

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672

3082 SCOMM 142: HOUSE SPECIAL COMMITTEE ON WAYS & MEANS 2005-2006

DISADVANTAGE # 1:

SWITCHING TO A DC PLAN IS LIKELY TO COST STATE AND LOCAL GOVERNMENTS MORE OVER THE SHORT-TERM. LONG-TERM COST SAVINGS ARE UNCERTAIN AT BEST.

- **DC plans are costly to establish and maintain.** A DC plan must be designed, vendors must be selected, and its operation must be monitored. In addition, employees must be informed about plan features and available investments. Staff time is spent throughout the process, and the sponsoring government must pay additional legal and consulting fees. If a third-party administrator is not hired to administer the plan, the government must do this as well. Even if a third-party administrator is hired, the government will still have operating costs related to the DC plan, possibly ranging in the millions of dollars. For example, the budget for the State of Florida's DC plan, established in 2000, totaled \$89 million from FY 2001 through FY 2004. This includes \$55 million to educate Florida's 650,000 government employees about the new plan.¹²
- **Pension benefits currently promised to state and local employees and retirees may not be abandoned. Switching to a DC plan does not reduce accrued DB plan benefits already earned.** Most governmental DB plan benefits are protected by the state's constitution or statutes that prevent accrued benefits from being reduced. Consequently, switching to a DC plan is usually accomplished by giving current and future employees the option of remaining in the current DB plan or electing to transfer to the new DC plan. For current DB plan members who elect the DC plan, the value of the member's accrued DB benefit is transferred to the DC plan.
- **When given the option, most employees remain in the DB plan.** In most cases, only a small percent of employees elect to transfer from the DB plan to the DC plan.¹³ To increase the number of employees who eventually enter the DC plan, a few governments have restricted the DB plan to current employees and have required newly hired employees to join the DC plan.¹⁴
- **Even when new hires are required to join the DC plan, long-term cost savings for employers are uncertain and may take many years to realize.** When a DB plan is closed to new hires, it still covers current employees and retirees, and benefits continue to accrue to active employees as a result of service. To the extent plan assets are less than accrued liabilities, unfunded

¹² Information provided by the Pension Protection Coalition, based on an analysis of the Florida Public Employee Optional Retirement Program's approved budgets and revenue collections. The analysis was done for the Coalition by the law offices of Olson, Hagel & Fishburn, LLP, January 18, 2005. The budgeted amounts exclude investment management fees paid by plan participants. Used with permission.

¹³ Anya Sostek, "Pension Pendulum," *Governing Magazine*, March 2004: 28. Three percent of employees covered by the DB plan elected to join the new DC plan in Florida, 6 percent in Michigan, and 2.5 percent in Ohio.

¹⁴ National Association of State Retirement Administrators, "Overview of Plan Types." Of the 14 state retirement systems discussed in this paper, only two (Michigan and West Virginia) required newly hired employees to join the DC plan. The remaining systems offered DC plans as a voluntary alternative to the DB plan or offered a new plan that combined DB and DC plan features. Available on the NASRA web site (www.nasra.org).

liabilities remain. For DB plans with unfunded liabilities, closing the DB plan to new hires will likely increase the employer's annual required contribution rate. Because new hires are not entering the plan, the cost of funding the liabilities is spread over a declining number of active members,¹⁵ thereby increasing the employer's contribution rate as a percent of covered payroll. In addition, since a growing portion of plan assets must be used to pay benefits, a growing portion of assets will likely be held in short-term securities, thereby reducing investment returns. For example, the Los Angeles County Employees Retirement Association (LACERA) estimated that the County's DB plan contribution rate would increase by 3.66% if employees hired after July 1, 2007, were required to join a DC plan. This would increase County contributions to the closed DB plan by \$206 million in 2008. While the contributions would gradually decline over time, the County would have to wait until 2018 to see any savings in DB plan costs as a result of the change.¹⁶

- **In several cases, states have replaced DC plans due to inadequacy of plan benefits or increased costs.**
 - In 1977, the North Dakota Public Employees Retirement System, originally established as a DC plan in 1966, was changed to a DB plan. Reasons given for the change include the need to provide adequate retirement benefits and the need to attract and retain quality employees.¹⁷
 - In 2000, the State of Nebraska reviewed its two DC retirement plans for state and county workers and found that between 1983 and 1999 the DC plans' investment returns averaged only 6 percent, compared with 11 percent for the state's DB plans. Recognizing these returns were inadequate to sustain retirement benefits, the state responded by creating a new hybrid plan for state and county workers, combining both DB and DC plan features.¹⁸
 - In May 2005, West Virginia passed a bill to allow teachers in the Teacher's Defined Contribution Plan (created in 1991) to transfer into the Teacher's Defined Benefit Retirement Plan. According to the West Virginia Consolidated Retirement Board's actuary, the change would save the State \$1.8 billion over the next 30 years, because of lower employer contributions required for the DB plan (4.3 percent of payroll) than for the DC plan (7.5 percent of payroll). House Speaker Bob Kiss said, "It actually costs the state more to fund the newer DC [private accounts] system." State teacher representatives said the change would help prevent teachers from leaving their jobs.¹⁹

¹⁵ Governmental Accounting Standards Board, Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* (Norwalk, CT: Governmental Accounting Standards Board, 1994), 7. In situations where a DB plan is closed to new members and unfunded liabilities are amortized as a level percent of projected payroll, projected decreases in active plan members should be included in the calculation.

¹⁶ Los Angeles County Employees Retirement Association, "Proposals to Close Public Defined Benefit Plans." (<http://www.lacera.com/home/ProposalsToClosePublicDefinedBenefitPlans.html>).

¹⁷ North Dakota Legislative Council, Employee Benefits Program Committee, "Public Employees Retirement Programs – History," October 1998.

¹⁸ Anya Sostek, p. 28.

¹⁹ "Pension Bond Will Benefit Taxpayers," *Charleston Daily Mail*.

DISADVANTAGE # 2:

ALMOST ALL STATE AND LOCAL DB PLANS PROVIDE DISABILITY AND SURVIVOR BENEFITS AS WELL AS RETIREMENT INCOME. SWITCHING TO A DC PLAN WOULD REQUIRE EMPLOYERS TO OBTAIN THESE BENEFITS FROM ANOTHER SOURCE, PROBABLY AT A HIGHER COST.

- **Almost all state and local DB plans provide disability and survivor benefits.** According to the U.S. Bureau of Labor Statistics, 97 percent of state and local government employees in DB plans have disability coverage through the plan and 93 percent may elect joint and survivor benefits.²⁰ These benefits are largely funded through contributions and investment earnings. Disability and survivor benefits are especially important for employees in hazardous occupations such as firefighters and police officers who may die or become disabled in the line of duty.
- **Few DC plans provide disability benefits. Moreover, DC plan survivor benefits are limited to the participant's account balance.** In the absence of a DB plan, employers would need to obtain disability and pre-retirement death benefits through commercial insurance or else would have to self-fund the benefits. Either of these options would result in additional administrative costs. If the benefits were obtained through commercial insurance, the employer's cost would also include the insurer's profit margin.

²⁰ U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, DC: U.S. Government Printing Office, December 2000), pp 94-98.

DISADVANTAGE # 3:

DB PLANS ENHANCE THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO ATTRACT QUALIFIED EMPLOYEES AND RETAIN THEM THROUGHOUT THEIR CAREERS. SWITCHING TO A DC PLAN WOULD LIMIT THIS ABILITY, POSSIBLY PRODUCING OR EXACERBATING LABOR SHORTAGES IN KEY SERVICE AREAS BY INCREASING EMPLOYEE TURNOVER RATES. HIGHER TURNOVER RATES RESULT IN INCREASED TRAINING COSTS AND LOWER LEVELS OF PRODUCTIVITY THAT CAN, IN TURN, RESULT IN THE NEED FOR A LARGER TOTAL WORKFORCE.

- **Employers offer retirement plans as a way to attract qualified employees and retain them so their skills and experience are used efficiently.** According to the Diversified Investment Advisors' Report on Retirement Plans, most large employers see a tangible value in offering a defined benefit plan to their employees – despite the high costs sometimes associated with it. Fifty-eight percent of plan sponsors with 25,000 or more employees believe that their DB plans have a major impact on employee retention.²¹
- **DB plan provisions encourage employees to remain with an employer longer than DC plan provisions.** The vesting period for DB plans is typically longer (e.g., 5 years) than the vesting period for DC plans (e.g., 6 months to 2 years). Consequently, employees have a financial incentive to continue working for the employer at least until they vest. After that, benefit accruals based on continued service provide an additional financial incentive.
- **Key governmental service areas, such as education and public safety, require skilled and dedicated employees to work in positions involving high levels of stress or physical activity or both.** Individuals with the skills and temperament to take on these roles usually have other opportunities in the labor market. DB plans provide strong incentives by rewarding long-term, dedicated service with a secure retirement.

²¹ "Majority of U.S. Companies That Offer a Pension Plan Say It Impacts Employee Retention," *Business Wire*, September 7, 2004.

DISADVANTAGE # 4:

DB PLANS HELP STATE AND LOCAL GOVERNMENTS MANAGE THEIR LABOR FORCE BY PROVIDING FLEXIBLE INCENTIVES THAT ENCOURAGE EMPLOYEES TO WORK LONGER OR RETIRE EARLIER, DEPENDING ON THE CIRCUMSTANCES. SWITCHING TO A DC PLAN WOULD LIMIT THIS FLEXIBILITY AND MAKE THESE INCENTIVES MORE EXPENSIVE FOR THE EMPLOYER.

- **Governments can use DB plan benefits as a way to manage their labor force by rewarding longer employment or encouraging retirement after a certain period employment.** DB plan benefit formulas can be structured to provide incentives for longer employment by increasing the benefit multiplier after a certain period of service. For example, the formula could provide benefits of 2.0 percent of final average earnings for the first 20 years of service and 2.2 percent for service over 20 years. To encourage retirement after a certain period of employment, DB benefit formulas can limit benefit accruals to a maximum percent of final average earnings or a maximum years of service. In the above example, if the benefit accrual was limited to 62 percent of final average earnings, it would encourage employees to retire after 30 years of service. Other options, such as early retirement incentives (ERIs) and deferred retirement option plans (DROPs), are also available.

DISADVANTAGE # 5:

DB PLANS LOWER OVERALL RETIREMENT BENEFIT COSTS BY POOLING THE RISKS OF OUTLIVING RETIREMENT BENEFITS AND OF INVESTMENT LOSSES OVER A RELATIVELY LARGE NUMBER OF PARTICIPANTS. SWITCHING TO A DC PLAN WOULD REQUIRE EACH INDIVIDUAL TO BEAR THESE RISKS ALONE, CONSEQUENTLY REQUIRING HIGHER CONTRIBUTIONS THAN IF THE RISKS WERE POOLED.

- **DC plan participants must save enough to ensure they will not outlive their benefits while protecting their funds against financial market fluctuations.** Average life expectancy at age 65 is 16 years for men (age 81) and 19 years for women (age 84).²² Furthermore, 71,000 people will be 100 years or older in 2005, and 1.9 million will be 85 or older.²³ This means that DC plan participants must contribute enough to ensure their benefits will be paid through their maximum life expectancy, i.e., at least until their late 90s.
- **In order to lower investment risk, DC plan participants usually shift a greater portion of their assets from stocks into bonds as they grow older. While this helps protect against equity market downturns, it also lowers likely investment return.** According to a recent Employee Benefit Research Institute study, 401(k) plan participants in their 20s invest 65 percent of their account balances in equities (including company stock) and 21 percent in fixed-income securities, on average. Participants in their 60s invest 49 percent in equities and 40 percent in fixed-income securities.²⁴ In contrast, large public retirement systems hold 57 percent of assets in equities, 32 percent in fixed-income securities, and the remaining 11 percent in other investments.²⁵
- **By averaging risks over a large number of participants, DB plans lower the total costs of providing retirement benefits.** Instead of requiring contributions that are large enough to fund retirement benefits through maximum life expectancy, DB plans only need to fund benefits through the average life expectancy of the group. This lowers required contributions. Moreover, by spreading investment risk over a longer period, DB plans can maintain an investment mix that includes a higher percentage of equity investments. This increases likely investment returns, which further lower required contributions.

²² U.S. Department of Health and Human Services, Social Security Administration, *2004 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Trust Funds* (Washington, DC: U.S. Government Printing Office, 2004), p. 81.

²³ U.S. Department of Commerce, U.S. Census Bureau, *Statistical Abstract of the United States 2004-2005* (Washington, DC: U.S. Government Printing Office, 2004), Table No. 12.

²⁴ Sara Holden and Jack VanDerhei, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2004," *EBRI Issue Brief*, No. 272, August 2004. Employee Benefit Research Institute.

²⁵ Keith Brainard, "Public Fund Survey, Summary of Findings, FY 2003," September 2004.

DISADVANTAGE # 6:

DB PLANS EARN HIGHER INVESTMENT RETURNS AND PAY LOWER INVESTMENT MANAGEMENT FEES, ON AVERAGE, THAN DC PLANS. SWITCHING TO A DC PLAN IS LIKELY TO LOWER INVESTMENT EARNINGS USED TO FINANCE RETIREMENT BENEFITS AND INCREASE MANAGEMENT COSTS, TO THE DETRIMENT OF PLAN MEMBERS.

- **Employees direct their own investments in a DC plan, usually selecting from among several funds that reflect major investment categories. Generally, employees have limited investment experience or training.** In a DB plan, investments are selected and monitored by investment professionals who have extensive experience and training.
- **On average, investment returns for DC plans are lower than for DB plans, resulting in significantly lower investment earnings over an individual's lifetime.** According to Boston College economist Alicia Munnell, DB plans outperformed DC plans by 0.8 percent annually, on average, between 1985 and 2001.²⁶ For a person contributing \$5,000 to a DC plan each year for 40 years, the difference between an 8.0 percent annual return and a 7.2 percent return amounts to a loss of over \$244,000 in retirement benefits.²⁷ Other surveys show that individual, non-professional investors may underperform the market by as much as 2.0 percent annually.²⁸ In the above example, the difference between an 8.0 annual return and a 6.0 percent return amounts to a loss of over \$521,000 in retirement benefits.²⁹
- **Administration and investment costs for DC plans can be more than four times higher than for DB plans. In DC plans, these costs are borne directly by individual plan participants through deductions from their DC accounts.** According to the Investment Management Institute, the operating expense ratio for DB plans averages 31 basis points (31 cents per \$100 of assets) compared with 96 to 175 basis points for DC plans.³⁰ According to the Illinois Municipal Retirement Fund, the total annual administrative and investment cost for their DB plan amounted to 44 basis points in 1999. If they had switched to a DC plan, total annual administrative and investment costs could have increased up to 225 basis points, or up to \$250 million more than the annual administrative and investment costs paid by the DB plan.³¹

²⁶ Alicia H. Munnell and Annika Sunden, *Coming up Short: The Challenge of 401(a) Plans*, (Washington, DC: Brookings Institution Press, 2004), p. 77.

²⁷ Author's calculations.

²⁸ W. Michael Carter, Actuary. February 6, 1998. Letter comment on "Pension Liberation: A Proactive Solution to the Nation's Public Pension Systems." Letter is posted on the National Council on Teacher Retirement website (www.nctr.org).

²⁹ Author's calculations.

³⁰ Sean Collins, "The Expenses of Defined Benefit Pension Plans and Mutual Funds," *Perspective*, Vol. 9, No. 6, December 2003. DC plan expenses include 12-b1 marketing and distribution fees.

³¹ Louis W. Kosiba, "The Defined Benefit vs. Defined Contribution Debate: The \$250 Million Question," Illinois Municipal Retirement Fund, October 13, 1999, p. 2. IMRF serves over 360,000 active employees, inactive members, retirees and beneficiaries.

- **DC plan participants often cash-out and spend some (or all) of their DC accounts when they switch jobs. As a result, the accounts contain less money to earn investment returns and to pay benefits at retirement.** According to Alicia Munnell, more than half of DC plan participants withdraw funds from their DC accounts when they change jobs, removing between one-quarter and one-third of total DC plan assets before they reached retirement.³²

³² Munnell and Sunden, p. 132.

DISADVANTAGE # 7:

DB PLAN INVESTMENT EARNINGS REDUCE FUTURE EMPLOYER CONTRIBUTIONS. SWITCHING TO A DC PLAN WOULD PREVENT STATE AND LOCAL GOVERNMENTS FROM REDUCING EMPLOYER CONTRIBUTIONS THROUGH INVESTMENT EARNINGS, WHICH CURRENTLY FUND OVER TWO-THIRDS OF PUBLIC RETIREMENT BENEFITS.

- **State and local governments have benefited from investment returns overall and many have used investment earnings to reduce employer contributions.** Over the long-term, an employer's cost of providing DB plan benefits depends on investment earnings. Although investment earnings can fluctuate sharply at times (as happened between 2000 and 2002), over the last 20 years state and local governments have benefited from investment returns and have used the accumulated assets to lower employer contributions. As provided in governmental accounting standards, plan assets that are greater than plan liabilities are amortized to reduce employer contributions.³³ A 2002 survey of Michigan state and local government retirement systems shows that of 115 independent local government retirement plans surveyed, employer contributions for 102 (89 percent) were below the normal cost of benefits as a result of this amortization.³⁴
- **Most of the money paid out of state and local retirement plans comes from investment earnings.** Over the last 20 years, state and local government investment earnings amounted to about \$1.65 trillion, compared with total employer contributions of \$696 billion.³⁵ This means two out of every three dollars paid from state and local retirement plans was received from investment earnings. According to a paper on state and local retirement plans prepared for the Wharton School's Pension Research Council: **"Setting aside all the other benefits to employers and employees of DB plans, contributions to public pension plans may be among the best investments a state or local government can make."**³⁶

Look at the facts:

Employer (taxpayer) Contributions = 26%
Employee Contributions = 12%
Investment Earnings = 62%

³³ Governmental Accounting Standards Board, Statement No. 27, p. 6.

³⁴ Gabriel, Roeder, Smith & Company, *2002 Michigan Public Employee Retirement Systems Survey*, (Southfield, MI: Gabriel, Roeder, Smith & Company, 2002).

³⁵ Gary W. Anderson and Keith Brainard, "Profitable Prudence: The Case for Public Employer Defined Benefit Plans," Pension Research Council, Wharton School, University of Pennsylvania, 2004, p. 22.

³⁶ Anderson and Brainard, p. 14.

