlie Huggins
The Honorable Senator Kim Elton
The Honorable Senator Donny Olson
The Honorable Senator Joe Thomas
The Honorable Senator Fred Dyson
The Honorable Representative Mike Hawker

2008-03-11-16-57-34



Memorandum

Date: March 4, 2008

To: Brian Andrews
Deven Mitchell

From: Goldman, Sachs & Co.

Subject: Indicative Pricing for Potential State of Alaska Pension Bonds

Thank you for the opportunity to speak with you last week and to offer comments at the Senate Finance Committee about the potential for Pension Obligation Bonds (POBs) to have a positive economic impact on the State's pension system. We look forward to continuing to assist the State in evaluating Pension Bonds and developing an approach to executing a transaction that can best take advantage of the opportunity while at the same time managing the costs and risks associated with the transaction.

The purpose of this memo is to provide current market pricing indications to help you and other State decision makers continue to evaluate the potential transaction. As you know, taxable municipal bonds are priced based on a spread to an underlying reference rate, typically either a U.S. Treasury Bond or the 20-year LIBOR (London Interbank Offered Rate) swap rate, depending on investor. The spread itself is based on the credit quality of the borrower and the terms of the security structure. In the municipal finance world, the highest quality credits with the lowest associated cost are typically general obligation bonds. Other credit structures such as 'subject to appropriation bonds' or state credits backed by specific revenue sources will generally carry a cost that is somewhat higher than a general obligation bond.

We are well aware that the State's Pension Bonds will not be issued as General Obligation debt and that the intent is to use a subject to appropriation structure. This is quite similar to the approach that has been used by a number of other issuers of POBs and will result in strong pricing based on the State's well regarded credit and the fact that investors view the risk of non-appropriation as modest, especially in the context of a pension financing. In the case of Alaska, this general comfort level with appropriation risk exists because Alaska has a history of issuing (and making good on) appropriation debt and due to the constitutional underpinnings of the State's obligations to provide for its contractual pension benefits. As we have discussed, we believe the rating agencies should rate State of Alaska Pension Bonds (subject to appropriation) one notch below the State's General Obligation credit. As of yesterday's market close, this would translate into the following indicative interest rates.

Indicative State of Alaska Taxable Pension Bond Interest Rates: as of Market Close 3/3/2008¹

Structure	Ratings	Underlying 20-year LIBOR Rate	Spread (bp)	Total Rate
Hypothetical General Obligation Bonds	AA/AA2/AA	4.80%	+ 60 - 70	5.40 - 5.50%
Proposed Subject to Appropriation Bonds	AA-/Aa3/AA- (expected)	4.80%	+ 75 - 85	5.55 - 5.65%

Two important caveats to these rates. First, as we discussed last week, when introducing the credit, it will be important that major buyers of taxable debt treat these bonds as they have other major state pension issues (i.e. Illinois, Wisconsin, Oregon) in terms of their risk assessment or risk weighting. We have no reason to believe that they won't and have assumed in our indicative spreads risk weighting that is similar to these precedent transactions. Second, the current capital markets environment is quite volatile. As such, we encourage you to continue to closely monitor market conditions as HB13 moves forward. In that spirit, we will update this information for you regularly throughout the balance of the legislative session.

We hope this information is useful. We will call to follow up and meanwhile, feel free to contact any of us.

¹ Exclusive of issuance costs, which would be roughly 5-7 bp for both structures.

Memorandum

To: Brian Andrews
Deven Mitchell
State of Alaska

From: Eric Whaley, Vice President
Greg Sundberg, Managing Director
Jeff Brown, Managing Director
Isaac Sine, Vice President
Merrill Lynch Public Finance

Date: March 3, 2008



Subject: Pension Obligation Bond Rating Considerations – Appropriation Bonds

The language in House Bill 13 provides for the issuance of pension obligation bonds (POBs) to pre-fund the State's accrued liabilities of government retirement systems. As currently drafted, the bill structures the POBs to be secured by annual appropriations of the State. This memo highlights: 1) how bonds that are secured by State appropriations compare in ratings and credit to State general obligation bonds and 2) the limited pricing differences between appropriation and general obligation bonds.

Appropriation Bonds Versus General Obligation Bonds

Appropriation bonds are very common in the municipal bond market and are usually rated just below an issuer's general obligation rating. Standard and Poor's clearly states in its latest *Public Finance Criteria: Appropriation-Backed Obligations* write-up that appropriation-backed obligations "are rated typically one notch off the GO ratings, as a reflection that appropriation-backed obligations are not legally debt and do not bear the same legal protections as GO bonds." This general "one-notch" differential between appropriation and general obligation credits holds true in Alaska, where the State's appropriation/lease credits for the Virology Lab and Seafood & Food Safety Lab are rated AA-, one notch below the State's AA general obligation credit.

Limited Impact on Bond Yields

Even with one-notch lower ratings, it is our opinion that the State's appropriation bonds represent a high investment grade credit and would price very similarly to the State's general obligation bonds; particularly since both fall within the double-A category (i.e. AA- to AA+). In addition, because pension obligation bonds must be sold as taxable obligations and will likely be met with global investor demand, there is a high likelihood that any State pension obligation debt will qualify for a "corporate-equivalent" bond rating. Since the rating agencies apply two different standards to municipal and corporate debt, it is quite probable that the State's likely AA-pension obligation bond rating would translate to a AAA corporate rating. Taxable municipal bonds can get bumped up to AAA when rated on a "corporate equivalent" basis because A-rated municipal bonds default far less frequently than corporate bonds with top triple-A ratings; further, even when municipal bonds default investors generally receive most if not all of their principal back. In recent work for other issuers of pension obligation bonds, we have successfully pursued the strategy of obtaining corporate-equivalent ratings, making these bonds extremely attractive to taxable investors in the global market. It is worth noting that both the State's appropriation and general obligation credit would likely carry the same AAA corporate equivalent bond rating, narrowing even further any possible pricing differential. In summary, the probable half-notch differential in credit ratings between the State's general obligation and appropriation debt will not likely result in any measurable difference in interest cost between the two forms of security.

We hope this helps answer any remaining questions related to the likely credit rating and pricing of any future State of Alaska pension obligation bonds. Please contact Greg Sundberg (206-830-6026), Eric Whaley (206-830-6027), Jeff Brown (206-830-6025), or Isaac Sine (206-830-6028) if you have any questions or would like additional information. We look forward to seeing you again next time we are up in Juneau.



Alaska Pension Obligation Bond Discussion

Alaska's legislation for pension funding bonds contemplates using a security that will be subject to annual appropriation.

What is the difference between general obligation bonds and "appropriation" bonds?

Where general obligation ("G.O.") bonds pledge the full faith and credit of the State, including its taxing power, to repayment of the bonds, appropriation bonds pledge only the amounts included for debt service in the annual budget and must be appropriated annually by the legislature.

Bond Ratings

Appropriation bonds receive a one notch lower rating by the rating agencies.

Agency	Alaska G.O. Rating	Est. Appropriation Rating
Moody's	Aa2	Aa3
S&P	AA	AA-
Fitch	AA	AA-

Appropriation Pledge and Pension Bonds

The appropriation pledge has been by many other issuers of pension bonds and has received excellent acceptance in the taxable markets where pension bonds are sold. States that have issued appropriation pension bonds:

- New Jersey \$2.8 billion 1997 Bonds
- Wisconsin \$1.8 billion 2003 Bonds
- Kansas \$500 million 2004 Bonds
- Wisconsin \$960 million 2008 Bonds (pending)

Investor Acceptance of Appropriation Pension Bonds

State pension bonds are sold in the global market for taxable securities and investors evaluate these bonds in accordance with the securities and banking regulations promulgated in each country. To facilitate common treatment across borders, banking firms follow international rules known as Basel I, and beginning in 2008 for many non-US banks, Basel II. Under Basel I, appropriation bonds are recognized by some investors as similar to G.O. bonds and accorded the same regulatory capital charges for owning the bonds (a key determinant in investor appetite for bonds). Under Basel II, it is likely that such securities will require less capital, making them more attractive. This is because Basel II rules will allow the relatively low default history of municipal bonds generally and appropriation bonds in particular to be accounted for.

Although appropriation bonds will never be viewed as strict equivalents to G.O. bonds, issuance by other states and the historical stability of the practice in domestic tax-exempt markets makes appropriation bonds a strong alternative for states such as Alaska.

Appropriation bonds do require slightly higher interest rates in the global markets, ranging from 10 basis points to 40 basis points. Turbulent markets tend to widen this difference as many investors limit their purchases to treasuries, sovereigns and G.O. bonds. As markets stabilize later this year, we expect these spreads to narrow.

Bolstering the Appropriation Pledge

Careful drafting of authorizing legislation can help investor acceptance of Alaska's appropriation pledge. Language should be included that:

- Expresses the intent of the legislature to continue appropriations (Moral Obligation)
- Accords debt service High Priority Status in the annual budget
- Sets forth the appropriation mechanism – allowing the Governor and the Budget Director to covenant that an appropriation request will be included in each annual budget request
- Allows for the establishment of adequate reserves
- Allows for a Stabilization Fund
- Permits Debt/Hedging Management Techniques so that the bond structure can be best structured to market demand

Alaska's Current Rating Profile and Pension Bonds

Alaska's current credit profile, particularly relative to other comparably rated credits, will help in mitigating any appropriation credit "premium." Key among the State's credit strengths that should be emphasized in the marketing of any pension obligation bonds are:

- Conservative budgeting and expenditure practices
- Unprecedented levels of reserves
 - \$5.60 billion in General Fund and other non-segregated investments (1/31/08)
 - \$3.15 billion in Constitutional Budget Reserve Fund (1/31/08)
 - \$39.9 billion in Permanent Fund (12/31/07)
- Oil provides a tremendously valuable primary revenue source



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- We will not require you to provide property or services to Citibank or any affiliate of Citibank as a condition to the extension of a commercial loan to you by Citibank or any of its subsidiaries, unless such a requirement is reasonably required to protect the safety and soundness of the loan.
- We will not require you to refrain from doing business with a competitor of Citi or any of its affiliates as a condition to receiving a commercial loan from Citibank or any of its subsidiaries, unless the requirement is reasonably designed to ensure the soundness of the loan.

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Presentation to the State of Alaska
Regarding Pension Obligation Bonds (POBs)

February 29, 2008

Pension Obligation Bonds are a common tool used by governments.

Since 2001, over \$30 billion of POBs have been issued nationwide

- \$10 billion State of Illinois
- \$2.1 billion State of Oregon
- \$927 million Oregon School Boards Association
- \$800 million Detroit Retirement System Fund

- As a result of the growth in unfunded pension liabilities and ideal market conditions, POB issuances have become increasingly prevalent over the past 5 years.
 - The relatively low interest rate environment, which widens the spreads between the POB interest costs paid by the issuer/employer and the assumed investment return rate of the pension systems makes the economics of the transaction more attractive.
 - The potential cost savings from a POB, as many state and local employers struggle with budgetary imbalances and other savings alternatives become scarce, may prove extremely valuable.



■ States With POB Issuances From 2001-Present

State of Alaska

Note: Includes state, county, city and local POB issuances.

POB Issues by Year

Year	Amount (\$Mn)	Number of Issues
2007	\$726.20	4
2006	1,408.34	10
2005	3,971.32	37
2004	3,676.42	32
2003	17,685.31	71
2002	2,599.31	25
2001	536.64	9
	\$30,603.54	188

POB Issues by Size

Issue Size (\$Mn)	Amount (\$Mn)	Number of Issues
\$100 and under	\$3,450.17	137
\$100-250	4,401.23	29
\$250-500	4,928.48	13
Over \$500	17,380.82	9
	\$30,160.72	188



POBs issued with a low interest cost have proven successful.

	State of Oregon	State of Illinois	State of New Jersey
Issue Size:	\$2,083,960,000	10,000,000,000	2,803,042,499
Delivery Date:	10/31/2003	6/12/2003	6/30/1997
Security Type:	General Obligation	General Obligation	Appropriation
Insurer:	None	None	FSA/MBIA/Ambac
Initial Underlying Ratings	Aa3/AA- Moody's Corporate Aaa	Aa3/AA/AA Moody's Corporate Aaa	A1/A+
Interest Cost:	5.79%	5.05%	7.64%
Assumed Actuarial Rate of Return:	8.00%	8.50%	8.75%
Actual Rate of Return in 3-years Following POB:	9.89%	12.86%	(3.0)% ^(a)

POB transactions in process for 2008.



State of Illinois

- Expected size: \$16 billion
 - Follows \$10 billion transaction in June 2003
- Timing: Pending legislative approval



Commonwealth of Puerto Rico

- Expected size: \$6.5 to \$9.0 billion
 - Bonds backed by future employer contributions
- Timing: Postponed due to market volatility



State of Connecticut

- Expected size: up to \$2.0 billion
- Timing: Approved, governor signed



Chicago Transit Authority

- Expected size: \$1.9 billion
- Timing: Approved, underwriting team selected

Recognizing and managing risks are key to POB success.

Benefits

- Arbitrage
 - The broad range of investments utilized by pension funds generally result in an investment return that is substantially higher than today's rates.
 - Returns above assumed actuarial investment return will produce greater than expected savings from POBs.
 - Returns below assumed actuarial investment return but above POB yield will produce savings, but less than projected.
- Defined Benefits
 - Pledge to make lump sum UAAL payment creates the opportunity to negotiate change in plan benefits.
- Budget Relief
 - POBs may lower annual pension past service payments
- Labor Relations Benefit
 - POBs can be used to improve relations with unions by reducing unfunded pension liability.

Risks

- Arbitrage Risk
 - Reinvestment returns below the bond interest rate will result in negative earnings.
- Conversion of flexible obligation to immutable obligation
 - POB converts a "soft" liability into a "hard" liability
- Market risk
 - POBs result in a lump-sum payment into a pension fund, concentrating rather than spreading market timing risk.
- Refunding cost
 - POBs are generally issued as fixed rate taxable noncallable bonds because a redemption feature will further push up the interest rate costs. This structure makes POBs expensive to refund or defease.

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2/29/08

Pension Obligation Bonds

The Oregon Story

February 8, 2008




 CITY HALL


Oregon vs: Alaska Pension System *

	Oregon	Alaska	
		PERS	TRS
Asset base	\$ 56.66 ⁽¹⁾ billion	\$9.4 billion	\$4.3 billion
Covered Employees	314,301	55,972	19,096
Average employer rate	14.40% ⁽²⁾	35.22% ⁽³⁾	44.17% ⁽³⁾
Funded ratio	110.50%	65.20%	59.50%
UAAL as of 2006 valuation	\$ 1.9 billion ⁽⁴⁾	\$5.5 billion	\$3.1 billion

* As of December 31, 2006 for Oregon and June 30, 2006 for Alaska.

(1) Includes \$7.2 billion in bond funded "side accounts."

(2) Tier 1 and Tier 2 only.


(3) Projected for Fiscal Year 2009 by Buck Consultants. Does not take SB125 into account.

(4) Not counting bond proceeds in side accounts valued at \$7.2 billion.



Oregon PERS

- Retirement benefits for most public employees in Oregon are administered through the "Oregon Public Employees' Retirement System," or "PERS."
- PERS maintains three separate retirement programs: Tier 1, Tier 2 (post 1996) and OPSRP (post 2003).
- In 1999, UAL of Oregon system was calculated at \$900 million. By 2002, UAL was projected to exceed \$17 billion.
- Main drivers of UAAL were poor investment performance, inadequate reserves, outdated mortality tables, and "money match" provisions that required employer match of individual account balances.
- Major legislative reforms in 2003 reduced estimated UAAL by approximately 50%. Among other modifications, a hybrid defined benefit/defined contribution pension program for new employees was created (OPSRP).



Y HALL



Bonding a Popular Tool

Over 100 Oregon jurisdictions have chosen to finance PERS' liabilities with bonds.

- Original statutory authority provided to local governments and school districts in 2001, along with authority to enter into intercept agreements with the State to provide credit enhancement.
- State Constitutional amendment was approved by voters in 2003 which authored the State to issue GO bonds for its share of the liability. Voter approval margin was 55.25%.
- Interest rates for most borrowings were well under 6%.



Oregon Bonding Examples

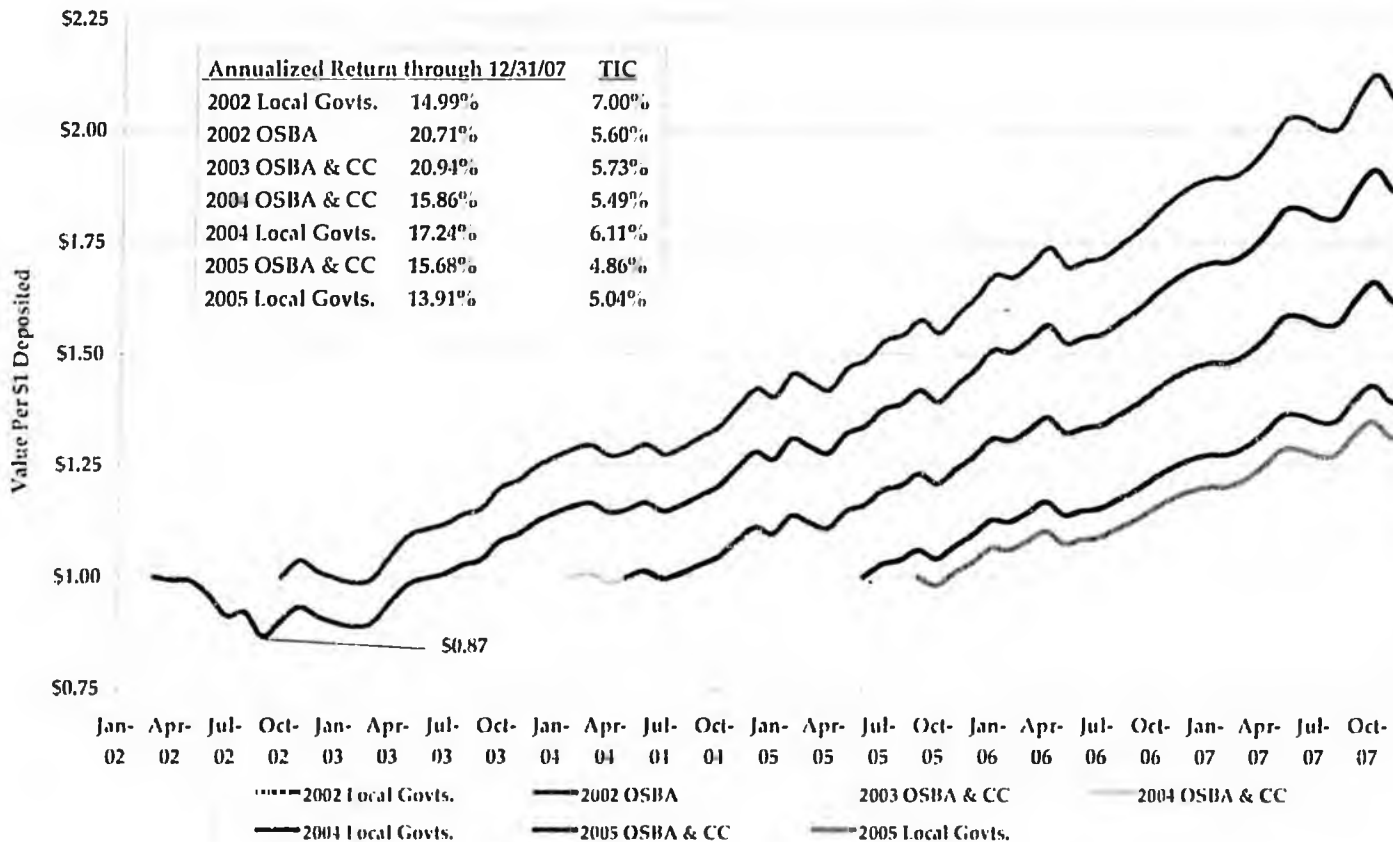
Date	Issuer	Par Amount	TIC	PV Savings
September 2005	Local Governments- 12 jurisdictions	\$ 186 m	5.04%	\$ 57 m
June 2005	OSBA - 16 school districts	\$ 492 m	4.77	\$ 171 m
June 2005	OCCA - 6 community colleges	\$ 57 m	4.86	\$ 19 m
May 2004	Local Government Pool – 10 cities, counties, special districts	\$ 126 m	6.11	\$ 23 m
February 2004	OSBA – 23 school districts	\$ 400 m	5.49	\$ 120 m
	OCCA – 6 community colleges	\$ 100 m	5.49	\$ 25 m
October 2003	State of Oregon	\$ 2,000 m	5.78	\$ 481 m
April 2003	OSBA – 44 school districts	\$ 927 m	5.73	\$ 230 m
	OCCA – 6 community colleges	\$ 153 m	5.72	\$ 37 m
October 2002	OSBA – 41 school districts	\$ 775 m	5.60	\$ 207 m
March 2002	Local Government Pool – 10 cities, counties, special districts	\$ 238 m	7.00	\$ 21 m
	Total	\$ 5,564 m		\$ 1,391 m ⁽¹⁾

(1) Assumes 8% return.



Oregon Pension Bonds Have Had Solid Investment Performance Records

Oregon Pension Bonds Earnings History
*Current Value of \$1 Deposited in Lump Sum Side Account**



Lessons Learned

1. Payment to PERS does NOT guarantee UAAL will be paid off in full.

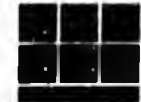
- Judicial, legislative, regulatory or investment activities can cause future changes to UAAL. Further increases would continue to be responsibility of jurisdiction.
- Important to continue consistent funding of pension program.

2. Structure of the financing matters

- Inappropriate to use unrealistic assumptions about rates of return.
- Amortization structure of bonds should match amortization of UAAL that PERS system uses.
- Not prudent to have back weighted structured where all savings are produced in early years.
- Not prudent to use savings for other budgeting needs.




HALL



SNW

Lessons Learned

3. The "housekeeping issues" are often critical
 - Adequate protection and proper accounting of lump sum deposits are critical.
 - Statutes and regulations needed to ensure that the employers making the deposit are the ones getting the credit, and that credit is for appropriate amount. This would be particularly true in the absence of SB 125.
 - Investment of funds need to be carefully considered given magnitude of deposits.
4. Variations in payroll growth not immediately reflected in debt payments
 - Under current structure, if payroll declines, payments to PERS decline.
 - Using bonds, if payroll declines, payments on the bonds do not change.



CITY HALL



SNW

Conclusions

- Pension Obligation Bonds have been used effectively by Oregon jurisdictions to defray pension costs.
- It is important to carefully structure the bond issue, prudently manage investment strategies and think ahead about administrative issues
- HB 13 has been drafted with these protections in mind.



SNW

Questions?

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 - rschober@snwsc.com

2/29

Good morning Mr. Chairman, honorable members. For the record my name is Brian Andrews. I'm a deputy commissioner in Revenue.

Last time I gave a description of Pension Obligation Bonds or POBs. I offered some reason as to why we should consider issuing them. What the risks are associated with a POB transaction. What the potential savings that may be achieved from a POB issuance. Why POBs are issued as taxable debt as opposed to tax-exempt debt.

I'll be brief this morning but I would like to highlight certain points on each one of these topics.

The actual mechanics of a POB transaction is relatively simple. What a POB transaction tries to accomplish is the replacement of an existing debt obligation with another for a debt which has a lower cost. The concept is the same as refinancing your home mortgage at a lower interest rate.

In my last testimony, I noted that the 2006 actuarial report points out that the State has an 8.6 billion dollar unfunded liability i.e. debt that it owes to the State pension plan participants. This debt carries a cost of 8.25%.

Two weeks ago we obtained pricing from three major investment banking institutions for a POB transaction. It was determined that a deal could be done for 5.25%. The difference between an 8.25% cost and 5.25% is 3%. That 3% savings over 25 years on a billion dollars represents 23 million a year or 323 million dollars over 25 years discounted at 5%.

Let me say that the debt markets currently are exhibiting a lot of instability. Whether a deal could be done today at 5.25% is questionable, but I'm confident that a transaction could be accomplished between 5.25% and 5.75%. We are in the lowest interest rate environment that we have seen in the past forty years. In fact the ten year treasury at 3.7ish area has only been lower 3.9% of the time in the past twenty years. The secret, if there is one, to a POB transaction is to do it at the lowest cost possible.

If we take the proceeds of a POB transaction and invest them with an earnings rate greater than our cost we are better off for doing the transaction. If we earn something less than our cost we made a bad deal. Over the past 16 years only 2 years, 2000 and 2001 in which we experienced the worst equity market correction since the depression, the issuance of a POB transaction would have proved to be a poor decision with the pension plans actual earnings results. Remember this is a 25 year transaction so you really don't know whether you made a good deal or a bad deal until the POBs are paid off.

Two other risks we talked about was political risk and market risk. Political risk is the risk of over funding the pension plans and then increasing the benefits of the plan that may be difficult to fund in the future. Remember that future pension liabilities as well as past unfunded liabilities that aren't at the lower cost of a POB transaction still carry the

3.25% cost. Market risk is the risk that deals with the timing of proceeds into the market and how they should be invested.

POBs are not General Obligation of the State, but rather are what is known as annual appropriation bonds meaning that each year the Legislature have to budget for their debt service. Although the issuance of a POB transaction is considered a neutral event for the State's AA credit rating, the rating of the POB bonds, because they are appropriation bonds, would carry a rating a AA- or one notch below the State's credit rating.

Go to Savings Matrixes

Page 27, Explain

Continue with Tax issues section and conclusion.



Pension Obligation Bonds

February 8, 2008

Alaska Department of Revenue



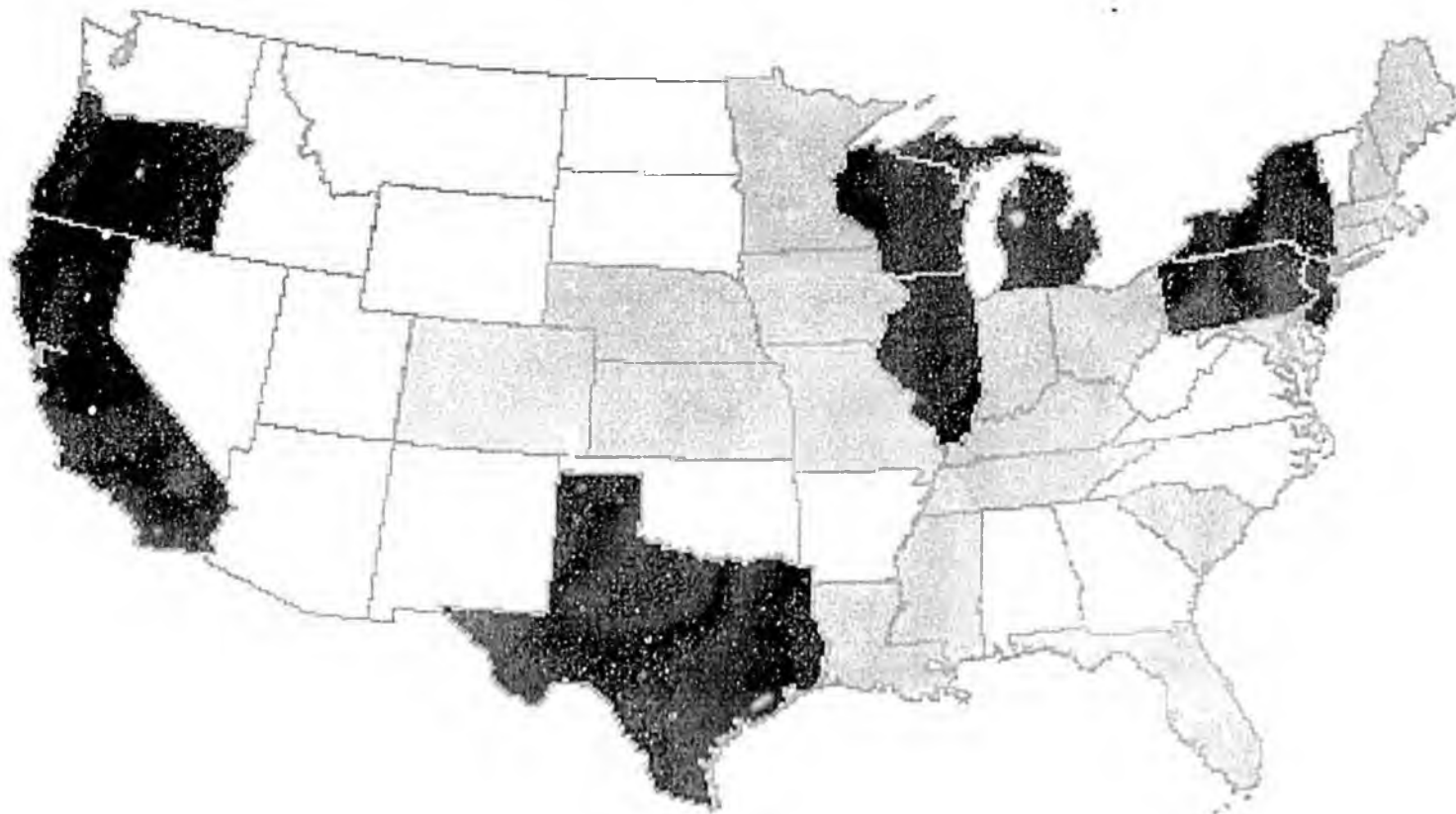
Overview of Pension Obligation Bonds (POBs)

Pension Obligation Bonds (POBs)

- Pension Obligation Bonds are bonds issued by a state or local government to pay its obligation to the pension system in which its employees are members.
- POBs have been an increasingly popular and successful way for state and local governments to accomplish financial objectives.
- Since 1995, six states and over 234 local governments have issued POBs totaling in excess of \$40 billion.

POBs Have Been Issued Throughout the US

- Over \$5 billion
- Between \$1 and \$5 billion total issued
- Less than \$1 billion issued



Why Should We Consider Issuing POBs?

- Interest rate savings – the interest rate of POBs issued in the near future will be lower than 8.25% charged by the pension system.
- Arbitrage – the actual investment return of pension asset exceeds the POB cost.
- POBs are not generally viewed as adding to the debt burden of the state or local government issuer because they replace existing pension obligations.
- POBs can improve funding ratios at a relatively low cost of funds and with a repayment schedule that fits the state's or local governments' goals and constraints.

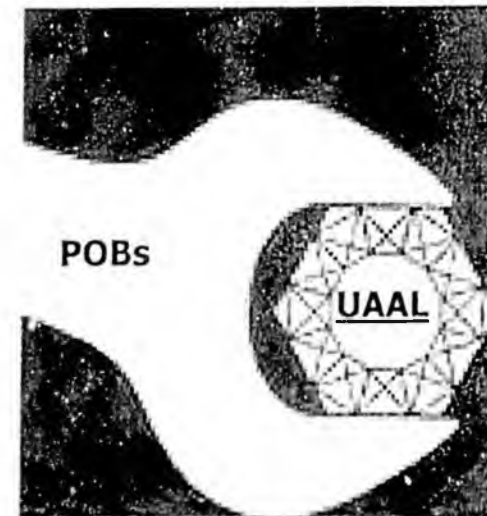
POBs Are:

Not ...



Golden Bullet

But ...



Financial Tool

Alaska Pension Bill/Unfunded Actuarial Accrued Liability (UAAL) in 2006

Total \$8.6 Billion:

\$5.5 Billion PERS

\$3.1 Billion TRS



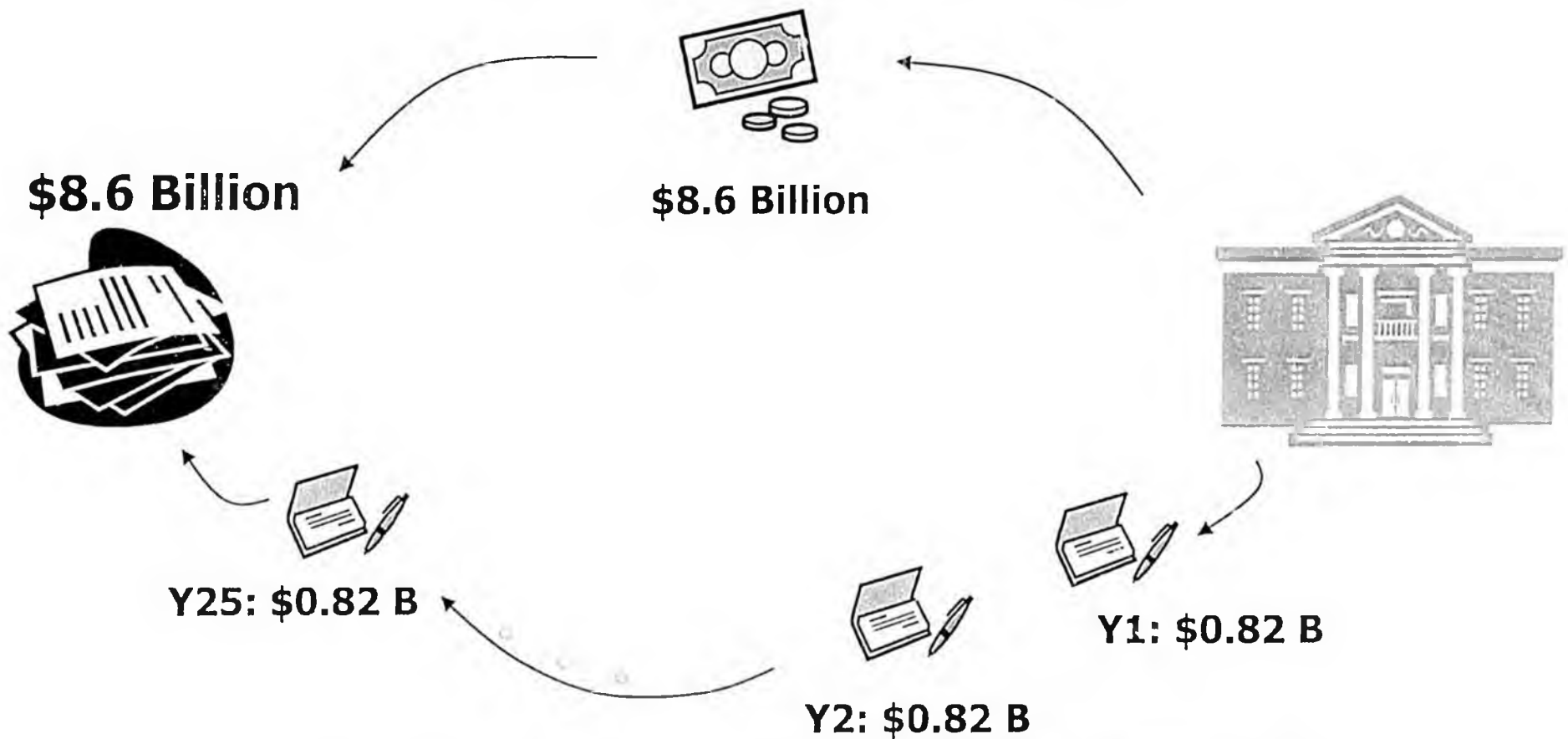
AK Pension System



**State & Local
Governments**

Paying the Bill/UAAL

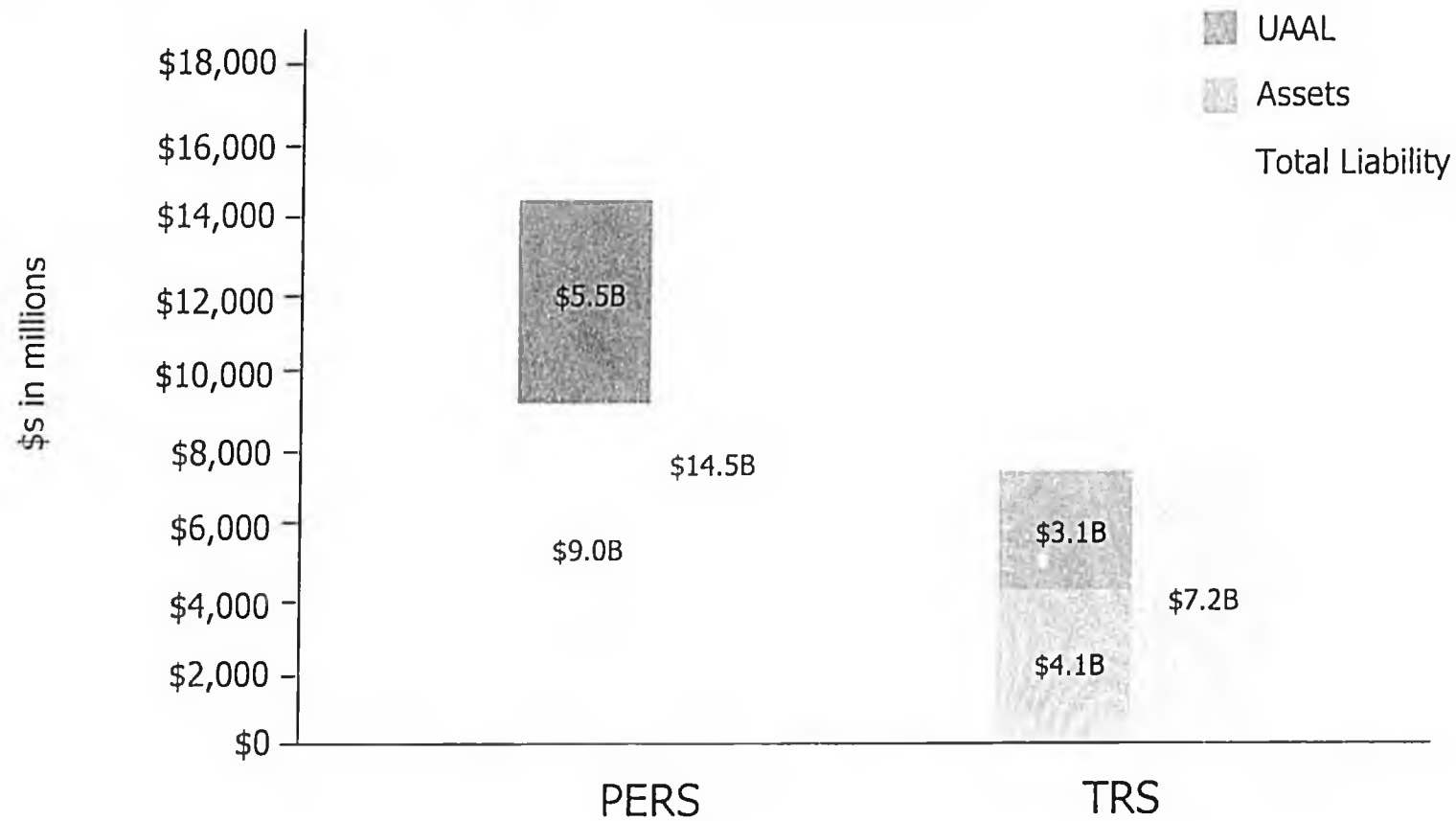
Option A: Pay the total with Cash



Option B: A "loan" of 25 years at 8.25% cost

Funding Status Overview

Summary of Funding Status for PERS and TRS as of June 30, 2006





Interest Rate Savings

Interest Rate Savings

Comparing the amortization of \$1 billion debt at 8.25% cost to \$1 billion debt at 5.25% over 25 years:

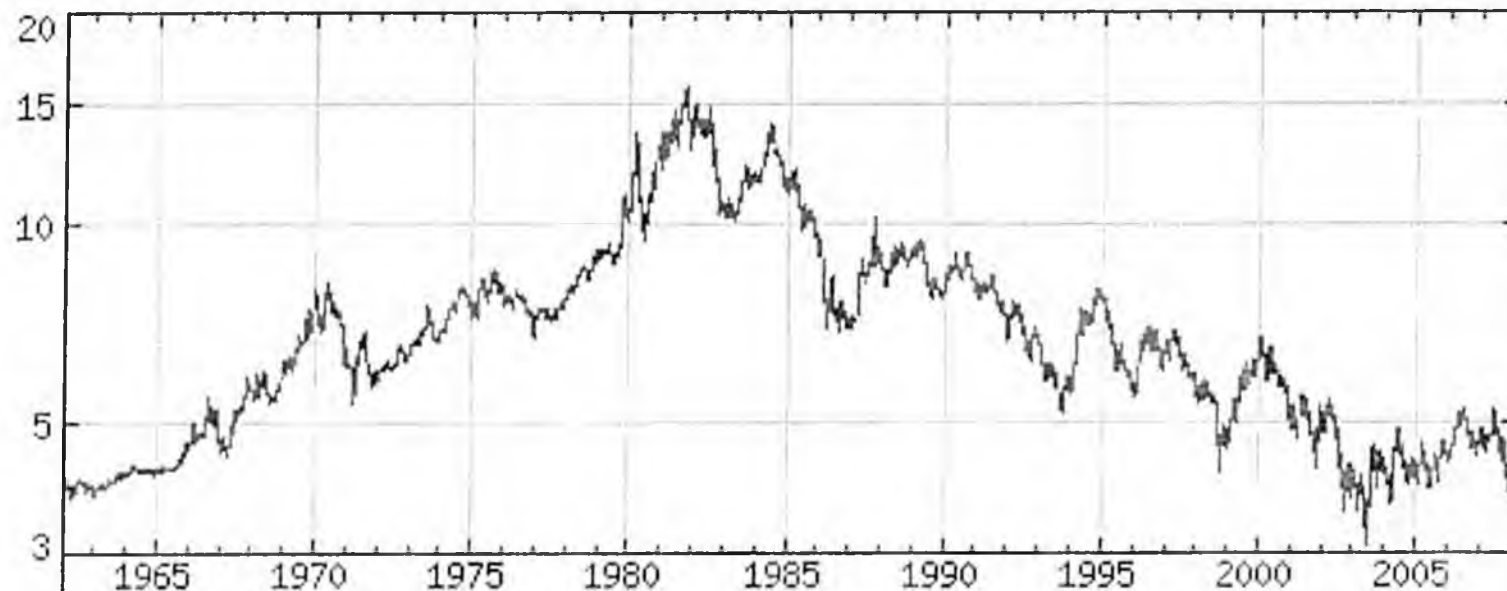
- Saving on interest cost is 3.0%;
- Saving on annual debt payment is \$23 million;
- NPV of savings on annual debt payment over 25 years is \$323 million discounted at 5%.

	Amount (\$Billion)	Interest Cost	Annual P&I Payment (\$Million)
\$	1	8.25%	\$ 96
\$	1	5.25%	\$ 73
Savings		3.00%	\$ 23
NPV of Cumulative Savings @ 5%			\$ 323

Interest Rate History

- 10-Year Treasury yield is 3.65% as of February 1, 2008. This rate is extraordinarily attractive when viewed in a historical context.

10-Year Treasury Yields

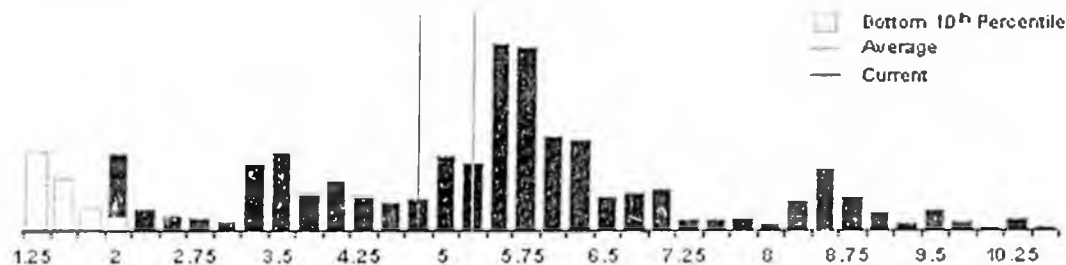


Treasury Rates Still Historically Attractive

3-month LIBOR Rate

Min:	1.00%
Average:	5.05%
Max:	10.63%
Current:	4.62%

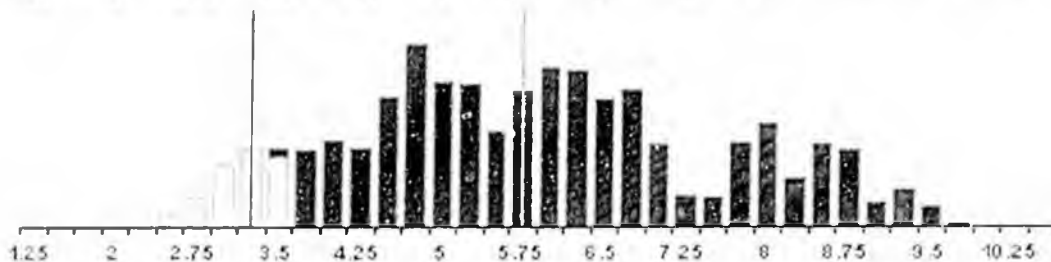
Lower than current level
36% of the time



5 Year Treasury Rate

Min:	2.03%
Average:	5.69%
Max:	9.73%
Current:	3.27%

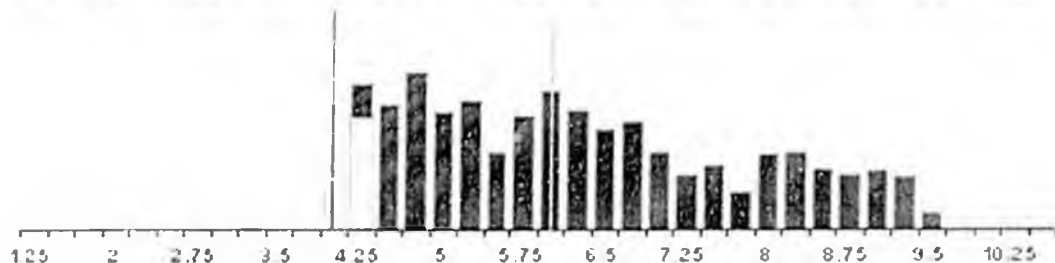
Lower than current level
8% of the time



10 Year Treasury Rate

Min:	3.11%
Average:	6.06%
Max:	9.54%
Current:	3.91%

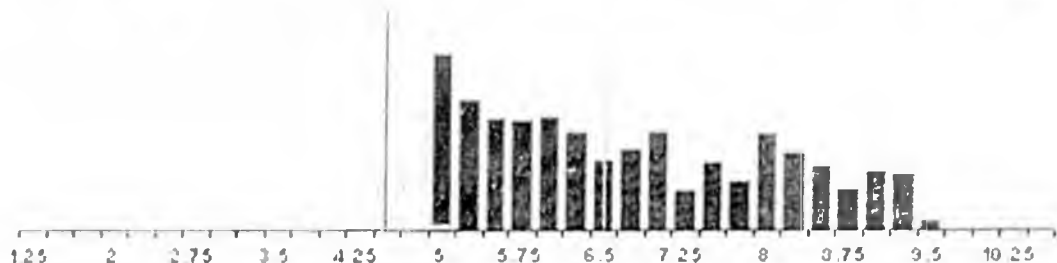
Lower than current level
3% of the time



30 Year Treasury Rate

Min:	4.17%
Average:	6.40%
Max:	9.45%
Current:	4.39%

Lower than current level
1% of the time

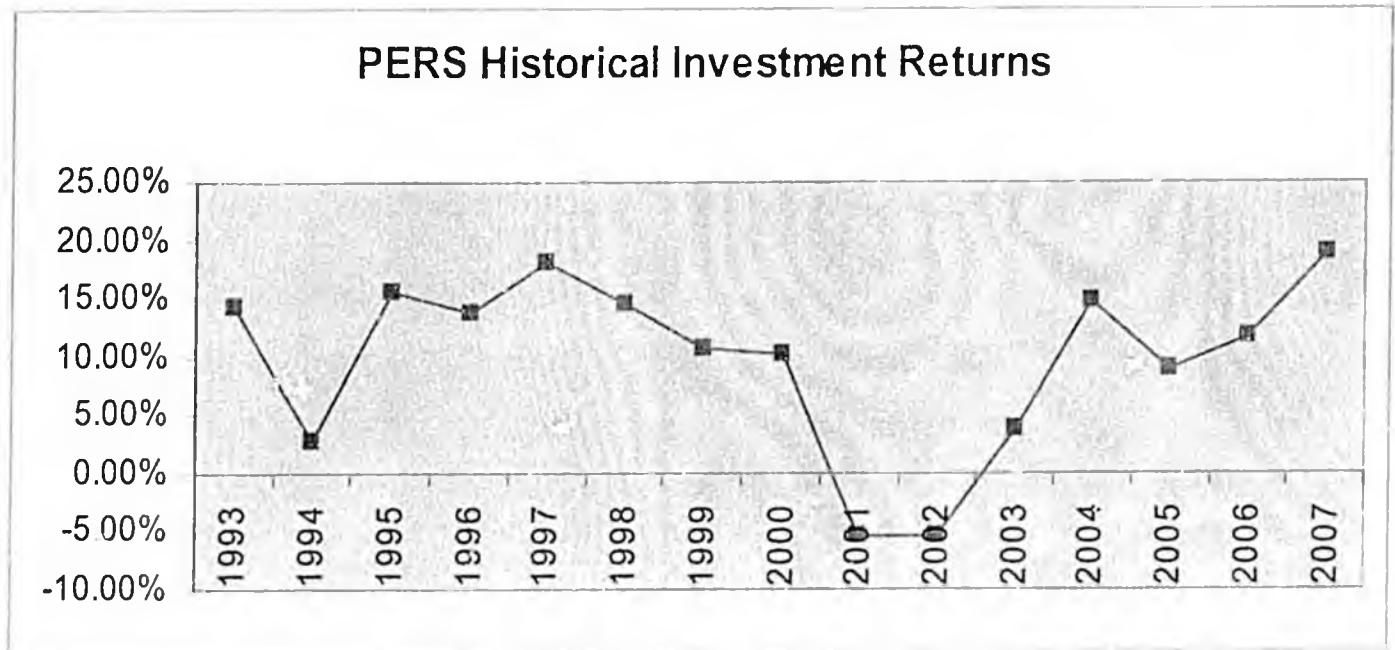




Arbitrage

Historical Investment Returns of State Pension Plans (PERS)

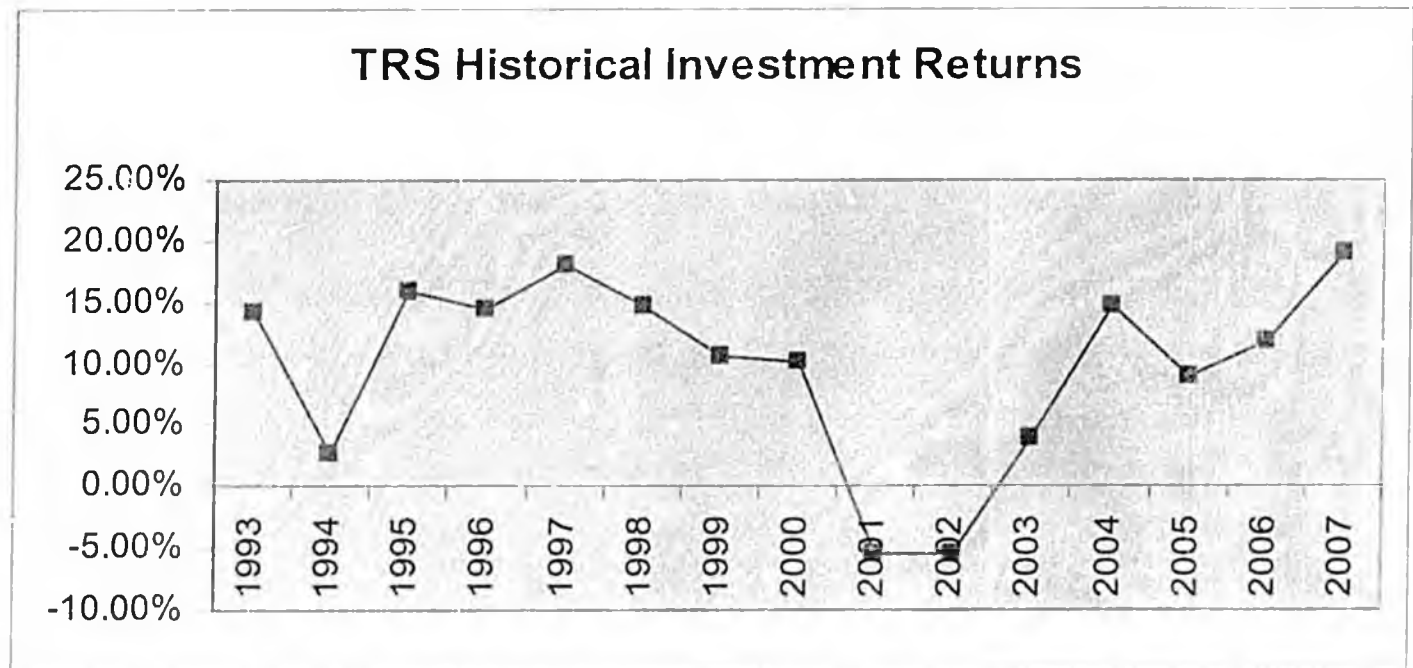
FY	PERS ROR
2007	18.88%
2006	11.69%
2005	8.86%
2004	14.73%
2003	3.82%
2002	-5.40%
2001	-5.30%
2000	10.12%
1999	10.65%
1998	14.62%
1997	18.07%
1996	13.70%
1995	15.56%
1994	2.66%
1993	14.25%
1992	11.80%



- The average return from 1992 to 2007 is 9.67%.
- Standard Deviation is 7.40%.

Historical Investment Returns of State Pension Plans (TRS)

FY	TRS ROR
2007	13.89%
2006	11.72%
2005	8.90%
2004	14.75%
2003	3.81%
2002	-5.41%
2001	-5.36%
2000	10.19%
1999	10.73%
1998	14.73%
1997	18.00%
1996	14.35%
1995	15.89%
1994	2.61%
1993	14.16%
1992	11.58%



- The average return from 1992 to 2007 is 9.72%.
- Standard Deviation is 7.45%.

Long Term Target Asset Allocation

Asset Class	Allocation	Range
Domestic Large Capitalization	30%	± 3%
Domestic Small Capitalization	6%	± 3%
International Equity	14%	± 3%
Emerging Markets Equity	2%	± 2%
Private Equity	7%	± 5%
Domestic Fixed-Income	20%	± 3%
High Yield	2%	± 2%
International Fixed-Income	2%	± 2%
Real Estate	10%	± 4%
Absolute Return	4%	± 4%
Other	3%	± 3%
Cash	0%	± 3%

Median Return **8.05%**
Standard Deviation **12.27%**



Credit Neutrality

Credit Rating Consideration

- Credit Neutral – debt obligation is already recognized and POBs are not considered new debt.
- “Moody’s believes the issuance of POBs is one effective way of addressing an unfunded liability.”
- “Standard & Poor’s has viewed POBs as a strategy for savings on carrying charges as long as the transaction are structured conservatively and the assumptions were reasonable and attainable.”

Prudently Structured, POBs are Ratings Neutral

Failure to fully fund the actuarially required contribution signals fiscal stress to the market ("willingness to pay").

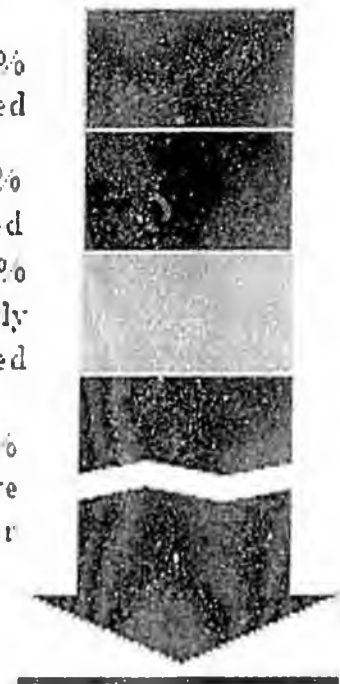
- Consistent underfunding is considered a credit negative.
- Funding ratios below 80% are a potential negative
 - Actuarially Required Contribution needed to "catch up" may "crowd out" other priorities, reducing the state's financial flexibility.
- Rating agencies generally view POBs as an acceptable tool for reducing the cost of an already existing liability.
- Significant term extensions and/or payment holidays are *not* viewed positively.

Above 90%
Well Funded

80% - 90%
Under-Funded

70%-50%
Significantly
Under-funded

Under 70%
Negative
Credit Factor



Risks

Risks Overview

- Investment Risk – POB financing is successful as long as the return of investment of proceeds exceed POB cost.
- Political Risk – Overfunded pension system can lead to political pressure to increase pension benefits, which can cause further increased pension liability in the future.
- Market Risk – Prudent investment of POB proceeds in early years is important.

Investment Risk Analysis

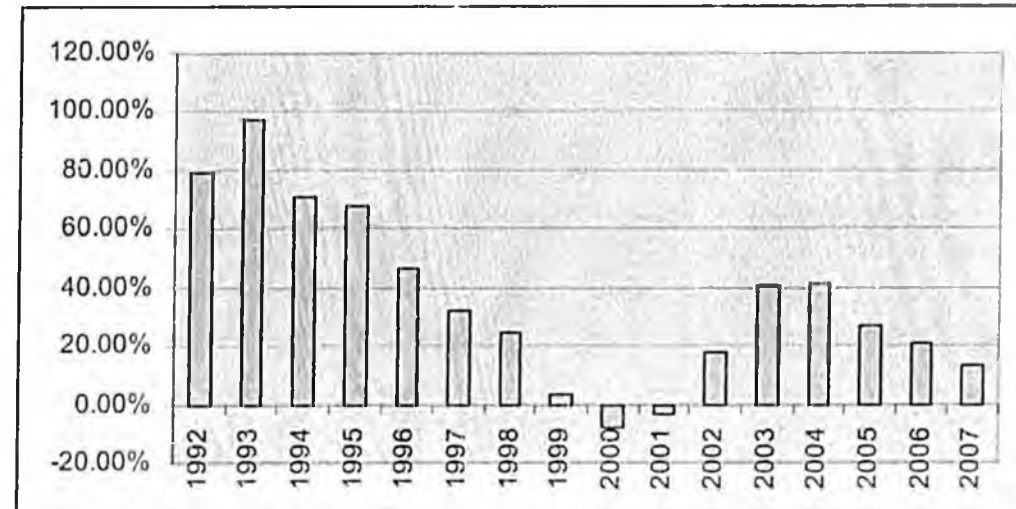
As long as those bond-funded assets earn more than 5.25%, we are better off for having borrowed.

- With the current low interest rate environment, POB issuance with cost around 5.25% is achievable.
- Historical investment returns of PERS and TRS indicate that we can outperform 5.25% most of the time.
- Simulations of future investment returns show that there are high possibility that we are going to outperform 5.25%.

