

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672

3095 SCOMM 142: HOUSE SPECIAL COMMITTEE ON WAYS & MEANS 2005-2006



BY RICHARD R. SHAVELL

The American Jobs Creation Act of 2004

Significant Tax Cut Legislation

On October 22, 2004, President Bush signed his fifth significant piece of tax-cut legislation, the American Jobs Creation Act of 2004 (P.L. 108-357). There are several important provisions for the construction industry in the Act, including:

- A new special deduction originally intended to focus on the export and manufacturing industries, but which now includes construction activities;
- Increased and newly accelerated depreciation opportunities that provide incentives for increased construction services; and
- Several business provisions that impact contractors.

The New Deduction

In exchange for repealing significant tax benefits for exporters, Congress is implementing a 9% (when fully phased-in) deduction for certain "qualified production activities." Available to corporate and most pass-through entities, the new deduction will be based on a complicated computation of "qualified production activities income" (QPAI).

"Domestic production gross receipts" is part of QPAI and includes: 1) "construction performed in the United States or," 2) "engineering or architectural services performed in the United States for construction projects in the United States." (P.L. 108-357 §199(c)(4)(A)(ii) and (iii))

Note that "construction activities" are directly related to the erection or substantial renovation of residential or commercial buildings and infrastructure. Substantial renovations include structural improvements – but not cosmetic changes, such as painting. The calculation of this deduction has significant limitations and adjustments that determine which portion of these activities' gross receipts will be considered.

Generally, the new deduction is calculated by applying a phased-in percentage to the lesser of QPAI or taxable income. The rate to calculate the deduction is scheduled to phase-in as: 3% for 2005-2006, 6% for 2007-2009, and 9% after 2009.

The implication is that, in many cases, contractors will benefit from the new deduction and be able to reduce taxable income. In exchange for this, contractors may be faced with ancillary concerns such as an increased compliance burden. (For interim guidance, see IRS Notice 2005-14.)

New Depreciation Provisions

Once again, *depreciation is the GOP's golden carrot* to entice businesses to purchase certain assets and begin construction activities that might otherwise be delayed. This latest Act provides several new provisions, extends expensing thresholds, and also addresses several perceived abuses.

15-Year Recovery Period

A new 15-year recovery period will apply to certain leasehold improvements placed in service after October 22, 2004 and before 2006. This is a significant reduction from the 39-year period that would otherwise apply. The new rules cover interior improvements to nonresidential property provided:

- The improvement is made under a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee);
- The improvement is placed in service more than three years after the date the building was first placed in service; and
- The improvement is not attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.

Generally, if a lessor makes a qualified leasehold improvement, a subsequent owner cannot claim it as qualified leasehold improvement property. Fifteen-year straight-line depreciation will be used instead of the 15-year MACRS (150% declining balance) method. The bonus depreciation regulations will apply to defined qualified leasehold improvements.

Qualified Restaurant Property

The restaurant industry secured a 15-year recovery period for "qualified restaurant property" placed in service after

October 22, 2004 and before 2006. For contractors specializing in restaurants, this provision may boost business.

Qualified restaurant property is defined as any improvement to a building:

- If the improvement is placed in service more than three years after the building was first placed in service; and
- More than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premise consumption of prepared meals.

Property/restaurant owners who take advantage of this recovery period must use the straight-line depreciation method.

Racetrack Improvements

Not to be outdone by the restaurant industry, a new provision assigns a MACRS recovery period of seven years to motorsport racetrack complexes (which include land improvements and support facilities, but not transportation equipment, warehouses, administrative buildings, hotels, or motels). The provision is effective for property placed in service after October 22, 2004 and before 2008.

Section 179

The §179 expensing threshold of \$100,000 (adjusted for inflation) was scheduled to revert to \$25,000 in 2005, but is now extended through 2007.

However, only \$25,000 of the cost of a heavy SUV may be expensed under §179, effective for vehicles placed in service after October 22, 2004. Heavy SUVs – those with a gross vehicle weight rating (GVWR) of more than 6,000 pounds – are generally not subject to the “luxury auto” depreciation dollar caps and lease income inclusion amount rules.

Under the rules that applied before the Act, the entire cost of a heavy SUV used 100% for business could be expensed. Now, Congress has limited the deduction to \$25,000.

Other Provisions

The Act has several provisions for businesses that should benefit contractors. For example, S corporations can now have up to 100 members, and all family members can elect to be treated as one member for the 100-member threshold. Other items of note include vehicle provisions and a general sales tax deduction.

Vehicle Provisions

Heavy & Highway contractors may wish to scrutinize a provision exempting mobile machinery from federal highway taxes.

These changes should mean that mobile cranes, concrete pumpers, and certain paving equipment will not be taxable.

The new law codifies the current three-part design test effective for machinery that is: **1)** permanently attached to a chassis, **2)** designed to operate off-highway, and **3)** reaches jobsites over public roads under its own power.

The Act retains the full exemption from the 12% federal excise tax on new vehicles and the heavy vehicle use tax for equipment that meets the three-part test. The fuel tax will still apply, but a refund can be obtained at year-end if the equipment travels less than 7,500 miles on public roads during the year. Tires designed exclusively for off-road equipment will be exempt from the federal tire tax.

General Sales Tax Deduction

Effective for 2004 and 2005, taxpayers may elect to take an itemized deduction for state and local general sales tax in lieu of the present-law deduction for state and local income taxes.

Taxpayers can either accumulate receipts or reference a table (see www.irs.gov/pub/irs-pdf/p600.pdf) to determine their sales tax paid. In addition to the table amount, they can also deduct eligible sales taxes paid for vehicles, boats, and certain specified items. This is an added benefit for residents of the 10 or so states that have no income taxes. Taxpayers in other states must decide if they want to deduct the income or sales tax paid during the year.

Conclusion

The American Jobs Creation Act of 2004 is a very broad and complex piece of legislation, with intricacies beyond this brief overview. To benefit from the Act, contractors need to contact a tax advisor to determine how the new law will affect their business. **BP**

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Rich has presented comments before the IRS on proposed regulations and has testified before the House and Senate on the business impact of proposed legislation.

A member of CFMA's South Florida Chapter, he is a member of the Tax and Legislative Affairs Committee, a trustee of the Institute of Certified Construction Financial Professionals (ICCFP), as well as a member and former Chairman of the National Tax Committee of the ABC.

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**Testimony
of the
Alaska Oil and Gas Association
to the
House Ways and Means Committee
Regarding HB 235
April 8, 2005**

Good morning. My name is Judy Brady, and I am the Executive Director of the Alaska Oil and Gas Association ("AOGA"). AOGA is a private trade association whose 18 members companies account for a majority of the oil and gas exploration, development, production, transportation, refining and marketing activities in Alaska. On behalf of AOGA and its members, I thank you for this opportunity to testify on House Bill 235.

AOGA opposes this legislation for two reasons. First, the justification for it has been misstated to you and its fiscal impacts have been significantly overstated. Second, the Bill represents yet another tax increase on the oil industry from this Administration.

To explain our reasons for opposing the Bill, let me first provide you briefly with some background. Last year Congress passed the federal Jobs Act creating, among other things, a tax incentive to improve the competitiveness of manufacturing in the United States, which currently is disadvantaged relative to the rest of the world because national income tax rates on such activity overseas are generally lower. This tax incentive takes the form of a new deduction that is equal to a percentage of a taxpayer's "qualified production activity income" ("QPA Income") from manufacturing activity occurring in the United States. The tax deduction equals 3% of this QPA Income initially; it increases to 6% in 2007 and reaches its full size of 9% beginning in 2010. In order to make this work as an incentive to create and keep jobs in the United States, Congress specifically limited QPA Income to income from domestic, U.S.-only activity.

Alaska's state income tax automatically adopts sections 1 – 1399 and 6001 – 7872 of the Internal Revenue Code, including new sections within these number ranges as they are enacted, amendments as they are made to existing sections, and even repeals of any of these sections in the federal Code. Alaska picks up these federal changes unless the Legislature enacts a law to prevent such a federal change from taking effect, or modify its effect, for state purposes. The new deduction for QPA Income is in Section 199 of the Internal Revenue Code and hence has been picked up for state purposes. House Bill 235 proposes to undo this automatic adoption of Section 199 and keep it from taking effect for state income-tax purposes.

In the fiscal note for this legislation, the Department of Revenue ("DOR") claims that letting Section 199 take effect for Alaska purposes would cost the State between \$94.88 million and

\$104.84 million in total over the FY05 – FY13 period. Further, DOR's fiscal note states it could cost more than half a million dollars a year for DOR to administer Section 199 if it takes effect for state purposes.

Both of these estimates are, in AOGA's opinion, severely overstated because of a faulty premise in DOR's analysis. This premise is stated in the fiscal note as follows:

In order to avoid impermissible discrimination against economic activity outside of the state, taxpayers will be allowed the QPA[Income] deduction on their Alaskan return for all production profits whether the activity occurred in Alaska, another state, or in a foreign country. Production activity conducted in-state, domestic out of state, or in a foreign country will be awarded an equal deduction.

In other words, in assessing the state revenue impact of letting Section 199 take effect, DOR looked at potential "production activity income" everywhere in the world. It did not look just at "qualified" production activity income as defined by Congress, which is only that income which comes from production activity inside the United States.

Despite what DOR asserts to the contrary in its fiscal note, when Alaska passively adopts a limited federal deduction, it does not legally or logically follow from this fact that DOR must, under the Foreign Commerce Clause of the U.S. Constitution, completely remove the limitation in the course of administering the deduction for state tax purposes. There is ample precedent where a geographically limited federal provision remains limited in precisely the same way when it is applied under the Alaska income tax. For instance, expenditures for enhanced oil recovery ("EOR") give rise to a federal tax credit that Alaska also allows, and the federal credit is limited to expenditures for EOR projects in the United States — in administering the EOR credit for state purposes, DOR does not impute a hypothetical credit for EOR projects outside the United States "[i]n order to avoid impermissible discrimination against economic activity outside of the state[.]" instead, DOR uses the same domestic territorial limitation as the federal credit has. We do not see how the domestic territorial limitation in the new QPA Income deduction would be any different from the one for EOR in terms of its potential for "impermissible discrimination." In other words, since DOR isn't applying the EOR credit on a worldwide basis, it is inconsistent for DOR to say it must apply the QPA Income deduction on a worldwide basis.

Because of its faulty premise about how broadly the QPA Income deduction must be applied for state purposes, DOR's estimated revenue impacts are overstated by at least a factor of two or three or more, depending on how much QPA-ish income it foresaw from non-U.S. production activities. Similarly, the estimated administrative cost of half a million dollars a year is entirely a result of this same faulty assumption. The IRS will audit taxpayers' QPA Income from activities in the U.S., and there will be nothing left for DOR to audit and enforce. The half a million dollars a year should, in other words, disappear.

AOGA also disagrees with DOR's conclusion in the fiscal note that the anticipated beneficial effects of the QPA Income deduction at the federal level "cannot be replicated at the state level." At least with respect to oil and gas, the two principal regions of qualified production

activity in the United States are the deep-water Gulf of Mexico and Alaska. With only two "hot spots" for the action to occur in, it seems likely that Alaska would be ahead of the game when the incentive works in attracting production activity to the U.S. Given DOR's contrary conclusion about these benefits for Alaska, it seems improbable that DOR made any serious attempt to estimate and include the increases in state tax revenues from the production activities in Alaska that this tax incentive would help attract to this state.

Thus, both on policy grounds as well as potential fiscal impacts, the justification that DOR has given for this legislation has been both overstated and misstated.