DISADVANTAGE # 8:

DB PLANS PROVIDE SECURE RETIREMENT BENEFITS BASED ON A PERSON'S SALARY AND PERIOD OF SERVICE. SWITCHING TO A DC PLAN IS LIKELY TO RESULT IN LOWER AND LESS SECURE RETIREMENT BENEFITS FOR MANY LONG-TERM GOVERNMENTAL EMPLOYEES, INCLUDING TEACHERS, POLICE OFFICERS, AND FIREFIGHTERS, WHO CONSTITUTE OVER HALF OF STATE AND LOCAL GOVERNMENT WORKERS. STATE AND LOCAL EMPLOYEES WHO ARE WITHOUT SOCIAL SECURITY COVERAGE WOULD BE PUT AT EVEN GREATER RISK.

- **Retirement benefits paid from DC plans are significantly less than those paid from DB plans.** The U.S. Congressional Research Service found that, for current older workers, DC-type plans will provide annual benefits of less than \$5,000 for half the workers.³⁷ This is less than one-third of the \$18,000 average annual benefits currently paid by governmental DB plans to state and local workers.
- **If average state and local retirement benefits fell from \$18,000 to \$5,000, it would mean a loss of about \$80 billion in annual personal income.**³⁸ This loss would be felt by state and local economies, since many retirees remain in the same location when they retire. These pension benefits are also, in most cases, subject to federal and state income taxes, thus resulting in a loss of tax revenues. The same would be true in states that rely solely on sales taxes as their source of revenue.
- **The change would have an even greater effect on the 25 percent of state and local government employees who are not covered by Social Security, including about half of school teachers and three-quarters of police officers and firefighters.** When first enacted in 1935, Social Security excluded state and local employees, due to constitutional questions about the federal government's right to tax state and local governments. In 1950, Congress amended Social Security to allow state and local governments to voluntarily elect coverage. By then, however, half of the largest state and local plans had already been established, including many plans for teachers and public safety employees.³⁹ These DB plans provide benefits that compensate for the lack of Social Security coverage. Replacing them with defined contribution plans would put members at even greater risk, since they would not have Social Security benefits to fall back on.

³⁷ Patrick J. Purcell, "Retirement Savings and Household Wealth: A Summary of Recent Data," Washington, DC: Library of Congress, Congressional Research Service, December 11, 2003.

³⁸ Based on \$110 billion in state and local annual benefit payments made in 2002.

³⁹ Mitchell, et al, p. 13.

DISADVANTAGE # 9:

DB PLANS HELP SUSTAIN STATE AND LOCAL ECONOMIES BY PROVIDING ADEQUATE RETIREMENT BENEFITS FOR A SIGNIFICANT PORTION OF THE WORKFORCE. SWITCHING TO A DC PLAN MAY SLOW STATE AND LOCAL ECONOMIES, SINCE A LARGE NUMBER OF RETIREES WOULD LIKELY RECEIVE LOWER RETIREMENT BENEFITS.

- The economic value added by the investment income of state and local DB plans over what would otherwise have been earned in DC plans is estimated to be about \$200 billion annually, or 2.0 percent of U.S. Gross Domestic Product.⁴⁰ In essence, state and local retirement plans act as financial engines, using employer and employee contributions to generate investment income that, when paid as retirement benefits, bolsters state and local economies by \$200 billion a year. State and local retirees purchase a wide range of goods and services with their retirement income. These purchases, in turn, promote employment and create additional economic demand, generating additional economic activity. As a result of this multiplier effect, the economic activity generated by the higher investment earnings amounts to 2.0 percent of U.S. Gross Domestic Product. As a growing number of state and local employees retire, this percentage will likely increase.

⁴⁰ Anderson and Brainard, p. 14.

DISADVANTAGE # 10:

SWITCHING TO A DC PLAN IS LIKELY TO RESULT IN PRESSURE ON STATE AND LOCAL GOVERNMENTS TO INCREASE DC PLAN BENEFITS AND PROVIDE ADDITIONAL FINANCIAL ASSISTANCE FOR PUBLIC SECTOR RETIREES.

- **If DC plan benefits are less than what is needed to ensure an adequate standard of living during retirement, continued pressure will be placed on state and local governments, legislators, and taxpayers as retirees outlive their retirement income.** Since DC benefits are not indexed to inflation, extended periods of even modest inflation will mean almost constant pressure for some form of additional financial support for retirees, who will make up a growing portion of the electorate. When DC plan benefit improvements are granted, they will be paid from current government revenues and will not be offset by investment earnings.

CONCLUSION

This paper addresses the question, "Should state and local government defined benefit plans be eliminated and replaced with defined contribution plans?" It concludes that such a move would have significant, long-term, detrimental effects on state and local governments, their employees, their economies, and ultimately the taxpayers.

In the final analysis, the real question is, "How can state and local governments efficiently provide secure and adequate retirement benefits to their employees?" To answer this question, retirement benefits should be viewed in total, including benefits from Social Security, defined benefit plans, defined contribution plans, and individual savings. No single source alone is sufficient, but together they can be used to provide effective and efficiently funded retirement income. Excluding defined benefit plans will only intensify future problems rather than help provide solutions.

Neither market fluctuations nor increased employer contributions should be the driving force for changing the structure of the pension benefits. Instead, decisions should be based on a clear understanding of what outcomes the current design creates and whom it rewards. Retirement plan design represents a significant public policy. Therefore, the plan sponsor contemplating change must understand the policy implications of any new proposal as well as those of the current retirement plan design.

Successful plan changes happen when plan sponsors analyze their current plan and define any problems they discover. When considering such changes, plan sponsors should review several possible actions:

- Survey active and retired members of the current retirement plan.
- Measure the satisfaction and confidence of those members.
- Understand the needs of retirement system employers.
- Understand comparative private sector plans and their goals.
- Adopt a formal policy for the retirement system plan design reflecting the plan sponsor's goals and those of the active and retired members.

Dramatic change is never the answer!

Rather, with the proper analysis and an understanding of the needs of a changing population, fine-tuning of the basic pension plan design can produce excellent results and flexibility for all the sponsors, employees, retirees, and the taxpayers.

TAXPAYERS BEWARE:

A New Pension System Will Be Costly & Chaotic

SUMMARY

Dismantling and replacing the traditional pension system with new private accounts will result in **higher costs for taxpayers** and **bureaucratic chaos**.

Taxpayers will foot the bill for the high costs to transition from a proven traditional pension system to a radical new system of millions of private accounts.

Across the country, there are about 14 million workers who are active employees in the public pension system. There will be **substantial costs** just to shut down the traditional pension, set up millions of private accounts, and educate participants.

For example, in California the estimated transition cost is **\$7.6 billion** – and even the most optimistic projections say savings will not be realized for at least 10 years. Los Angeles County actuaries found that the county would not see any net savings for the next 20 years.

Florida modified its traditional system to give workers the option to move to private accounts. After spending **\$89 million** to set up these accounts, fewer than 5 percent of the workforce opted to move.

According to an actuary for the West Virginia teacher retirement plan, the new private account system had significantly **higher costs** to taxpayers than the traditional pension system. The actuary also found that switching back to a traditional pension system will save taxpayers millions of dollars annually in pension contributions. **West Virginia switched back to a traditional pension plan.**

On top of these costs, taxpayers will incur a **new direct cost to pay for death and disability pension benefits**. These benefits – critical for police, firefighters and others in hazardous occupations – are part of the traditional pension program, but not for private accounts. Governments will have to pay commercial insurance companies to set up death and disability plans, or fund the plans themselves. Either way, taxpayers pay more.

Setting up and implementing a new system will be complex and chaotic.

Setting up and implementing a new system of private accounts could potentially involve moving millions of workers.

Moving millions of workers to a new system of private accounts will be **chaotic**. In addition, a whole new **complex bureaucratic structure** will be needed to set up and manage these accounts. Educating public sector workers on the private accounts and how to invest will be costly and time consuming. The costs and time lost are better spent providing services to taxpayers.

TAXPAYERS BEWARE:

A New Pension System will be Costly & Chaotic (cont.)

Local, state and national economies will suffer as a result of lower investment returns from private accounts.

Public pensions are an important and continuous source of economic stimulus to every state, city, and town across America. In fact, the traditional system distributes **\$120 billion** annually and adds **\$200 billion** in economic stimulus each year.

A shift to private accounts will have a dramatic and detrimental impact on local economies because businesses depend upon the stimulus of investment income from the traditional pension system.

Taxpayers can't afford to lose a high quality, experienced workforce.

The traditional pension system attracts and retains valuable and experienced civil servants – many of whom are in vital and high-risk jobs. These workers fight fires, protect our streets, educate our children, and provide medical care.

Many cities and states already have labor shortages and high turnover. A new system of private accounts – with lower, unstable retirement income – will further **diminish the ability to attract and retain a solid workforce** that serves taxpayers – especially for high risk and stressful positions.

Taxpayers will pay for workers who outlive inadequate, unstable retirement income.

Not everyone has the time, resources, or experience to be good investors. Some will win, but **most will lose**. It is unreasonable to expect individual investors to outperform the professional investors who manage traditional pension assets.

Under a new system of private accounts system, many workers will find they have lower and inadequate retirement income. Under the current system, public workers' already have modest pensions – an average of \$18,500 per year.

For example, in West Virginia, private accounts for teachers have left workers less prepared for retirement – so much so that they switched back to the traditional plan. States that experimented with private accounts saw lower investment returns – nearly a 50 percent reduction.

It is a **risky, guaranteed gamble** to ask workers to bet their entire retirement income on their ability to become investment experts and professional money managers. Transitioning to private accounts is like putting money in the slot machine and hoping to win with three "7s."

We can continue to provide a modest, stable pension to workers who have spent a career providing essential public services. Otherwise, **taxpayers will pay** for public assistance to support workers who outlive inadequate, unstable retirement income.

TRADITIONAL PENSIONS WORK

Don't Destroy a Proven System

SUMMARY

The traditional pension system works – and has for more than 100 years. It is flexible and provides vital services to taxpayers at a low cost. Further, it provides a modest and stable retirement income for workers who have dedicated their career serving the public.

It's a system that works.

For 100 years, the traditional pension system has provided a **modest, stable** retirement income for workers who provide **vital services** at a **low cost** to taxpayers.

The system is a proven tool **for recruiting and retaining workers** for critical and often hazardous public sector positions.

The traditional pension system is a **financially sound** approach. These plans **create value** by pooling investment risk and reducing expenses. These benefits – **reducing investment risk and administrative costs** – are lost with a system of millions of private accounts.

The system provides the **flexibility** needed by state and local governments to meet the changing needs and demands for public services.

The traditional system provides important **death and disability benefits** for public employees in hazardous occupations – such as police officers and firefighters – who risk death and disability in the line of duty. Private accounts do not provide disability benefits or death benefits to survivors. This is unfair to workers and an added cost to taxpayers.

The private sector also relies on traditional pension plans.

81 of the Fortune 100 companies offer a traditional pension plan, as do 360 of the Fortune 500 companies.

The private sector utilizes traditional pension plans to efficiently manage a large workforce, as well as recruit and retain skilled workers.

TRADITIONAL PENSIONS WORK

Don't Destroy a Proven System (cont.)

Dismantling traditional plans is a costly failure.

States that have experimented with private accounts as workers' primary retirement benefit have found that **a traditional pension plan is a better option**. These states recognized that traditional pension plans are cost effective, efficient, create value, and help workers attain a modest, stable retirement.

For example, **West Virginia** moved from a traditional pension plan to private accounts – and then recently right back to a traditional plan. **Florida, Nebraska** and **North Dakota** also found that a new system of private accounts was not a success.

In the end, taxpayers foot the bill for these failed bureaucratic experiments. In California, the projected cost to citizens for switching to a system of private accounts is **\$7.6 billion**. Florida spent **\$89 million** to set up these accounts, but fewer than 5 percent of the workers moved.

Fix issues rather than discard a solid system.

States have recognized that the traditional pension system is sound. As with any program or system, issues can arise. When necessary, states have taken steps to modify the design of their plans, or to accommodate issues, changing circumstances, and needs.

If your car has a flat tire, repair the tire. Don't waste money on a new car.

If your kitchen sink is clogged, unclog the sink. Don't tear down the whole house.

States are prudent to fix any issues with the traditional system rather than completely dismantling a sound, proven pension system.

Some states have experienced issues with funding shortfalls because they failed to make contributions to the pension fund. **States and local governments should not be surprised when they have to make "catch-up" contributions – just like missing a mortgage payment.** This is the case in states such as California and Illinois. Workers are required to regularly contribute to their pension plans – but employers are not.

TRADITIONAL PENSIONS:

A Tried & True System That Benefits Taxpayers

SUMMARY

The traditional public pension system is the **best way to ensure taxpayers can reliably receive vital services**. It is a **cost-effective, proven and stable method** to attract and retain qualified people to perform critical public sector work.

The system safeguards the delivery of vital public services such as:

- Emergency & First Response – Medical, 911, Disaster Relief
- Police Protection
- Firefighting
- Healthcare Services
- Child Welfare Protection
- Health Inspections
- Forensic Investigations
- Education for Children K-12 and College
- Prison & Correctional Services

Providing a modest pension for public servants helps retain and recruit a strong and experienced workforce needed to continue to provide these vital services. A new system could put at risk vital taxpayer services.

The system is cost-effective.

The traditional pension system is the most **cost-effective** solution to ensure taxpayers continue to receive vital services.

Taxpayers contribute **less than 26 cents for every dollar paid out** in pension benefits. The remainder is funded by investment income and employee contributions. In fact, most state and local workers are required to contribute regularly to their public pension benefit – unlike most corporate pension plans.

The system is proven, stable and efficient.

The current system has worked for **more than 100 years**. It is a proven and critical tool to ensure taxpayers receive reliable services from experienced workers.

The traditional pension system is **efficiently managed** by professionals. There are far lower overhead and administrative costs than a radical new system of millions of individual private accounts.

It provides a **modest** and reliable retirement income for people who have spent a career working for the public good. The average retirement pension is only about \$18,500 per year. States that experimented with private accounts saw lower investment returns – nearly a 50 percent reduction.

EXPERT TESTIMONIALS

July 13, 2005

TAKE IT FROM THE EXPERTS

The traditional public pension system is the best way to ensure taxpayers can reliably receive vital services. It is a cost-effective, proven, and stable method to attract and retain qualified people to perform critical public sector work.

"...public pension plans are in a strong position to handle the coming influx of retirees since, unlike Social Security, public pensions are rather well-funded."

"Investing the \$2.3 trillion in public pension assets and the flow of benefit payments to annuitants promises a continuous, predictable, and growing source of economic stimulus."

"...through efficient asset management and pooling of resources, public defined pension plans have a significant, positive effect on financial markets."

Source: "Profitable Prudence: The Case for Public Employer Defined Benefit Plans," Pension Research Council, The Wharton School, University of Pennsylvania.

"Another concern raised by defined contribution plans [private accounts] is that it is much more expensive to manage millions of little accounts than one big one. Therefore, under defined contribution plans, too much of the money put into pension savings goes to pay administrative costs instead of pension benefits."

Source: "Protecting the Nest Egg: A Primer on Defined Benefit and Defined Contribution Retirement Plans," The Council of Institutional Investors.

"We've seen from other countries that carving out private accounts from the basic public retirement system doesn't provide enough money for most workers to retire on, and it causes huge financing problems for the basic public program."

Source: "Other Nation's Programs Show Great Risk," Editorial in the *Sacramento Bee*.

"Most retiring workers take their 401(k) [private accounts] distribution as a lump sum. Without an annuity, they risk either running out of money before they die or unnecessarily constraining their standard of living by clinging to this nest egg."

Source: "Coming Up Short: The Challenge of 401(k) Plans," Alicia H. Munnell and Annika Sunden, The Brookings Institution Press.

"There are good reasons for employers to retain a defined benefit [traditional pension system] as the primary retirement benefit for public employees. A defined benefit plan is an effective tool for recruiting and retaining quality employees. Providing a defined benefit plan helps assure a secure source of income for retired employees, reducing the likelihood of these employees relying on public assistance retirement."

Source: "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans,"
The National Association of State Retirement Administrators.

"Most defined contribution [private account] participants will fall well shy of the estimated 75 percent of pre-retirement income needed to maintain the same lifestyle in retirement."

Source: John Hancock Financial Services Retirement Survey.

"401(k)-style plans [private accounts] were not designed to replace pensions. A 401(k) is not a pension; it's a supplemental tax-incentive thrift plan."

Source: Dan Farrell, professor and compensation expert, Western Michigan University in
"Days of Extravagant Pension Plans Fading," *Detroit Free Press*.

"In 401(k) plans [private accounts], we're putting all of the responsibility to save on individual participants, and that can be dangerous."

Source: Amy Monahan, associate law professor, University of Missouri,
in "Wither Future Retirees?" *St. Louis Post-Dispatch*.

"[People] will mess up. I'm worried about 20 or 30 years from now. There will be a big problem with elderly poverty."

Source: Robert Schiller, economics professor, Yale University,
in "Wither Future Retirees?" *St. Louis Post-Dispatch*.

Individual accounts are a "gamble." "I don't think people really recognize the risk that they're taking."

Source: Steve Dustmann, vice president, McCourtney-Breckenridge & Co., in
"Wither Future Retirees?" *St. Louis Post-Dispatch*.

"It actually costs the state more to fund the newer defined contribution [private accounts] system. [By merging back to the traditional system], there are distinct benefits to the taxpayers. The state will experience a large cash flow from the new participants, along with a lowered state taxpayer contribution of 6 percent, down from 7.5 percent. The state will save about \$24 million in the first year and there will be a decrease in required taxpayer dollars each year over the next 30 years."

Source: Speaker Bob Kiss, West Virginia Speaker of the House of Delegates, in
"Pension Bond Will Benefit Taxpayers; The State Will Save \$24 Million in the 1st Year,"
Editorial in *Charleston Daily Mail*.