Investment Risk (PERS)

FY	PERS ROR	Estimated Cost of Borrowing	Accm. Returns as of EOY FY07	Annualized Returns as of EOY FY07
2007	18.88%	5.75%	13.13%	13.13%
2006	11.69%	5.55%	20.63%	9.83%
2005	8.86%	5.04%	26.82%	8.24%
2004	14.73%	5.02%	40.92%	8.95%
2003	3.82%	4.76%	40.65%	7.06%
2002	-5.40%	5.36%	18.16%	2.82%
2001	-5.30%	5.77%	-3.29%	-0.48%
2000	10.12%	6.78%	-8.21%	-1.07%
1999	10.65%	6.40%	3.38%	0.37%
1998	14.62%	6.01%	24.72%	2.23%
1997	18.07%	7.10%	31.90%	2.55%
1996	13.70%	7.19%	46.90%	3.26%
1995	15.56%	7.32%	68.16%	4.08%
1994	2.66%	7.84%	70.80%	3.90%
1993	14.25%	6.62%	96.98%	4.62%
1992	11.80%	7.76%	79.24%	3.71%

Estimated Cumulative Net Return to 2007 (PERS)

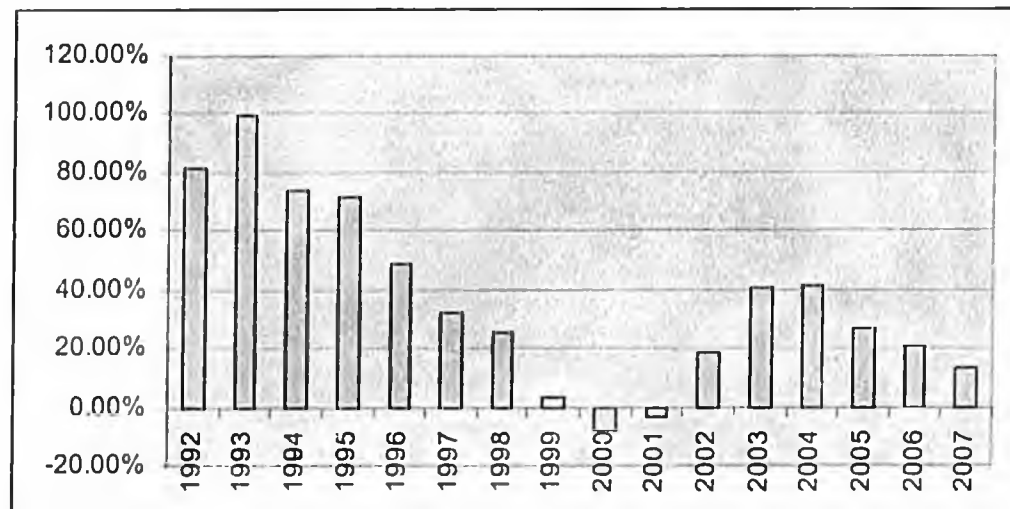


- Based on PERS actual investment history, we can see what the cumulative net return to 2007 might have been if POBs had been issued in any given year.
- For 14 out of 16 years the issuance of POBs would have resulted in a gain to the pension system.

Investment Risk (TRS)

FY	TRS ROR	Estimated Cost of Borrowing	Accm. Returns as of EOY FY07	Annualized Returns as of EOY FY07
2007	18.89%	5.75%	13.14%	13.14%
2006	11.72%	5.55%	20.68%	9.85%
2005	8.90%	5.04%	26.92%	8.27%
2004	14.75%	5.02%	41.06%	8.98%
2003	3.81%	4.76%	40.78%	7.08%
2002	-5.41%	5.36%	18.25%	2.83%
2001	-5.36%	5.77%	-3.32%	-0.48%
2000	10.19%	6.78%	-8.13%	-1.05%
1999	10.73%	6.40%	3.60%	0.39%
1998	14.73%	6.01%	25.17%	2.27%
1997	18.00%	7.10%	32.25%	2.57%
1996	14.35%	7.19%	48.94%	3.38%
1995	15.89%	7.32%	71.33%	4.23%
1994	2.61%	7.84%	73.70%	4.02%
1993	14.16%	6.62%	99.82%	4.72%
1992	11.58%	7.76%	81.23%	3.79%

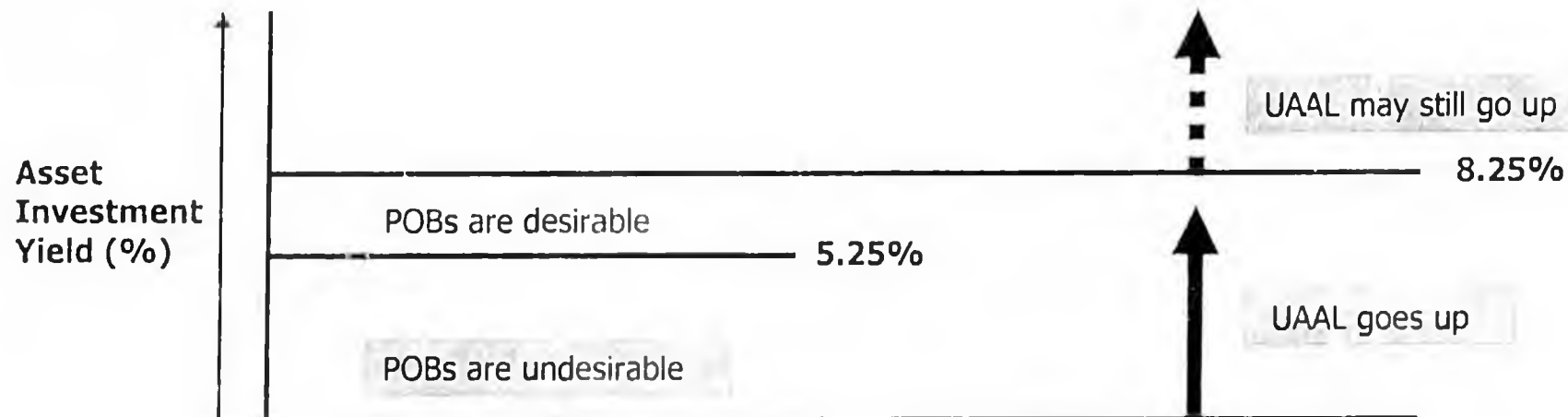
Estimated Cumulative Net Return to 2007 (TRS)



- Based on TRS actual investment history, we can see what the cumulative net return to 2007 might have been if POBs had been issued in any given year.
- For 14 out of 16 years the issuance of POBs would have resulted in a gain to the pension system.

UAAL vs. POB Financial Success

- POB financing:
 - As long as those bond-funded assets earn $> 5.25\%$, we are better off for having borrowed.
 - POB financing is undesirable if assets earn $< 5.25\%$.
- All other things equal, when PERS and TRS assets earn $< 8.25\%$, the UAAL goes up.
- Further, even if those assets earn $> 8.25\%$, the UAAL can increase due to actuarial and / or accounting changes.



Investment Return Forecast

Monte Carlo simulation with 10,000 iterations for each scenario; Assuming a 25-year investment period.

Conservative – 70/30

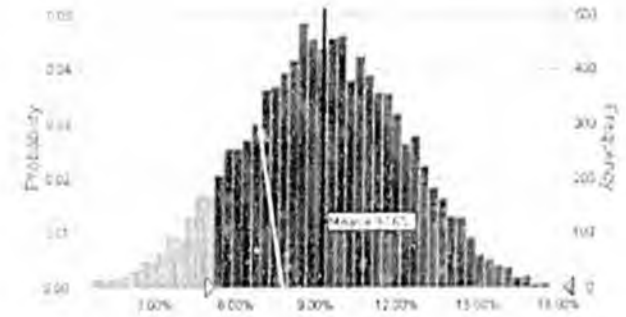
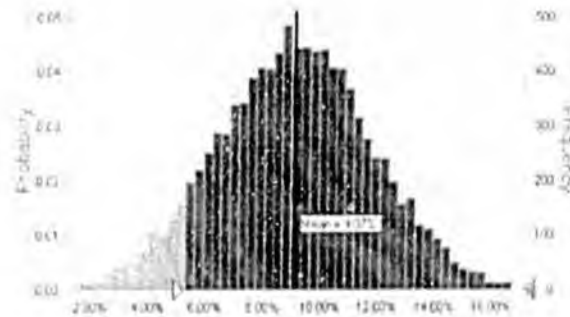
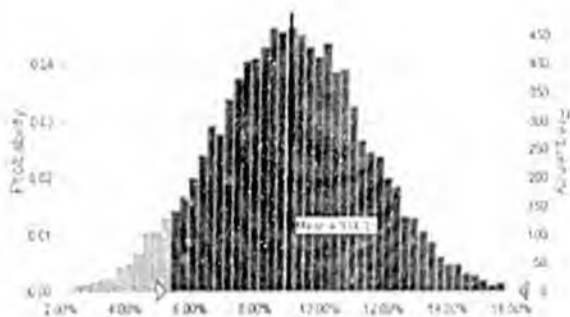
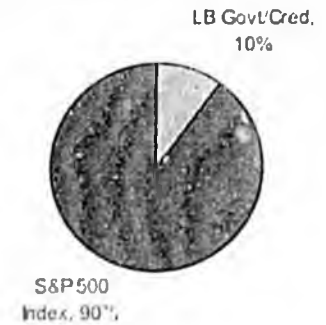
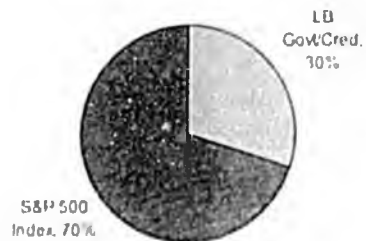
Annualized Average Return	9.00%
Stand Deviation of Returns	2.37%
Probability of outperforming 5.25%	94.2%

Moderate – 80/20

Annualized Average Return	9.07%
Stand Deviation of Returns	2.71%
Probability of outperforming 5.25%	92.2%

Aggressive – 90/10

Annualized Average Return	9.16%
Stand Deviation of Returns	3.03%
Probability of outperforming 5.25%	89.87%



Political Risk – Key Driver of UAAL

Between 1992 and 2003, increasing liabilities – not poor investment performance – caused the most damage to the PERS/TRS system.

- Presented by State Actuary to ARM Board in 2005

Changes in Assets Include:

- Investment performance (i.e. investment risk)

Changes in Liabilities Include:

- Health benefits cost experience
- Health assumption changes
- Plan changes
- Demographic experience
- Non-health changes

Drivers of PERS/TRS Funding Ratio Changes (1992-2003)

	PERS Change in Funded Status	TRS Change in Funded Status
Change Due to Assets	-3.8%	-2.7%
Change Due to Liabilities	-18.5%	-26.6%
Total Change in Funded Status	-22.3%	-29.3%

Political Risk

High amount of POBs proceeds may cause the pension system to be over-funded, which could lead to political pressure calling for benefit increases that incur new liabilities in the future.

Risk Control:

- POBs are not issued for the full UAAL; a funded ratio of 70-80% is an industry standard.
- Manage pension benefits and UAAL with discipline.

Market Risk

POBs proceeds cause a large amount of capital infusion into the pension system at once. Prudent investment of the proceeds in early years is critical.

Risk Control:

- Thorough market assessment before POB issuance;
- Considering whether to have a special investment allocation strategy for the proceeds, or stick with the traditional allocations.



Types of Public Debt

Security

- **General obligation bonds**

Bonds that satisfy any constitutional debt limitation and are backed by the full faith and credit and taxing power of the issuing state and local government.

- **Obligations imposed by law**

Obligations imposed by the state or local government by the constitution or by statute or by court judgment as distinguished from a voluntary exercise of the borrowing power by the state or local government.

- **Annual appropriation bonds**

Bonds that are not considered debt subject to a constitutional debt limitation because the state and local government issuer has no legal obligation to pay them and payment is therefore subject to annual appropriation of funds for that purpose at the discretion of the legislature or governing body of the state or local government issuer.

- **HB13 Restriction**

Please note that HB13 Sec. 37.15.900(b) indicates that "The bonds do not constitute a general obligation of the state."



Potential Savings

POBs and Cash Infusion

Pay partial UAAL off with cash and borrow partial at 5.25% by issuance of Pension Obligation Bonds (POBs).

Implications

- Immediate reduction of the UAAL;
- Increase in the Funded Ratio;
- Reduction of employer past service contribution rate.

Case Study (PERS)

Employer Contribution Rates
POBs (in billions)

Cash (in billions)	\$	0%	18%	36%	55%	73%	91%	100%
	0%	18%	36%	55%	73%	91%	100%	
\$	0	35.22%	34.07%	32.91%	31.76%	30.61%	29.46%	28.88%
\$	1.0	29.51%	28.36%	27.20%	26.05%	24.90%	23.74%	
\$	2.0	23.80%	22.64%	21.49%	20.34%	19.19%		
\$	3.0	18.08%	16.93%	15.78%	14.63%			
\$	4.0	12.37%	11.22%	10.07%				
\$	5.0	6.66%	5.51%					
\$	5.5	6.66%	5.51%					
\$	5.5	3.80%						

Savings on Annual Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	\$	0%	18%	36%	55%	73%	91%	100%
	0%	18%	36%	55%	73%	91%	100%	
\$	0	\$0.00	\$19.31	\$38.62	\$57.93	\$77.24	\$96.55	\$106.20
\$	1.0	\$95.69	\$115.00	\$134.31	\$153.61	\$172.92	\$192.23	
\$	2.0	\$191.37	\$210.68	\$229.99	\$249.30	\$268.61		
\$	3.0	\$287.06	\$306.37	\$325.68	\$344.99			
\$	4.0	\$382.75	\$402.06	\$421.37				
\$	5.0	\$478.44	\$497.75					
\$	5.5	\$526.28						

Savings on Employer Contribution Rates
POBs (in billions)

Cash (in billions)	\$	0%	18%	36%	55%	73%	91%	100%
	0%	18%	36%	55%	73%	91%	100%	
\$	0	0.00%	1.15%	2.31%	3.46%	4.61%	5.76%	6.34%
\$	1.0	5.71%	6.86%	8.02%	9.17%	10.32%	11.48%	
\$	2.0	11.42%	12.56%	13.73%	14.66%	16.03%		
\$	3.0	17.14%	18.29%	19.44%	20.59%			
\$	4.0	22.85%	24.00%	25.15%				
\$	5.0	28.55%	29.71%					
\$	5.5	31.42%						

NPV of Savings on 25-year Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	\$	0%	18%	36%	55%	73%	91%	100%
	0%	18%	36%	55%	73%	91%	100%	
\$	0	\$0.00	\$272.14	\$544.28	\$816.43	\$1,088.57	\$1,360.71	\$1,496.73
\$	1.0	\$1,348.61	\$1,620.75	\$1,692.90	\$2,165.04	\$2,437.18	\$2,709.32	
\$	2.0	\$2,697.22	\$2,969.37	\$3,241.51	\$3,513.65	\$3,785.79		
\$	3.0	\$4,045.84	\$4,317.98	\$4,590.12	\$4,862.26			
\$	4.0	\$5,394.45	\$5,666.59	\$5,938.73				
\$	5.0	\$6,743.06	\$7,015.20					
\$	5.5	\$7,417.37						

1. \$2.0 billion POBs issued in 2008
2. Assumed \$5.5 billion PERS UAAL in 2007
3. Annual employer contribution amount for Tiers I, II, and III would be \$590 million without POBs starting in 2007
4. Funding ratio will be improved from 65.12% to 77.81% (based on preliminary \$10.27 billion PERS asset as of Dec 31, 2006)

Case Study (TRS)

Employer Contribution Rates
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$.	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1	
	0%	32%	48%	65%	81%	97%	100%	
\$ -	44.17%	40.36%	38.45%	36.55%	34.64%	32.74%	32.36%	
\$ 0.5	36.23%	32.42%	30.51%	28.60%	26.70%	24.79%		
\$ 1.0	28.28%	24.47%	22.57%	20.66%	18.75%			
\$ 1.5	20.34%	16.53%	14.62%	12.72%				
\$ 2.0	12.39%	8.58%	6.68%					
\$ 2.5	4.45%	0.64%						

Savings on Annual Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$.	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1	
	0%	32%	48%	65%	81%	97%	100%	
\$ -	\$0.00	\$22.95	\$34.42	\$45.89	\$57.37	\$68.84	\$71.13	
\$ 0.5	\$47.84	\$70.79	\$92.26	\$93.74	\$105.21	\$116.63		
\$ 1.0	\$95.69	\$118.63	\$130.11	\$141.58	\$153.05			
\$ 1.5	\$143.53	\$166.43	\$177.95	\$189.42				
\$ 2.0	\$191.37	\$214.32	\$225.79					
\$ 2.5	\$239.22	\$262.16						

Savings on Employer Contribution Rates
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$.	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1	
	0%	32%	48%	65%	81%	97%	100%	
\$ -	0.00%	3.81%	5.72%	7.62%	9.53%	11.43%	11.81%	
\$ 0.5	7.94%	11.75%	13.66%	15.57%	17.47%	19.38%		
\$ 1.0	15.89%	19.70%	21.60%	23.51%	25.42%			
\$ 1.5	23.83%	27.64%	29.55%	31.45%				
\$ 2.0	31.78%	35.59%	37.49%					
\$ 2.5	39.72%	43.53%						

NPV of Savings on 25-year Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$.	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1	
	0%	32%	48%	65%	81%	97%	100%	
\$ -	\$0.00	\$323.41	\$465.11	\$646.62	\$808.52	\$970.23	\$1,002.57	
\$ 0.5	\$674.31	\$997.72	\$1,159.42	\$1,321.12	\$1,482.83	\$1,644.53		
\$ 1.0	\$1,348.61	\$1,672.02	\$1,833.73	\$1,995.43	\$2,157.13			
\$ 1.5	\$2,022.92	\$2,346.33	\$2,508.03	\$2,669.74				
\$ 2.0	\$2,697.22	\$3,020.63	\$3,182.34					
\$ 2.5	\$3,371.53	\$3,694.94						

1. \$0.5 billion cash infusion and no POBs issued in 2008
2. Assumed \$3.1 billion TRS UAAL in 2007
3. Annual employer contribution amount for Tiers I, II, and III would be \$266 million without cash infusion and POBs starting in 2007
4. Funding ratio will be improved from 59.9% to 66.36% (based on preliminary \$4.63 billion TRS asset as of Dec 31, 2006)



Tax Issues

Taxable Bonds vs. Tax Exempt Bonds

- Taxable Bonds
 - Can be issued for any purpose
 - Complete flexibility with use of proceeds
 - Interest rate about 1% higher than tax exempt in current market

- Tax Exempt Bonds
 - Can only be issued for public capital projects
 - Earnings on proceeds are restricted to yield paid on bonds
 - 1% lower interest rate than taxable bonds in current market

The Difficulty with Tax Exempt

- Very difficult to identify appropriate GF funded capital projects to issue bonds for.
- Certificates of Participation issuance is the most viable option.
 - However the existing, yet unexpended GF funded capital projects are small, for private purposes, short lived acquisitions, operational grants, or federal match.
 - Fiscal Year 2008 capital budget is only \$100 million, all of which could not be funded with tax exempt bonds.
- Any use of tax exempt bonds to fund capital projects would have to be coincidental, rather than integrated, to any use of on hand cash to fund PERS/TRS contributions.



Take-aways

Take-aways

1. If we can earn more than the cost of POB, we are better off for issuing it.
2. We are in a very favorable interest rate environment – take advantage of it!
3. Risks associated with POB issuance are quantifiable and statistically justified by the rewards.
4. Doing nothing is not a viable option.

Q & A



State of Alaska

Department of Revenue
Commissioner's Office



2/29/08
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February 15, 2008

cc Miles
Darwin

The Honorable Senator Bert Stedman, Co-Chair
The Honorable Senator Lyman Hoffman, Co-Chair
Senate Finance Committee
Juneau, AK 99801

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Dear Senator Stedman and Senator Hoffman,

I appreciate your allocating time on February 8 for the presentation on a financial technique regarding Pension Obligation Bonds (POBs). During the hearing, your committee requested cash flows that indicate the returns displayed on pages 18 and 19 in my presentation. This letter includes the requested cash flows on pages two to eight. Since the methodology is the same behind each scenario, I include in this letter only four cash flows for illustrative purpose.

I appreciate yours and the committee's attention to the matter of POBs and the retirement systems' unfunded liabilities. I look forward to discussing with the committee further details regarding this matter. Please feel free to contact me with any feedback or questions.

Very truly yours,

Brian Andrews
Deputy Commissioner
Department of Revenue

CC: The Honorable Senator Charlie Huggins
The Honorable Senator Kim Elton
The Honorable Senator Donny Olson
The Honorable Senator Joe Thomas
The Honorable Senator Fred Dyson
The Honorable Representative Mike Hawker

This information is provided as a follow-up on a request made at the POBs presentation on February 8, 2008 to provide cash flow analysis that supports the charts that were included on pages 18 and 19 of the presentation. The following cash flow analyses show the differential between the interest cost on a borrowing of \$1 billion and the interest earnings that the pension funds could obtain based upon historical performance.

This analysis does not address the impact on the actuarially required contributions to the pension fund and/or the appropriations for repayment of principal and interest on the debt.

It should be noted that the success of an issuance of POBs can only be determined at the maturity of the POBs – i.e., over the term of the POBs, did the investment return realized on investment of the bond proceeds exceed the cost of the POBs? During the period that the POBs are outstanding, there may be significant gains or realized losses on the program. Assuming an investment strategy consistent with past practice of the pension funds, statistically the probability of realizing a gain from the program exceeds 90%.

Cash flow #1

This example shows the cumulative return if the POBS had been issued in 1992, at the estimated cost of borrowing in 1992, and the bond proceeds had been invested in the pension funds, and realized the investment returns that the pension funds had experienced over the period from 1992 - 2007.

Note that the estimated cost of borrowing in 1992 was 7.76%. This rate exceeds the rate at which POBs could be issued under current conditions under the proposed legislation. The legislation limits the all-in interest cost of the POBs to not more than 1.5% below the actuarially assumed investment rate. Under current conditions, the actuarially assumed investment rate is 8.25%; thus, the all-in interest cost could not exceed 6.75%.

Assumptions:

An issuance of \$1 billion POBs in 1992 at an all-in interest cost of 7.76%; the annual fiscal year investment returns are actual Public Employee Retirement System (PERS) returns.

POB borrowing cost (all in)	7.76%
POB issuance amount	\$1,000,000,000
POB term	25 years

FY	PERS ROR	BoFY Balance	Returns in \$	POB Annual Interest Costs	EoFY Balance	Surplus or (shortfall)
1992	11.80%	\$ 1,000,000,000	\$ 118,000,000	\$ (77,600,000)	\$ 1,040,400,000	\$ 40,400,000
1993	14.25%	\$ 1,040,400,000	\$ 148,257,000	\$ (77,600,000)	\$ 1,111,057,000	\$ 111,057,000
1994	2.66%	\$ 1,111,057,000	\$ 29,554,116	\$ (77,600,000)	\$ 1,063,011,116	\$ 63,011,116
1995	15.56%	\$ 1,063,011,116	\$ 165,404,530	\$ (77,600,000)	\$ 1,150,815,646	\$ 150,815,646
1996	13.70%	\$ 1,150,815,646	\$ 157,661,743	\$ (77,600,000)	\$ 1,230,877,389	\$ 230,877,389
1997	19.07%	\$ 1,230,877,389	\$ 222,419,544	\$ (77,600,000)	\$ 1,375,696,934	\$ 375,696,934
1998	14.62%	\$ 1,375,696,934	\$ 201,126,892	\$ (77,600,000)	\$ 1,499,223,825	\$ 499,223,825
1999	10.65%	\$ 1,499,223,825	\$ 159,667,337	\$ (77,600,000)	\$ 1,581,291,163	\$ 581,291,163
2000	10.12%	\$ 1,581,291,163	\$ 160,026,866	\$ (77,600,000)	\$ 1,663,717,828	\$ 663,717,828
2001	-5.30%	\$ 1,663,717,828	\$ (88,177,045)	\$ (77,600,000)	\$ 1,497,940,783	\$ 497,940,783
2002	-5.40%	\$ 1,497,940,783	\$ (80,888,802)	\$ (77,600,000)	\$ 1,339,451,981	\$ 339,451,981
2003	3.82%	\$ 1,339,451,981	\$ 51,167,068	\$ (77,600,000)	\$ 1,313,019,047	\$ 313,019,047
2004	14.73%	\$ 1,313,019,047	\$ 193,407,708	\$ (77,600,000)	\$ 1,428,826,752	\$ 428,826,752
2005	8.86%	\$ 1,428,826,752	\$ 126,594,050	\$ (77,600,000)	\$ 1,477,820,803	\$ 477,820,803
2006	11.69%	\$ 1,477,820,803	\$ 172,757,252	\$ (77,600,000)	\$ 1,572,978,055	\$ 572,978,055
2007	18.88%	\$ 1,572,978,055	\$ 296,978,257	\$ (77,600,000)	\$ 1,792,356,311	\$ 792,356,311

Results as of the end of FY2007:

Annual POB interest payment with cost @ 7.76%	\$ (77,600,000)
Total POB interest payment for 16 years	\$ (1,468,252,912)
Overall surplus/(shortfall) because of arbitrage at the end the 16 years	\$ 792,356,311
Accumulated returns at the end of the 16 years	79.24%

It should also be noted that the period from 1992 – 2007 is less than the assumed 25-year term of the POBs. But, if the investment return on the pension funds were assumed to earn an investment return of the actuarially assumed investment rate of 8.25% for the period from 2003 – 2016, the cash flow benefit would be increased.

Cash flow based on actual PERS returns from FY1992-2007

FY	PERS ROR	BoFY Balance	Returns in \$	POB Annual Interest Costs	EoFY Balance	Surplus or (shortfall)
1992	11.80%	\$ 1,000,000,000	\$ 118,000,000	\$ (77,600,000)	\$ 1,040,400,000	\$ 40,400,000
1993	14.25%	\$ 1,040,400,000	\$ 148,257,000	\$ (77,600,000)	\$ 1,111,057,000	\$ 111,057,000
1994	2.66%	\$ 1,111,057,000	\$ 29,554,116	\$ (77,600,000)	\$ 1,063,011,116	\$ 63,011,116
1995	15.56%	\$ 1,063,011,116	\$ 165,404,530	\$ (77,600,000)	\$ 1,150,815,646	\$ 150,815,646
1996	13.70%	\$ 1,150,815,646	\$ 157,661,743	\$ (77,600,000)	\$ 1,230,877,389	\$ 230,877,389
1997	18.07%	\$ 1,230,877,389	\$ 222,419,544	\$ (77,600,000)	\$ 1,375,696,934	\$ 375,696,934
1998	14.82%	\$ 1,375,696,934	\$ 201,126,892	\$ (77,600,000)	\$ 1,499,223,825	\$ 499,223,825
1999	10.65%	\$ 1,499,223,825	\$ 159,667,337	\$ (77,600,000)	\$ 1,581,291,163	\$ 581,291,163
2000	10.12%	\$ 1,581,291,163	\$ 160,026,666	\$ (77,600,000)	\$ 1,663,717,828	\$ 663,717,828
2001	-5.30%	\$ 1,663,717,828	\$ (88,177,045)	\$ (77,600,000)	\$ 1,497,940,783	\$ 497,940,783
2002	-5.40%	\$ 1,497,940,783	\$ (80,888,802)	\$ (77,600,000)	\$ 1,339,451,981	\$ 339,451,981
2003	3.82%	\$ 1,339,451,981	\$ 51,167,066	\$ (77,600,000)	\$ 1,313,019,047	\$ 313,019,047
2004	14.73%	\$ 1,313,019,047	\$ 193,407,708	\$ (77,600,000)	\$ 1,428,826,752	\$ 428,826,752
2005	8.86%	\$ 1,428,826,752	\$ 126,594,050	\$ (77,600,000)	\$ 1,477,820,803	\$ 477,820,803
2006	11.69%	\$ 1,477,820,903	\$ 172,757,252	\$ (77,600,000)	\$ 1,572,978,055	\$ 572,978,055
2007	18.88%	\$ 1,572,978,055	\$ 298,978,257	\$ (77,600,000)	\$ 1,792,356,311	\$ 792,356,311
2008	8.25%	\$ 1,792,356,311	\$ 147,869,398	\$ (77,600,000)	\$ 1,862,625,707	\$ 862,625,707
2009	8.25%	\$ 1,862,625,707	\$ 153,666,621	\$ (77,600,000)	\$ 1,938,692,328	\$ 938,692,328
2010	8.25%	\$ 1,938,692,323	\$ 159,942,117	\$ (77,600,000)	\$ 2,021,034,445	\$ 1,021,034,445
2011	8.25%	\$ 2,021,034,445	\$ 166,735,342	\$ (77,600,000)	\$ 2,110,169,786	\$ 1,110,169,786
2012	8.25%	\$ 2,110,169,786	\$ 174,089,007	\$ (77,600,000)	\$ 2,206,658,794	\$ 1,206,658,794
2013	8.25%	\$ 2,206,658,794	\$ 182,049,350	\$ (77,600,000)	\$ 2,311,108,144	\$ 1,311,108,144
2014	8.25%	\$ 2,311,108,144	\$ 190,666,422	\$ (77,600,000)	\$ 2,424,174,566	\$ 1,424,174,566
2015	8.25%	\$ 2,424,174,566	\$ 199,994,402	\$ (77,600,000)	\$ 2,546,568,968	\$ 1,546,568,968
2016	8.25%	\$ 2,546,568,968	\$ 210,091,940	\$ (77,600,000)	\$ 2,679,060,908	\$ 1,679,060,908

Results as of the end of FY2016:

Overall surplus/(shortfall) because of arbitrage at the end
the 25 years

\$ 1,679,060,908

Accumulated returns at the end of the 25 years

167.91%

Cash flow #2

This example shows the cumulative return if the POBS had been issued in 2001, at the time of the downturn in the equity markets, at the estimated cost of borrowing in 2001 (i.e., 5.77%), and the bond proceeds had been invested in the pension funds, and realized the investment returns that the pension funds had experienced over the period from 2001 - 2007.

Note that the period from 2001 - 2007 is significantly less than the assumed 25-year term of the POBs. With such a short period of performance to review, it is not possible to determine how the program would perform over the term of the POBs. Clearly, the seven period from 2001 - 2007 was not enough in order to earn back the losses that were experienced in the early years of the program. However, if the investment returns on the pension funds were assumed to earn an investment return of the actuarially assumed investment rate of 8.25% for the period from 2008 - 2025, the cash flow deficit would be erased and the program would experience a cash flow benefit.

Assumptions:

An issuance of \$1 billion POBs in 2001 at an all-in interest cost of 5.77%; the annual fiscal year investment returns are actual PERS returns.

POB borrowing cost (all in)	5.77%
POB issuance amount	\$1,000,000,000
POB term	25 years

FY	PERS ROR	BoFY Balance	Returns in \$	POB Annual Interest Costs	EoFY Balance	Surplus or (shortfall)
2001	-5.30%	\$ 1,000,000,000	\$ (53,000,000)	\$ (57,700,000)	\$ 889,300,000	\$ (110,700,000)
2002	-5.40%	\$ 889,300,000	\$ (48,022,200)	\$ (57,700,000)	\$ 783,577,800	\$ (216,422,200)
2003	3.22%	\$ 783,577,800	\$ 29,932,872	\$ (57,700,000)	\$ 755,810,472	\$ (244,189,528)
2004	14.73%	\$ 755,810,472	\$ 111,330,883	\$ (57,700,000)	\$ 809,441,354	\$ (190,558,646)
2005	8.86%	\$ 809,441,354	\$ 71,716,504	\$ (57,700,000)	\$ 823,457,858	\$ (176,542,142)
2006	11.69%	\$ 823,457,858	\$ 96,262,224	\$ (57,700,000)	\$ 862,020,082	\$ (137,979,918)
2007	18.88%	\$ 862,020,082	\$ 162,749,392	\$ (57,700,000)	\$ 967,069,474	\$ (32,930,526)

Results as of the end of FY2007:

Annual POB interest payment with cost @ 5.77%	\$ (57,700,000)
Total POB interest payment for 7 years	\$ (403,900,000)
Overall surplus/(shortfall) because of arbitrage at the end the 7 years	\$ (32,930,526)
Accumulated returns at the end of the 7 years	-3.29%

Cash flow #3

This example shows the cumulative return if the POBS had been issued in 1992 and the bond proceeds had been invested in the pension funds, and realized the investment returns that the pension funds had experienced over the period from 1992 - 2007. For purposes of this example, we have used an estimate of the interest cost at which POBs could be issued under current market conditions. Thus, this example uses current interest rates, but historical performance of the pension fund.

It should also be noted that the period from 1992 - 2007 is less than the assumed 25-year term of the POBs. But, if the investment return on the pension funds were assumed to earn an investment return of the actuarially assumed investment rate of 8.25% for the period from 2008 - 2016, the cash flow benefit would be increased.

Assumptions:

An issuance of \$1 billion POBs in 1992 at an all-in interest cost of 5.25%, which is likely to be available under the current market condition; the annual fiscal year investment returns are actual PERS returns.

POB borrowing cost (all in)	5.25%
POB issuance amount	\$1,000,000,000
POB term	25 years

FY	PERS ROR	BoFY Balance	Returns In \$	POB Annual Interest Costs	EoFY Balance	Surplus or (shortfall)
1992	11.80%	\$ 1,000,000,000	\$ 118,000,000	\$ (52,500,000)	\$ 1,065,500,000	\$ 65,500,000
1993	14.25%	\$ 1,065,500,000	\$ 151,833,750	\$ (52,500,000)	\$ 1,164,833,750	\$ 164,833,750
1994	2.66%	\$ 1,164,833,750	\$ 30,984,578	\$ (52,500,000)	\$ 1,143,318,328	\$ 143,318,328
1995	15.56%	\$ 1,143,318,328	\$ 177,900,332	\$ (52,500,000)	\$ 1,268,718,660	\$ 268,718,660
1996	13.70%	\$ 1,268,718,660	\$ 173,814,456	\$ (52,500,000)	\$ 1,390,033,116	\$ 390,033,116
1997	18.07%	\$ 1,390,033,116	\$ 251,178,984	\$ (52,500,000)	\$ 1,588,712,100	\$ 588,712,100
1998	14.62%	\$ 1,588,712,100	\$ 232,269,709	\$ (52,500,000)	\$ 1,768,481,809	\$ 768,481,809
1999	10.65%	\$ 1,768,481,809	\$ 188,343,313	\$ (52,500,000)	\$ 1,904,325,122	\$ 904,325,122
2000	10.12%	\$ 1,904,325,122	\$ 192,717,702	\$ (52,500,000)	\$ 2,044,542,824	\$ 1,044,542,824
2001	-5.30%	\$ 2,044,542,824	\$ (108,360,770)	\$ (52,500,000)	\$ 1,883,682,054	\$ 883,682,054
2002	-5.40%	\$ 1,883,682,054	\$ (101,718,831)	\$ (52,500,000)	\$ 1,729,463,223	\$ 729,463,223
2003	3.82%	\$ 1,729,463,223	\$ 66,065,496	\$ (52,500,000)	\$ 1,743,028,718	\$ 743,028,718
2004	14.73%	\$ 1,743,028,718	\$ 258,748,130	\$ (52,500,000)	\$ 1,947,276,849	\$ 947,276,849
2005	8.86%	\$ 1,947,276,849	\$ 172,528,729	\$ (52,500,000)	\$ 2,067,305,577	\$ 1,067,305,577
2006	11.68%	\$ 2,067,305,577	\$ 241,668,022	\$ (52,500,000)	\$ 2,256,473,599	\$ 1,256,473,599
2007	18.88%	\$ 2,256,473,599	\$ 426,022,216	\$ (52,500,000)	\$ 2,629,995,815	\$ 1,629,995,815

Results as of the end of FY2007:

Annual POB interest payment with cost @ 5.25%	\$ (52,500,000)
Total POB interest payment for 16 years	\$ (840,000,000)
Overall surplus/(shortfall) because of arbitrage at the end the 16 years	\$ 1,629,995,815
Accumulated returns at the end of the 16 years	163.00%

Cash flow #4

This example shows the cumulative return if the POBS had been issued in year 1. The interest cost is an estimate of the interest cost at which the POBs could be issued under current market conditions. The investment returns use the actual historical investment returns of the pension fund, but the annual returns are rearranged such that the four years having the worst returns occur in Years 1 - 4. This scenario illustrates the impact of issuing the POBs in a down stock market, and the need for additional years of good returns to bring the program out of the deficit position.

It should also be noted that the period from Years 1 - 16 is less than the assumed 25-year term of the POBs. But, if the investment return on the pension funds were assumed to earn an investment return of the actuarially assumed investment rate of 8.25% for the period from Years 17 - 25, the cash flow benefit would be increased.

Assumptions:

An issuance of \$1 billion POBs in Year 1 at an all-in interest cost of 5.25%, which is likely to be available under current market conditions; the annual fiscal year investment returns are rearranged PERS returns in order to simulate a shock scenario with the first four years having the worst investment returns.

POB borrowing cost (all in)	5.25%
POB issuance amount	\$1,000,000,000
POB term	25 years

A shock scenario: Cash flow based on low ROR in the beginning

FY	PERS ROR	BoFY Balance	Returns In \$	POB Annual Interest Costs	EoFY Balance	Surplus or (shortfall)
1	-5.40%	\$ 1,000,000,000	\$ (54,000,000)	\$ (52,500,000)	\$ 893,500,000	\$ (106,500,000)
2	-5.30%	\$ 893,500,000	\$ (47,355,500)	\$ (52,500,000)	\$ 793,644,500	\$ (206,355,500)
3	2.86%	\$ 793,644,500	\$ 21,110,944	\$ (52,500,000)	\$ 762,255,444	\$ (237,744,556)
4	3.82%	\$ 762,255,444	\$ 29,118,158	\$ (52,500,000)	\$ 738,873,602	\$ (261,126,398)
5	14.62%	\$ 738,873,602	\$ 108,023,321	\$ (52,500,000)	\$ 794,396,922	\$ (205,603,078)
6	11.69%	\$ 794,396,922	\$ 92,865,000	\$ (52,500,000)	\$ 834,761,922	\$ (165,238,078)
7	13.70%	\$ 834,761,922	\$ 114,362,383	\$ (52,500,000)	\$ 896,624,306	\$ (103,375,694)
8	11.80%	\$ 896,624,306	\$ 105,801,668	\$ (52,500,000)	\$ 949,925,974	\$ (50,074,026)
9	10.65%	\$ 949,925,974	\$ 101,167,110	\$ (52,500,000)	\$ 998,593,090	\$ (1,406,910)
10	18.88%	\$ 998,593,090	\$ 188,534,375	\$ (52,500,000)	\$ 1,134,627,465	\$ 134,627,465
11	14.73%	\$ 1,134,627,465	\$ 167,130,626	\$ (52,500,000)	\$ 1,249,258,091	\$ 249,258,091
12	14.25%	\$ 1,249,258,091	\$ 178,019,278	\$ (52,500,000)	\$ 1,374,777,369	\$ 374,777,369
13	15.56%	\$ 1,374,777,369	\$ 213,915,359	\$ (52,500,000)	\$ 1,536,192,728	\$ 536,192,728
14	8.86%	\$ 1,536,192,728	\$ 136,106,676	\$ (52,500,000)	\$ 1,619,799,403	\$ 619,799,403
15	18.07%	\$ 1,619,799,403	\$ 292,697,752	\$ (52,500,000)	\$ 1,859,997,156	\$ 859,997,156
16	10.12%	\$ 1,859,997,156	\$ 189,231,712	\$ (52,500,000)	\$ 1,995,728,868	\$ 995,728,868

Results as of the end of Year 16:

Annual POB interest payment with cost @ 5.25%	\$ (52,500,000)
Total POB interest payment for 16 years	\$ (840,000,000)
Overall surplus/(shortfall) because of arbitrage at the end the 16 years	\$ 995,728,868
Accumulated returns at the end of the 16 years	99.57%

This scenario shows that if the POBs were issued in a down market, additional few years of good returns will be required to bring the program to a position that investment returns cover the POB costs. Such market risk is the main reason why I recommended in my presentation a thorough market assessment before POB issuance and considering a special investment allocation strategy for the proceeds, if necessary.

Representative Mike Hawker

Alaska State Legislature



House Bill 13 Sponsor Statement

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Portage
Whitmer
Sunrise
Hope*

Short Title: Retirement System Liability/Bonds

HB 13 provides governmental employers the opportunity to utilize a financial mechanism generally referred to as a "Pension Obligation Bond" (POB) to help reduce the ultimate cost of satisfying the unfunded accrued actuarial liabilities of their retirement systems. A POB is essentially a legal arbitrage transaction where money is borrowed at a lower rate of interest than the money earns when invested by the retirement system.

HB 13 clarifies the ability of municipal entities to include POBs in their strategy to reduce the cost of meeting unfunded pension liabilities and expands the authority of the Alaska Municipal Bond Bank Authority, the Alaska Housing Finance Corporation, and the state bond committee to support governmental employers seeking assistance engaging in such transactions. HB 13 also creates the Alaska Pension Obligation Bond Corporation. The authority granted in this legislation will allow for the greatest flexibility in creating transactions to fit the needs of public employers.

This bill does not authorize any debt instruments to be issued. Separate specific action would be required to initiate any transaction under the authority provided by HB 13.

Representative Mike Hawker

Alaska State Legislature



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Indian
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CHANGES TO HOUSE BILL 13

House Special Committee on Ways & Means

The major changes between HB 13 and CS HB 13 (W&M) are the requirement for an employer's contribution rate to be recalculated within 180 days of a lump sum payment authorized under this bill, the authorization for the Alaska Housing Finance Corporation and the state bond committee to participate in the sale of Pension Obligation Bonds, and the creation of the Alaska Pension Obligation Bond Corporation.

- Added new sections to require the plan administrator to recalculate the employer's contribution rate within 180 days of a lump sum payment to reduce their unfunded accrued actuarial liability.
- Authorized the Alaska Housing Finance Corporation to create a subsidiary corporation to assist in the financing of Pension Obligation Bonds.
- Authorized the state bond committee to assist in the financing of Pension Obligation Bonds and set guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.
- Created the Alaska Pension Obligation Bond Corporation to assist in the financing of Pension Obligation Bonds, defined its organization and structure, and set guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.
- Necessary title and conforming amendments to accommodate new language.

House Finance Committee

- Reduced the time for a plan administrator to recalculate the employer's contribution rate from 180 days to 30 days of receipt of a lump sum payment.
- Reworded sections to accommodate a payment made by another entity on the behalf of a governmental employer.
- Added a requirement that the actuarially assumed rate of return on PBOs issued by the Alaska Housing Finance Corporation exceed 1.5 percent annually. This mirrors existing requirements in the bill for bonds issued by the State Bond Committee and Alaska Pension Obligation Bond Corporation.
- Exempted the Alaska Pension Obligation Bond Corporation from the Procurement Code.

CS House Bill 13 (FIN)

Sectional Analysis

Prepared by Representative Mike Hawker's Office

- Section 1:** Allows a lump sum payment to be made to prepay all or a part of a Teacher's Retirement System (TRS) employer's unfunded accrued actuarial pension liability (UAAL); allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers. Requires the administrator of the TRS plan to recalculate the employer contribution rate within 30 days of the lump sum payment.
- Sections 2 - 5:** These sections allow the Alaska Housing Finance Corporation (AHFC) to create a subsidiary to aid an employer in the financing of a prepayment of all or a portion of that employer's UAAL.
- Section 6:** Outlines how municipalities can join together to issue debt obligations and allows funds diversion agreements between the municipalities and state agencies.
- Section 7:** Exempts the Alaska Pension Obligation Bond Corporation from the Procurement Code.
- Section 8:** Adds Article 8 to the State Bonding Act, which authorizes the state bond committee to issue Pension Obligation Bonds (POBs) and provides guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.
- Section 9:** Creates the Alaska Pension Obligation Bond Corporation, which is authorized to issue POBs. Provides guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.
- Sections 10 - 11:** Adds facilitating language to two sections of the accounting statute for the Public Employees Retirement System (PERS) to accommodate lump sum payments.
- Section 12:** Allows a lump sum payment to be made to prepay all or a part of a PERS employer's unfunded accrued actuarial pension liability (UAAL); allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers. Requires the administrator of the PERS plan to recalculate the employer contribution rate within 30 days of the lump sum prepayment.
- Section 13:** Adds to the statutory policies established for the Municipal Bond Bank Authority. Provides a directive to assist governmental employers to meet their unfunded retirement system obligations by issuing POBs on their behalf. Specifies that the bond bank should provide the lowest rates possible without subsidizing the employers beyond their means.

- Sections 14 - 15:** These sections allow the Municipal Bond Bank to create a subsidiary to aid an employer in the financing of a prepayment of all or a portion of that employer's UAAL.
- Section 16:** Exempts "Pension Obligation Bonds" from the current limit for revenue bonds that the Municipal Bond Bank may issue each year.
- Section 17:** Authorizes the Municipal Bond Bank to issue "Pension Obligation Bonds."
- Section 18:** Exempts "Pension Obligation Bonds" from the current limit for total revenue bonds and notes that the Municipal Bond Bank may have outstanding at any time.
- Section 19:** Adds a definition for "governmental employer" to the definitions section for the Municipal Bond Bank.
- Section 20:** Immediate effective date.

Promises with a Price

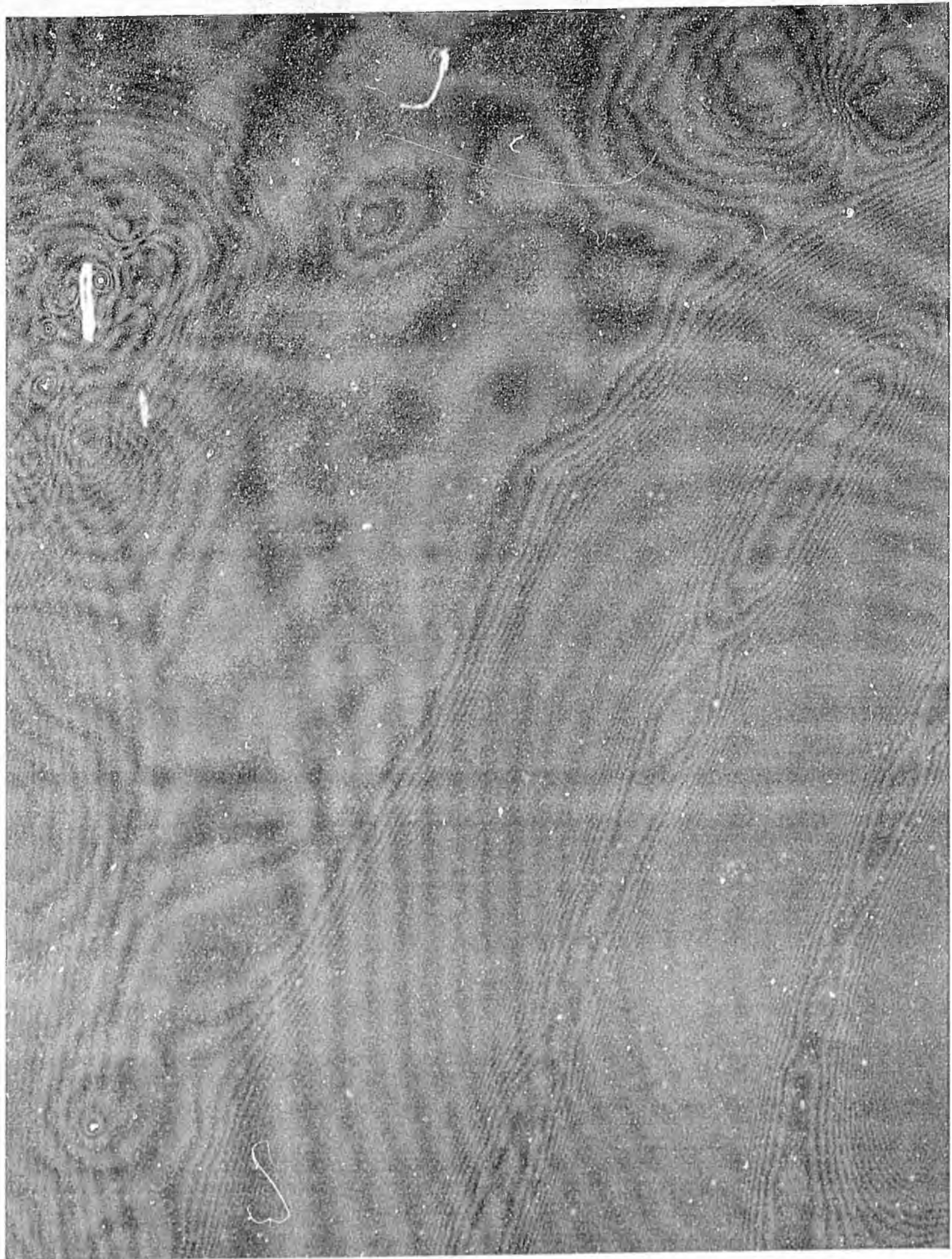
Public Sector Retirement Benefits



THE
PEW
CENTER ON THE STATES



Distributed by Senator Steelman





Dear reader:

\$2.73 trillion. That is a conservative estimate of what states will spend on pensions, health care and other retirement benefits for their employees over the next 30 years. It is an enormous investment of taxpayer dollars—so the stakes are extraordinarily high. Across the country, state policy leaders are trying to strike the right balance between controlling costs and recruiting and retaining talent in the public sector.

This groundbreaking report, *Promises with a Price*, provides first-of-its-kind data about the long-term costs of public sector benefits. It highlights which states are prepared to pay the significant bill coming due, which are not, and why it matters to state lawmakers and citizens alike.

States' fiscal health depends greatly on policy makers' ability to wisely manage their bills coming due—and The Pew Charitable Trusts' Center on the States (PCS) is tracking their efforts across a range of issues. For instance, last year we published a report on states' efforts to rein in ballooning Medicaid costs while ensuring high-quality health care for citizens in need. This year we issued a 50-state assessment forecasting that, without data-driven policy reforms, many states will see significant growth in their prison populations and corrections spending in the next five years.

Equally important is whether states have the right policies in place to be competitive in a global, 21st-Century economy. In July, PCS and the National Governors Association joined forces to produce a governors' guide on states' research and development funds, aimed at stirring innovation and creating new jobs. In January 2008, PCS and *Governing* magazine will publish a report on whether states' tax structures encourage or impede states' economic vitality.

Finally, in March, our Government Performance Project will release a 50-state report card on how efficiently and effectively states are managing their budgets, employees, information and infrastructure—all critical to ensuring that state policies ultimately deliver the results lawmakers and taxpayers expect.

Researching emerging topics, developing 50-state comparisons, identifying innovative approaches among states to complex problems, and, when the facts are clear, advocating for nonpartisan, pragmatic solutions—these are the signature efforts of PCS.

The Pew Charitable Trusts applies the power of knowledge to solve today's most challenging problems, and PCS, a division of Pew, identifies and advances effective policy approaches to critical issues facing states. We hope all of our work, including this report, helps states make sound, data-driven policy choices on a wide range of issues.

To learn more about Pew and our Center on the States, please visit www.pewcenteronthestates.org.

Sincerely,
Susan Urahn
Managing Director, Pew Center on the States

Acknowledgments

The Pew Charitable Trusts applies the power of knowledge to solve today's most challenging problems. Our Pew Center on the States identifies and advances effective policy approaches to critical issues facing states.

PEW CENTER ON THE STATES

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The report has also benefited from the insights and expertise of three external reviewers. These experts provided feedback and guidance at various stages in the project.

- Richard Keevey, director, Policy Research Institute for the Region, Woodrow Wilson School at Princeton University. Keevey previously was director of the New Jersey Office of Management and Budget, as well as state budget director and state comptroller.
- Girard Miller, commentator and consultant on public finance issues. Miller previously was president and chief operating officer of Janus Capital Group and president and CEO of ICMA Retirement Corporation.
- Parry Young, commentator and consultant on public finance issues, with a focus on pension and retiree health care benefits. Young previously was director of Standard & Poor's Ratings Services.

While these experts have screened the report for methodology and accuracy, neither they nor their current or former organizations necessarily endorse its findings or conclusions.

For additional information on Pew and our Center on the States, please visit www.pewcenteronthestates.org.

Executive Summary

FOR MANY AMERICANS, POST-RETIREMENT BENEFITS—principally pensions and health care—for state government employees is an obscure topic. But because of how they can affect state budgets, these benefits have become an issue of critical importance. Research by Pew's Center on the States shows states' retiree pensions and other benefits represent a bill coming due over the next few decades that can be conservatively estimated at \$2.73 trillion. That includes about \$2.35 trillion for a wide range of employee pensions, including those for teachers, and an additional \$381 billion for retiree health care and other non-pension benefits for state employees only, excluding those for teachers and a handful of other groups.

The bill coming due over the next few decades can be conservatively estimated at \$2.73 trillion.

the large obligations that many governments have incurred for retiree health care and other non-pension benefits.

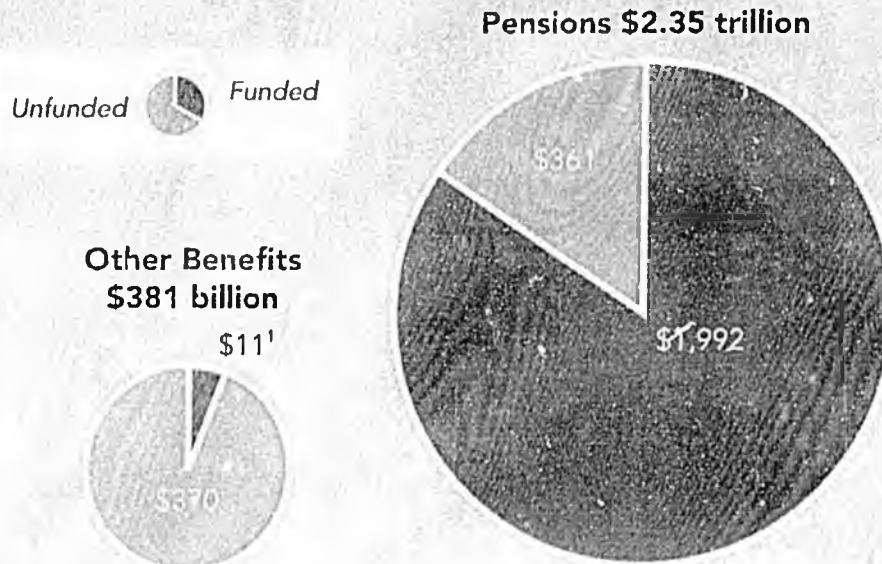
States' liabilities and their ability to cover those costs are affected by a variety of factors, including the strength of their economies, shifts in their populations and their tax capacity. But policy decisions are equally critical. In some states, retiree benefits have been vulnerable to a buy-now, pay-later mentality. In bad budget times, retirement benefits become easy substitutes for salary increases because states can put off the bills. In good times, feelings of legislative largesse can create new retirement benefit policies that have costly long-term price tags.

To their credit, states have socked away enough to cover about 85 percent of the pension bill. But there is very little put aside for non-pension benefits. All told, states face about \$731 billion in unfunded bills coming due. (See Exhibit 1-1.)

The way in which states provide retirement benefits, and at what levels, to their employees has become the subject of increasingly volatile debate. Several important developments have drawn attention to the issue, including the precipitous drop in public pension funding levels in the early years of the decade and new accounting rules that identify, for the first time,

Today, the need to intelligently control and manage the cost of post-retirement benefits is integral to states' capacity to fund competing needs, such as adequate roads, bridges, water systems and high-quality public education. But at a time when states are competing with the private sector and other nations for the best and the brightest, many fear that reducing benefits could make public sector employment less attractive. "Addressing this issue now is responsible public policy," said Robert N. Campbell III, vice chairman, Deloitte & Touche USA, LLP, which provides financial, human resource and technological services to business and government. "It is in the public interest to

The pension bill is much larger than that of other benefits, but it is 85 percent funded; the bill for other benefits is only 3 percent funded (in billions).



¹ This number is an estimate of assets for state employees only. According to actuarial valuations, which include cost-sharing plans, the assets total \$18 billion.

NOTES: Numbers are the totals of the states' 30-year obligations as calculated in 2006. Other benefit costs only include state employees. The "Other Benefits" number is based on actuarial valuations from the states, which include some cost-sharing plans (i.e., Arizona, North Carolina and Ohio).

SOURCE: Pew Center on the States; Based on States' Comprehensive Annual Financial Report and Actuarial Valuation Data

ensure that qualified, skilled and capable individuals continue to be attracted to careers in public service."

The issues surrounding retirement benefits are highly technical, involving complex calculations and arcane financial terms; in general, the public doesn't pay nearly as much attention to them as they do to education, health care and other topics. This lack of public awareness is part of the reason some states now find themselves in trouble. But the complexity of public sector retirement benefits belies their potential consequences for everyday citizens. Even seemingly modest changes can have significant impacts on public employees, taxpayers and states' fiscal health.

Given the amount of public funds invested, it is more important than ever that states be informed by the best available data, analysis and practices when making decisions about post-retirement benefits.

This report, by the Pew Center on the States (PCS), seeks to provide such information to state policy makers across the country. The report is divided into three sections. This executive summary highlights key findings of the report, describes current forces driving up costs in both pensions and other post-employment benefits (primarily health care), and explains why state budgets will be affected for years to come. The second section focuses on pensions, offering 50-state data illuminating different ways states have handled these

obligations and opportunities for states to control future costs. The last section examines other post-employment benefits, providing groundbreaking data on states' liabilities for retiree health care and profiling initial measures some states have taken to manage the issue.

PCS's analysis flows from an intensive review of data compiled and reported by the states—information that is publicly available but not always easily accessed by policy makers. To examine pension funding trends, PCS aggregated all the pension data that were available in states' comprehensive annual financial reports, including plans for teachers, state employees, law enforcement personnel,

elected officials, judges and, in some cases, municipal employees whose benefits are administered through state plans. To assess the impact of health care and other non-pension benefits, PCS collected actuarial valuations that have now been completed by most of the states and which calculate long-term costs of retiree health and other benefits that have previously been unknown. In this case, to offer a consistent comparison among states, information was collected for state employees only. Non-pension benefits for teachers will be the topic of a subsequent report. (For a more detailed explanation of our methodology, see page 17.)