This brings me to AOGA's second reason for opposing this legislation: it represents yet another tax increase on the oil industry from this Administration. It is a tax increase because Section 199 of the Internal Revenue Code was automatically adopted for state purposes as of January first of this year, when it took effect for federal purposes. Section 199 is, in other words, already the status quo. HB 235 proposes to change this status quo by undoing the adoption of Section 199, and in doing so it will raise corporate income taxes for our industry and every other industry in the state having "qualified production activity."

DOR's just-released Spring 2005 Revenue Sources Book predicts future state oil and gas revenues through FY2015 based on assumptions that tens of billions of dollars of new investments will be made during that time which will hold oil production at the projected levels and keep it from declining as it otherwise will. Fortunately for Alaska, the opportunities for making these investments, and the possibility that they will indeed result in the production being hoped for, are not some wild pipe dream, but a plausible expectation. The key to fulfilling this bright expectation lies in winning the competition for funding so that the potential Alaskan investments will become actual investments.

Raising taxes does not make Alaska's investment opportunities more competitive. It makes them less competitive.

Some have said that, with today's high oil prices, Alaska can and should raise its oil taxes — the producers can afford to pay a larger share out of this "windfall," they say. This reasoning misses the real issues here. From the industry's perspective, the question is not about how much it can afford to pay to Alaska, but how much it can afford to invest in Alaska relative to opportunities elsewhere. Fifty-dollar oil is not \$50 just for Alaskan oil, but for all oil wherever produced. High oil prices do not change the fact that Alaska is among the most expensive places in the world to operate and produce oil.

From the State's perspective as well, the question is not so simplistic as to be only about what the industry might be able to pay. There is a trade-off between, on the one hand, taking a larger share now and having less available to be shared in the future because some investments cease to be competitive enough to win funding, and on the other hand, taking the same or perhaps even a more modest share and having more available to be shared in the future because more investments become competitive enough to win funding. Or to put it another way, which

gives the State more — taking a wider slice out of a smaller pie, or a narrower slice out of a larger pie? and what is the optimum width for that slice so that it has the most fiscal “weight”?

Some simplistically believe that \$50 oil will justify any and all of the investment opportunities that industry has in Alaska, despite raising taxes as proposed in this Bill or raising them by lumping satellite fields with their parent field for ELF purposes. Such reasoning apparently led DOR and DNR to advise the Governor to introduce this Bill, and to make the Prudhoe Bay ELF decision. The Governor was, no doubt, assured in both situations that neither action would actually change investment decisions.

The advice that the Governor received about the ELF decision has already been proven wrong. The Orion field in the western region of the Prudhoe Bay Unit, for example, is a development that industry has been diligently pursuing to help stem the decline of North Slope production. The producers have already stated that, because of the tax increase under that decision, they will not be able to proceed with the planned expansion of the Orion field as it is currently proposed. This expansion would have been a \$650 million project to develop viscous oil in the Prudhoe Bay Unit. An associated casualty is the I-100 Well for viscous oil development that was on this year's drilling schedule for Prudhoe Bay, but now has been removed and indefinitely deferred.

The advice that the Governor has been given about this Bill is also wrong, for the same reasons. Because it has not become law, there is no hard, empirical evidence to offer you to show that this Bill is ill-advised for the State. Fortunately, however, this same circumstance means it is not too late for you, the Legislature, to avoid repeating the mistake of the Governor's advisors. You are in the position of being able to refrain from acting, and you should.

AOGA has long said, and we say again now, any change to Alaska's existing fiscal regime for our industry needs to be carefully evaluated for its impacts on each of the different kinds of investments there are for getting more oil produced. Otherwise, there is a substantial risk that the anticipated benefits from such a change could end up being more than offset by unanticipated negative effects of that change on other kinds of oil investments.

We believe that raising oil taxes now, as HB 235 would do, will send precisely the wrong message to the industry about making the investments that Alaska so desperately needs and is counting on for its own fiscal future. Accordingly, AOGA opposes this Bill and respectfully urges that you oppose it too.

This concludes our testimony. Thank you again for the opportunity to appear before you today and testify.

SCOMM

142:20

Bill Summary

HB 262

“An Act relating to the taxation of income”

HB 262 would impose a state income tax on individuals and fiduciaries (estates and trusts) only if State expenses exceed revenues. The rate of tax increases as the gap between revenues and expenses increases. The Department of Revenue calculates the tax rate annually, based on the criteria outlined in Section 1 of the bill if there is a fiscal gap. The department notifies the legislature and the governor of the tax rate within 60 days after the beginning of the fiscal year. The tax rate remains in effect until the Department determines that an adjustment should be made.

This measure is a component of a long-range fiscal plan for the State of Alaska, and speaks to the apparent need for additional state revenues only in one instance – when expenses exceed revenues. Section 1 of the bill includes residents, nonresidents, and part year residents as income tax payers. The income tax rate will be the same for all wage earners in Alaska, thus transient workers will contribute to the coffers of the State of Alaska and share the tax burden with residents of Alaska, if the tax is imposed.

The bill does not preclude use of any other revenue source to close any future fiscal gap, and it will be the full responsibility of the legislature to adopt a balanced budget, or else the people will pay an income tax.

HB 262 – An Act Relating to Taxation of Income

Sectional Analysis

Introduction:

HB 262 would re-impose a state income tax on individuals and fiduciaries (estates and trusts) only in certain instances. A state income tax was last on the books in Alaska in 1980. HB 262 reflects the elements of HB 470 (introduced in 2004) except for Section 1.

The core of the bill reinstitutes the individual income tax if there is a negative fiscal gap, makes the tax a percentage of a taxpayer's federal income tax liability (form 1040, line 60), and sets up a graduated scale of taxation depending on the size of the State's fiscal gap. The bill also provides requirements for completing filing and employer responsibilities, makes provision for amended filings, and identifies those credits available to the taxpayer.

The major tax credit of interest to Alaskans would be the tax credit authorized for real and personal property taxes paid to a municipality if the tax is imposed. This credit impacts the greater potential for revenue under this measure, but is designed to soften the effect of the contingent income tax on working families.

Bill Section 1: Adds to AS 43.20.011, a provision for the taxation of income of every resident, nonresident, and part year resident, individual and fiduciary in the state. It apportions the tax liability of a non-resident, part year resident, or fiduciary, as a percentage of their federal income tax liability that is their taxable income from sources within Alaska only. However, tax would be paid only if the State's expenses exceed revenues. The tax would only be imposed if the gap were as follows:

<u>Gap (millions \$)</u>	<u>Tax Rate (%)</u>
≤ 20	0.5
20-80	1.0
80-100	2.0
100-300	3.0
300-600	5.0
600-800	8.0
≥800	10.0

This section further requires the use of one's federal filing status as that which would be used in determining the state income tax liability.

Bill Section 2: Directs individuals and fiduciaries to file state income tax returns with the

Department of Revenue, the same as corporations and others required to file under 26 U.S.C., the Internal Revenue Code. Provides for allowable credits and payments against the state tax liability.

Bill Section 3: Makes the state income tax liability due and payable at the same time and in the same manner as one's federal income tax liability.

Bill Section 4: Requires the taxpayer to file with the state tax return, a copy of one's federal tax return for the same tax year. It also provides for the filing of an amended return within sixty days following a final determination of the taxpayer's federal tax liability if such should be in question.

Bill Section 5: Adds a new section to AS 43.20 that determines income sources within the state, which would be used in calculating the tax liabilities of non-residents, part-year residents, or fiduciaries. For purposes of calculating taxable income attributable to sources from within the state, this section also provides that deductions and adjustments are allowed only to the extent they are connected with income that arises from sources within the state.

Bill Section 6: Adds salaries or wages, and estate or trust income, to the list of income sources considered as being from within the state.

Bill Section 7: Provides for the Multi-state Tax Compact, AS 43.19, as the authority in determining what income is taxable from entities, which do business both partly inside and partly outside of the state.

Bill Section 8: Establishes credits against the state income tax liability, beginning with the amount of payroll tax withheld. It further establishes a credit for resident and part-year resident taxpayers for income taxes imposed by other U.S. states or territories, on income that is also subject to tax in Alaska. This credit, though, is limited to the proportion of the tax calculated under Alaska statute that relates to the percentage the taxable income from the other jurisdiction bears to the taxpayer's total taxable income. The credit may not exceed actual taxes paid to the other jurisdiction.

A significant tax credit authorized under this section allows a tax deduction for real and personal property taxes paid to a municipality in this state.

Bill Section 9: Provides for corporate taxpayers to allocate and apportion their net income as provided in the Multi-state Tax Compact, on income taxable both inside and outside the state, or on income from other sources both inside and outside Alaska.

Bill Section 10: Establishes tax collection procedures, including deduction and withholding features and instructions to employers regarding tax payments and other information due the state. This section also describes the employer reporting responsibilities to the employee, annually by January 31st, or thirty days after termination,

of wages / compensation, and withholding/deductions. Employer penalties are also referenced as those in AS 43.05.220 (d).

This section also establishes the authority for governmental entities to deduct and withhold from employees, as well as return deductions and withholdings to those officers of the entities appropriately designated to perform these functions. The terms "employee," "employer," and "wages" are defined by the Internal Revenue Code under 26 U.S.C.

Bill Section 11: Imposes the same time limitations on the assessment and collection of taxes by the state, and the same exceptions, as is found in the Internal Revenue Code, 26 U.S.C. 6501- 6503. When additional tax is due from changes made to a federal income tax return, the period of limitation begins from the date that one files an amended return. If no amended return is filed, the additional tax due may be assessed at any time.

Bill Section 12: Defines the terms "bank," "corporation," "fiduciary," "fiscal year," "individual," "Internal Revenue Code," "resident," "non-resident," "part-year resident," "person," "taxable year," "taxpayer," and "trade or business."

Bill Section 13: Identifies necessary repealers.

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

Fiscal Note Number: _____
Bill Version: HB 262
() Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue 04
Title Income Tax RDU Tax and Treasury
Component Tax
Sponsor Ways & Means
Requester (H) W& M Component No. 2476

Expenditures/Revenues (Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	*	*	*	*	*	*

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

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	*	*	*	*	*	*

Estimate of any current year (FY2005) cost: 0.0

Check this box (X) if funding for this bill is included in the Governor's FY 2006 budget proposal: ☐

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

*See page 2

Prepared by: Mike Williams & Chuck Harlamert Phone 269-6620
Division Tax Division Date/Time 4/14/05 4:32 PM
Approved by: Tom Boutin, Deputy Commissioner Date 4/14/2005
Agency Department of Revenue

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

BILL NO. HB 262

ANALYSIS CONTINUATION

Revenue Analysis

The proposed bill would create an income tax on individuals and fiduciaries, based on a percentage of the individual's entire federal income tax liability. The proposed tax rate varies, based on the how much state expenditures exceeds state revenues in the preceeding fiscal year.

The proposed bill would allow property tax paid to a municipality as a credit against the income tax, as well as taxes paid to other states on income earned in those states.

The proposed bill provides for withholding on income at the source, and creates a duty of the employer to remit taxes to the state.