STATE AID IN **PRESENT** DOLLAR VALUE FOR NEW EMPLOYEES UNDER A DC PROGRAM

	2005	2010	2015	2020	2025	2028 TOTAL	
Alaska, State of	2,419,571	33,708,350	43,996,369	46,925,199	45,266,474	6,596,742	836,993,871
Aleutian Housing Authority	1,361	4,994	6,518	6,952	6,706	4,178	136,281
Aleutians East Borough	1,557	5,711	7,454	7,951	7,670	5,899	156,975
Aleutians East Borough School District	2,654	31,513	41,131	43,869	42,318	7,236	793,065
Aleutians West CRSA	174	2,595	3,387	3,613	3,485	475	64,035
Anchorage Parking Authority	3,185	21,943	28,640	30,546	29,466	8,683	581,359
Anchorage School District	233,622	2,871,807	3,748,302	3,997,826	3,856,510	636,949	72,068,457
Anchorage, Municipality of	410,330	4,543,504	5,930,213	6,324,986	6,101,409	1,118,727	115,028,714
Fairbanks North Star Borough	52,603	416,547	543,680	579,872	559,375	143,417	10,902,337
Fairbanks North Star Borough School District	76,753	736,509	961,296	1,025,290	989,047	209,261	18,899,984
Fairbanks, City of	18,014	278,598	383,824	424,473	416,678	49,113	7,264,035
Homer, City of	13,840	123,706	161,462	172,211	166,123	37,734	3,197,994
Juneau Borough School District	27,963	325,613	424,992	453,284	437,261	76,238	8,207,827
Juneau, City & Borough of	82,163	1,114,901	1,455,177	1,552,048	1,497,186	224,009	27,754,956
Kenai Peninsula Borough	39,334	477,521	623,263	664,754	641,256	107,241	11,995,549
Kenai Peninsula Borough School District	34,645	494,211	645,047	687,988	663,668	94,456	12,243,731
Lake & Peninsula Borough	1,081	14,560	19,003	20,268	19,552	2,948	362,736
Lake & Peninsula Borough School District	5,050	48,363	63,123	67,325	64,946	13,768	1,241,310
Unalaska City School District	2,627	13,766	17,967	19,163	18,486	7,161	370,164
Unalaska, City of	29,541	108,378	141,456	150,873	145,540	80,751	2,947,565
Wrangell Public School District	2,162	20,006	26,112	27,850	26,865	5,895	515,293
Wrangell, City of	7,994	110,531	144,266	153,869	148,430	21,795	2,746,542
Total of All Employers (158 employers)	4,683,873	55,311,800	72,267,141	77,128,275	74,424,134	12,921,078	1,389,468,066

PRESENT DOLLAR VALUE

Ginny Austerman

From: Ginny Austerman
Sent: Thursday, July 28, 2005 2:12 PM
To: David Teal
Subject: RE: Memo for Ways and means committee

Thank you, David. I will forward this to Rep. Weyhrauch. He is away from his office until August 1st.

I will ask him to respond to you via email, rather than by phone. If we have his thoughts in writing, then there is less chance of missing information or misunderstanding what the committee wants.

I will be working from the Kodiak LIO for the month of August, and back to work on September 6. You can reach me through this email address. When I get set up at the LIO in Kodiak, I will advise you of my telephone numbers.

Hopefully, you will hear from Rep. Weyhrauch early next week.

Thank you for being so thorough with your comments.

Ginny Austerman

From: David Teal [mailto:david_teal@legis.state.ak.us]
Sent: Thursday, July 28, 2005 1:57 PM
To: Ginny Austerman
Subject: Re: Memo for Ways and means committee

My comments at the July 14 meeting of the House Ways and Means Committee were not prepared ahead of time; I just took some notes at the meeting and used them as a basis for my comments. Based on what others said at the meeting and the pre-meeting direction provided by the Chairman, I thought it would be helpful for committee members to know the following:

The State's fiscal situation

This topic was intended to give the committee an idea of the difficulty of filling the retirement system's \$5.7 billion unfunded liability. The bottom line is that the state is unlikely to have budget surpluses in the foreseeable future that could make a significant dent in the unfunded liability. In fact, budget deficits are the more likely scenario under the prevalent "no tax increases and no use of Permanent Fund earnings" attitude. There is no easy solution on the revenue side of the fiscal outlook, even with oil at current prices.

A clear definition of "unfunded liability"

I could not speak to this topic because I don't know exactly what "unfunded liability" means or what implications changes to the system might have. I can only point out that making progress is difficult when solution-seekers don't fully understand the issues and problems. It might be nice if the committee knew how the number is calculated, the short- and long-term implications of an unfunded liability and the impact of adopting a defined contribution plan for new employees, how our situation compares to other pension plans (both public and private, using various methods to determine fiscal health), projected trends (including cash flow), options to solve the problem, and advantages and disadvantages

of various options. As it stands, I do not know whether we face a true crisis or a statistical boogeyman.

The potential role of Legislative Finance Division

I stated that we could help in a number of ways (including review of assumptions and/or projections, explanation of reports, and review of potential actions), but needed direction in order to be valuable. This topic is perhaps why Ginny asked me to write down my comments. She asked if I was now clear on the direction of the committee. I had to admit to some doubts that I did not express at the meeting.

You said (before the meeting) that you intended to focus on the future and on solving the system's unfunded liability problem rather than reviewing the legislature's recent actions or trying to assess blame for the fiscal situation. However, the committee spent significant time on the "what did you know, when did you know it and why didn't you tell us" approach to the situation. Should we look forward or backward?

Several committee members expressed a desire for a "one page" perspective of issues. Do you expect committee members to 1) know the issues/situation well enough to propose and evaluate solutions or 2) be briefed on issues and make policy decisions based on recommendations of staff (including Legislative Finance)? Staff reports are not likely to be helpful if we do not understand the expectations of our audience.

I don't know whether you want to discuss these questions at all, let alone at a public meeting, but I am available anytime if want to discuss them with me.

Ginny Austerman wrote:

David:

Instead of faxing me your memo, would you please email it to me. That way, if Bruce wants it in the packet, it will be easier for us to get it into the public records. I am leaving for Kodiak on Friday the 29th. I will be working from the Kodiak LIO and from my home there. Terry will be working with me to coordinate data for the committee packets.

Bruce is out of town until August 5, so if you take a few more days to get the memo to us, it's fine.

Thanks, Ginny

David Teal – 9/8 House Ways and Means hearing (FBX)

I'll be talking from a set of 7 charts –

The chairman knows this, but the rest of you don't, I did meet with Rep. Weyhrauch last week and he showed me an article that was cut out of a Nebraska newspaper. The article was on pension plans in Nebraska, and he asked me to create a similar chart for the State of Alaska, that chart is on page 1. The gist of the article, and it's shown right on the graph under the Nebraska School Public Employees Pension Fund, the statement there, like many public pensions, the benefits tend to increase when the fund is flush, contributions go up when shortfalls occur. And then at the bottom of the graph you see a number of actions that the state took, they lowered the retirement age, they increased cost of living benefits, they went to early retirement; those sorts of things. They are blaming that for the problems they are now facing with unfunded liabilities. The good news is we didn't really modify our program in Alaska. There were no cost of living changes, no benefit increases, and no changes of the retirement age. If you look on page 2, you will see the bad news; half of our charts look the same as the Nebraska charts do, maybe worse. The chart's pretty simple, but neither of us were really sure what it meant or what it means. That's not an issue of grasping the size of the \$5.7 billion liability, it's trying to figure out what it means. \$5.7 billion is twice the annual state budget or 1/4 of the Permanent Fund, or if you are into minutia, I guess you could say that if you stacked dollar bills end to end it would go around the earth 21 times. It's a lot of money, but when we figure out what it means, Mr. Chairman,

As Rep. Weyhrauch said, what does it mean to employees, to retirees, to state finances, to communities and school districts among others, that's the question that we face, I think, and let's go with some more questions, why do we have a problem when we didn't do anything wrong? This unfunded liability appeared in a flash, so is it going to vanish just as quickly? Does the state have to take action? What's going to happen if we don't? What actions will have the most impact? So really, I think, this chart is too simple. It's just a snapshot. Pensions are long-term issues. It's better to avoid snap decisions on long-term issues. That's not political advice to the committee, I'm simply recognizing that small differences compound over time, or conversely, that the impact of changes takes a long time to materialize. So, again, more questions, why did the gap appear, where is it headed, are we looking for a solution where none needs to be found? You know why the gap appeared; Melanie (Millhorn) talked about that. Market returns, life expectancy, medical costs; but turn back to page 1 and I really think you see two stories there. School employees see an increase, they see the assets losing steam, we can see that as a change in that dark line, which is their assets. What that means is, they decided to change their assumptions on market rate of return, but the pension which was already increasing rapidly, we didn't show any major jumps like our system did. On the other hand, Omaha Police and Fire Pension Fund shows assets increasing over this period, they don't appear to have been hit by a market downturn, but the benefits jumped tremendously. So, Alaska shows both on page 2, we get a kink upward in benefits, the long-term liabilities, and we get a kink downward in our assets. Where is it headed? Can it vanish, or are we going to continue.....(indisc.) Maybe the members of this task force know more than we do, but neither the chairman nor I knew exactly how this number was calculated, the sensitivity of changing rates – what would this be.

The sensitivity of the rates is one of the things Melanie talked about. So we talked about the dangers of making decisions without knowing exactly where we are and what the projections are on cash flow. The issue being is the system increasing its asset base or are we compounding the problem right now by annual payouts that exceed cash in-flow, and therefore, increasing the size of that liability. In short, rather than looking at a chart like here, we thought we should be saying, "I don't want to look at a chart that looks backward and stops today. Show me a chart of the future, complete with the impact of modifying those assumptions and taking action or not taking action. Tell me whether we face a crisis, or is it just a potential liability that's going to hit us at some point in the future. Describe the consequences of delaying; convince me that this issue is not the same as hearing the Constitutional Budget Reserve will be gone in two years, every single year for the past decade. That's what we have heard there, and how do we know that this isn't the same thing? Last meeting you heard that unfunded liability is a nationwide problem, and you also heard a whole list of things that states are doing about it. You can copy those other states, perhaps you can stumble a solution of your own. I think, and more importantly, the Chairman thinks, that there is a better chance of success in this task force if you really understand the problem and the impact, the pros and cons of each potential action. Then Rep. Weyhrauch asked me to provide more detail on the resources we have to address the problem, more specifically, given the price of oil what are the limitations on the actions we face because we have or don't have money to address it. Turning to page 3, is the financial information; and here I should say that Retirement and Benefits is in a much better position than I am to talk about those questions that I just asked. The issues of sensitivity, and that sort of thing. The Chairman asked me to look at the

overview of the budget, so it's a little more than just PERS, it's sort of a heads-up on what the Legislature may face when they return to Juneau in January. On page 3 you'll see a fiscal summary. That circled number on line 29 of the '06 budget shows that we've got a \$2.6 billion budget, and that gives us a surplus on line 30 of about \$40 million, but there's a footnote there, and that's oil at \$38 in footnote 1, and in particular, look at footnote 4 that says FY '06 appropriations for formula programs excludes \$414 million that went to public education. That's because the appropriation for education crossed fiscal years and in doing that, it actually distorts year-to-year comparisons. If we were to adjust for that, the budget is actually at \$3 billion. The next chart on page 4 is a chart that is on our website. Typically, what that shows, is the fiscal gap and then at the type of various prices of oil, you can see that at \$38 that gap begins to turn into a surplus appearing at the top of the chart. At \$38, we breakeven, no gap, no surplus. The current price of oil is \$57 and change. That's noted on the charts, and that shows a surplus there of \$1.1 for FY '06. Page 5 shows a revised fiscal summary, this is the response to that footnote on page 4 the fiscal note on the traditional summary a footnote 4. The danger there is that, as I said, the FY '06 budget is really understated by \$400 million, and if not for the use of that '05 surplus we would be at \$3 billion, breakeven oil prices of \$44, and the danger here is that we are not really looking at '06 anymore, we're looking at FY '07, and it's this \$3 billion budget that's going to be the base for the '07 budget, not the \$2.6 billion that (indisc.).....in the fiscal summary. So what I did was prepare another break-even chart at a \$3.5 billion budget. Now you can argue about when we're going to hit \$3.5 billion, whether it is '07 or '08 or '09 or '10, but we will get there soon, and you can see on this chart the breakeven point is \$53 a barrel, and that \$57, where we are at

right now wouldn't give us much of a surplus of \$250 million which comes and goes real quickly in a volatile oil market.

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

The Marine Highway System another source of supplemental needs, partly because of fuel, and partly because changes in under funding, \$20-25 million may go there. Fires suppression was huge supplemental last year, about \$40 million. Fire season's bad this year, as well, but many of those fires are on Federal land this year, and we may get away with no supplemental for fire suppression. Typically, we'll have about \$75 million a year for other purposes, or other supplemental needs. I'm looking at a \$150-200 million supplemental budget request. What we're looking at here is a true FY '06 surplus of about \$500 million (indisc). We'll have cash, but a lot of that, \$400 million of it, is carried forward from last year, so bottom line is, you'll have about \$900 million on the table available for purposes other than this \$150 - 200 million supplemental. Looking to '07, the critical point there is that the starting point of the '07 budget

will be the \$3 billion spent in '06 after adjusting for that '05 – '06 crossover. The '07 budget is likely to see increases from that point as always, the FMAP will jump to about \$75 million a year, beginning in '07. The state PERS rate increase will cost another \$25 million or so, in general funds. If the Legislature again, decides to fund PERS for school districts, that's another \$40 million, and if they give the same sort of increase that they gave school districts last year, you are looking at \$80 million, so we're up somewhere between \$140 to \$180 million increase on just those items for '07.

Medicaid – that's probably going to go up as well. It's been increasing at the rate of 14% a year and it's a \$600 million budget there, so you are looking at potentially \$50-60 million increase, there. In addition to that dividends from Alaska Housing are down, school debt is up. I wouldn't be at all surprised to see a \$3.2 or even a \$3.3 billion budget in '07. On the other hand, the Capital Budget in '06 was at a little over \$300 million and if the Legislature chose to go back to a more normal Capital Budget of \$100 – 150 million there is some potential for reduction there. Getting back to the retirement system and how this plays, on this break-even chart you've got \$3.5 billion, you've got oil at \$53. \$57 as break-even there. Where we are in '07 and in the future, all depends on oil. The forecast is now ahead, that occurs in October and the numbers will be released, probably in December. I don't expect an oil forecast above \$50. That supports a spending plan of about \$3.3 billion, which is, as I just said, wouldn't be a surprise. If all that was a little too confusing about oil prices and so on, there's a summary of that on page 7. Page 7 just shows you General Fund expenditures starting in FY '06 at \$3 billion. It increases by \$200 million per year. Then it shows how much revenue we would have at \$40, \$45, \$50, \$55 and \$60 per barrel computes the surplus by simply subtracting the expenditures

and revenues and then tells you what the cumulative surplus is there. You can see that we've got deficits through 2010, even with oil at \$50. You need \$50 oil just to break even in '07 through '010. At \$55 a barrel, you show a cumulative surplus out there, but you're back to an annual deficit by 2010, meaning that you are on the downslide again. The Chairman asked me about a fiscal plan, specifically the role that this unfunded liability may play in that plan, and whether there is any money to reduce the unfunded liability if you choose to do so. If you look at the \$55 scenario, you will see that theirs a surplus in '07 of \$418 million, which combined with the surplus through '06 of a little over a billion, gives you about \$1 1/2 billion on the table. Your options range from spending that money all at once; and regardless of how you spend it, it's gone – so I don't think that's much of a fiscal plan, a fiscal plan generally involves not spending money in some fashion, so in order of declining flexibility, you have several options, 1. deposit the money to the Permanent Fund, making it untouchable forever; 2. let it fall to the CBR by simply not (indisc.), because that's the way the system was designed to work, it requires a super majority to pull money out when there is insufficient money to pay for the entire budget, the theory being that the money goes back into the CBR in times of surplus revenue; 3. you can put money towards retirement where it rolls to the very distant future, or you can put money into the public education fund, as you did this year, and that's going to roll the surplus forward to following year.

If you are looking for recommendations here, I would put that '06 surplus into the education fund. Not because it costs us any money, or saves us any money. It just takes the money off the table very early in the process and moves the decision to the full FY '07 process so that rather than going through this abbreviated supplemental process where the

scrutiny is limited, you would put money in the education fund, freeing up that \$1 billion or so that is required to go into the education fund. You could then spend it in the '07 budget process. The same amount of money, it just would, in theory then, be given more scrutiny. Even with this, you could pay up to \$1.5 billion of the unfunded liability of the retirement system in '07. That's a long way to get to the answer, which is, you do have money to address the problem, not necessarily to fund this gap, but you can make significant progress. So then the question is should you do this, should you fund some of this unfunded liability, if so how much, and what impact would it have on various interest groups?

(indisc.) the state's liability is only about half of the systems' liability, so when we talk about a \$5.7 billion unfunded liability, about \$3 billion of that is the state's. The other \$3 billion is the cities, communities and the school districts.