Key Findings

Pensions

State of the States:

- From a national perspective, states' pension plans seem to be in reasonable shape. Looking at all pension plans covered in the states' financial reports, there were \$2.35 trillion in long-term liabilities at the end of fiscal year 2006, of which \$361 billion was unfunded. Data collected by PCS show that, in the aggregate, states' systems were 85 percent funded for fiscal year 2006.
- But the national perspective masks important variations across the states. Twenty states had less than 80 percent of the funds necessary to cover their long-term pension obligations—the level most experts consider to be healthy. Given shifts in funding levels caused by volatility in the stock market and other forces, underfunding could leave states in a very precarious position. And several states, including Connecticut, Illinois, Hawaii, Kentucky and New Hampshire, have experienced particularly troubling drops in their funding ratios.
- While the overall story about states' pension plans seems generally positive, policy makers should be cautious about this news. Past experience indicates that good times may become perilous for the long-term health of pension systems. In the late 1990s and early 2000s, when half the states' pension plans were fully funded, many states reacted by increasing benefits. In the years that followed, funding levels for state pension plans dropped substantially, some by as much as 30 to 40 percentage points.

- In the past 10 years, only about a third of the states have consistently contributed the full annual amount their own actuaries said was necessary. In 2006, 20 states contributed less than 95 percent of the amount their actuaries targeted to meet their annual contribution for pension funding, and 10 states contributed less than 80 percent. States that have consistently fallen short in recent years include Colorado, Illinois, Kansas, Michigan, New Jersey, Oklahoma and Washington.

Promising Approaches:

- States should fully fund their liabilities each and every year. And they should be sure that any new benefits promised are genuinely affordable—once given, pension benefits are very difficult to take away. Both Georgia and Oklahoma require that any proposed benefit increase be accompanied by actuarial calculations of long-term affordability.
- A number of states are taking additional steps to reduce their long-term costs. At least five states now offer hybrid plans that

combine elements of both defined benefit and defined contribution plans. (The former promises recipients a set level of benefits; with the latter, the employer contributes a defined amount to the plan.) According to a September 2007 report by the U.S. Government Accountability Office (GAO),¹ Oregon officials estimate that a new hybrid program adopted by the state in 2003 contributed to \$400 million in pension reform savings.

- Some states are closing loopholes within pension systems that allow employees to increase the amount they collect after retirement, such as inflating the number of years counted toward retirement or final salary during the last years of employment.
- Some states are strengthening how they govern their pension systems so the funds will be better managed and less volatile. A number of states also are requiring faster, more accurate financial reporting so that policy makers will have the best and most up-to-date information when making decisions about pension plans.

Other Post-Employment Benefits

In response to a 2004 rule from the Governmental Accounting Standards Board (GASB), most states have now completed their calculations of the long-term cost of the non-pension retiree benefits they offer to their own state employees. Of these benefits, the biggest by far is health care, but benefits can also include such coverage as dental care and life insurance.



State of the States:

- The long-term price tag for retiree health care and other benefits for state employees alone is about \$381 billion, according to PCS's analysis. About 97 percent—\$370 billion—of that 30-year bill was unfunded at the end of fiscal year 2006. And this is a conservative estimate because it doesn't include obligations for teachers or local government workers.
- When it comes to states' total liabilities for employee retirement, pensions represent a far bigger portion than retiree health care and other non-pension benefits. But states are doing a far better job socking away money to cover pension costs. That means that non-pension liabilities make up a disproportionate share—more than half—of what states haven't yet funded.
- States differ tremendously in the kinds of non-pension benefits they offer to retirees. Half the states account for almost 94 percent of the liabilities—largely the result of decisions that governments have made about how large or small these retirement benefits should be and who should receive them. Per capita costs for other post-employment benefits range from less than \$200 in states like North Dakota, South Dakota and Wyoming to more than \$5,000 in Delaware, Hawaii and Connecticut.
- At the end of fiscal year 2006, just six states—Arizona, North Dakota, Ohio, Oregon, Utah and Wisconsin—were on track to have fully funded their non-pension obligations during the next 30 years. Of the five largest states—California, Texas, New York, Florida and Illinois—none had put aside money for non-pension benefits. Eleven states face long-term liabilities in

excess of \$10 billion, led by New York at \$50 billion, California at \$48 billion, and Connecticut and New Jersey at \$22 billion each. (Illinois does not have an official valuation yet, but estimates put its liability at \$48 billion.)

Promising Approaches:

- At least 13 states have set up irrevocable trusts to pay for retirement benefits in years to come, ensuring that none of the funds are diverted to other purposes.
- States can cut their long-term costs substantially if they start fully funding their annual required contribution for other post-employment benefits. For example, Massachusetts would face \$13.3 billion in long-term costs if it didn't put aside funds for retiree health care and other non-pension benefits. If the state consistently funds its required contribution every year—as it is doing in 2008—the long-term costs will be reduced to \$7.6 billion. Why? Because the interest the state is likely to earn when it invests more money over the long term can be applied to paying down the bill.
- Many states owe so much that they may find it cost-prohibitive to fully fund their non-pension liabilities—the median annual contribution required is almost three times what they currently are paying. So a growing number of states are both setting aside some money and restructuring benefits to reduce costs. (In general, states have more flexibility to make changes to retiree health care than to pensions—although this subject is likely to be litigated as governments test their latitude for making changes.)

- States can reduce costs by raising the retirement age, increasing employee and retiree premiums and co-pays, increasing the number of years of employment required for lifetime or fully subsidized benefits, requiring new retirees to pay a percentage of their base salary at retirement for health care costs, and requiring retirees to join a Medicare advantage prescription drug plan.
- Some states also are reducing retiree health costs by promoting wellness programs and other preventive measures, and by managing their benefit plans more cost efficiently—for instance, by joining with localities to bundle their plans under a single administrative umbrella.
- States can, in fact, lower their long-term liabilities. For example, after setting up a trust fund for its other post-employment benefits and adopting several reforms, including increased co-pays and requirements for retirees to join a Medicare advantage prescription drug plan, West Virginia reduced its long-term liability by more than half, from an estimated \$7.8 billion at the end of June 2006 to \$3.4 billion in April 2007.

Why It Matters

Today it is more important than ever that decision-makers—state policy leaders, boards of trustees, agency and union heads, and others—pay serious attention to decisions about post-employment benefits for public

sector employees and that they strike the right balance between managing costs and recruiting and retaining good talent. Five key forces significantly affect post-employment benefits and states' ability to pay for them.

1. Pension funding levels are volatile

Pension investment practices have shifted dramatically in the past 30 years. Federal Reserve Board data from June 2007 indicate that 70 percent of state and local pension investments are in equities, broadly defined, up from 62 percent in 2000 and 38 percent in 1990.² Because equity investment was a relatively new phenomenon for a lot of states in the 1990s, decision-makers may have ignored the idea that what goes up also comes down.

By 2000, about half the states' pension systems were fully funded, due to strong and sustained stock market growth. Legislatures responded in 1999 and 2000 by shortening

vesting periods, increasing the multipliers used in determining benefit amounts, decreasing the age at which employees could receive full retirement benefits and shortening the years of service needed to qualify. New York, New Jersey, Illinois, Pennsylvania, Kentucky, California, Colorado and other states increased benefits.³ Some also decreased required employer contributions to the plans (see Exhibit A-2 in Appendix A).

But the rosy investment picture of the late 1990s was already starting to wilt in 2000, with the dot.com bust followed by the 9/11 attacks and weakening economy beginning in 2001.

Added benefits increased accrued liabilities while shortfalls in contributions ate into asset growth. In the early years of the decade, as poor investment returns caused funding levels to dip, it became even more difficult for states to make the employer contributions required to keep up. By 2006, only five states—Florida, New York,⁴ North Carolina, Oregon and Wisconsin⁵—had pension funding ratios at a 100 percent or greater level. A handful of others—Delaware, Georgia, South Dakota, Tennessee and Utah—were moving close to that point.

This story provides a cautionary tale for policy makers today.

Most states employ a multiyear smoothing process, which evens out gains and losses over time, to calculate the value of their assets. For that reason, pension funding levels have continued to experience the effects of poor returns in fiscal years 2001 and 2002,⁶ even

though investment returns have done well recently. States have responded to their lowered pension funding levels with caution, enacting relatively few benefit increases in the past several years. States such as Rhode Island, Kansas and Illinois have implemented reforms to try to reduce long-term costs.⁷

But in the next year, there is a chance that pension funding levels will start to rise again, as the bleak returns of the early 2000s are removed from the picture. The big question is whether state leaders will learn the lessons of the past decade or whether they will respond to rising funding levels as many did in the period between 1999 and 2001.

One basic fact significantly affects all retiree benefit equations: While funding levels may rise and fall with the economy, once given, a defined benefit is very difficult to take away.

2. Retiree health care costs are rising dramatically

Retiree health benefits have been offered to public sector employees for decades, but their long-term costs have received relatively little attention. That changed in 2004, when the Governmental Accounting Standards Board (GASB) adopted new standards that ask governments to calculate the long-term actuarial liabilities for non-pension benefits, called “other post-employment benefits” (OPEB), using an approach similar to the one they take for pensions.⁸ For the largest governments, including all states, these numbers will be reported for the first time in fiscal year 2008 financial reports.⁹

In some states, the actuarial unfunded liability for non-pension benefits just for state employees is greater than the aggregate unfunded liability for all their pension plans. This is because states have long set aside money for future retirees in their pension systems, but most states have paid for other post-retirement benefits on a pay-as-you-go basis. Each year, as the number of retirees grows and medical costs go up, so does the bill that must be paid out of current revenues.

Exhibit 1-2 shows eight of the 15 states in which the unfunded actuarial accrued liability (UAAL) for retiree health and other post-employment benefits for state employees is greater than the aggregate unfunded actuarial liability for pensions.

States	OPEB UAAL	Pension UAAL	States	OPEB UAAL	Pension UAAL
California	\$47,878,000	\$46,673,644	Hawaii	\$6,791,000	\$5,132,028
Connecticut	\$21,681,000	\$14,914,600	Maryland	\$14,543,000	\$7,634,087
Delaware	\$4,410,000	\$207,635	Pennsylvania	\$13,501,000	\$12,223,300
Georgia	\$4,905,000	\$2,503,741	Tennessee	\$2,305,000	\$366,114

NOTE: PCS assembled these data from 2006 Comprehensive Annual Financial Reports for all 50 states, and their respective pension plans. Additional data were obtained from 2006 actuarial valuations of state pension systems and actuarial valuations of other post-employment benefits when available.

SOURCE: Pew Center on the States

3. The gap between private and public sector benefits is expanding

Private sector retiree benefits differ greatly, depending on the size of companies, the level of unionization and the industry.¹⁰ But in general, the private sector never offered the level of benefits that have been traditionally available in the public sector. At its high point in 1980, only about 35 percent of private sector workers had defined benefit pension plans.¹¹ That number is expected to drop to 13 percent by 2016, according to Dallas Salisbury, chief executive officer of the Employee Benefit Research Institute (EBRI).

As Exhibit 1-3 shows, public sector employees are far more likely to receive retirement benefits—and the gulf between private and public sectors continues to grow. While there are signs that governments are instituting some reforms to scale back benefits, particularly for new employees, the pace of change is dramatically slower than in the business world.

In spring 2007, EBRI and Mercer Human Resource Consulting surveyed private sector defined benefit sponsors and found that more than 35 percent had made changes to their plan in the past two years. About a quarter had closed the plan to new hires, while nearly 13 percent had frozen their plans for all members.¹²

About a third of the organizations that had not changed their plans said they intended to do so in the next two years. And 19 percent said they were considering closing the plans to new hires. The vast majority of private sector companies that intend to shift away from defined benefit systems also say they will increase contributions to defined contribution plans.¹³

The same phenomenon has taken place with retiree health benefits. According to the Kaiser Family Foundation, only a third of big companies offer retiree health insurance. The number has been cut in half since 1988.¹⁴ Of those that do offer benefits, they tend to be considerably less generous than those offered by state government. The Citizens Budget Commission in New York took a look at employers that offer retiree health coverage and found that 10 percent pay the full premium, compared with 32 percent in the states.¹⁵

The gap between public and private sector benefits fuels the political debate, as taxpayers notice that they are contributing to government employee retirement benefits that are increasingly unavailable in the private sector. This disparity—and resulting pension envy among private sector employees—has generated a wide variety of political reactions, with some calling for a reduction in government

benefits and others decrying the declining benefits in the private sector and citing the public sector as an example of how long-term employees should be treated. "The larger issue of what working people are entitled to in our society needs to be considered too," wrote Jon Shure, president of the New Jersey Policy

Perspective in a commentary in the New Jersey section of the *New York Times* on November 26, 2006. "Is one group getting plush benefits at the expense of the other? Or, rather, is it government's responsibility to set an example for what the private sector should do as well?"

4. The number of retirees increases every year

The number of retirees will continue to grow as the baby boomer generation reaches retirement age—a massive demographic shift that will affect government on all levels and across sectors. The number of Americans over age 65 increased eleven-fold from 1900 to 1997. Steady increases have continued since then, but the growth in the elderly population will accelerate even more with the aging of the baby boom generation, with a projected increase of 80 percent between 2010 and 2030.¹⁶ By 2030, 71 million Americans—one of every five people—will be over 65, according to projections from the Social Security Administration.¹⁷

Meanwhile, the public sector will face an escalating number of retirements sooner than

the private sector because of the older average age of public employees. In Illinois, for example, the state comptroller reports that in fiscal year 2006, 65 percent of public employees were in their 40s and 50s—up from 41 percent in 1986.¹⁸

As the number of retirees multiplies, the enormous variation in states will become more pronounced. States with large unfunded actuarial liabilities either in health benefits or pensions will face increasingly large annual costs to provide benefits that were promised. California provides a telling example: The Center for Government Analysis reports the \$4 billion required to pay for California's annual state and local retiree health costs in 2006 will escalate to \$6 billion in 2009, almost \$10 billion in 2012 and \$27 billion by 2019.¹⁹

1-3

A PICTURE OF PRIVATE AND PUBLIC RETIREMENT BENEFITS

Compensation/Benefit	Private Sector Employees	Public Sector Employees
Defined benefit plan	20% ¹	90% ²
Median pension in 2005	\$7,692 ³	\$17,640 ⁴
Retiree health benefit of any kind	33% ⁵	82% ⁶

1 Data from the U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States", (March 2007) 7, <http://www.bls.gov/ncs/ebs/sp/ebsm0006.pdf>

2 Data from Employee Benefit Research Institute, "Fundamentals of Employee Benefit Programs, Part Five: Public Sector," 2005:16. <http://www.ebri.org/pdf/publications/books/fundamentals/Fnd05.Prt05.Chp40.pdf>

3 Data from Debra Whitman and Patrick Purcell, "Topics in Aging: Income and Poverty Among Older Americans in 2005," Congressional Research Service, September 21, 2006.

4 Ibid.

5 A little more than a fifth of large employers that offer retiree health pay no part of the premium, according to the Citizens Budget Commission in New York. New York's Citizen Budget Commission, "The Case for Redesigning Retirement Benefits for New York's Public Employees," April 29, 2005.

6 The 82 percent figure pertains to state and local governments that have more than 200 employees.

SOURCES: Defined benefit data from BLS/EBRI; median pension data from Congressional Research Service; and Retiree health data from Kaiser Family Foundation.

California's annual state and local retiree health costs of \$4 billion in 2006 will escalate to \$6 billion in 2009, almost \$10 billion in 2012 and \$27 billion by 2019.

5. People are living longer

Life expectancy has trended upward for the U.S. population, from 69.7 years in 1960 to a projected 79.2 years in 2015, according to the National Center for Health Statistics. Some of this change stems from a drop in infant mortality, but it also reflects improvements in health care for adults.¹¹

Given the financial pressures that result from increased longevity, the Social Security Administration is gradually shifting its retirement age upward, based on birth year. For people born before 1943, full Social Security benefits will kick in at age 65, but the retirement age will escalate. For example, a person born in 1967 or later will have to wait until age 67 to qualify for full Social Security. Some observers predict that when Social Security is next reformed, the retirement age will go up even further.

Many private sector companies that offer retirement benefits conform their retirement ages to those provided by the federal government. But for states and localities, the eligibility age for receiving full benefits has traditionally been much lower. A December 2005 study from Wisconsin's Legislative Services Council noted that only Minnesota had conformed to Social Security's practice of

increasing retirement age over time. Of 87 plans studied across the 50 states, 85 allowed retirement with full benefits at age 62 or earlier for individuals with long service, and 57 provided retirement at age 62 or lower with only 10 years or fewer of service. Only two plans stipulated that it was necessary to reach age 65 to receive full benefits.¹²

In addition, some public sector employees (for example, police and corrections officers) who are in hazardous jobs or in jobs that require heightened physical strength or agility are eligible for full retirement benefits at even earlier ages. Offering benefits at an early age greatly affects health care costs because Medicare coverage has not yet kicked in. For this reason, it is generally much more expensive for governments to provide retirement benefits for pre-Medicare retirees.

The Wisconsin report noted that at the end of 2005, states were still moving toward earlier retirement ages; nine plans had reduced normal retirement provisions since 2000 and 10 had reduced the minimum age or years of service required for early retirement. Since 2005, however, some states, presumably preparing for the significant demographic shifts on the horizon, have started to reverse course.¹³

Endnotes

- 1 United States Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections and Fiscal Outlook for Funding Future Costs*, report to the Committee on Finance, U.S. Senate (September 2007).
- 2 Total assets of retirement plan and their allocation are based on Federal Reserve Board, *Flow of Funds Accounts of the United States, Z1*, Release June 7, 2007.
- 3 A list of pension and retirement legislation for the 50 states for each of the last nine years is available at the National Conference of State Legislatures (NCSL) Web site at http://www.ncsl.org/programs/fiscal/all_pensun.htm.
- 4 Up through 2006, New York has used a method of accounting for its pension benefits that doesn't yield a funding ratio. The Governmental Accounting Standards Board (GASB) has implemented a new standard that requires governments that use this aggregate cost method to employ the more common entry age normal method to provide funding information. New York officials say their internal calculations, based on an entry age normal approach, indicate that in 2006, their pension funds were more than 100 percent funded.
- 5 Wisconsin's pension system is funded at 99.57 percent, and rounded up for the purposes of this study.
- 6 Forty-six states use a fiscal year that starts July 1 and runs through June 30. Fiscal year 2001 refers to the year that ended June 30, 2001.
- 7 See NCSL Web site, "Pension and Retirement Plan Enactments," http://www.ncsl.org/programs/fiscal/all_pensun.htm.
- 8 These standards are dubbed GASB 43 and GASB 45. GASB 43 addresses reporting on other post-employment benefit plan assets by a trustee or plan administrator, while GASB 45 addresses accounting and reporting of these benefits by the employers themselves—for example, the state governments. These benefits are dominated by retiree health care, but also may include life insurance, dental, disability or other non-pension benefits.
- 9 These standards have sparked considerable controversy and a small rebellion in Texas, where Governor Rick Perry signed a bill in spring 2007 that gives the state and local governments the option of accounting for OPEB using standards developed by its own comptroller in place of the GASB standards. The argument against GASB's approach, first articulated in Travis County, was that Texas governments offered retiree benefits on a year-to-year basis, that these benefits were entirely dependent on the current budget situation and that there was no implied promise of future benefits, according to Paul Maco, a partner with the law firm Vinson and Elkins, which was involved in the initial Travis County study of this issue.
- 10 Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2005," *Employee Benefit Research Institute Issue Brief*, no. 299 (November 2006): 8-9.
- 11 Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2005*, no. 10 (Summer 2006): 60, <http://www.pbgc.gov/docs/2005databook.pdf>.
- 12 Jack VanDerhei, "Retirement Income Adequacy After PPA and FAS 158: Part One, Plan Sponsors Reactions," *Employee Benefit Research Institute Issue Brief*, no. 307 (July 2007).
- 13 Ibid.
- 14 Henry J. Kaiser Family Foundation and Hewitt, *Retiree Health Benefits Examined: Findings from the Kaiser/Hewitt 2006 Survey on Retiree Health Benefits*, by Amy Atchison et al., (December 2006).
- 15 Citizens Budget Commission, *Old Assumptions, New Realities: The Truth about Wages and Retirement Benefits for Government Employees*, (2006).
- 16 Population Resource Center, *The Demographics of Aging in America*, (2004), <http://www.prcdc.org/summaries/aging/aging.html>.
- 17 Population Reference Bureau, *The Future of Social Security*, by Christine Himes, (June 2005), <http://www.prb.org/Articles/2005/TheFutureofSocialSecurity.aspx>.
- 18 Illinois Comptroller's Office, *State Government Workforce Getting Older, Fiscal Focus* (January-February 2007) 4.
- 19 California HealthCare Foundation, *Snapshot: Benefits in the Balance: The Uncertain Future of Public Retiree Health Coverage*, (2006): 6.
- 20 Centers for Disease Control and Prevention and National Center for Health Statistics, *Health, United States, 2006*, (2006): 176.
- 21 Wisconsin Legislative Council, *2004 Comparative Study of Major Public Employee Retirement Systems*, by William Ford, senior staff attorney (December 2005).
- 22 William Ford, senior staff attorney for the Wisconsin Legislative Council, is currently working on the 2007 version of the Wisconsin report. In collecting the 2006 data, he said he is seeing "markedly fewer states that are reducing their normal retirement date requirements or early retirement ages."
- 23 (See page 16 of this report.) National Association of State Retirement Administrators, *Public Fund Survey Summary of Findings for FY 2006*, prepared by Keith Bramard, research director (October 2007) 1.

Glossary

ACTUARIAL ACCRUED LIABILITY (AAL) – The total value of pension benefits owed to current and retired employees or dependents based on past years of service.

AMORTIZATION PERIOD – The span of time set to fully pay for actuarial accrued liabilities. To adhere to generally accepted accounting principles (GAAP), governments must use a period of 30 years or less to calculate their net pension or other post-employment benefits obligation and their expense on an annual basis. Some states, which are not in compliance with GAAP, choose longer periods for funding purposes to reduce current contributions.

ANNUAL REQUIRED CONTRIBUTION or ACTUARIALLY REQUIRED CONTRIBUTION (ARC) – The amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period. (This calculation assumes the employer will continue contributing the ARC on a consistent basis.) The ARC is made up of “normal cost” (sometimes referred to as “service cost”)—the cost of benefits earned by employees in the current year—and an additional amount that will enable the government to reduce unfunded past service costs to zero by the end of the amortization period.

ASSETS – The amount of money that a pension fund has on hand to fund benefits. The assets (also known as plan assets) build up over time, generally from three sources: employee contributions, employer contributions and investment returns. Plan assets generally are expended to pay pension benefits when due, refund contributions of members who leave

the plan before qualifying for benefits and cover the plan’s administrative expenses.

ASSUMPTIONS – Estimates made by actuaries about the future behavior of various economic and demographic factors that will impact the amount of pension benefits owed over time. These estimates, of factors such as investment returns, inflation rates and retiree life spans, are used by actuaries to calculate the AAL and the ARC.

DEFINED BENEFIT PLAN – A plan that promises its recipients a set level of benefits, generally for life. In the case of pension benefits, it is based on a “defining” formula that usually includes the number of years served and an employee’s salary multiplied by a preset figure (e.g., 30 years x \$40,000 x 1.75). In the case of retiree health, the promised benefit is typically the payment of a portion of (or the entire) medical insurance premium. However, it can also be based on a defined formula much like a pension. In this case, a certain monthly income is promised that must be used for health expenses.

DEFINED CONTRIBUTION PLAN – A plan to which the employer, and often the employee, contributes a defined amount (e.g., 8 percent of salary) to an individual account in the employee’s name while the employee is in active service, but which does not guarantee any set benefit. The amount available for retirement is based solely on the amount of money that has been saved, along with investment income credited to the employee’s account. When these funds are used up by the retiree, the benefit is exhausted.

NORMAL COST – The cost of benefits earned by employees in any given year.

OTHER POST-EMPLOYMENT BENEFITS (OPEB) – Benefits other than pension benefits that an employer provides to former employees as a deferred form of compensation for their services. OPEB is defined by GASB as including (1) post-employment health care benefits and (2) other types of post-employment benefits—for example, life insurance—if provided separately from a pension plan.

PAY-AS-YOU-GO – A method of financing pension benefits or OPEB in which the amount contributed by the employers or employees each year is approximately the amount needed to pay the benefits currently due and payable to retirees (or the premiums currently due and payable to provide for health care coverage or other non-pension benefits for retirees for the current period). Under this method, the source of financing for current benefits often is the employer's current collections.

SMOOTHING – To counter the natural volatility of the stock market, the vast majority of states do not measure the funded status of pension benefits using the current market values of plan assets. Instead, most use methods of determining the actuarial value of plan assets that average out the effects of increases or decreases in market values each year over several years (generally four or five). The effect of this approach is to mute the immediate impact during a severe market drop or spike in growth and to spread it out over time.

UNFUNDED ACTUARIAL ACCRUED LIABILITY (UAAL) – The difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.



The Basics of Funding

The following principles apply to both pensions and post-employment health care benefits, based on a general consensus of experts in the field:

- The long-term costs of retiree benefits are based on a passel of variables, the future values of which are unknown. Actuaries try to pin down these variables through the use of best or at least reasonable "assumptions" and a professional methodology developed to manage multiple uncertainties. If all the actuaries' projections were correct over time, governments funded benefits earned by employees every year and no new benefits were added, then pensions and retiree health benefits would be fully funded by the end of the amortization period.
 - When a state has an unfunded actuarial liability, it is often because over time those "ifs" did not happen. To pay for the unfunded liability, governments add another chunk of money to their annual contribution to spread the unpaid costs over the amortization period, which is usually 30 years. Generally, when funding ratios decline, employer contributions need to increase.
 - Overly optimistic assumptions, benefit increases and underfunded contributions all put greater demands on future government payments.
 - Inaccurate assumptions also can result in a situation where funding levels rise unexpectedly. This occurred in the late 1990s when most investments earned higher than anticipated returns, which prompted some governments to skip the ARC payment during a so-called funding holiday.
- However, as the recession in the early half of this decade demonstrated, bad years often follow good ones and the contribution holidays aggravated the impact of market losses.
- In a mature pension plan that is reasonably well funded, most of the total additions to plan assets each year will come from investment returns of assets that have been set aside over decades. In a poorly funded plan (pensions or OPEB), more future money comes from direct state contributions and from the same state coffers that fund education, economic development and health care.
 - A poorly funded plan or one that is moving in the wrong direction may also eventually cause trouble for an organization's credit rating. This could increase the cost of borrowing money, which will make it more expensive for governments to pay for infrastructure improvements such as bridges and roads that typically are supported through borrowing.
 - Although states aspire to having fully funded pensions, it is important to recognize that "underfunding is a matter of degree," said Keith Brainard, research director for the National Association of State Retirement Administrators (NASRA).¹¹ The important point is not whether states have reached 98 percent or 101 percent funding; it is the direction in which they are heading and the distance they have to travel to get there.

Methodology

This report is the product of an extensive data collection effort, a review of the literature, a thorough analysis of actuarial studies and evaluations, and interviews with experts and individuals knowledgeable about particular states.

To analyze states' pension systems, PCS examined state annual reports with information over a 10-year time period. Data in the pension section of this report were obtained from State Comprehensive Annual Financial Reports (CAFRs) as well as CAFRs from state pension systems. The numbers aggregate multiple plans in the state pension system and include, in many instances, municipal workers and teachers. PCS did not attempt to disaggregate municipal workers because this could not be accomplished for every state.

To analyze states' other post-employment benefits, PCS reviewed CAFRs and the preliminary actuarial assessments of state non-pension liabilities over the next 30 years. In this case, PCS focused the analysis on state employees alone, in order to achieve a more consistent comparison, because states vary

greatly in whether non-pension retiree benefits for teachers are funded at the state or local level. Armed with those preliminary assessments, gathered from a variety of government offices at the state level, PCS assembled a comprehensive and up-to-date compilation of these liabilities, the amounts the states are currently paying for retirement benefits and their funding practices. PCS collected actuarial valuations in spring and summer 2007, continuing through the fall to pursue valuations from states that had not been completed previously. One caveat: Many of these calculations are preliminary and are likely to change as health plans are altered and actuaries re-examine the subject. A handful of states had not finished actuarial valuations by the completion of this report. Where feasible this research was augmented with interviews with actuaries, economists, state controllers, auditors, legislative analysts and other experts in the field.

The expert statements included in this report come directly from interviews conducted by PCS between September 2006 and October 2007, unless otherwise noted. A complete list of resources can be found on PCS's Web site at www.pewcenteronthestates.org.



Figures are in thousands.

State	Actuarial liability	Unfunded liability	Annual required contribution	Actual payments in 2006	State	Actuarial liability	Unfunded liability	Annual required contribution	Actual payments in 2006
Alabama ¹	\$33,961,978	\$5,522,322	\$684,861	\$684,861	Montana	\$8,584,710	\$1,675,759	\$157,078	\$239,822
Alaska	13,090,657	3,369,759	423,666	259,496	Nebraska	7,395,639	832,277	210,977	210,977
Arizona	34,353,623	5,274,143	640,199	640,199	Nevada	25,794,627	6,482,437	1,058,892	1,015,757
Arkansas	19,114,260	3,409,290	463,786	500,475	New Hampshire	6,402,875	2,474,605	170,578	170,578
California ¹	355,483,412	46,673,644	6,342,208	6,265,138	New Jersey	109,610,983	23,141,602	2,180,913	591,342
Colorado	49,490,604	12,803,562	978,924	609,853	New Mexico	72,544,980	4,076,390	484,506	439,274
Connecticut	34,190,000	14,914,600	1,031,000	1,031,000	New York ²	140,150,000	0	2,782,147	2,782,147
Delaware	6,416,275	207,635	122,914	118,950	North Carolina	61,827,530	2,954,470	516,570	516,689
Florida	110,977,831	-6,181,784	2,193,928	2,106,171	North Dakota	3,473,500	681,600	81,586	54,089
Georgia	65,994,177	2,501,741	1,117,742	1,117,742	Ohio	139,251,460	26,200,600	2,604,033	2,433,921
Hawaii	14,661,399	5,132,028	423,446	423,446	Okahoma	27,839,660	11,468,080	1,053,336	763,719
Idaho	9,951,100	525,200	244,600	262,800	Oregon	51,254,000	5,362,000	488,500	492,408
Illinois	103,073,463	40,732,132	3,085,601	1,025,341	Pennsylvania	91,494,400	12,223,300	1,877,118	652,231
Indiana	28,953,950	10,565,887	947,890	955,620	Rhode Island¹	9,822,437	4,329,104	193,394	193,394
Iowa	21,651,122	2,507,086	387,542	324,677	South Carolina¹	33,712,394	9,134,923	689,400	690,374
Kansas	17,552,000	5,364,000	471,424	298,883	South Dakota ¹	5,903,592	197,808	81,620	81,620
Kentucky	30,659,476	9,303,806	564,361	483,740	Tennessee	28,117,127	366,114	665,879	665,879
Louisiana	33,358,313	10,978,703	1,066,311	1,075,547	Texas	132,087,713	15,140,379	2,315,721	1,944,441
Maine	12,357,418	2,826,820	294,888	312,017	Utah	18,783,454	689,963	535,152	535,152
Maryland	41,537,681	7,614,087	874,079	716,745	Vermont	3,195,421	256,358	102,681	78,358
Massachusetts	50,431,974	14,055,201	1,320,178	1,242,751	Virginia ¹	51,683,000	9,934,000	988,662	857,660
Michigan	63,268,090	12,155,000	1,564,557	1,297,741	Washington¹	29,074,500	5,984,300	1,421,200	396,100
Minnesota	30,787,259	2,111,112	284,372	280,874	West Virginia	11,774,772	5,330,649	484,234	879,888
Mississippi	25,680,550	6,865,090	537,721	537,580	Wisconsin	73,735,800	320,500	569,000	569,000
Missouri	43,856,576	8,426,945	1,048,125	852,530	Wyoming	6,215,540	316,168	78,257	117,074

1 2005 data were used to report on the state's liability and unfunded liability, as 2006 data were not available from the state.

2 See p. 4, page 13

3 2005 data were used to report on the state's liability and unfunded liability, as 2006 data were not available from the state. Rhode Island did not have financial reporting on its specific pension plans after 2004 at the time of this report.

4 South Dakota has two plans, 2006 data were only available for its major retirement plan and 2005 figures for its smaller plan were used in the total calculation.

NOTE: States in bold represent pension systems below 80 percent funded.

Actuarial liability is the total value of pension benefits owed to current and retired employees or dependents based on past years of service.

Annual required contribution is the amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period, which is typically 30 years or less.

SOURCE: Pew Center on the States

Saving for the Bill Coming Due

FOR THE SAKE OF SIMPLICITY, it may be tempting for the press and policy makers to paint a one-size-fits-all portrait of state pensions. But each state has its own complicated story to tell. From 2000 to 2006, for example, New Hampshire's pension funds took a tumble, while North Carolina's funding status was nearly unchanged. Kansas¹ set aside only about two-thirds of its annual required pension contribution in 2006, while neighboring Nebraska set aside the full amount.² About half the states have troubling unfunded liabilities in some of their pension plans and the other half do not, at least at the moment.

Overall, the national pension "balance sheet" is in relatively decent shape,³ with 30 state pension systems more than 80 percent funded (Exhibit 2-1). Almost half of those are over 90 percent funded, according to PCS research. However, the remaining 20 states have funding ratios of less than 80 percent, meaning that their proportion of assets to liabilities may create fiscal stress if unaddressed, according to many experts in the field (see Exhibit 2-1—the 20 states are in bold).

All told, states have contributed enough money—about \$1.99 trillion—to cover roughly 85 percent of their \$2.35 trillion⁴ long-term

liability for their retirees' pensions over the next 30 years. Still, that leaves them with about \$361 billion in unfunded liabilities.

Large underfunded long-term liabilities put future budgets—and taxpayers—at risk. For years, West Virginia has had difficulty putting sufficient money into education or health care because of its need to cover huge pension liabilities the state accrued decades ago, according to Governor Joe Manchin III.²⁴ And while West Virginia has been aggressive and responsible in overfunding its annual pension contribution over the past decade—the state's system is now 55 percent funded, compared with a 39 percent funding level in 2003—the funding mistakes of the past make catching up extremely difficult (see Appendix Exhibits A-1 and A-2).

*20 states
have funding
ratios of
less than
80 percent*

States can delay action to deal with an underfunded pension, but only temporarily. The share of the population aged 65 or older will grow to 20 percent in 2030, according to the U.S. Census Bureau. In 1950, the number of workers relative to retirees was 16.5 to 1, today the ratio is 3.3 to 1, and it will move down to 2 to 1 during the next 40 years, according to Census estimates.¹ When a pension system is fully funded, the ratio of workers to retirees matters little, because the money for retirees is already in

the bank.³⁹ But when a plan is underfunded, making the payouts can become extremely burdensome for states.

PCS's research highlights two important rules for states to follow if they are to address their long-term pension obligations cost-effectively. Agreement on these points is nearly universal, and they have been voiced by experts ranging from researchers at rating agencies such as Standard & Poor's and academic institutions such as the University of Pennsylvania, the University of Michigan and Harvard University to retirement administrators in a number of states. Following these sound financial principles allows states to evenly spread out the costs of long-term benefits over time, rather than have low costs now and a substantial—and potentially budget-breaking—cost spike later.⁴¹

FULL FUNDING. First, it is critical for a state to diligently meet its own yearly goal for funding its long-term pension liability (known in actuarial terms as the actuarial required contribution, or ARC) and to base that goal on accurate assumptions.

Florida's legislature is displaying a high degree of fiscal caution that has presumably helped the state achieve the fully funded status it has held since 1998. The state passed legislation that basically reserved a portion of the pension surplus to serve as a safeguard against unexpected increases in liabilities, providing the state with extra financial security.⁴² North Carolina has also had consistently high levels of funding, even when the stock market dropped or the state was under fiscal stress. The state has been disciplined about paying its annual bill and maintaining the financial health of its pension system. Illinois and New Jersey are examples of poor financial decision-making as both states have actively reduced

contributions to their plans over the past 10 years, leading to chronic underfunding.

AFFORDABILITY OF NEW BENEFITS. Second, a state must make sure it can afford new promises, as once a benefit increase is made it is extremely difficult to take back. This means the state must carefully consider the long-term impact of benefit changes, including shifts in vesting periods, early retirement programs, cost-of-living adjustments, salary calculation methods, and a host of other factors that affect pension amounts and the states' own long-term fiscal health. States, in general, have become more careful about adding benefits in the last few years and several have enacted legislation that establishes safeguards against benefit increases enacted in haste. A 2007 Hawaii law, for example, bars benefit enhancements between January 2, 2008 and January 2, 2011 if the plan has an unfunded accrued liability. A 2007 Missouri law prevents pension plans in the state from increasing benefits if they are less than 80 percent funded.⁴³

Finally, states can take additional steps to reduce their long-term pension obligations. Among other measures, they can close loopholes in pension systems that allow employees to inflate the amount they collect after retirement. They can consider creating hybrid plans that combine elements of defined contribution and defined benefit plans. And they can improve oversight and governance of their system so that decisions are well informed by up-to-date, accurate and reliable data, and to ensure the funds are well managed.

The detailed analysis that follows seeks to help state policy makers and the public answer these critical questions:

- What differences are there among the states in how they manage their pension plans?

- What are the fundamental reasons for these differences?
- What tools can troubled states bring to bear to prevent problems in the future, and what can they do to ameliorate the problems of today?



Pension Funding Levels: The State of Play

Generally, the money to pay for pensions comes from three sources: employees' contributions; employer contributions, and investment returns. Employee contributions, which are required in the vast majority of states, must be paid annually. But in many states, governments—the employers—are able to put off some of their own required payments. These payments include the cost of benefits earned by their employees in any given year, as well as contributions that will help make up for past underfunding and lead to full funding of the plan over the amortization period (typically 30 years). If the government's contribution falls short, the costs for services rendered in that year will be shifted to future taxpayers and the state also will forego the advantage of investment returns on those dollars.

Exhibit 2-1 shows how well, or how poorly, the 50 states are doing at funding their long-term pension obligations, and shows the great variation in the level of funding of states' pension plans. These aggregate figures, which include all pension plans that states listed in their latest comprehensive annual financial reports, give a snapshot of funding status as of June 30, 2006.

According to PCS research, the average funding level in 2006 was 82 percent, a drop from the high point in 2000 when the mean ratio of pension assets to pension liabilities was 97 percent.

Note that the 82 percent average is lower than the 84 percent average funding level reflected in the 2006 Public Fund Survey data compiled by the National Association of State Retirement Administrators. That survey includes the largest public retirement systems in the United States, focusing chiefly on systems for general employees, public school teachers and public safety personnel. PCS's report includes all pension funds covered in the state comprehensive annual financial reports. Teacher and state employee funds dominate in numbers, but the reports also include plans for elected officials and judicial, public safety, corrections and university employees, and, in some cases, municipal plans operated by the state.

What Drives Differences in Funding Levels?

Our analysis shows that states have considerable control in either moderating the bad times through effective planning or diminishing the good times through poor decision-making. The 1990s were a time of growth for pension plans as a healthy economy and a booming stock market enabled swift rises

in pension funding levels. In 2000, half of the states were fully funded. But in that year, dot.com problems were already having a negative impact. The 9/11 attack and continuing stock market drop in 2002 devastated the asset levels of many pension plans. Between 2000 and 2002, the average

A Word about Pension Funding Levels

The data in Exhibit 2-1 and Appendix Exhibits A-1 and A-2 are derived from the work of actuaries, who develop a variety of assumptions³⁴ tailored to the particular situation of individual states. Tiny variations in these assumptions cascade like numerical snowballs into dramatic differences between states. For example, New Hampshire calculated its actuarial accrued liability assuming it would receive a return of 9 percent on the funds it had invested—higher than any other state. If it used the same 7.5 percent assumption used by West Virginia, its unfunded liability would rise considerably.³⁵

An important caveat to these exhibits: A major difference among states is the way they smooth out the impact of market changes over time. Currently, only a handful of states, including Idaho, Illinois, Oregon and West Virginia, use a fair market value approach for valuing their largest funds. Because they are looking at the current value, these states respond more dramatically to year-to-year shifts, but their numbers do not retain the impact of bad or good years over time. Otherwise, smoothing periods generally range from four years (for example, in Colorado, Louisiana and Ohio) to as many as 15 years in California. Not surprisingly, states with shorter smoothing periods will currently appear to have better funding levels than those with longer periods, because the down years in the early part of the decade are no longer reflected in their averages. Funding in Louisiana and Colorado has been on an upward trend since 2005, and Ohio started to show upward motion in 2006.

In addition, a few states use the “aggregate cost method” of accounting, which does not provide an unfunded liability amount. Washington and New Hampshire supplied notes in their annual reports that allowed researchers to derive this ratio. New York did not supply notes, but provided its internal calculations to PCS. A new standard from the Governmental Accounting Standards Board, GASB 50, stipulates that states provide unfunded liability calculations by using one of the five permissible actuarial cost methods other than aggregate cost.

A final concept to mention is the treatment of summary statistics. In calculating average funding rates for states in this report, we have simply taken all the state funding levels and taken the mean. However, one can also look at national funding levels by adding up the assets of all 50 states and dividing them by the liabilities of all 50 states. That number also reflects an aggregate picture of pension funding levels. Using this method generates substantially higher aggregate funding levels than simply averaging state funding levels, because the larger states have better funded pension plans than the smaller states.

pension funding level dropped from 97 percent to 89 percent, resulting in an increase of unfunded liabilities of \$166 billion. Furthermore, due to smoothing, many states were still feeling the effect of those bleak years up through 2006.

In general, states that are poorly funded have done a combination of three things over time: failed to annually pay their own actuarially required contribution; increased benefits, or made overly optimistic actuarial predictions. States with large underfunded pension plans will be forced to eventually meet those obligations, which will require increases in taxes or reductions in other spending. Thus, the states with unfunded liabilities are the ones that will face increased financial stress in the future to pay for obligations incurred in the past.

Over the long term, states control whether their pension plans will be appropriately funded. But decision-makers may have to grapple with tough choices that stem from previous policy decisions. In general, this is not necessarily an issue of pensions being too generous. States offer pensions and other benefits in part to attract and retain skilled workers despite the lower salaries offered in the public sector.³⁶ The important consideration is that when states, for whatever reason, decide to incur an expense like employee benefits, they also should have a plan for how to pay for that expense. This is what some states have failed to do.

States have considerable control in either moderating the bad times through effective planning or diminishing the good times through poor decision-making.

A Two-State Comparison

Comparing states is always a tricky business. The details of how pension benefits and costs are calculated vary tremendously. Averages can be misleading, and a huge number of factors, such as the underlying financial assumptions, have an impact on the costs of the system and the benefits received.

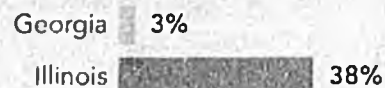
But putting aside the kinds of calculations that leave even experts scratching their heads, a very simple comparison of two states, Illinois and Georgia, is illustrative.³⁷ These two large states—ranked fifth and tenth in total population, respectively—have relatively similarly sized state employee plans but have taken very different approaches to funding

their pensions. As a result, in 2006 Georgia's pension fund was 96 percent funded, while the Illinois system was 60 percent funded.

Georgia's unfunded pension obligation, or UAAL, during the next 30 years is 30 percent of covered payroll, whereas the unfunded pension bill for the Illinois plan is 147 percent (Exhibit 2-2). The unfunded liability is 38 percent of 2006 total operating expenditures in Illinois and just 3 percent of total expenses in Georgia. The annual required contribution is 10 percent of payroll for both Illinois and Georgia; however, while Georgia was able to pay the contribution in full, Illinois paid only 33 percent of its required contribution in 2006.

While Georgia is fully funding its pension contributions, Illinois is failing to meet its obligations, leading to a big difference in the health of the two pension systems.

Unfunded pension obligations as a percentage of total state expenses



Unfunded pension obligations as a percentage of covered payroll*



NOTE: Covered payroll includes all employees participating in the state's pension plan.

SOURCE: Pew Center on the States

The problems with the Illinois pension system do not stem from unusual generosity to average employees. In fact, Illinois asks most employees to contribute 4 percent of their salary,¹⁸ while Georgia's employee contribution is 1.25 percent.¹⁹ The average pension in Illinois state government is on the low end compared with other states, according to an analysis by the Illinois Comptroller's office last winter. According to these figures, given a final salary of \$45,000 in each place and 30 years of service, the Georgia pension would pay out \$28,938 per year and the Illinois pension would be \$22,545 annually.²⁰

According to a 2007 study by the Illinois Center for Tax and Budget Accountability, "The data make it clear that the state's unfunded pension liability accrued to date was not caused by overly generous benefits, high head counts, excessive costs or even poor investment returns. Instead, the real culprit has been and continues to be the repeated failure of the state to make its full annual employer contribution to the system."²¹

Sound Principles and Promising Practices

Key to achieving a fully funded pension plan is a commitment to pay the actuarial required contributions (ARC) in full each year. The annual pension cost, which is calculated every year, is the amount of funding needed to pay for new liabilities accrued in that year as well

as to pay off a portion of the unfunded liabilities accrued in previous years. States that are able to pay the full ARC each year will experience a gradual reduction in unfunded liabilities until they are fully funded, provided that assumptions are accurate over the long

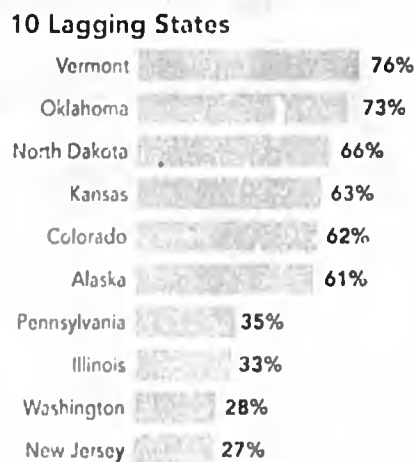
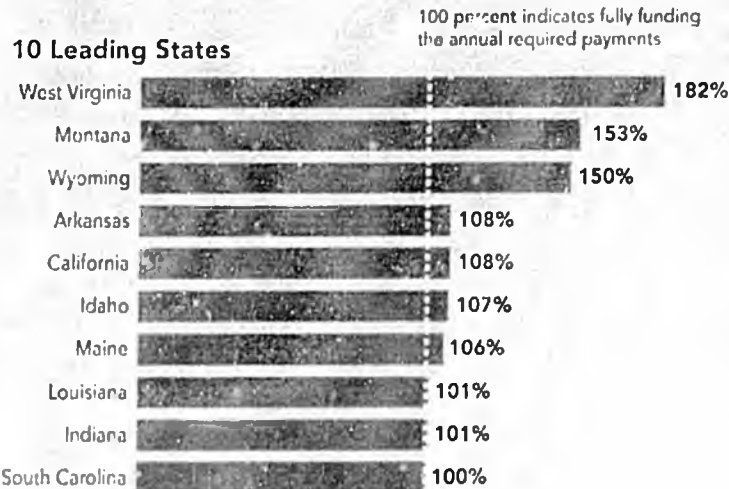
term and calculations take into account any additional benefits that have been granted.

Recently, the split between states meeting their funding requirements and those failing to do so is about 50-50. Exhibit 2-3 shows 10 leading states that have more than fully funded

their annual pension costs in 2006 and 10 states that failed to contribute what actuaries said they should. This annual pension cost is generated using one of the GASB-approved actuarial funding methods and is designed to distribute costs for worker benefits over the course of the workers' employment.

2-3

PAYING THE ANNUAL PENSION BILL, 2006 - 10 LEADING STATES, 10 LAGGING STATES



SOURCE: Pew Center on the States; Based on States' 2006 Comprehensive Annual Financial Report Data.

A single year of adequate funding, however, does not add up to a properly maintained pension plan.¹²

States such as Alabama, Arkansas and North Carolina, which fully fund each year, seem to have established an ethos that mandates this fiscally sensible practice. Others, such as Virginia, Kansas and Massachusetts, have more erratic records.

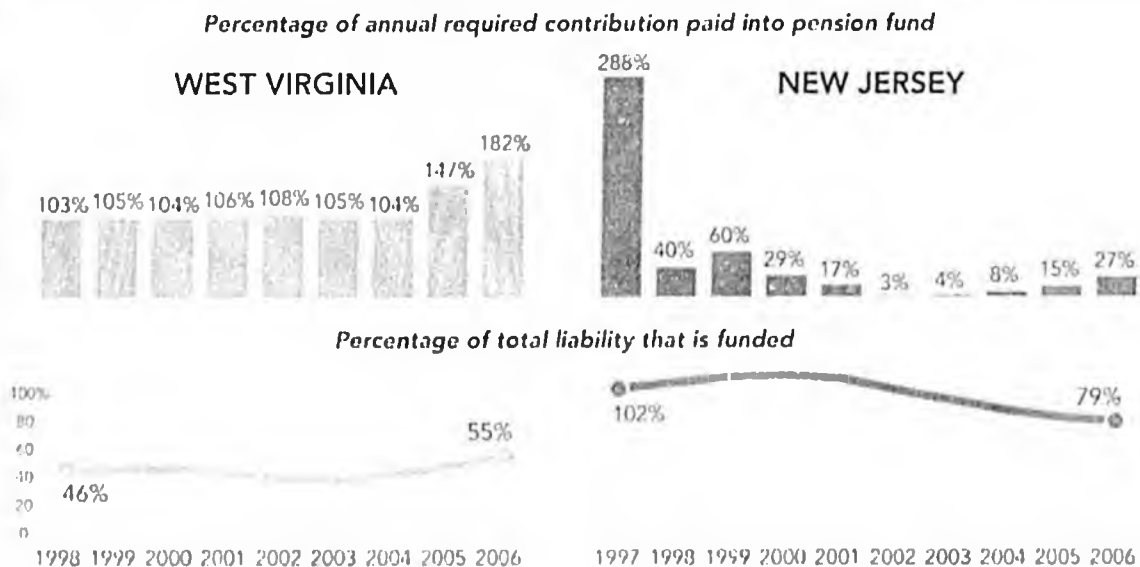
However, states that fund their required contributions at 100 percent each year—beginning as far back as 1997—could still have a dramatic unfunded liability today. Unfortunately, short-changing plans in decades past can have ripple effects many

years later. In addition, if actuarial assumptions missed the mark, even a 100 percent contribution may fail to move the state toward a fully funded position.

Nonetheless, a commitment to pay the ARC year after year is good practice, and it can substantially improve the position of even a poorly funded state like West Virginia. As Exhibit 2-4 demonstrates, West Virginia's performance in paying the annual pension cost over the past decade has improved vastly, and it is starting to pay dividends in addressing the state's unfunded liability. In a short time, from 2003 (its low point) to 2006, the state shrank its unfunded liability by 17 percent and \$1.1 billion.

2-4 PAYING THE BILL ... OR FALLING BEHIND

West Virginia's pension fund is improving thanks to diligence in making its required annual payments, while years of not paying enough has diminished New Jersey's pension system funding level.



NOTE: 1997 data unavailable for West Virginia.

SOURCE: Pew Center on the States; Based on States' Comprehensive Annual Financial Report Data

Other states, however, have proven unable or unwilling to raise the necessary funds to pay an actuarially sound amount into their pension fund. In New Jersey, for example, leaders skipped some required pension contributions that resulted in an \$8 billion shortfall between 1998 and 2003.¹³ The low point came in 2002 when the state contributed \$16 million out of the \$560 million actuarially recommended amount, resulting in only 3 percent of the ARC being put into the pension fund. New Jersey's funded ratio stands at 79 percent in 2006 after being fully funded only four years before. New Jersey is an extreme example but, as Exhibit 2-4 shows, it is highly illustrative of how critical consistent contributions can be to a state's pension system.

Decisions to skimp on annual contributions have taken a dramatic toll on pension funding levels in other states as well. A few examples:

- **ILLINOIS.** The decision to cut pension contributions sharply in 1982 and 1983, followed by only moderate increases through 1995, are cited by the Illinois Comptroller as the root of the state's pension problems.¹⁴ Although the state recently passed several long-term reforms to its pension system, the pattern of underfunding actuarially required contributions has not abated. The state used \$2 billion from a 2003 pension bond offering to make payments in fiscal years 2003 and 2004 and cut pension payments by \$2.3 billion in fiscal years 2006 and 2007, according to the Civic Federation of Chicago. The rationale was that savings to the pension system from the bond sale and funding reforms adopted by the legislature made those payment cuts possible, but longtime

observers of the state's troubled pension system were dismayed. "These partial pension holidays are short-sighted and ill-considered," said Civic Federation Vice President Lise Valentine. "You have to examine the pension holidays in the context of the overall budget, where we see expansions of other state programs and discretionary spending at the same time that pension contributions are cut. This demonstrates an unwillingness to fully fund the pension obligations and to pay for the true cost of employee benefits."

- **HAWAII.** Hawaii's budget director told Pew's Government Performance Project in 2000 that the state, facing enormous budget pressures, had failed to make pension contributions of \$44.1 million in 1999 and \$155.8 million in 2000. Data from the state's comprehensive annual financial reports show that pension contributions stood at about 83 percent of what actuaries required in 1999. In 2000, actual contributions met only 13 percent of the required amount. The following year, the state held back even further, contributing only about 5 percent. Since that time, Hawaii has solidly funded its pensions. But the three-year hiatus from full funding, coupled with investment losses, took a severe toll on the funding status of the

"These partial pension holidays are short-sighted and ill-considered."

— Civic Federation Vice President Lise Valentine

state employee plan, which dropped from its high of about 94 percent funded in 2000 to 65 percent funded at the close of 2006.

- **KENTUCKY.** Kentucky also had one of the most dramatic descents in funding levels, from about 111 percent funded in 2000 to about 70 percent funded in 2006. Employer contribution rates for both the Kentucky

Employees Retirement System and the State Police Retirement System have fallen short in nine of the past 15 years. According to the Legislative Research Commission, the pattern of reduced contributions continued for the past six straight years, including fiscal year 2007, resulting in "more than \$744 million in lost contributions and investment opportunities."⁴⁵

Additional Strategies for Ensuring Sound Pension Plans

Fully funding pension contributions each year requires a great deal of political fortitude and the kind of long-term thinking that is hard to come by, particularly in difficult economic times.

The good news is that there are additional measures states can take to have an impact on their long-term pension liabilities. These measures include:

PLUGGING THE LEAKS: Auditor reports are full of examples of loopholes within pension systems that allow individuals to inflate the amounts they collect after retirement. But states can close the loopholes and stem possible abuses.

EVALUATING THE FISCAL IMPACT OF BENEFIT CHANGES: Even tiny changes in benefits can result in very large long-term liabilities. Some states have started to require that a careful actuarial assessment of long-term costs accompany any proposed pension benefit increase.

CONSIDERING HYBRID PLANS: Despite legislative initiatives in some states to convert state pension plans to defined contribution systems (in which recipients are promised only

that a set amount of cash will be put aside for them each year), the defined benefit plan format (in which recipients are promised a specified package upon retirement) remains the dominant and most popular form. Most professionals expect that defined benefit plans will remain the core retirement benefit for many years to come, in most states. But some states have begun experimenting with hybrid plans, which are a mix of defined benefit and contribution plans.

REQUIRING FASTER, MORE ACCURATE FINANCIAL REPORTING: Pension systems are extremely complex and difficult to compare due to the wide variety of choices that actuaries make when determining asset value, calculating actuarial liability, and setting funding and recommended contribution levels. Faster, clearer financial reporting among plans could improve the accuracy of actuarial projections and would provide policy makers and other state officials with the most current data to inform their decisions.

IMPROVING PENSION OVERSIGHT: Although the states have resisted suggestions that the federal government step in to provide more accountability for state and local pension

plans, many are starting to improve governance practices and provide greater oversight of their own plans. Commissions that pay attention to pension funding levels, benefits and practices can promote sustained, consistent attention on an issue that tends to float in and out of public awareness with changes in the economy.



Plugging the Leaks

States can pull back on the amount of money that goes out in pension benefits without attacking the general principles of a defined benefit plan or the pension benefits on which the average employee relies. Here are a handful of issues to target, drawn from a PCS review of recent reports from auditors, legislative task forces, independent government watchdog groups, universities, pension systems and special commissions in the 50 states. The examples are representative of problems that have surfaced in multiple states.

FINAL-SALARY INFLATION. In general, the way pension benefits are calculated requires that "final salary" be multiplied by a preset formula based on the number of years employed. In several states and local governments, this practice has resulted in employees hiking up their salaries during the last years of their employment by any method allowed.

This is a particular problem in states such as Kentucky, where overtime pay is allowed to be included in the calculation,¹⁶ and in New Hampshire, where accrued sick leave and vacation time can be used to increase final income.¹⁷

The fewer the number of years used to determine final salary, the greater the possibility that the figure can be manipulated. For this reason, several states have moved—or are trying to move—from a three-year average to a five-year average. Kansas and North Dakota passed legislation to change to five-year averaging in 2007,¹⁸ and a change in Kentucky is scheduled to go into effect in 2009.¹⁹ New Hampshire considered some reforms to its system in 2007, including changing from a three-year to a five-year average and preventing the use of accrued sick leave and vacation time in salary calculations, but the reforms did not pass.²⁰

A related problem occurs when employees change jobs in the last years of their career so that the pension determination is based on a salary that is far from typical of their career. For example, in Iowa, former legislators often move into executive branch positions with salaries that pay two to three times the amount they received as a part-time legislator. "This is a bipartisan ploy that has played out regardless of the party in control of the executive branch for at least the last 20 years," said Randy Bauer, former Iowa budget director.