Estimating revenue is particularly difficult with this bill because of the variable nature of the tax and the bill language does not define what "entire federal tax liability" means. Also, on a per-individual basis there is no method currently available to match property tax and personal income tax liabilities. Consequently, we used data from the Internal Revenue Service to estimate property tax credits by income group, and made assumptions about home ownership statewide using US Census Bureau data. The following table provides the range of revenue possible (net of credits) at the rates given:

Rate	Half year	Full year
• 0.5%:	\$ 1.5 million	\$3.3 million
• 1.0%:	\$ 3.0 million	\$ 6.0 million
• 2.0%:	\$ 7.0 million	\$14.0 million
• 3.0%:	\$10.0 million	\$20.0 million
• 5.0%:	\$16.0 million	\$32.0 million
• 8.0%:	\$26.0 million	\$52.0 million
• 10.0%:	\$30.0 million	\$65.0 million

Cost Discussion

The department has previously estimated the operating costs of a statewide income tax at approximately \$8 million per year with initial capital costs ranging between \$7 and \$8 million. These estimates however were for a stable program and do not reflect the needs and financial considerations associated with a contingent tax program such as proposed in this bill. Turning a program of this size on and off year to year will produce significant inefficiencies compared to a stable program and will impair service levels. The program will require the department to maintain operating infrastructure and professional and technical staff during periods when the tax is dormant and ramp up to full operating capacity when the tax is triggered. We project that the program will demand a significant capital investment to facilitate intermittent processing by temporary staff with minimal training requirements.

Our rough cost estimates call for \$15-\$20 million in capital spending with dormant period operating costs of \$5-\$6 million increasing to \$7-\$8 million during fiscal years beginning in any calendar year in which the tax is imposed. For example, were the tax in effect for calendar year 2006, the active program budget level of \$7-\$8 million would be necessary for FY07.

This program would be the first state income tax program established during the internet age and, because the program is intermittent, will necessarily rely on internet and other technologies to be successful. It is important that the bill reflect these needs and opportunities by providing the department with the authority to provide incentives for payment, filing, and reporting methods that facilitate efficient tax administration. It may also be necessary to authorize the imposition of electronic filing mandates for paid tax preparers.

General

At present, no other state uses federal tax liability as a basis for calculating income tax. In context of the national debate for income tax simplification, this bill confounds the concepts of simplicity, stability, and predictability.

SCOMM

142:21

Sponsor Statement

HB 263

HB 263 would impose a tax of \$10 per year on each employed individual age 19 or older, including the self-employed. Under this bill, the employer would deduct \$10 from each employee's salary on his or her first regular payroll after January 1, 2006. A provision has been added to prevent this tax from being deducted more than once when the employee provides proof to their new employer that the tax has already been satisfied. The tax will not apply to individuals not required to file a federal income tax return under 26 U.S.C. (Internal Revenue Service Code).

The tax collected under AS 43.45.021 would be deposited into the state's general fund, but accounted for separately. In turn, the legislature may then appropriate the amounts collected under this section for education.

This authorization is not intended to create a dedication of funds in violation of art. IX, 7, of the Constitution of the State of Alaska.

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: **HB263-DOLWD-UI-04-12-05**
 () Publish Date: _____

Revision Date/Time (Note if correction): _____
 Title: **Employment Tax**

Department: **Labor and Workforce Development**
 RDU: **Employment Security**
 Component: **Unemployment Insurance**

Sponsor: **House Ways & Means**
 Requester: **House Ways & Means**

Component Number: **2276**

Expenditures/Revenues

(Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
-----------------------------	--	--	--	--	--	--

CHANGE IN REVENUES ()						
-------------------------------	--	--	--	--	--	--

FUND SOURCE

(Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other Training and Building Fund)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2005) cost: None

Mark this box (X) if funding for this bill is included in the Governor's FY 2006 budget proposal: ☐

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

There is no anticipated fiscal impact to this department resulting from this legislation as the Alaska Department of Revenue will collect the tax.

Prepared by: **Thomas W. Nelson, Director**
 Division: **Employment Security Division**
 Approved by: **Greg O'Claray, Commissioner**
 Agency: **Department of Labor and Workforce Development**

Phone: **465-5933**
 Date/Time: **4/12/05 10:33 AM**
 Date: **4/12/2005**

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

Fiscal Note Number: _____
Bill Version: HB 263
() Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue 04
Title Employment Tax RDU Tax and Treasury
Component Tax
Sponsor Ways & Means
Requester (H) W& M Component No. 2476

Expenditures/Revenues (Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	*	*	*	*	*	*

CAPITAL EXPENDITURES						
-----------------------------	--	--	--	--	--	--

CHANGE IN REVENUES ()	3,439.6	3,769.2	3,769.2	3,769.2	3,769.2	3,769.2
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	*	*	*	*	*	*

Estimate of any current year (FY2005) cost: 0.0

Check this box (X) if funding for this bill is included in the Governor's FY 2006 budget proposal: ☐

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

*See Page 2

Prepared by: Micheal Williams & Brett Fried Phone 269-6620
Division Tax Division Date/Time 4/13/05 8:31 AM
Approved by: Tom Boutin, Deputy Commissioner Date 4/13/2005
Agency Revenue

FISCAL NOTE

STATE OF ALASKA
2005 LEGISLATIVE SESSION

BILL NO. HB 263

ANALYSIS CONTINUATION

Discussion:

A tax of \$10 a year is imposed on each individual 19 years of age or older who, during the entire calendar year, receives compensation greater than \$1,000 in the state. We estimate that there are about 432,704 workers in the state. We used the Alaska Department of Labor 2004 average monthly federal employment data for the number of federal workers (17,100), IRS tax year 2001 return data to estimate the number of self-employed workers (37,831) and the Department of Labor's "Nonresidents Working in Alaska 2003" to estimate the remaining workers (377,773). We then adjusted this data using the estimated ratio of workers who are both 19 years of age or older and earn over \$1,000 a year to total workers in the state (about 87 percent based on Department of Labor data). The tax base is then an estimated 376,916 individuals or approximately \$3.8 million at \$10 a person. It is a little less in the first year because we won't receive returns from self-employed individuals until FY 2007. Based on Department of Labor data, we estimate that about 16 percent of the individuals who will be subject to this tax are nonresidents.

Based on previous cost projections for an education (head) tax we project \$1.1 million in annual operating costs and \$750,000 in capital expenditure. These estimates assume that it is the legislature's intent to pursue enforcement efforts and employ processing capability that enables the department to monitor refund claims and provide taxpayer service under our existing standards. The estimated and performance objectives are consistent with a \$100 education tax and may not be appropriate for a \$10 education tax.

SCOMM

142:22

24-LS1453\Y
Wayne
1/24/06

CS FOR HOUSE BILL NO. 374()

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY

Offered:

Referred:

Sponsor(s): HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to the dividend paid to the state by the Alaska Housing Finance
2 Corporation and to establishment of a retirement benefit liability account in the
3 Department of Revenue, and redirecting deposit of a part of the annual dividend of the
4 Alaska Housing Finance Corporation to that account; and providing for an effective
5 date."

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

7 * **Section 1.** AS 18.56.089(c) is amended to read:

8 (c) The corporation shall make a dividend available to the state each fiscal
9 year. The legislature may appropriate the dividend for capital projects. The
10 corporation shall pay the dividend for a current fiscal year, minus amounts
11 appropriated for capital projects, into the retirement benefit liability account
12 established in AS 37.10.200 [TO THE STATE] before the end of that fiscal year.
13 [THE LEGISLATURE MAY APPROPRIATE THE DIVIDEND FOR CAPITAL

1 PROJECTS.] The corporation shall notify the commissioner of revenue of the amount
2 of each dividend under this subsection for inclusion in the state operating budget and
3 shall also notify the commissioner when each dividend is available for payment [TO
4 THE STATE]. The amount of the dividend for a current fiscal year is calculated as
5 follows:

6 (1) the lesser of \$103,000,000 or 75 percent of the adjusted change in
7 net assets [NET INCOME] of the corporation for the base fiscal year;

8 (2) minus the amount of money from the corporation used during that
9 current fiscal year for bond repayment and other costs related to the bonds issued
10 under

11 (A) ch. 26, SLA 1996, up to a maximum of \$1,000,000;

12 (B) sec. 10(b), ch. 130, SLA 2000;

13 (C) sec. 1, ch. 1, SSSLA 2002;

14 (D) sec. 4, ch. 120, SLA 2004; and

15 (3) minus any appropriation of unrestricted unencumbered money of
16 the corporation during the current fiscal year, other than an appropriation for the
17 corporation's operating budget.

18 * **Sec. 2.** AS 18.56.089(d) is amended by adding a new paragraph to read:

19 (4) "adjusted change in net assets" means the change in net assets from
20 the base fiscal year, adjusted for capital expenditures incurred during the base fiscal
21 year.

22 * **Sec. 3.** AS 37.10 is amended by adding a new section to read:

23 **Article 4A. Retirement Benefit Liability Account.**

24 **Sec. 37.10.200. Retirement benefit liability account.** (a) The retirement
25 benefit liability account is created in the Department of Revenue.

26 (b) Money in the retirement benefit liability account may be appropriated to
27 the state and political subdivisions of the state, including regional educational
28 attendance areas, for employer contributions to pay past service liabilities of the public
29 employees' retirement system and the teachers' retirement system and for other
30 purposes. Income earned on money in the account may be appropriated to the account
31 annually.

1 (c) Nothing in this section dedicates funds for a specific purpose.

2 (d) In this section, "employer contribution" means a contribution described in
3 AS 14.25.070(a) and AS 39.35.270(a).

4 * **Sec. 4.** AS 37.10.220 is amended by adding a new paragraph to read:

5 (16) recommend to the legislature an amount to be appropriated for the
6 next fiscal year from the account established under AS 37.10.200 to each political
7 subdivision, including regional educational attendance areas, participating in the
8 teachers' retirement system under AS 14.25 or the public employees' retirement system
9 under AS 39.35, which amount shall be determined by

10 (A) calculating the amount needed by the political subdivision
11 for that fiscal year to liquidate past service liability using the rate determined
12 under (8)(B) of this section;

13 (B) deducting from the amount determined under (A) of this
14 paragraph the amount of the total appropriation from the account under
15 AS 37.10.200 that was received by that political subdivision for the previous
16 fiscal year and spent for a purpose other than the purpose for which the
17 appropriation was made.