Second, we're not going to get a bill for the state, nor will the school districts or the communities ever get a bill for this \$5.7 billion, and by that I mean, it doesn't come due in 2017 or 2033 or pick you date out there, because, the way the system works is that the rate increase is designed to eliminate that unfunded liability in 25 years, meaning that you don't have to do anything about it except pay the rate increases, and your problem is solved. Then the primary reason to be concerned about solutions other than rate increases, is that those increases are unacceptable or unaffordable, so I look at it this way, the task force needs to clarify whether you are looking for a solution to the TRS/PERS system wide problem, or simply looking at it from the state's perspective and saying we've got \$3 billion of this unfunded liability and that's the solution we are looking for. Are we looking for a solution to the \$5.7 billion system wide problem? Then you need to decide whether those rate increases are an acceptable solution, if the focus is the state, I think the rate increases are an acceptable solution, you just increase the operating

budget, the money comes from various fund sources and the critical thing here is that as you saw last year, the state's liability was about \$50 million. The general fund portion of that was only \$25 million. The other portion comes from Federal and other funds. Now, if we took that \$3 billion liability and closed it, making a \$3 billion cash injection, you would be spending \$3 billion worth of Federal General Funds. That creates a problem, you'll pay for it in rates, in which case the state pays half, and Federal and other sources pay the other half. I guess I would say, why would you want to fix the problem with a infusion of General Funds that cost you twice as much than if you just let it ride. Look at school districts: Anchorage teachers, every teacher, every school..... Teachers are now negotiating for pay increases, but the districts look at it this way, each teacher costs us an additional 5% because of its benefit increase, and we can't afford to increase take home pay in addition to this 5%, and then you've got education advocates saying, "thank you for funding education, but not enough of it went to the classroom." The trouble here is that everybody is right, and in this case, it made may make more sense to pay off the unfunded liability upfront in order to keep rate increases down so that districts aren't faced with the employment dilemma they've got now. The way I look at this, I don't understand how any employer can have a benefit rate of 50%, you hire someone at \$50,000 it costs you another \$75,000 in benefits, you just can't be competitive, and therefore, because your employees cost you so much, you have to not hire them. The same goes for communities, except the state's not responsible for communities, at least not in the same direct manner as for school districts, so I guess I see this unfunded liability entering the budget debate, really at school districts and communities. The question being whether you want to pre-fund them. You are going to pay now or pay later, you are not going to escape this unfunded liability. From my

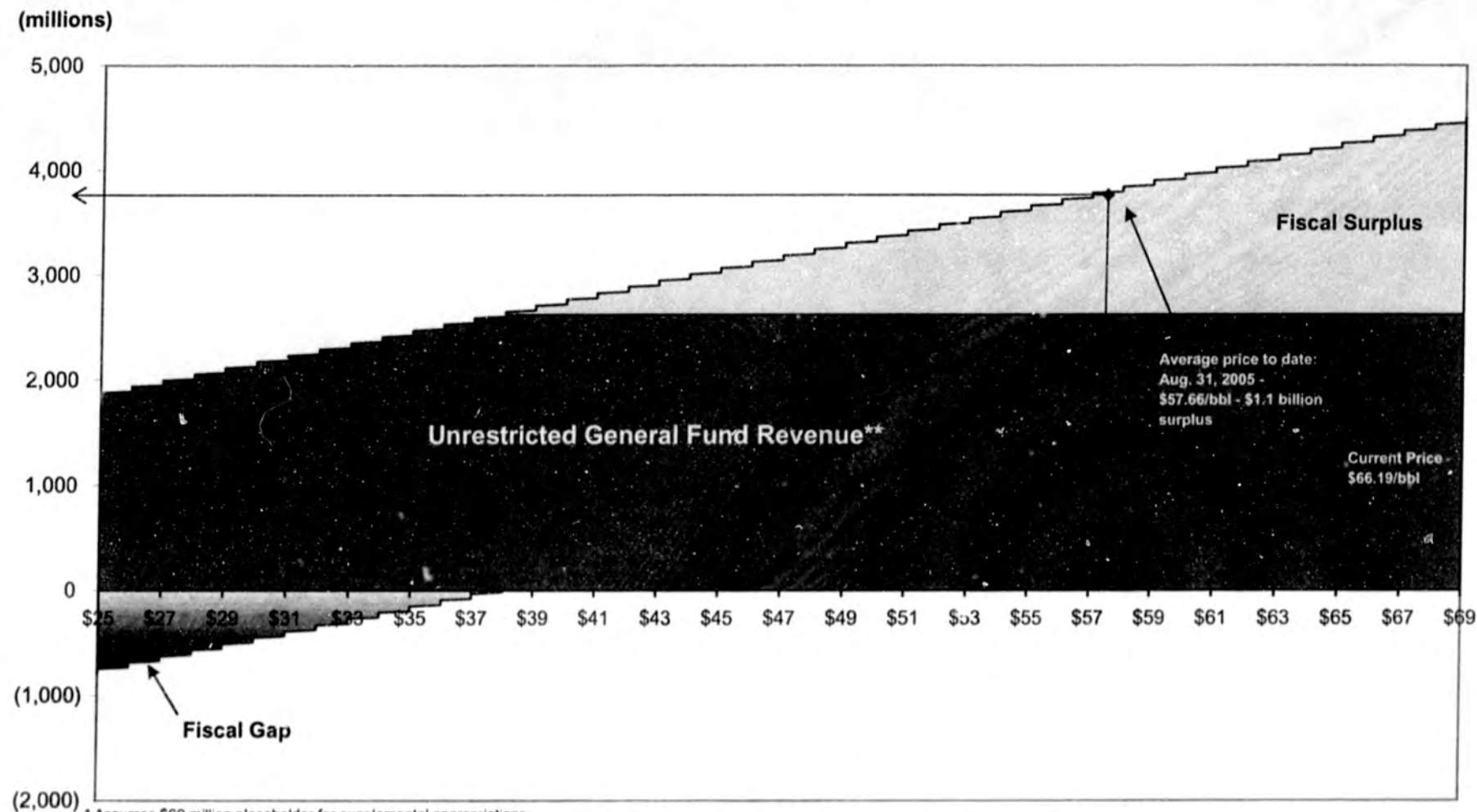
perspective, if you use this surplus in a way of spending it now that starts a new program to increase future spending, you are just compounding the problem. If you use this surplus and put it towards retirement or some other program that's going to cost you now or cost you later, what you are doing is spending the surplus now and reducing future budgets instead of increasing them. My recommendation is that when a surplus exists, use it.

(Here Rep. Weyhrauch asks – "That means letting it lapse into the CBR?

David Teal replies: I would pre-fund, but again, I would pre-fund school districts liability and I would think about pre-funding communities, as I said, you've got no direct liability for communities, but of course, who is it you represent? It's a form of revenue sharing, community assistance, whatever you want to call it. Communities are far less able to afford these 5% increases. If you do that, then the communities which are also hit with fuel cost increases, I guess the logic here is that with high oil prices the primary impact on the state's surplus revenue, we have minor bills, DOT, the University, Troopers that are hit with higher fuel cost, but that's far out weighed by the revenue increase, but high oil prices don't add any revenue to the communities, but it certainly costs them money. That's the only logic I have for saying the communities that need the money and don't have the revenue sources. The state has the revenue sources, and your question in January is "are you going to share with the communities". I don't have any answers, here, I guess we're certainly willing to work with Retirement and Benefits and work with you to try to find the answers, but \$5.7 billion's a lot of money, we don't have it all now, and even if we did, there are other things to spend the money on.

From this point on, it's questions and answers.

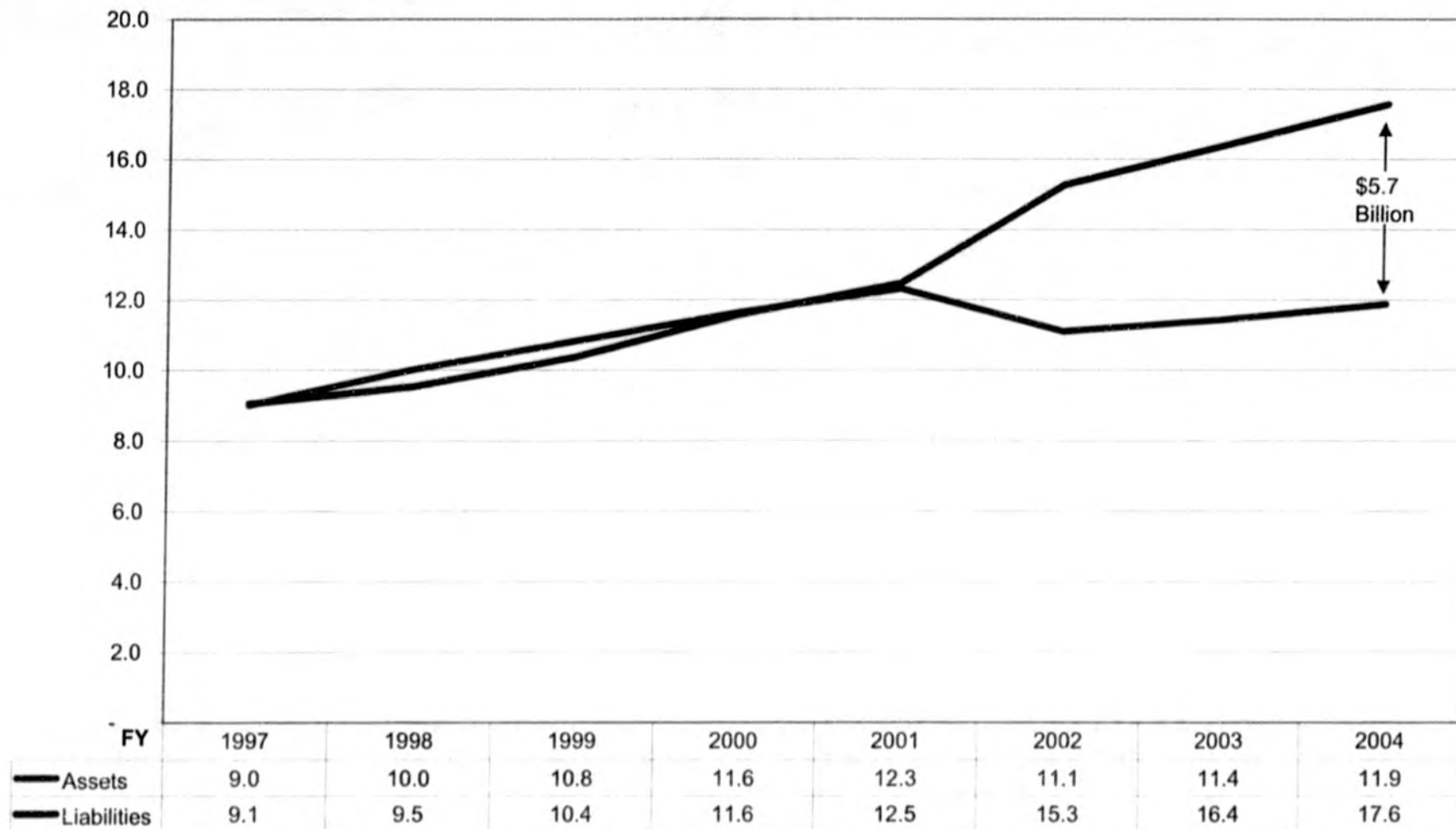
**Projected Fiscal Gap/Surplus at Various Year-End Average ANS Crude Prices Given \$2.62 Billion
FY06 General Fund Budget***



* Assumes \$60 million placeholder for supplemental appropriations.

**Includes revenues not directly affected by fluctuations in oil prices. Assumes DOR Spring 2005 Production Projection of .911 million barrels per day.

**PERS/TRS
Assets vs. Accrued Liability
(billions)**



State of Alaska Fiscal Summary
(\$ millions)

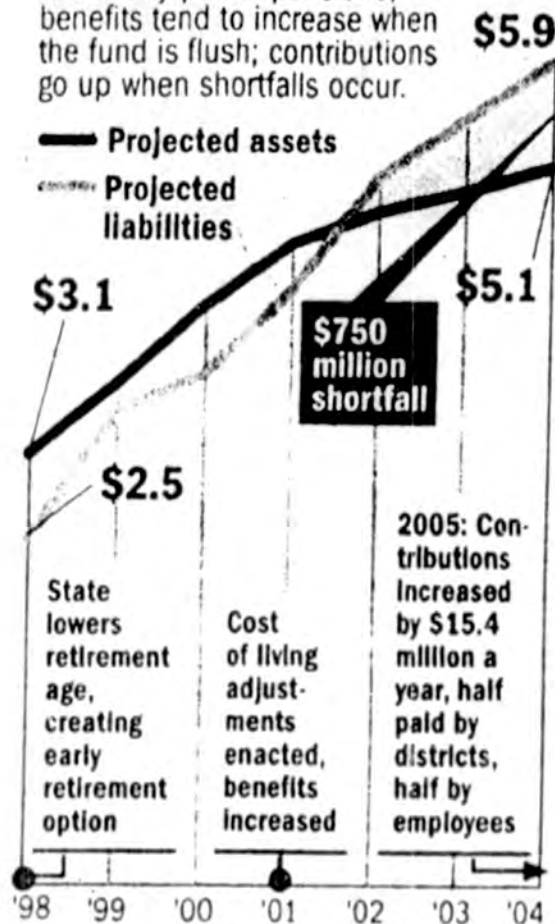
	FY05 Authorized				FY06 Budget (after vetoes)				GF Change
	GF	Federal	Other	Total	GF	Federal	Other	Total	
1 REVENUE (Excludes Permanent Fund Earnings)									
2 Unrestricted General Fund Revenue (1)	2,946.9			2,946.9	2,664.0			2,664.0	
3 Revised Revenue Forecast (5/18/05 \$43.46/bbl in FY05)	107.8	11.1	6.0				20.0	20.0	
4 Bond Proceeds and Other Borrowing (2)			120.0	120.0			330.2	330.2	
5 Corporate Dividends (3)			130.6	130.6			114.9	114.9	
6 Retained Corporate Dividends (3)			(53.9)	(53.9)			(59.9)	(59.9)	
7 Federal and Other Funds		3,235.3	977.1	4,212.3		2,753.3	851.0	3,604.3	
8 Total Revenue	3,054.7	3,246.4	1,179.8	7,480.8	2,664.0	2,753.3	1,256.2	6,673.4	(390.7)
9 APPROPRIATIONS									
10 Operating	2,321.7	1,633.7	1,008.1	4,963.5	2,214.1	1,679.6	1,011.2	4,904.9	(107.6)
11 Agency Operations (Non-Formula) & RPLs	1,116.4	814.2	1,309.4	3,240.0	1,298.2	819.0	1,345.0	3,462.1	
12 Formula Programs (4)	1,150.9	778.3	148.6	2,077.8	845.7	818.7	141.9	1,806.4	
13 Debt Service	2.7	8.6	250.0	261.3	52.0	8.0	241.2	301.2	
14 Fund Capitalization	51.7	32.6	27.7	112.0	18.2	33.9	15.3	67.3	
15 Duplicated Authorization (5)			(727.7)	(727.7)			(732.2)	(732.2)	
16 Capital	8.8	1,458.8	153.5	1,621.1	338.7	1,075.9	238.4	1,653.1	329.9
17 Project Appropriations & RPLs (Revised Programs)	7.0	1,457.4	101.4	1,565.8	332.2	1,075.9	197.8	1,606.0	
18 Mental Health Projects	1.9	1.5	4.1	7.4	6.5	0.0	5.6	12.1	
19 Projects Funded with Debt Proceeds			95.2	95.2	0.0	0.0	308.2	308.2	
20 Duplicated Authorization (5)			(47.2)	(47.2)			(273.2)	(273.2)	
21 New Legislation					11.4	(2.3)	6.6	15.7	
22 Total Authorization (unduplicated)	2,330.5	3,092.5	1,161.6	6,584.6	2,564.2	2,753.3	1,256.2	6,573.7	233.7
23 Surplus (Draw From CBR)	724.2				99.8				(624.4)
24 Post-Session Activity									
25 Supplemental Operating Appropriations (6)	181.2	61.2	20.3	262.7	60.0			60.0	
26 Capitalization of the Public Education Fund (4)	414.2	0.0	0.0	414.2				0.0	
27 Supplemental Capital Appropriations	128.8	92.6	74.3	295.7				0.0	
28 Duplicated Authorization (5)			(76.3)	(76.3)				0.0	
29 Total Authorization	3,054.7	3,246.4	1,179.8	7,480.8	2,624.2	2,753.3	1,256.2	6,633.7	(430.5)
30 Revised Surplus (Draw From CBR)	(0.0)				39.8				
31 Permanent Fund Dividends			532.0	532.0			620.0	620.0	
32 Deposits to Permanent Fund Principal			641.0	641.0		1.7	651.0	652.7	
33 Capital Income Fund			27.0	27.0			30.0	30.0	
34 TOTAL WITH PERMANENT FUND	3,054.7	3,246.4	2,379.8	8,680.8	2,624.2	2,755.0	2,557.2	7,936.4	

Notes:

- (1) Revenue assumptions are from the Spring 2005 Revenue Sources Book. The oil forecast is \$41.75 per barrel and .920 million barrels per day in FY05 and \$38.60 per barrel and .911 mbd in FY06.
- (2) Money borrowed for FY05 projects includes \$45 million in AHFC bonds and \$50.1 million in ASLC bonds. Money borrowed for FY06 projects and debt service includes \$62.1 million in revenue bonds, \$138 million in Airport bonds, \$20.4 million in COPs, \$85 million in ASLC bonds and \$20 million in line of credit.
- (3) Corporate dividends include funds made available to the State by the boards of AHFC, AIDEA, and ASLC. Dividends retained by AHFC for debt service on state capital project bonds are subtracted.
- (4) FY06 appropriations for formula programs excludes the \$414 million FY05 capitalization of the Public Education Fund (line 26) that will be used for K-12 education in FY06. Appropriating money in one fiscal year while spending it in another distorts year-to-year comparisons. Adjusting for K-12 funding would reduce FY05 GF appropriations to \$2.6 billion and increase FY06 appropriations to \$3.0 billion.
- (5) Duplicated authorizations are in the budget twice, such as when funds flow in and out of a holding account or one agency pays another for services provided.
- (6) Supplemental appropriations for FY06 is an estimate

Nebraska school employees pension fund (in billions)

Like many public pensions, benefits tend to increase when the fund is flush; contributions go up when shortfalls occur.



NOTE: Omaha school district has separate fund.