INFLATING YEARS OF SERVICE. Since the number of years worked is generally part of the formula for determining a pension, another

ploy for increasing the payout is to bulk up the number of years counted toward retirement. Until 2007, New Jersey made this easy for employees and elected and appointed officials by allowing pension credit for any year in which a minimum of \$1,500 was earned.⁵¹ This allowed people to relatively easily add extra years of service to their pension calculation. In 2006, the New Jersey legislature considered but did not pass a change in the law to increase the threshold to \$5,000.⁵² In May 2007, Governor Jon Corzine signed a law that abolished the practice for elected and

add years of service spent in a volunteer job—for example, serving as an unpaid town alderman—to add to his pension benefits. Because volunteer jobs do not pay a salary, the state has set a proxy rate of \$2,500 as a base for employee contributions. In these cases, the employee would need to contribute 7 percent of \$2,500—\$175—for each year of service added. According to a study by Ken Ardon at the Pioneer Institute for Public Policy Research, that payment is a pretty good deal, because it buys about \$1,000 in additional lifetime pension benefits for each year purchased.⁵⁶



appointed officials.⁵³ This was one of 41 recommendations by the Joint Legislative Committee on Public Employees Benefits Reform.⁵⁴ Prior to this change, individuals had remained active in the state's pension system by earning minimal amounts, sometimes at "no show" jobs.⁵⁵

Sometimes states allow workers to count time served in jobs outside of state government toward the determination of their pension, contributing a percentage of salary as they would on a state job. As long as the rate of payment is appropriate, this may cause little difficulty. But sometimes it's not. In Massachusetts, for example, an employee can

EARLY RETIREMENT PROGRAMS. Often, early retirement programs allow individuals to retire before the normal retirement age by buying service credits for additional "years." So, for example, if the government has a rule of 80—meaning that a person's age and years of service must add up to that number to qualify for full retirement benefits—a prospective retiree who is 55 and has worked 20 years could buy

five additional years to qualify for full benefits immediately.

This practice can work fine if the price of the additional years of service is calculated with careful attention to actuarial needs. But often, in the zeal to cut the workforce through an early retirement program, the details are not well thought out.

That is what happened in the late 1990s and the early 2000s in Colorado. According to information provided to Pew's Government Performance Project (GPP), practices in the late 1990s allowed employees to buy five to 20 years of service at "fire sale prices."⁵⁷ Although

the program certainly cut the workforce, it added significant costs to the pension system and contributed to the dramatic drop in funding levels from about 105 percent funding in 2000 to about 73 percent funding at the end of fiscal year 2005. "It was not an actuarially sound price," one Colorado finance official told the GPP in 2005. "People got a bargain, and everyone knew they were getting a bargain and that's why everyone was flocking over there to purchase extra years."

States have embarked on far fewer early retirement programs recently, compared with the early part of the decade, according to the Public Fund Survey, *Summary of Findings for FY2006*. As longevity increases and the gap between public and private retirement ages widens, they are looking for ways to add years to the normal retirement age as well. Often changes are targeted just at new employees to avoid legal challenges that may result from shifting the rules on current workers. In Colorado, a rule of 80 was changed to a rule of 85 for anyone joining the workforce after January 1, 2007. In North Dakota, a similar change moved the teachers' plan from a rule of 85 to a rule of 90.⁵⁸ In California, an initiative that was filed this year to control pension costs would require the state to conform to the U.S. Social Security age for new civilian employees and age 55 for law enforcement.⁵⁹

ELIGIBILITY FOR ENHANCED RETIREMENT BENEFITS. Some jobs have physical requirements that make it sensible to offer retirement at a younger age. State police and corrections workers often qualify for enhanced benefits due to the difficulty and danger of their jobs. The problem in many states is that over time there tends to be an expansion in the number of people covered in these special plans. In California, for example, a third of the

workforce receives public safety pensions compared with one in 20 in the 1960s, according to a Deloitte Research Study published in 2006.⁶⁰

In Illinois, Governor Rod Blagojevich told *Business Week* that one in three state employees receive "hazard rate" pension benefits that were originally intended for state police.⁶¹ It is a matter of states' own public policy to determine which jobs should qualify for these enhanced benefits. The important thing is for policy makers to recognize the financial costs associated with these expansions. In Massachusetts, a blue ribbon panel on the state's public employees' pension classification systems noted that the pension benefits available for "hazardous" jobs had been extended to district attorneys and supervisors at MassPort, a public authority that manages transportation infrastructure in the state.⁶²

In its two-year session that concluded in 2006, the Pennsylvania legislature gave "enforcement officer" status to game commission officers, which would have allowed retirement at age 50 instead of 60. This was one of 130 retirement-related bills introduced during this period, many asking for benefit expansions. Governor Edward Rendell vetoed the bill.⁶³

POWER WITHOUT ACCOUNTABILITY. When there is a disconnect between those who have the power to increase pension benefits and those who have the responsibility of funding those increases, fiscal responsibility can get lost. Illinois, for example, took note of this problem in 2006 when its legislature capped end-of-career salary hikes at 6 percent for teachers, school administrators and university personnel. Prior to this, there was a fear that school districts and universities "may have been inflating payments to employees in their last



years of employment," because the pension costs were carried by the state budget and not their own budgets, according to the Illinois Comptroller.⁶¹

The new law requires school districts that grant raises of more than 6 percent to fund pension benefit costs associated with those raises. The law also requires employers who grant sick leave "in excess of the member's normal annual sick leave allotment" to fund related pension benefit increases.⁶⁵

Evaluating the Fiscal Impact of Benefit Changes

It is far easier to increase benefits than to take them away. That is why legislatures need to carefully consider the long-term impact of any proposed increases. But when state coffers are full and the benefits appear to have little immediate cost to the state, increases can be

difficult to resist. In addition, in states where salaries and benefits are the subject of labor negotiations, retirement benefits, which make workers happy but require fewer current dollars, are offered in place of bigger salary increases.

Although states generally require that fiscal impact statements accompany legislation that is expected to have a financial effect, this is not always done rigorously and benefit increases can sneak through without adequate attention. "Municipal governments and pension fund managers have long complained that legislative pension proposals often feature inadequate or even inaccurate forecasts," according to E.J. McMahon, senior fellow at the Center for Civic Innovation at the Manhattan Institute. In a fiscal memo, he cites a number of examples of benefit increases in New York that have been justified in the legislature based on severely outdated information. For example, a reduction in the

Remember: Promises Come With a Price

Good times may be the most hazardous for pension plans. This is a particularly important point, because many pension plans are likely to show an increase in funding levels in 2007. State investment returns have been very good in the past few years and the majority of states use five-year smoothing periods, which will no longer factor in the bleak investment returns of 2002.

Some pension observers worry that the upturn in funding levels may lead legislators to focus only on the most recent figures and ignore the inevitable pendulum swings of any stock market-related investments. "Good times are dangerous if you raise benefits, because you're adding another commitment that will increase the burden when interest rates fall and your liabilities surge," said Alicia Munnell, director of the Center for Retirement Research at Boston College.⁶⁸

This is particularly true because a pension benefit, once given, is very difficult to take away. The majority of states have some form of constitutional protection for their pensions, according to a September 2007 report by the U.S. Government Accountability Office (GAO).⁶⁹ And although state interpretations of constitutions may vary, courts generally have held that pensions belong to employees and benefits cannot be withdrawn or altered in a way that is detrimental or contrary to past agreements.

number of years—from 30 to 25—required to receive benefits passed the legislature in 2005. But the “justification” section of the support memo provided outdated stock market data from the year 2000.⁶⁶

To help ensure that adequate attention is given to long-term consequences of decisions about pension benefits, Oklahoma passed the Actuarial Analysis Act in 2006. Modeled on a similar law in Georgia, the act requires that specific review and oversight actions accompany any legislation that could have a long-term impact on the retirement system. For example, bills with a fiscal impact can only be introduced in the first year of a two-year session and can only be approved in the second year—to make sure that there is no rush to action. If a bill will have an impact on costs, it has to be accompanied by an increase in employer contributions or another appropriation to fully fund the benefits.⁶⁷

Georgia’s legislation has been in effect about eight years. It requires the legislature’s retirement committee to send for an actuarial study whenever any change to the benefit structure is suggested. Here, too, the requirement for additional study results in a year “cooling off period” between the introduction of a bill and any vote that’s taken. “It’s had a very salutary effect on us,” said Tom Hills, the chief financial officer in Georgia. “If someone says, ‘Let’s triple the retirement

benefit for any state employee who served in Iraq,’ you might do that in the emotion of the moment. This allows you to drop back and study it.”

Considering Hybrid Plans

In the past 10 years, two states have shifted to defined contribution plans for new employees. In Michigan and Alaska, employees who started work after 1997 and 2006, respectively, are no longer promised a set benefit when they retire. Instead, they have savings plans to which they make annual contributions, which are supplemented by contributions from the state government.

Leaders in other states including California, South Carolina, Massachusetts, Illinois and Virginia have tried to make a similar switch,

but have been unsuccessful to date.⁷³ The controversy surrounding defined contribution plans should not be much of a surprise. Nebraska, for example, moved to a defined contribution plan in 1964. But between 1983 and 1999,

state and county workers averaged a 6 percent return on their individual accounts, compared with an 11 percent return for teachers and judges who had a defined benefit plan.⁷⁴ Testifying before the House Committee on Pensions and Investments in 2000, Anne Sullivan, director of the Nebraska Public

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Employees Retirement System, said, "We have had over 35 years to 'test' this experiment and find generally that our defined contribution plan members retire with lower benefits than their defined benefit plan counterparts."²²

Employees' preference for defined benefits can also be seen in the states that have offered a primary defined contribution plan as an alternative to a defined benefit plan. (These include Colorado, Florida, Montana, North Dakota, Ohio and South Carolina.) In those states, employees still overwhelmingly pick the defined benefit plan, according to a recent study of state experience by Mark C. Olleman, a consulting actuary and principal at Milliman, Inc.²³

There are several key differences between defined benefit and defined contribution plans. Some states have found that their annual costs for their defined benefit plans have become burdensome due to past funding decisions, increased longevity among state employees, and in some cases the capacity of both state employees and employers to abuse the system. Cost containment/control is a major benefit of defined contribution plans. The other key difference between the two types of pension systems is risk. In a defined benefit plan the financial risk is borne by the state, while in a defined contribution plan the employee bears the risk. This is of special concern for state employees who are not part of the Social Security system and thus do not have that safety net. As states consider utilizing defined contribution plans, they will need to ensure that adequate funds are available to support retirees either by providing annuities through defined contribution plans or simply heavily encouraging adequate employee contribution rates.

Potentially more promising are hybrid plans, which incorporate parts of both types of plans.

At least five states offer hybrid plans, according to the Kentucky Legislative Research Commission.²⁴ In Ohio and Washington, for example, employees have the option of signing up for a combined plan in which employer contributions fund a lower but guaranteed retirement benefit, while employee contributions are invested separately in a defined contribution plan. Oregon officials estimate that a new hybrid program adopted by the state in 2003 contributed to more than \$400 million in pension reform savings.

Washington has further improved individual investment returns on the employee side by giving employees the option of investing in a portfolio that mirrors the investments of the state's defined benefit plan. About 70 percent of defined contribution assets are now invested in this way, according to Olleman.²⁵

In 2003, moved at least in part by the evidence cited above, Nebraska offered state employees another choice instead of a defined contribution plan. The so-called "cash balance plan" is a hybrid of a defined benefit plan, in which employees and the state both make annual contributions, according to Phyllis Chambers, director of the Nebraska Public Employees Retirement System. Employees are guaranteed a 5 percent annual rate of return, although successful investments may push the rate even higher.²⁶

"We think this plan is working well," Chambers said. "Since 2003, the returns have been good and we have been giving a dividend to employees above the credited rate. For those employees that do not want the volatility of a defined contribution plan, the cash balance is a good option because they know that there will be a minimum return of 5 percent. Also, they don't have to worry about what to invest in because it is done for them."

Requiring Faster, More Accurate Financial Reporting

Corporations must disclose timely information about their pension plans to investors and file information with the Securities and Exchange Commission. There are no similar requirements for public pensions. Although many of them do an excellent job of reporting to members and the public, a number of states have significantly late annual financial reports.

In March of each year, Wilshire Associates, an investment consulting and management firm, reports on pension funding status of the largest public pension plans. One of the issues it perennially faces is the delay of financial reports. In March 2007, for instance, 17 out of 125 state pension funds examined had a financial report issued prior to June 30, 2005. Another 61 reports were released prior to June 30, 2006.¹⁸

Timely financial reporting has obvious benefits in delivering important information to policy makers, managers and citizens. It also may be a sign that other aspects of a system are running effectively. An analysis of a database of public pension plans from 1990 to 2000, at Wharton's Pension Research Council, revealed pension systems with stellar financial reporting practices also had annual investment returns that were 2.1 percent higher than funds with lesser financial reporting practices.¹⁹

The issue of timeliness also applies to actuarial valuations, which are now required every two years (compared with an annual requirement in the private sector). Jim Rizzo, an actuary with Gabriel Roeder

Smith, said many states opt to do actuarial valuations more frequently, but they don't have to. "The numbers you put in a comprehensive annual financial report could be so old and stale that they're not useful to the reader," Rizzo said. "If the year ends September 30, 2007, then that year began on October 1, 2006, and you could be using an actuarial valuation for the year that began in 2004. By the time the Comprehensive Annual Financial Report gets published, it could be three years since the valuation."²⁰

The Governmental Accounting Standards Board (GASB) continues to look into ways that accounting and financial reporting for retirement benefits could be improved. In 2007, GASB issued a standard that will provide improved transparency for state and local government pension activities. Among the changes is a requirement for those plans that use the aggregate method in determining actuarial funding requirements to provide funding status information using another method.²¹



In addition, GASB is conducting a research project that will assess the effectiveness of current pension standards in meeting financial statement user needs. Issues that will be addressed include the overall approach to calculate annual pension costs and pension liabilities and detailed issues, including the discount rate, amortization methods and amortization periods, and actuarial cost methods.

The initial research phase of the project will be completed by April 2008. After consulting with its advisory committee, GASB is scheduled to decide whether a pension project should be added to the current technical agenda.



Improving Pension Oversight

One concern voiced by critics of government pension systems is that they are not subject to adequate oversight. This worry, expressed by Senators Charles Grassley and Max Baucus, ranking members of the U.S. Senate Finance Committee, led to the launch of a 15-month exploration of state and local retirement benefits by the GAO in July 2006. The GAO recently released a report on this topic and another is due in the coming months.

The senators expressed their concerns in a letter to David Walker, the Comptroller General of the United States, in which they argued that public pensions are held to a lower level of scrutiny than those in the private sector.⁸⁰ Most states, watchful of increased federal regulation, have reacted with alarm to the idea that the GAO study might spark more federal oversight. The *Nation's* Association of State Retirement Administrators and the National Council on Teacher Retirement responded to the senators with a letter that defended the status and security of state and local funds.⁸¹ This was followed with another letter from 28 national organizations emphasizing the soundness of public funds and the importance of recognizing the difference in the public and private sectors.⁸² In fact, when the first GAO report was released, it conveyed a generally positive tone about the health of state and local pension systems.

Whatever happens on the federal level, there are abundant signs that increased oversight by the states is coming. This issue is explored in depth in the October 2007 *Governing* magazine article, "Who's Minding the \$3 Trillion Store," which was researched under the auspices of PCS in conjunction with this report.⁸³ The Civic Federation of Chicago has also done valuable work on the subject of pension governance.⁸⁴

Many states have standing legislative committees devoted to pensions and a number of states also have oversight commissions that keep an eye on pension fund operations. According to the National Conference of State Legislatures, these include:

- Indiana - Pension Management Oversight Commission
- Louisiana - Commission on Public Retirement

- Massachusetts - Public Employee Retirement Administration Commission
- New Jersey - Pension and Health Benefits Review Commission
- Ohio - Retirement Study Council
- Oklahoma - State Pension Commission
- Pennsylvania - Public Employee Retirement Study Commission
- Texas - Pension Review Board
- Washington - Office of the State Actuary; Pension Funding Council; Select Committee on Pension Policy

In early 2007, Texas's Attorney General Greg Abbott also stepped into the action, taking a look at the state's 96 state and local pensions.

Abbott's concerns largely centered on pension governance. He noted that a number of local pension funds were using amortization periods longer than stipulated by GASB,⁶⁶ and in a

June 2007 speech to the Pension Review Board, he complained of unbalanced board membership, a lack of transparency in financial reporting and poor decisions in setting actuarial assumptions.⁶⁶ Abbott said he was particularly concerned about the possibility of conflicts of interest after discovering situations in which investment managers had hired board members after these firms had contracted with the retirement boards on which they sat. "They develop a chummy relationship," he said. "These job offers can be seen as a reward or inducement to shift the board member's allegiance to that particular investment manager."

Abbott says he hopes other attorneys general will also start to look at this issue, working on compliance with the law, while legislatures and boards of trustees focus on reforms needed to improve pension governance systems.

Conclusion

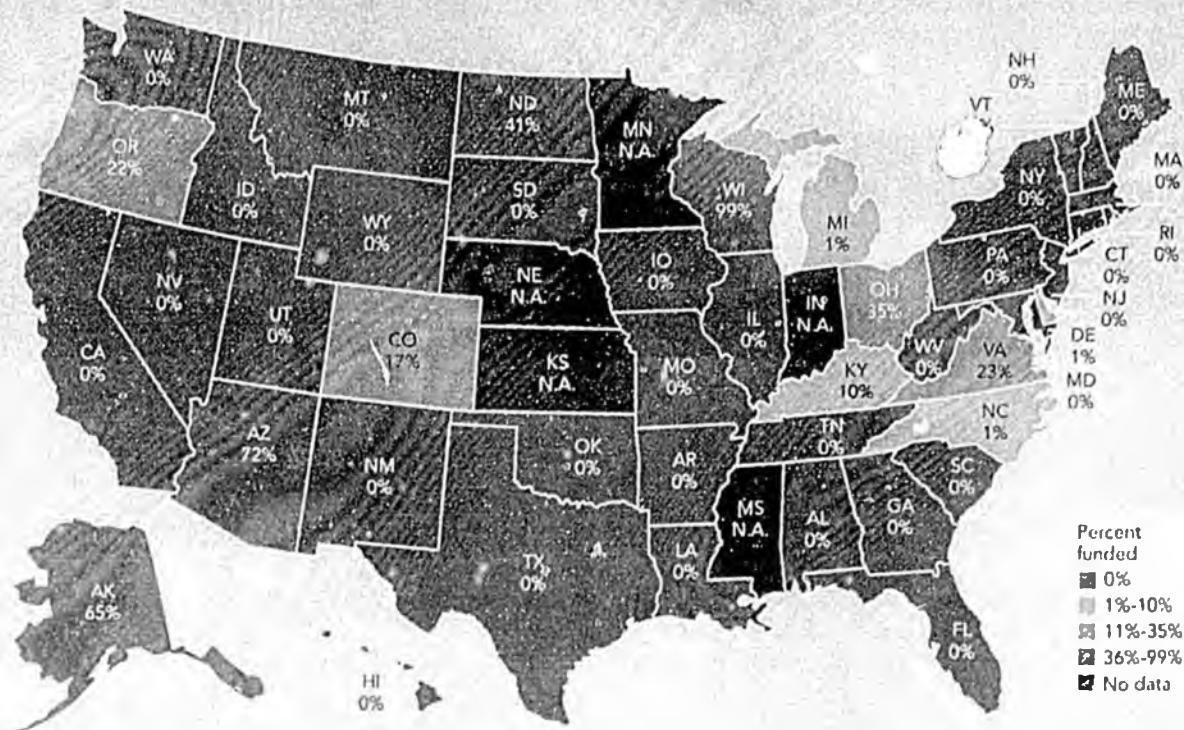
The strategies discussed in this section can help states reduce government pension costs and improve current pension management and future decision-making. However, these strategies will not eliminate the fundamental issue—that some states have liabilities they have not adequately funded. For the states that have fallen behind, there is no easy fix. Achieving an improved position requires the political will and

discipline necessary to begin funding their pension plans at actuarially adequate levels. Even states that are currently in a good position in terms of pension funding should heed the lessons in this report to help avoid the poor decision-making that led to the problems other states now face. When states delay action, the problem grows exponentially and the costs of a solution grow right along with it.

Endnotes

- 24 Kansas established a number of pension reforms in 2007. One new provision requires that employer contributions equal the actuarially required amount (and not be less than employee contributions).
- 25 See Table A-2 in Appendix A. Information in this report aggregates financial data from all pension funds listed in states' 2006 comprehensive annual financial reports.
- 26 This PCS conclusion generally tracks with the findings of a September 2007 report by the U.S. Government Accountability Office. See GAO, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*, report to the Committee on Finance, U.S. Senate (GAO 07-1156) (September 2007). The GAO report cites the opinion of "public sector experts, union officials and advocates" that 80 percent is a responsible funding ratio for pension systems. There is some disagreement on this point, however. It is useful to regard funding levels as a snapshot and recognize that they are always changing and are also extremely dependent on the health of the economy, and affected by a wide variety of individual practices relating to how they are calculated. A funding level of 80 percent, following a recession, is very different from a funding level of 80 percent following an economic expansion.
- 27 The actual total of actuarial assets in state pension funds, as calculated by PCS, is \$1.992 trillion.
- 28 Interview with PCS, December 2006.
- 29 Sujit M. CanagaRetna, "State Retirement Systems: Recent Trends," (presentation at the Fall Southern Legislative Issues Conference, Savannah, Ga., November 12, 2006).
- 30 There is no guarantee, of course, that a pension that appears to be fully funded will stay that way. Benefit increases are often retroactive and will add to the actuarial accrued liability. Assumptions are also constantly readjusted as actuaries reexamine past projections and experience.
- 31 Pre-funding also has the benefit of addressing intergenerational equity issues. The idea behind intergenerational equity is that the taxpayers paying for government employee benefits should have been the ones who received services from those employees, however, if states put off funding their obligations, future generations will be on the hook for past and future bills.
- 32 An important note, Florida's surplus is not amortized as the GASB expects. The Florida legislature essentially ensured that this set aside would remain for longer than the GASB approved 30 year period. This is an extremely cautious approach, but it illustrates that if a state is serious about being fully funded, it can make certain it stays that way.
- 33 National Conference of State Legislatures, *Pension and Retirement Plan Enactments in 2007 State Legislatures*, by Ronald K. Snell (October, 2007).
- 34 See glossary in Section I.
- 35 There are many other variations that can cause difficulties in comparing states. The Pew Center on the States Web site provides a state-by-state listing showing how assumptions and amortization periods vary. A resources section provides readers an opportunity to call up financial reports of individual states and check out the assumptions themselves. Even within a state, assumptions may vary from plan to plan.
- 36 There have been conflicting studies on this point. Public and private sector jobs are difficult to compare because many of the categories of employment tend to be different. The most recent compensation survey of public sector employees, the *AFT Public Employees 2007 Compensation Survey*, reports that most state employees earn less than their private-sector counterparts, though the median increase in average salaries across the 45 jobs surveyed was 5.7 percent, "the highest increase recorded in the last five years."
- 37 For this illustration, PCS is using the unfunded liabilities and annual required payment figures from only the respective state employee plans for Georgia and Illinois.
- 38 As with much pension information, there is considerable variation even within one state. Employees of the Illinois State Employees Retirement System (SERS) pay 8 percent if they are not in Social Security and 4 percent if they are in Social Security, unless they get the "Alternative Formula" for higher-risk jobs. Then they pay 9.5 percent or 6 percent according to information provided by the Civic Federation in Chicago. Employee contribution rates are listed in the financial statements of each of five state pension funds in Illinois. There is also a summary in the Illinois Division of Insurance's biennial reports. <http://www.idfpr.com/DOI/Pension/Pension.asp>
- 39 PCS interview with Tom Hills, chief financial officer, State of Georgia, September 2007.
- 40 Illinois Comptroller's Office, "Illinois Pension Benefits Lower Than Most States," *Fiscal Focus* (January-February 2007).
- 41 Illinois Retirement Security Initiative, Center for Tax and Budget Accountability, *The Illinois Public Pension Funding Crisis: Is Moving from the Current Defined Benefit System to a Defined Contribution System an Option That Makes Sense?*, by Jourdane Gabriel and Chrissy A. Mancini (Chicago, 2007), 8.
- 42 See Table A-2 in Appendix A, which goes back 10 years to show the extent to which each state has kept up with the amount its actuaries believe is necessary to maintain or move toward full funding.
- 43 New Jersey Legislature, Joint Legislative Committee, *Public Employee Benefits Reform, Final Report, 2006 Special Session* (Trenton, December 1, 2006), 37-38. The \$9 billion reflects the UAAI, however, the ARC was shorted by only \$3.2 billion over that time period.
- 44 Illinois Comptroller's Office, "Illinois State Pensions Continue to Put Pressure on State Budget," *Fiscal Focus* (January-February 2007).
- 45 Legislative Research Commission, *Issues Confronting the 2007 Kentucky General Assembly, An Update of Informational Bulletin No. 21 (1-05)*, Informational Bulletin no. 221 (Frankfort, October 2, 2006). In its other pension systems, Kentucky has done a better job of funding the Annual Required Contribution. For example, the full contribution for the teachers' system has been made in each of the last 10 years. This has contributed to a more positive appearance of ARC funding for the state as a whole. See www.pewcenteronthestates.org for state pension tables.
- 46 Dan Hassert, "The Public Pension Squeeze," *Kentucky Post*, 14 April 2007.
- 47 "State Workers Needn't Rush into Retirement," *Concord (New Hampshire) Monitor*, 13 May 2007.
- 48 National Conference of State Legislatures, *Pension and Retirement Plan Enactments in 2007 State Legislatures*, by Ronald Snell (Washington DC, October 2007). The NCSL provides summary information on legislative changes in retirement benefits for the last nine years at http://www.ncsl.org/programs/fiscal/all_pension.htm.
- 49 Hassert, "The Public Pension Squeeze."
- 50 "State Workers Needn't Rush into Retirement," *Concord Monitor*.
- 51 Charles Stilo, "New Law Will Remove Many From Public Pension System," *(New Jersey) Record*, 11 May 2007.

- 52 Gregory J. Volpe, "Many Staffers Qualified for Pension Credit," *Cherry Hill (New Jersey) Courier Post*, 29 April 2007.
- 53 Stile, "New Law Will Remove Many From Public Pension System."
- 54 New Jersey, Joint Committee, *Public Employee Benefits Reform, Final Report* (December 2006). The list of recommendations is on pages 59 to 153. The document, which covers both pensions and other post-employment benefits, is available at http://www.njleg.state.nj.us/PropertyTaxSession/OPI/cpe_final_report.pdf.
- 55 Legislation in 2007 removes new elected and appointed officials from the defined benefit system, shifting them to a defined contribution plan. Going forward, it also prevents professional service contractors - like lawyers and engineers - from being part of the defined benefit plan.
- 56 Ken Ardon, "Public Pensions: Unfair to State Employees, Unfair to Taxpayers," Public Employee Benefits Series - Part 1," *White Paper* no. 30, Pioneer Institute for Public Policy Research, (May 2006). 12.
- 57 Government Performance Project interview with Miller Hudson, executive director of the Colorado Association of Public Employees, August 2004.
- 58 See NCSL, "Pension and Retirement Plan Enactments," http://www.ncsl.org/programs/fiscal/all_pensun.htm.
- 59 The initiative was filed in 2007, with supporters aiming for it to appear on the November 2008 ballot. As of September 2007, signature collection had not yet begun.
- 60 Rick Davenport et al., *Paying for Tomorrow: Practical Strategies for Tackling the Public Pension Crisis*, A Deloitte Research Study, (July 2006). 7.
- 61 Nanette Byrnes and Christopher Palmeri, "Sinkhole! How Public Pension Promises Are Draining State and City Budgets," Special Report - Public Pensions, *Business Week*, 13 June 2005.
- 62 Alicia H. Munnell, et al., *Report of the Blue Ribbon Panel on Massachusetts Public Employees' Pension Classification System*, presented to the senate and house chairs of the Joint Committee on Public Service, (Massachusetts, July 2006), 9.
- 63 Mark Scalfaro, "Sweet Pension Deal Turns Sour," *Pittsburg Post-Gazette*, 17 December 2006, http://www.10000news.org/downloads/Sweet_Pension_deal_turns_sour_part_1_Pgh_Post_Gazette_121706.pdf.
- 64 Illinois Comptroller's Office, "Illinois Pensions Continue."
- 65 Tom Phoenix and Lance Weiss, Deloitte Consulting (LP, "The Impending Pension and Health Plan Crisis and the Impact of an Aging Workforce on Talent Management," presentation at the States & Local Government Pension Forum, Chicago, IL, February 28, 2006).
- 66 E. J. McMahon, "Legislators Still Aim to Sweeten Public Pensions," *Fiscal Watch Memo*, Manhattan Institute for Public Policy Research, (revised 15 July 2005). <http://www.nyfiscalwatch.com>.
- 67 David Blatt, "Oklahoma's Pension System, Tomorrow's Problem Requires Attention Today: 'The Oklahoma Pension Legislation Actuarial Analysis Act of 2006: Tying Odysseus to the Mast?'," Issue Brief, Community Action Project (January 2007).
- 68 In the past, the Center for Retirement Research has generally focused its research on pensions in the private sector, but it recently began a two year project to establish a database on state and local pension systems and explore funding status and economic impact. This work is funded by a \$1.5 million grant from the Center for State and Local Government Excellence.
- 69 United States Government Accountability Office, *State and Local Government Retiree Benefits*.
- 70 CanagaRetna, "State Retirement Systems," 5-6.
- 71 Illinois Retirement Security Initiative, *The Illinois Public Pension Funding Crisis*, 11.
- 72 House Committee on Pensions and Investments, Texas House of Representatives. *Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature*, (Austin, November 2000), 26.
- 73 Mark C. Olleman, "Defined Contribution Experience in the Public Sector," *Benefits & Compensation Digest*, International Foundation of Employee Benefit Plans (February 2007).
- 74 Legislative Research Commission, *Issues Confronting the 2007 Kentucky*, 58.
- 75 Olleman, "Defined Contribution Experience," 23.
- 76 PCS interview, October 2007.
- 77 Julia Bonafede, et al., Wilshire Consulting, *2007 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation*, Wilshire Associates Incorporated, (March 5, 2007), http://www.wilshire.com/BusinessUnits/Consulting/Investment/2007_State_Retirement_Funding_Report.pdf.
- 78 Tongxuan (Stella) Yang and Olivia S. Mitchell, "Public Pension Governance, Funding, and Performance: A Longitudinal Appraisal," *Pension Fund Governance: A Global Perspective*. Ed. John Evans and John Piggott. Edward Elgar. Forthcoming.
- 79 The aggregate cost method does not produce a number for the unfunded liability, thus the funded ratio is always 100 percent.
- 80 United States Senate Committee on Finance, "Grassley, Baucus Seek GAO Review of Public Pension Plans Funding," press release, (July 10, 2006), <http://www.senate.gov/finance/press/Bpress/2005press/pr071006.pdf>.
- 81 Letter to the Hon. Charles E. Grassley, Chairman, and the Hon. Max Baucus, ranking member, United States Senate Committee on Finance, July 14, 2006 <http://www.nasra.org/resources/NASRANCTR%20Grassley-Baucus%20Ltr%20RE%20GAO.pdf>.
- 82 Letter to the Hon. Charles E. Grassley, Chairman, and the Hon. Max Baucus, ranking member, United States Senate Committee on Finance and the Hon. David M. Walker, Comptroller General of the United States, (August 2, 2006), <http://www.nasra.org/resources/Grassley-Baucus%20Joint%20Letter.pdf>.
- 83 Katherine Barrett and Richard Greene, "Who's Minding the \$3 Trillion Store," *Governing Magazine*, Washington, D.C. Congressional Quarterly, Inc., (2007).
- 84 Civic Federation, "Civic Federation Calls For Public Pension Reform" (Chicago, February 13, 2006), http://www.civiced.org/articles/civiced_203.pdf.
- 85 A handful of state pension plans don't meet the Governmental Accounting Standards Boards guideline that amortization periods should be 30 years or less. This is because they have chosen to spread out payments over a longer period and thereby pay less in any given year. States with 40 year amortization periods at the end of 2006 included Illinois, Kansas, Michigan and Oklahoma. Whatever the length of time, the number of years in an amortization period can have a significant impact on the required contribution. For example, in January 2006, the Nebraska Retirement Systems Committee of the legislature quite candidly examined the merits of changing from a 25 year amortization period to a 30 year amortization period as a way of reducing contribution rates for the Nebraska school pension plan. That change alone, it concluded, would reduce the required contribution from \$12.8 million to \$6.6 million. A full list of amortization periods used by states is available at the PCS Web site.
- 86 Pamela Yip, "Watch Those Government Pension Plans," *Dallas Morning News*, 2 July 2007.



Figures are in thousands.

State	Actuarial liability	Unfunded liability	Annual required contribution	Actual payments in 2006	State	Actuarial liability	Unfunded liability	Annual required contribution	Actual payments in 2006
Alabama	\$5,290,000	\$5,290,000	\$344,000	\$76,000	New Hampshire	\$2,906,000	\$2,906,000	\$226,000	\$45,500
Alaska	3,413,000	1,206,000	152,000	97,000	New Jersey	21,587,000	21,587,000	1,881,000	313,000
Arizona ¹	421,300	94,800	93,000	93,000	New Mexico ³	4,990,000	4,990,000	467,000	83,000
Arkansas	2,130,000	2,130,000	--	185,000	New York	49,663,000	49,663,000	3,810,000	934,000
California	47,878,000	47,878,000	3,593,000	1,363,000	North Carolina ¹	11,460,000	11,400,000	2,390,000	230,000
Colorado	1,248,000	1,033,000	71,000	21,000	North Dakota	83,000	49,000	6,000	6,000
Connecticut	21,681,000	21,681,000	1,597,000	393,000	Ohio ¹	10,784,959	6,509,000	1,597,000	1,597,000
Delaware	4,435,000	4,410,000	475,000	136,000	Oklahoma	814,000	814,000	87,000	18,000
Florida	3,628,000	3,628,000	213,000	57,000	Oregon ²	832,000	645,000	75,000	75,000
Georgia	4,905,000	4,705,000	368,000	173,000	Pennsylvania	13,778,000	13,501,000	1,125,000	519,000
Hawaii	6,791,000	6,791,000	488,000	141,000	Rhode Island	696,000	696,000	53,000	18,000
Idaho	486,000	486,000	38,000	2,000	South Carolina	4,252,000	4,252,000	320,000	122,000
Illinois ^{2,4}	48,000,000	48,000,000	--	578,000	South Dakota	127,000	127,000	--	62,000
Iowa	220,000	220,000	23,000	20,000	Tennessee	2,305,000	2,305,000	156,000	64,000
Kentucky	9,019,000	8,090,000	130,000	66,000	Texas ^{2,4}	26,817,000	26,817,000	--	-111,000
Louisiana	7,344,000	7,344,000	967,000	190,000	Utah	749,000	749,000	47,000	47,000
Maine	2,297,000	2,297,000	177,000	73,000	Virginia	3,001,500	2,320,000	311,500	150,000
Maryland	14,543,000	14,543,000	1,114,000	236,000	Washington	3,800,000	3,800,000	314,000	68,000
Massachusetts	13,287,000	13,287,000	1,062,000	354,000	West Virginia ¹	7,761,000	7,761,000	824,000	133,000
Michigan	8,028,000	7,968,000	631,404	394,000	Wisconsin ²	1,823,000	17,000	52,000	52,000
Missouri	2,186,000	2,186,000	159,000	78,000	Wyoming	72,000	72,000	6,000	3,000
Montana	525,000	525,000	51,000	8,000					
Nevada	4,100,000	4,100,000	273,000	41,000					

1 States with combined state and local systems where PCS was able to estimate the state actuarial liability and unfunded liability of other post-employment benefits. PCS was unable to isolate the annual required contribution and 2006 actual payments for state employees only, and these numbers reflect the combined state and local system. Combined AAL and UAAL figures, respectively, from the actuarial valuations include: Arizona-\$1.5 billion, \$420 million; North Carolina-\$23.9 billion, \$23.7 billion; Ohio-\$11.6 billion, \$20.5 billion.

2 No actuarial valuation exists at this time.

3 Combined state and local systems where isolating the state component of other benefits may not be possible.

4 Actuarial liability and unfunded liability estimates for Illinois and Texas are from the Civic Committee of the Commercial Club of Chicago and Credit Suisse (2007), respectively.

NOTES: States in bold are moving toward fully funding their non-pension obligations. The actuarial accrued liability and unfunded actuarially accrued liability are based on short-term discount rates, which presume no pre-funding of the obligation. The amounts decrease if the annual required contribution is consistently funded each year.

Actuarial liability is the total value of benefits owed to current and retired employees or dependents based on past years of service.

Annual required contribution is the amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period, which is typically 30 years or less.

SOURCE: Pew Center on the States



Other Benefits

Rising Costs and Unfunded Obligations

LAST YEAR, THE STATES PAID ABOUT \$9.7 BILLION in retiree benefits other than pensions, according to PCS's study of data collected from comprehensive annual financial reports. Health care is by far the most significant of these other post-employment benefits (OPEB), but they also include dental care, life insurance and other promised benefits that provide economic security to retirees. What is most significant, however, is not the amount states are spending on these benefits today. The real impact on states' fiscal health—and on the public sector employees counting on these benefits—comes from the dramatic and unrelenting growth of the annual costs of OPEB.

For many years, the fiscal challenges and complexity of retirement benefits were barely noticed in many states. But new accounting standards, established in 2004 by GASB, are finally bringing the issue front and center.

States and other large governments (those with annual revenues greater than \$100 million) will first report on these liabilities in their fiscal year 2008 financial reports, which will generally come out sometime between December 2008 and March 2009. But actuaries for most states have already completed preliminary assessments of the bill that will come due for retirement benefits during the next 30 years. Armed with these and other documents gathered from a number of state governments, PCS has developed a complete and up-to-date compilation of states' long-

term liabilities for those benefits.⁶⁷ These numbers are likely to be refined over the coming year—but they are reasonably accurate and the best available figures at this time.

According to PCS data, the total actuarial accrued liability for state employees' retiree health care and other post-employment benefits is about \$381 billion.⁶⁸ About 97 percent—\$370 billion—of the obligations for state employees over an amortization period that usually runs about 30 years was unfunded at the end of fiscal year 2006 (see Exhibit 3-1).

The \$381 billion figure is a conservative number that does not reflect the full extent of the long-term cost, as some states face large bills for teachers as well. Cities, counties and school districts also are totaling up their own liabilities and will continue to do so over the next several years. (Credit Suisse, which published a report on OPEB liabilities last March, estimated the total liability for states and local governments at about \$1.5 trillion.⁶⁹)

In an ideal world, states would fund retiree health care and other non-pension benefits as they're earned, as they generally do with

"The evolution in states dealing with post-retirement health care costs is calculation, surprise and shock."

with Howard, assistant director for the Department of State's Government Administration

Other Benefits

pensions. This would reduce intergenerational inequity and would also lessen the total amount owed. (This is because a state that puts money aside for the future in a qualified irrevocable trust can earn higher interest rates over time.) But because states generally have not pre-funded retiree health and other non-pension benefits, there's a lot of catching up to do. Moving to full funding is a daunting task, because the annual required contribution is, on average, about three times what states currently pay each year to meet costs for current retirees.

So what are states doing to address current and future obligations to their employees as they try to balance competing pressures to build a strong workforce and control spending? Some are embarking on the pre-funding road and are putting money aside in trust funds. Others are redesigning the benefits themselves, using accrued sick leave

to set up retiree health care savings accounts or shifting retirees to Medicare advantage drug prescription programs. Some states are already cutting back in various ways that will whittle down costs—for instance, by elevating retirement ages for new or non-vested employees or by increasing retiree contributions to premiums. At least one state, Illinois, has attempted to buy out some employees by offering a lump sum, as General Motors has done in the private sector.⁹⁰

As the shock of identifying the long-term costs of retiree health care and other non-pension benefits ebbs, many questions remain about how cuts in benefits or other changes may affect employee behavior and the bottom line. States and other governments have embarked on a multiyear process in which they surely will be watching each other to see what works and what does not. This is just the beginning.

How Retiree Health Care Benefits Differ from Pensions

In 2004, after almost 20 years of study on the issue, GASB established new standards of accounting and financial reporting by public entities for other post-employment benefits, amending generally accepted accounting principles related to those transactions. (These same standards have been in place for private sector companies since the early 1990s.) Governments were given a few years to phase in the new standards. For state entities, that meant coming up with an actuarial accrued liability figure for their 2008 annual reports.

For governments and actuaries, developing long-term liability figures for retiree health care and other non-pension benefits can be complicated because several new assumptions must be built into the equation. These new assumptions include the annual rise in health care costs and the number of retirees who will actually take the state up on its offer of benefits (sometimes an employee chooses a spouse's coverage over the state's plan).

The greater uncertainties involved nearly guarantee that the valuations of long-term liabilities will rise and fall, particularly during the next few years, as states and actuaries evaluate plan characteristics, modify some plans to make them affordable, and decide how to manage benefits going forward.

States face a number of other big unknowns. Will the nation's health care financing system change substantially in the next 30 years? How will any changes affect retiree benefits? How far will courts allow governments to go in reducing benefits, as has happened in the private sector? These are just a few of the questions governments will be considering in the coming years.

Highlights From the Data

Exhibit 3-1 provides data for 45 states: 43 states have produced actuarial valuations of their OPEB; the data include estimates for Illinois and Texas. The figures in the exhibit assume that the state is paying for these benefits on a pay-as-you-go basis.⁹¹ The long-term costs drop considerably if states consistently pay their annual required contribution (ARC) and deposit it in a qualified irrevocable trust. The savings come from the higher investment return that results from long-term savings and earnings that build up over time. As of the end of fiscal year 2006:

- Only six states—Arizona, Ohio, Oregon, North Dakota, Utah and Wisconsin—were on track to have fully funded OPEB obligations during the next 30 years. A few other states have moved in that direction since fiscal year 2006.
- Only three states had funded more than 50 percent of their actuarial liability: Wisconsin at 99 percent, Arizona at 72 percent and Alaska at 65 percent.
- Of the five largest states—California, Texas, New York, Florida and Illinois—none had put aside any money for other post-employment benefits.
- Eleven states had estimated liabilities in excess of \$10 billion, led by New York with \$50 billion, California with \$48 billion and New Jersey and Connecticut with \$22 billion each. Illinois is also included on this list with \$48 billion in liabilities, according to estimates by the Civic Committee of the Commercial Club of Chicago.⁹²
- Most of the states with large liabilities relative to their size are located in the East: New Jersey, New York, Connecticut, Maryland, Delaware and New Hampshire.
- Four states had put aside at least \$1 billion for future OPEB expenses: Ohio, with \$11.1 billion; Alaska, with \$2.2 billion; Wisconsin, with \$1.8 billion, and Arizona with \$1 billion.

The Challenge of Rising Costs

This report does not attempt to evaluate the virtues or flaws of states' decisions to offer larger or smaller benefit packages to their employees. Instead, the analysis focuses on the real world as it exists today—one in which many states will see the price tag on retirement benefits rise significantly well into the future.

New Jersey, for example, paid \$200 million—a systemwide total—for the health care costs of its current retirees in fiscal year 2000. By fiscal year 2005, this amount had mushroomed by

355 percent to \$911 million. In the years since 2005, and for the foreseeable future, the costs are rising far faster than the rest of the budget. The state's 2007 retiree health costs were \$1.2 billion, and the 2008 bill will be 25 percent higher than that. By contrast, state spending generally will rise 7.2 percent from fiscal year 2007 to fiscal year 2008, according to the New Jersey Treasury Department.⁹³

States that pay a large portion of retirees' health care costs have generally struggled with rising

Understanding the Numbers

The data used for this report include information from 45 states. The data for 43 states are based on actuarial computations produced by the states themselves. As of mid-October 2007, the remaining seven states had not finished producing actuarial valuations. Five of those—Indiana, Kansas, Minnesota, Mississippi and Nebraska—are likely to show relatively small liabilities because they are among the 10 states where retirees pay their own health insurance premiums. In these states, the governments' cost is limited to an "implicit subsidy," which comes from allowing retirees to participate in the same insurance pool as younger and generally healthier state employees.

Of the states with substantial OPEB obligations, only Illinois and Texas were missing an actuarial valuation. A 2006 report from the Civic Committee of the Commercial Club of Chicago estimated that number at \$48 billion for Illinois, a figure that includes state employees only.⁹³ The Texas legislature passed a law last spring that gave state and local governments a choice of following GASB standards or standards developed by its own comptroller. Governments that chose the latter course of action would still need to include a projection of long-term non-pension costs as supplementary information to the financial statement, but this would not be considered a liability. No publicly available actuarial valuation existed yet for Texas state government when this report went to press. The Legislative Budget Board has estimated the total liability as more than \$50 billion after 10 years, including local governments.⁹⁴ Credit Suisse has estimated the state portion at \$26.8 billion.⁹⁵

In an effort to ensure consistency among the states, PCS has limited its analysis to state employees, with OPEB obligations for teachers and local employees removed whenever possible. As a result, the figures in Exhibit 3-1 may not match with unfunded liability figures that have appeared in local newspapers. For example, New Jersey's most recent actuarial valuation shows a total of \$68.8 billion in liabilities. Of this amount, however, \$36.5 billion covers school teachers and another \$10.8 billion covers municipal and county employees. The portion for state employees is \$21.6 billion.

When states were unable to break out the data that applied exclusively to state employees, the inclusion of either teachers' plans or local plans is noted on the table. The source of each figure, and the date of the calculation, can be found on the PCS Web site (www.pewcenteronthestates.org). In some cases, the valuations used were preliminary and states are currently working on updated versions. The actuarial valuations used for this table were supplemented with information from comprehensive annual financial reports. In cases where PCS researchers needed help isolating state data, they contacted state officials.

Even if benefits remain the same, however, it is highly likely that some of the figures shown in Exhibit 3-1 will change significantly in future valuations. Calculating the long-term cost of retiree benefits is new to the states and adjustments in their calculations are not unusual. Maine, for example, had a valuation in 2003 that put its long-term OPEB actuarial liability at \$1.2 billion. As of January 2007, it determined the liability to be about \$3.2 billion. That amount includes the state's obligations for both retired state employees and retired teachers, according to Frank Johnson, executive director of Maine's employee health and benefits department. (The amount listed in Exhibit 3-1 represents state employees only.)

These calculations require sophisticated actuarial projections that take into account many hard-to-predict variables such as the rate of retirements, the lifespan of retirees, the increase in health costs and the interest earned on money set aside as benefits are earned. Changes in any of the assumptions over time will alter the data.

bills. In Maine, benefit payments were 6.7 percent of payroll for fiscal year 2007, but will rise to at least 11.2 percent of payroll in fiscal year 2016, according to state figures.¹⁷ California's Legislative Analyst's Office pegged growth in retiree health care costs at nearly 11.8 percent between 2007 and 2008. By contrast, other state spending grew less than 1 percent.

In Nevada, pay-as-you-go costs were projected to rise 20 percent from 2008 to 2009, according to information presented to the legislature in January 2007. If the state were to fund its ARC in 2008, the payment would be four times the pay-as-you-go cost.¹⁸

If states persist on the pay-as-you-go path, the bills for retiree benefits other than pensions will continue to grow quickly. Nevada and Maine, two very different states socioeconomically and

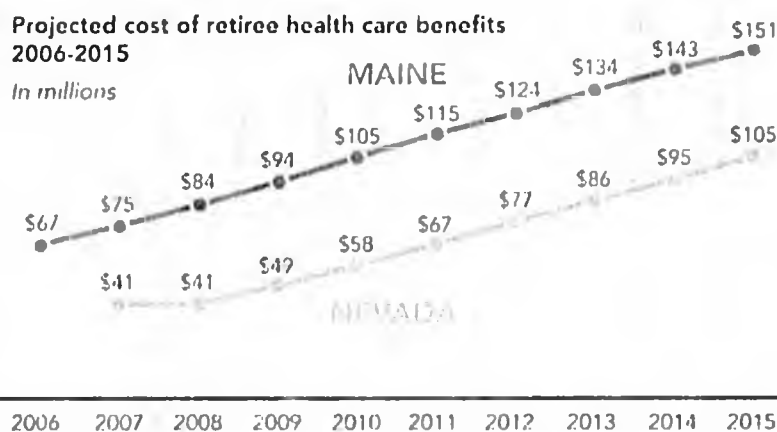
geographically, are largely in the same boat when it comes to bills coming due for OPEB, as Exhibit 3-2 illustrates. That is why these and other states are thinking hard about what mix of actions to take. Without appropriate attention and planning, these obligations only get bigger and more difficult to manage.

Until recently, most states have permitted their OPEB obligations to grow with little or no consideration for how to pay for them. As noted earlier, our analysis revealed that about 97 percent, or \$370 billion, of these 30-year obligations were unfunded at the end of fiscal year 2006. By sharp contrast, all states attempt to set aside large pools of assets to fund long-term pension liabilities, albeit with varying success.

However, a few states, including Utah, Maine and Michigan, have been estimating the costs

3-2 PAYING THE MINIMUM IS NOT ENOUGH

The rising costs of health care benefits for retirees will be felt most acutely by states on the pay-as-you-go* path, as illustrated by Nevada and Maine.



* "Pay as you go" is defined as paying only the amount needed to pay for benefits currently due and payable to retirees. Often this means financing for current benefits comes from current employees' contributions.

NOTE: 2006 data unavailable for Nevada.

SOURCES: Leslie Johnston, Memorandum to Nevada Joint Ways and Senate Finance Subcommittee, RE: GASB 43 and 45 Supplemental Information, January 24, 2007; Nevada CAFR pp. 69-70.; John Bartel and Steven Glicksman, State of Maine: Retiree Healthcare Plan Actuarial Valuation, January 2007.

"I hope the experience with retiree health makes people realize that we have some pretty significant fiscal challenges over the long term."

— *Scott Pattison, executive director of the National Association of State Budget Officers*

of their non-pension benefits for some time. Others, such as Alaska, Kentucky and Arizona, have included retiree health care as part of pension funding. As a result, although these states' pension funding levels may have appeared somewhat deflated compared with other states in the past (when few states were paying attention to long-term retiree health care costs), they now have a jump on many other states."

At the end of fiscal year 2006, 13 states had some funding set aside, although most of the amounts were minimal. Ohio stands out in the amount of money socked away: \$11.1 billion at the end of fiscal year 2006, a sum that grew to \$12.8 billion by the end of fiscal year 2007, according to the Ohio Public Employee Retirement System. But even Ohio's retiree health benefits are only 39 percent funded, up from 35 percent in 2006.

How the States Stack Up

PCS's analysis shows how strikingly different the states are from one another. Half the states account for almost 94 percent of the total unfunded OPEB liabilities. "The diversity of the states is far more dramatic on the retiree health issue than many others," said Pattison. "We have some members who see this as almost a crisis and others have no problems."

The job is all the tougher because of the many other long-term costs emerging as states' populations and infrastructures age. States face retiree OPEB bills simultaneously with rising pension costs; expanding budgets for prisons; and demands for more money for schools, maintenance backlogs for bridges, roads and water systems and other needs.

At the same time, governments are under pressure to keep taxes low.

The underlying problem, said Elizabeth Keating, a professor at Boston College's Carroll School of Management, has been fiscal systems based on an annual cash budget, which does not hold decision-makers responsible for the results of their choices down the road. She and others maintain that governments need to focus attention on the long-term ramifications of their decisions. Meanwhile, state budgets, employees, retirees and taxpayers are likely to face tough times ahead. "I hope the experience with retiree health makes people realize that we have some pretty significant fiscal challenges over the long term," said Scott Pattison, executive director of the National Association of State Budget Officers. "I hope this changes the dynamic in which we make policy decisions over the short term without a realization of the costs that are going to grow over the next five, 10, 15 years and beyond."

Much of the difference is directly tied to the decisions that governments have made about how large or small retirement benefits should be and who should receive them. Even neighboring states, which may well be drawing employees from the same group of applicants, have made remarkably different choices about the benefits they provide their retirees. For

example, Virginia's unfunded liability is \$2.3 billion, while Maryland's is \$14.5 billion, according to the states' own disclosures.¹⁰⁰ Maryland offers a more substantial premium subsidy and provides assistance to retirees with fewer years of service.

In general, the largest states have the largest liabilities. Of the 10 states with the highest populations, only Florida stands out as having a relatively small actuarial accrued liability. That is not surprising because Florida's cash subsidy for health insurance is limited, providing a \$5

The Other Post-Employment Benefits Menu

All states that offer post-retirement health care benefits to employees do so in different ways. A few of the key differences include:

- **The nature of the benefits.** While standard major medical coverage tends to receive the most attention, life insurance, dental and vision coverage and other benefits can be included.
- **Divisions of contribution.** In some states, the government contributes most or all of the monthly premiums for retiree health benefits. In others, the government contribution is capped and employees make up the rest. In still other states, the government pays only the implicit rate subsidy (the cost incurred by allowing retirees, who are generally older and less healthy, to participate in the same plan as active employees).
- **Eligibility.** In many states, employees become eligible for these benefits based on a combination of age and years of service. For example, an employee turning 55 with 10 years of service to the state may be eligible to continue receiving the same health benefits after retirement. Retiree health plans are frequently tiered so that benefits increase after more years of service.
- **Coverage.** Some plans cover only employees, while others include spouses and other dependents. States also differ widely in whether or not they provide coverage to early retirees who do not yet qualify for Medicare.
- **Basic plan structure.** As in the private sector, virtually all OPEB plans fall into one of two categories: defined benefit or defined contribution. Defined benefit plans specify the amount of benefits to be provided to the employees after their employment ends. Defined contribution plans stipulate only the amounts to be contributed by a government employer to a plan member's account, but do not promise a certain amount of benefits employees will receive after their employment ends.
- **The number of participating governments.** So-called single-employer plans involve only the state government; multiple-employer plans include more than one government, often localities.
- **Varieties of multiple-employer plans.** When multiple governments pool or share the costs of financing benefits and administering the plan and the assets, the plan is called a cost-sharing multiple-employer plan. In agent multiple-employer plans, states still share the administrative costs and pool investments, but separate actuarial calculations are made for each participating government, and separate accounts are maintained to ensure that each employer's contributions are used only to provide benefits for employees of that government. The goal of these plans is to spread risk and administrative costs while providing centralized expertise.

Other Post-Employment Benefits

monthly subsidy toward health insurance coverage for every year of employment up to 30 years. On the other hand, California, North Carolina and Texas often pay retirees' entire premiums, according to the Workplace Economics 2006 State Employee Benefits Survey.¹⁹¹

States' liability amounts are determined not only by the size of states' contribution to retirees' insurance premiums, but also by such factors as the number of retirees covered, the vesting period, the type of health plan, and dependent and spousal coverage. (See "The OPEB Menu" for a more thorough description of the most important variables that come into play.)

Retirement age is a particularly pertinent factor. All states' retirees are living longer and so remain beneficiaries for a longer time.

Beyond that, the age at which states permit various employees to retire and collect benefits varies greatly. The retirement age is critical because the cost of covering an individual retiree who has not yet become eligible for Medicare can be much greater than the cost of covering a retiree who is Medicare eligible. In New Jersey, for instance, spending for the average pre-Medicare retiree is \$573 a month, 189 percent of the cost for a retiree who is covered by Medicare, according to the most recent State Health Benefits Survey from the Segal Company.¹⁹² A study by Alaska's actuary analyzed retiree health care costs and found that 75 percent of the state's OPEB spending came from employees who retired before 65. This information helped convince the Alaska legislature to cut off benefits to pre-Medicare retirees as part of its substantial retirement reforms of 2005.¹⁹³

States Attempt to Move Forward

GASB's role is to establish accounting and financial reporting standards—not to require governments to make any particular policy or management decisions. But on the verge of disclosing their liabilities for retirement benefits, many governments confront the need to take action. "There are two ways to address the issue," said Jason Dickerson, a legislative analyst in California who has been following the topic there and in other states. "You can put money aside to fund benefits or you can change benefits so as to reduce future costs."

A January 2007 Aon Consulting survey of governments of all sizes shows many leaders are still unsure of where to turn.¹⁹⁴ The survey, released in July, showed that fewer than half the governments surveyed had developed a

plan of action to handle the new accounting standards. Ninety percent did not know how they would get the money to fund the long-term obligation, although more than half were considering long-term funding options. A third of the respondents were contemplating plan modifications—either revising eligibility requirements, increasing cost sharing, cutting coverage for future employees or moving to a defined contribution approach, which would shift the risk of medical inflation to retirees.

In fact, a hybrid approach seems increasingly likely for a number of states. "Initially, a lot of our clients were looking at this in black and white: pay for it all or reduce all the benefits," said Tim Nimmer, an actuary at Aon, which performed the actuarial valuations for non-

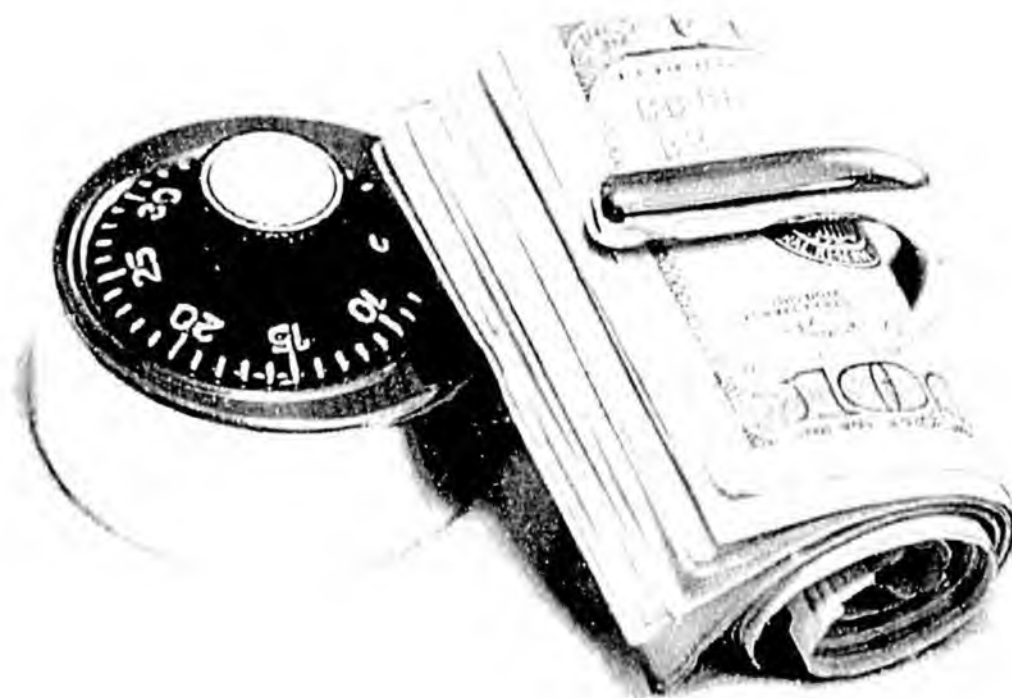
pension benefits in eight states. "I'm guessing that almost all of them will land in that gray area of a combination of the two. They're looking for what's politically palatable and what is fiscally palatable."