18 * **Sec. 5.** The uncodified law of the State of Alaska enacted by sec. 2, ch. 76, SLA 2003, as
19 amended by sec. 3, ch. 120, SLA 2004, is amended to read:

20 Sec. 2. TRANSITION: PHASE-IN OF AMOUNT OF DIVIDEND. (a)
21 Notwithstanding the amount of the annual dividend under AS 18.56.089(c), the
22 dividend is calculated as follows for the following years:

23 (1) fiscal year 2004:

24 (A) \$103,000,000;

25 (B) minus the amount of money from the Alaska Housing
26 Finance Corporation used during fiscal year 2004 for bond repayments and
27 other costs related to the bonds issued under

28 (i) ch. 26, SLA 1996, up to maximum of \$1,000,000;

29 (ii) sec. 2, ch. 129, SLA 1998;

30 (iii) sec. 10(b), ch. 130, SLA 2000;

31 (iv) sec. 1, ch. 1, SSSLA 2002;

1 (v) sec. 4, ch. 120, SLA 2004 [OF THIS ACT]; and

2 (C) minus any appropriation of unrestricted, unencumbered
3 money of the corporation during fiscal year 2004, other than an appropriation
4 for the corporation's operating budget;

5 (2) fiscal year 2005:

6 (A) \$103,000,000;

7 (B) minus the amount of money from the Alaska Housing
8 Finance Corporation used during fiscal year 2005 for bond repayments and
9 other costs related to the bonds issued under

10 (i) ch. 26, SLA 1996, up to a maximum of \$1,000,000;

11 (ii) sec. 2, ch. 129, SLA 1998;

12 (iii) sec. 10(b), ch. 130, SLA 2000;

13 (iv) sec. 1, ch. 1, SSSLA 2002;

14 (v) sec. 4, ch. 120, SLA 2004 [OF THIS ACT]; and

15 (C) minus any appropriation of unrestricted, unencumbered
16 money of the corporation during fiscal year 2005, other than an appropriation
17 for the corporation's operating budget;

18 (3) fiscal year 2006:

19 (A) \$103,000,000;

20 (B) minus the amount of money from the Alaska Housing
21 Finance Corporation used during fiscal year 2006 for bond repayments and
22 other costs related to the bonds issued under

23 (i) ch. 26, SLA 1996, up to a maximum of \$1,000,000;

24 (ii) sec. 2, ch. 129, SLA 1998;

25 (iii) sec. 10(b), ch. 130, SLA 2000;

26 (iv) sec. 1, ch. 1, SSSLA 2002;

27 (v) sec. 4, ch. 120, SLA 2004 [OF THIS ACT]; and

28 (C) minus any appropriation of unrestricted, unencumbered
29 money of the corporation during fiscal year 2006, other than an appropriation
30 for the corporation's operating budget;

31 (4) fiscal year 2007:

(A) the lesser of \$103,000,000 or 95 percent of the adjusted change in net assets [NET INCOME] of the Alaska Housing Finance Corporation for fiscal year 2005;

(B) minus the amount of money from the Alaska Housing Finance Corporation used during fiscal year 2007 for bond repayments and other costs related to the bonds issued under

(i) ch. 26, SLA 1996, up to a maximum of \$1,000,000;

(ii) sec. 10(b), ch. 130, SLA 2000;

(iii) sec. 1, ch. 1, SSSLA 2002;

(iv) sec. 4, ch. 120, SLA 2004 [OF THIS ACT]; and

(C) minus any appropriation of unrestricted, unencumbered money of the corporation during fiscal year 2007, other than an appropriation for the corporation's operating budget;

(5) fiscal year 2008:

(A) the lesser of \$103,000,000 or 85 percent of the adjusted change in net assets [NET INCOME] of the Alaska Housing Finance Corporation for fiscal year 2006;

(B) minus the amount of money from the Alaska Housing Finance Corporation used during fiscal year 2008 for bond repayments and other costs related to the bonds issued under

(i) ch. 26, SLA 1996, up to a maximum of \$1,000,000;

(ii) sec. 10(b), ch. 130, SLA 2000;

(iii) sec. 1, ch. 1, SSSLA 2002;

(iv) sec. 4, ch. 120, SLA 2004 [OF THIS ACT]; and

(C) minus any appropriation of unrestricted, unencumbered money of the corporation during fiscal year 2008, other than an appropriation for the corporation's operating budget.

(b) For purposes of this section, "adjusted change in net assets" ["NET INCOME"] has the meaning set out in AS 18.56.089(d).

* **Sec. 6.** AS 18.56.089(d)(3) is repealed.

* **Sec. 7.** This Act takes effect July 1, 2006.

ALASKA STATE LEGISLATURE

REPRESENTATIVE BRUCE WEYHRAUCH

CHAIR



ALASKA
STATE CAPITOL
JUNEAU, ALASKA 99801-1182

(907) 465-6863
FAX (907) 465-2273

HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

Sponsor Statement *HB 374*

"An act relating to establishment of a retirement benefit liability account in the Department of Revenue and redirecting deposit of annual dividends of the Alaska Housing Finance Corporation to that account; and providing for an effective date."

The State of Alaska faces a \$6 billion funding shortfall in the State's two retirement systems, PERS and TRS.

This bill establishes the Retirement Benefit Liability Account. The funding source for this account is the annual dividend paid to the State of Alaska by the Alaska Housing Finance Corporation. Calculation formulas are outlined in Sec. 1 of the bill. The Retirement Liability Account is created in the Department of Revenue. Funds in the account may be appropriated to state and political subdivisions of the state, including Regional Educational Attendance Areas (REAA's), to pay the employer contributions for past service liabilities in the PERS and TRS, and for other purposes. Any income earned by the account is appropriated back into the account annually.

Political subdivisions of the state, including REAA's, receiving fiscal year 2006 appropriations of money for use as employer contributions to pay past service liabilities of the PERS and TRS, are rewarded with an appropriation of funds paid directly to the Retirement Benefit Liability Account.

This legislation addresses the need for a recurring source of funding to pay past service liabilities in the PERS and TRS. The bill holds harmless any community failing to use appropriated funds to cover past service retirement system employer liabilities, *if* the failure results from reliance on representations by state officials about employer contribution levels.

FISCAL NOTE

STATE OF ALASKA
2006 LEGISLATIVE SESSION

Fiscal Note Number: 1
 Bill Version: HB 374
 () Publish Date: 1/19/2006

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
 Title An Act relating to establishment of a retirement RDU Taxation and Treasury
benefit liability acct; redirecting the deposit of AHFC dividends Component Treasury Division
 Sponsor House Ways and Means
 Requester _____ Component No. _____

Expenditures/Revenues (Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Personal Services						
Travel						
Contractual	0.0	0.0	0.0	0.0	0.0	0.0
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

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

1002 Federal Receipts						
1003 GF Match						
1004 GF	0.0	0.0	0.0	0.0	0.0	0.0
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2006) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal: ☐

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

HB374 creates a new account in the Department of Revenue, Treasury Division, called the retirement benefit liability account. Subject to appropriation, it also redirects the Alaska Housing Finance Corporation annual dividend to this new account. AHFC estimates the annual dividend in FY2007 at \$80 million and at \$40 million over the next five years.

This fiscal note assumes the funds would stay in the retirement benefit liability account for one quarter and would be transferred to each political subdivision, including regional education attendance areas, participating in teachers' retirement system or public employees retirement system. The total amount available for transfer in FY2007 would be \$80,650,000 and \$40,325,000 in subsequent years. In order to avoid administrative costs of processing the transfers, the Department of Revenue would work with

Prepared by: Susan M. Taylor, Comptroller Phone 907-465-2352
 Division Treasury Date/Time 1/19/2006, 4:00 pm
 Approved by: Tom Boutin, Deputy Commissioner Date 1/19/2006
 Agency Department of Revenue

FISCAL NOTE

STATE OF ALASKA
2006 LEGISLATIVE SESSION

BILL NO. HB374

ANALYSIS CONTINUATION

the Department of Education and Early Development and Department of Commerce, Community and Economic Development for efficiencies in transferring the funds to the pension system participants according to their normal schedule of payments to political subdivisions, including regional educational attendance areas, participating in the pension systems.

FISCAL NOTE

STATE OF ALASKA
2006 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: HB 374
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Administration
 Title An Act relating to establishment of a retirement RDU Centralized Administrative Services
benefit liability account in the Dept. of Revenue... Component Retirement and Benefits
 Sponsor House Special Committee on Ways and Means
 Requester House Special Committee on Ways and Means Component No. 64

Expenditures/Revenues (Thousands of Dollars)

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

OPERATING EXPENDITURES	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
-------------------------------	--	--	--	--	--	--

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2006) cost: 0.0

Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal: ☐

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

HB 374 establishes a new account, the Retirement Benefit Liability Account (RBLA), in the Department of Revenue from which appropriations may be made by the legislature for grants to political subdivisions and regional education attendance areas. Appropriations may also be made to the State. The purpose of the appropriations from the RBLA may be for participating employers to pay their past service liabilities to the Public Employees' and Teachers' Retirement systems or for other purposes.

The legislation also directs the annual dividend from the Alaska Housing Finance Corporation be deposited into the Retirement Benefit Liability Account.

This bill has no fiscal impact on the Division of Retirement and Benefits.

Prepared by: Melanie Millhorn, Director Phone 465-4408
 Division Retirement and Benefits Date/Time 1/20/06 8:03 AM
 Approved by: Mike Tibbles, Deputy Commissioner Date 1/20/2006
 Agency Department of Administration



Alaska Retirement Management Board

P.O. Box 110405
Juneau, Alaska 999811-0405
(907) 465-3749

January 20, 2006

The Honorable John Harris
Speaker, Alaska House of Representatives
Alaska State Capitol
Juneau, Alaska 99801-1182

Re: Alaska Retirement Management Board
Report to the Legislature

Dear Representative Harris:

In accordance with the provisions of Senate Bill 141, the Alaska Retirement Management Board (ARMB) was appointed by the governor and accepted fiduciary responsibility for the state's retirement systems as of October 1, 2005. At its initial meeting, I was elected chair by my fellow board members.

Section 141 of the legislation required the ARMB to present a report to the legislature within 120 days of board appointment or 15 days after the first day of the legislative session. This section further directed that the report include the board's (1) preliminary assessment of the financial health of all public employees' retirement plans and all teachers' retirement plans; (2) assessment of the actuarial services purchased by the board; (3) recommendations for additional legislative or administrative policy to improve the financial health of the retirement plans; (4) short-term and long-term recommendations for addressing the unfunded liability of the retirement plans; and (5) recommendations for legislative procedures regarding fiscal notes for new legislation affecting the retirement plans.

Enclosed is the Report to the Legislature prepared and submitted by the ARMB. We request an opportunity for the chair to present the report to an appropriate House committee, and answer any questions legislators may have.

Sincerely,

A handwritten signature in cursive script that reads "Gary M. Bader for".

Gail R. Schubert, Chair

Enclosure

ALASKA RETIREMENT MANAGEMENT BOARD

REPORT TO LEGISLATURE

January 20, 2006

Table of Contents

I. Introduction

II. Report

A. Senate Bill 141 Report Requirements:

1. Preliminary Assessment of the financial health of all public employees' retirement plans and all teachers' retirement plans
2. Assessment of the actuarial services purchased by the board
3. Recommendations for additional legislative or administrative policy to improve the financial health of the retirement plans
4. Short-term and long-term recommendations for addressing the unfunded liability of the retirement plans
5. Recommendations for legislative procedures regarding fiscal notes for new legislation affecting the retirement plans

B. Other Senate Bill 141 Requirements:

1. Defined contribution plan
2. Health Reimbursement Arrangement Plan
3. Office of Administrative Appeals

III. Alaska Retirement Management Board

A. Trustee Appointments

B. Board Organization and Structure

I. Introduction

Senate Bill 141, an act relating to the teachers' and public employees' retirement systems and creating a defined contribution plan for employees hired on or after July 1, 2006, passed the legislature May 23, 2005 and was signed into law by Governor Murkowski on July 27, 2005. The legislation created the Alaska Retirement Management Board to serve as the fiduciary of the assets of the state's retirement systems, the Supplemental Annuity Plan, and the deferred compensation program for state employees. Senate Bill 141 charged the board with responsibility to report its findings and recommendations on the following five items:

1. the board's preliminary assessment of the financial health of all public employees' retirement plans and all teachers' retirement plans;
2. an assessment of the actuarial services purchased by the board;
3. recommendations for additional legislative or administrative policy to improve the financial health of the retirement plans;
4. short-term and long-term recommendations for addressing the unfunded liability of the retirement plans; and
5. recommendations for legislative procedures regarding fiscal notes for new legislation affecting the retirement plans.

The board assumed its statutory role October 1, 2005 and held its first meeting on October 11-12, 2005. The board approved the hiring of Buck Consultants as its actuary, and at its second meeting on November 29-30, 2005, heard its first presentation from Buck Consultants. At that meeting, the actuary advised the board it would not have a Fiscal Year 2005 valuation for the public employees' retirement system (PERS) or the teachers' retirement system (TRS) available until March 2006. Without sound actuarial information, the board believes it can best serve the legislature by providing preliminary assessments and recommendations at this time, and provide additional recommendations based upon updated actuarial data when available in March.