SOURCE: State of Nebraska

DAVE CROY/THE WORLD HERALD

Omaha police and fire pension fund (in millions)

\$657.7

Projected assets (solid line)
Projected liabilities (dashed line)



2006: Both police and fire benefits increase from 69% to 72%

2007: Both police and fire benefits increase from 72% to 75%

State of Alaska Fiscal Summary

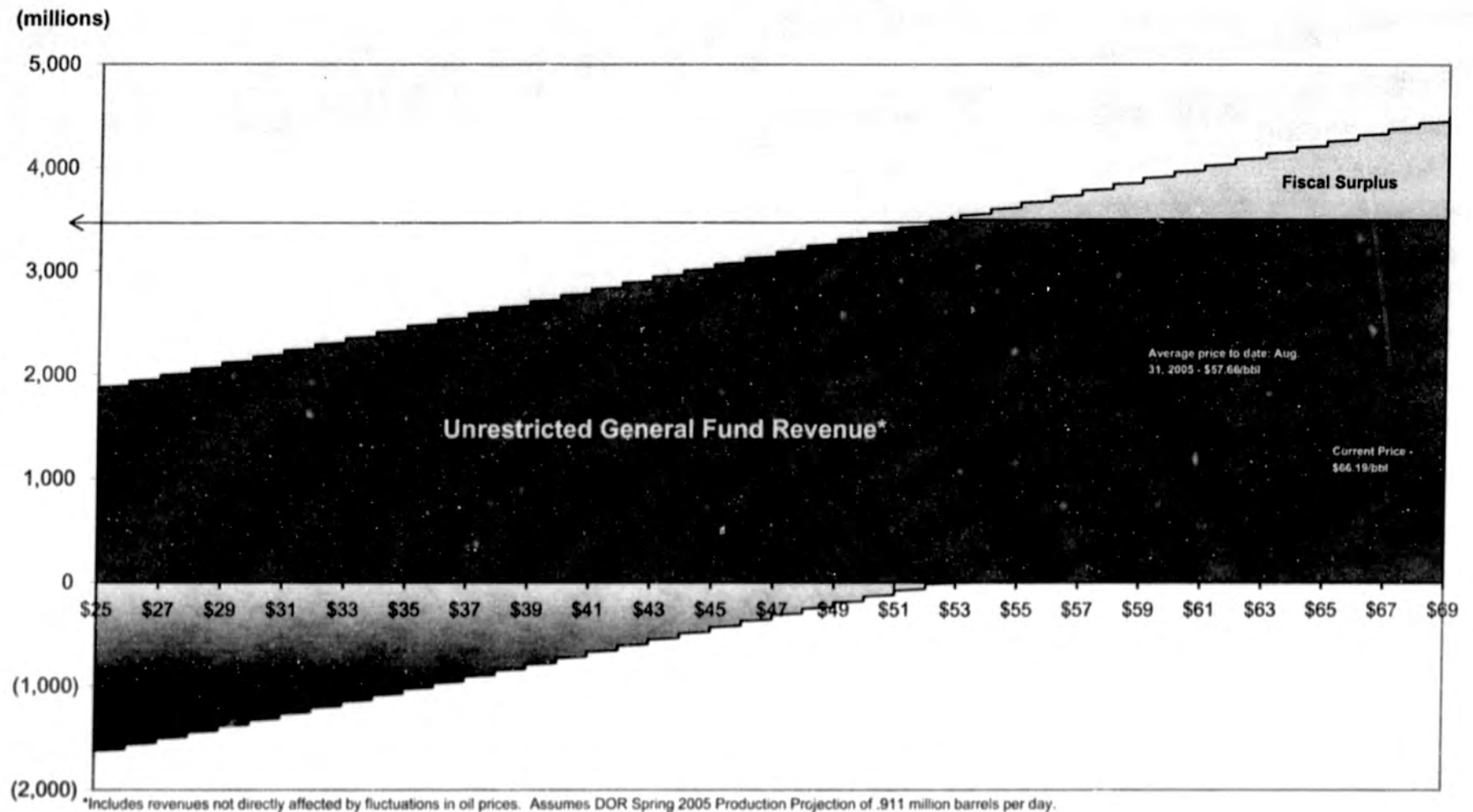
(\$ millions)

	FY05 Authorized				FY06 Budget (after votes)				GF Change
	GF	Federal	Other	Total	GF	Federal	Other	Total	
1 REVENUE (Excludes Permanent Fund Earnings)									
2 Unrestricted General Fund Revenue (1)	2,946.9			2,946.9	2,664.0			2,664.0	
3 Revised Revenue Forecast (5/18/05 \$43.46/bbl in FY05)	107.8	11.1	6.0				20.0	20.0	
4 Bond Proceeds and Other Borrowing (2)			120.0	120.0			330.2	330.2	
5 Corporate Dividends (3)			130.6	130.6			114.9	114.9	
6 Retained Corporate Dividends (3)			(53.9)	(53.9)			(59.9)	(59.9)	
7 Capitalization of the Public Education Fund (4)	(414.2)		0.0	(414.2)	414.2		0.0	414.2	
8 Federal and Other Funds		3,327.9	1,051.3	4,379.2		2,753.3	851.0	3,604.3	
9 Total Revenue	2,640.5	3,339.0	1,254.0	7,233.5	3,078.2	2,753.3	1,256.2	7,087.6	437.7
10 APPROPRIATIONS									
11 Operating	2,321.7	1,633.7	1,008.1	4,963.5	2,214.1	1,679.6	1,011.2	4,904.9	(107.6)
12 Agency Operations (Non-Formula) & RPLs	1,116.4	814.2	1,309.4	3,240.0	1,298.2	819.0	1,345.0	3,462.1	
13 Formula Programs	1,150.9	778.3	148.6	2,077.8	845.7	818.7	141.9	1,806.4	
14 Debt Service	2.7	8.6	250.0	261.3	52.0	8.0	241.2	301.2	
15 Fund Capitalization	51.7	32.6	27.7	112.0	18.2	33.9	15.3	67.3	
16 Duplicated Authorization (5)			(727.7)	(727.7)			(732.2)	(732.2)	
17 Capital	8.8	1,458.8	153.5	1,621.1	338.7	1,075.9	238.4	1,653.1	329.9
18 Project Appropriations & RPLs (Revised Programs)	7.0	1,457.4	101.4	1,565.8	332.2	1,075.9	197.8	1,606.0	
19 Mental Health Projects	1.9	1.5	4.1	7.4	6.5	0.0	5.6	12.1	
20 Projects Funded with Debt Proceeds			95.2	95.2	0.0	0.0	308.2	308.2	
21 Duplicated Authorization (5)			(47.2)	(47.2)			(273.2)	(273.2)	
22 New Legislation					11.4	(2.3)	6.6	15.7	
23 Total Authorization (unduplicated)	2,330.5	3,092.5	1,161.6	6,584.6	2,564.2	2,753.3	1,256.2	6,573.7	233.7
24 Surplus (Draw From CBR)	310.0				514.0				204.0
25 Post-Session Activity									
26 Supplemental Operating Appropriations (6)	181.2	61.2	20.3	262.7	60.0			60.0	
27 Capitalization of the Public Education Fund (4)	414.2	0.0	0.0	414.2				0.0	
28 Capitalization of the Public Education Fund (4)	(414.2)	92.6	74.3	(247.3)	414.2			414.2	
29 Supplemental Capital Appropriations	128.8	92.6	74.3	295.7				0.0	
30 Duplicated Authorization (5)			(76.3)	(76.3)				0.0	
31 Total Authorization	2,640.5	3,339.0	1,254.0	7,233.5	3,038.4	2,753.3	1,256.2	7,047.9	397.9
32 Revised Surplus (Draw From CBR)	(0.0)				39.8				
33 Permanent Fund Dividends			532.0	532.0			620.0	620.0	
34 Deposits to Permanent Fund Principal			641.0	641.0		1.7	651.0	652.7	
35 Capital Income Fund			27.0	27.0			30.0	30.0	
36 TOTAL WITH PERMANENT FUND	2,640.5	3,339.0	2,454.0	8,433.5	3,038.4	2,755.0	2,557.2	8,350.6	

Notes:

- (1) Revenue assumptions are from the Spring 2005 Revenue Sources Book. The oil forecast is \$41.75 per barrel and .920 million barrels per day in FY05 and \$38.60 per barrel and .911 mbd in FY06.
- (2) Money borrowed for FY05 projects includes \$45 million in AHFC bonds and \$50.1 million in ASLC bonds. Money borrowed for FY06 projects and debt service includes \$62.1 million in revenue bonds, \$138 million in Airport bonds, \$20.4 million in COPs, \$85 million in ASLC bonds and \$20 million in line of credit.
- (3) Corporate dividends include funds made available to the State by the boards of AHFC, AIDEA, and ASLC. Dividends retained by AHFC for debt service on state capital project bonds are subtracted.
- (4) \$414.2 million of FY05 GF revenue will be used for K-12 education during FY06. In order to make cross-year comparisons more meaningful, this version of the fiscal summary shows a transfer of revenue from FY05 to FY06 (line 7) and a transfer of appropriations (line 28).
- (5) Duplicated authorizations are in the budget twice, such as when funds flow in and out of a holding account or one agency pays another for services provided.
- (6) Supplemental appropriations for FY06 is an estimate.

**Projected Fiscal Gap/Surplus at Various Year-End Average ANS Crude Prices Given
\$3.5 Billion General Fund Budget**



Projected General Fund Expenditures and Revenues						
		FY06	FY07	FY08	FY09	FY10
	GF Expenditures	3,000	3,200	3,400	3,600	3,800
	Oil At \$40/bbl					
	Revenue	2,725	2,725	2,725	2,725	2,725
	Surplus	(275)	(475)	(675)	(875)	(1,075)
	Cumulative Surplus	139	(336)	(1,011)	(1,886)	(2,961)
	Oil At \$45/bbl					
	Revenue	3,023	3,023	3,023	3,023	3,023
	Surplus	23	(177)	(377)	(577)	(777)
	Cumulative Surplus	437	260	(117)	(694)	(1,471)
	Oil At \$50/bbl					
	Revenue	3,305	3,305	3,305	3,305	3,305
	Surplus	305	105	(95)	(295)	(495)
	Cumulative Surplus	719	824	729	434	(61)
	Oil At \$55/bbl					
	Revenue	3,618	3,618	3,618	3,618	3,618
	Surplus	618	418	218	18	(182)
	Cumulative Surplus	1,032	1,450	1,668	1,686	1,504
	Oil At \$60/bbl					
	Revenue	3,915	3,915	3,915	3,915	3,915
	Surplus	915	715	515	315	115
	Cumulative Surplus	1,329	2,044	2,559	2,874	2,989

PERS and TRS Funded Status Report
Alaska House of Representatives
Special Committee on Ways and Means
July 14, 2005

Presented by Joseph Esuchanko, MAAA
Actuarial Service Company, P.C

Unfunded Accrued Liability

1. At June 30, 2004, the combined unfunded accrued liability of the combined PERS and TRS systems was \$5.7 billion.
 - a. At June 30, 2000, the surplus accrued liability was \$63 million.
 - b. At June 30, 2001, the unfunded accrued liability was \$158 million, a decrease in funded liability of \$221 million.
 - c. At June 30, 2002, the unfunded accrued liability was \$4.2 billion, a decrease in funded liability of \$4 billion. In the June 30, 2002 actuarial valuation, the systems' actuary, Mercer Human Resource Consulting, as a result of an actuarial audit performed by Milliman, USA, made significant changes in the assumptions they were using to value the accrued liabilities and in the method of calculating the actuarial value of assets. Therefore, the June 30, 2002 unfunded accrued liability, as calculated, is more indicative of the correct value,
 - d. At June 30, 2003, the unfunded accrued liability was \$5.0 billion, a decrease in funded liability of \$0.8 billion.
2. At June 30, 2002, Mercer projected the unfunded accrued liability at June 30, 2003 would be \$4.6 billion, compared to \$5.0 billion actually calculated at June 30, 2003. They also projected the unfunded accrued liability at June 30, 2004 would be \$5.0 billion, compared to \$5.7 billion actually calculated at June 30, 2004. Further, they projected the unfunded accrued liability at June 30, 2005 would be \$5.0 billion, and at June 30, 2006, it would be \$5.1 billion.
3. At June 30, 2003, Mercer projected the unfunded accrued liability at June 30, 2004 would be \$5.5 billion, compared to their previous projection of \$5.0. Further, they projected the unfunded accrued liability at June 30, 2005 would be \$5.9 billion, and at June 30, 2006, it would be \$6.1 billion.

4. At June 30, 2004, Mercer projected the unfunded accrued liability at June 30, 2005 would be \$6.2 billion, and at June 30, 2006, it would be \$6.7 billion.
5. Using statistical methods, without access to actual assets or liabilities, I project the unfunded accrued liability at June 30, 2005 would be \$6.5 to \$6.6 billion, and at June 30, 2006, it would be \$6.9 to \$7.7 billion.
6. The chart on the next page presents these figures in a more easily understood fashion.
7. From these numbers, you can conclude that the unfunded accrued liability is growing at a rate higher than each previous projection.

Progression of Unfunded Accrued Liability, both Calculated and Projected

Date at Which Unfunded Accrued Liability was Calculated or Projected	2000 Calculated (C) or Projected (P) Unfunded Accrued Liability	2001 Calculated (C) or Projected (P) Unfunded Accrued Liability	2002 Calculated (C) or Projected (P) Unfunded Accrued Liability	2003 Calculated (C) or Projected (P) Unfunded Accrued Liability	2004 Calculated (C) or Projected (P) Unfunded Accrued Liability	2005 Calculated (C) or Projected (P) Unfunded Accrued Liability	2006 Calculated (C) or Projected (P) Unfunded Accrued Liability
2000	\$-63 million C Note 1						
2001		\$158 million C					
2002			\$4.2 billion C	\$4.6 billion P	\$5.0 billion P	\$5.0 billion P	\$5.1 billion P
2003				\$5.0 billion C	\$5.5 billion P	\$5.9 billion P	\$6.1 billion P
2004					\$5.7 billion C	\$6.2 billion P	\$6.7 billion P
2005 Note 2						\$6.5 to \$6.6 billion P	\$6.9 to \$7.7 billion P

Notes:

1. Indicates a surplus
2. Projections by Joseph Esuchanko

Observations:

- A. From 2002 to 2004, the unfunded accrued liability grew from \$4.2 billion to \$5.7 billion. That represents 16.5% per year. I project a growth to 2005 of 14.0% to 15.8%.
- B. The calculated unfunded accrued liability in 2004 exceeded the 2002 projection by \$700 million and the 2003 projection by \$200 million.
- C. My estimated unfunded accrued liability in 2005 (\$6.6 billion) exceeds the 2002 projection by \$1.5 billion, the 2003 projection by \$700 million and the 2004 projection by \$400 million.
- D. My estimated unfunded accrued liability in 2006 (\$7.7 billion) exceeds the 2002 projection by \$2.6 billion, the 2003 projection by \$1.6 billion and the 2004 projection by \$1 billion.

Alternative Methods of Calculating the Unfunded Accrued Liability

1. The method currently being used is called the Projected Unit Credit method. Under this method, each participant's projected retirement benefit is calculated using the various actuarial assumptions relating to such things as salary increases, expected retirement date and probabilities of death and disability. The fraction of that benefit relative to accrued service compared to ultimate total service is the participant's projected accrued benefit. The liability associated with that projected accrued benefit is derived using actuarial assumptions. The sum of all the participants' accrued liabilities is then subtracted from the actuarial value of assets to determine the unfunded accrued liability. Only 11% of public employee retirement systems use the Projected Unit Credit method.
2. 75% of public employee retirement systems use the Entry Age Normal method. Under this method, each participant's annual normal cost (i.e. the cost associated with that year's accrual) is calculated for each year up to the current year. The accumulated value of those annual normal costs becomes the participant's accrued liability. The sum of all the participants' accrued liabilities is then subtracted from the actuarial value of assets to determine the unfunded accrued liability. Using this method would make it possible to better compare the funded status of the Alaska PERS and TRS to other systems.
3. The Present Value of Accrued Benefits method calculates each participant's actual accrued benefit based on service and salaries to date. It does not use a projected benefit. The liability associated with that accrued benefit is derived using actuarial assumptions. The sum of all the participants' accrued liabilities is then subtracted from the market value of assets to determine the unfunded accrued liability. Using this method determines whether sufficient assets exist to cover actually accrued benefits. This method would not be used to present to unfunded accrued liability for reporting purposes, but would give valuable insight. For reporting purposes, either the Projected Unit Credit method or the Entry Age Normal method would be used.
4. The Aggregate Method, while also not good for reporting the unfunded accrued liability, calculates a total required contribution rate without allocating portions to normal cost and amortization of the unfunded accrued liability. Performing this calculation allows you to determine the appropriateness of calculated funding levels. Under this method, the present value of all projected benefits is calculated. The difference between this present value and the actuarial value of assets is then spread over the future work life of the participants, thus giving the current year's cost.

Future Trend

1. The unfunded accrued liability can be expected to increase over the near future, level out for a period of time, and then begin to decrease as the unfunded accrued liability approaches full amortization. The precise pattern will only be revealed by future events which determine the amounts of benefits paid, the return on investments and the expenses of operating the systems.

Medical Benefits

1. Medical benefits represent a large portion of the systems' benefits paid, accrued liability and normal cost
 - A. 28% of all benefit payments to retirees in the year ended June 30, 2004 was for medical benefits.
 - B. 38% of the systems' accrued liability is attributable to medical benefits.
 - C. 43% of the systems' normal cost is due to medical benefits.
2. The cost of medical benefits increased substantially during the period 1999 through 2004.
 - A. National inflation increased 13.1%.
 - B. National wages increased 16.7%.
 - C. Nationally, average medical premiums increased 67.5%.
 - D. PERS/TRS medical premiums increased 82.4%.
3. The growth rate for medical costs far outpaces inflation and continues to grow as a proportion of gross national product.

Recommendations

1. Perform a full actuarial valuation as of June 30, 2005 as quickly as possible.
 - A. Use the valuation procedure to determine the sources of the unfunded accrued liability.
 - I. First, identify each Tier's accrued liability.
 - II. Second, within each Tier, identify each plan benefit's accrued liability.
 - III. Use this information to determine strategies for the future.
 - B. During the valuation procedure, perform marginal (sensitivity) analyses to understand the future effect on the unfunded accrued liability of experience differing from actuarial assumptions.
 - I. Allow the assumptions to vary with respect to health cost trend rates, inflation, investment return and salary increases.
 - II. Assume experience both more favorable and less favorable than assumed.
 - C. While performing the actuarial valuation, consider alternative actuarial funding methods and assumptions.
 - I. Develop the unfunded accrued liability using the Projected Unit Credit, Entry Age Normal, Present Value of Accrued Benefits and Aggregate methods.
 - II. Make minor variations in actuarial assumptions.
2. Develop a strategic plan for the future.
 - A. Identify ways likely to increase net return on investments.
 - B. Study ways to experience medical cost savings.
 - C. Determine whether it would be possible to reduce future pension payments without violating the mandate that benefits not be reduced.
 - D. Audit operating procedures to develop ways to reduce expenses.

RICHARD J. SOLIE, Ph.D.

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E-Mail: DickSolie@AOL.com

August 17, 2005

Representative Bruce Weyhrauch
Alaska State Legislature
Ways and Means Committee
Juneau, Alaska 99801-1182

Dear Representative Weyhrauch:

Although I understand that the primary focus of your committee's work is the PERS/TRS Funding Shortfall, I would like to make a few comments about the legislature's efforts this past session to deal with perceived problems in the retirement systems that had lead to the current unfunded liability.

First, I believe that the situation facing the legislature was a very serious one, and there was a need for action to both (1) fund the unfunded liability, and (2) fix the retirement systems so as to prevent a future reoccurrence of the problem. The legislature, of course, chose to deal only with the 2nd issue in the last session, and, in my opinion, it took unnecessarily drastic steps which will negatively affect the future ability to recruit and retain future quality employees.

I was a member of the PERS/TRS Tier Committee which had developed a proposal that included major changes in the health plan and a DC/DB hybrid plan for pension benefits. The health care plan in the current PERS Tier 3 and TRS Tier 2 was clearly unsustainable, and I believe the approach adopted by the legislature was a good one – probably superior to that recommended by the Tier Committee. I was, however, extremely disappointed by the decision to create a pension benefit plan for new employees that was 100% DC with no opportunity for choice on the part of new employees.