To see what states are doing at this early stage, PCS analyzed survey responses from Pew's Government Performance Project and legislative data from the National Conference of State Legislatures (NCSL).

Fully Funding the Long-term Obligations

According to NCSL's legislative tracking, at least 13 states in 2007 set up state trust funds or provided enabling legislation for local trust funds. A handful of other states had already taken these actions. These irrevocable trusts require that all the money that goes in is used in a predetermined way—in this case, to pay for retirement benefits in years to come. The stipulation prevents budget raiders from siphoning off these funds for current needs. Ohio (see "States to Watch") has used such a mechanism to hold the funds it has been setting aside for OPEB obligations since 1974. Utah

also established an irrevocable trust for its OPEB costs and appropriated the full actuarially required contribution of about \$17 million for both fiscal years 2007 and 2008. Alabama, Delaware, Georgia and West Virginia (see "States to Watch") are among the states that have also set up irrevocable trusts. Some states are considering earmarking revenue streams to fund their long-term liability, such as a portion of lottery proceeds or tobacco settlement dollars, according to the National Association of State Comptrollers, which has set up an OPEB Implementation Network.¹³



Massachusetts passed irrevocable trust legislation for fiscal year 2008 and is fully funding its \$1.1 billion anticipated annual required contribution for 2008 with approximately \$340 million of general fund dollars and most of its accumulated unspent tobacco settlement receipts. Governor Deval Patrick proposed dedicating up to 90 percent of future tobacco settlement proceeds to at least partially fund OPEB costs in the irrevocable trust. The legislature rejected the proposal, but created a commission to study future funding with a report due in December in time for the fiscal year 2009 budget debate.

Other states may be looking at the option of bonding out their OPEB obligations. One state that selected this option is Wisconsin. In 2003, it issued \$600 million in OPEB bonds as part of a larger transaction that also included the issuance of \$729 million in pension bonds. The OPEB portion of this transaction was the first time a bond had been used to pay for the actuarial liability for other post-employment benefits at the state level. It has enabled the state to come close to fully funding its fairly modest OPEB obligation.^{18A}

However, there is an inherent risk in bonding to meet retiree obligations, based on the timing of the transaction. For example, New Jersey implemented a \$2.8 billion pension bonding plan in 1997, and it fell victim to bad timing when the market turned sour and the interest paid on the bond exceeded what the state earned on its pension investments. Other governments that sold pension obligation bonds in the late 1990s also lost money in the early part of this decade.

The appeal of irrevocable trusts goes beyond the obvious desire to provide security for retirees and protection for future taxpayers. If states start funding their retiree benefits

through this vehicle, their actuaries can actually decrease the total actuarial liability. That's because it is presumed that invested money will earn more interest if it is set aside for the long haul, reducing the long-term cost of benefits. (See "Other Benefits of Full Funding.")

However, government officials wonder what will happen to money that has been "irrevocably" dedicated to retiree health care if the federal government passes some kind of universal health insurance. "A lot of people are resistant to putting that money aside because tax laws aren't clear on their ability to take that money out," said Dickerson of the California Legislative Analyst's Office.

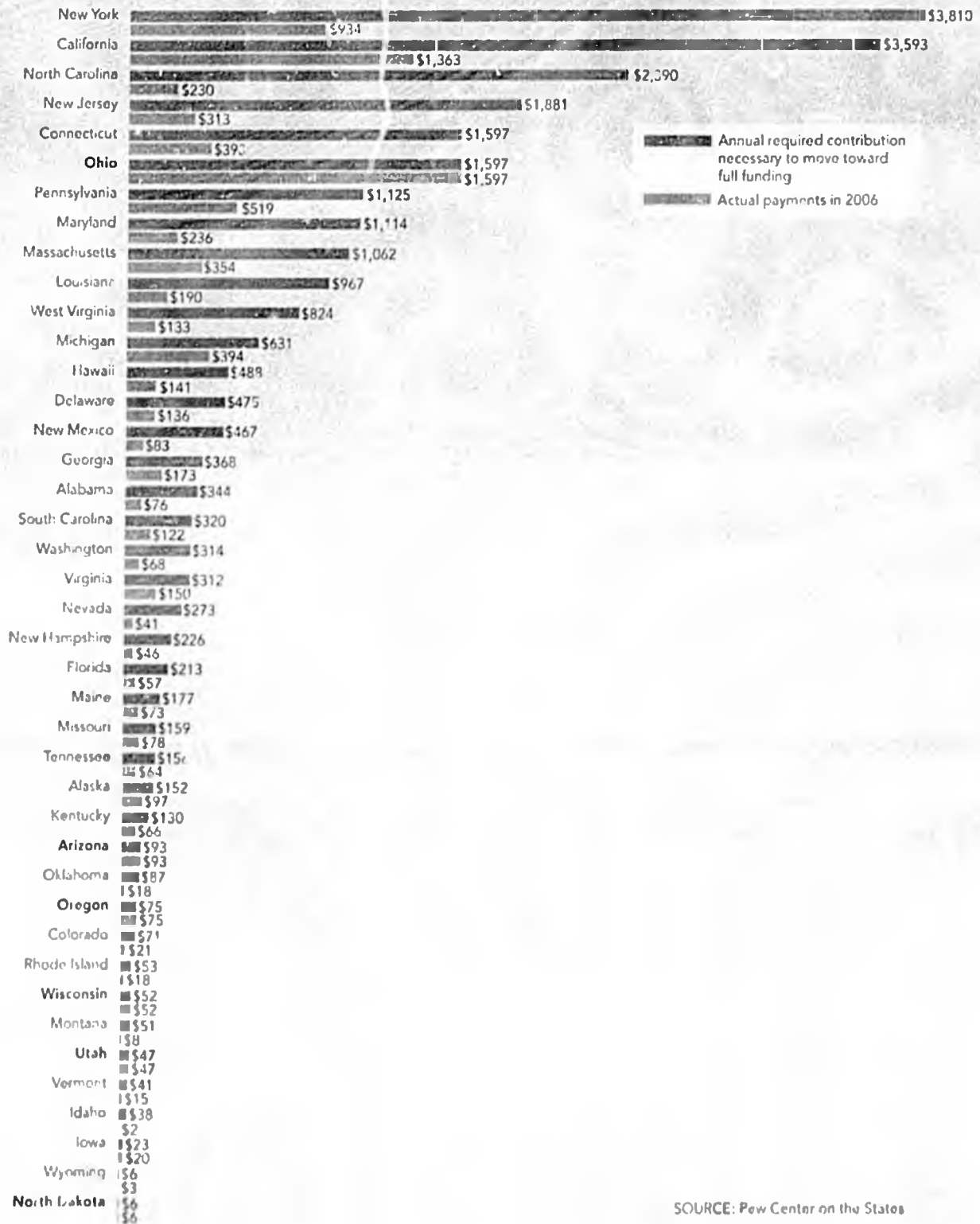
In any case, for most if not all states, the option of fully funding these liabilities in the near future is not feasible because of the dramatic rise in costs. Exhibit 3-3 compares the costs states spent in 2006 with the amount determined by actuarial valuations as necessary to move toward full funding. The states where the red and blue lines are closest have already started moving toward funding these benefits.

In fact, based on data from 40 states with explicit OPEB liabilities, PCS has calculated that the median annual required contribution states would need to move toward full funding of their plans can be almost three times what they are paying right now: \$314 million compared with \$110 million, respectively.

An effort to begin funding for the future is worth considering for a variety of reasons. However, given the size of their long-term liabilities, many states are going to be supplementing that effort with other steps to reduce the bill coming due.

FALLING SHORT ON PAYING THE ANNUAL BILL FOR OTHER BENEFITS

Almost all states need to pay more into their retiree health care plans if they want to move toward full funding. States in bold paid their annual required contribution in 2006. Data shown are for the 41 states with available figures. Numbers are in millions.



SOURCE: Pew Center on the States

Other Benefits

State	Expected Return on Pay as You Go	Expected Return if Funded
Alabama	4.00%	6.00%
California	4.50%	7.75%
Massachusetts	4.50%	8.25%
Nevada	3.80%	8.00%
S. Carolina	4.50%	7.25%
West Virginia	4.50%	7.75%

NOTE: If the annual required contribution were funded consistently each year, a higher interest rate could be used and the dollar amounts would be reduced.

SOURCE: Pew Center on the States

Scaling Back on Benefits

In general, states have far more flexibility to make changes to retiree benefits like health care than they do to pensions. But it gets more complicated when it comes to individual states, in part because of how they make their decisions about benefits. One might assume, for instance, that in heavily unionized states, benefits would be determined by labor negotiations. But that's

not always true. At the state level in California, for example, retiree health benefits are not a topic open to union negotiation. These decisions are the province of the pension systems' board, according to Dickerson of the California Legislative Analyst's Office. On the other hand, in California's local governments, labor negotiations have already started to have

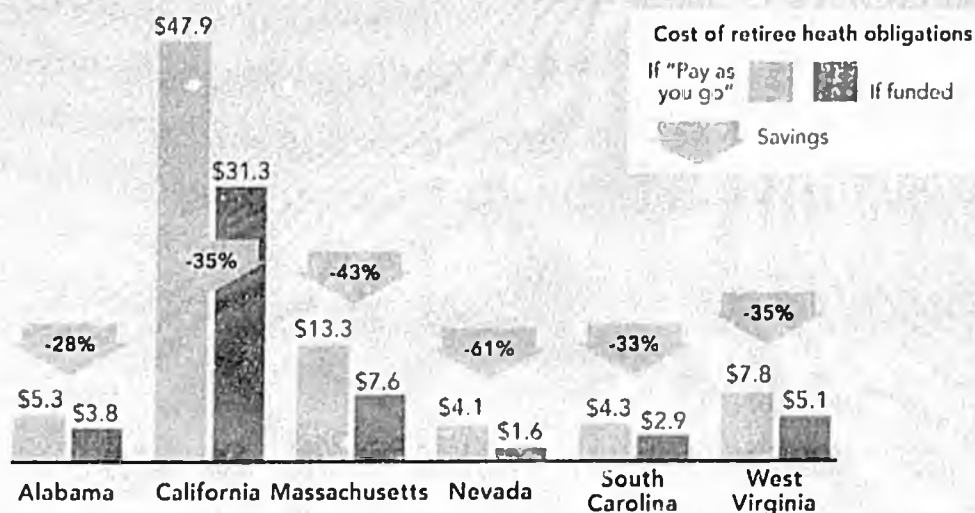
Other Benefits of Full Funding

The benefit that comes from putting money in a trust is that it starts to earn interest and, over time, that interest becomes another funding source for the benefits, replacing some of the contribution that would otherwise come from future taxpayers.

In fact, states that move toward full funding of their benefits will see an immediate impact on the actuarial accrued liability because there is an increase in the discount rate that is used to calculate this amount. Exhibits 3-4 and 3-5 highlight a sampling of states, the impact of discount rates when they simply pay the benefits out of current monies, and the impact of the higher discount rate that would be permitted if they establish a qualified trust and begin providing consistent long-term funding. Most states that provide long-term funding likely will provide a portion and not the whole thing, which will enable them to use a discount rate somewhere between the two options shown.

For example, in California, actuaries have calculated the long-term obligation for state employees at \$48 billion. One important element in that calculation is the "discount rate"—the interest rate assumption the state is allowed to apply to current assets used to pay future bills. With that bill paid for on a pay-as-you-go basis, the actuaries assume a 4.5 percent interest rate, similar to what the state earns in its short-term cash accounts. But if California were to start putting aside sufficient money each year in a qualified trust, higher interest earnings could be achievable. So the actuaries would use a 7.75 percent interest rate—the same rate used in its pension system—reducing the total amount owed to \$31 billion.

The examples below demonstrate the financial benefits of a qualified trust that is consistently funded.
(In billions)



SOURCE: Pew Center on the States

an impact. This has also been the case in the private sector (see "A Harbinger?").

In other states the decisions may fall to the legislature or collective bargaining with unions, and the flexibility to make changes depends on state law and past labor agreements. For example, in 1997 in Connecticut, the administration of then-Governor John Rowland reached a 20-year agreement with the state's labor unions, which prevents any significant changes from being made until 2017. "That's tied our hands," said Nancy Wyman, state comptroller.

A smattering of states have made changes over the last several years—but experts predict that this kind of activity will be ever more common as states move from the head-scratching phase to more clear-cut plans.

This topic is so new that there is little or no evidence that any one of the approaches that states have taken thus far is necessarily superior to others. Here are examples of what's been happening across the country in the last several years:

- In 2005, Pennsylvania started requiring new retirees to pay 1 percent of their annual base salary at the time of retirement for health care costs. In addition, as of July 1, 2008, 20 years of state service will be required for lifetime health benefits in Pennsylvania compared with 15 years in the past.¹⁷
- In 2005, North Carolina increased the time that new employees need to work to qualify for full subsidization of benefits.¹⁸ (See "States to Watch.")

A Harbinger?

In September, the United Auto Workers union and General Motors reached an agreement that some observers point to as a useful example for the public sector. Faced with a \$50 billion actuarial accrued liability for post-retirement benefits and ongoing intense competition from international carmakers, GM and the union agreed to end the company's defined benefit plan for non-pension benefits and shift to a Voluntary Employee Beneficiary Association deal in which the automaker pays an annual amount to a union-run medical benefit plan.

This defined contribution approach removes the risk to GM of dealing with health care inflation. The unions were willing to accept this option, faced with the potential of more drastic cuts in the future or layoffs if the company couldn't afford to pay the benefits promised.¹¹²

For states in which retiree benefits are the subject of labor negotiations, this topic is highly likely to be a prominent part of future discussions. At the local level, for example, several unions have negotiated changes in benefits or benefit structure over the last year. One theme, particularly in California, has been for a union to protect benefits of current employees while allowing benefits to be diminished for new employees. Unions in Orange County went a step further, negotiating a pay increase for current employees while substantially reducing non-pension benefits for future hires and retirees. It is likely that this case will be litigated, said Dickerson.

- In 2006, Maryland increased co-payments on prescriptions and increased employee and retiree premium payments.¹¹³
- In 2005, Alaska ended early retiree health coverage for new employees, limiting retiree coverage to those who are 65 and older.¹¹⁴ (The state also shifted new employees from defined benefit pension plans to defined contribution plans.)
- In 2006, Illinois began offering 15,000 state retirees not covered by Medicare the option of dropping their state-subsidized health insurance in exchange for a \$150 monthly payment. Only those who had another source of insurance were eligible. The state pays \$834 per month to insure the health of a retiree not covered by Medicare. As of September 30, 2007, 124 employees had accepted this offer, according to Timothy Blair, executive secretary for the State Employees' Retirement System of Illinois.¹¹⁵

States to Watch

West Virginia

Having experienced the bitter toll that underfunded pensions take on a state budget, West Virginia was one of the states that moved most rapidly to deal with a \$7.8 billion unfunded liability for its other post-employment benefits. Among other things, the state increased retiree co-payments, set up an irrevocable trust for funding and shifted retirees to a Medicare advantage prescription drug plan.

According to Ted Cheatham, executive director of West Virginia Public Employees Insurance, the actions reduced the state's long-term liability by more than half, to \$3.4 billion. Part of the savings stems from a reduction in medical cost inflation, with the state shifting from the 8 percent inflation rate it expected in the next few years to a 6 percent inflation rate, based on health care cost growth that mitigated substantially in fiscal year 2007.

The following describes the state's health care benefits for retirees before and after the reforms.

BEFORE. The state required co-payments from active employees but not from retirees. Retirees paid a premium based on years of service and date of hire, but it was considerably discounted from what the state actually spent. Retiree health care costs were covered on a pay-as-you-go basis, with the premiums from active employees providing a \$100 million subsidy for retiree costs every year. Supplemental Medicare coverage was provided on a fee for service basis. Meanwhile, the number of retirees was growing at a net rate of 1,000 a year.

AFTER. Co-pays were set for retirees at \$10 for primary care, \$20 for specialists and \$50 for emergency room visits, with retirees expected to pay 20 percent of hospital expenses not covered by Medicare. Out of pocket expenses were capped at \$500. All retirees were required to join a Medicare advantage prescription drug plan. These actions reduced per capita costs from \$300 per member per month to \$121 per member per month. In addition, the West Virginia Retiree Health Benefits Trust Fund was set up. It currently has \$39 million with another \$63 million deposit expected by year's end. Finally, to relieve some pressure on retirees' wallets, the state reduced premium costs by a flat \$22 per Medicare member per month.

A number of retirees are unhappy with the change, but it could have been worse; the state's original proposal in fall 2006 was considerably more expensive for retirees. In adopting the new plan, the state—heavily unionized—worked with a number of labor groups. Although they vary in their level of acceptance, Cheatham said “most are satisfied with where we ended up.” At this point, there

“Had we not made these changes to reduce the liability we would have had to do something more drastic to retiree benefits in the future.”

*— Ted Cheatham,
executive director of West Virginia
Public Employees Insurance*

has not been any litigation regarding the changes. “Had we not made these changes to reduce the liability we would have had to do something more drastic to retiree benefits in the future,” said Cheatham.

Cheatham added that by changing to the Medicare drug prescription plan, the state was able to take advantage of federal dollars that directly fund that program. By contrast, if the state had continued to provide its own prescription drug benefits, the subsidy provided by the federal government under Medicare Part D could not be used to reduce the other post-employment benefits liability, according to GASB rules.

Ohio

Only a small number of states have accumulated significant assets to offset their OPEB obligations. Ohio, which had \$11.1 billion saved as of fiscal year 2006, has accumulated much more than even the next closest state (Alaska at \$2.2 billion).

Ohio began offering health care to its retirees in 1969 and started paying their health insurance premiums in 1974.¹¹¹ Managers initiated the first round of restructuring in 1986 by raising eligibility from five years of service to 10. The state introduced wellness programs and choice of plan during the 1990s. And it continued to restructure further by placing a cap on the lifetime benefit an individual retiree can receive as well as increasing deductibles and co-payments and tightening definitions of dependents.



The solvency test measures how long any dedicated funds will last given the expected level and timing of expenditures. Because Ohio has partially funded its OPEB obligation, the solvency test can be used to gauge its progress. In 2005, officials with the Ohio Public Employees Retirement System estimated the solvency period at 17 years. It grew to 18 years in 2006 and is estimated at 27 years for 2007, according to state officials.

Utah

Utah is noteworthy because it has a relatively modest long-term liability of \$750 million or \$488 million, respectively, for its non-pension benefits, depending on whether the state follows a pay-as-you-go approach or continues to pay the annual required contribution, as it has done in 2007 and 2008. Yet it has taken steps to restructure its benefits as a result of requirements to disclose these obligations.

During its 2005 session, the Utah legislature passed a bill, effective January 1, 2006, allowing retiring employees to receive 25 percent of the value of unused sick leave as a contribution into a 401(k) account.¹¹² (Those who retired before January 1, 2006, were able to cash out this amount of unused sick leave.) The value of any unused sick leave earned after this date is converted into a health reimbursement account. A prior provision allowing employees to receive health and life insurance coverage for up to five years or until they turned 65 is being phased out.

Employees have not accepted these changes without a fight. Utah was sued by the Utah Public Employees Association on behalf of five anonymous plaintiffs who charged that the legislature had illegally changed the rules of vesting and contributions.¹¹³ The state Supreme Court held that the legislative change was not an unconstitutional taking and that the plaintiffs did not have a property interest in the specific use of unused sick leave.

North Carolina

North Carolina offers other post-employment benefits to retired state employees, its universities and community college faculty and teachers who are members of the Teachers' and State Employees' Retirement System, as well as to other systems covering the judicial and legislative branches of government. The plan is the same as the one covering active employees.

In 2006, the North Carolina legislature overwhelmingly passed a bill that increased OPEB vesting periods from five to 20 years for employees hired after September 30, 2006. Those retiring with fewer than 20 years' service will have to pay between 50 percent and 100 percent of their health insurance premium, depending upon the number of years served.¹⁷

Because this reform is prospective, the state will not realize any financial benefits until 2011, when its OPEB obligation is likely to be somewhat reduced.¹⁷ Figuring out the impact of the change is highly complex. While it

certainly cuts back on the number of individuals who are eligible for full benefits, it will also result in a phenomenon economists call "adverse selection," which occurs when plan members who pay more in premiums than they consume in services exit the plan. Because those retiring with fewer than 20 years of service will now have to pay a significant portion of their premiums, many employees are expected to obtain health insurance from a lower cost provider. This loss of premium payments partially offsets the positive fiscal impact. It also means the resulting pool of plan members will be older and sicker, which could have a similar effect.

The net result of this reform is still anticipated to save money. But states should thoroughly investigate all restructuring options to ensure that the unintended consequences of changes to OPEB plans are not greater than the anticipated benefits.

Innovation in Management

Two factors lead to the large year-to-year increases in retiree health care benefits: the increasing number of retirees and the inflation of medical costs. States' estimates of liabilities vary somewhat depending on their assumptions about these two variables. Pinning down medical inflation is particularly tricky. Analysts in California and elsewhere have expressed concern that assumptions paint a way-too-optimistic portrait of what will happen over time. Still, governments have used a variety of management tools to whittle away at what they're spending on health care. Practices that have proven particularly useful

include establishing preferred drug lists, pushing the use of generics rather than brand-name drugs, shifting to managed care, and providing preventive services.

Here are three particularly hot areas of focus for governments to bring down retiree health costs:

Savings through consolidation

States can help their localities and themselves by bundling their plans under a single administrative umbrella. This can have immediate benefit because when risk is spread

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over a larger population, premiums tend to decline. Also, the so-called "big pencil" approach makes it far easier to bargain effectively with health care providers. Groups of employees can potentially also lower administrative costs as investment costs and overhead decline per member.

Missouri has been resolutely attempting to use consolidation to check health care costs for retirees. As of February 2007, the Missouri Consolidated Health Plan (MCHCP) claimed 104,545 members, or about 24 percent of all government workers in the state.¹¹⁹ The plan's comprehensive annual financial report points to an extremely moderate increase of 1.7 percent in medical costs from fiscal year 2005 to fiscal year 2006 and an overall increase in operating expenses of only 3.3 percent during that period.¹²⁰

In March 2006, a Missouri Foundation for Health report called on the state to expand eligibility for the plan to include non-governmental entities, seeing an opportunity to provide affordable health care coverage for all citizens using this successful structure. The report stated, "Because MCHCP already

provides coverage not just for state employees but also for a variety of municipal employers, it is logical to consider it as a candidate to serve small non-governmental employers as well."¹²⁰

Wellness programs

Many governments are promoting smarter choices for employees and retirees in four categories: health assessments and monitoring; health insurance incentives; healthy work environment initiatives, and physical fitness programs. Governments can use these programs to lower costs and get beneficiaries more involved in managing their care.

Texas offers among the most comprehensive wellness programs. In its plan year ending August 31, 2006, the Texas Blue Connection Preventive Care Intervention program sent nearly 92,000 women over age 40 "birthday cards," encouraging them to be screened for cancer and osteoporosis. Nearly 50,000 men over age 50 were sent similar cards encouraging prostate exams.¹²¹



Aggressive health care management

California's public employee retirement system recently initiated a purchasers' coalition to work with hospitals to increase the quality of service while managing costs. Called a "Partnership for Change," the program promotes performance measurement and public reporting. It strives to increase competition by negotiating rates with hospitals based on performance and value, while providing reliable data for purchasers to help make decisions. Benchmarking is used to increase transparency.

In summer 2003, the Massachusetts Group Insurance Commission (GIC) embarked on a multiyear effort called the Clinical Performance Improvement Initiative.¹²² The initiative, which

has become central to the GIC's strategy for health care coverage, seeks to deliver high-quality and cost-efficient health care to the GIC's 289,000 members. Now in its third year of implementation, the initiative relies on a database of over 150 million claim lines supplied by the six health plans currently providing coverage to GIC members. All of the claims are de-identified, which means that personal information is protected. The database is used to make quality and resource efficiency comparisons among physicians. The GIC's health plans use the results of the analysis to rank their doctors and stratify them into different groups or tiers. The health plans use modest co-pay differentials as incentives to encourage members to utilize higher tiered, more cost-efficient providers. This approach also seeks to encourage providers to improve their care delivery so as to "lift all the boats."

Conclusion

As states begin to report on the costs of health care and other non-pension benefits for public sector retirees, the long-term liabilities appearing on their "balance sheets" are likely to generate significant attention. A handful of states have been coping with how to pay for other post-employment benefits for some time, and these examples highlight the

benefits of consistent funding, reasoned policy decisions and good management. At this point, most states are just beginning to understand the problem, which is an important first step. The challenge of averting a funding crisis is daunting—but it will get exponentially larger if ignored.



Endnotes

- 87 Currently 43 states have completed at least preliminary actuarial valuations for their other post-employment benefit liabilities. Although efforts have been made to confine research to state employees, some states are unable to isolate state employee benefits from teacher or local benefits included in cost-sharing plans.
- 88 The PCS analysis centers on OPEB obligations for state employees, due to the wide range of practices regarding state involvement with other post-employment benefits for teachers or municipal employees.
- 89 David Zion and Amit Varshney, "You Dropped a Bomb on Me, GASB," *Credit Suisse* (March 22, 2007). *Credit Suisse* estimated the unfunded liabilities for states at \$558 billion, but included calculations for teachers in the total. It estimated the liability for localities at \$951 billion to arrive at the \$1.5 trillion. For the 16 states for which it had no estimates, *Credit Suisse* used a formula calculation in which it multiplied the number of employees by \$100,000.
- 90 Michéle Maynard and Jeremy W. Peters, "GM to Offer Buyout Deal to More Than 125,000 Workers," *The New York Times*, 22 March 2006.
- 91 For definitions of these terms, see the Glossary in Section 1.
- 92 There was no actuarial valuation for Illinois' other retiree benefits.
- 93 Civic Committee of the Commercial Club of Chicago, *Facing Facts: A Report of the Civic Committee's Task Force on Illinois State Finance* (Commercial Club of Chicago, December 6, 2006), <http://www.civiccommittee.org/initiatives/StateFinance/FacingFacts.pdf>.
- 94 Legislative Budget Board staff, *Texas State Government Effectiveness and Efficiency: Selected Issues and Recommendations*, submitted to the 80th Texas Legislature (Austin, January 2007), 129.
- 95 Zion and Varshney, "You Dropped a Bomb on Me," 10.
- 96 New Jersey Legislature, Office of Legislative Services, *Analysis of the New Jersey Budget: Fiscal Year 2007-2008*, (New Jersey New Jersey Department of the Treasury, 2007).
- 97 John E. Bartel of Bartel Associates, Inc., and Steven Glicksman of Glicksman Consulting, LLC, "State of Maine, Retiree Healthcare Plan, Actuarial Valuation, June 30, 2006," January 2007.
- 98 Leslie Johnstone, "Public Employees' Benefits Program" (presentation to the Joint Ways and Means and Senate Finance Subcommittee, Carson City, NV, January 24, 2007), 37.
- 99 Alaska is 65 percent funded, Arizona is 72 percent funded and Kentucky is 10 percent funded.
- 100 These numbers reflect state obligations for state employees only.
- 101 Workplace Economics, Inc., *2006 State Employee Benefits Survey* (The premium subsidy for retiree health benefits is very difficult to summarize as there are often multiple plans and tiered benefits depending on years served. The two-page chart on health benefits provided by Workplace Economics in its survey is followed by 13 pages of footnotes.)
- 102 Segal Group, Inc., *2003 Segal State Health Benefits Survey: Medical Benefits for Employees and Retirees*, (2003). Segal is currently updating this survey, in partnership with the National Association of State Personnel Executives.
- 103 Rich Saskal, "Despite Squabbles, They're Ahead of the Game on GASB," *Bond Buyer* 355, no. 32350 (March 30, 2006).
- 104 Aon Consulting, *Navigating the GASB OPEB Standards, Aon Consulting 2007 GASB OPEB Survey* (July 2007).
- 105 Survey results from the National Association of State Comptrollers OPEB Implementation Network can be found at <http://nasact.org/techupdates/techpubs.cfm>. The most recent survey was conducted in May 2007.
- 106 Frank R. Hoadley, "Observations on Pension-Related Liabilities and Disclosure," (Presentation to Milwaukee County Task Force, Milwaukee, WI., October 4, 2006).
- 107 Mark Scolloro, "Health Tab for Public Pa. Retirees Nears \$34 Billion," *Pittsburg Post Gazette*, 20 December 2006, <http://www.post-gazette.com/pg/06355/747768.85.stm>.
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- 109 Saskal, "Despite Squabbles."
- 110 Ibid.
- 111 Doug Finkle, "Few state retirees choosing cash over health insurance. Option for those with other coverage, not eligible for Medicare," State Capitol Bureau, *State Journal Register*, 30 August 2006 [0].
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- 114 Utah State Legislature, *Utah House Bill 27: Unused Sick Leave At Retirement Amendments*, sponsored by David Clark (January 2006), <http://www.leg.state.ut.us/~2005/htmdoc/hbillhtm/HB0213.htm>.
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- 118 Email from Ron Meyer, Executive Director, Missouri Consolidated Health Plan, received July 16, 2007.
- 119 Bi-State Development Agency of the Missouri-Illinois Metropolitan District St. Louis, Missouri, Financial Division, *Missouri Consolidated Health Care Plan, 2006: Comprehensive Annual Financial Report*, (Fiscal Year ended June 30, 2006): 20.
- 120 Missouri Foundation for Health and Urban Institute, *Cover Missouri Project: Report 7, Expanding Coverage Through the Missouri Consolidated Health Care Plan (MCHCP)*, by Elliot Wicks, March 2006: 13.
- 121 Employees Retirement System of Texas, *Controlling Costs and Preventing Fraud in the Texas Employees Group Benefits Program Fiscal Year 2006: The Key to Cost Containment*, by Ann S. Fuelberg (Austin 2006).
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Appendices

Appendix A

A-1

A-MOVING PICTURE: HOW STATE PENSION FUNDING LEVELS HAVE CHANGED, 1997-2006

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Alabama		84%	90%	93%	97%	101%	103%	102%	101%	111%
Alaska	74%	64%	67%	70%	73%	99%	100%	104%	103%	101%
Arizona	85%	86%	90%	99%	108%	118%	122%	118%	120%	117%
Arkansas	82%	82%	86%	90%	96%	100%	101%	101%	100%	97%
California		87%	86%	84%	96%	106%	116%	118%	114%	105%
Colorado	74%	73%	71%	76%	88%	99%	105%	103%	96%	92%
Connecticut	56%	59%	60%	66%	69%	72%	72%	65%	65%	64%
Delaware	97%	97%	98%	101%	103%	105%	108%	107%	100%	97%
Florida	106%	107%	112%	114%	115%	118%	118%	113%	106%	91%
Georgia	96%	98%	100%	101%	102%	103%	103%	98%	96%	90%
Hawaii	65%	69%	72%	76%	84%	91%	94%	94%		
Idaho	95%	93%	90%	82%	83%	95%	113%	109%	106%	94%
Illinois	60%	60%	64%	49%	54%	63%	75%	73%	72%	70%
Indiana	64%	65%	67%	67%	64%	67%	67%	64%	61%	
Iowa	88%	89%	89%	90%	93%	97%	98%	97%	95%	94%
Kansas	69%	69%	70%	75%	78%	85%	88%	86%	83%	83%
Kentucky	70%	76%	83%	88%	94%	102%	111%	105%	97%	94%
Louisiana	67%	64%	63%	68%	74%	78%	79%	75%	73%	68%
Maine	77%	76%	75%	74%	77%	78%	79%	75%	69%	63%
Maryland	82%	88%	92%	93%	94%	98%	101%	97%	90%	86%
Massachusetts	72%	73%	75%	70%	83%	84%	87%	81%	81%	75%
Michigan	81%	79%	84%	87%	93%	99%	101%	101%	99%	103%
Minnesota	93%	98%	100%	102%	105%	108%	107%	107%	107%	102%
Mississippi	73%	72%	75%	79%	83%	87%	82%	82%	84%	79%
Missouri	81%	81%	80%	81%	93%	96%	100%	98%	96%	95%

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A-1

**A MOVING PICTURE - HOW STATE PENSION FUNDING LEVELS HAVE CHANGED,
1997-2006 CONTINUED**

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Montana	80%	78%	80%	91%	91%	103%	.03%	83%	83%	79%
Nebraska	89%	88%	89%	92%	96%					
Nevada	75%	76%	79%	81%	82%	84%	85%	82%	78%	76%
New Hampshire	61%	60%	71%	75%	82%	85%	90%	89%	108%	110%
New Jersey	79%	82%	87%	94%	101%	109%	111%	110%	106%	102%
New Mexico	82%	84%	87%	92%	98%	99%	96%	90%	84%	82%
New York ¹	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
North Carolina	105%	106%	106%	106%	109%	110%	108%	104%	99%	99%
North Dakota	81%	82%	86%	91%	97%	103%	108%	97%	99%	100%
Ohio	81%	80%	81%	79%	81%	96%	96%	94%	92%	89%
Oklahoma	59%	60%	60%	66%	65%	66%	68%	65%	64%	58%
Oregon	110%	104%	96%	97%	91%	107%	98%	99%	93%	93%
Pennsylvania	87%	87%	93%	100%	106%	115%	127%	121%	111%	106%
Rhode Island		56%	60%	64%	73%	78%	81%	83%	78%	75%
South Carolina		73%	81%	83%	86%	88%	89%	98%	94%	91%
South Dakota		96%	98%	97%	97%	96%	96%	97%	96%	95%
Tennessee	99%	99%	99%	99%	98%	98%	99%	99%	99%	99%
Texas	89%	88%	93%	95%	97%	121%	107%	104%	105%	100%
Utah	96%	93%	92%	95%	93%	103%	105%	102%	96%	91%
Vermont	92%	95%	94%	94%	94%	92%	92%	91%	90%	86%
Virginia		81%	89%	95%	100%	106%	104%	94%	87%	79%
Washington		79%	85%	88%	93%	98%	102%	96%	88%	81%
West Virginia	55%	49%	43%	39%	40%	44%	47%	46%	46%	
Wisconsin	100%	99%	99%	99%	97%	96%	96%	96%	95%	95%
Wyoming	95%	95%	86%	92%	92%	103%	115%			
US Average	82%	82%	83%	86%	89%	95%	97%	94%	92%	90%

¹ See n. 4, page 13.

NOTE: Missing cells indicate that data were unavailable.

SOURCE: Pew Center on the States

PAYING THE ANNUAL BILL - KEEPING UP WITH ANNUAL REQUIRED PAYMENTS
 1997-2006

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Alabama	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Alaska	61%	47%	92%	118%	120%	109%	99%	105%	91%	93%
Arizona	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Arkansas	108%	110%	101%	102%	102%	101%	102%	101%	101%	101%
California	108%	110%	101%	102%	102%	101%	102%	101%	101%	101%
Colorado	62%	49%	52%	69%	100%	100%	100%	100%	100%	100%
Connecticut	100%	88%	89%	94%	99%	94%	94%	94%	66%	70%
Delaware	97%	93%	91%	88%	80%	80%	84%	85%	85%	85%
Florida	96%	102%	92%	98%	97%	110%	111%	100%	100%	100%
Georgia	100%	100%	100%	100%	100%	100%	101%	101%	100%	100%
Hawaii	100%	100%	100%	100%	100%	5%	13%	83%		
Idaho	107%	102%	98%	110%	131%	131%	117%	100%	99%	99%
Illinois	33%	44%	111%	67%	78%	80%	114%	98%	96%	74%
Indiana	101%	85%	78%	103%	108%	123%	125%	120%	92%	85%
Iowa	84%	86%	91%	99%	100%	100%	101%	104%	101%	103%
Kansas	63%	69%	69%	79%	80%	78%	77%	77%	74%	72%
Kentucky	86%	93%	94%	100%	104%	101%	101%	101%	104%	99%
Louisiana	101%	101%	93%	97%	102%	107%	105%	107%	103%	100%
Maine	106%	105%	112%	109%	165%	100%	102%	108%	109%	108%
Maryland	82%	83%	89%	92%	100%	100%	100%	100%	100%	100%
Massachusetts	94%	101%	63%	67%	101%	116%	99%	120%	156%	174%
Michigan	83%	78%	65%	78%	89%	126%	111%	99%	123%	109%
Minnesota	99%	115%	114%	148%	172%	156%	162%	152%	137%	131%
Mississippi	100%	100%	100%	100%	101%	101%	100%	100%	100%	115%
Missouri	81%	77%	84%	96%	100%	100%	100%	100%	99%	99%
Montana	153%	91%	94%	99%	100%	130%	129%	101%		
Nebraska	100%	91%	100%	99%	100%	100%				
Nevada	96%	100%	99%	90%	96%	100%	97%	95%	94%	100%
New Hampshire	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
New Jersey	27%	15%	8%	4%	3%	17%	29%	60%	40%	288%
New Mexico	91%	96%	100%	100%	100%	99%	99%	99%	99%	99%
New York	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
North Carolina	100%	100%	100%	100%	100%	82%	100%	100%	100%	100%
North Dakota	66%	67%	81%	97%	101%	101%	101%	100%	100%	100%
Ohio	93%	98%	97%	100%	100%	100%	100%	100%	100%	100%

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**PAYING THE ANNUAL BILL - KEEPING UP WITH ANNUAL REQUIRED PAYMENTS,
1997-2006 CONTINUED**

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Oklahoma	73%	58%	60%	64%	71%	77%	71%	74%	81%	78%
Oregon		101%	100%	100%	97%	95%	95%	97%	100%	100%
Pennsylvania	35%	46%	100%	117%	219%	112%	100%	100%	100%	100%
Rhode Island	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
South Carolina	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
South Dakota	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Tennessee	100%	100%	100%	100%	100%	100%	100%	100%	100%	
Texas	84%	83%	83%	86%	104%	138%	102%	103%	97%	101%
Utah	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Vermont	76%	75%	67%	86%	96%	96%	96%	94%	85%	78%
Virginia	87%	83%	85%	64%	71%	100%	93%	85%	71%	62%
Washington	28%	20%	22%	27%	57%	164%	104%	287%	114%	80%
West Virginia	182%	147%	104%	105%	108%	106%	104%	105%	103%	
Wisconsin	100%	100%	100%	100%	100%	100%	96%	100%	100%	100%
Wyoming	150%	113%	75%	69%	127%	469%	189%			

NOTE: Missing cells indicate that data were unavailable in order to calculate the percent of the annual required contribution funded.

SOURCE: Pew Center on the States

Appendix B

The Stand-Out States

To identify the degree of challenge states face in meeting their non-pension obligations to retirees, PCS turned to means used by GASB, Standard & Poor's and Moody's Investor Services for adjusting comparisons of states. We looked at the 40 states for which actuarial valuations are now available and for which we could isolate the state contribution for state employees only. Exhibits B-1 through B-4 put retiree benefit liabilities in context based on population, personal income and payroll.

For those 40 states, the mean per capita costs of their accrued liabilities is \$1,283.¹²¹ Since

there's a wide range of benefits offered, the median is \$774. Looking at the unfunded liabilities as a percentage of total state personal income, the mean is 3.4 percent and the median is 2.5 percent,¹²⁴ and when viewed as a percent of covered payroll, the mean is 191 percent and the median is 135 percent.¹²⁵ The following section provides tables showing the states that stand out from the pack. These figures assume that the states are not pre-funding the obligation. Once again, if the ARC is paid consistently over time, the AAL and UAAL drop considerably.

Per capita

Exhibit B-1, which is based on population data from the U.S. Bureau of the Census and the U.S. Department of Commerce, shows the 10 states with the highest per-capita unfunded actuarial accrued liability (UAAL) for their state employees. This indicates the fiscal burden each state's citizens are carrying because of the UAAL, although it does not assess their ability or capacity to pay.

The top three states all have per-capita unfunded accrued liabilities over five times the median, suggesting a relatively heavy burden. Illinois does not appear in Exhibit B-1 because an actuarial valuation was not available. However, as previously noted, the Civic Committee of the Commercial Club of Chicago estimated the liability for state employees at \$48 billion. Using this information, PCS estimates Illinois' per capita liability at \$3,741, which would make it among the top five states in liabilities per state resident.

B-1

UNFUNDED RETIREE HEALTH BILL PER CAPITA

States	UAAL/Capita	States	UAAL/Capita
Connecticut	\$6,186	New Hampshire	\$2,210
Hawaii	\$5,283	Massachusetts	\$2,064
Delaware	\$5,167	Kentucky	\$1,923
Maryland	\$2,590	Alaska	\$1,800
New York	\$2,572	Median	\$774
New Jersey	\$2,474	Mean	\$1,283

SOURCE: Pew Center on the States; Based on Actuarial Valuations

Appendix B

As a percentage of personal income

Per-capita statistics, however, do not tell the whole story because they do not take into account the differences in wealth or ability to pay. Measures of personal income in the states, as reported by the U.S. Department of Commerce, help get at that factor. Subject to this further level of analysis, the 10 states with

the largest liabilities do not change dramatically. But the order shifts a bit. Hawaii climbs to the top, and Kentucky appears as its burden rises when measured by its ability to pay. If Illinois data were included, it would appear in Exhibit B-2—again in the top five—at 9.8 percent.

B-2

UNFUNDED RETIREE HEALTH BILL AS A PART OF PERSONAL INCOME

States	UAAL/Personal Income	States	UAAL/Personal Income
Hawaii	14.6%	New Hampshire	5.6%
Delaware	13.2%	Louisiana	5.5%
Connecticut	12.4%	Maine	5.4%
Kentucky	6.6%	New Jersey	5.3%
New York	6.1%	Median	2.5%
Maryland	5.9%	Mean	3.4%

SOURCE: Pew Center on the States; Based on Actuarial Valuations

As a percentage of payroll

Another measure used to gauge relative burden—and one that GASB will ask states to produce in their financial reporting—involves the size of the obligation compared to the size of the payroll being covered. Covered payroll is a tricky statistic because some states report the covered payroll for the state portion of their retiree benefits while others report only

the amount for the entire plan. For purposes of this calculation, PCS has excluded the data for those states reporting the latter. For the 34 states where both UAAL and covered payroll data for the state only were available, the median ratio is 135 percent. The 10 states with the highest ratio are reflected in Exhibit B-3.

B-3

UNFUNDED RETIREE HEALTH BILL AS A PART OF PAYROLL

States	UAAL/Covered Payroll	States	UAAL/Covered Payroll
Connecticut	690%	Louisiana	362%
New York	552%	Maryland	362%
Kentucky	422%	California	347%
Alabama	410%	New Jersey	333%
Hawaii	395%	Median	135%
Maine	377%	Mean	191%

SOURCE: Pew Center on the States; Based on Actuarial Valuations

Note the rise of New York and the appearance of Alabama, Maine and California. Again, if Illinois data were considered, its unfunded liability as a share of payroll would be ranked first at 709 percent. Why did these states rate so high on UAAL/covered payroll? One

plausible explanation according to a number of sources, including New York's Citizens Budget Commission, is that employees in some of those states may have received wage increases that were relatively low in exchange for better post-retirement benefits over the years.¹²⁶

States at the Other End of the Spectrum

Until recently, Indiana and Nebraska were the only two states that offer no benefits for retirees over age 65 (although both do have some provisions for retirees who are not yet eligible for Medicare).¹²⁷ Oregon also eliminated its coverage for Medicare eligible retirees who were hired on or after August 29, 2003, according to the GAO.¹²⁸ Eight additional states—Idaho, Iowa, Kansas, Minnesota, Mississippi, Montana, South Dakota and Wyoming—pay no premiums for retirees, but do allow all eligible retirees to sign on to the state plan.¹²⁹ This type of benefit provides an “implicit subsidy,” which comes from allowing retirees to participate in the same pool as younger and generally healthier state employees. Because retirees are much older than the average participant in state plans,

they are more expensive to cover, bringing up the average costs of the entire plan. In Wyoming, for example, although the retirees pay for benefits themselves, the inclusion of these older men and women in the insured pool increases the costs to the state by some \$72 million over a 30-year period.¹³⁰

Exhibit B-4 shows states that have the smallest long-term obligations relative to the state's population and as a share of personal income.¹³¹

In Kansas, Indiana, Minnesota, Mississippi and Nebraska—five of the seven states where actuarial valuations were unavailable—the unfunded actuarial liabilities are likely small.

B-4 UNFUNDED RETIREE HEALTH BILL PER CAPITA AND AS A SHARE OF PERSONAL INCOME

States	UAAL/Capita	UAAL/Personal Income
Wisconsin ¹³²	\$3	0.0%
Arizona	\$15	0.0%
Iowa	\$74	0.2%
North Dakota	\$77	0.2%
Wyoming	\$140	0.3%
Median	\$774	2.5%

SOURCE: Pew Center on the States; Based on Actuarial Valuations

Appendices

Endnotes

- 123 Of the 43 states that have completed an actuarial valuation, 40 states were used in this calculation. These numbers do not reflect Oregon, New Mexico and West Virginia because their valuations did not disaggregate state only data. PCS was able to calculate the state employee portion of OPEB UA/L for Arizona, North Carolina and Ohio.
- 124 Similar to the per capita calculations, Oregon, New Mexico and West Virginia were not included because their valuations did not disaggregate state only data.
- 125 PCS was only able to gather covered payroll for state employees in 37 of the 40 states where we have actuarial valuations and were able to disaggregate state data.
- 126 New York's Citizen Budget Committee, *The Case for Redesigning Retirement Benefits for New York's Public Employees*, (April 29, 2005)
- 127 Workplace Economics, Inc, *2006 State Employee Benefits Survey*
- 128 United States Government Accountability Office, 2007.
- 129 Workplace Economics, Inc, *2006 State Employee Benefits Survey*
- 130 *Report on the State of Wyoming Retiree Health Insurance Study and GASB 45 Liability* (presented by Buck Consultants to the State of Wyoming Joint Appropriations Committee, November 1, 2005), <http://personnel.state.wy.us/EGI/Buck%20Retiree%20Study.pdf>
- 131 Once again, these figures are only for the 40 states which have actuarial valuations and where state employees could be isolated.
- 132 Wisconsin took care of its modest unfunded liability for other post-employment benefits by bonding it out. See p. 50 in Section 3, Other Benefits. The \$600 million in other post-employment benefit bonds may not take care of the full amount, however, as costs are outpacing projections.



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Promises with a Price Public Sector Retirement Benefits



Pension Obligation Bonds

February 4, 2008

Alaska Department of Revenue



Overview of Pension Obligation Bonds (POBs)

Pension Obligation Bonds (POBs)

- Pension Obligation Bonds are bonds issued by a state or local government to pay its obligation to the pension system in which its employees are members.
- POBs have been an increasingly popular and successful way for state and local governments to accomplish financial objectives.
- Since 1995, six states and over 234 local governments have issued POBs totaling in excess of \$40 billion.

POBs Have Been Issued Throughout the US

- Over \$6 billion
- Between \$1 and \$6 billion total issued
- Less than \$1 billion issued



Source: Lehman Brothers

Why Should We Consider Issuing POBs?

- Interest rate savings – the interest rate of POBs issued in the near future will be lower than 8.25% charged by the pension system.
- Arbitrage – the actual investment return of pension asset exceeds the POB cost.
- POBs are not generally viewed as adding to the debt burden of the state or local government issuer because they replace existing pension obligations.
- POBs can improve funding ratios at a relatively low cost of funds and with a repayment schedule that fits the state's or local governments' goals and constraints.

POBs Are:

Not ...



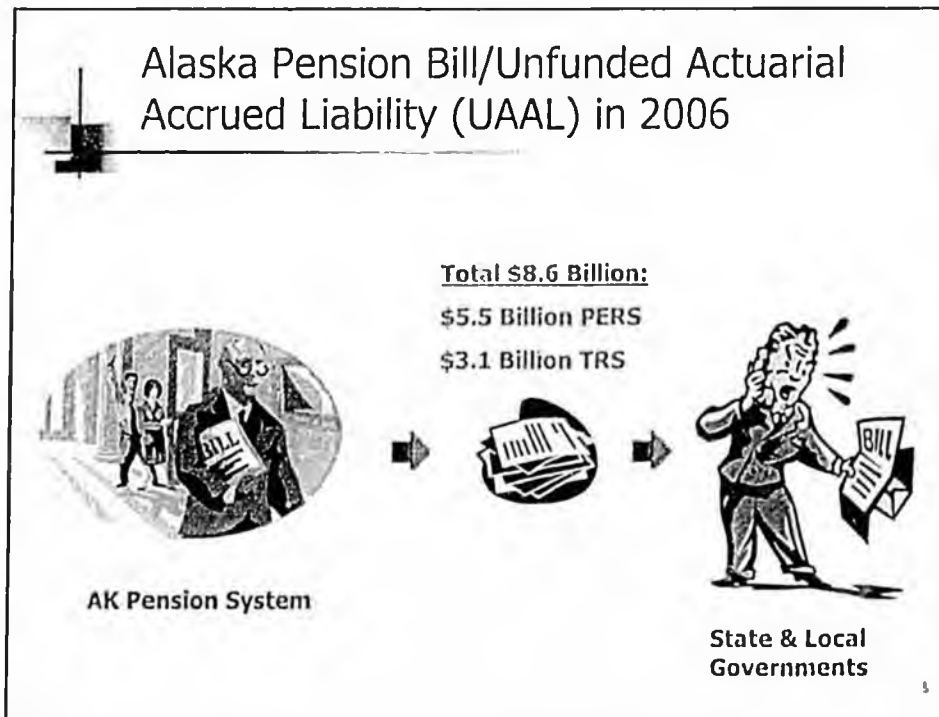
Golden Bullet

But ...

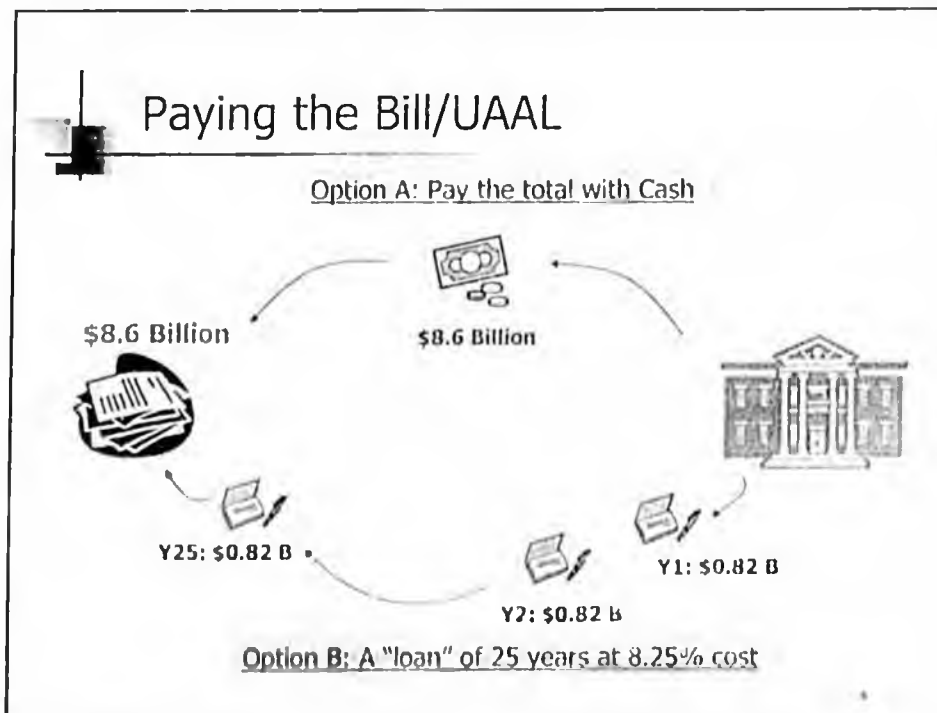


Financial Tool

Alaska Pension Bill/Unfunded Actuarial Accrued Liability (UAAL) in 2006

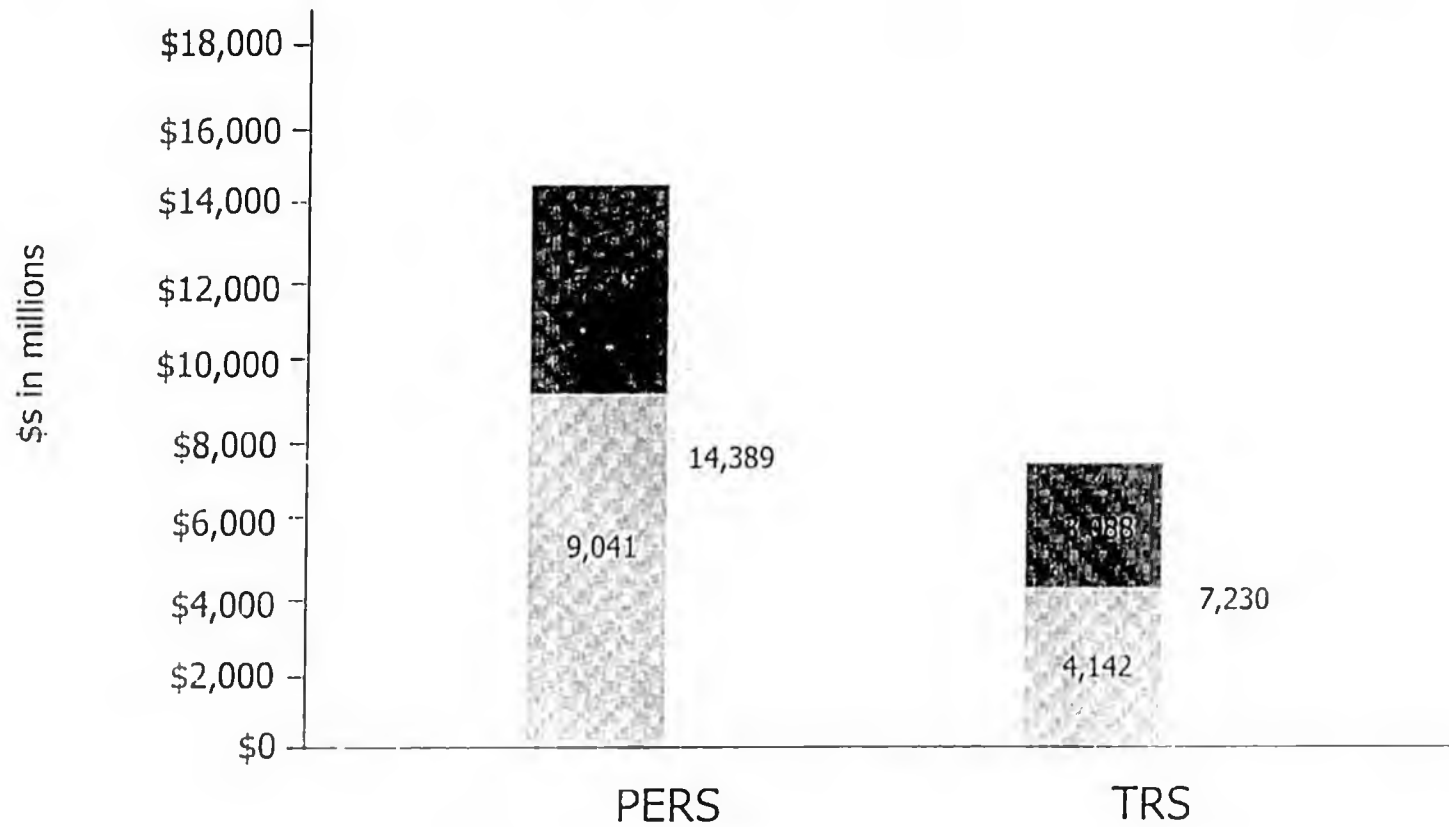


Paying the Bill/UAAL



Funding Status Overview

Summary of Funding Status for PERS and TRS as of June 30, 2006



Interest Rate Savings

Interest Rate Savings

Comparing the amortization of \$1 billion debt at 8.25% cost to \$1 billion debt at 5.25% over 25 years:

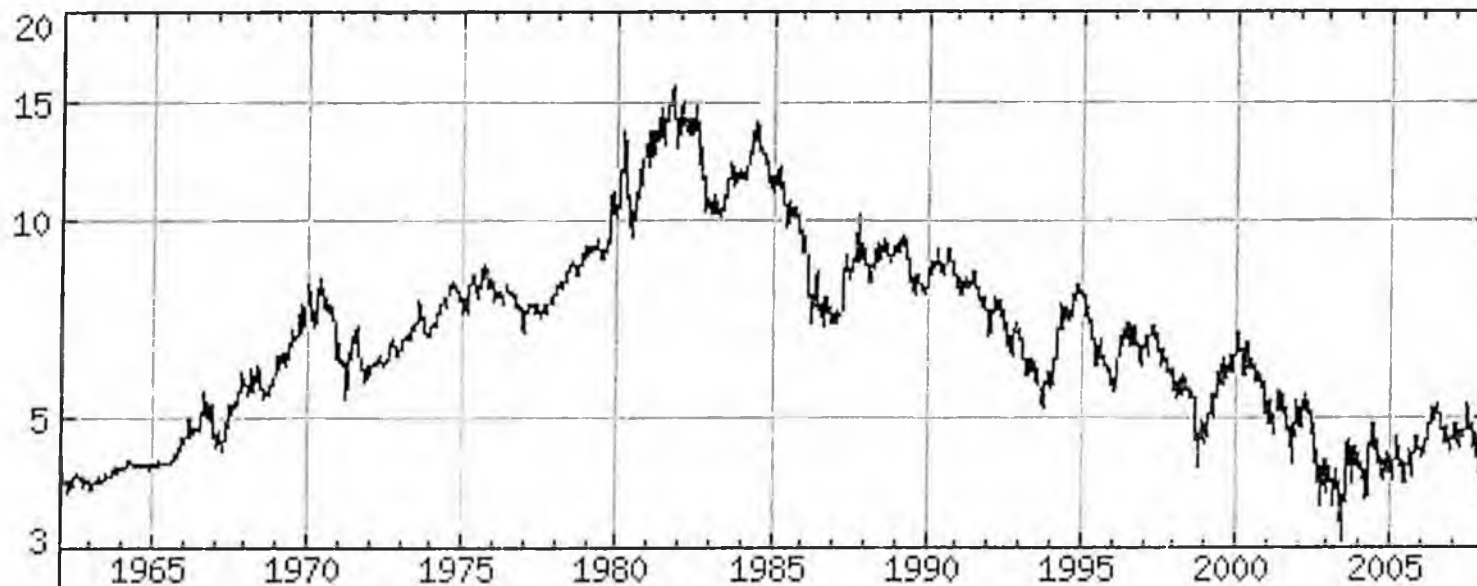
- Saving on interest cost is 3.0%;
- Saving on annual debt payment is \$23 million;
- NPV of savings on annual debt payment over 25 years is \$323 million discounted at 5%.