II. Report

A. Senate Bill 141 Report Requirements

1. Preliminary Assessment of the financial health of all public employees' retirement plans and all teachers' retirement plans

The ultimate cost of a pension plan is the cost of benefits and the cost of administration less investment returns generated by the plan's assets. None of these factors are known exactly until the last benefit is paid, so they are estimated and measured in an actuarial valuation. To develop these estimates, assumptions must be made with regard to the amount of plan costs and their economic value on the valuation date. The assumptions chosen for the actuarial valuation are central to funding the plan in an orderly way and with assurance that the funds accumulated through annual contributions and investment returns will provide participants with promised benefits.

The June 30, 2005 valuation will be prepared and presented to the board in March 2006 for review and approval. If approved, final valuation reports will be available in April, with the exception of the Public Employees' Retirement System supplemental report, which will be available in June.

Since economic and demographic factors change over time, periodic studies of the assumptions and their relation to past and expected future experience are undertaken to determine whether they continue to be valid or if changes should be made. These studies are referred to as experience studies. The last experience study conducted on the Public Employees' Retirement System and the Teachers' Retirement System was performed in 2000. Changes to assumptions were incorporated into the June 30, 2002 valuation.

The system's actuary (Buck Consultants) will perform an experience study covering fiscal years 2002 to 2005. The actuary will then develop proposed changes to past assumptions in a study to be presented to the board in late May for discussion at its June meeting. Approved assumption changes will be incorporated into the study to determine the actuarial cost impact of new assumptions. The actuary will present this information to the board at the September meeting. Assumption changes approved by the board will be incorporated into the next valuation (June 30, 2006).

The last valuation date for the plans in the retirement system was June 30, 2004. The funding ratios, unfunded liabilities and contribution rates of each system as of that date are as follows:

(a) Public Employees' Retirement System (PERS). The PERS defined benefit plan funding ratio (valuation assets to liabilities) was 70.2%, and the plan had an unfunded liability of \$3.4 billion.

The average actuarially determined contribution rate for the PERS defined benefit plan was 28.19%. Valuation data is used to set contribution rates in the future. Therefore, June 30, 2004 valuation data is used to set contribution rates for fiscal year 2007. The board set the fiscal year 2007 contribution rate at 21.77%, a 5 point increase in the rate for the prior fiscal year, as communicated to employers prior to the formation of the board.

(b) Teachers' Retirement System (TRS). The TRS defined benefit plan funding ratio was 62.8% and the plan had an unfunded liability of \$2.3 billion.

The actuarially determined contribution rate for the TRS defined benefit plan was 41.78%. Valuation data is used to set contribution rates in the future. Therefore, June 30, 2004 valuation data is used to set contribution rates for fiscal year 2007. The board set the fiscal year 2007 contribution rate at 26.00%, a 5 point increase in the rate for the prior fiscal year, as communicated to employers prior to the formation of the board.

(c) Judicial Retirement System (JRS). The JRS defined benefit plan funding ratio was 88.01% and the plan had an unfunded liability of \$9.6 million.

The actuarially determined contribution rate for the JRS defined benefit plan was 37.37%. Valuation data is used to set contribution rates in the future. Therefore, June 30, 2004 valuation data is used to set contribution rates for fiscal years 2007 and 2008 (valuations are done every other year for this plan). The Commissioner of Administration set the fiscal years 2007 and 2008 contribution rates at 37.37%.

(d) National Guard and Naval Militia System (NGNMRS). The NGNMRS defined benefit plan funding ratio was 67.8% and the plan had an unfunded liability of \$6.4 million.

The actuarially determined contribution amount for the NGNMRS defined benefit plan was \$1,737,406. Valuation data is used to set contribution amounts for future years. Therefore, June 30, 2004 valuation data is used to set contribution amounts for fiscal years 2007 and 2008 (valuations are done every other year for this plan). The board set the fiscal years 2007 and 2008 contribution amount at \$1,737,406 for each year.

2. Assessment of the actuarial services purchased by the board

Senate Bill 141 sets forth the requirement that the board contract for an independent audit of the state's actuary at least once in a four-year period. Notwithstanding this requirement, it has been the practice of the Alaska Division of Retirement and Benefits to conduct audits on the actuary as recommended by the division or at the request of the boards at periodic time intervals. The most recent audit was performed in 2002 by Milliman USA and prior to that date an audit was conducted in 1995 by Foster Higgins.

In November 2005 the division, on behalf of the board, procured the services of Buck Consultants as the actuary for the State of Alaska Public Employees' Retirement System (PERS), Teachers' Retirement System (TRS), Judicial Retirement System (JRS) and the National Guard

and Naval Militia Retirement System (NGNMRS). Buck will replace Mercer Human Resource Consulting, which has been the division's actuarial consultant for over 25 years.

Founded in 1916, Buck Consultants is a pioneer of pension plan funding. The company is only two years younger than the Casualty Actuarial Society, the first actuarial organization founded in the United States in 1914. The three principal and consulting actuaries with Buck's Alaska team are all members of the American Academy of Actuaries and the Society of Actuaries with a combined 80 years of experience in the profession. Additionally, two of the team members are enrolled with the Joint Board of Enrolled Actuaries which allows them to perform actuarial services for private retirement plans governed by the Employee Retirement Income Security Act (ERISA). Buck Consultants has more than 60 public retirement system clients.

The change to a new actuary is timely and will essentially result in a 2006 audit of Mercer Human Resource Consulting. In order to determine that the data they received is complete and to verify Mercer's work, the first thing Buck Consultants will do is replicate Mercer's June 30, 2004 actuarial valuation results of both the PERS and the TRS using the same data sets used by Mercer. The expectation by Buck is the replication will be within one percent, plus or minus, of the valuation results. Along with the replication, Buck will provide the board with observations of the actuarial methods and assumptions used by Mercer.

Once the replication is completed in February 2006, Buck will prepare and present to the board in March the June 30, 2005 actuarial valuation reports. This will be immediately followed by an experience analysis for the period of 2002-2005. The board will contract for a review of these results by another qualified actuarial firm before adopting any new assumptions that may be recommended as a result of either the audit or experience analysis.

Through this process, the board is confident the requirements of AS 37.10.220(9) are met and the best possible practices are adopted in carrying out the Board's fiduciary obligations for the State's retirement systems.

3. *Recommendations for additional legislative or administrative policy to improve the financial health of the retirement plans*

(a) No enhancements to benefits to the PERS or TRS defined benefit plans for at least one year. Up to date actuarial valuations will not be available until approximately March or April of 2006. Consequently, it would be advisable to place any retirement legislation that enhances benefits in abeyance pending updated financial information. An exception to this recommendation would be if there was convincing evidence that passage of the proposed legislation will result in an improvement in the financial condition of the fund.

(b) Index the beneficiary health deductible in the new defined contribution plan to increase commensurate to increases in the cost of living. Health care costs represent a substantial component in the under funding of the defined benefit plans. Even though beneficiaries will be responsible for a larger proportion of their health care cost under the new

plan, health costs will continue to be a significant cost item in the new plan. Given that the Alaska Constitution provides that retirement benefits cannot be diminished, it is important that the benefit that is available to a member at retirement is the same as what was intended when the member was hired. The health plan consultant at Buck Consulting should be utilized to ensure this objective is accomplished.

For example, a health plan may presently provide that an employee pay the first \$100 of his/her medical cost annually. If the plan stipulates a specific dollar amount, that amount would be fixed for the entering member for life unless there is an escalation provision in the plan. Conversely, the plan may provide for a fixed dollar amount of a benefit to a member. The plan should also attempt to ensure that benefits that are specified in dollars are also indexed to inflation. It is therefore the recommendation of the board that the administrator issue a health plan booklet for the new plans that indexes all relevant stipulated dollar amounts to the Anchorage CPI.

4. *Short-term and long-term recommendations for addressing the unfunded liability of the retirement plans*

As stated above, the board engaged an actuary within two weeks after the board began its statutory existence. Although the board has acted quickly, the actuary has notified the board it does not anticipate completing a 2005 valuation of the PERS and TRS until March 2006. Clearly, until the board has up to date actuarial information, the board is hard pressed to produce specific long term recommendations for addressing the unfunded liability of the retirement plans. The passage of Senate Bill 141 may require changes in some of the actuarial assumptions. For example, closing the plan to new members will likely change assumptions related to salary growth, health experience, age, etc.

It is the desire of the board that any recommendation to the legislature be based upon the best actuarial data available. For this reason, it is the opinion of the board that long term recommendations should be deferred until the post SB141 actuarial assumptions have been completed. It is doubtful that new actuarial assumptions will be available in time for the board to make a complete analysis of possible long term recommendations. Nevertheless, the board is able to make some recommendations for the short term and the long term that will begin to address the under funding of the plans.

(a) Short-Term Recommendations:

(1) Create new health plan for new hires after June 30, 2006. Entrants into the new retirement plan after June 30, 2006 will have a pension plan based on individual accounts and a health plan that significantly limits, but does not eliminate, future employer liability. However, to the extent employer liability is diminished, employee liability will increase. Therefore, it is imperative that the health plan itself be managed so that the plan liabilities do not increase at an unsustainable rate. Accordingly, it is the recommendation that the Division of Retirement & Benefits work closely with Buck Consultants and its health specialists to create a new retiree health plan for new hires. While this will not impact the unfunded liability of the prior defined

benefit plan, this is intended to avoid a future unfunded liability in the new defined contribution plan.

As stated above, it is the recommendation of the board that the health plan for new members of the system be written so that retirees have benefits comparable to what retirees have today, but that the benefits be indexed appropriately to ensure that dollar defined coverage does not become too expensive for the beneficiaries to sustain.

(2) Implement a preferred provider program in communities where possible. Preferred provider programs save money for the beneficiary and for the plan. It is the understanding of the board that the state active employee and retiree health plan have a preferred provider program, which is compulsory for active employees and voluntary for retirees. While the absence of multiple providers in many of our communities will limit widespread implementation, the board believes preferred provider programs should be implemented to the extent possible.

(3) Continue to aggressively promote the use of generic drugs. It is the understanding of the board that the administrator, prior boards, retiree groups and health plan administrators have promoted the use of generic drugs and that the program has been successful. Estimates are that for every one percent of generic drug use, the plan saves \$1 million. Given that medical cost represents a large component of the unfunded liability and that the use of prescription drugs is increasing, it is the view of the board that the administrator and the board explore additional ways to promote the use of generic drugs.

(4) Implement other cost containment initiatives. The board has established a number of committees to investigate how to make the retirement plans operate more efficiently. Among the items the committees are likely to consider are: hospital and doctor preferred provider organizations, enhanced member outreach, paying for hospice care reimbursement, substitution of over the counter drugs for prescription drugs, formulary programs, education of members, education of physicians, and negotiated drug prices. Because the committees are just beginning their work, the board will endeavor to implement other cost containment initiatives as they become known.

(5) Establish procedures for the periodic review of the eligibility of retiree dependents. The retiree health plan is a qualified plan in accordance with Section 401 (h) of the tax code. Medical benefits for retirees, spouses and dependents as defined by the Internal Revenue Code, are tax-free. Eligibility audits are conducted on health plans for two reasons: (1) ensure compliance with federal tax laws and (2) to reduce claims costs to the health plan.