The legislature was understandably concerned about the future risk involved with the existing plans, but I do not feel that shifting all of the pension benefit risk to the employees was reasonable. If you recall, the Tier Committee had requested that the Division of Retirement and Benefits undertake a survey of Alaska public employers, and that survey included questions that dealt explicitly with investment, inflation and longevity risk. There were a combined 126 employers who responded to the risk questions and in all cases the modal response favored an equal sharing of the risk. Furthermore, from 63.7% to 68.6% of the respondents (depending on the particular risk

Written testimony from Richard J. Solie, Sr.

element involved) indicated that the employers share of the risk should be 50% or greater! Despite that, the legislature acted to shift all of the pension risk to employees in the case of future hires. I would urge you, therefore, to consider amending SB 141 to include either a hybrid plan (with both a DC & DB component) or a choice between a DC & DB pension plan. Further, I would suggest that any DB component should contain a "lifetime average earnings" base for calculating pension benefits as was recommended by the Tier Committee.

I indicated above that I felt that the health plan contained in SB 141 was an improvement on the plan recommended by the Tier Committee. I believe that it does a good job of reducing plan costs, balancing the risks between employers and employees, and providing an incentive to future employees to monitor their health care expenses and to be open to plan modifications that would save them and the plan money. Thus, I would recommend that any future modification of the pension plan should retain a health care plan along the lines of that included in SB 141.

Having stated the above, I want to turn to the issue of the Funding Shortfall. In this regard, let me first state my opinion that the ultimate shortfall will turn out to be significantly larger than the \$5.7 billion estimate in the June 30, 2004 Mercer actuarial reports. There are several reasons why I am convinced of this. First, the mere fact that, even with the recommended increases in employer contribution rates we are still not covering the interest costs on the unfunded liability, means that it will increase.

Second, the 2004 Mercer report estimates are based on a health cost trend that assumes the combined Medical-Rx inflation rate will fall from approximately 10% in FY07 to 5% by FY14. That assumption is made despite the fact that there is, to my knowledge, no credible evidence to suggest a substantial decline in Alaska or national health cost inflation, and the PERS/TRS medical cost inflation rate has averaged 10% since FY78! Further, it should be remembered that a past understatement of medical inflation was a major contributor (in my opinion, the most significant contributor) to the current unfunded liability.

Third, the June 30, 2004, Mercer report continued to utilize the 1994 Group Annuity Mortality Basic Table for estimating life expectancies. At the time the 2004 Mercer report was prepared, the US National Center for Health Statistics had already released its 2004 mortality estimates (based on 2003 data) and it has since released its 2005 report. The new data indicate that the over-all life expectancy for Americans at birth had increased by 1.9 years from 1994 to 2003, an average rate of more than 2 years per decade! Again, it is significant to note that an understatement of life expectancies was a major element leading to the current unfunded liability. In my opinion, future actuarial estimates should build-in, not only the most recent mortality data, but also the projected long-term trend in future mortality and life expectancies.

Fourth, the 2004 actuarial report continued to assume an average investment return of 8.25% on assets. Past net investment returns have been very close to this average rate, but the current investment climate suggests that a lower rate would be more prudent. A

number of other public pension plans agree with this and have lowered their assumed investment rate of return.

Obviously, changes in the above assumptions would, in and of themselves, increase the unfunded liability, but it would be much better to face that up front than to have a repeat of our recent experience when the current assumptions were belatedly discovered to be in error. Additionally, if the changes made now prove to be overly conservative, future adjustments could be made -- after a suitable time period to establish that the fund is truly dealing with long-term trends -- and such a change would not be painful as would a change in the opposite direction.

Taken together, the above four factors may mean that the \$5.7 billion estimate of the unfunded liability may be very significantly low. It behooves the legislature to get the best possible estimate of the actual shortfall so that any "fix" at this time will not need to be repeated in the near future.

With respect to ways of covering the estimated unfunded liability, I do not profess either any extensive study or expertise. This was not an issue with which the Tier Committee or the TRS/PERS boards dealt. Thus my comments in this regard should be viewed as only those of an ordinary, concerned Alaska citizen. That stated, I do have several observations to make, and one of them is that the primary responsibility should fall on the State of Alaska. This is especially true in the case of TRS since the State already recognizes its primary responsibility with respect to education. Nevertheless, a portion of the added cost should, in my opinion, be borne by the school districts and municipalities and in this respect, possibly the already increased employer contribution rates would be a reasonable level for such participation.

Consideration should be given to Pension Obligation Bonds, but the potential negatives of such an approach should be weighed carefully along with the possible interest arbitrage savings. The question of whether these bonds would qualify for federal tax exempt status would, of course be significant, and with respect to such bonds, the sooner a decision can be made, the better, since short-term interest rates are continuing to rise, and long-term rates also appear to be increasing. Of course, if the assumed rate of return on the fund's assets were reduced from the current 8.25%, the potential interest savings would decline. A further question in regard to POBs would, of course, be whether the State should be the primary loan guarantor or whether individual municipalities should be responsible for a portion of their own liability.

From the standpoint of the State of Alaska, it is very fortunate that high oil prices are providing significant unexpected surpluses. It is my strong feeling that the legislature should not fall into the trap of spending those added revenues on further increases in general fund spending. Rather, I feel that a very high priority should be given to dedicating a major portion of those added revenues to covering the unfunded retirement plan liabilities.

In addition to the added revenues, the State, of course, has a significant balance in the Constitutional Budget Reserve which could be used to fund part of the liabilities. Beyond that, consideration may have to be given to drawing on the Permanent Fund -- including a portion of the earnings and/or the principal. Since tapping the earnings would probably face strong public opposition, and drawing on the principal would require a vote of the people, public support would need to be developed if these alternatives were considered. In this regard, a ruling from the Alaska Supreme Court as to the State's fundamental obligation with respect to the unfunded liabilities might be helpful.

One final observation that I would make is that -- as many people have already observed -- the funds in question are not due today. In fact, a significant portion represents the obligation for retirement benefits due 25 years or more in the future. Thus, it may not be necessary or desirable to pay off the entire amount of the liabilities in the near term. In my opinion, however, it is absolutely essential that the actions taken by the legislature in the coming session provide for funds and commitments that will cover all of the interest (actually lost investment returns) on the unfunded liabilities and begin to make a substantial payment on the principal.

Thank you for your consideration of my comments. If you should have any questions of me regarding the above comments, I will be happy to respond.

Sincerely,

Richard J. Solie, Sr.
Former member of TRS Board
And Member of Tier Committee

Ginny Austerman

From: Rep. Bruce Weyhrauch
Sent: Tuesday, July 19, 2005 9:29 AM
To: Bruce Weyhrauch
Cc: Ginny Austerman
Subject: FW: S.B.141

-----Original Message-----

From: Alyce Hanley [mailto:ahanley@chugach.net]
Sent: Saturday, July 16, 2005 8:53 AM
To: Rep. Bruce Weyhrauch
Subject: S.B.141

Dear Rep. Weyhrauch, I had hoped to tell you how much I appreciated all the work you did on the retirement legislation. I was pleased when I saw you at the luncheon on Thurs., but the conversation was apparently dominated by the gentleman who was convinced that no one should be dependent on Gov't. for retirement plans and everyone should have his/her own retirement account.

I am so thankful my husband wanted a job with retirement benefits after watching all his family of fishermen have little or nothing in their senior years. I have never considered myself dependent on Government, but have been very appreciative that I am financially independent because of Gov't and state pension plans.

I am pleased I was able to serve on the PERS board for almost 2 years. I think retirees were well served by the PERS, TRS and ASPIB boards. Getting rid of those boards was a major mistake in my mind. I realized the finger pointing that Ms. Millhorn referred to was probably all the questions that Pat Wellington asked. There was a concerted effort to get rid of him. He had been on the Board for 27 years and was really dedicated to taking care of retirees and the benefits they had earned. If he had not asked the questions of the AG, I am convinced the \$222,000 never would have been returned to the trust fund. He also asked early on what the position of the Div. of Retirement and Benefits was in regard to a defined contribution plan. He was given the run around and then told they had no position since a bill had not been introduced. Of course we learned that Ms. Millhorn had been instrumental in drafting the bill and later stated she was a real advocate of defined contribution plans. They were not honest with the PERS board.

I didn't mean to go at such great length, but again had hoped to be able to chat with you a little and again thank you for your efforts in trying to make this a better piece of legislation. Alyce Hanley

AUG 22 2005

August 22, 2005

The Honorable Bruce Weyhrauch, Representative
Alaska State Legislature
State Capitol Room 421

Dear Representative Weyhrauch:

The purpose of this letter is to offer three possible retirement cost containment recommendations. Two of my recommendations could affect the cost of state provided retirement health insurance and one as a possible cost containment method for the retirees optional life insurance, audio, dental, visual, and long term care.

I would hope that you would pass this on to your special committee that is reviewing cost containment for the state health insurance program.

RETIREE HEALTH INSURANCE BUYOUT

Upon retirement tier one employees receive free health insurance for their spouses and themselves, which we both know is extremely costly. It's quite possible that a tier one employee, at the time of retirement, does not need the state provided health insurance, but subscribes to it, because it is free. They may be receiving health insurance because of their spouses employment, military retirement health insurance, or another employee sponsored health insurance.

My recommendation would be that the state explore the benefits of offering, at the time of retirement, an actuarial determined health insurance buyout. This would be a one time payment, which would be binding upon the retiree. This cash incentive I feel could be quite attractive to those retirees that do not need the state provided free health coverage. It would also be my recommendation that if this program is implemented, the spouse and the retiree must sign off on this option as it irrevocable.

I have personally talked to several state retirees who would have been interested in an option such as this at retirement, because their spouses are also covered under a health insurance program. Also I have discussed this concept with a number of tier one employees who that stated they would be interested in evaluating the financial incentives of such a program at the time of retirement.

RETIREE PREVENTION, WELLNESS, AND CASE MANAGEMENT

The above programs may go under different names by a health insurance provider, but basically, are designed to keep the retiree healthy, manage those retirees major medical problems, and contain cost.

Several years ago the PERS and TERS Boards became painfully aware of the escalating health costs. As a result of this, the boards reviewed several options, which if implemented, could reduce costs.

The Boards felt that they could only address one cost containment program at a time. We selected a program to enhance the use of generic drugs by retirees. Involved in developing this program were the Division of Retirement and Benefits, Aetna, Deloitte Consulting [The States Health Insurance Consultant], the PERS and TERS Boards, and RPEA. After a year of developing the program, a formal recommendation was made to the, then director, Guy Bell, which he accepted and implemented. Aetna advised us that for every 1% increase of generic drugs by retirees, could effectively save the program \$1,000,000. It is my understanding that this program has resulted in a 5% increase in generic drugs, which saves the system approximately \$5,000,000 a year. I point this out to illustrate the success that a cost containment program can have when there is a collaborative effort and not one which the retirees feel is forced upon them by the State or Aetna.

In recent discussions with a representative from Aetna, it was still his opinion that the state could save money on the retiree health insurance cost by implementing the case management, prevention, and wellness program for retirees. I should point out that Aetna has different company names, but they mean the same. The PERS and TERS boards had received, over the past 4 years, numerous presentations, and were prepared to address them and make recommendations by the middle of 2006, of course this will not happen. Aetna has indicated sometimes it is necessary to spend money to save money, but it is their professional opinion, that every \$1.00 spent implementing these programs could result in a \$2.00 savings.

It is my opinion that implementing new health programs for retirees can only be successful if they feel that this is a cooperative effort, and not something being pushed on them by the state or Aetna. One of the major outside resources that we used when developing the generic drug program was the Retired Public Employees Association of Alaska, through their state president Sam Trivette and his health insurance sub committee. This collaborative effort added credibility to the program and the retirees accepted it.

I am not sure how this credibility is going to be maintained when implementing new cost containment measures because there will be no Boards involved or forum for RPEA to interact with.

If a cost containment program is achieve its goals, once again the retirees have to feel comfortable with the process.

RETIREE OPTIONAL AUDIO, DENTAL, VISUAL, LONGTERM CARE AND LIFE INSURANCE

The above programs are totally funded by the retirees premiums. These premiums are periodically adjusted as a result of claims experienced. There is no mandatory program either through state statute or regulation that requires a timely review process for these optional programs, which has led to overprices premiums for the retirees.

Case in Point: Approximately four years ago the insurance carrier for the optional life insurance program advised the State that the premiums the retirees were paying were out of adjustment and were not necessary to actuarially maintain the program.

Approximately a year and a half ago, the PERS Board and RPEA asked the Division of Retirement and Benefits to make it a priority to review the optional life insurance program for retirees. The Boards and RPEA have received information that many retirees were dropping this program as it became cost prohibitive. The rates for the program could be adjusted yearly and are automatically increased every five years based on age. So the older you get the more it costs. Any rate adjustment can be done just once at the first of the year. And the board and RPEA felt that the review needed to be done before January 1, 2005. At the November 2004 PERS meeting the division provided audited figures which in fact confirmed that for a number of years the retirees had been paying an inflated premium. Based on the divisions figures, and supported by them, the board recommended a 40% decrease in premiums beginning January 1, 2005. This recommendation was supported by RPEA. As I recall possible an additional two million was held in reserve above and beyond what was actuarially required to keep the program solvent. The division stated that they would address this possible over funding before 2006, and make appropriate recommendations to the PERS Board for their consideration and recommendation for possible rate adjustments beginning January 1, 2006. I am not sure how this process will work now.

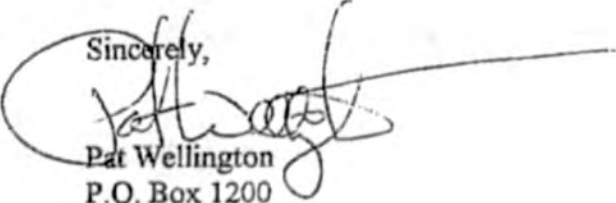
I know we are all very interested in developing cost containment programs for our State provided health insurance, but I feel the State has an equal responsibility to provide oversight for the optional programs totally funded by the retirees. At this time there is no state statute or regulation that these programs be audited and adjusted as appropriate.

I would recommend that the legislature adopt a statute, or directed the Division of Retirement and Benefits to adopt regulations that require mandatory, yearly review of the financial status of these programs. If not we could conceivable find that once again the retirees are paying inflated premiums. Remember that the optional life insurance premiums can only be adjusted once a year in January. This being nearly September, if an

adjustment is to be afforded to retirees in January, as anticipated, the Division of Retirement and Benefits will have to address this very soon.

I hope you and your committee has found this information useful in your endeavors to contain cost, and if I can ever be of assistance to you and your committee please feel free to contact me.

Sincerely,



Pat Wellington

P.O. Box 1200

Utopia, TX 78884

(830)966-2235

(830)966-2234 [Fax]

June 20 2005

To: Representative Bruce Weyhrauch

From: Gayle W. Harbo
Box 10201
Fairbanks Ak 99710

JUN 27 2005

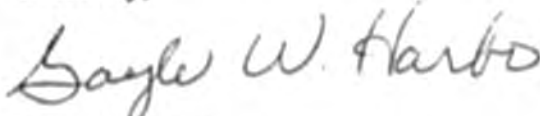
Dear Representative Weyhrach,

I want to thank you for your support of teachers and public employees during the legislative session. My husband and I have resided in Alaska for almost 50 years and we have never seen a more arrogant and uncaring Senate. The rush to push through a poorly crafted bill, Senate Bill 141, which shows little regard for hiring and retaining qualified, dedicated teachers and public employees was a sad comment on what they see needed to build strong communities. We thank you for continuing to oppose this bill which will give no immediate relief to employers but will sentence future employees to an unsure and insecure retirement. It is a bill which benefits the money managers and the private investors and will do little for the communities. Employees and retirees both will take their money and run. There may, in fact, be no retirees living in the state and spending their retirement dollars. This was made clear to me at a retired teachers' meeting - one person said, "If it was my retirement, I would take the dollars and go where it is cheaper to live as I know my dollars might not last for my last years of life."

I have included several things in this packet I am sending. You may not want, or have the time, to use them, but I did want to emphasize the major factors, health care and Mercer's poor advice. There is plenty to support that Mercer erred and the fact that they also advised Fairbanks erroneously is telling. Several members from the three boards, Pat Wellington, Dorothy Wells and Dr. Merritt Olson, have many years of history as do past directors like Guy Bell and Gary Bader, and of course, the Boards' attorney, Rob Johnson, who has a wealth of knowledge. These people are well respected and, above all, honest. The people who served on the three boards, in my short experience, have been honest, dedicated, hardworking and knowledgeable. They do not have a hidden agenda and only the best interest in serving the systems' members and earning the best return.

Thank you again for your time and dedication.

Sincerely,



Gayle W. Harbo

June 19, 2005

To: Representative Bruce Weyhrauch

From: Gayle W. Harbo, Box 10201, Fairbanks, Ak. 99710, Chair, TRS Board

Re: Committee seeking information regarding PERS/TRS funding ratio

Dear Representative Weyhrauch;

Your interest in resolving the issue of the PERS/TRS situation is heartening and I hope you will contact some of the employees who worked for the Division of Retirement and Benefits for many years with purely the system members' interests at heart. They have the history, the knowledge and the dedication to give you an accurate, honest and complete picture of the problem.

I am including copies of the testimony I gave before the Senate Finance Committee, copies of a letter I wrote to Mr. Bob Boko, Chair of the Joint Tier Committee for TRS and PERS and copies of two articles I wrote regarding the PERS/TERS situation. I know you will get many pieces of information, but observations by current and past Board members may be helpful.

I have been a resident of Alaska since 1957. My husband Sam worked for Fish and Game from 1959 to 1961 and we opened the first Fish and Game office in Nome in 1959. He is now a retired professor of biomathematics from the U of A, Fairbanks and I am a retired high school math teacher, with a BS in mathematics. We have made our home in Fairbanks since 1962. I was appointed to the TRS Bd in 1999 and have been privileged to work with members and members' concerns, particularly in the health care area.

I would like to address three particular areas; some of it is covered in my testimony. Much of what I write is specifically to the TRS system. First I will give a bit of history and then speak to two major problems, Mercer advice and health care, the two main causes of the the reduced funding ratio. I am not an expert, by any means, and so would ask that the loyal former employees of R and B be contacted.

History

As you know the Constitution of Alaska guarantees a Retirement System, not a savings account, to the public employees and teachers of this state. We should be proud of our current fifty year old model system. There are some inequities between TRS and PERS, particularly in the area of Social Security. When teachers were pulled from Social Security in late 50's they were not given the option to establish a separate savings account, as were public employees, with a SBS match of dollars from the state. Also, as you well know, if public employees and teachers not covered by Social Security earn SS

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credits by working extra jobs they will be penalized and receive reduced or no SS benefit because of the federal pension offsets, GPO and WEP.