	Amount (\$Billion)	Interest Cost	Annual P&I Payment (\$Million)
\$	1	8.25%	\$ 96
\$	1	5.25%	\$ 73
Savings		3.00%	\$ 23
NPV of Cumulative Savings @ 5%			\$ 323

Interest Rate History

- 10-Year Treasury yield is 3.65% as of February 1, 2008. This rate is extraordinarily attractive when viewed in a historical context.

10-Year Treasury Yields



Treasury Rates Still Historically Attractive

3-month LIBOR Rate

Min:	1.00%
Average:	5.03%
Max:	10.63%
Current:	4.62%

Lower than current level
36% of the time

5-Year Treasury Rate

Min:	2.03%
Average:	5.69%
Max:	9.73%
Current:	3.27%

Lower than current level
8% of the time

10-Year Treasury Rate

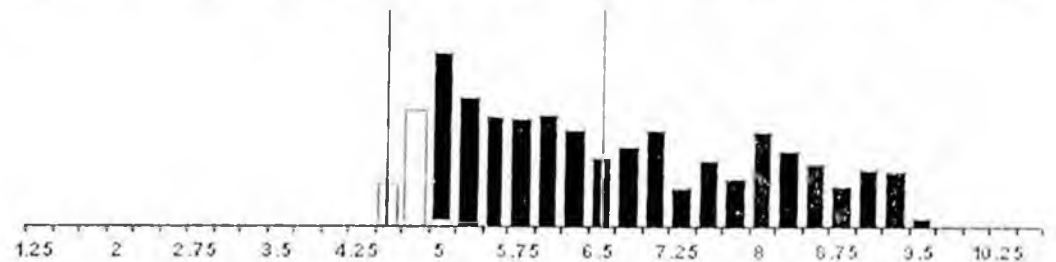
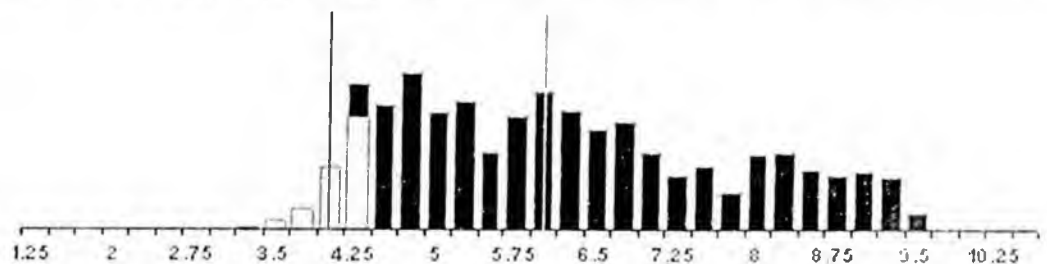
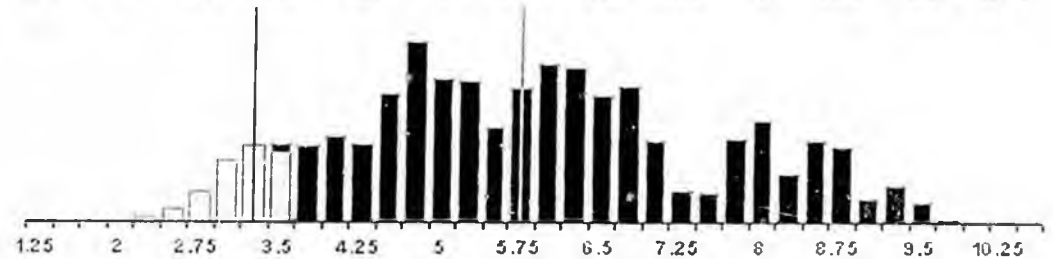
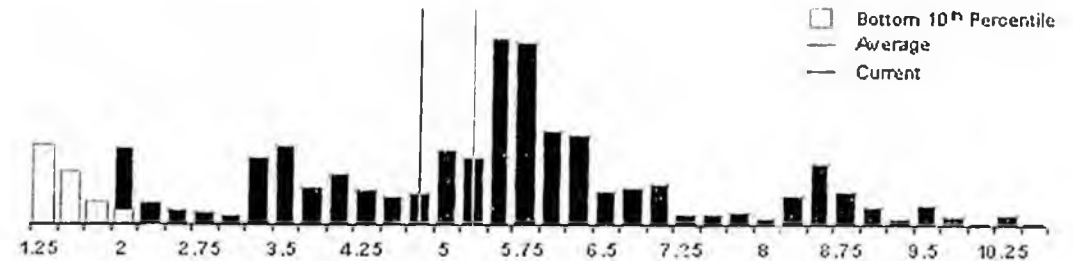
Min:	3.11%
Average:	6.06%
Max:	9.54%
Current:	3.91%

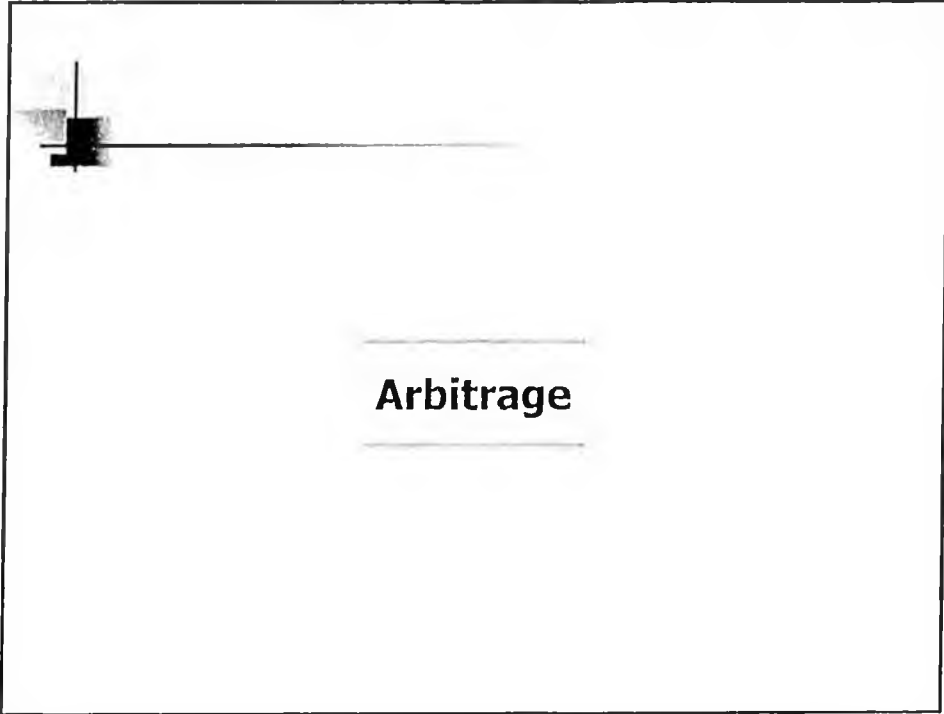
Lower than current level
3% of the time

30-Year Treasury Rate

Min:	4.17%
Average:	6.40%
Max:	9.45%
Current:	4.39%

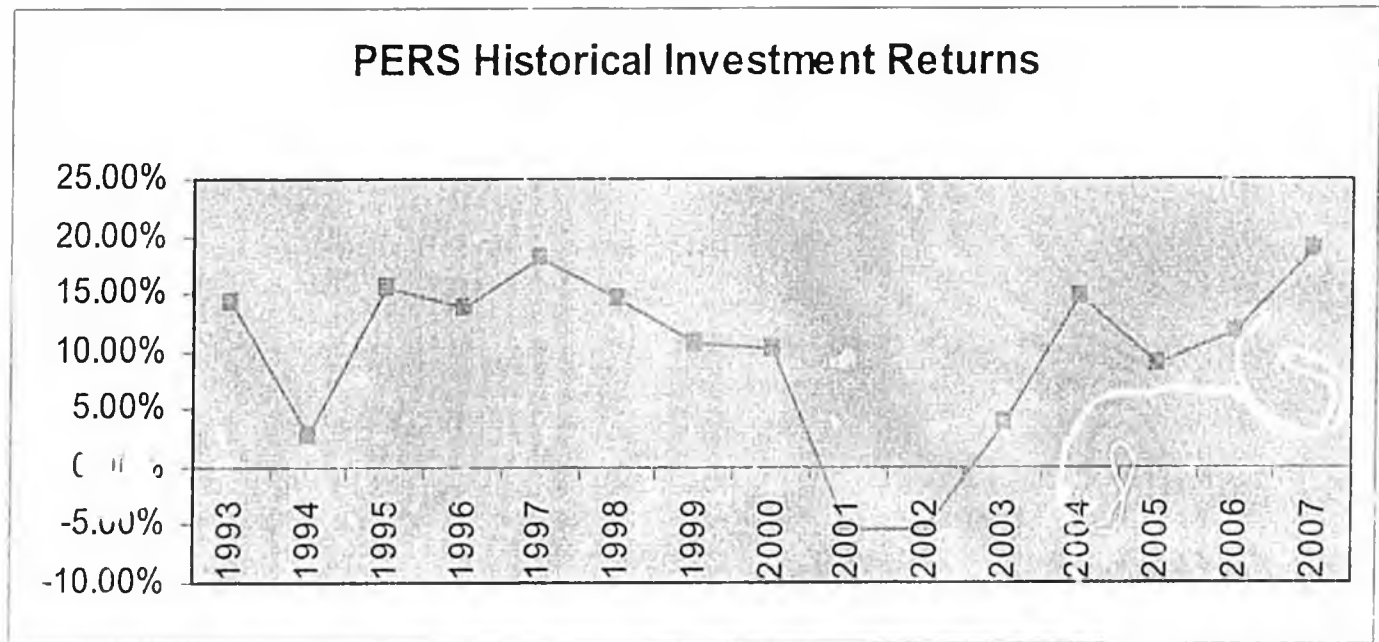
Lower than current level
1% of the time





Historical Investment Returns of State Pension Plans (PERS)

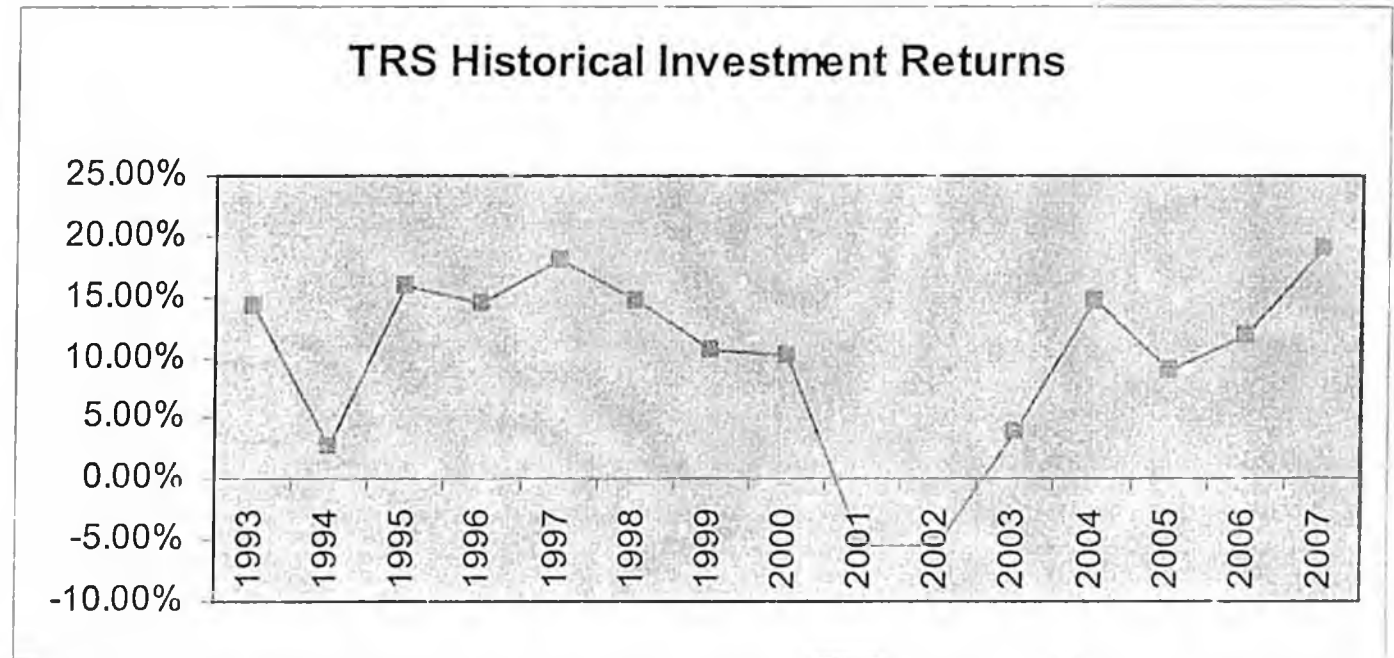
FY	PERS ROR
2007	18.88%
2006	11.69%
2005	8.86%
2004	14.73%
2003	3.82%
2002	-5.40%
2001	-5.30%
2000	10.12%
1999	10.65%
1998	14.62%
1997	18.07%
1996	13.70%
1995	15.56%
1994	2.66%
1993	14.25%
1992	11.80%



- The average return from 1992 to 2007 is 9.67%.
- Standard Deviation is 7.40%.

Historical Investment Returns of State Pension Plans (TRS)

FY	TRS ROR
2007	18.89%
2006	11.72%
2005	8.90%
2004	14.75%
2003	3.81%
2002	-5.41%
2001	-5.36%
2000	10.19%
1999	10.73%
1998	14.73%
1997	18.00%
1996	14.35%
1995	15.89%
1994	2.61%
1993	14.16%
1992	11.58%



- The average return from 1992 to 2007 is 9.72%.
- Standard Deviation is 7.45%.

Long Term Target Asset Allocation

Asset Class	Allocation	Range
Domestic Large Capitalization	30%	± 3%
Domestic Small Capitalization	6%	± 3%
International Equity	14%	± 3%
Emerging Markets Equity	2%	± 2%
Private Equity	7%	± 5%
Domestic Fixed-Income	26%	± 3%
High Yield	2%	± 2%
International Fixed Income	2%	± 2%
Real Estate	10%	± 4%
Absolute Return	4%	± 4%
Other	3%	± 3%
Cash	0%	± 3%

Median Return 8.05%
Standard Deviation 12.27%

Source: Callan Associates, Inc.

13

Credit Neutrality

Credit Rating Consideration

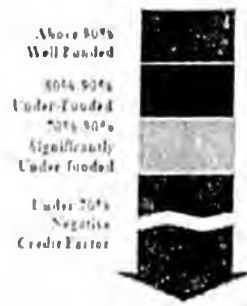
- Credit Neutral – debt obligation is already recognized and POBs are not considered new debt.
- "Moody's believes the issuance of POBs is one effective way of addressing an unfunded liability."
- "Standard & Poor's has viewed POBs as a strategy for savings on carrying charges as long as the transaction are structured conservatively and the assumptions were reasonable and attainable."

14

Prudently Structured, POBs are Ratings Neutral


Failure to fully fund the actuarially required contribution signals fiscal stress to the market ("willingness to pay").

- Consistent underfunding is considered a credit negative.
- Funding ratios below 80% are a potential negative
 - Actuarially Required Contribution needed to "catch up" may "crowd out" other priorities, reducing the state's financial flexibility.
- Rating agencies generally view POBs as an acceptable tool for reducing the cost of an already existing liability.
- Significant term extensions and/or payment holidays are *not* viewed positively.



Source: Lehman Brothers

15



Risks



Risks Overview

- Investment Risk – POB financing is successful as long as the return of investment of proceeds exceed PCB cost.
- Political Risk – Overfunded pension system can lead to political pressure to increase pension benefits, which can cause further increased pension liability in the future.
- Market Risk – Prudent investment of POB proceeds in early years is important.

Investment Risk Analysis

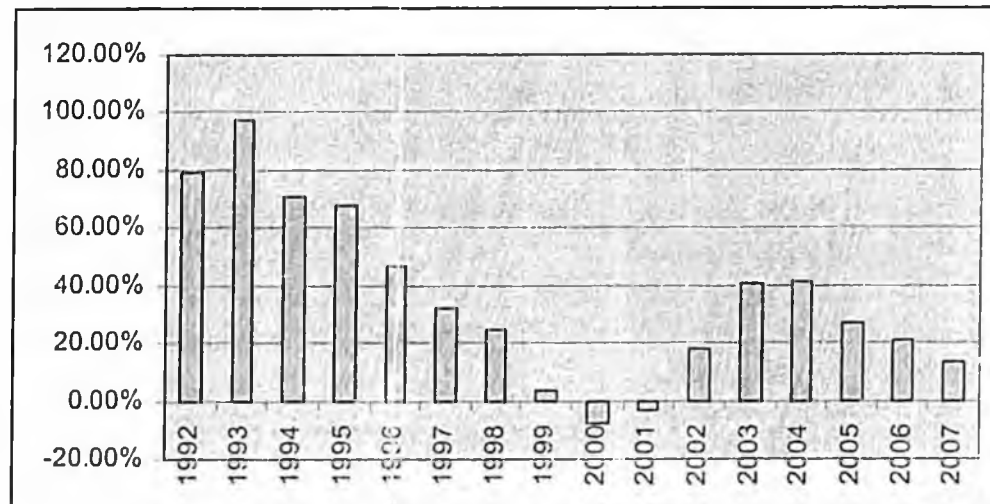
As long as those bond-funded assets earn more than 5.25%, we are better off for having borrowed.

- With the current low interest rate environment, POB issuance with cost around 5.25% is achievable.
- Historical investment returns of PERS and TRS indicate that we can outperform 5.25% most of the time.
- Simulations of future investment returns show that there are high possibility that we are going to outperform 5.25%.

Investment Risk (PERS)

FY	PERS ROR	Estimated Cost of Borrowing	Accm. Returns as of EOY FY07	Annualized Returns as of EOY FY07
2007	18.88%	5.75%	13.13%	13.13%
2006	11.69%	5.55%	20.63%	9.83%
2005	8.86%	5.04%	26.82%	8.24%
2004	14.73%	5.02%	40.92%	8.95%
2003	3.82%	4.76%	40.65%	7.06%
2002	-5.40%	5.36%	18.16%	2.82%
2001	-5.30%	5.77%	-3.29%	-0.48%
2000	10.12%	6.78%	-8.21%	-1.07%
1999	10.65%	6.40%	3.38%	0.37%
1998	14.62%	6.01%	24.72%	2.23%
1997	18.07%	7.10%	31.90%	2.55%
1996	13.70%	7.19%	46.90%	3.26%
1995	15.56%	7.32%	68.16%	4.08%
1994	2.66%	7.84%	70.80%	3.90%
1993	14.25%	6.62%	96.98%	4.62%
1992	11.80%	7.76%	79.24%	3.71%

Estimated Cumulative Net Return to 2007 (PERS)

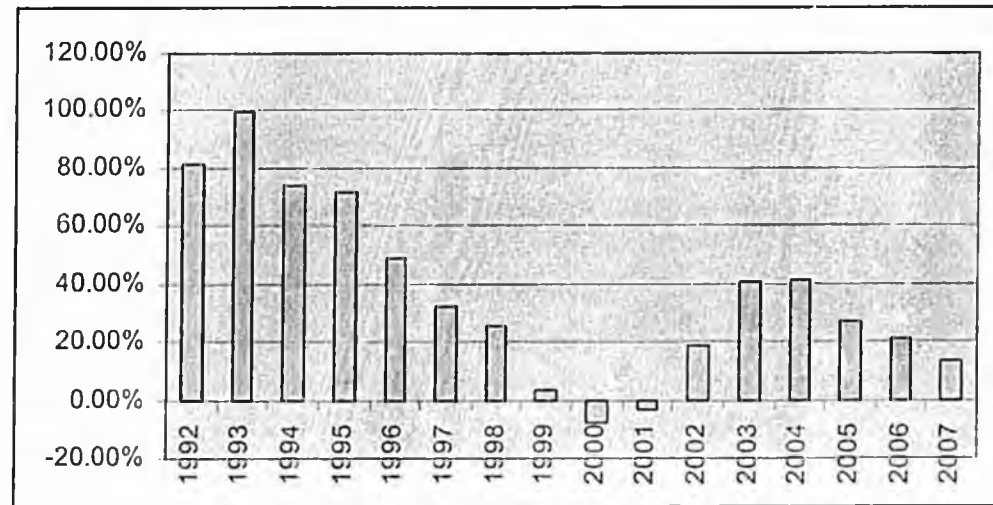


- Based on PERS actual investment history, we can see what the cumulative net return to 2007 might have been if POBs had been issued in any given year.
- For 14 out of 16 years the issuance of POBs would have resulted in a gain to the pension system.

Investment Risk (TRS)

FY	TRS ROR	Estimated Cost of Borrowing	Accm. Returns as of EOY FY07	Annualized Returns as of EOY FY07
2007	18.89%	5.75%	13.14%	13.14%
2006	11.72%	5.55%	20.68%	9.85%
2005	8.90%	5.04%	26.92%	8.27%
2004	14.75%	5.02%	41.06%	8.98%
2003	3.81%	4.76%	40.78%	7.08%
2002	-5.41%	5.36%	18.25%	2.83%
2001	-5.36%	5.77%	-3.32%	-0.48%
2000	10.19%	6.78%	-8.13%	-1.05%
1999	10.73%	6.40%	3.60%	0.39%
1998	14.73%	6.01%	25.17%	2.27%
1997	18.00%	7.10%	32.25%	2.57%
1996	14.35%	7.19%	48.94%	3.38%
1995	15.89%	7.32%	71.33%	4.23%
1994	2.61%	7.84%	73.70%	4.02%
1993	14.16%	6.62%	99.82%	4.72%
1992	11.58%	7.76%	81.23%	3.79%

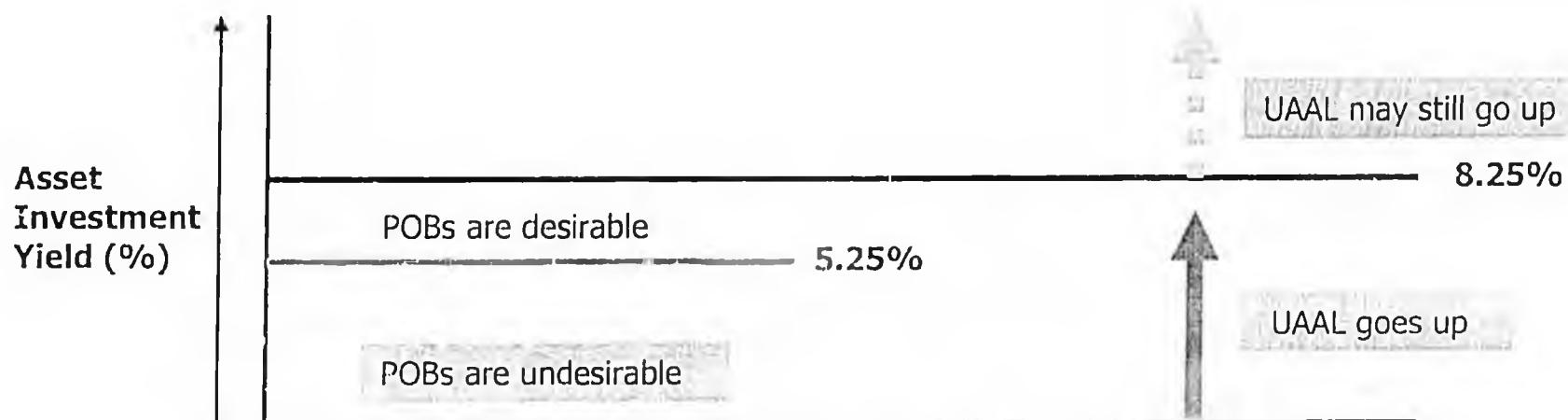
Estimated Cumulative Net Return to 2007 (TRS)



- Based on TRS actual investment history, we can see what the cumulative net return to 2007 might have been if POBs had been issued in any given year.
- For 14 out of 16 years the issuance of POBs would have resulted in a gain to the pension system.

UAAL vs. POB Financial Success

- POB financing:
 - As long as those bond-funded assets earn $> 5.25\%$, we are better off for having borrowed.
 - POB financing is undesirable if assets earn $< 5.25\%$.
- All other things equal, when PERS and TRS assets earn $< 8.25\%$, the UAAL goes up.
- Further, even if those assets earn $> 8.25\%$, the UAAL can increase due to actuarial and / or accounting changes.

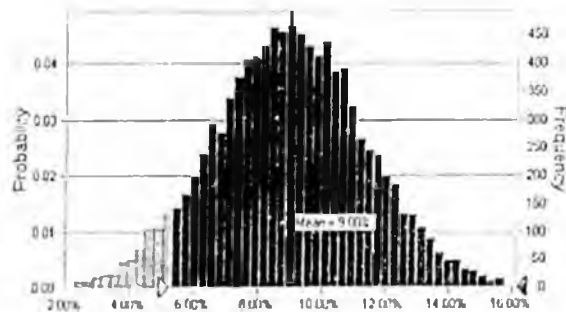
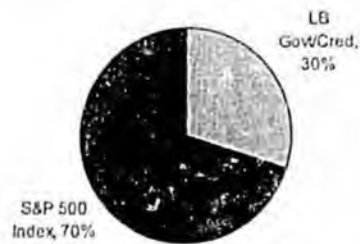


Investment Return Forecast

Monte Carlo simulation with 10,000 iterations for each scenario.

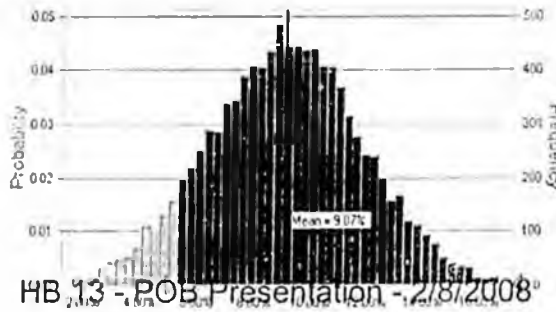
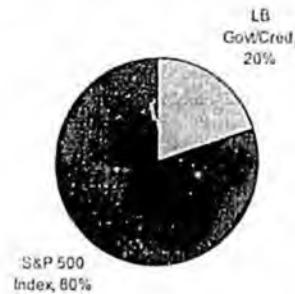
Conservative – 70/30

Annualized Average Return	9.00%
Stand Deviation of Returns	2.37%
Probability of outperforming 5.25%	94.2%



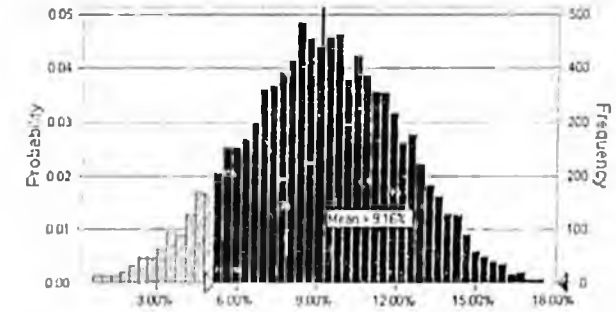
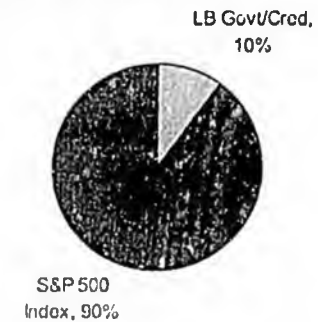
Moderate – 80/20

Annualized Average Return	9.07%
Stand Deviation of Returns	2.71%
Probability of outperforming 5.25%	92.2%



Aggressive – 90/10

Annualized Average Return	9.16%
Stand Deviation of Returns	3.03%
Probability of outperforming 5.25%	89.87%



Political Risk – Key Driver of UAAL

Between 1992 and 2003, increasing liabilities – not poor investment performance – caused the most damage to the PERS/TRS system.

- Presented by State Actuary to ARM Board in 2005

Changes in Assets Include:

- Investment performance (i.e. investment risk)

Changes in Liabilities Include:

- Health benefits cost experience
- Health assumption changes
- Plan changes
- Demographic experience
- Non-health changes

Drivers of PERS/TRS Funding Ratio Changes (1992-2003)

	PERS Change in Funded Status	TRS Change in Funded Status
Change Due to Assets	+3.5%	+1.0%
Change Due to Liabilities	-18.5%	-20.6%
Total Change in Funded Status	-22.3%	-29.3%

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Political Risk

High amount of POBs proceeds may cause the pension system to be over-funded, which could lead to political pressure calling for benefit increases that incur new liabilities in the future.

Risk Control:

- POBs are not issued for the full UAAL; a funded ratio of 70-80% is an industry standard.
- Manage pension benefits and UAAL with discipline.

73




Market Risk

POBs proceeds cause a large amount of capital infusion into the pension system at once. Prudent investment of the proceeds in early years is critical.

Risk Control:

- Thorough market assessment before POB issuance;
- Considering whether to have a special investment allocation strategy for the proceeds, or stick with the traditional allocations.

24



Types of Public Debt



Security

- **General obligation bonds**
Bonds that satisfy any constitutional debt limitation and are backed by the full faith and credit and taxing power of the issuing state and local government.
- **Obligations imposed by law**
Obligations imposed by the state or local government by the constitution or by statute or by court judgment as distinguished from a voluntary exercise of the borrowing power by the state or local government.
- **Annual appropriation bonds**
Bonds that are not considered debt subject to a constitutional debt limitation because the state and local government issuer has no legal obligation to pay them and payment is therefore subject to annual appropriation of funds for that purpose at the discretion of the legislature or governing body of the state or local government issuer.
- **HB13 Restriction**
Please note that HB13 Sec. 37.15.900(b) indicates that "The bonds do not constitute a general obligation of the state."



Potential Savings

POBs and Cash Infusion

Pay partial UAAL off with cash and borrow partial at 5.25% by issuance of Pension Obligation Bonds (POBs).

Implications

- Immediate reduction of the UAAL;
- Increase in the Funded Ratio;
- Reduction of employer past service contribution rate.

Case Study (PERS)

Employer Contribution Rates
POBs (in billions)

Cash (in billions)	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 4.0	\$ 5.0	\$ 5.5
	0%	18%	36%	55%	73%	91%	100%
\$ -	35.22%	34.07%	32.91%	31.76%	30.61%	29.46%	28.88%
\$ 1.0	29.51%	28.36%	27.20%	26.05%	24.90%	23.74%	
\$ 2.0	23.80%	22.64%	21.49%	20.34%	19.19%		
\$ 3.0	18.08%	16.93%	15.78%	14.63%			
\$ 4.0	12.37%	11.22%	10.07%				
\$ 5.0	6.66%	5.51%					
\$ 5.5	6.66%	5.51%					
\$ 5.5	3.80%						

Savings on Annual Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 4.0	\$ 5.0	\$ 5.5
	0%	18%	36%	55%	73%	91%	100%
\$ -	\$0.00	\$19.31	\$38.62	\$57.93	\$77.24	\$96.55	\$106.20
\$ 1.0	\$95.69	\$115.00	\$134.31	\$153.61	\$172.92	\$192.23	
\$ 2.0	\$191.37	\$210.68	\$229.99	\$249.30	\$268.61		
\$ 3.0	\$287.06	\$306.37	\$325.68	\$344.99			
\$ 4.0	\$382.75	\$402.06	\$421.37				
\$ 5.0	\$478.44	\$497.75					
\$ 5.5	\$526.28						

Savings on Employer Contribution Rates
POBs (in billions)

Cash (in billions)	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 4.0	\$ 5.0	\$ 5.5
	0%	18%	36%	55%	73%	91%	100%
\$ -	0.00%	1.15%	2.31%	3.46%	4.61%	5.76%	6.34%
\$ 1.0	5.71%	6.86%	8.02%	9.17%	10.32%	11.48%	
\$ 2.0	11.42%	12.58%	13.73%	14.88%	16.03%		
\$ 3.0	17.14%	18.29%	19.44%	20.59%			
\$ 4.0	22.85%	24.00%	25.15%				
\$ 5.0	28.55%	29.71%					
\$ 5.5	31.42%						

NPV of Savings on 25-year Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 4.0	\$ 5.0	\$ 5.5
	0%	18%	36%	55%	73%	91%	100%
\$ -	\$0.00	\$272.14	\$544.28	\$816.43	\$1,088.57	\$1,360.71	\$1,496.78
\$ 1.0	\$1,348.61	\$1,620.75	\$1,892.90	\$2,165.04	\$2,437.18	\$2,709.32	
\$ 2.0	\$2,697.22	\$2,969.37	\$3,241.51	\$3,513.65	\$3,785.79		
\$ 3.0	\$4,045.84	\$4,317.98	\$4,590.12	\$4,862.26			
\$ 4.0	\$5,394.45	\$5,666.59	\$5,938.73				
\$ 5.0	\$6,743.06	\$7,015.20					
\$ 5.5	\$7,417.37						

- \$2.0 billion POBs issued in 2008
- Assumed \$5.5 billion PERS UAAL in 2007
- Annual employer contribution amount for Tiers I, II, and III would be \$590 million without POBs starting in 2007
- Funding ratio will be improved from 65.12% to 77.81% (based on preliminary \$10.27 billion PERS asset as of Dec 31, 2006)

HB 13 - POB Presentation - 2/8/2008

Case Study (TRS)

Employer Contribution Rates
POBs (in billions)

Cash (in billions)	\$ -	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1
	0%	32%	48%	65%	81%	97%	100%
\$ -	44.17%	40.36%	38.45%	36.55%	34.64%	32.74%	32.36%
\$ 0.5	36.23%	32.42%	30.51%	28.60%	26.70%	24.79%	
\$ 1.0	28.28%	24.47%	22.57%	20.66%	18.75%		
\$ 1.5	20.34%	16.53%	14.62%	12.72%			
\$ 2.0	12.39%	8.58%	6.68%				
\$ 2.5	4.45%	0.64%					

Savings on Annual Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	\$ -	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1
	0%	32%	48%	65%	81%	97%	100%
\$ -	\$0.00	\$22.95	\$34.42	\$45.89	\$57.37	\$68.84	\$71.13
\$ 0.5	\$47.84	\$70.79	\$82.26	\$93.74	\$105.21	\$116.68	
\$ 1.0	\$95.69	\$118.63	\$130.11	\$141.58	\$153.05		
\$ 1.5	\$143.53	\$166.48	\$177.95	\$189.42			
\$ 2.0	\$191.37	\$214.32	\$225.79				
\$ 2.5	\$239.22	\$262.16					

Savings on Employer Contribution Rates
POBs (in billions)


Cash (in billions)	\$ -	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1
	0%	32%	48%	65%	81%	97%	100%
\$ -	0.00%	3.81%	5.72%	7.62%	9.53%	11.43%	11.81%
\$ 0.5	7.94%	11.75%	13.66%	15.57%	17.47%	19.38%	
\$ 1.0	15.89%	19.70%	21.60%	23.51%	25.42%		
\$ 1.5	23.83%	27.64%	29.55%	31.45%			
\$ 2.0	31.78%	35.59%	37.49%				
\$ 2.5	39.72%	43.53%					

NPV of Savings on 25-year Contribution Amount (in millions)
POBs (in billions)


Cash (in billions)	\$ -	\$ 1.0	\$ 1.5	\$ 2.0	\$ 2.5	\$ 3.0	\$ 3.1
	0%	32%	48%	65%	81%	97%	100%
\$ -	\$0.00	\$323.41	\$465.11	\$646.82	\$808.52	\$970.23	\$1,002.57
\$ 0.5	\$674.31	\$997.72	\$1,159.42	\$1,321.12	\$1,482.83	\$1,644.53	
\$ 1.0	\$1,348.61	\$1,672.02	\$1,833.73	\$1,995.43	\$2,157.13		
\$ 1.5	\$2,022.92	\$2,346.33	\$2,508.03	\$2,669.74			
\$ 2.0	\$2,697.22	\$3,020.63	\$3,182.34				
\$ 2.5	\$3,371.53	\$3,694.94					

1. \$0.5 billion cash infusion and no POBs issued in 2008
2. Assumed \$3.1 billion TRS UAAL in 2007
3. Annual employer contribution amount for Tiers I, II, and III would be \$266 million without cash infusion and POBs starting in 2007
4. Funding ratio will be improved from 59.9% to 66.36% (based on preliminary \$4.63 billion TRS asset as of Dec 31, 2006)

HB 13 - POB Presentation - 2/8/2008



Tax Issues



Taxable Bonds vs. Tax Exempt Bonds

- Taxable Bonds
 - Can be issued for any purpose
 - Complete flexibility with use of proceeds
 - Interest rate about 1% higher than tax exempt in current market

- Tax Exempt Bonds
 - Can only be issued for public capital projects
 - Earnings on proceeds are restricted to yield paid on bonds
 - 1% lower interest rate than taxable bonds in current market



The Difficulty with Tax Exempt

- Very difficult to identify appropriate GF funded capital projects to issue bonds for.
- Certificates of Participation issuance is the most viable option.
 - However the existing, yet unexpended GF funded capital projects are small, for private purposes, short lived acquisitions, operational grants, or federal match.
 - Fiscal Year 2008 capital budget is only \$100 million, all of which could not be funded with tax exempt bonds.
- Any use of tax exempt bonds to fund capital projects would have to be coincidental, rather than integrated, to any use of on hand cash to fund PERS/TRS contributions.

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Take-aways

Take-aways

1. If we can earn more than the cost of POB, we are better off for issuing it.
2. We are in a very favorable interest rate environment – take advantage of it!
3. Risks associated with POB issuance are quantifiable and statistically justified by the rewards.
4. Doing nothing is not a viable option.

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Q & A





ALASKA'S FUNDING LEVEL FOR its pension system—at 74% in 2006—is below the national average, but that is a major jump from the state's 64% funding level in 2005. Alaska is one of just a few states to have funded retiree health and other non-pension benefits as part of its pension system. Its long-term liability of \$3.4 billion for retiree health benefits was 65% funded as of 2005. Alaska started pre-funding its retiree health costs in the 1970s and was one of only three states in 2006 to have set aside enough to cover more than 50% of its liability. Alaska is one of seven states in which neither teachers nor state employees participate in the U.S. Social Security system.

PENSIONS

TOTAL BILL COMING DUE: **\$13 billion¹**

FUNDS SET ASIDE: **\$9.7 billion**

PORTION UNFUNDED: **\$3.3 billion**

PERCENT FUNDED: **74 as of 2006²**

TEN YEAR FUNDING HIGH: **104% in 1999**

TEN YEAR FUNDING LOW: **64% in 2005**

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?



Assessments: Alaska assesses a somewhat higher rate of return for its pension investments (8.25%) than the 50 state norm (6%). As with most states, it uses a five-year smoothing period to calculate the actual value of assets. The amortization period conforms to a standard standard.

1 Pension funds include public and private employees, teachers and railroad employees (not included for personnel).

2 50 state mean as of 2005.

OTHER BENEFITS

TOTAL BILL COMING DUE: **\$3.4 billion**

FUNDS SET ASIDE: **\$2.2 billion**

PORTION UNFUNDED: **\$1.2 billion¹**

PERCENT FUNDED: **65 as of 2005²**

HOW IS THE STATE DOING IN MANAGING THIS BILL?



1 13% of covered payroll, compared to a national median of 13%.

2 Alaska is one of only three states that has set aside more than 50% of its total pension liabilities.

REFORMS: To stem unfunded pension costs, Alaska passed legislation in 2005 to place employees hired after July 1, 2006, in a defined contribution plan rather than a defined benefit plan. At the same time, the state stopped promising retiree health coverage for new employees during the period prior to Medicare eligibility. It also changed the governance structure for its pension systems, establishing the Alaska Retirement Management Board in the state Department of Revenue.

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This fact sheet stems from a 50-state analysis of states' retiree benefit obligations by Pew's Center on the States. The full report and 50 state fact sheets can be found at www.pewcenteronthestates.org.



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CALIFORNIA HAS A LONG-TERM RECORD of solidly funding its pension system, so its concerns about retirement benefit costs for public sector employees are largely focused on health care and other non-pension benefits—and with good reason. California faces a long-term liability of \$48 billion for retiree health care for its public workers—an amount second only to New York’s in size—but it is one of the five largest states in the country that has not put aside any money for this bill. The state legislative analyst’s office has been active in following this issue in California and nationally; see www.lao.ca.gov/retireehealth.

PENSIONS

TOTAL BILL COMING DUE: **\$355.5 billion¹**

FUNDS SET ASIDE: **\$309 billion**

PORTION UNFUNDED: **\$46.5 billion**

PERCENT FUNDED: **87 as of 2005²**

TEN YEAR FUNDING HIGH: **118% in 1999**

TEN YEAR FUNDING LOW: **84% in 2003**

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?



What's the catch? California smooths out its annual pension contributions over a 15-year period, the longest used by any state. This should contribute to less volatility in its funding levels on a year-to-year basis. It assumed a slightly lower return on investments (7.77%) for its public employees' fund than the median for the 50 states (8%). The assumption probably reduces its accounting liability.

1. Does not include public employees, judges, volunteer firefighters and teachers.

2. 50 states median was 82% in 2006. California's 2005 figure was not available at the time of Pew's report.

OTHER BENEFITS

TOTAL BILL COMING DUE: **\$48 billion**

FUNDS SET ASIDE: **\$0**

PORTION UNFUNDED: **\$48 billion¹**

PERCENT FUNDED: **0 as of 2006**

HOW IS THE STATE DOING IN MANAGING THIS BILL?



1. 14% of covered payroll, compared to a national median of 1.5%.

REFORMS: The legislature has taken several steps in recent years to close pension system loopholes. The California Public Employees' Retirement System also has set up a trust fund so that local employers that contract with the state can pre-fund obligations in a qualified trust. Governor Schwarzenegger has convened a special commission to examine public employee pension and retiree health benefits. The commission has been asked to recommend a plan to the legislature by January 1, 2008.



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CONNECTICUT HAS DOUBLE THE TROUBLE of most states: a severely underfunded pension system and some of the steepest bills in the country coming due for retirement health and other non-pension benefits. The state funded its pension bill at 100% in 2006, but has often fallen short of funding its whole annual contribution. The state's actuaries have calculated the non-pension bill at \$21.7 billion—a figure that does not include benefits for teachers. No money has been set aside yet for this liability, which amounts to about \$6,186 per capita, based on the population of the state. That figure is larger than that faced by any other state and far higher than the \$774 median for the country. Non-pension benefits for state employees are based on labor negotiations that occurred in the late 1990s—an agreement that is in place until 2017, according to the Connecticut comptroller's office. To move toward full funding of this obligation, the state's annual contribution would be \$1.6 billion—four times more than the \$393 million in non-pension benefits that it paid for current retirees in 2006.

PENSIONS

TOTAL BILL COMING DUE: **\$34 billion¹**

FUNDS SET ASIDE: **\$19 billion**

PORTION UNFUNDED: **\$15 billion**

PERCENT FUNDED: **56 as of 2006²**

TEN YEAR FUNDING HIGH: **72% in 2001**

TEN YEAR FUNDING LOW: **56% in 2006**

HOW IS THE STATE DOING IN
PAYING ITS ANNUAL BILL?



ASSUMPTIONS: Connecticut assumed a 5% on its pension investments in 2004, compared to the 5% median for the 50 states. But its 5% inflation assumption for the public employee pension was also high relative to other states—which means the "real rate of return" its actuaries expect is on the lower side. It uses a five-year smoothing period to calculate the actuarial value of assets, similar to the majority of states. The amortization period conforms to accounting standards.

¹ Pension bills include state and judicial employees and teachers.

² 50-state median was 42%.

OTHER BENEFITS

TOTAL BILL COMING DUE: **\$21.7 billion**

FUNDS SET ASIDE: **\$0**

PORTION UNFUNDED: **\$21.7 billion¹**

PERCENT FUNDED: **0 as of 2006**

HOW IS THE STATE DOING IN
MANAGING THIS BILL?



¹ 69% of covered payroll, compared to a national median of 135%.

REFORMS: Connecticut is working on improving the funding situation of its very underfunded teachers' pension plan. The General Assembly authorized \$2 billion in pension obligation bonds in 2007, and appropriated an additional \$300 million for the fund for fiscal years 2008 and 2009. It also committed the state to making its annual required contribution to the teachers' fund while the bonds are outstanding.

KEY



At or Above Par



Hardly Impaired



Below Par



Non-Pension Benefits Are Maximal

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ILLINOIS HAS DOUBLE THE TROUBLE of most states: a severely underfunded pension system and some of the steepest bills in the country for retiree health care benefits. On the pension side, Illinois has one of the poorest-funded systems in the country. While the state has made a number of reforms, it still is underfunding its annual contributions. On an aggregate basis, the state contributed only about 44% of what its own actuaries deemed necessary in 2005, and only 33% in 2006. Illinois' precarious finances will be further aggravated by what is likely to be a significant liability for non-pension benefits. Illinois offers substantial retiree health benefits to public sector employees, and while the state has not yet determined the long-term cost of doing so (officials say an actuarial valuation is now in progress), the Civic Committee of the Commercial Club of Chicago has estimated the price tag for state employees at \$48 billion.

PENSIONS

TOTAL BILL COMING DUE: **\$103 billion¹**

FUNDS SET ASIDE: **\$62 billion**

PORTION UNFUNDED: **\$41 billion**

PERCENT FUNDED: **60 as of 2006²**

TEN YEAR FUNDING HIGH: **75% in 2000**

TEN YEAR FUNDING LOW: **49% in 2003**

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?



ASSUMPTIONS: Illinois' three largest funds assume a 5% interest on pension investments compared to a 50 state median of 8%. It's one of a handful of states that values its assets on a fair market basis rather than smoothing out gains and losses over time. This means that a downturn or upswing in the stock market will be reflected in its pension funding levels immediately. As of 2006, Illinois was using a 40 year amortization period, which does not conform to accounting standards. (The Governmental Accounting Standards Board establishes the time used to amortize pension benefits as 30 years or less.)

¹ Pension funds include state employees, judges, the general assembly, teachers and state universities.

² 50 state median was 62%.

KEY:



Funds Set Aside



Total Bill Coming Due



Portion Unfunded



Percent Funded (2006)

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OTHER BENEFITS

TOTAL BILL COMING DUE: **\$48 billion¹**

FUNDS SET ASIDE: **\$0**

PORTION UNFUNDED: **\$48 billion²**

PERCENT FUNDED: **0 as of 2006**

HOW IS THE STATE DOING IN MANAGING THIS BILL?



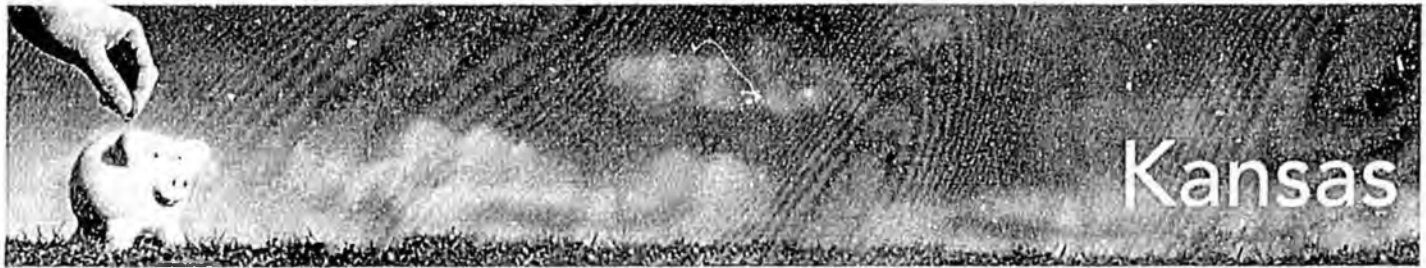
¹ Estimated, for state employees.

² Estimated, 70% of covered payroll, compared to a national median of 135%.

REFORMS: Illinois established a pension stabilization fund in 2006; it also has enacted a series of offers to encourage employees to opt out of the retirement system in exchange for a lump sum payment. Legislation in the last several years has targeted salary "spiking," changing the way that employees calculate the final salary on which their pension is based. In addition, the state has required that school districts and universities provide partial funding to the pension system for any salary hikes for their employees that exceed 6% and would affect the final salary calculation on which pension benefits are based. In 2003, the legislature authorized the use of \$10 billion in pension obligation bonds, which helped move the state from about a 49% funding level in 2003 to a 64% funding level in 2004.



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KANSAS IS LAGGING BEHIND many other states when it comes to managing its long-term bill coming due for pensions. The state has fallen short of meeting its annual payments toward its long-term pension obligation for each of the last 10 years. In the last several years, Kansas' payments have dropped to a little less than 70% of what the state's own actuaries say is needed to keep up, hitting a low of 63% of the required contribution in 2006. Kansas has undertaken significant pension reform in the last year, however. On the non-pensions side, Kansas is one of seven states that had not completed its actuarial valuation of the long-term costs of retiree health benefits at the time of Pew's report. But the liability likely will be small relative to that of other states. Kansas does not offer a cash subsidy, but only the "implicit subsidy" that comes from including retirees and typically healthier active employees in the same health plan.

PENSIONS

TOTAL BILL COMING DUE: **\$17.6 billion¹**

FUNDS SET ASIDE: **\$12.2 billion**

PORTION UNFUNDED: **\$5.4 billion**

PERCENT FUNDED: **69 as of 2006²**

TEN YEAR FUNDING HIGH: **88% in 2000**

TEN YEAR FUNDING LOW: **68.8% in 2005**

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL? 

ASSUMPTIONS: Kansas assumed an 8% return for its pension investments as of 2006, which is the 50 state median. It used a five year smoothing period to determine the actuarial value of assets, also the most common approach. As of 2006, it used a 40 year amortization period for its pension system, which does not conform to accounting standards. The Governmental Accounting Standards Board has set 30 years or less as the appropriate length of time.

¹ Public employees retirement system, a funded fund.

² 50 state median was 62%.

OTHER BENEFITS

TOTAL BILL COMING DUE: **Not available¹**

FUNDS SET ASIDE: **\$0**

PORTION UNFUNDED: **Not available**

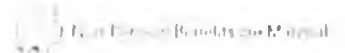
PERCENT FUNDED: **0 as of 2006**

HOW IS THE STATE DOING IN MANAGING THIS BILL? 

¹ Kansas' actuarial valuation was not completed at the time of Pew's report, but the liability is likely to be small.

REFORMS: Kansas enacted significant pension reforms in 2007, creating a new defined benefit plan for state, school and local employees hired after July 1, 2009. The new plan will have stricter age and service requirements for receiving benefits, it also will change the method of calculating the final salary that's used in determining pension benefits so that five years are included in the calculation instead of three—a way that states try to control salary "spiking." According to the National Conference of State Legislatures, an unusual feature of the reform is that future costs of the new plan are to be equally shared by employees and employers. The new plan stipulates that government contributions will be at actuarial levels and will not be less than the employee contribution.

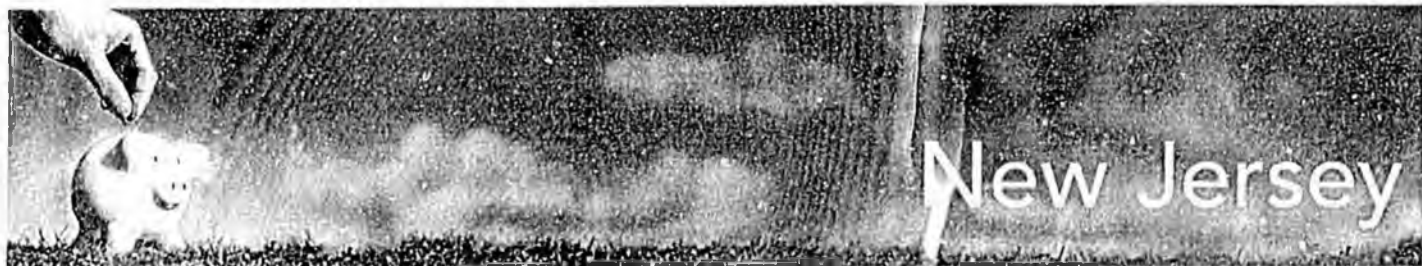
KFF



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NEW JERSEY HAS DONE AN ABYSMAL JOB of keeping up with annual funding requirements for its pension system. And when it comes to retiree health benefits, the state faces bills coming due of nearly \$22 billion just for state employees, and another \$36.5 billion for teachers. (Only some states have calculated the latter; in many, the liability for teachers will appear at the local school district level.) Although New Jersey's pensions, in the aggregate, are only slightly less well funded than the 50-state mean, the system has suffered from a number of problems. The state recently passed several reforms designed to improve its performance and provide better and clearer public disclosure of the inner workings of the pension systems. On the non-pension side, retiree health benefit costs are substantial and growing far faster than the rest of the state budget.

PENSIONS

TOTAL BILL COMING DUE: **\$109.6 billion¹**

FUNDS SET ASIDE: **\$86.5 billion**

PORTION UNFUNDED: **\$23.1 billion**

PERCENT FUNDED: **79 as of 2006²**

TEN YEAR FUNDING HIGH: **111% in 2000**

TEN YEAR FUNDING LOW: **79% in 2006**

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL? 

ASSUMPTIONS: New Jersey assumes a 25% interest on its pension investments (compared with a 50 state median of 8%). It uses a five year smoothing period, similar to most states. The amortization period conforms to accounting standards.

¹ Pension funds include public employees, teachers, and judicial state police and police and fire employees.

² 50 state mean was 82%.

OTHER BENEFITS

TOTAL BILL COMING DUE: **\$21.6 billion¹**

FUNDS SET ASIDE: **\$0**

PORTION UNFUNDED: **\$21.6 billion²**

PERCENT FUNDED: **0 as of 2006**

HOW IS THE STATE DOING IN MANAGING THIS BILL? 

¹ With another \$36.5 billion for teachers.

² 33% of covered payroll, compared to a national median of 13%.

REFORMS: In 2007 the legislature established a defined contribution plan, in place of the traditional defined benefit plan, for newly elected and some appointed officials, and prohibited professional service contractors from being part of the state's pension system as of January 1, 2008. In addition, state policy makers approved a 10% increase in contributions for some of its public employees, teachers and defined contribution plans. Pension contributions for wages over the maximum wage contribution mark for Social Security will be shifted to a defined contribution plan.

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Top Performer



Best Investment



Low Risk



Most Documented

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OREGON CURRENTLY HAS THE BEST-FUNDED pension system in the country, and it is one of just six states on track to fund its modest retiree health benefits as well. On the pension side, Oregon's strong performance is partially due to the state's use of bonds to finance its liabilities following a significant drop in pension funding levels in 2002. The state also substantially reorganized its pension system in 2003, shifting to a hybrid plan that has both defined contribution and defined benefit elements. Oregon's non-pension, retiree health benefits are extremely modest, but the state was on track to fully fund those obligations at the end of fiscal year 2006. (In fact, it was one of only 13 states with any assets set aside for non-pension benefits as of 2006.) If Oregon continues on this path, its total non-pension liability will be reduced from \$832 million to \$238 million, based on the higher interest rate the state can assume if it consistently sets funding aside in an irrevocable qualified trust.

PENSIONS

TOTAL BILL COMING DUE: **\$51.2 billion¹**

FUNDS SET ASIDE: **\$56.6 billion**

PORTION UNFUNDED: **\$0**

PERCENT FUNDED: **110 as of 2006²**

TEN YEAR FUNDING HIGH: **110% in 2006**

TEN YEAR FUNDING LOW: **91% in 2002**

HOW IS THE STATE DOING IN
PAYING ITS ANNUAL BILL?



Assumptions: Oregon assumes 8% investment returns, which is the 50 state median. It's one of a handful of states that values its assets on a fair market basis rather than smoothing out gains and losses over time. This means that a downturn or upswing in the stock market will be reflected in its pension funding levels immediately (as occurred in 2002 when the pension funding level dropped to 91% from 106.7% the previous year).

¹ Consolidated public employees retirement fund.

² 50 state median was 86%.

OTHER BENEFITS

TOTAL BILL COMING DUE: **\$832 million¹**

FUNDS SET ASIDE: **\$187 million**

PORTION UNFUNDED: **\$645 million²**

PERCENT FUNDED: **22 as of 2006**

HOW IS THE STATE DOING IN
MANAGING THIS BILL?



¹ About \$415 million for state employees.

² Total covered payroll, compared to a national median of 120%.

REFORMS: Oregon significantly reorganized its pension systems in 2003, with a hybrid defined contribution/defined benefit plan put in place that the state believes has resulted in substantial savings. The state also restructured the retirement system board at the time and instituted a number of changes to its actuarial practices.

REF



City Performance



Need Improvement



Excellent



High Pension Benefits and Metrics

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Washington

WASHINGTON HAS GENERALLY KEPT a careful eye on the health of its many pension plans, which are well funded on an aggregate basis. The state also has moved quickly to resolve potential problems. For example, the legislature suspended contributions to several large closed pension funds in the 2003-2005 biennium and planned to do so again in 2005-2007, but the 2006 supplemental budget included \$350 million for a pension stabilization account that helps position the state to recover from past missed payments. Additional funding has brought that account to \$448 million. Retiree health benefits are moderate. So far, the state has chosen not to set aside any retiree health funding for the future, but is trying to use management reforms to lower growth in health costs.

PENSIONS

TOTAL BILL COMING DUE: **\$48.1 billion**¹

FUNDS SET ASIDE: **\$47.9 billion**

PORTION UNFUNDED: **\$201 million**

PERCENT FUNDED: **99.58% as of 2006**²

TEN YEAR FUNDING HIGH: **124% in 2000**

TEN YEAR FUNDING LOW: **96% in 2005**

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?



EXPLANATION: Washington returned an 8% return on its pension investments, the same as the 50-state median in 2006. It uses an eight-year graded smoothing period for most of its pension funds, which would tend to mute the immediate impact of sudden drops or upsurges in investments. Washington has used the aggregate cost method for its pension calculations for several large funds, which doesn't provide a funding ratio, but this information is available in the pension systems' actuarial valuations. The amortization period conforms to accounting standards.

1 Pension funds include public and school employees, teachers, law enforcement and state patrol, judicial employees and volunteer firefighters.