In December of 2005, the Division of Retirement and Benefits initiated the first eligibility verification project for all retirees covered under the AlaskaCare Plan. Dependents include spouses, and children up to age 23 if they are enrolled full-time at an accredited educational or technical institution. Retirees are being asked to provide documentation that supports dependent eligibility. Completion of this process is anticipated to save up to \$16 million annually. The board encourages the division to maintain plan compliance with the Internal Revenue Code

through eligibility verification audits and in order to manage health care costs by establishing a review process to be conducted at regular intervals in the future.

(b) Long-Term Recommendations:

In order to make sound long-term recommendations to address the unfunded liability, reliable actuarial data must be available. A new actuary has been hired and a second actuary will be hired in 2006 to review the results of all actuarial assumptions prepared by the first actuary. It is the opinion of the board that some long term recommendations should not be offered until all of the work of the actuary has been vetted by a second actuary as prescribed in Senate Bill 141.

It is clear that the under funding problems of the retirement systems did not occur overnight and it is also clear that there are no easy solutions to the under funding problem. The solution will not be painless because it will require the commitment of scarce resources that have competing demands. However, ignoring this problem will result in deferring to future generations when solutions involving resource allocation may prove more painful than they are today. Alaska's defined benefit plans have a pension component that is set in statute with constitutional guarantees. Consequently, there is no immediate opportunity available to the board to change the pension liability. The health component of the defined benefit plans provide some opportunity for addressing the short fall to the extent that the costs to provide that benefit can be managed. The board has identified those strategies in the section of this report labeled "Short-Term Recommendations." Although the short-term strategies can be implemented rather quickly, their impact will be long-term.

It is the board's goal to identify cost saving and funding strategies to fully fund the retirement obligations to our public employees with a minimal impact on the services to the residents of Alaska. In pursuit of that goal, the likely recommendations of the board will include some combination of the following:

(1) Consider extending the pay-off period for the liabilities. Currently the calculations for employer contribution rates are based on a payment schedule of 25 years. A shorter payoff of the liability is desirable, but not mandatory. Given that projections indicate employer contribution rates as high as 50% of payroll, it may be in the best interest of the citizens of Alaska to assure that funds are available to meet the obligations to public employees, but also to pay for them at a sustainable level. A longer payback period may reduce the employer rate such that impacts on services are minimized. The board will request the actuary to provide actuarial calculations of various amortization schedules.

(2) Request contributions to systems. Until the FY2005 valuation is completed, the board does not have the ability to analyze the impact of direct contributions to the systems, but there is no disputing that a significant payment would be positive in terms of the plans' funding status. Since the state is expected to have a large budget surplus this year, we recommend that the legislature make contributions to the systems in order to increase the funding status and reduce the burden on employers in the future. The impact of this is similar to paying down a mortgage. A small additional one-time payment will have minimal impact, but a large payment

or regular supplemental payments will have significant impact on total payments over the life of the liability.

(3) Adopt a funding strategy that will set a limit on the rate of employer contributions. This strategy will be linked to the first two strategies. It is not recommended that anything short of full funding be provided. This recommendation is intended to be applied in combination with the strategy to extend the payoff period similar to a home mortgage. The board intends to explore combinations of employer contribution rates and payoff periods.

(4) Additional Actuarial Data. The board will submit additional data regarding funding status and recommendations upon receipt of actuarial assessments expected to be delivered by Buck Consultants during and after March 2006.

(5) Pension Obligation Bonds. The board received information on pension obligation bonds as a potential tool to assist employers in reducing exposure to unfunded accrued actuarial liabilities. The board will continue to assess the fiscal, practical and legal issues regarding issuance of such bonds by or for the benefit of public employers.

5. *Recommendations for legislative procedures regarding fiscal notes for new legislation affecting the retirement plans*

Alaska statutes provide guidance for preparation of fiscal notes for bills and resolutions introduced in the legislature. AS 24.08.035 relates to all bills and resolutions introduced in the legislature and has applicability to retirement legislation. AS 24.08.036 relates specifically to bills affecting the state retirement systems.

AS 24.08.036. *Fiscal notes on bills affecting state retirement systems.* Before a bill which would have an effect on the retirement systems of the state is reported to the rules committee, there shall be attached to the bill an analysis of the long-term and short-term costs to the state if the bill is adopted, as well as the impact of the bill on the actuarial soundness of the fund. The analysis is in addition to the fiscal note requirements of AS 24.08.035.

In many cases, the Division of Retirement and Benefits must use the division's actuary in order to provide fiscal notes on bills that would affect the retirement systems. The division's actuary requires time and resources in order to prepare a fiscal analysis on various bills. In order to comply with AS 24.08.036 and the time lines found in AS 24.08.035, the board recommends that bills affecting the retirement system be submitted as early in the legislative session as possible. This will allow the actuary the necessary time to prepare a comprehensive analysis, the Alaska Retirement Management Board the opportunity to review and make recommendations on proposals, the municipalities time to review the impact of proposals and the legislature more time to hold public hearings.

In addition, the board recommends that fiscal note legislation include the following:

- a) if a bill provides for enhanced benefits, cost estimates should include a high and low case scenario based upon the percentage of members electing to take advantage of the enhanced benefits;
- b) the dollar amount of the unfunded liability increase or decrease if the proposal was enacted, as well as the percent change in employer and/or employee contributions;
- c) identification of revenue sources to cover ongoing costs to the system;
- d) information on unfunded liability, and that any excess accrued liability over the assets of the plan constitutes annual payments for 25 years in order to amortize the unfunded liability;
- e) certification that the costs and revenues have been developed in accordance with generally accepted actuarial principles; and
- f) any fiscal impact to individual employers.

B. Other Senate Bill 141 Requirements

1. Defined Contribution Plan

The defined contribution plan becomes mandatory to all new entrants as of July 1, 2006. It is a plan in which employer and employee contributions are accumulated in individual accounts and invested by the members for the exclusive benefit of the members. Contribution provisions are established by State law and may be amended only by the State Legislature. The plan also includes some defined benefit features, such as occupational death and disability benefits. It also includes provisions for a retiree medical program and individual health reimbursement arrangement (HRA) accounts.

The Alaska Retirement Management Board is the fiduciary for the defined contribution plan and is responsible for selecting investment options and investment managers. The investment options for the defined contribution plan were selected to provide broad exposure to the risk/return spectrum and to allow for diversification across several asset classes. Generally, higher potential return investments have a higher degree of risk as measured by volatility of returns.

The investment managers went through a rigorous hiring process and are high quality firms with significant institutional business. All firms are either investment advisors registered with the Securities and Exchange Commission or bank/trust companies. All investment options and managers will be monitored on an ongoing basis by the board, investment staff, and consultants.

The following table provides information with respect to the investment options for the defined contribution plan and is arranged from highest potential risk and return to lowest.

	INVESTMENT OPTION	OBJECTIVE	① INVESTMENT TYPE ② MANAGEMENT STYLE ③ MANAGER
Higher Risk / Higher Return ↑	Brandes Institutional International Equity Fund	To provide long-term capital appreciation. The Fund invests principally in common and preferred stocks of foreign companies and securities that are convertible into such common stocks.	① International Stocks ② Actively managed ③ Brandes Investment Partners, L.P.
	T. Rowe Price Small-Cap Stock Trust	To achieve long-term capital growth by investing primarily in stocks of companies in the Russell 2000 Index, a widely used benchmark for small-cap stock performance.	① Smaller company common stocks ② Actively managed ③ T. Rowe Price Associates, Inc.
	Citizens Core Growth Fund	To achieve long-term capital appreciation while investing in companies that are managed in a socially responsible manner.	① The fund invests in the companies that make up the Citizens Index, a proprietary index designed to serve as a benchmark for socially responsible investing. The Citizens Index TM consists of approximately 300 primarily large-cap companies. ② Actively managed ③ Citizens Advisers
	S&P 500 Stock Index Fund	To provide income and capital appreciation matching the total return of the Standard & Poor's 500 Composite Stock Price Index.	① All 500 of the equity securities in the S&P 500 Index, in proportion to the size of each as measured by its total market value. ② Passively managed ③ State Street Global Advisors
	Alaska Target 2025	To provide a diversified mix of stocks, bonds, and cash for long-term investors with a higher tolerance for risk. The fund is designed to gradually invest more conservatively, with an emphasis on capital preservation, as the year 2025 approaches.	① Large- & Small-Cap stocks, international stocks, government & corporate bonds, mortgages, and money market instruments. ② Combination of Enhanced Index (Passive), Structured-Active, and Actively Managed Portfolios. ③ T. Rowe Price Associates, Inc.
	Global Balanced Fund	To achieve balanced long-term growth of capital, current income, and conservation of principal through investments in stocks and fixed-income securities.	① Stocks of large and small companies and corporate & government bonds based around the world ② Actively managed ③ Capital Guardian Trust Company
	Alaska Long-Term Balanced Fund	To provide a balanced and diversified mix of stocks, bonds, federally guaranteed mortgages, and money market instruments for investors with an average risk tolerance.	① Stocks of large & small U.S. & established international companies, investment-grade U.S. bonds, federally guaranteed mortgages, and money market instruments ② Combination of Enhanced Index (Passive), Structured-Active, and Actively Managed Portfolios. ③ T. Rowe Price Associates, Inc.
	Alaska Balanced Fund	To provide a balanced and diversified mix of stocks, bonds, federally guaranteed mortgages, and money market instruments for investors with a low to average risk tolerance.	① Stocks of large & small U.S. & established international companies, investment-grade U.S. bonds, federally guaranteed mortgages, and money market instruments ② Combination of Enhanced Index (Passive), Structured-Active, and Actively Managed Portfolios. ③ T. Rowe Price Associates, Inc.
Lower Risk / Lower Return ↓	Government/Corporate Bond Fund	To meet or exceed the return of the Lehman Brothers Government/ Credit Bond Index.	① Investment-grade fixed income securities represented in the Lehman Brothers Government/Credit Bond Index. ② Actively managed ③ State Street Global Advisors
	Short-Term Interest Fund	To preserve principal, offer current income, and provide liquidity.	① Cash equivalent instruments with maturities less than one year including commercial paper, banker's acceptance, certificates of deposit, obligations of the United States Government and its agencies, and repurchase agreements collateralized by US Treasury instruments ② Actively managed ③ T. Rowe Price Associates, Inc.

2. *Health Reimbursement Arrangement Plan*

Senate Bill 141 establishes the Health Reimbursement Arrangement Plan to allow medical care reimbursement from individual savings accounts of eligible persons. Employers shall contribute an amount equal to three percent (3%) of the employer's average annual employee compensation to the plan.

AS 37.10.220(a)(6) provides in part that the board shall establish the rate of interest that shall be annually credited to each member's account in the health reimbursement arrangement plan under AS 39.30.300 – 39.30.495. It also provides that the rate shall be adopted on the basis of the probable effective rate of interest on a long-term basis, and the rate may be changed from time to time.

Because the rate will be credited annually, it is not imperative that the board establish the crediting rate for the health reimbursement arrangement until June of 2007. In order to ensure that assets in the health reimbursement arrangement plan are equal to or greater than the sum of the individual accounts, the board will have to take into consideration the fact that plan assets will start the year at zero and grow with each contribution over the course of a year. Accordingly, the first year crediting rate is likely to be one-half of what the board would consider to be a reasonable crediting rate once the fund is mature.

Inasmuch as the health reimbursement arrangement plan crediting rate will be related to long term interest rates, the board will adopt an asset allocation targeted at achieving a rate of return it believes it has a high probability of earning every year.