In terms of the current funding ratio, the funds have been there before and at a time when health care costs were not as high. In 1980, the funding ratio for TRS was 67%. In 1980 the employee, the employer and the state each contributed approximately 7%, or a total of 21% of payroll, to the system. Gradually, as the state started to funnel its share through the districts, the employer/state share dropped until, in the 90's the TRS Bd established a rate they hoped to use for 20 years, of 12%. The state seems to have completely forgotten its obligation and in the new legislation speaks only of employee/employer. You will find in FY'02 and '03, Mercer recommended rates lower than 8%, but the TRS Bd stayed with 11% and 12%, respectively. In the spring '97 PERS Bd meeting of Mar 20 and 21, Mercer even suggests that the Boards can retroactively lower employer rates. If the Boards had tried to increase the rates during the years, from '97 to '00, the employers would have screamed because the funding ratios for both systems were at or over 100%. (In the late '70's the state neglected to pay its TRS obligation. With interest, that amount repaid would be considerable)

As you know the Alaska State Pension Investment Board has done an excellent job of earning money for the funds. They look at a five year horizon while the Joint Boards, for actuarial assumptions, look at a 25 year horizon and also must consider health care costs. Michael O'Leary, the Callen consultant to the ASPIB Board, said "how important the time period, when considering investment return performance." It is the reason, that the disparaging remarks of Senator Stedeman were so uncalled for - ASPIB has done a good job and is a good check and balance on the Administration. The newly created ARM Board puts too much power in the hands of the Administration (two Commissioners) and no elected representation of system members.

MERCER

In copies of my testimonies you will find several references to Mercer, but some of the most blatant errors they made are pointed out in the Joint Meeting minutes of PERS/TRS, Sept. 21, 2004. I enclose a copy of pages 6 and 7. Milliman audited Mercer and as result found significant errors. They also advised Mercer to change the way they recognized gains/losses, from a corridor method to a five year smoothing, which resulted in a significant, one time jump, in the employer contribution rate. The first five years of using this new method is not yet over.

Mercer has advised the Boards for a long time and is the firm which said Retirement Incentive Programs would be cost neutral and then changed their story these past two years. They advised the PERS/TRS Boards on how to deal with "surplus" funds in 2000, while at the same time underestimating health care cost increases and significantly impacting the employer contribution rate due to mortality. In '95 they had used an '84 mortality table when the '94 was available and in 2000, the '94 table. They also, in a March 18 memo to the Division of R and B, attributed high costs to the Ad Hoc PRPA, but failed to mention that the largest part of the cost was the settlement of a lawsuit

which made all retirees whole from the beginning of the program. Some members received one time checks as high as \$9000.

In speaking with Mayor Steve Thompson of Fairbanks, I learned that Mercer advised the City of Fairbanks on the sale of MUS to GVEA and indicated that the city would suffer no adverse affects. You may know that Fairbanks has huge past service costs resulting from the sale and from MUS workers going from PERS to a labor union. Those workers will now have two retirements and the city is obligated for their pension costs. The same situation recently occurred in Anchorage with Local 302(contact Mayor Sullivan). Mercer has given poor advice to many. Contact Mayor Thompson or Sharon Boko, widow of former city councilman Bob Boko, who also chaired the Tier subcommittee as a member of the TRS Board, to find out the history of this PERS mess. Anselm Staack, former CFO with Retirement and Benefits, is also an excellent, *honest* source of this information.

Dollars paid to Mercer have increased from \$350,000 in FY'01 to the budgeted amount of \$560,000 for FY'06.

Health

As we all know the rising cost of health care is a problem, not only in Alaska, but in every state. The Joint Boards, in the summer of 2000, began an education plan to encourage members in the use of generic drugs. It has been very successful. I have been chair of the Health Subcommittee since 2003 and we have recommended many cost saving methods to the Administration. The Boards can only recommend, not implement. The Administration can make changes to the health care plan, as long as they are prospective - affecting only future retirees. For current retirees they may make changes for convenience or choice, but though they have done this for actives, as in the case of making Providence a preferred provider, they did not do it for retirees. You might ask "why"? Were they waiting, keeping the costs high, until SB141 passed? They will implement a program called "positive enrollment" this fall, claiming it will save \$16 million dollars annually on retiree health care. You might ask "why did they wait three years"to implement this cost saving program. In 2003 Retirement and Benefits moved money from the medical reserves, over \$20 million, to the funds managed by ASPIB, to get a better return. That left the medical reserves at about \$75 million. That figure for '04 is now at \$109 million - why are there \$30 million in excess reserves.(\$75 million was considered sufficient in '03). The total amount of reserves for medical, long term care and DVA(the last two are funded by members only) reserves is over \$213 million. Anselm Staack, former CFO, has a better grasp of these figures than I do, but the point is, were the high rates quoted inflated? For FY'05 the actual increase in medical cost was 5.5%, down from the 12% of the previous year. Dollars paid to the health care consultants, Deloitte and Touche has increased from \$213,000 in FY'01 to a budget amount of \$475,000 for FY'06. My other comments on health care are in my testimony, but it is the significant driver in the decrease in the funding ratio and those costs could have been addressed early on by the Administration without resorting to legislation.

Legislation

You are aware that some of the unfunded liability is due to enhancements to current tiers passed by the legislature. The Joint Boards in 2003 and again in 2004 sent letters to

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the leaders in the House and Senate requesting that they hold any bills which would provide enhancements and with the exception of the bill that excused the current Commissioner of Education from paying the state back the money he owed when he retired under a retirement incentive, most bills were held back.

In 2003 the Commissioner of Administration, Mike Miller, replaced a very capable, and nationally respected, director of retirement and benefits, with a person with no experience, but with the set agenda to dismantle the retirement system as we know it. Commissioner Miller requested the Boards form a Tier Committee and it was hoped that with the three Murkowski appointees on each board it would be a snap. The Committee was very much managed by the new director, much to the chagrin of Chair Bob Boko. The Committee was indeed a sham to use members' fund money to bankroll a study to be used by the legislature. No committee member recommended a pure DC plan. It was at the insistence of the Administration that Option 2, a pure DC plan, be put in. The committee members, as Dr. Solie said in his testimony, did *not* recommend the pure DC plan. All the work done by Mercer, paid for by plan members, as well as all the extra time and energy spent by long time, well respected Retirement and Benefit Division employees, went directly to support the Senate Finance work. The Director spent countless hours working with supporters of any bill which promoted a DC plan, a dismantling of the three Board, more control for the Administration, and less oversight by members of the three boards, several members with over 25 years of service on the boards. Technically, the dollars spent may be legal, but the ethics of those using the funds are questionable. Many long time, dedicated employees of the Division were driven out, moved to other state jobs or resigned in disgust.

When I wrote a letter to the Governor about my concerns, it was answered by the Commissioner of Administration. In May the Boards were told they did not have to meet in June, because Mercer was going to come out with "new assumptions". The PERS Board chose to meet anyway, but the Governor intervened and asked them not to. When Mayor Sullivan told the Governor that Pat Wellington, long time elected member of both PERS and ASPIB, would be in Juneau June 23 for the ASPIB meeting, the Governor said "What's ASPIB?" - a very telling statement.

Thank you, Representative Weyhrauch, for reading my letter and my testimonies (if you have time). My main concern is the quality and longevity of teachers and state employees. I want people to come to Alaska to make their homes, raise children and grandchildren and contribute to their respective communities. SB141, as you well know, does not encourage that, nor does it solve the problem of past service costs for employers. It offers no security. If a person did teach to retirement, he or she would be foolish to stay in Alaska and pay high costs in a harsh climate. Retirees will take the money and run. I wish you luck with your committee and would be happy to help in any way. I would ask you to consult with past, dedicated employees, not the current leadership, if you want a complete and honest picture. I will be visiting my 96 year old Mom for a time, but will be in Fairbanks July 13.

Sincerely

Gayle W. Harbo
sjharbo@yahoo.com

January 23, 2004

To: Bob Boko, Chair, Tier Comm. TRS/PERS
From: Gayle Harbo, member, TRS Comm.

Re: Items for discussion at the Feb. 16 meeting

During the discussion regarding whether a new tier is necessary for either TRS, PERS or both, I hope we will keep in mind some of the reasons for the perceived need and also seriously look at some of the abuses to the systems because of loopholes and/or the ability of non-full time employees to "latch onto a good thing" for the health care benefits. I will list some of my thoughts as a starting point and realize it is in no way a complete list and those of you with more experience with city and borough govt. can add a great deal more.

Some of the reasons for the perceived loss/gain to the systems and therefore a change in the funding ratio:

- * increase in health care costs
- * increase in the percentage of retirees to actives (TRS, PERS?)
- * increase in life span - longer lives (good news), longer draw on systems (bad news)
- * impact on prescription drug costs for those over 65 in year "06 and beyond - will the state be reimbursed by Medicare for some share of its expenses.
- * districts and boroughs offering early buyouts, increasing final salaries and unfunded liability

Some of the abuses to the systems:

- * allowing people who are not full or part time employees of TRS or PERS to contribute minimum dollars, but who then qualify for full health care - help me list them - city and village councils, borough assembly members, legislators, school board members - are there others and am I correct on these? Can we get the places where this occurs and the numbers involved? How many people contribute on earnings of less than \$5000 per year and yet are eligible for \$9600 per year in health ins. pmts when they retire?
- * Employees at the University or school districts who work 9 mo. for most of their careers, then work more than 9 mo. each their last 3 years to "bump up" their average salary.
- * School districts which give superintendents and teachers huge bonuses in their final year to "bump up" their average
- * allowing TRS employees to vest in PERS and then use the additional years credited to retirement to be paid at the higher TRS average salary

It would be my hope that we would deal with some of the blatant abuses first before considering imposing restrictions on the new employees coming in. Some suggestions to handle the health care abuses and the bump ups would be to:

1. Look at a total service average salary or at least a 10 year average salary
2. Health care benefits are only paid to retired members who have contributed to the retirement system for (then state a minnum number of years and state at least a minimum annual contribution amt. to TRS or PERS). I do not mean this to include the many PERS employees who work part time for many years, but only those elected officials etc. who see our systems as "the health care gravy train".

Some other thoughts dealing with increased longevity - Maybe 20 years and out is no longer viable. Anyone now retiring at age 42 will most likely draw benefits for longer than they were active contributors.

I would caution considering a DC plan, even in part, for TRS. It has been a disaster for teachers in most states where it has been implemented and most teachers, I am sorry to say, are not wise investors. It may seem paternalistic, but I would much rather see our teachers have a comfortable monthly benefit coming in rather than be faced with drawing out of a DC plan once the market has tanked. We have all heard horror stories these past few years of people unable to retire or people losing their entire retirement savings because of unwise market investments. Three past presidents of NCTR would be available to present information on DC/DB and if we are considering discussing this very important topic I would suggest we request their input and advice. Also Cindee Moore who is the counsel for NCTR is a valuable resource and she would be happy to give us help.

I would appreciate any sharing of ideas and thoughts before the Feb. 16 mtg and look forward to the discussion. I think it would also be helpful to have data from R and B which tells us the number people who contribute little money annually, but qualify for the health care benefit when they retire. Where did they earn their benefits, who did they work for or serve on some bd or council???

Nov 104
Harte

Tier Committee

Thanks to the members of the Tier Comm. and to Chair Boko for all the work they have done this past year.

Request of the Administration to form the Committee, not the idea of the Boards.

Reason was ,supposedly, poor earnings the past few years, a declining funding ratio and increasing health care costs.

The Admin and R and B and some Bd members will meet with ASPIB, the investors and monitors of earnings of the TRS and PERS funds Dec.1 to discuss recent earnings. In FY'03 each fund earned over 15%. Over the past ten years the funds have earned an average of slightly more than 9%, above the 8.25% rate of return the Bds have in the assumptions adopted in Dec.2000.

Health care costs are indeed a problem, but in January I addressed a letter to Chair Boko and asked it be entered in the record stating what I called abuses to the system. As we go through this presentation I will ask whether these abuses were addressed and/or considered in the deliberations. Some are:

1. People who are not career employees, but members of school bds, city councils, borough assemblies, legislators etc. who earn small wages for a period of time to vest in either or both systems, then retire and get ,in addition to their small benefit, a health care benefit that costs the system \$10000, annually. How many people are on the "health care gravy train"?
2. Employees of the university, community colleges, school districts who are hired on contracts, 49% positions (if already retired), as adjuncts etc. These people replace people who would otherwise have full time positions and who would contribute to the retirement system. These people do not contribute to TRS and in some cases are drawing a retirement check and getting health care from the system. How many full time positions has the university lost in the past ten years?
3. Retirement incentive programs and district incentives which increase the unfunded liability and negatively affect the funding ratio. School Bds and the University which allows some employees to "bump up" their salary in their last few years.
4. Employees who only work the minumum time to vest, then retire and get a great health care benefit. The Committee has addressed this in part in that

you have to retire from active status to get health care. It helps with those people who vest in their 20's then do something else and when they retire get health care.

Mercer is our actuary, but we have not always received good information from them. In the early 90's they said the Retirement Incentive Programs would not negatively affect the funding ratio. This past year they changed their story. For the 2000 assumptions they used the 1994 Mortality Table which had a huge impact on the recommended employer contribution rate. Had they used that table in 1995 when the previous assumptions had been adopted the impact wouldn't have been as great. (budget info on the Mercer line item: FY'02 to FY'05 a % increase)

We do not have to go to the legislature to change the health program which is really the only thing that has affected the funding ratio - it is above 90% without health care. Rob Johnson has mentioned at every meeting, sometime several times, that the Administration can make changes to the Health Care Program, without going to the Legislature, as long as they are prospective.

We have several choices today after we hear the presentation.

1. We do not have to recommend either Model
2. We can postpone action until after the Admin and R and B meet with ASPIB
3. We can ask the Admin to adopt some of the changes to Health Care that the two Bds agree on

I look forward to the presentation and the opportunity to ask questions.

Article for Retired Newsletter 1)

Are we in need of another tier???????

- Sandy Harbo - Fall '07

In Sept. 2003 the Administration requested the PERS and TRS Bds to look at information regarding employee pension benefits to see if a new tier might be necessary. The question is : are we in bad shape financially? The current reports of the ASPIB Board show that earnings for FY '03 were just over 15% each for PERS and TRS investments and the average annual earnings for the past 10 years have been just over 9%, which is above the assumed rate of return of 8.25% for the PERS and TRS funds. For '03 the funding ratio for TRS was 90% without medical and 64% with medical. Health care is a very important benefit. An element which had a significant, and one-time effect on the funding ratio was the methodology change in recognition of deferred losses - a change from a corridor method to a 5 year smoothing for the recognition of these gains and losses. This impact, alone, in the '03 valuation was 15.03% increase in the recommended employer contribution rate necessary to fund TRS at 100% for 25 years. (See pg. 8 of Mercer's Accuarial Valuation Report, June 30, 2002) The fact is the Retirement System is not going broke - it is in quite good shape considering it is one of only 4 systems which prefunds Health Care.

The actuaries are contracted by the administration to give us information to make reasonable decisions in setting contribution rates, but some of the information provided has proved to be less than reliable. In the early '90's the actuaries, Mercer, assured the Boards that Retirement Incentive Plans offered by the Legislature would have a neutral effect on the funding ratio. Many retirement incentives were offered by the state and by local districts in the '90's.

In 2003 Mercer changed their story and admitted these plans do have a negative effect. The Boards in March wrote a letter to the House and Senate Leaders requesting they not consider legislation which would negativel affect the funding ratio including any Retirement Incentives. Employers and legislators have to accept some responsibility for increased rates. Another significant impact on the recommended employer contribution rate was when the last assumptions were adopted in December of 2000. The assumptions were greatly affected by the increase in mortality as the result of using 1994 Mortality tables. These tables were available in 1995 when the last valuation had been done, but Mercer chose to use '85 tables in '95 thus making the '00 impact greater.

At the first meeting of the Tier Committee, the question was asked about what the purpose of a good retirement system should be - is it to keep costs down for the employer or is it to attract and retain a well qualified and stable work force? The consensus of the

2)

committee seemed to be for the stable, qualified working population. Members of both Boards were interested in seeing some of the abuses of the system changed, such as including huge bonuses in the last year of employment or other arbitrary contributions which cause a huge increase in the average salary for the last years on which the retirement benefit is based. It was also mentioned that the State is not obligated to contribute a match to public employees SBS contributions and ceasing this practice would save the State money.

The Tier Committee has had several meetings this past year, at significant cost to members of the system and the cost for the actuaries, Mercer, and consultants, DeLoitte and Touche is way over budget. Mercer was budgeted \$400,000 for FY'04, but \$552,500 was spent and \$580,100 is budgeted for FY'05. D and T was budgeted \$340,800 for FY'04, but \$432,821 was spent and \$454,400 is budgeted for FY'05.

At the Sept. 2004 meeting the Tier Comm. was presented with two Tier Alternatives and I have requested a copy of their minutes from their June meeting and the Sept meeting. At the July meeting, on page 17 of the minutes, the director, Melanie Millhorn, requested that Mercer provide a pure DC plan cost model, though members of the committee, including, Mr. Solie and Mr. Boko stated that a pure DC plan would not meet with approval. The committee members did not suggest a pure DC plan, the Administration did.

The two plans presented place a considerable health care burden on the retiree before age 65 and a burden greater than now on current post 65 retirees. Currently post 65 retirees do suffer a diminishment in benefits as they are required to pay for Medicare Part B which this year is about \$800, but will increase almost 20% in January. In calculating the health care monthly premium D and T use a blended rate which comes from pre and post 65 figures, yet Mercer claims (see minutes July 15-16, pg. 4) that for purposes of constructing the Tier model they could not split claims between pre and post medicare because the number information is not available, yet retirees must notify the Division of R and B when they reach 65 to tell them whether or not they are Medicare eligible. It would be assumed to get the cost per month of care for pre and post age 65 retirees, they would use total claims in each group divided by the numbers in each group.

I will be going through the two models and will make notes, but the minutes reflect that Jack Kreinheder, from OMB, and Kevin Ritchie from the Alaska Municipal League, thought the system models proposed were not conducive to attracting and keeping a stable workforce. One commented - I wouldn't want to work under this system.

It is imperative to stress that the systems are not in bad shape, but the Administration has been releasing information to paint a bleak picture in hope of getting a new tier through. At the SPIB meeting in September in Fairbanks, Dorothy Wells made a motion to request the actuaries to compute the funding ratio using the old smoothing method. Other members of SPIB were also upset about the bad press regarding earnings and they hope to have a meeting with the Administration in early December to talk about their perspective regarding the health of the fund.