2 90-state total was 82% as of December 2007.

KEY



Total Pension Bill (All Employees)



Funds Set Aside



Portion Unfunded



How is the State Doing in Managing this Bill?

This fact sheet stems from a 50-state analysis of states' retiree benefit obligations by Pew's Center on the States. The full report and 50 state fact sheets can be found at www.pewcenteronthestates.org.



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OTHER BENEFITS

TOTAL BILL COMING DUE: **\$3.8 billion**¹

FUNDS SET ASIDE: **\$0**

PORTION UNFUNDED: **\$3.8 billion**²

PERCENT FUNDED: **0 as of 2006**

HOW IS THE STATE DOING IN MANAGING THIS BILL?



1 For state employees an additional \$3.3 billion was calculated for teachers.

2 For state employees; 70% of covered payroll, compared to a national median of 135%.

REFORMS: In 2007, Washington created gain sharing for teachers and public employees, which provided that half of investment returns exceeding 10% went to additional pension benefits for members. While popular with employees, gain sharing can be rough on a pension fund's fiscal health since it means that states can take a hit from poor investment returns but cannot fully make up prior losses when investments rise. The state offset the repeal of gain sharing with some benefit enhancements. In addition to setting up a pension stabilization fund, Washington earlier in the decade created an optional hybrid plan for state and local employees. In terms of non-pension benefits, Washington provides an implicit health subsidy prior to Medicare eligibility, allowing retirees to sign on to the same plan as employees. It also provides a modest cash subsidy for Medicare eligible retirees. Officials say that in 2007, the state's management of its health care had limited the rate of costs to 1.7%.



WHEN IT COMES TO PENSION FUNDING LEVELS, West Virginia—with about 55% of its aggregate pension obligations covered—lags behind every other state. Just four years ago, however, the situation looked much worse. In recent years, West Virginia stands out for responsibly funding its annual required contribution to its pension plans. It also was one of the speediest states in taking action to reduce its sizeable liability for non-pension benefits—mostly retiree health care. The state, along with a dozen others, established an irrevocable trust in 2007 in which to set aside assets for funding those benefits. It also increased co-payments for retirees and reduced costs by requiring that most retirees participate in a Medicare advantage prescription drug program. West Virginia's intention to at least partially fund its non-pension benefits, along with aggressive cost-containment efforts, resulted in a significant drop in the state's long-term bill—from \$7.8 billion in the initial valuation to \$3.4 billion in a subsequent valuation in April 2007.

PENSIONS

TOTAL BILL COMING DUE: **\$11.8 billion¹**

FUNDS SET ASIDE: **\$6.5 billion**

PORTION UNFUNDED: **\$5.3 billion**

PERCENT FUNDED: **55 as of 2006²**

TEN YEAR FUNDING HIGH: **55% in 2006**

TEN YEAR FUNDING LOW: **39% in 2003**

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?



ASSUMPTIONS: West Virginia assumed an investment return of 7.5% as of 2006, below the 50-state median of 8%. It's one of a handful of states that values its assets on a fair market basis rather than smoothing out gains and losses over time. This means that a downturn or upswing in the stock market will be reflected in its pension funding levels immediately. The amortization period conforms to accounting standards.

¹ Pension funds include public employees, teachers, public safety and "shared" personnel, state police and judges.

² 50-state median was 62%.

OTHER BENEFITS

TOTAL BILL COMING DUE: **\$3.4 billion¹**

FUNDS SET ASIDE: **\$0**

PORTION UNFUNDED: **\$3.4 billion²**

PERCENT FUNDED: **0 as of 2006**

HOW IS THE STATE DOING IN MANAGING THIS BILL?



¹ As of April 2007; \$7.8 billion in the original actuarial valuation.

² As of 2006; \$19 million was deposited in a trust in 2007, with another deposit expected by year's end.

REFORMS: In 2005, the West Virginia legislature closed its defined contribution plan for teachers and reopened the Teachers Retirement System defined benefit plan that had been shut down in 1991. (The legislation that consolidated the two plans was subsequently ruled unconstitutional by the Kanawha County Circuit Court and the decision is being appealed, according to the National Conference of State Legislatures.) In 2005, voters rejected Governor Manchin's plan to repair the state's poorly funded retirement system by selling \$5.5 billion in bonds. In 2007, the state set up an irrevocable trust for its non-pension benefits.

More



Top Pay States



Public Employment



Debt by City



How Do we pay for roads and transit?

This fact sheet stems from a 50-state analysis of states' retiree benefit obligations by Pew's Center on the States. The full report and 50 state fact sheets can be found at www.pewcenteronthestates.org.



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WISCONSIN STANDS OUT in how it has managed the bill coming due for its public sector pension obligations. In fact, the state's pension system has had a remarkably steady ride over the last 10 years. Wisconsin has an excellent record of making its full annual required contribution. It issued \$729 million in pension bonds in 2003, and at that time became the first state to issue bonds for non-pension benefits as well, to the tune of \$600 million. This makes it the only state in the country that has just about fully funded these liabilities. This is not as tall an order as in many states, because the benefits are very modest. Wisconsin's long-term retiree health care costs stem from a subsidy that allows retirees to participate in the same plan as younger and healthier active employees. It also allows unused sick leave of departing employees to be converted to health care accounts.

PENSIONS

TOTAL BILL COMING DUE: **\$73.7 billion¹**

FUNDS SET ASIDE: **\$73.4 billion**

PORTION UNFUNDED: **\$320 million**

PERCENT FUNDED: **99.6 as of 2006²**

TEN YEAR FUNDING HIGH: **99.6% in 2006**

TEN YEAR FUNDING LOW: **95% in 1997**

HOW IS THE STATE DOING IN
PAYING ITS ANNUAL BILL?



ASSUMPTIONS: Wisconsin assumed 7.8% interest on its pension investments as of 2006, slightly under the 50 state median of 8%. It uses a two-year smoothing period, similar to the majority of the states. The amortization period conforms to accounting standards.

¹ Wisconsin Retirement System

² 50 state median was 92%

OTHER BENEFITS

TOTAL BILL COMING DUE: **\$1.823 billion**

FUNDS SET ASIDE: **\$1.806 billion**

PORTION UNFUNDED: **\$17 million¹**

PERCENT FUNDED: **99 as of 2006²**

HOW IS THE STATE DOING IN
MANAGING THIS BILL?

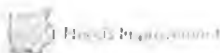


¹ Less than half a percent of covered payroll, compared to a national median of 135%.

² Wisconsin had the highest funding ratio for non-pension benefits as of 2006, due to its decision to bond out much of its medical obligation. Only 12 other states had any assets at all set aside at this time.

REFORMS: Wisconsin has not had substantial pension reform in recent years. The biggest news was its 2003 bond issuance to help keep up with pension and retiree health liabilities (see above). In 2005, the state transferred responsibilities of the Legislature's Retirement Research Committee to the Legislative Council. Every two years it produces an excellent report comparing pension systems in the 50 states; the new one is due out in December 2007.

KEY



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State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
Relating to Pension Obligation Bonds

Resolution 2007-17

WHEREAS, the Alaska Retirement Management Board (Board) was established by law to serve as trustee to the assets of the State's retirement systems; and

WHEREAS, the State of Alaska and its political subdivisions participate in the retirement systems as a matter of law and through participation agreements and pursuant to those provisions public employer contribution rates are set by the Board based on information including actuarial assumptions and calculations of unfunded accrued actuarial liability; and

WHEREAS, Chapter 9 FSSLA 2005 (SB 141) enacted changes to the retirement systems and among other things required the Board to provide reports to the legislature and make recommendations regarding short term and long term solutions to improve the financial health of the retirement systems; and

WHEREAS, the Board has received information from public employers as well as advisors, consultants, and other experts concerning the potential usefulness of pension obligation bonds ("POB's") to assist public employers in meeting their obligations to the retirement systems and in particular to pay the unfunded accrued actuarial liability of the systems; and

WHEREAS, public employers as well as consultants and experts have represented to the Board certain matters concerning POB's including:

1. POB's have been used to finance liabilities associated with under funded pension plans and under the right circumstances POB's can significantly reduce the cost of financing a pension liability;

2. POB's carry the risk if the pension system earns less on the bond proceeds than the cost of issuance and interest on the bonds, the issuer would incur higher costs than would have been incurred without issuing the bonds; conversely if the system earns higher returns than the cost of capital rising from issuance of the POB's, the public employer issuing the POB's will potentially benefit;

3. Determining success of POB's is a long term proposition because a final assessment is not possible until the POB's are paid off;

4. POB's provide an option for public employers to make higher than normal contributions to the systems and such higher than normal contributions appeal to the Board because the contributions could reduce the unfunded accrued actuarial liability and therefore improve the funded status of the systems;

5. There are certain concerns regarding the ability to invest proceeds of POB's according to the Board's normal asset allocation plans upon receipt of such funds; as such there is a need to assure that an asset allocation specific to the proceeds of particular POB's can be made: a specific allocation and risk profile may be necessary in order to recognize that some asset classes such as real estate may not allow immediate access to quality investments with respect to proceeds contributed through the issuance of POB's;

6. There would be no guarantee of a particular rate of return by the Board with respect to investments of proceeds of POB's; and

WHEREAS, since it is a primary responsibility of the Board to ensure that pension systems are fully funded, POB's may offer an appropriate mechanism if appropriate legislative actions are taken to meaningfully enable issuance of POB's by interested public employers under state law and constitutional provisions.

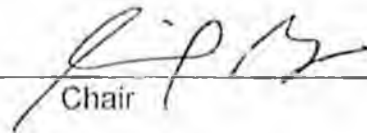
NOW THEREFORE BE IT RESOLVED BY THE ALASKA RETIREMENT MANAGEMENT BOARD THAT:

1. The Board acknowledges employers participating in the public employees' retirement system, teachers' retirement system, and judicial retirement system should be encouraged to evaluate all feasible options to finance their pension obligations including the use of POB's as such an option;

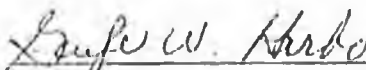
2. The Board recommends that the legislature undertake appropriate action to enable public employers to access capital markets in the most favorable means possible, with the issuance of POB's being one such potential means of access;

3. The Board believes that POB's constitute a concept worthy of fair and further consideration and supports passage of legislation to allow the issuance of POB's when an employer determines it would be beneficial.

DATED at Juneau, Alaska this 27th day of April, 2007.


Chair

ATTEST:


Secretary



Retired Public Employees of Alaska, APEA/AFT

Anchorage Office

3310 Arctic Blvd., Suite 200, Anchorage, Alaska 99503

Phone (907) 274-1703, (800) 478-9992, Fax 907-277-4588

March 12, 2007

Representative Mike Chenault
Representative Kevin Meyer
Co-Chairs, Finance Committee
Alaska House of Representatives
State Capitol
Juneau, AK 99801-1182

Representatives Chenault and Meyer:

The Retired Public Employees of Alaska represents over 3,000 members that worked hard for Alaskans for decades at the State and local levels of government. Two thirds of our members remain in Alaska and contribute many thousands of volunteer hours and substantial sums of money to the Alaska economy. Our members care about the future of Alaska and many are very actively involved in our communities and in the political process.

We understand that the projected under funding of the Public Employees Retirement System, Teacher Retirement System, Judicial Retirement System and National Guard Retirement System will result in a significant increase in employer contributions for FY-08. RPEA supports the full funding of these costs from State general funds. We ask that you support this approach during your budget deliberations in the upcoming weeks.

There are two bills regarding the retirement system that the Retired Public Employees of Alaska support. We support HB 12 as we believe the projected under funding needs to be paid down on an annual basis. We know there is no "magic" in the 7 year period in the bill, it is a point of departure for discussion. We support HB 13 as it gives municipalities an option to deal with their portion of the under funded obligation.

Please feel free to contact me if you have any questions on RPEA's positions on these issues.

Respectfully,

Sam Trivette
President

cc: Finance Committee Members

*Mike, this helps some!
Hope this helps some!
Thanks for your help over
the last few years.
Sam*

Protecting & Enriching

Your Retirement Years

January 23, 2008

Time May Be Ripe For A POB Revival

Primary Credit Analyst:

Peter Block, Chicago (1) 312-233-7040; peter_block@standardandpoors.com

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Time May Be Ripe For A POB Revival

Despite the prospect of increased funding ratios for public pension funds over the next several years, pension obligation bonds (POBs) may reemerge as a key financing tool for unfunded pension liabilities. The key to this reemergence, after a two-year hiatus, will depend upon actual investment performance in 2008 and 2009, the ability of plan sponsors to make actuarially required contributions (ARCs) in light of uncertain economic and revenue conditions, and burgeoning liabilities for other postemployment benefits (OPEB).

According to the National Association of State Retirement Administrators (NASRA) Public Fund Survey of 2007, public pension fund assets returned a healthy 11.9% on average between 2003 and 2006. Given these very strong returns, which are above the average assumed return rate of 8% for most fund assets, Standard & Poor's Ratings Services expects to see increased average pension funding levels over the next several years. However, NASRA reported that the average ratio of the 112 public pension plans in the survey was 86% in 2006. Although the ratio is still relatively strong, it is down significantly from the fully funded status in 2000 and 2001. In general, funding ratios declined due to poor returns in 2001-2002, benefit enhancements, demographic assumption changes, and underpayment of ARCs by several large state sponsors.

We are already beginning to see some POB activity, with Alaska, Connecticut, Puerto Rico, and Kentucky among the states currently contemplating a large POB issuance to bolster funding ratios and reduce costs. West Virginia recently securitized its tobacco settlement revenues and used proceeds to fund its pension plan, although the issue was not a POB in the traditional sense. POBs have been popular with issuers and successful for the sponsors in the 20 years through 2005, but issuance slowed in recent years because of strong investment returns.

Rating Implications

Employers looking to help manage their unfunded liabilities through the issuance of a POB should carefully weigh the pros and cons. It is also important to understand how the POB fits into the overall debt and liability structure of a prospective issuer. There should be a clear POB plan with attainable actuarial and investment assumptions and a conservative structure. Prudent allocation for projected savings over time limits the chances for problems.

POBs could have a negative effect on credit quality if they were structured poorly. Standard & Poor's will continue to evaluate POB risks in light of each employer's profile at the time of sale as well as their projected effects over time. POBs may work as planned over the long term, but could cause short-term fiscal dislocations depending upon actual investment returns.

Brief History

Overall, POBs have largely been successful for the sponsors who have used this strategy. In the past 20 years when the vast majority of these bonds were issued, investment yields overall exceeded investment return assumptions of public pension funds and the interest cost of the POBs, generating actuarial gains for the plans. While a few POBs issued in the 1980s, the first big wave of POBs came in the early 1990s. By the end of the decade, about \$15 billion of POBs had been issued.

The years 2000 and 2001 were slow for POB issuance because of the strength of U.S. public pension funding,

especially in 2000 when the average funded ratio was slightly over 100%, up from only about 80% in 1990. These robust funding gains were fueled by above-average equity returns during the late 1990s and a general shift in the weighting of public pension assets to higher-yielding equity assets from fixed-income assets.

Beginning in 2003, however, public pension funding ratios fell sharply, exacerbated by a combination of adverse circumstances, including the decrease in pension asset values due to poor equity returns following the dot-com bust in 2001-2002, the increase in liabilities from benefit enhancements put in place during that time, and demographic changes, such as increased member longevity. These factors created the second significant wave of POBs in 2002-2005. As in the first wave, California counties led the pack, and there were a number of repeat borrowers, but there were also significant new players. The state of Illinois, which issued a POB in June of 2004, holds the POB record for sheer size at \$10 billion — almost four times larger than the previous record. Oregon, Kansas, and Wisconsin, have completed \$1 billion plus POB sales in recent years.

POB Mechanics

Complex financial implications, simple execution

While the financial implications of POBs are complex, the actual mechanics are relatively simple. Generally, the municipal employer will use the findings from the most recent actuarial valuation, or have a new valuation completed, to determine the pension system's unfunded actuarial accrued liability (UAAL). Then, it will decide what portion of the UAAL will be funded with the POB. In the 1990s, most employers funded the entire UAAL, but for various reasons discussed below, many now tend to finance less than the full amount. Once the POB is sized and sold, the net proceeds are placed in the pension trust fund to be commingled with the other funds, and usually invested according to existing asset allocation guidelines. Thus, the pension fund experiences a rapid increase in assets resulting in a higher funded ratio.

For the POB to generate savings for the employer, the investment return rate on the invested POB proceeds must be greater than the interest cost of the bonds (and ideally equal to, or exceed the pension system's investment return assumption), and the larger the spread between these two rates, the better. The employer, as POB issuer and obligor, would then be projected to achieve lower total pension contributions than it would have if it had not sold the POB.

POB Risks

POB issuers face three principal risks:

- Arbitrage;
- Leverage; and
- Political

Arbitrage

POBs are essentially an arbitrage arrangement, the success of which depends on the premise that the pension trust fund assets (including POB proceeds) will earn on average more than the POBs' interest cost, and hopefully the pension plan's assumed investment return rate (generally about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example, the spread could generate savings if the investment return goals are met over the life of the bonds.

If the POB trust fund earns 8% or more on the bond proceeds, the issuer would pay lower pension-related costs (contributions plus POB interest) than without the POB. However, if the investment return is less than the POB interest cost, the transaction becomes a drag on cash flow since an unfunded actuarial accrued liability could reemerge. If returns are above 6% (as in the example above) but below 8%, the employer would have increasing contribution costs, but would have had them even without the POB.

While certain periods, particularly the late 1990s, produced some impressive investment returns, returns can vary dramatically and may or may not average the investment return assumption or even the POB interest rate cost. For this reason, a POB's full effect is only known at the bonds' final maturity. Many POBs have appeared successful for several years, or even a decade, only to have investment gains eroded upon maturity. Conversely, after poor results in the early years, some POBs achieved projected benefits in the final analysis.

In any event, we do know that even if projections are met on average over the life of the POBs, there will be years of higher returns, and some that are lower (maybe significantly), than the investment hurdle. We do not have to look back very far to see evidence of such swings: in fiscal 2001, the S&P 500 index of domestic equities fell 16%; in 2002, it fell 19%, but in 2003, it fell only 1.6%. These market declines hurt issuers with POBs outstanding: most had to pay increased contribution rates to cover the new actuarial losses and they had the higher debt service costs due to issuing the POB.

Leverage

Adding too much leverage is another risk factor for POB issuers. Borrowing for any purpose increases leverage and fixed costs. While the issuer is substituting one type of long-term liability (POB) for another (pension UAAL), there is a difference. In most cases, bond debt service is a "hard" obligation compared with the "softer" contribution payments used to amortize the UAAL. Bond debt service becomes a fixed cost and must be paid in full and on time or the issuer falls into default with wide ramifications. Conversely, employers' contribution payments to a pension trust may be temporarily deferred or reduced without serious negative consequences.

However, risks and opportunities are also associated with "softer" obligations. A soft obligation may be deferred during a temporary period of reduced liquidity resulting from a onetime unexpected expenditure or an unexpected dip in revenues. The obligation may be deferred until fiscal balance is restored to bring payment of the obligation back on schedule, resulting in no credit impact. Unfortunately, soft obligations may also be deferred for political expediency, creating significant credit issues if this deferral is practiced over successive periods. A hard obligation could lead to better long-term fiscal stability if political deferrals are a real risk. Regardless of the political climate, the size of the POB relative to the issuer's total debt structure must be measured in terms of the level of debt service that can be managed if actual future investment returns do not meet the original POB plan projections.

Political

POBs can become a political issue if the debt is sold to the public as a complete solution to the government's pension funding problem. For example, if a POB is issued for the full UAAL, resulting in a 100% funded ratio, and subsequent higher-than-average returns push the ratio to 110% or 120%, political pressure could arise to distribute the so-called excess funding by increasing benefits or decreasing contributions. In fact, in a lower-return environment with declining funding levels over the long term, those systems that have taken the bulk of their excess funding out of their POB structure may see trouble ahead. For example, say the POB issuer described above had average annual investment returns of 10% against its investment assumption of 8%. However, instead of permitting the natural increase in the funded ratio that these conditions would have caused, the issuer managed its funding

ratio, through contribution holidays and benefit improvements, to maintain the ratio at around 100%. If investment returns decline, the issuer may have already reaped all its gains from the transaction structure and be headed for actuarial losses. If actuarial losses are incurred, employer and employee contribution rates will likely increase.

Rating Process

The rating of POBs parallels that of long-term debt with similar security but also considers certain additional analytical factors pertinent to the POB and trust fund. POBs issued to date usually have a GO or appropriation pledge. In our analysis of POBs, we focus on the bonds' effect on the issuer's debt structure and the ability to meet obligations. The financial review includes the impact on both the balance sheet and the operating statement or cash flows. The status of the issuer's pension trust fund on a pro forma basis is also part of the review.

From the balance sheet perspective, we look at how the POB fits into the issuer's total debt structure, including a review of future capital requirements that may require bonding, as well as other long-term liabilities. We look at total debt with and without the POB so as not to penalize an issuer in comparison to another issuer that may have relatively low debt (and no POBs) but sizable unfunded liabilities. We also evaluate the leverage added by the POB to determine if the issue markedly increases hard, fixed costs (bond debt service) in place of a softer, more discretionary obligation. We will also seek to determine if subpar investment returns could put upward pressure on pension contribution rates and whether higher contribution rates, coupled with the POB debt service costs, put the issuer's budget under greater strain. The issuer must also be cognizant of the effect a POB issue may have on statutory debt limits or whether the issuance impedes debt issuance for the capital improvement plan.

From a cash flow standpoint, we review projected debt service and contribution costs, with and without the POB, and the validity of the assumptions, including those for POB interest costs and trust fund investment returns to determine how these projections compare in total and annually.

The spread between interest costs and investment return generates the savings expected from the transaction. The issuer must be able to provide details on the following:

- Magnitude of annual savings and total present value savings.
- Where (in what years) are the savings taken?
- Are the savings front-loaded in an attempt to mask budgetary stress?
- Will any front-loading lead to higher, unsustainable contribution rates in later years?
- Do the potential savings from the POB outweigh the risks involved?

The cash flow analysis is critical to understanding the full impact of the transaction. As part of the POB analysis, we also review the status of the pension trust fund, which receives the bond proceeds:

- What is the statutory relationship between the issuer/employer and the pension fund?
- How have the laws and precedents for contributing affected funding progress, and how do they play into the POB strategy?
- What are the funding goals and how will the POB affect these objectives?

Special rating documentation requirements for POBs

The unique nature of POBs calls for certain additional documentation not normally requested for other types of ratings:

- POB financing plan, including its effect on the overall debt plan;
- Projections of UAAL contributions and debt service with and without the POB;
- Latest pension fund annual report,
- Most recent actuarial valuation and experience studies of the fund; and
- Pension fund's current asset allocation strategy and plan for investing POB proceeds.

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An Introduction to



Pension Obligation Bonds
and Other Post-Employment
Benefits

Third Edition

ROGER L. DAVIS



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An Introduction to



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Members of Orrick's **Pension Obligation/OPEB Bond Group** are shown on the contact list at the end of this booklet.

DISCLAIMER: Nothing in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as an introduction to the general subject of the use of pension obligation bonds and other post-employment benefit bonds, from which better informed requests for advice, legal and financial, can be formulated.

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CHAPTER ONE

Introduction

Pension obligation bonds ("POBs") are bonds issued by a state or local government to pay its obligation to the pension fund or system in which its employees (or others for whose pension benefits it is responsible) are members.

POBs have been an increasingly popular and successful way for state or local governments to accomplish a variety of financial and other (including political) objectives. According to Thomson Financial, during the past decade there have been 340 POB issues by state and local governments in at least 26 states.

The purpose of this pamphlet is to introduce interested parties to the reasons why POBs are issued, advantages/disadvantages, structure alternatives, federal tax issues, and representative programs in three states where POBs are particularly popular.

Since the first edition of this pamphlet in 2003, new accounting rule GASB 45 has been promulgated, requiring that other (nonpension) post employment benefits ("OPEB") be accounted for much like pension obligations. This has given rise to intense interest in defining OPEB, calculating the unfunded accrued actuarial OPEB liability, developing a strategy for handling this liability, establishing OPEB trusts in which to make deposits against such liability, and the possible use of bonds to fund such deposits. Therefore, the purpose and coverage of this pamphlet has been expanded to provide an introduction to these topics.

The author is chair of the Public Finance Department at Orrick, Herrington & Sutcliffe LLP and has been bond counsel on several dozen POBs in various states.

He has also been in the forefront of establishing OPEB trust and OPEB bond strategies. He is one of the few recognized authorities in these aspects of OPEB. Orrick is the nation's premier public finance/bond counsel firm, ranked number one for more than a decade,¹ with extensive experience in all types of OPEB and similar financings.²

1. Rankings for securities transactions of various types are performed annually by Thomson Financial, which has ranked Orrick number one in the country as bond counsel since prior to 1990. In an average year, Orrick handles more than 500 bond issues, aggregating more than \$20 billion.
2. Orrick is ranked by Thomson Financial as the number one bond counsel in the country for 11 years over the last decade, with many more such issues than even the second ranked firm.

CHAPTER TWO

Pension Obligations

Pension obligations generally fall into two categories:

A. Unfunded Accrued Actuarial Liability (UAAL)

The unfunded accrued actuarial liability ("UAAL") is determined by the actuary for the pension fund to be the amount by which the pension fund is short of the amount that will be necessary, without further payments from the state or local government, to pay benefits already earned by current and former employees covered by the pension system. The UAAL is based on assumptions (in some cases established by the actuary and in some cases by the pension system or by the state or local government) as to retirement age, mortality, projected salary increases attributed to inflation, across-the-board raises and merit raises, increases in retirement benefits, cost-of-living adjustments, valuation of current assets, investment return and other matters. In order to avoid volatility in the UAAL, based on swings in market valuation, the investment gains and losses on assets in the pension fund are often recognized (sometimes referred to as "smoothed") over a 3 to 5 year (or longer) period.³ The state or local government is obligated to amortize the UAAL over a period established by law or agreement with the pension system, typically at an assigned interest rate established by the pension system, which assigned interest rate is usually the same as the actuary's assumed rate of investment return on pension fund assets (sometimes referred to as the "Actuarial Rate").

³ Note that the smoothing methodology referred to may result in "unrealized" or "lagging" unfunded liability. See discussion of POB possibilities in footnote 4. Note also that, in April 2009, CalPERS adopted a new policy that will result in smoothing over 15 years (instead of 3).

B. Normal annual contribution

In addition to making payments toward any UAAL, the state or local government is required to make payments to the pension fund each year in respect of the present value of the benefits being earned by the current employees covered by the pension fund (that is, the amount being earned by those employees with each paycheck) necessary to pay future retirement benefits, based on assumptions of mortality rates, salary increases, assumed rate of investment income and the other assumptions referred to in the preceding paragraph), generally referred to as the "normal annual contribution."

CHAPTER THREE

Reasons For Issuing POBs

The reasons why state or local governments issue POBs vary from issuer to issuer and from time to time with economic conditions and other circumstances. However, these reasons generally fall into one or more of the following categories:

A. Interest Rate Savings

As described in Chapter 2, most pension systems assign an interest component to the payments the state or local government is required to make in respect of its UAAL. Assigned interest rates currently generally range from 7% to 8% depending on the particular pension system. When taxable bond rates are low, and as of beginning of 2006 they are roughly 5.45% or less for 30 year debt, then POBs can function like a classic interest rate savings refunding. For example, if the assigned rate is 7.5% on a UAAL of \$100,000,000, the annual all in cost would be roughly \$8,500,000 assuming a 30 year amortization, compared to an all in cost of \$6,900,000 on POBs amortized over the same period assuming a 5.45% interest rate and costs of issuance of 1%. These savings to a degree can be front loaded or otherwise structured to occur when most needed (see Section C of Chapter 5).

On the other hand, because the factors on which the UAAL is based are constantly changing (such as mortality and investment return), the final amount of interest rate savings cannot be determined with certainty. Also, the assigned interest rate may change from time to time during the life of the bond issue, and, at least theoretically, the amount of interest rate savings could become negative (even if all the other factors remain the same) if the assigned interest rate were to drop and remain below the bond interest rate for a substantial period. So far this has not occurred, even though the assigned interest rate in some cases has dropped by more than one

percentage point since the mid-1990s. This possibility is furthermore generally considered to be unlikely, because the assigned interest rate is based on an assumed investment rate of return which reflects investments with a higher risk profile and, therefore, higher projected return than the POBs.

B. Discounts

In some cases, it may also be possible to negotiate discounts with the pension system for early payment of the normal annual contribution or even the UAAL (which may reflect the pension fund's assumed rate of investment return or even its then current investment opportunity). It may also be an opportunity to renegotiate other terms of the pension obligation.

C. Arbitrage

Generally, pension funds may invest in a much broader range of investments than the state or local governments, and the size and diversity of the pension fund portfolio allows for a higher risk profile than the state or local government could prudently sustain with its own investments. As mentioned above, this is with the assumed rate of investment return is generally materially higher than the bond rate. The actual investment performance of most pension systems (at least in most years) has substantially exceeded the assumed interest rate. Therefore, there is the possibility that proceeds of the POBs will be invested by the pension fund at significantly higher return than the interest cost on the POBs (even if interest on the POBs is taxable).

In almost all cases, the benefit of earnings on investment of bond proceeds by the pension fund will be credited to the state or local government issuer either by reduced UAAL or reduced normal annual contribution or both. In some cases, the allocation of this benefit is subject to negotiation between the state or local government and the pension system and may even be decided by the state or local government from year to year. This benefit from earnings is why interest on POBs is generally not exempt from federal income tax (see Chapter 6). So this arbitrage is not the typical municipal bond arbitrage derived from borrowing at tax-exempt rates and investing at taxable rates, but rather what might be called risk arbitrage derived from borrowing against

the credit of the state or local government and participating through the pension fund in a portfolio of investments that is designed to produce a higher yield and manage the higher risk through diversification. Of course, there is no guaranty that such arbitrage will be positive.

One study of POBs in 2004 concluded that 84% were profitable to their issuers. Another 7% were at breakeven, leaving only 9% that have lost money. Even measured as of the least favorable time in the stock market, late 2002, only 34% were money losers, most of which were less than four years old and most of which are now at breakeven or profitable. Virtually all POBs are expected to be profitable over their term.

D. Budget Relief

During periods of substantial budget deficits, POBs are frequently used for budget relief. This may be accomplished by:

- (1) reamortizing the UAAL by replacing the obligation to the pension fund with POBs having a longer term and/or lower payments in the early years (or even no debt service in the early years if capital appreciation bonds (CABs) or capitalized interest is used); and/or
- (2) funding the normal annual contribution for the current (and maybe the next) fiscal year (to the extent permitted by applicable state law).

E. Labor Relations Benefits

Some state or local governments have used POBs, at least in part, to improve relations (or negotiations) with its employees and their unions by funding unfunded pension liability to those employees.

F. Better than the Alternatives

In some cases, POBs are simply better than the alternatives: (i) paying more into the pension fund; (ii) asking employees to pay more into the pension fund; (iii) reducing benefits; or (iv) hoping that gains on pension fund investments will substantially exceed the assumed rate of investment return.



CHAPTER FOUR

Possible Disadvantages of POBs

Despite the foregoing benefits of POBs, there are a few possible disadvantages:

- A. In some jurisdictions, a state or local government may negotiate or even unilaterally make changes in its pension obligation, perhaps by postponing payments or changing assumptions. POBs replace this potentially flexible pension obligation with a more immutable bond obligation.
- B. As explained in Chapter 3, while unlikely, it is possible that the assigned interest rate will drop below the bond interest rate or that the pension fund will have negative earnings, in each case for a sustained period.
- C. If the pension fund enjoys higher than expected earnings, the pension fund may become overfunded and result in temporary contribution holidays, but also can lead to increases in retirement benefits that may be costly to sustain at some point in the future.
- D. POBs result in payment to and investment by the pension fund of a lump sum amount that otherwise would have been paid and invested in increments over a period of years, concentrating rather than spreading market timing risks.
- E. Almost all POBs are taxable and most taxable bonds with fixed interest rates are sold as noncallable bonds. Adding a redemption feature will ordinarily result in a materially higher interest rate cost than the same redemption feature in tax-exempt bonds. Therefore, taxable noncallable bonds may be expensive to refund or defease, although there have been a number of successful tender offer refundings of taxable POBs (that is, a tender offer was made for the prior bonds and the tender price was paid with proceeds of new refunding bonds).

Another way to address this concern is by using variable rate bonds, which may contain redemption provisions without additional interest rate cost, and may be accompanied by a floating-to-fixed interest rate swap if a fixed rate obligation is desired.

Note that many of these issues can be addressed in whole or in part by using P²Os to fund less than all of the UAAL.

Types of POBs

A. Security

Most POBs are payable from the general fund of the issuing state or local government. As such, they must either satisfy or be exempt from the debt limitation provisions typically found in the applicable state constitution and, accordingly, generally fall into one of the following three categories:

1. *General obligation bonds*, which term generally refers to bonds that satisfy any constitutional debt limitation and are backed by the full faith and credit and taxing power of the issuing state or local government. An example is the \$10,000,000,000 State of Illinois General Obligation Bonds Pension Funding Series of June 2000 (Taxable), the largest POB issue to date. A variation is full faith and credit limited tax bonds payable from available general funds but without any obligation to levy additional taxes. See, for example, discussion in Appendix C.
2. *Obligations imposed by law*, which term refers to an exception recognized in a few states from the otherwise applicable debt limitation contained in the state constitution. It applies to obligations imposed on the state or local government by the constitution or by statute or, in some cases, by court judgment as distinguished from a voluntary exercise of the borrowing power by the state or local government.²⁰⁷ Most pension obligations would qualify and, in states in which the obligations imposed by law concept applies, bonds issued to fund those pension obligations (POBs) are considered to have the same legal character as the pension obligations themselves. POBs issued in California during the past decade have all been obligations imposed by law. See discussion in Appendix B.

POBs issued as obligations imposed by law generally cannot include reserves or capitalized interest because those components of the obligation are not considered to be imposed by law, even on the theory they are essential to marketing the bonds (because so many obligations imposed by law POBs have been issued without them). On the other hand, costs of issuance may be included. The inability to include capitalized interest means that it may be difficult to achieve complete budget relief in the early period following issuance of the bonds without resort to capital appreciation bonds (CABs).

3. *Annual appropriation bonds*, which term refers to bonds that are not considered debt subject to a constitutional debt limitation because the state or local government issuer has no legal obligation to pay them and payment is therefore subject to annual (or other periodic) appropriation of funds for that purpose at the discretion of the legislature or governing body of the state or local government issuer. Examples include the \$773.5 million POBs issued in 1996 for the State of New York and the \$2.8 billion POBs issued in 1997 for the State of New Jersey.

4. *Other*: In the mid-1980s and occasionally since, some cities and counties in California issued POBs as so called asset-strip lease revenue bonds or certificates of participation (COPs). The city or county leased existing facilities (with a value at least equivalent to the amount of bonds/COPs to be issued) to a joint powers authority or other governmental entity or to a nonprofit corporation, simultaneously leasing them back; the leaseback was assigned to a trustee and bonds/COPs were issued secured by the leaseback payable from the city or county's general fund, and the proceeds of the bonds/COPs were paid to the pension fund net of costs of issuance and reserves and capitalized interest retained by the trustee.

In certain circumstances, it may also make sense to use revenue bonds as POBs (for example, if the issuer is a revenue producing enterprise, authority or district). (See also Appendix C.)

B. Credit Ratings/Borrowing Capacity

Because POBs replace existing pension obligations, they are not generally viewed as adding to the debt burden of the state or local government issuer (much like a conventional refunding).⁴ To quote the rating agencies:

"Moody's believes the issuance of pension obligation bonds (POBs) is one effective way of addressing an unfunded liability. Since POBs reduce the cost of funding an unfunded liability, their issuance is not by itself a credit weakness. However, the planning and analysis conducted by a local government as part of the decision to grant expanded benefits, the government's plan for funding any unfunded pension liability, and its ability and willingness to budget appropriately for any attendant higher costs, are reflective of the quality of the government's overall financial management. These factors, therefore, will be considered in our assessment of a government's general credit quality."

"Standard & Poor's factors the effects of a pension obligation bond strategy into the long-term rating of the sponsor. Standard & Poor's has viewed POBs as a strategy for savings on carrying charges as long as the transaction was structured conservatively and the assumptions were reasonable and attainable. This requires a clear financing plan including reasonable assumptions and manageable leverage. Prudent expectations for investment returns and the cautious use of resultant savings help insure a POB's success. Another positive factor for a POB is, of course, to be fortunate enough to sell the bonds in a low interest rate environment, thereby increasing the spread between interest costs and investment return expectations and lowering the risk of underperformance."

"Fitch believes that POBs, if used moderately and in conjunction with a prudent approach to investing the proceeds and other pension assets, can be a useful tool in asset-liability management. However, a failure to follow

⁴ Note that to the extent the POBs fund the normal annual contributions to a long term created which could have an effect on credit rating, not covered if the POBs fund only the DBAL.

balanced and prudent investment practices with respect to POB proceeds could expose the sponsor to market losses.

Because a sponsor's unfunded pension liability is already factored into the rating, the issuance of POBs simply moves the obligation from one part of the balance sheet to another. However, Fitch notes that POBs create a true debt, one which must be paid on time and in full, rather than a softer pension liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, POBs can have a significant effect on financial flexibility over time."

The actual ratings on the POBs will depend primarily on legal structure. General obligation bonds and annual appropriation POBs should be rated the same as the issuer's other general obligation or annual appropriation debt. Obligations imposed by law POBs are generally rated in between: a notch below the issuer's general obligation bond rating and a notch above its lease or other annual appropriation debt.

C. Structures

Because POBs are typically payable directly from the general fund of the state or local governmental issuer, the structure of the bond issue is usually simple and straightforward, varying primarily in interest rate mode, using one or a combination of the following:

1. Fixed rate bonds. Because most POBs are issued, at least in part, to achieve interest rate savings, most POBs are issued as fixed rate bonds. The advantages are the same as fixed rate bonds generally; namely, they lock in interest cost. And with interest rates at historic lows, this is a very attractive prospect in itself. The disadvantages are: (i) the assigned interest rate on the pension obligations funded with POBs is not fixed, so interest savings cannot be fixed with certainty (see Section A of Chapter 3); and (ii) fixed rate taxable bonds are usually sold as noncallable, so they cannot be easily refunded or defeased if rates drop or circumstances change (see discussion Section E of Chapter 4).

2. *Variable rate demand bonds.* Variable rate demand bonds are bonds the holders of which may tender them back to the issuer or its agent upon short notice (usually 7 days, but may be 1 day, 1 month or other periods), for a purchase price equal to par plus accrued interest. As a result, they bear interest at rates like, and have some other characteristics of, short term obligations. Variable rate demand bonds generally require a bank letter of credit, standby purchase agreement or other facility to assure liquidity in the event bonds are tendered and cannot be remarketed. Unless the issuer is highly rated, variable rate demand bonds are typically also credit enhanced with either bond insurance or bank letter of credit or other credit facility. The advantages of variable rate demand POBs are that (i) their interest rates are generally lower than fixed rate bonds, and (ii) they are usually subject to redemption at any time without premium and at no extra interest rate cost for the right to redeem. However, while the interest rate usually starts out lower than fixed rate bonds, the rate is variable and subjects the issuer to interest rate exposure and risk to the interest rate savings objective and to the risk arbitrage pension fund investment objective for issuing the POBs (see discussion in Sections A and C of Chapter 3). Interest rates may be affected not only by market conditions but also by the financial condition of the issuer or the credit provider or liquidity provider. In addition, there are risk, cost and aggravation associated with renewal of any bank liquidity or credit facilities which usually have a term of one to five years, compared to the POBs which typically have a term of more than 20 years.

3. *Auction rate bonds.* Auction rate bonds appear to be the most popular current variable rate mode at this time because they do not require a bank letter of credit, standby purchase agreement or similar liquidity facility required for variable rate demand bonds or commercial paper. This is because auction rate bonds are not puttable back to the issuer, but instead are subject to periodic auction (typically every 7, 28 or 35 days) if the holder would like to dispose of its bonds other than by direct sale. The interest rate is reset by the auction price and tends to be materially less than the then current fixed rates (for example, in the fall of 2005, 28 day insured auction rate taxable POBs bore rates of roughly 3.80% to 4.00% compared to 30 year tax-exempt fixed rates of approximately 5.45%). However, there is no assurance that auction rates will not increase to exceed the fixed rate at which the POBs could have been

originally issued. If there is an auction with no buyers (*i.e.*, a failed auction), the interest rate usually goes to the maximum rate (typically 12 to 15%). Failed auctions are rare. The primary reason they may occur is (i) a cloud of some kind on the tax-exemption of the bonds (for example, an IRS audit or challenge to the tax-exemption of similar bonds), which is not a risk for most POBs because they are taxable; or (ii) a shock to the security for the bonds (for example, bankruptcy of an important source of revenue) which is improbable with general fund obligations like POBs unless the issuer goes bankrupt (which states cannot do under U.S. bankruptcy law, and cities and counties do very rarely).

4. Indexed bonds. Indexed bonds are variable rate bonds that are not subject to tender back to the issuer and, therefore, do not require a bank liquidity facility, and bear interest at a fixed spread over a market index (typically either three or six month LIBOR) reset at the end of each accrual period (typically quarterly if three month LIBOR is used or semiannually if six month LIBOR is used). LIBOR refers to the London Interbank Offered Rate and is published daily by various news and information services. Indexed bonds of this type are used primarily to facilitate marketing of POBs outside of the U.S. where investors are more accustomed to LIBOR based investments, but are also attractive to many U.S. investors as well. Like auction rate bonds, index bonds may be subject to redemption without penalty. However, also like auction rate bonds there is no assurance that LIBOR indexed rates will not increase to exceed the fixed rate at which the POBs could have been originally issued. However, unlike auction rates, the LIBOR index is not affected by events affecting the POBs issuer or the POBs. Index bonds may also be swapped to fixed more efficiently and with little or no basis risk compared to auction or other variable rate bonds because the global swap market is primarily LIBOR based.

5. Capital appreciation bonds. Capital appreciation bonds (CABs) are bonds that bear no current interest, which instead is accrued, compounded (usually semiannually) and paid at the maturity of the bonds. They are used primarily to reduce debt service in the early years. A variation is convertible CABs, that function as CABs for several years and then convert on a certain date to current income bonds (with interest paid on the then accrued value of the bonds, being the original principal amount plus the amount of accrued, compounded interest up to the

conversion date). The disadvantage of CABs is that higher rates of interest are required in order to market them.

6. Swaps. If variable rate bonds are used, the resulting interest rate exposure may be swapped to a fixed rate, in whole or in part, using a floating-to-fixed interest rate swap. While swaps may often make a great deal of sense in this context, they are complex financial investments and beyond the scope of this pamphlet. Please refer to another of our pamphlets, entitled Interest Rate Swaps: Application to Tax-Exempt Financing (much of which is applicable even though POBs are taxable). It is important to make sure that if a swap is to be used, it is consistent with the issuer's objectives and does not itself expose the issuer to risks or consequences the issuer does not fully understand or are inconsistent with its objectives. For example, if the purpose of using variable rate POBs is to allow for refunding or early redemption if rates drop or other circumstances change, the termination payment that may be due on early termination of the swap may offset the benefit of and effectively prevent refunding or redemption. There are also other circumstances in which a substantial termination payment may be due from the state or local government, such as default of the swap provider or downrating of either party, as well as other terms that can be modified to suit the state or local government's objectives. Expert advice should be sought before entering into any swap.

D. Payments to the Pension Fund: Whole or Part

POBs may be issued to pay all or any part of the UAM, or (depending on applicable state law) the normal annual contribution. Frequently, issuers choose to use POBs to fund only a portion of the UAM, generally to avoid or reduce the concerns described in Chapter 4. The portion of the UAM funded may be (1) a percentage of the total UAM as of the date of issuance of the POBs, or (2) all or part of certain years contributions to the UAM. If agreed to by the pension system, the second approach can result in suspension of UAM contributions during those years (for example, the next succeeding 10 years). At the end of the period, the UAM will be

5. Depending on state law and financing structure, it may also be possible to finance future year annual contribution and/or unfunded liability created by investment losses not yet realized due to actuarial smoothing methodologies which phase in investment gains and losses over a period of, usually, 30 years.

recalculated and amortized over the remaining original term of the UAAL. The risk of this second approach to partial payment of the UAAL, which is much less common than the first approach, is that if investment performance of the pension fund is substantially below the assumed rate of return, there could be a significant increase in the amount of UAAL to be amortized over the remaining term. To a degree, that risk can be addressed by subsequent issues of POBs (before or after the date of recalculation).

CHAPTER SIX

Tax Issues

A. Taxable Bonds

Most POBs are taxable. That is, interest on the bonds is included in gross income for federal tax purposes, although they are usually exempt from income taxes of the state in which the issuer is located. This affects not only the interest rate at which the POBs are sold but also the types of investors to which they are marketed (for example, corporate pension funds, charitable endowments and others not subject to federal income tax and, for some of the larger issues, non-U.S. investors). There are, however, a few circumstances in which POBs may be tax-exempt.

Why most POBs are taxable, with these few exceptions, is explained below.

B. Tax-Exempt POBs Prior to 1986 Tax Act

Prior to the enactment of the Tax Reform Act of 1986 (the "1986 Tax Act"), POBs that were properly structured could bear interest that was excluded from gross income for federal tax purposes. However, to get tax-exempt treatment, investment of bond proceeds for the benefit of the covered employees and former employees had to be designed so that the issuer/employer did not benefit from the investment in any way other than relieving the issuer of the responsibility of paying its retirement

If proceeds deposited in the pension fund were expected to be invested in securities or obligations with a yield higher than the yield on the POBs, the issuer's obligation to make additional contributions into the fund would be reduced in the future. This prohibited anticipated direct benefit from the investment of the bond proceeds in the pension fund.

However, the situation was different where the issuer contracted with someone else to take over the responsibility of making payment to the retirees and paid for that transfer of risk with proceeds of POBs – for example, by purchasing an insurance company annuity whereby the insurance company took over all liability for the payment of the pension benefits. In that case, the insurance company bore the risks and benefits of investment return – the issuer got no benefit from investments made by the insurance company even if the expected investment return was reflected in the price paid by the issuer for the annuity policy. In addition, the purchase of an annuity was not treated as the purchase of a “security” or “obligation” under the tax law. A number of tax-exempt POB transactions were consummated in the early 1980’s in which the proceeds were deposited into a pension fund and were used to acquire insurance company annuity contracts.

C. Tax Reform Act of 1986; Transition Rules

1. Stopping New Issues of Tax-Exempt Pension Bonds. As a result of the threat of a proliferation of tax-exempt POB issues, Congress decided to amend the tax law to prevent the investment of tax-exempt bond proceeds in annuity contracts. New rules were adopted in the 1986 Tax Act. “Investment type property,” including annuity contracts, was added to “securities” and “obligations” as potential arbitrage investments. In addition, because of the urgency with which it viewed the matter, Congress included a special effective date rule in the 1986 Tax Act relating to annuity contracts which applied to all bonds issued after September 25, 1985. The 1986 Tax Act essentially ended the issuance of tax-exempt POBs for the purpose of depositing the proceeds into a pension fund or for the purpose of purchasing annuities to replace the issuer’s responsibilities to its retirees, except as described below.

2. Transition Rules for Refundings of POBs. The status of refundings of pre-1986 Tax Act POBs was not specifically addressed in the 1986 Tax Act. In connection with two later tax acts, the Technical Corrections Bill of 1988 and Technical and Miscellaneous Revenue Act of 1988, Congress attempted to clarify its position on refundings. While the statutory language and legislative history are a bit confused, the related House, Senate, and Conference Committee Reports indicate that

Congress intended generally to permit one advance refunding of pre-September 25, 1985 POBs (at least where the amount of the refunding is not greater than the amount of prior bonds). Additionally, the legislative history indicates that Congress intended to permit any number of current refundings of pre-September 25, 1985 POBs where the refunding bonds do not additionally burden the tax-exempt market, but merely replace existing tax-exempt debt.

D. Columbus Case

The State of Ohio created a state fund into which municipal corporations in the State were required to transfer, on January 1, 1967, all existing assets and liabilities of their local pension funds for police and firefighters. Under the State law, all pension liabilities accruing after the transfer would be supported by current employer and employee contributions. However, while the State fund completely assumed the assets and liabilities of a city's retirement fund, the law mandated the city pay to the fund, either immediately or over time, an amount equal to the present value of the accrued but unfunded liability determined at the time of the transfer. The City of Columbus opted to satisfy its obligation over time together with the required interest.

In 1993, the State modified the law to allow any city still owing money to the fund to extinguish its remaining UAAL in return for a single payment equal to 65% of the then unpaid principal balance. The City decided to prepay its obligation. However, upon hearing that the City was going to issue tax-exempt bonds to fund its prepayment, representatives of the Internal Revenue Service notified the City that they would assert that interest on these bonds would be taxable. The City sought a private letter ruling from the Internal Revenue Service and received an adverse ruling which it appealed to the Tax Court.

In the court proceedings the Service argued, among other things, that the discount the City received on the prepayment of its obligation to the fund was a form of investment return and thus created impermissible arbitrage profit. The Service reasoned that the pricing of the prepayment reflected the expectation of the State fund that it would be able to invest the amount of the prepayment at a yield materially higher than the yield on the City's bonds. As a result, the Service believed

that both the City and State fund would benefit from the earnings on the investments. In addition, the Service argued that the prepayment constituted the use of bond proceeds to acquire "investment-type property" at a yield higher than that on the bonds (after taking into account the discount received on the prepayment) in that absent the discount pricing of the prepayment there would be no economic savings for the City.

Ultimately, the City prevailed on appeal as the Court of Appeals concluded that there was an existing obligation of the City to the State fund, the City would not benefit from the investment of amounts by the State fund and the prepayment of the City's own debt obligation to the State fund did not constitute the acquisition of investment type property by the City. The City was then able to refund its obligation to the State fund by issuing tax exempt POBs.

While the unusual facts in this case have application beyond the City of Columbus, such application is likely to be fairly limited and to attract unfavorable attention from the Internal Revenue Service.

E. Tax-Exempt Working Capital Bonds

While directly issuing bonds to deposit the proceeds into a pension fund does not appear to be permitted under current tax law governing tax-exempt bonds, in certain cases it may be possible for a state or local government to indirectly fund the current year's pension deposit. For example, a state or local government may issue short term tax or revenue anticipation notes or long term working capital bonds to finance a cash flow budget deficit or a so-called structural budget deficit. The deficit analysis would include any cash flow deficit relating to the state or local government's obligation to deposit amounts into its pension fund.

It may be that this type of financing is best done so that the bond proceeds are not required to be deposited in the pension fund, but rather, are used to fund deficits created by working capital expenditures including the deposit of amounts into the pension fund. In other words, it is important that the bond proceeds not be "traced" into the pension fund or required to be deposited there and the bonds should not be called Pension Obligation Bonds.

Among other things, long term bonds of this type would bring into play the application of some complex federal tax rules relating to when proceeds can be treated as spent, allocation of the deficit in sizing the issue, permitted amortization structure, the application of so-called "other replacement proceeds" rules, applicable yield and other investment restrictions, post-issuance compliance matters, plus the intersection in sizing and in post-issuance compliance with the issuance of normal tax or revenue anticipation notes and any other short term or long term working capital obligations.

F. Investment of POB Proceeds in Municipal Obligations

The primary tax problem in the use of tax-exempt POBs to make a deposit to a pension fund is that the proceeds are not treated as spent, but rather are treated as invested. Moreover, under the so-called "proceeds spent last" rule applicable to working capital financings, these proceeds cannot be treated as paid out to pension recipients until all other available amounts are first expended, which as a practical matter, means that the proceeds will never be deemed expended. Unless the investment yield on the investments in the pension fund is not more than the yield on the bonds, the bonds will become taxable arbitrage bonds. In addition, the "hedge bond" rules would result in the bonds being treated as taxable hedge bonds unless the issuer actually expected to spend the proceeds within a three- or five- year time frame, taking into account the "proceeds spent last" rule.

However, under both the arbitrage rules and the hedge bond rules, interest on the bonds used to fund the pension fund could be tax exempt if the issuer invested the proceeds of the bonds in municipal obligations the interest on which is not subject to the alternative minimum tax (so-called "non-AMT" municipal bonds). Under these provisions as long as the amount of non-AMT municipal bond investments in the pension fund is at least equal to 95% of the amount of POBs outstanding at any time, interest on the POBs will be tax exempt. As the POBs are amortized, there is a similar reduction in the amount required to be invested only in non-AMT municipal bonds in the pension fund.

While this structure allows for POBs to be issued as tax exempt, the benefit of the tax exemption on the bonds may be outweighed by the limitation on the type of investments allowed with the proceeds.

G. Other Considerations: Effect on TRANS

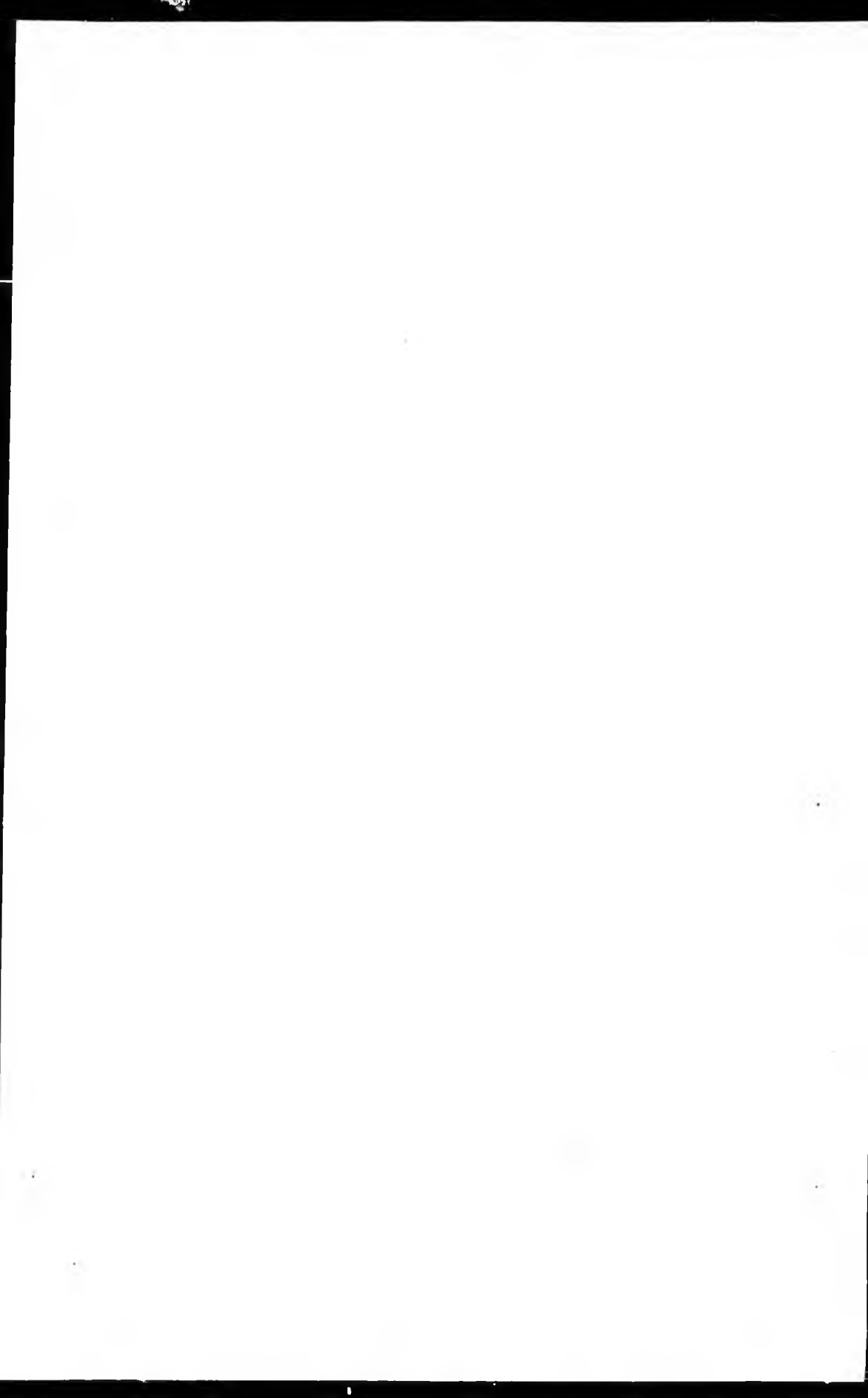
Tax and revenue anticipation notes (TRANS), are typically issued by state and governmental units of all sizes to fund the annual cash flow deficit which arises due to the timing mismatch between annual revenues and annual expenses. TRANS are almost always issued as short term notes with maturities of 13 months or less and are repaid at or shortly after the end of the fiscal year by which time it is expected that revenues will have "caught up" with expenses. To the extent the POB proceeds are used to fund a deposit to the pension fund that otherwise would have been made out of current year's revenues, the deficit will be likely be reduced by the same amount, impacting the sizing of any TRANS issued for that year. The one circumstance where this would not happen is if the calculation of the maximum cash flow deficit used in sizing the TRANS shows that it is incurred prior to the time of the pension deposit. In that case, the use of proceeds to make that deposit would not have any impact on the size of the TRANS issue.

CHAPTER SEVEN

Federal Reimbursement Issues

Certain costs of state and local government in administering programs under grants from or contracts with the federal government are eligible for reimbursement from the federal government. Such costs include compensation and benefits, including pension benefits, of state or local government employees for the time devoted to the administration of such programs. Such allocable pension benefit costs even include the interest assigned to the state or local government's unfunded liability. The principles governing such reimbursement are set out in Office of Management and Budget Circular A-87. Some states have similar programs for reimbursement of local governments for costs related to the administration of state programs.

POBs replace the state or local government's payment of some or all of these pension costs with payment of the principal of and interest on the POBs. Issuers will want to be comfortable that the federal government will treat debt service on the POBs as the surrogate for the pension obligations funded or refunded with the POBs and will continue to reimburse its allocable share. Statements have been issued by the Office of Management and Budget and the Department of Health and Human Services to the effect that the POBs, including principal (representing amounts paid to the pension fund), interest and costs of issuance, will be allowable as the pension costs funded or refunded thereby, so long as the POBs are not more costly to the federal government than the regular pension costs funded or refunded over the remaining life of the unfunded liability. The same principles should apply to refunding POBs. Further details of federal and state reimbursement programs are beyond the scope of this pamphlet.