3. *Office of Administrative Appeals*

The Office of Administrative Appeals is charged with hearing appeals by members formerly heard by either the Public Employees' Retirement Board or the Teachers' Retirement Board. As of December 1, 2005, there have been no appeals for the Public Employees' and Teachers' Retirement Systems adjudicated by the Office of Administrative Hearings (OAH). However, there have been 18 appeals transmitted to OAH by the Division of Retirement and Benefits, 15 of which have had or been scheduled for a pre-hearing, one of which has had a hearing and the decision is pending.

III. Alaska Retirement Management Board

A. Trustee Appointment and Biographies

Senate Bill 141 established the Alaska Retirement Management Board consisting of nine trustees: the commissioner of administration and commissioner of revenue; two trustees from the general public who are not members or beneficiaries of the retirement system; one trustee employed as a finance officer for a political subdivision in either the public employees' retirement system (PERS) or the teachers' retirement system (TRS); two trustees who are members of PERS; and two trustees who are members of TRS.

Trustees must meet eligibility requirements for an Alaska permanent fund dividend and be professionally credentialed or have recognized competence in investment management, finance, banking, economics, accounting, pension administration, or actuarial analysis.

In early October, Governor Murkowski made the following trustee appointments: Gail Schubert and Martin Pihl (public members), Lawrence Semmens (finance officer), Samuel Trivette and Michael Williams (PERS members), and Gayle Harbo and John (Bob) Roses (TRS members). Commissioner of Administration Scott Nordstrand and Commissioner of Revenue William Corbus are ex officio members.

B. Board Organization and Structure

Policies and Contracts. At the initial meeting of the Alaska Retirement Management Board October 11, 2005, the trustees adopted Resolution 2005-01, accepting fiduciary responsibility for the funds of the retirement systems and, on an interim basis subject to further review, the securities lending, custody, asset allocation, investment policies and contracts for external money managers and consultants of the Alaska State Pension Investment Board.

Committees. Committees are established to monitor ongoing investment programs, and also provide governance, compliance and problem solving. Committees of the board, generally comprised of three to five trustees, provide an opportunity for in depth and detailed oversight in fulfilling the responsibilities assigned to the trustees as fiduciaries of the funds. Committees take no action on behalf of the board; the committee role is to advise and recommend. Ad Hoc or temporary committees are sometimes named to facilitate a manager search or to complete a time-sensitive project. Committee meetings are open to the public and board members may attend any committee meeting in person or by teleconference.

Investment Advisory Council. Senate Bill 141 provides that the board may appoint an Investment Advisory Council comprised of at least three but no more than five members. At the initial board meeting, the trustees approved by motion the staff recommendation that the Investment Advisory Council be maintained, and that the contracts with the three current members, Dr. Jerrold Mitchell, Timothy M. O'Brien, and Dr. William Jennings, be continued.



KENAI PENINSULA BOROUGH

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JOHN J. WILLIAMS
MAYOR

January 4, 2006

Representative Weyhrauch, Chair
House Ways and Means Committee

Dear Representative Weyhrauch and members of the Ways and Means Committee:

Thank you for holding the committee meeting in Kenai on December 7. I thought the testimony helped get valuable information out and will serve to increase understanding and facilitate a solution.

However, I am concerned about the reaction that I saw regarding municipalities that were not among the twenty that were listed in Attachment #4 of Melanie Millhorn's report as 'Employers who chose to stay at their previously reported (FY06) rate'. The reality is that employers do not have the option to pay less than the rate established by the PERS Board. All of the employers are paying at least the rate that they were told to pay, which is the FY06 rate. Twenty employers have chosen to pay an additional 5% above the required rate.

SB 46 says: **Sec. 59. RETIREMENT SYSTEM FUNDING FOR INCREASED EMPLOYER COSTS FOR POLITICAL SUBDIVISIONS.** (a) The sum of \$18,426,923 is appropriated from the general fund to the Department of Administration to reduce the liability to the public employees' retirement system of political subdivisions that are members of that system, **in order to reduce the increased employer costs resulting from fiscal year 2006 employer contribution rate increases.** The Department of Administration shall allocate the appropriation to the public employees' retirement system account of each political subdivision based on the increased employer cost for that political subdivision resulting from fiscal year 2006 employer contribution rate increases, as estimated by the Department of Administration as of September 29, 2004, and as set out in (b) of this section. **The appropriation made by this subsection is intended to reduce these increased employer costs, based on current estimates, but may not fully eliminate the increased employer costs because of changes in political subdivision payroll amounts and other factors.** The appropriation made by this subsection is a one-time appropriation and is not intended to recur for fiscal year 2007.

Per letter received from the Department of Administration dated June 8, 2005, is the following: "Based on the language in the bill, funds will be transferred from the State of Alaska, Department of Administration to the PERS. These funds will then be placed in your employer assets." This transfer was done August 8, 2005.

In addition, the letter from the Department of Administration also advised of the following:

Previously reported employer contribution rate	17.81%
Less reduction due to SB 46	5.00%

Revised employer contribution rate

12.81%

The intent of this legislation was to reduce the impact of the 5% increase in PERS rates on municipalities by contributing State money equal to the 5% increase directly to the PERS. Municipalities never touched this money, it went directly to the PERS. They had no ability to spend the money at all, let alone spend it for some purpose other than what it was intended for. Rates were going up 5%, but municipalities would not be impacted because the State was paying the 5%. So municipalities were expected to subtract the 5% from the required rate because the State already paid it on their behalf.

The twenty that chose to pay the full 5% increase from their own resources have actually paid more than the PERS required. Everyone should have that prerogative, but those that were not able to make that extra commitment (or that simply had other priorities) should not be viewed unfavorably. The legislation was intended to reduce the impact of the 5% rate increase and for most municipalities that is exactly what happened.

I hope that this clarifies this issue.

If you have any questions please contact me.

Sincerely,



Craig C. Chapman
Finance Director

Cc: Senator Tom Wagoner
Representative Mike Chenault
Melanie Millhorn
Kevin Richie

STATE OF ALASKA

DEPARTMENT OF ADMINISTRATION

DIVISION OF RETIREMENT AND BENEFITS

...ANK H. MURKOWSKI, GOVERNOR

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JUNEAU, AK 99811-0203
TDD: (907) 465-2805
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TOLL-FREE 1-800-821-2251

June 8, 2005

FILE COPY

Mr. Scott Holt, Finance Director
Kenai Peninsula Borough
144 North Binkley Street
Soldotna, AK 99669

PERS: 180

Re: FY 2006 PERS Employer Contribution Rate Reduction

Dear Mr. Holt:

Recently, the Division of Retirement and Benefits notified you of your FY 2006 Public Employees' Retirement System (PERS) Employer Contribution Rate. Due to recent legislation enacted, there will be an employer contribution rate reduction for Fiscal Year (FY) 2006.

Senate Bill (SB) 46, section 59 "Retirement System Funding for Increased Employer Costs for Political Subdivisions" appropriated \$18,426,923 to the Department of Administration, Division of Retirement & Benefits to reduce the liability to the public employees' retirement system of political subdivisions that are members in order to reduce the increased employer costs resulting from fiscal year 2006 employer contribution rate increases. This appropriation is a one-time appropriation and is not intended to recur for fiscal year 2007.

Based on the language in the bill, funds will be transferred from the State of Alaska, Department of Administration to the PERS. These funds will then be placed in your employer assets. It is not known at this time exactly when this transfer will take place, but once it has occurred, the Division will notify you of this transaction.

The intent of SB 46, section 59 is to assist political subdivisions facing increasing PERS employer contribution costs, up to 5% for FY 2006. This assistance is meant to partially offset estimated increases employers would have incurred. However, it was not meant to reduce an employer's matching contribution rate below the rate paid in FY 2005. Therefore, if your employer contribution rate increase was less than 5% from FY 2005 to FY 2006, you are still required to contribute, at a minimum, the rate used in FY 2005.

Mr. Scott Holt

- 2 -

June 8, 2005

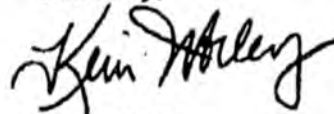
REVISED PERS EMPLOYER CONTRIBUTION RATE FOR FY 2006:

Previously Reported Employer Contribution Rate	17.81%
Less: Reduction due to SB 46	5.00%
Revised Employer Contribution Rate	12.81%

These rates have been updated in our records. However, if you would prefer to pay the rate previously provided to you, we will make the necessary changes to accommodate your request. No warrants will be issued to individual employers for the assistance provided under SB 46.

If you have any questions regarding this letter, please contact me toll free at 1-800-821-2251, or in Juneau at (907) 465-1845 or via email at Kevin.Worley@admin.state.ak.us.

Sincerely,



Kevin Worley
Defined Benefits Accounting Supervisor

KW/dkk

Enclosure - Senate Bill 46, Section 59

G:/mailouts/accounting section/fy06 sb 46 rate rev-pers admin.doc

Ginny Austerman

From: Kevin Ritchie [kevin@akml.org]
Sent: Monday, January 09, 2006 3:25 PM
To: Bruce Weyrauch; Ginny Austerman
Subject: Munis and PERS 06 funding by state

Hi Bruce

Thanks for meeting with me today. I sincerely appreciate your approach to tough issues.

Per our discussion, regarding the way municipalities approached using the PERS funding from the State last year:

The SB 64 appropriation language clearly states that the funding is intended to allow municipalities to avoid paying the 5% 2006 increase. It does not direct, or even seem to imply, that municipalities must pay down their long-term PERS liability. SB 64 (sec 59) states, **"...is appropriated...in order to reduce the increased employer costs resulting from fiscal year 2006 employer contribution rate increases."** and **"The appropriation made by this subsection is intended to reduce these increased employer costs..."** Every municipality complied with the intent of the appropriation, but some were financially able to instead pay down the long-term liability somewhat by paying the increase in PERS rates anyway.

Thanks
Kevin

Here is the full text of SB 64 (Section 59):

SB 64 "An Act making and amending appropriations, including capital appropriations, supplemental appropriations, reappropriations, and appropriations to capitalize funds

*** Sec. 59. RETIREMENT SYSTEM FUNDING FOR INCREASED EMPLOYER COSTS**

FOR POLITICAL SUBDIVISIONS. (a) The sum of \$18,426,923 is appropriated from the general fund to the Department of Administration to reduce the liability to the public employees' retirement system of political subdivisions that are members of that system, **in order to reduce the increased employer costs resulting from fiscal year 2006 employer contribution rate increases.** The Department of Administration shall allocate the appropriation to the public employees' retirement system account of each political subdivision based on the increased employer cost for that political subdivision resulting from fiscal year 2006 employer contribution rate increases, as estimated by the Department of Administration as of September 29, 2004, and as set out in (b) of this section. **The appropriation made by this subsection is intended to reduce these increased employer costs, based on current estimates,** but may not fully eliminate the increased employer costs because of changes in political subdivision payroll amounts and other factors. The appropriation made by this subsection is a one-time appropriation and is not intended to recur for fiscal year 2007.

b) For purposes of allocating the appropriation made by (a) of this section to the

public employees' retirement system account of each member political subdivision, the increased employer costs of the political subdivisions are as follows:

POLITICAL SUBDIVISION	AMOUNT
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Kevin Ritchie, Executive Director
Alaska Municipal League
kevin@akml.org
office: 907-586-1325
Fax: 907-463-5480



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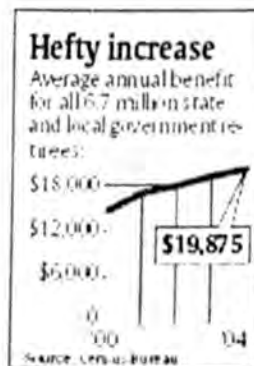
Public workers' pensions swelling

By Dennis Cauchon, USA TODAY

Public employee pensions have become increasingly generous since 2000, promising a more comfortable retirement for civil servants but a serious financial challenge for future taxpayers.