Feb 2005

In January, 2005, the Department of Administration presented to the Legislature a plan for a new Tier for both PERS (Tier 4) and TRS (Tier 3), this in spite of a vote by both the PERS and TRS Boards Nov. 19 to "not recommend" a new tier. The plan has two options and each option includes a Defined Contribution component inserted in the plan at the request of the Administration, not the members of the Tier Subcommittee.

We need your help in contacting Legislators on the reasons why a new tier, and particularly a Defined Contribution plan, rather than the current Defined Benefit plan, is not in the best interest of attracting a quality stable workforce. It is interesting that the Tier Plan presented to Legislators included results of the Employer Survey, but not the results of the Employee Survey. Employees surveyed felt a new tier would result in difficulty in recruitment and Tier I employees expressed feelings of guilt that some coworkers doing the same job received fewer benefits. Employees felt retirement health insurance coverage the most important benefit.

How did we get to the point for the Administration to advocate a DC plan? There have been increases in health care costs, but the latest annual increase projected for 2005 is 5.5%, down from 12% in 2004. A special thanks to our retirees for switching to generics and making careful health care choices. The invested TRS and PERS funds had three years of negative investment experience, but in FY'04 both PERS and TRS invested funds earned above 15%, significantly more than the actuary's assumed rate of 8.25%. We have had years of poor earnings before, in the '70's, and recovered to the point that in the fall of 2000 the actuary to the PERS and TRS Boards, Mercer, was advising the Division of Retirement and Benefits on how to allocate assets surplus to 100% funding for TRS and 102% funding for PERS. Also in those years Mercer was recommending an employer contribution rate of 7.09% for FY'002 and 8.29% for FY'03. Fortunately the TRS Board kept the employer rate at 11%, because by 2003 Mercer was recommending an employer contribution rate of 35.57% for FY'05. A significant portion of the recommended 2003 rate increase, however, was due to a change in the method for recognizing gains(losses) and not for actual loss. The TRS Board adopted an employer rate of 16%. Where did Mercer go wrong?? In the early '90's and until last year they insisted the early retirements or RIP's would not affect the funding ratio. They changed their story this year and said that early retirements and "buyouts" negatively affect the funding ratio. This admission came, of course, after the years 2000 - 2003 when the large districts of Anchorage and Fairbanks offered huge bonuses for early retirement and more than 250 people took early retirement. Suddenly \$10000 per year per retiree of health care costs was shifted from the school district employers to the retirement system. To

compound the problem, many of these same retirees were rehired the next fall and received a full salary from the district, their retirement check and also had their health care paid by the retirement system. In the assumptions adopted in December 2000 Mercer failed to predict double digit increases in health insurance premiums. In the assumptions presented to the joint boards for adoption they indicated 4 - 5% annual increases. They gave several other poor suggestions, but how can we help now? We do not want a DC plan and need to advise Legislators on some other things that can be done to help the systems recover. The TRS and PERS funds are in good shape compared to most funds in our country, even though we have one of only four systems that prefunds health care. Without medical benefits our TRS system is almost 90 funded.

Here are some things that we need to discuss with legislators. First, they should not be introducing new legislation that enhances benefits for current retirees or active members in the current tiers - any enhancements will just negatively affect the funding ratios of the two systems. The respective boards of PERS and TRS sent a letter to the Legislature in March 2004 to ask them not to pass any introduced legislation that enhanced benefits, yet early in the 2005 Legislature several bills have already been introduced to enhance benefits for special groups. These bills include House Bills 6 and 40 and Senate Bills 21, 24 and 31. The last two seek to remove the sunset on the bill to allow districts to rehire retired teachers while the teachers still draw a retirement salary and have their health care paid for by the retirement system, a \$10000 a year drain on the system.

Second, although some of you may not agree, the University and the school districts need to refrain from issuing 49% contracts to retirees. These contracts pull positions, that previously paid in to TRS, from the system. Retirees get the jobs and the districts and University do not have to pay benefits. This increases the unfunded liability, yet the employers are complaining. This happens in PERS positions also, where retirees are hired back, and previous contributing positions are lost. Some Municipalities, Fairbanks and now Anchorage, because of poor management decisions have lost PERS positions to other unions, but still have a PERS liability. They complain, but they are part of the problem.

Third, many groups, school boards, borough assemblies, legislators, city council members put themselves in the TRS or PERS system. They contribute very little, get minimal salaries, but vest and, though they may get less than \$10000 per year in retirement they receive more than \$10000 a year health care benefit. There are almost 8000 recipients in the PERS and TRS systems who received minimum benefits. These are loopholes that need to be closed.

Why is a defined contribution system proposed by the Administration not a good thing? As Alyce Hanley of PERS and Dick Shultz of TRS so eloquently stated, now is not the time. Why should future retirees be burdened with a new tier or a DC plan because of Mercer's poor advice and poor judgement on the part of some employers. We want to attract new, young workers to Alaska and we want them to stay. Salary is no longer a draw. The Job Fairs that used to have 5 and 6 applicants for every job now have empty rooms. People can go to places where weather is better, the cost of living is cheaper and

they can get higher wages. Alaska is no longer at the top of the list. If we want to attract new and vital young people to Alaska we need a good retirement system, one that assures security in old age. We are already losing many people because of the GPO/WEP pension offsets which reduce or eliminate any Social Security benefits we may have earned.

Seniors who work and retire in Alaska deserve more than a risky DC plan that does not guarantee a lifetime income, has no cost of living provision and may require, if a senior suffers a stroke or alzheimer's disease, that some stranger would manage the lifetime DC benefit which they would get as a lump sum. In Governor Murkowski's letter to seniors in December 2004, he states that "Alaska's future also depends on the health and well being of our people and communities." Let us keep that promise to Alaska's seniors and our future retirees and not adopt a new tier and , definitely not, a DC plan. A Defined Benefit plan, which we now enjoy, is the way to keep and attract qualified, long term employees whose children and grandchildren will be Alaska's future.

*Testimony - Gayle Harbo
Senate Finance
Mar. 29, 2005*

Good afternoon. My name is Gayle Harbo and I have been a resident of Alaska since 1957, most of the time living in Fairbanks. I taught in Fairbanks for 25 years, most of the time at Lathrop High School and was Chair of the Math Dept and Advanced Placement Coordinator for almost 20 years. I am here as a member of the Teacher Retirement Board. The joint boards thank Senator Stedeman for his willingness to teleconference with us on Friday Mar. 25. We are sorry his plans changed but since he could not teleconference hope he and the Committee will read the verbatim transcript of the morning's discussion so they realize the depth of true concern that each Board member has regarding all the bills which seriously impact a retirement system which has worked well for 50 years. The only significant changes that have been made in recent years have been enhancements of benefits due to legislation. The Joint Boards have sent letters to the Legislature these past two years asking that you not introduce any bills which enhance benefits and the Administration has agreed to testify against these bills because all would increase the unfunded liability.

I am going to address 3 topics in my remarks and will be happy to answer any questions. If I don't know the answer I will try to find out.

My first issue is the interaction of the 3 Pension Boards. As you know the main work of the TRS and PERS Boards is listening to appeals of members, recommending employer contribution rates and adopting actuarial assumptions every 5 years based on the recommendations of the Commissioner of Administration and the actuary. ASPIB manages and invests the contributions to the system. The Joint Board members have great admiration and respect for the way ASPIB and the staff of Revenue, who work with Gary Bader, invest and care for our funds. Over the past 10 years the funds have earned almost 9% annually, at or near the assumed rate of our actuary. Earnings are not the problem causing the unfunded liability.

This leads to my second issue. The main driver of the decrease in the funding ratio has been the rapid increase in health care costs, a problem not unique to Alaska. You have seen in past presentations that without the inclusion of medical costs the funding ratio is a respectable 91% for TRS and 120% for PERS. Health care costs have accounted for 50% of the employer contribution rate increases in past few years. The Administration can make changes in the Health Care plan without legislation. First, changes can be made to the plan for current tiers if they do not diminish benefits, but are a matter of choice or convenience. (An example would be requiring members use hospitals, both in and out of Alaska, which are preferred providers so

significant savings could be negotiated - Providence in Anch. is not a PP yet over 80% of retirees go there, the hospitals in Juneau and Sitka are owned by their respective cities. They are not preferred providers and there is little savings to the state.) Secondly, significant changes can be made to the plan for employees hired after a specific date.

About 5 years ago the Joint Boards recommended an education program to encourage members to use Generic Drugs. The members responded and now 42% of the drugs used are generic. Every percent of brand name drugs replaced by generics saves the plan 1M. (see Oct. '04 Newsbreak). The Health Care Committee has for several years recommended the state pilot a disease mgt. program, particularly for diabetes, but we were told that the start up cost of \$240000 was too much. In speaking with other health plan administrators who utilize disease mgt. I have been told that the cost savings in the first four years are considerable and would more than recoup the start up costs. Mr. Mike Humphries, from the benefits division at the U of A, the NEA Health Trust and, perhaps Mr. Jarrell, our new trustee from Bering Straits School District, indicate their plans incorporate this element. For retirees this past year, 474 members had claims of over \$50000 each and accounted for 53M of the medical expenses to the state plan. Surely disease mgt could have reduced some of this cost. Other than the generic drug campaign no substantive cost savings measures have been taken. The Health Care Committee has presented a list of several cost savings measures that we, and the entire Jt Board, would like to see initiated. The Boards can only recommend, however, not implement. I feel we would not be at this juncture, with drastic changes recommended to the system, if this Administration and past Administrations had held a Forum with employers, legislators, representatives of unions and the Municipal League and medical professionals to discuss methods of resolving these skyrocketing costs. We all recognize the problem and would like to be part of the solution, not adversaries. ^{Sen. Seaton} Senator Seaton has a bill regarding generics and closed formularies. This does not have to be legislated - the Administration can make those changes now as long as they do not diminish benefits to the current tiers.

My third issue deals with the comments by some that the Boards have not been responsible in recommending the employer contribution rate and with the awarding of the ad hoc PRPA. Wrt TERS and the employer rate, it is a

recommendation, the Administration can set the rate higher. The Boards act with information provided them by the Administration and the actuary. In the early '90's the TRS Bd adopted a 12% employer rate and to ensure stability for employers for future planning, they intended this rate be used for at least 20 years. In 2000 and 2001, however, when setting the rates for FY'02 and FY'03, Mercer, our actuary, recommended rates as low as 7.09% and 8.29% for those fiscal years. The TRS Bds did, in those two years, drop the rate to 11%; had they not, the employers may have been upset. In '03 we set the rate at 16%, though the first motion was for 17%. The contribution rate has been higher - in FY' 83 and '84 the combined rate for state and school district was close to 18%. When I started teaching in the '60's, employee, employer and the state each contributed 7%. The employee population at the University that is not under TRS, but under private accounts has a match by the employer of roughly two to one.

The other issue of Ad Hoc PRPA's apparently needs to be clarified since you were given a paper dated Mar. 18 from Mercer regarding the funding status due to plan changes, mostly enhancements through legislation, and Ad Hoc PRPAs. As you know the Boards recommend Ad Hocs on the basis of information provided by the actuary and the Commissioner of Administration. The Boards have only made recommendations when the funds were healthy. No Ad Hoc has been recommended since 2003. A retiree gets either the Ad Hoc or the automatic PRPA, not both. In the past years when the Ad Hoc has been awarded it only causes a small "blip" in the increase of the employer contribution rate, probably less than .06%. The Mar. 18 letter fails to indicate that probably 99% of the ad hoc cost mentioned, resulted from the settlement of a lawsuit in the mid '90's. The state lost the lawsuit and as a result had to make all retirees whole, from the time they retired, wrt the PRPA. The dollars paid out include not only past prpas but the interest earned. Many individual retirees who had been retired 30 to 40 years received checks close to \$10000. The lawsuit, as many of you may remember resulted because past administrations had not awarded a prpa when the fund was "healthy".

The Mar. 18 letter also attributes nearly 1B of the increase to the unfunded liability to benefit enhancements by the legislature. The Boards have said many times that "tinkering" with the tiers, once they have been established has not been in the best interest of the funds and for some of

these changes the actuary has not accurately predicted the rapid rise in health care costs. In the assumptions adopted by the Boards, the last time in Dec. of 2000, Mercer had a Medical assumption rate of 5.5%. We now know was not a realistic assumption. The Boards requested an Actuarial Audit in 2001 and the resulting report indicated that we should look at Medical assumptions on an annual basis. You also know that the R/P programs advocated by the Legislature in the early '90's were to be cost neutral, but this past year Mercer indicated they have had a negative affect on the funding ratio, primarily because of escalating Medical costs. Despite this poor advice, if you examine Mercer's budget line item over the past few years, you will see there has been a 100% increase in their fees.

I thank you again for your time and hope you will carefully consider whether drastic measures need to be taken at this time. We all agree there is a problem and we hope by working together we can begin to solve it, but please do not burden future hires for the mistakes of others. Changes can be made, without legislation, to control current and future costs. Please let us work together to make Alaska continue to be the place young people will want to come to work, as you and I once did.

Testimony turned in to Senate Finance - Mar 30, 05

Good Morning . My name is Gayle Harbo and I have been a resident of Alaska since 1957. I am a mother, a grandmother and a teacher and most recently a member of the Teacher Retirement System Board. As a parent and a grandmother I am most concerned about the quality and stability of the education employees in the state of Alaska. When I came to Alaska there were many applicants for each job, with prospective teachers often subbing for years before they were hired to a permanent position. Salaries in the late '60's and early '70's were very competitive. That is no longer true. I believe teacher job fairs are no longer held in either Anchorage or Fairbanks. The point is, Alaska is no longer the place to come to get a good salary . A friend in Wasilla said if she had stayed in Wisconsin for her teaching career she would have a better retirement then she will have here.

I want the best and brightest to teach my grandchildren. To attract teacher's it is important we keep the DB system. Many of the changes recommended by the Tier Subcommittee of the Joint BDs could be adopted without going to a defined contribution system. One, in particular, would change the number of years over which an average salary is computed.

It is important to realize that, under the proposed system, seniors would be given a "pot" of money when they retire and then have to manage a resource that is to last them for a lifetime in terms of annual income. They would have no inflation proofing(PRPA, which even SS provides)and they would be at the mercy of investment advisors and unknown investment costs. As individuals, they would not be able to get the breaks ASPIB gets by investing large sums of money, putting their dollars at even greater risk. You have all read the horror stories of retirees who have lost everything because they did not have the expertise to invest. Most are emotional, not long term investors and their resources may not match their lifetime expectancy.

Another issue for seniors is health. I personally know many seniors who have suffered from stroke, Parkinson's, and dementia in their late 60's and early '70's. Who will look out for their well-being and security? Our retirees who invest their lives working for the state of Alaska deserve more.

The proposed legislation is particularly unfair to members of TRS who were pulled from Social Security, but not given the option PERS employees received when SBS was formed and the state matched the employee contribution of 6.13% . In addition PERS employees may participate in a

deferred comp plan. Teachers not only do not have a parallel SBS plan, they often receive little or no benefits under Social Security because of the provisions of the Government Pension Offset (spousal offset) and the Windfall Elimination Provision. These provisions eliminate or greatly reduce promised benefits from Social Security for quarters worked. Not only that, because the state mandates participation in Medicare Part B when a retiree reaches age 65, every retiree must pay almost \$80 a month out of pocket ^{for that coverage}.

Last year this Legislature unanimously passed a resolution requesting our Alaska Delegation in Congress work for the repeal of GPO/WEP. They recognized the inequities for public employees not covered by SS.

I urge you to give this matter more thought before you make sweeping changes. Let's work together for a year to get the health care costs down and look at some of the suggestions made by the Joint Boards at the presentation of the Tier subcommittee's proposal in November. I am sure working together we can reach a solution that will be beneficial to future employees and also to Alaska's children. I want young people to come to Alaska and to stay in Alaska. We have much to offer. Thank you for this opportunity.

Steinman's comment - re. Bds - "we've had them all in here and all there's been is finger pointing" I have never observed finger pointing, only questioning of the ^{conclusions} ^{information and} ^{data}. I've been on TRS bds - this is the 1st time I've been allowed to come to testify. The other members can speak for themselves, but to my knowledge, none have been down to testify since this process began & that includes A-S-B. I testified yesterday that TRS bds have great respect for A-S-B's work and performance and for the time they spend managing retirees' funds.

Regarding testimony 8 Mar 30, I was not called on, so listened to others

To: Senator Lyda Green, Chair, Senate Finance
From: Gayle Harbo, Teacher Retirement System Bd.
Re: Senator Stedman's Comments, Mar. 30 am, SFC

Senator Stedman, during his presentation on proposed Board reconfiguration, made a comment to which I take exception. Had I been allowed to give my testimony that day I would have responded in person, but realize the Committee had limited time that morning.

Senator Stedman, speaking in regard to the 3 retirement boards, said, "we've had them all in here and all there's been is finger pointing." I have never observed members of any of the three boards finger pointing. The Boards, in fact, requested an actuarial audit several years ago because they questioned some of the information they were receiving from Mercer. Milliman, the auditors, found several gross errors, particularly with respect for medical expense accounting. (see Sept. Joint Board minutes, page 6).

As I stated in my testimony on March 29, the three boards work well together and I have great respect for the members of ASPIB, the work they do and the staff which supports them. I don't know who Senator Stedman is referring to when he says "we've had them all in" - Mar. 29 is the first time in my 6 years on the TRS Board that I have testified and to my knowledge since SB141 came out no one on the three boards had testified before any committee. If he has names then tell us, but please do not make accusations.

Senator Stedman talks about professionalism on the Boards. The members we have now and have had are well respected members in their communities and give countless hours preparing for appeals and for other meetings, all on their own time. The Boards have always asked good questions and sought information from the actuary and Administration to make sound decisions.

I was dismayed at our last joint meeting that many of the Board members did not even receive the actuary's valuation until the day of the meeting. New information on how to calculate and project medical costs was contained in the valuation. For the first time health and prescription costs were separated and presented on cost per member basis, something I asked the actuaries for years ago. It makes it much easier to compare costs from year to year at a glance. Not only did we get new material, the Division had put a presentation on LTC on the agenda, which could have been held at a later time or scheduled for Fri., Mar.

25. These Boards are dedicated to serving members interests, another reason to have member representation. Employers are members of the system. They too may be represented.

Thank for allowing me to testify on the 29th and I know my written testimony for the 30th is in the record.

Respectfully

Gayle Harbo

Retired Teacher
TRS Trustee