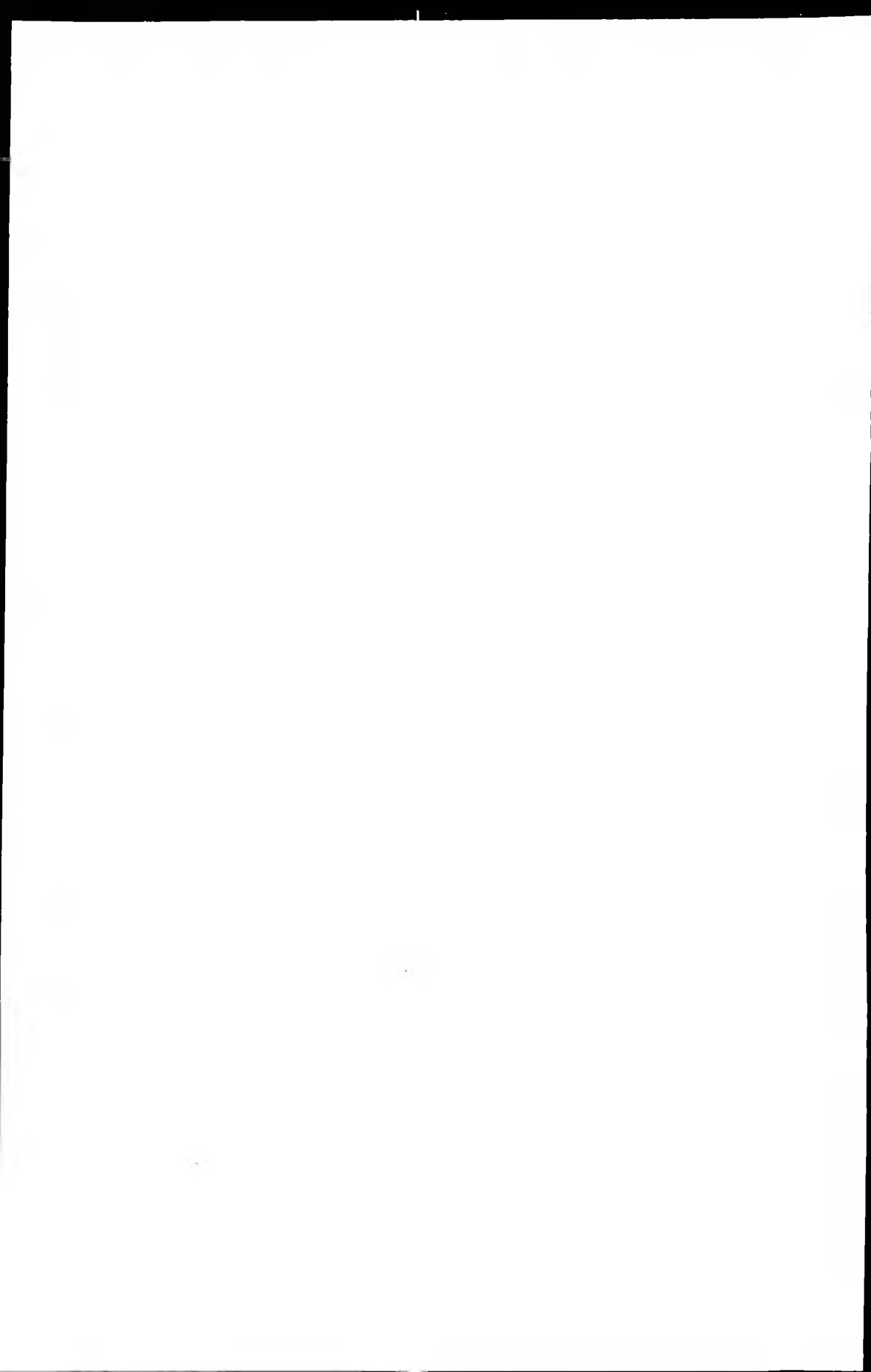


CHAPTER EIGHT

Other Post Employment Benefits (OPEB)

There are some other state and local government non-bond obligations, which are like pension obligations and which it may be possible to fund in a manner similar to POBs. The first edition of this pamphlet in 2003 covered primarily POBs, the most frequently used and highly developed of this category. It noted, at least briefly, that there may be other applications of the same concepts. Several examples (not an exhaustive list) include such other actuarially based insurance or benefit obligations as workers compensation, health benefits and unemployment insurance, and such non-actuarial obligations imposed by law as court rendered judgments for damages against state or local governments and, in California, county obligations under the Teller delinquent property tax program.

In June 2004, the Governmental Accounting Standards Board issued GASB 37, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions," ushering in intense interest in funding options for OPEB and the logical extension of this pamphlet to cover this emerging topic.



CHAPTER NINE

GASB 45

A. Accounting Change.

OPEB refers to "other post-employment benefits," meaning other than pension benefits. OPEB consist primarily of health care benefits, and may include other benefits such as life insurance, long term care and similar benefits. Until now, these benefits have generally been administered on a pay-as-you-go basis and have not been reported as a liability on municipal financial statements.

GASB 45 will require municipalities to account for OPEB liabilities much like they already account for pension liabilities, generally adopting the actuarial methodologies used for pensions, with adjustments for the different characteristics of OPEB and the fact that most municipalities have not set aside any funds against this liability. Unlike GASB 27, which covers accounting for pensions, GASB 45 does not require municipalities to report a net OPEB obligation at the start.

B. Annual Required Contribution (ARC) and Net OPEB Obligation (NOO).

Under GASB 45, based on an actuarial valuation, an annual required contribution (ARC) is determined for each municipality. The ARC is the sum of (a) the normal cost for the year (the present value of future benefits being earned by current employees) plus (b) amortization of the unfunded actuarial accrued liability (benefits already earned by current and former employees but not yet provided for) (U.A.L.), using an amortization period of not more than 30 years. If a municipality contributes an amount less than the ARC, a net OPEB obligation (NOO) will result, which is required to be recorded as a liability on its financial statements.

Note that the UAAL will be much greater than the NOO. Although not required to be treated as a liability on financial statements, the UAAL will likely appear in a related footnote and be disclosed in connection with the municipality's bond or note offerings.

Some actuaries have estimated that for many municipalities the ARC may be 5 to 10 times higher than current pay-as-you-go expenses. However, after a period of years, because of factors such as increasing number of retirees and inflation in health care costs, pay-as-you-go costs are expected to far exceed the ARC. GASB 45 does not require that the unfunded liability actually be amortized, only that the municipality account for its unfunded accrued liability and compliance in meeting its ARC.

GASB 45 does not specify the actuarial assumptions to be used in calculating an OPEB liability. Most likely, assumptions will be based on methodology that has developed in connection with FAS 106 (the private sector counterpart to GASB 45 implemented in the early-1990s).

An actuarial valuation is required every 2 years for OPEB plans with more than 200 members, or every 3 years if there are less than 200 members.

C. Effective Date.

Although GASB 45 encourages earlier adoption, implementation is required by the following dates, based on the size of government measured by annual revenue:

Annual Revenue	Effective for Fiscal Year Beginning After:
Greater than \$100 million	December 15, 2006
Between \$10 million and \$100 million	December 15, 2007
Less than \$10 million	December 15, 2008

CHAPTER TEN

OPEB OPTIONS

Municipalities have a number of options to consider in developing an OPEB strategy or otherwise addressing their OPEB liability, such as:

A. Reduce OPEB Obligation

Unlike pensions, which municipalities are required to provide to their employees as a matter of law in most states, state law generally does not impose on municipalities the obligation to provide OPEB. Instead, the OPEB obligation usually arises purely by action of the municipality, whether by collective bargaining agreement, MOU, other employee contract, ordinance, resolution, board policy or even just past practices. Many of these are subject to renewal, renegotiation, change or termination. In some cases, municipalities have been careful to describe all of their OPEB obligations as discretionary and/or subject to change or discontinuation. However, while the ability to change or discontinue OPEB for future employees should be an option in most cases, the ability to change or discontinue OPEB with respect to retired or current employees may vary from state to state, depending on the degree to which the courts in a particular state treat OPEB, even if not contractually vested by express contractual terms, as not subject to unilateral change by the municipality on the theory that they are "fundamental benefits", "inducement to remain employed," "elements of compensation contractually vested in accordance with their terms upon acceptance," "earned by remaining employed" or similar theory and on the particular facts pertaining to the municipality, its employees, and its OPEB. This is an evolving area of the law, and while it evolves, most municipalities are expected to assume OPEB are discretionary and try to preserve the option to reduce them.

Other approaches to reducing the municipality's OPEB liability include charging or increasing premiums charged to employees and retirees, charging higher premiums to retirees than current employees (eliminating or reducing an implicit subsidy that GASB 45 requires being included in OPEB liability), increasing the length of time employees must work to be eligible, capping employer's total exposure, treating new employees less favorably than existing and prior employees, and/or shifting in whole or part to a defined contribution instead of defined benefit plan.

B. Continue pay-as-you-go.

In the short run this is the simplest and cheapest option. However, at some point in the future pay-as-you-go will become much more expensive than the ARC or fixed bond payments. Pay-as-you-go will result in an annually increasing NOO for GASB 45 purposes, and higher OPEB UAAL and ARC amounts due to an ability to apply a higher investment return assumption to the calculation of these amounts and may become a ratings factor (for example, Fitch Ratings has commented that "an absence of action taken to fund OPEB liabilities or otherwise manage them will be received as a negative rating factor").

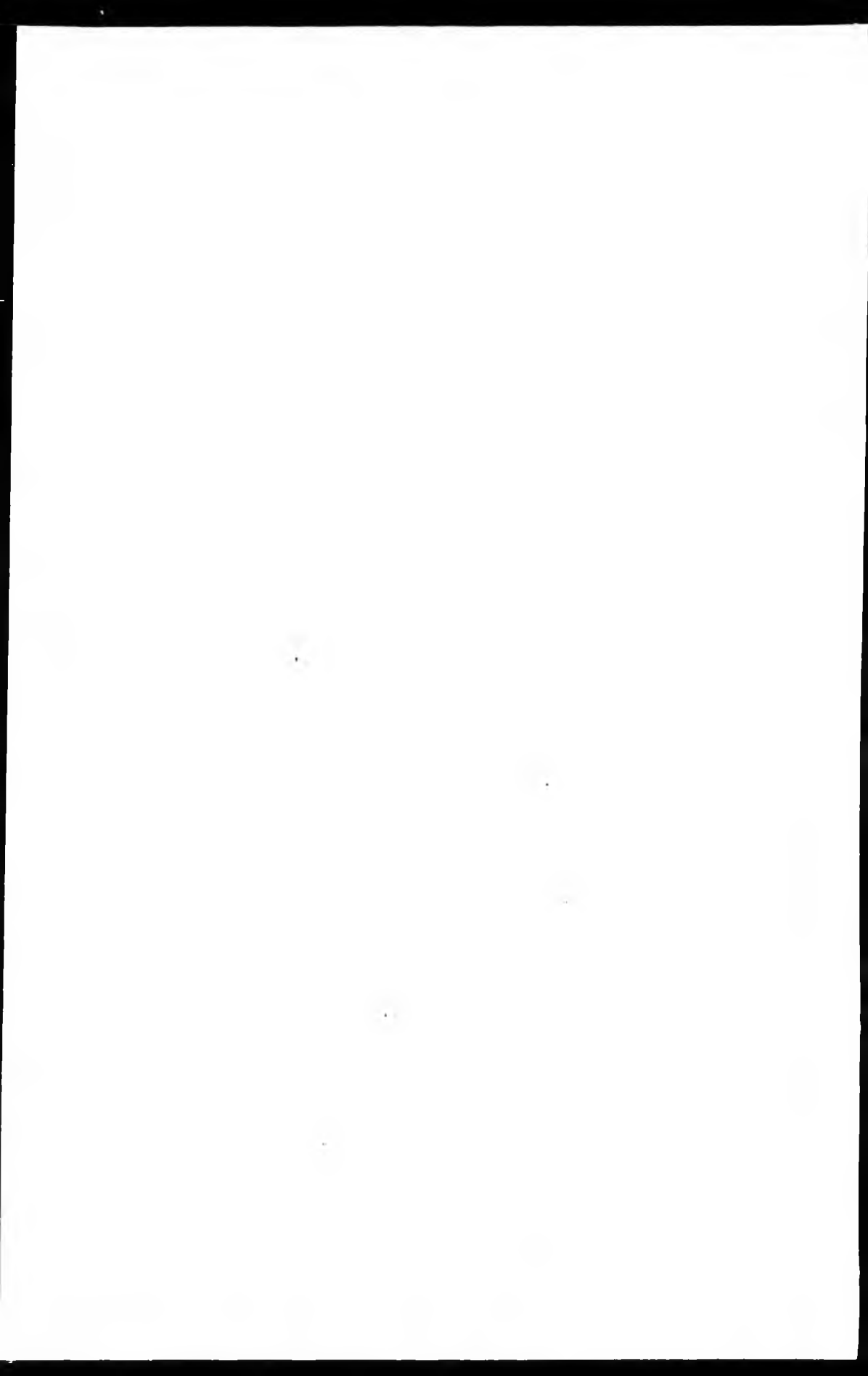
C. Undertake a funding program, using either:

1. Special reserve or other dedicated fund within the treasury of the municipality. However, contributions to such an internal fund will generally not qualify as contributions toward the ARC nor as plan assets for GASB 45 purposes, which require an irrevocable contribution to a trust or equivalent arrangement protected from creditors and dedicated solely to providing benefits to retirees and beneficiaries in accordance with the terms of the OPEB plan. Therefore, an internal special reserve or similar fund will still be considered pay-as-you-go for GASB 45 purposes, and, in calculating the OPEB UAAL and related ARC, the investment return assumption applicable to deposits in such fund will likely be based on the municipality's return on its general (largely short-term) investments (roughly 2½%–3% today) compared to the much higher investment return assumption (7% to 8%) used by pension funds, especially if large and diversified. The investment return assumption is the equivalent of a discount rate used in present valuing future OPEB payments, and the foregoing difference in investment return assumptions will make a very significant difference in

OPEB UAAL and ARC amounts (in some cases cutting them in half). Therefore, most municipalities choosing to undertake an OPEB funding program will use an OPEB trust of some kind. Some may use the special reserve fund option temporarily until a suitable OPEB trust is available.

2. *OPEB Trust.* Funding may consist of just the ARC or a larger portion of the UAAL, for which purpose the municipality may choose to use OPEB Bonds. See Chapter 11 for a discussion of OPEB trusts and Chapter 12 for a discussion of OPEB bonds.

3. *Insurance.* Note that most of the same objectives could be achieved by purchasing insurance for future OPEB obligations, but such long-term insurance is not currently available and cost and availability are likely to continue to foreclose or severely limit this option.



CHAPTER ELEVEN

OPEB TRUSTS

GASB 45 does not require OPEB liabilities to be funded or, if funded, by funding an irrevocable trust of some kind. However, as explained in of Chapter 10C, the existence of GASB 45 creates strong incentives to establish such a trust.

A. Types of OPEB Trusts.

The following types of OPEB trusts are each named for the section of the Internal Revenue Code from which they derive their exemption from federal income tax.

1. *401(b) account.* This is a separate account in a tax-qualified pension fund for health benefits of retirees, their spouses and dependents. The aggregate actual contributions to this account cannot exceed 25% of the total actual contributions to the pension fund (other than contributions to fund past service credits) after the date on which the account is established. This limitation could present a problem for some municipalities' OPEB funding strategies, unless either the 401(b) account has been a component of the pension fund for a substantial period or the municipality is going to fund the pension benefits component of the fund at three or more times the amount at which it is going to fund the 401(b) account component. Amounts in a 401(b) account may not be used for or diverted to any other purpose, including pension income benefits.

2. *115 trust.* This type of trust is considered exempt from federal income tax either because it is an "integral part" of a single governmental entity or because it serves an "essential governmental function" of one or more governmental entities. This type of trust most municipalities are likely to use, whether alone or in combination

with other municipalities – at least until adoption of 401(b) accounts by a majority of pension funds and quite possibly notwithstanding such a development.

3. 501(c)(9) trust. Also known as a “voluntary employees’ beneficiary association” (“VEBA”) trust, this is the primary vehicle used by the private sector for funding health benefits. Among the requirements are that membership be voluntary (which is deemed satisfied if mandated by collective bargaining agreement or if membership imposes no detriment and is required of all employees), and that the trust be controlled by its membership (which can be satisfied if the membership, directly or through representatives, designates the trustee or trustees who control(s) the trust, or if the trustee(s) are designated pursuant to a collective bargaining agreement). Because the form and operation of VEBA trusts are so well developed in the private sector, some municipalities may elect to adopt this model (or borrow from it in establishing a 115 trust.)

B. Characteristics of OPEB Trusts.

To accomplish the goals for which OPEB trusts are created (see Chapter 100), they generally must satisfy at least the following three requirements:

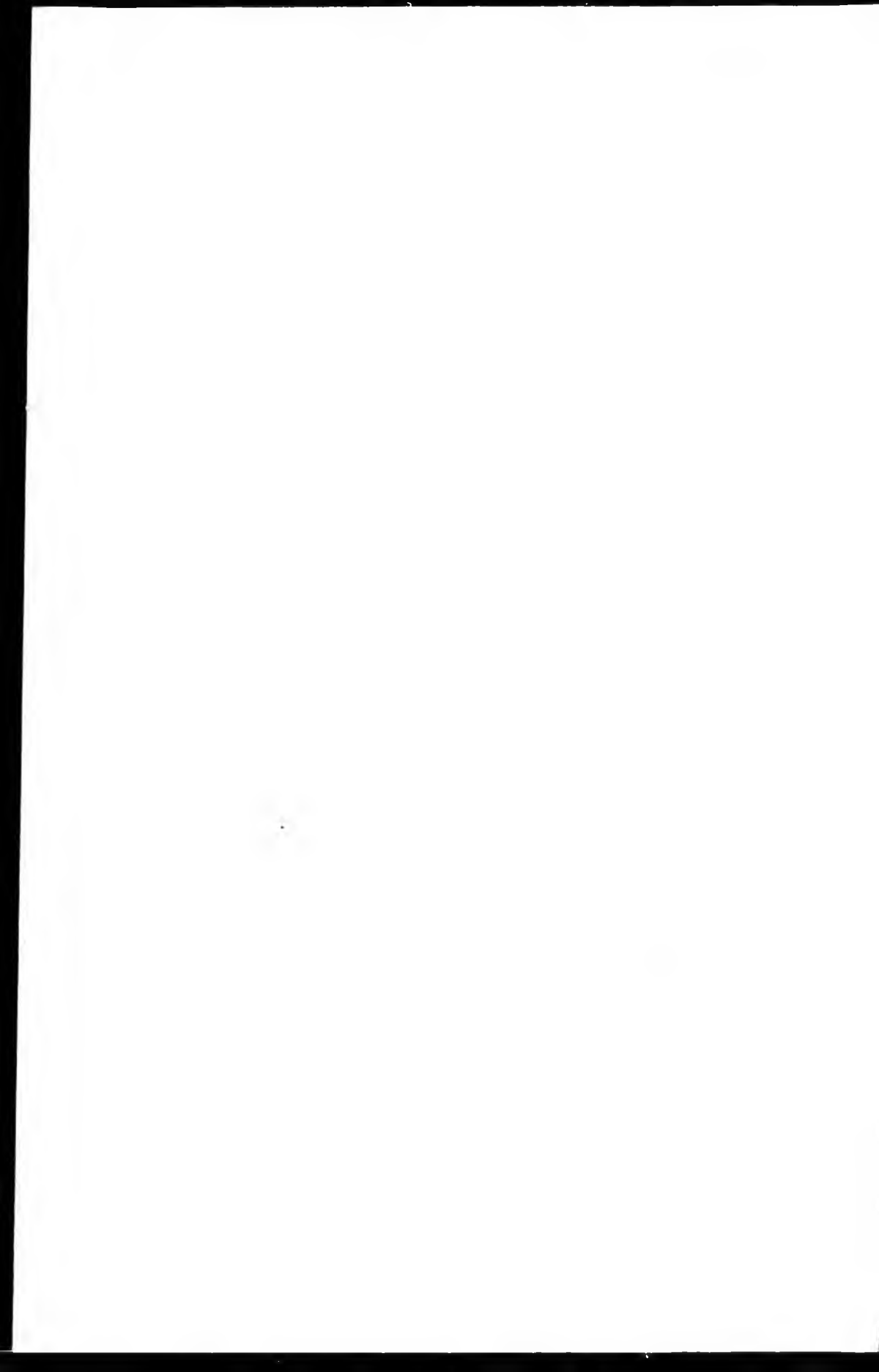
1. Exemption from federal income tax. In addition to income on investment of trust assets being exempt from income tax (as described in A above), contributions to the trust must not be treated as income to the employee or retiree (in each case under federal and state income tax laws).

2. Qualified trust for GASB 45 purposes. For contributions and deposits to count for GASB 45 purposes, they must be irrevocable, protected from creditors of the municipal employer and dedicated solely to providing benefits to retirees or beneficiaries in accordance with the OPEB plan (see discussion in Chapter 100).

3. Broad investment powers, including equities. In order to be entitled to use the higher investment return assumption (see discussion in Chapter 100, above) and perhaps actually to earn a higher rate of return, the trust must be able to invest in a broader range of investments than those to which municipal funds are generally restricted, including the ability to invest in equities. In the absence of specific legislation governing investment by OPEB trusts in most cases (and perhaps even if

there is such legislation, if the investment restriction is contained in the state constitution), it will generally be necessary to conclude that the OPEB trust is a pension or retirement fund within the meaning of any applicable exception to the restrictions otherwise applicable to the investment of municipal funds or that the OPEB trust is sufficiently separate from the municipality to not be included among the types of entities covered by state statutory (or, in some cases, constitutional) investment restrictions.

4. Single or multiple employer trusts. An OPEB trust may be a single employer trust established by and for a single municipality or a multiple employer trust established by an association or other collection of municipalities for membership by any interested municipality or by specific categories (such as, cities, counties, school districts, etc.)



OPEB BONDS

A. Advantages/Disadvantages.

The benefits of OPEB bonds are essentially the same as for pension obligation bonds (POBs) and are listed in Chapter 3 above, including interest rate savings (comparing bond interest costs against the investment return assumption/discount rate used in calculating the UAAL and ARC), arbitrage (see below), budget relief (compared to the ARC alternative), labor relations, and better than alternative strategies. Additional benefits pertaining to or receiving more emphasis as applied to OPEB bonds include the following:

- 1. Reducing the OPEB UAAL and ARC* by funding a qualified trust entitled to use a higher investment return assumption (discount rate on future OPEB payments) than pay-as-you-go or funded internal reserve fund plans. This, in turn, also reduces the political burden of reporting a higher UAAL and the political and financial burden of budgeting for a higher ARC.
- 2. Lowering long-term cost of OPEB.* While debt service on OPEB bonds (like the ARC) will generally be higher than pay-as-you-go costs for the first few years, pay-as-you-go costs (and resulting ARC costs and NOO) are likely to increase sharply, and after a few years exceed the cost of debt service and continue to grow thereafter.
- 3. Potential arbitrage opportunity,* if not only the investment return assumption but also the actual investment return earned by the OPEB trust exceeds the yield on the bonds. As noted in Chapter 3, a 2004 study found 84% of POBs were in a positive arbitrage position and another 7% were at breakeven, notwithstanding substantial decline in stock market values in 2000-2002.

4. *Reducing public pressure* to reduce or discontinue OPEB benefits, which may result from publication of this substantial "new" unfunded liability, particularly in context of the growing debate over pension reform occurring in some states.

5. *Credit rating protection.* As noted above, rating agencies will be evaluating a municipality's strategy for managing its OPEB liability. A couple of rating agencies have indicated that OPEB bonds, properly used, will be considered a positive factor in a municipality's general credit evaluation.

The possible disadvantages of OPEB Bonds are the same as for POBs in Chapter 4 above, including replacing negotiable or even discretionary OPEB obligations with immutable bond obligations, the concentration of investment risk through lump sum deposit compared to spreading market timing risks by making ARC deposits annually, and possible negative arbitrage.

B. Types and Legal Authority.

Legal authority for OPEB bonds will vary from state to state and, within states, by type of entity. For some entities, the legal authority and structure will be essentially the same as for POBs:

1. General obligation bonds
2. Obligations imposed by law (OPEB variation, see discussion below)
3. Annual appropriation bonds
4. Asset-strip lease bonds
5. Revenue bonds (enterprise special districts and authorities)

See more complete discussion in Chapter 5A above. However, for the reasons discussed in Chapter 10A above, the "obligations imposed by law" theory used in California and some other states to support POBs may not be so easily applied to OPEB and, even if it could be applied, municipalities may not want to lose the option of treating OPEB as discretionary or negotiable by declaring them to be "obligations imposed by law." For those situations, we have developed a slightly different legal theory, which avoids that trap, but which for all other purposes would

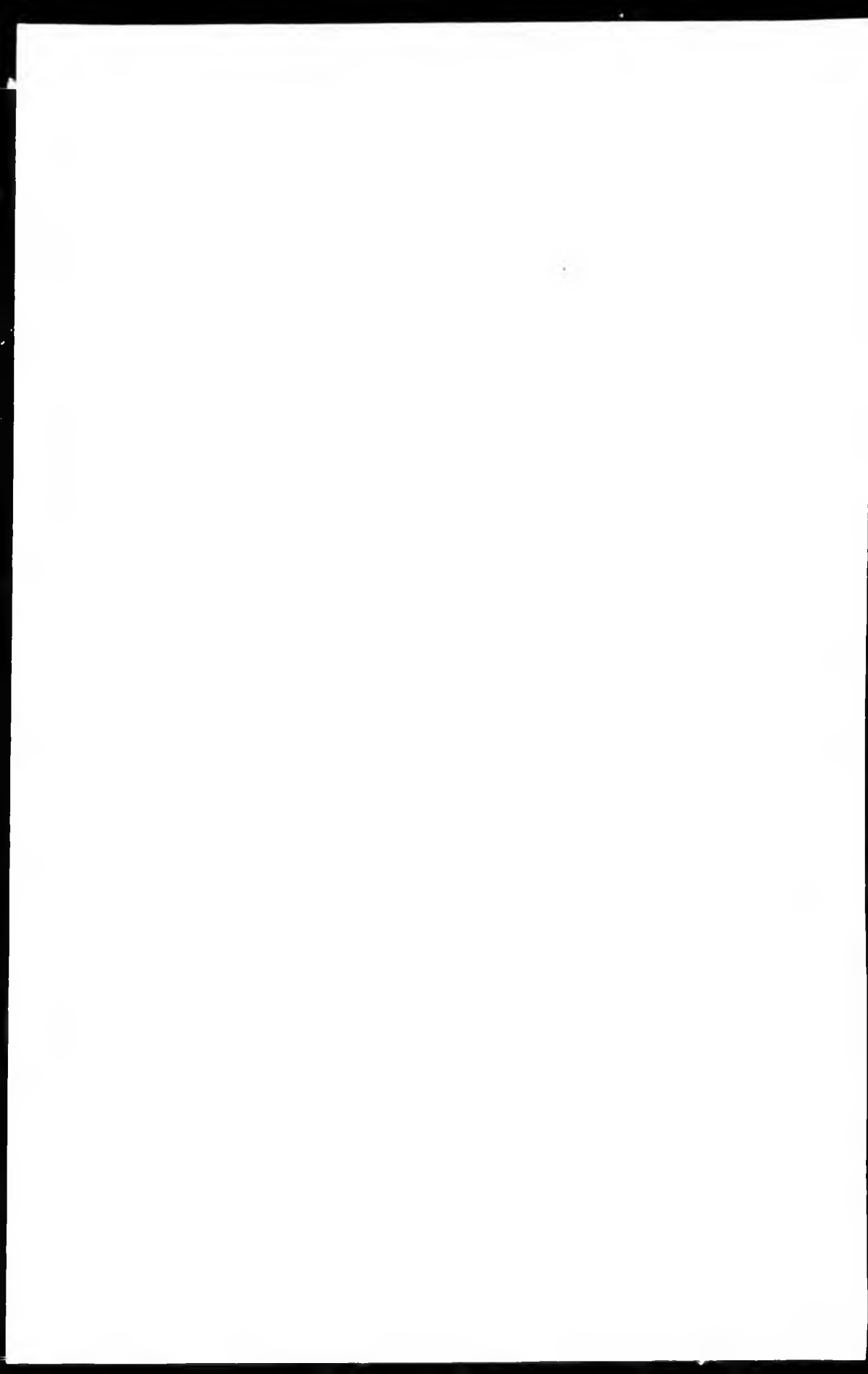
function (and be structured) exactly like "obligations imposed by law" bonds. See discussion in Appendix B.

C. Taxable.

Just like POBs, interest on OPEB bonds will be included in gross income for federal income tax purposes, although they will usually be exempt from income taxes of the state in which the issuer is located. See more complete discussion at Chapter 6 above.

D. Federal Reimbursement Issuers.

Certain costs (including OPEB) of state and local governments in administering programs under grants from or contracts with the federal government are eligible for reimbursement from the federal government pursuant to Office of Management and Budget Circular A-87. See discussion of effects of replacing direct costs with bond and debt service at Chapter 7 above.



APPENDIX A

New York

A greater number of POBs (roughly 95) have been issued by the state and local governments in New York over the past decade than from any other state.

The issuance of POBs by local governments in New York was first authorized in 1989. The State and Local Employees Retirement System of the State of New York ("ERS"), the New York State Police and Fire Retirement System ("PFRS") and the New York State Teachers Retirement System ("TRS"; in the aggregate referred to as the "NYS Retirement System") were all modified in 1989 with respect to the method by which the annual contribution amounts were to be calculated in the future. As a result, each system was significantly underfunded, requiring a "catch-up" payment to return to actuarial full funding. Participating local governmental units were offered the option of (1) amortizing the UAAL amount due by a date certain through a direct loan from the State which carried an 8% (for TRS) or 8 1/4% (for ERS and PFRS) rate of interest until the liability was fully met, or (2) financing the UAAL through the issuance of general obligation bonds over a statutory period (applicable to the particular retirement system), or (3) paying cash by the date certain. Few local governments, except small jurisdictions with few employees, took the third option.

During the period 1989 through 1993, counties, cities and larger school districts, in particular, issued general obligation bonds to pay off their then current balance of unamortized UAAL whenever interest rates dipped sufficiently to permit a lower net interest cost on their own bonds than the 8% or 8 1/4% rate being charged by the State. During this period, local governments could issue ten-year general obligation bonds with net interest costs in the range of 6% to 7.375% depending on their credit rating. The 1989 legislation further provided that at such time as the

remaining amortization period was less than five years, local governments could no longer issue pension obligation bonds their own debt to pay off the outstanding balances. Thus, with a permitted maximum statutory amortization period of seventeen years for most UAALs, the possibility of financing of the 1989 UAALs ended in the 2001-2002 fiscal year of most local governments.

Beginning in 1995, the State adopted legislation almost every year creating new retirement incentive programs for various categories of State and local government employees, largely to support a goal of efficient downsizing of government. Generally, the legislation establishing these programs did not at the time include provisions for financing of the resulting unfunded liabilities. Such costs, which added to any existing UAAL, were paid either by amortization through the NYS Retirement System or by cash.

Concurrently in this time period, another type of pension-related program was developed by the State legislature which authorized local governments to create service award and defined benefit programs for volunteer ambulance and fire-fighting personnel. The legislation permitted the financing of contributions to certain of such programs attributable to years of volunteer service rendered during the five years prior to adoption of such programs. Such financing cannot be amortized over a period exceeding five years.

In 2003, new legislation was adopted for the purpose of structural reform in the method and manner of employer contributions to the NYS Retirement System, which legislation also included two provisions for the issuance of POBs:

1 Local governments are now permitted to issue POBs for any outstanding obligations to the State for any existing retirement incentive program (i.e., the retirement incentive programs established annually in the years from 1995 through 2002). (This provision was drafted by Orrick attorneys on behalf of the New York State Association of Counties.) The amortization period is limited to five years.

2 Similar to the 1989 legislation, a local government (and the State itself with regard to its own employees) is permitted to amortize a portion of its normal annual contribution for one fiscal year—that is, local governments are permitted

to amortize the amount due on December 15, 2004 to the ERS or PERS component of the NYS Retirement System (except deficiency payments, adjustments relating to prior year payments, obligations for retirement incentives or other similar amounts) to the extent that such amount exceeds 7% of the estimated "pensionable salary" base for the then current fiscal year (2004-2005). This "amount eligible for amortization" may be amortized over a five year period at 8% with the State, or local governments are authorized to issue their own debt obligations to pay such amount, with maximum maturity not to exceed five years. On or about October 15, 2003, the State Comptroller is to determine the "amounts eligible for amortization."

The only type of financing specifically authorized for POBs in New York State are general obligation bonds (which obligations include a pledge of the full faith and credit and taxing power of the local government). These bonds must be issued in the same manner, under the same procedural requirements and subject to the same debt limits and other constraints as for any capital project of the local government. Mandatory or permissive referendum requirements applicable to general obligation bonds of the particular type of local government apply to bond resolutions authorizing POBs. For example, school districts must receive voter approval before issuing debt for any purpose authorized by the 2003 legislation. (Note that the legislation in 1989 exempted such school district POBs from the voter approval requirement; this omission in the 2003 legislation may be corrected during a future legislative session.) Likewise, fire districts would need prior voter approval. The bond resolutions of counties, towns and villages which authorize payment for five years or less are not subject to mandatory or permissive referendum. Similarly, city bond ordinances should not be subject to mandatory or permissive referendum unless specified by applicable special city charter provisions.

Once a bond resolution has been adopted by a local government authorizing the issuance of POBs, it is generally necessary to publish a legal notice of estoppel including a summary of the bond resolution and allow the 20-day estoppel period to elapse prior to the sale of the POBs. The purpose of the estoppel notice is to ensure that debt issued by the local government cannot be challenged on an

basis, procedural or otherwise, except on constitutional grounds once the estoppel period elapsed.

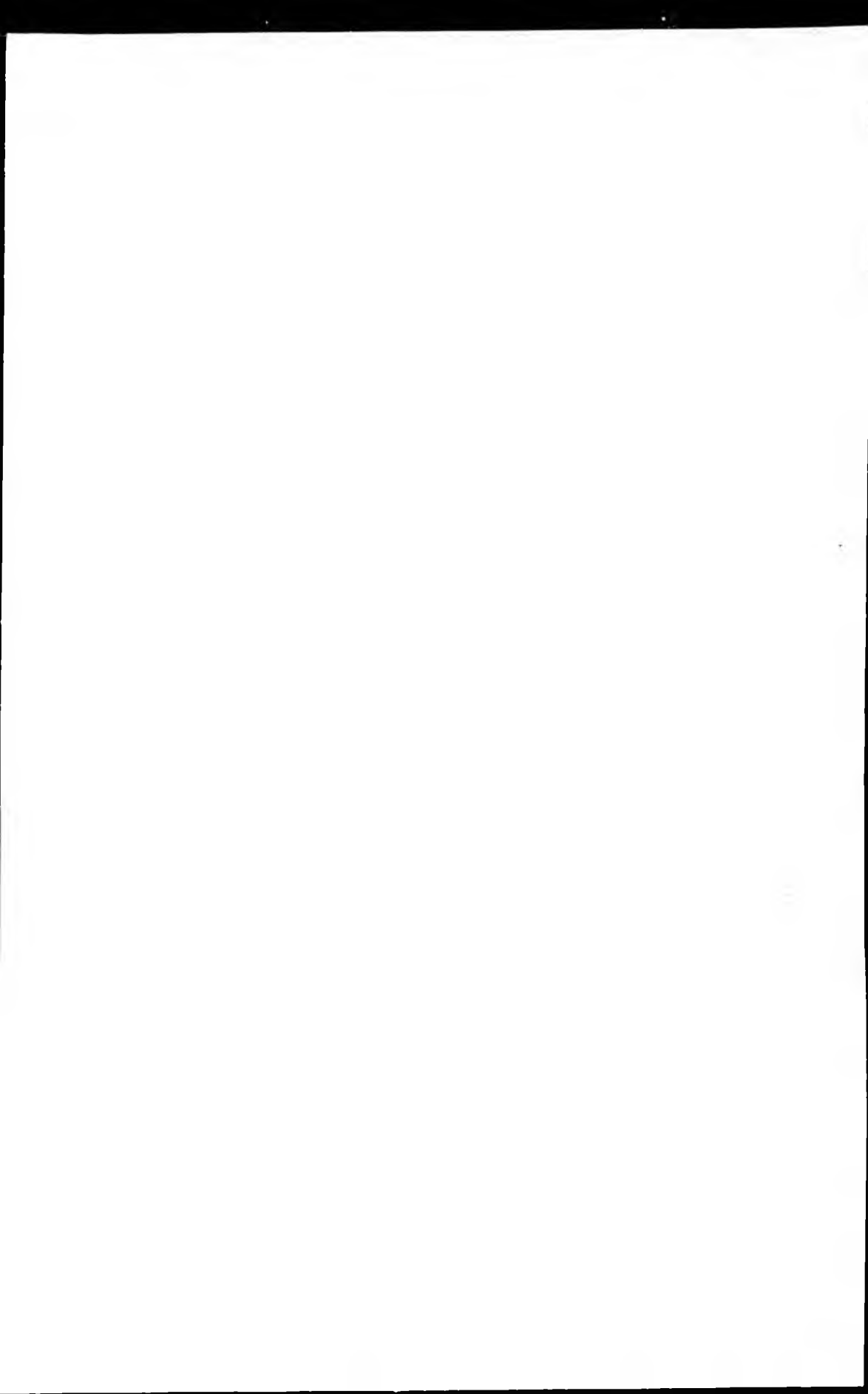
The New York State Legislature has also authorized the State itself to borrow in order to fund its UAAL on at least two occasions. In 1996, the State through the Dormitory Authority of the State of New York issued \$773,475,000 of POBs as annual appropriation debt. These bonds had a final maturity in 2003. The 2003 legislation described above also amended the State Retirement and Social Security Law to authorize the State to amortize a portion of the State's contribution bill for the fiscal year ending March 31, 2005. The amortizable portion is calculated in the same manner as that permitted local governments. Likewise, the State may either amortize that portion through the office of the State Comptroller for five years at 8% or issue POBs.

In New York State, most municipal issuers also provide post-employment healthcare benefits to their retirees. Indeed, school districts, by law, have been prohibited since 1994 from reducing retiree healthcare benefits to less than those offered to current employees. This protection from unilateral reduction of benefits has been extended annually and continues through May 15, 2006 pursuant to Chapter 16 of the Laws of 2005. While numerous attempts to mandate such protection have been made in the State Legislature for cities, towns, villages, fire districts and other units of local government, none has succeeded to date. Nevertheless, many such local governments do in fact contractually provide such protection.

Historically, the New York State Retirement System has not been involved in the administration of OPEB and legislation would likely be necessary to expand its responsibilities from pensions to OPEB. Currently, each local unit of government contracts individually to provide OPEB benefits as an annual budgeted expense. Several of the municipal trade associations for specific levels of government are presently looking at formation of multi-employer trusts for their members.

Advance funding of OPEB liabilities through debt issuance by municipalities and school districts in New York State would require special state legislation determining OPEB liabilities to be a valid public purpose (and providing some method of their calculation) in order to permit general obligation bonds to be issued. Like POBs,

OPEB bonds would be subject to the same constitutional and statutory requirements applicable to any capital project financing of the local government. In addition, such legislation could give the Common Retirement Fund on behalf of State or State and local employees and those local governments which may not have the express or implied powers to do so, the authority to set up and/or participate in OPEB trusts as described earlier.



APPENDIX B

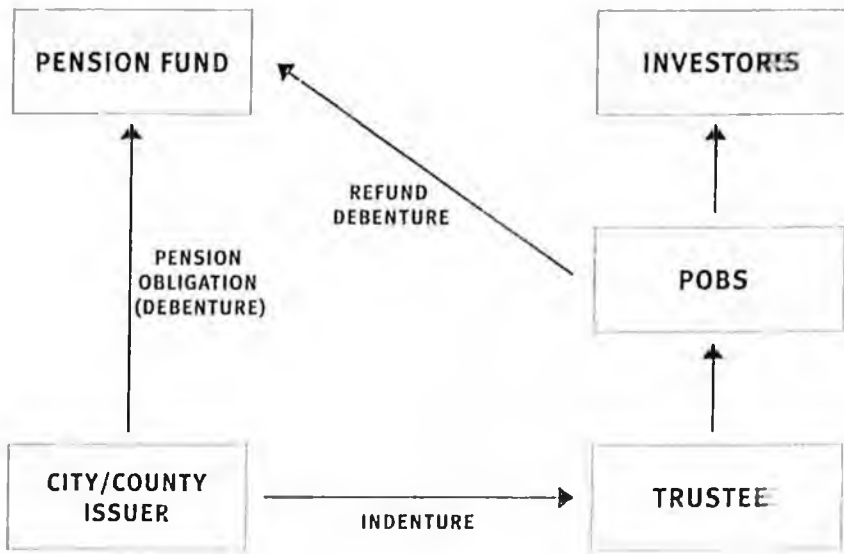
California

Pension obligation bonds had their start with the famous City of Oakland, California pension bond financing in 1985, the first POB in the country, which Orrick helped to invent and for which it served as bond counsel. That financing, and a number of copy-cats that rapidly followed were tax-exempt and primarily driven by then legal arbitrage possibilities. As explained in Chapter 6, tax-exempt POBs largely came to an end with the introduction of tax legislation that became part of the Tax Reform Act of 1986.

A new taxable version of POBs surfaced in late 1993. During the last decade since, seventeen or so cities and twenty-one or so counties in California have issued 90 POBs (second only to New York) aggregating \$11 billion (more than from any other state). The California Statewide Communities Development Authority has established a pool POB program to lower costs and interest rates through economies of scale by pooling POBs issued by cities, counties and special districts.

California public entities do not have specific authority to issue POBs.⁶ With the exception of one tax-exempt transition rule (see Chapter 6C) POB transaction issued as lease revenue bonds, all of these POBs have been issued under the local agency refunding law (drafted by Orrick a few years before for other purposes). However, the local agency refunding law authorizes all local public entities in California to refund prior bonds or "other evidence of indebtedness." The pension obligation on the county pension system, the California Public Employees Retirement System or other retirement system is memorialized as a "debenture," thereby becoming an "evidence of indebtedness," which can be refunded by POBs under the local agency refunding law.

⁶ The State of California enacted specific authority for State POBs in 2003 and again in 2004.



The POBs are typically structured as obligations payable from the general fund of the issuer. They are not full faith and credit taxing power general obligation bonds backed by the issuer's taxing power, because the California Constitution's debt limitation requires such type of bonds issued by the state, cities, counties or school districts ("Debt Limit Entities") to be approved by two-thirds of the electorate. Instead, California POBs issued by Debt Limit Entities have generally been designed to be valid without voter approval under a judicially created exception to the State Constitutional debt limitation, which exception is generally referred to as "obligations imposed by law." See discussion in Section A2 of Chapter 5. Because this exception to the Constitutional debt limit was and is much less developed in the case law (few cases not directly on point) than the other two judicially created exceptions (for lease financing and revenue bonds) each POB issue by Debt Limit Entities in California has been validated pursuant to California's validation statute (Code of Civil Procedure §§860 *et seq.*). Entities other than Debt Limit Entities, meaning authorities, agencies and districts of various kinds (other than school districts and community college districts), because they are not subject to the Constitutional Debt Limit, need not rely on "obligations imposed by law theory" and can simply use the local agency refunding law as authority for this issuance of POBs, without a validation action.

While there have been many validation actions for POBs, they have no precedential value or application to any transaction other than the specific transaction(s) validated.

What is validated in such validation actions is not legal principles but the bonds and the other principal legal documents approved in a bond resolution. Before the validation action is filed, it is necessary for the state or local government issuer to first adopt the resolution and authorize the bonds, the documents and the validation action. The validation action is filed in the superior court of the county in which the issuer is located, and an order for publication of summons is received. Summons can then be published (usually in a newspaper of general circulation in the city or county in which the issuer is located), which takes a minimum of 21 days. If no one answers the complaint by the date specified in the summons, which must be at least 10 days after completion of publication, the clerk can enter a default, and schedule a hearing before the judge for the default judgment (the timing of which will depend on the jurisdiction, and may be a day or two or, in some jurisdictions, at least 15 days after the clerk enters the default).

So assuming the very best case, obtaining a validation judgment takes a minimum of 31 to 40 days (depending on the jurisdiction) after filing the validation complaint. Of course, issuers are at the mercy of the judge and the clerk, and it sometimes takes a week or more to get an order for publication of summons, or longer than 15 days after the clerk enters a default to schedule the hearing. In addition, the judge could take the matter under submission for an indefinite amount of time, or even disagree with the proposed default judgment, and decline to validate the transaction. Of course, the default judgment may be appealed within 30 days, but only on jurisdictional grounds. Therefore, it is typically assumed that the validation action will take approximately 60 days (not including the appeal period). It is generally considered reasonable to sell the POBs without waiting for the 30 day appeal period to run, assuming no one has answered the complaint, because the grounds for appeal are so narrow, but usually the bond closing does not occur until after the appeal period has expired.

If someone does answer the complaint, then there is true two party litigation on the merits. While some expedited procedures are available, the timing for resolution of the litigation cannot be predicted, and may take many months unless settled or abandoned. So far, no one has answered the complaint and default judgments have been obtained for every city and county POB issuer. However, the same was not true of the State of California, whose validation complaint was answered by the Howard Jarvis Taxpayers Association, and resulted in a decision on September 23, 2003 by the Superior Court in Sacramento County declining to validate the State's proposed POBs. Similarly, a second validation brought by the State was answered by the Fullerton Association of Concerned Taxpayers and resulted in a decision on October 25, 2005 by a different judge of the Superior Court in Sacramento County to the effect that the State has imposed its pension obligations on itself, distinguishing those imposed on local government by the State, and therefore the State's pension obligations are not obligations imposed by law. The State, as of this writing, is appealing this decision.

The validation actions can and usually do validate not only the POBs to be issued but also any future POBs or refunding POBs. Not all validation actions are as inclusive or as flexible as they could be (some leaving out future new money or refunding POBs or costs of issuance or locking in semiannual interest payment dates, etc.), and must be carefully reviewed before relied on for future POBs or refunding POBs.

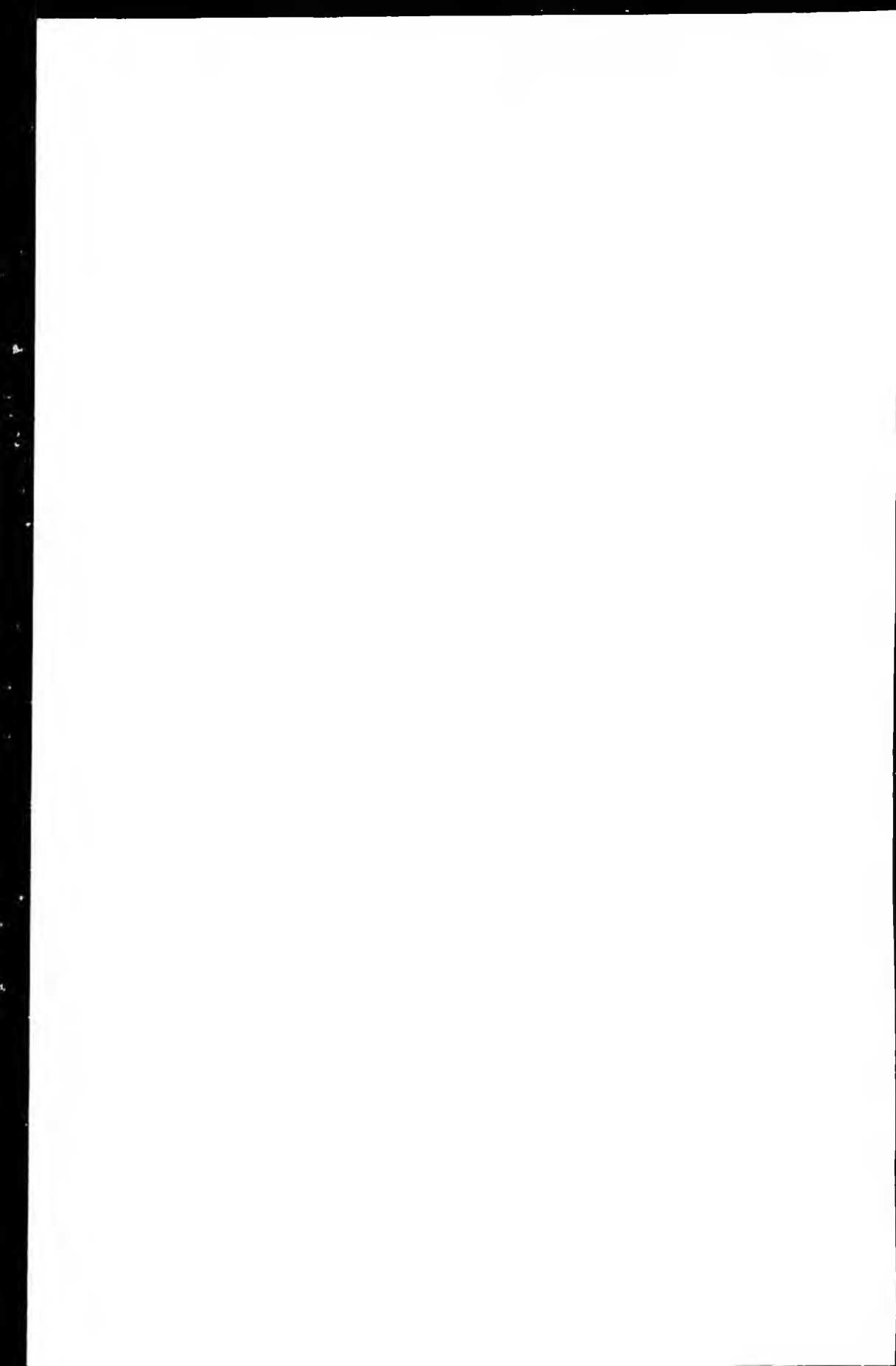
Note, as mentioned in Section A2 of Chapter 5, that the "obligations imposed by law" concept that is generally used to support POBs in California does not support reserves or capitalized interest because inclusion of such components in the bond issue are considered volitional not mandatory (as evidenced by the numerous California POBs issued without them) and therefore not "obligations imposed by law." Costs of issuance, on the other hand, can be included on the theory that they cannot be avoided. The inability to include capitalized interest makes achieving current budget relief more challenging (see discussion of structure options in Section C of Chapter 5). Alternatively, the POBs could be issued as annual appropriation bonds or asset-strip lease revenue bonds (see Section A3 and 4 of Chapter 5) which can include reserves and capitalized interest.

OPEB come in a variety of different forms: collective bargaining agreements, employment contracts, MOUs, ordinances, board policies, even historical practices not supported by formal action – many of which are short-term, subject to reauthorization, renegotiation or discretion. Therefore, the case for “obligations imposed by law” treatment may not work as well in each case for OPEB as it has for pension obligations. Even if “obligations imposed by law” theory could apply, based on the particular facts or legislation or validation action, most municipalities do not want to take a definitive legal position that its OPEB obligations are legally binding obligations imposed by law.

Therefore, the Orrick team has developed a separate legal theory which avoids these problems but otherwise functions exactly like “obligations imposed by law” so far as the financing structure described above for POBs is concerned. That is why we refer to it as a “first cousin” to obligations imposed by law. The main difference is some of the arguments made in the validation papers.

Even entities that are not Debt Limit Entities, and therefore do not need to rely on an “obligations imposed by law” theory or any variation and do not need a validation action, will encounter some of the same issues because, in relying on the local agency refunding law, they still must have some “evidence of indebtedness” to refund. However, a variation on the POB structure can address this problem as well.

Most OPEB bonds in California are likely to follow very closely the form and structure of POBs. The same alternative structures (annual appropriation bonds or asset-strip lease revenue bonds) would also be available.



APPENDIX C

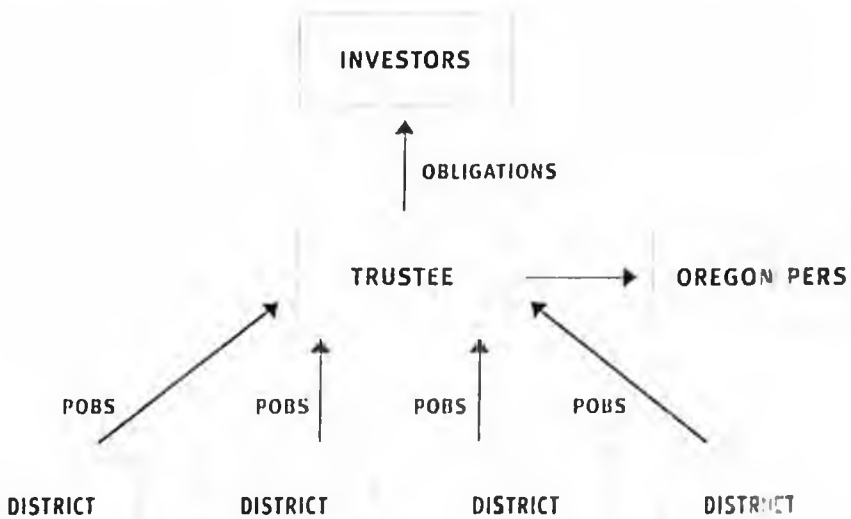
Oregon

State and local government issuers in Oregon have been among the most active users of POBs to finance their share of unfunded liability to the Oregon Public Employees Retirement System. POBs are issued in Oregon either as limited tax bonds or as revenue bonds.

Prior to the passage of the Pension Bonding Act in 2001, the City of Portland, Multnomah County and Josephine County issued significant sized POBs under Oregon's Uniform Revenue Bond Act. In 2001, the Oregon Legislative Assembly approved the Pension Bonding Act (which Orrick attorneys were involved in drafting). The Pension Bonding Act granted authority to "governmental units," including cities, counties, school districts, special districts, public corporations and intergovernmental corporations, to sell full faith and credit obligations for the purpose of refinancing pension obligations. POBs issued under the Pension Bonding Act are not subject to voter approval or annual appropriation and may be issued by local governments individually or jointly.

Significant pooled POB issues have been done by Oregon school districts, community college districts and local governments pursuant to the Pension Bonding Act. In these transactions, the participants pledged their full faith and credit within the limitations of the Oregon Constitution and issued limited tax bonds, payable from available general funds of the issuer. Available general funds include all ad valorem property tax revenues received from levies under each issuer's permanent rate limit and all other unrestricted taxes, fees, charges and revenues legally available to pay debt service on the POBs. The issuers are not authorized to levy additional taxes to pay the POBs.

In the pooled school district and community college district transactions, individual districts issued limited tax POBs in favor of a bond Trustee, which in turn issued obligations that represent a proportionate and undivided interest in and right to receive POB payments pursuant to a Trust Agreement. These POBs have been further secured by an Intercept Agreement between the State Department of Education and the school districts and community colleges under which the Trustee was authorized to intercept specific education revenues otherwise paid by the State to the school districts and community colleges in an amount equal to the debt service on each issuer's POBs. Since 2003, several pooled POB issues have been completed for Oregon school districts, education services districts, community colleges, counties, cities and special districts. Each of the pooled transactions to date have been enhanced by bond insurance. By pooling these transactions, the issuers were able to increase the amount of bonds sold, which increased access to investors, lowered interest rates and reduced costs of issuance.



Other jurisdictions, including the City of Portland, City of Corvallis, Multnomah County, Marion County, Josephine County, Eugene Water and Electric Board and Portland Community College District have sold POBs on a stand-alone basis.

As an alternative to issuing POBs as limited tax bonds pursuant to the Pension Bonding Act as described above, issuers have the option to issue POBs as revenue bonds pursuant to the Uniform Revenue Bond Act or the Pension Bonding Act. The Uniform Revenue Bond Act allows municipalities to issue revenue bonds for any public purpose secured by designated "revenues," which may include taxes and virtually all other general and special fund revenues and receipts of the municipalities. The financing authority provided by the Uniform Revenue Bond Act is broad enough to include legal authority for public bodies in Oregon to issue POBs. The Uniform Revenue Bond Act requires issuer approval pursuant to a nonemergency ordinance or, in the alternative, a resolution followed by notice and a 60-day referendum period, during such period the revenue bonds may be referred to a vote of the electorate if a referendum petition is signed by at least 5% of the issuer's electors in the case of a resolution or, in case of a nonemergency ordinance, as specified in the applicable charter or code provision. Revenue bonds issued pursuant to the Pension Bonding Act are exempt from this potential referendum requirement.

With respect to potential OPEB bond issues in Oregon, the financing authority provided by the Uniform Revenue Bond Act and the Pension Bonding Act is believed to be sufficiently broad to permit public bodies in Oregon to issue OPEB bonds. However, because of the unique issues associated with OPEB bonds and particularly OPEB trusts, it is anticipated that special OPEB bond legislation will be sought in the 2007 Legislative Session.

In a special election the fall of 2003, Oregon voters approved an amendment to the Oregon Constitution authorizing the State Treasurer to issue POBs as general obligation bonds of the State of Oregon for the purpose of paying substantially all of the State's UAAL. The amendment provided that the general obligation of the State must contain a direct promise on behalf of the State to pay the principal, premium, if any, and interest on that indebtedness. The State is also required to pledge its full faith and credit and taxing power to pay that indebtedness; however, the additional taxing power of the State may not be pledged to pay that indebtedness. The amount of POB indebtedness authorized by the amendment that may be outstanding at any time cannot exceed 1% of the real market value of all property in the State. In

October 2003, the State issued approximately \$2 billion in POBs. These POBs were listed on the Luxembourg Stock Exchange in order to facilitate sales to European investors.

In 2003, the Oregon Legislative Assembly made substantial changes to Oregon PERS. These PERS reforms resulted in extended litigation. This litigation included a number of challenges to the legislative reforms seeking to, among other things, have implementation of the reforms enjoined or declared an unconstitutional impairment of contract or unconstitutional taking of property. Although these cases are not directly related to any particular bond issues, and have resulted generally in the legislative reforms being upheld. Continuing litigation, as well as subsequent legislation or administrative action, could have significant implications with respect to PERS and the related liability of Oregon state and local government units.

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