The beefed-up pension benefits come at a time when the pension funds' financial health has deteriorated and private pensions have been scaled back. (**Related story:** [Pension funds fall short of guarantees](#))

Many corporations have replaced traditional pension plans, which pay monthly benefits for life, with plans that cost employers less and pay workers a lump sum when they retire. Alcoa, the world's largest aluminum producer, announced Monday that it would do so for most new employees effective March 1.



Governments have been moving in the opposite direction: increasing monthly benefits, making it easier to retire at 55 and spending more on retiree health benefits. State and local governments, which cover 21 million workers and retirees, have been adding benefits the fastest:

- A December study of 85 big public pensions in all 50 states — covering three-fourths of public employees nationwide — found that governments continued to enhance benefit formulas, ease early retirement and improve other benefits from 2000 through 2004 despite states' financial problems. The increases were enacted on top of even larger benefit changes approved from 1996 to 2000. The study, conducted by the Wisconsin Legislature, is one of the most comprehensive on the issue.

- The New Jersey Legislature has approved 17 benefit enhancements since 2000 that increased the unfunded obligations of public pensions in the state by \$6.8 billion, according to a task force studying the issue.

- Average annual benefits for retired state and local workers grew 37% to \$19,875 from 2000 to 2004, the most recent data available, according to the Census Bureau. The rising payments reflect the early retirement of baby boomers, who started to qualify for full benefits in 2001, at age 55, under most government pensions.

"These pensions are unaffordable," says Alaska state Rep. Bert Stedman, a Republican. "If we don't act now, we're going to have social conflict in the future between the haves and the have-nots — those with government pensions and those without."

Reg Weaver, president of the National Education Association, which represents teachers, says legislators shouldn't respond to pension problems in the private sector by attacking government pensions. "Pensions are a national problem, but it's not in the interest of workers to diminish either type," he says.

The portion of the private workforce enrolled in plans that pay monthly benefits for life has fallen from 39% in 1980 to 18% in 2004, according to the Employee Benefit Research Institute. By comparison, more than 90% of government workers are covered by such plans, the Bureau of Labor Statistics says. Unlike private companies, most state and local governments cannot reduce pension benefits for existing workers or retirees.

Federal, state and local governments have promised pension and retiree medical benefits that would require more than \$5 trillion to be invested today to cover costs over the next 75 years, according to the financial statements of

the retirement plans.

▪ [REPRINTS & PERMISSIONS](#)

Links referenced within this article

Pension funds fall short of guarantees

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Pension funds fall short of guarantees

By Dennis Cauchon, USA TODAY

George Haven, 61, retired five years ago after 35 years as a teacher, guidance supervisor and assistant high school principal in Springfield, Ill. His pension benefit is about \$5,000 a month, and his wife, also a retired teacher, collects \$3,500.

The pension is not quite as lucrative as it seems. Like one-fourth of public employees, Haven is not eligible for Social Security. He also contributed to the pension — as much as 9% of his salary some years — and pays \$362 a month for his state-subsidized health benefits, important for a man who has survived three heart bypass surgeries.

Still, his teacher's pension lets Haven enjoy a comfortable retirement and give back to the community where he spent his career. He officiates at high school soccer games, helps student teachers and spends time with his 6-year-old grandson.

Comparing paychecks

Average hourly total compensation (salary plus benefits) for U.S. workers:

Private industry

\$24.34

State or local government

\$36.16

Federal government

\$44.82

The total package

Hourly amounts paid by employers:

	Private	State-local	Federal
Wages	\$17.23	\$24.52	\$30.85
Retirement	\$0.90	\$2.48	\$4.78
Health insurance	\$1.66	\$3.82	\$2.16
Social Security/Medicare	\$1.45	\$1.61	\$2.34
Paid days off	\$1.55	\$2.72	\$3.42
Bonuses/other	\$1.55	\$1.01	\$1.27
Total benefits	\$7.11	\$11.64	\$13.97

Note: Federal government figures do not include military or postal service.
Source: Bureau of Labor Statistics, U.S. Office of Personnel Management and USA TODAY research.

By Adrienne Lewis, USA TODAY

Haven and millions of other teachers and government employees nationwide present a daunting financial challenge to state taxpayers over the coming decades.

The public servants have been guaranteed retirement benefits that are far richer than private pensions, yet elected officials have failed to set aside enough money to cover the promised benefits.

The Illinois Teachers Retirement System, which pays Haven's benefits, is typical of a troubled system. The pension fund had \$32 billion in stocks, bonds and other assets at the end of its 2004 fiscal year, but it needed \$51 billion to cover its long-term obligations to 158,000 educators still working and 77,000 retirees.

Illinois taxpayers are responsible for the \$19 billion in unfunded teacher pensions, plus \$15 billion more to cover pension obligations to university employees and other state employees.

These amounts are what Illinois needs to set aside immediately — tucked in a pension fund and earning investment returns of 8% a year — to make the system solvent. Instead, Illinois legislators plan to forgo \$1 billion in annual pension payments in fiscal 2006 and 2007, so they can spend money on more immediate needs.

Illinois is not alone. Although some states have increased pension contributions in recent years, others have cut their contributions to balance their budgets.

Washington, for example, skipped a \$176 million pension payment last year.

Legislators are considering making a late payment this year.

Some policy analysts say the problem is that pension benefits are too lucrative. "The public sector is offering gold-plated benefits that society cannot afford because of the high tax cost it creates," says Chris Edward, director of fiscal studies at the libertarian Cato Institute in Washington.

He says pensions, health benefits, numerous paid holidays and the value of job security make government workers too well compensated compared with the private sector.

Public workers benefit

Private businesses employed 112.4 million workers in 2005, according to the Bureau of Labor Statistics. Federal, state and local governments employed 21.9 million, about half in education.

The belief that government offers good benefits to make up for lower wages appears to be a myth. Government workers earn higher average wages and get better benefits than people in the private sector, according to bureau statistics. Even white-collar workers — managers and professionals — earn more on average than their counterparts in private industry.

Keith Brainard, research director of the National Association of State Retirement Administrators, says those numbers don't recognize the special nature of government jobs. "Two-thirds of government employees work in education, public safety, corrections or are judges," he says. "You don't want high turnover in those professions, so you need benefits that encourage long-term retention."

The Bureau of Labor Statistics details how superior government benefits are to those in the private sector. Private companies contributed an average of 90 cents to a worker's pension plans for every hour worked in 2005. By comparison, state and local governments contributed \$2.48 for every hour an employee worked.

Those numbers don't include retiree health benefits, which make it possible for civil servants to retire before federal Medicare health coverage begins at age 65.

Medical costs rising

Starting this year, governments must report the cost of promised retiree medical benefits. "The numbers are going to be staggering," says Ron Snell, a pension expert at the National Conference of State Legislatures. "It's going to force legislators to look at the long-term costs of these benefits."

Maryland recently estimated its retiree health benefits were a \$20 billion liability. The national total is likely to be hundreds of billions of dollars.

Most public pensions also have automatic cost-of-living increases. Private pensions usually do not. That means the difference between public and private pensions grows every year, even after retirement.

Bill Jones, 67, president of the Association of BellTel Retirees, retired from phone company Nynex in 1990 and expected the company to continue a tradition of cost-of-living increases equal to half the inflation rate. Instead, the company hasn't made any adjustments since he retired, so inflation has reduced the value of his pension benefit about 31%. Government employees don't have to worry about losing benefits. State constitutions and court precedents forbid cutting pension benefits to civil servants. Only new employees can get leaner benefits.

Alaska became the first state in a decade to put new employees hired in 2006 into a 401(k)-style defined contribution plan similar to those in the private sector. Current employees will stay in the old pension plan, which has a \$5.7 billion unfunded liability that is the responsibility of future taxpayers.

"These unfunded liabilities are not a big problem," says Frederick Nesbitt, executive director of the National Conference on Public Employee Retirement Systems, which lobbies for public employee pension rights. "We have 40 or 50 years to recoup the money through investments. A person who owes \$400,000 on a mortgage wouldn't say, 'Oh, my God, we're doomed,' because they know they have 30 years to pay it off."

• REPRINTS & PERMISSIONS

Find this article at:

http://www.usatoday.com/money/perfi/retirement/2006-01-16-pension-funds_x.htm

Kenai pensions lack funds ***Miscalculation leaves city owing millions to cover PERS costs***

By PHIL HERMANEK
Peninsula Clarion

Prefacing his comments by saying he did not want to alarm anyone, the Kenai city finance director told the city council of projected shortfalls in Kenai's pension plan funding.

Larry Semmens said the city has always paid the Public Employees' Retirement System rate the state of Alaska said the city needed to pay in order to fund the plan in accordance with actuarial projections.

"Until 2001, we were more than 100 percent funded," Semmens said.

Actuarial projections, however, were wrong, and by 2002, the city was shown to be only 80 percent funded — down from 106 percent the previous year.

Semmens explained that the actuarial projections were based on a number of assumptions such as health care costs and mortality tables that reflect normal life spans.

When the assumptions were corrected in 2002, the city's liabilities to PERS were dramatically increased, he said.

"By fiscal year 2010, the PERS rate will be 30 percent of payroll and will stay there for 25 years," Semmens said.

He said the total payroll for the city is approximately \$5 million.

In a prepared memorandum to the mayor and council members, Semmens said, "The bottom line is that the city went from a funding surplus in (fiscal year) 2001 to an \$11,565,000 unfunded liability in three years."

Revised actuarial reports show Kenai should be paying 26.17 percent in fiscal year 2006, but the city currently is paying only 13.67 percent.

In fiscal year 2007, the actuarially required rate will be 29.81 percent and the city is slated to pay 18.67 percent.

"Clearly our liability will grow if we pay significantly less than the actuarially required amount," Semmens said.

He said Kenai is not alone in facing the retirement funding dilemma.

It is an issue for the state of Alaska and most municipalities and school districts, he said.

"Soldotna increased its payment by \$1 million toward PERS to bring down their unfunded liability," Semmens said.

"We should carefully consider paying down our PERS liability," he said.

As a member of the Alaska Retirement Management Board, Semmens said the group will make a

report to the state legislature this month, which will include short-term and long-term strategies for addressing the problem.

He advised the council to keep the situation in mind when deciding whether or not to pave Kenai streets or approve other expenditures.

He said that although the city paid what the state said it should pay all along, and the state's projections were wrong, it is the city's problem.

"It's the city's obligation to its employees," Semmens said.

Council member Linda Swarner disagreed, saying the state was to blame for the shortfall.

"It's the city that promised past workers their pensions," Semmens said.

"There will need to be service cuts or revenue increases to fund PERS," Semmens said.

He also said the state should reinstitute a revenue sharing program for municipalities that it once had.

"In 1982, we got 50 percent of general fund expenditures from revenue sharing. Now we get zero," Semmens said.

While the situation is expensive for the city of Kenai, he said, "For the state of Alaska, it's a \$6 billion problem."

The Seattle Times

seattletimes.com

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IBM to join trend of freezing pensions in favor of 401(k)s

By Albert B. Crenshaw
The Washington Post

WASHINGTON — IBM said Thursday it will freeze the pension plans of some 120,000 employees in the United States, effective at the end of next year, and will offer instead a more generous 401(k) plan.

IBM's move is part of a corporate stampede away from traditional pension plans. IBM officials called the change essential to remain competitive with foreign and domestic information-technology rivals.

The freeze means that benefits earned by current workers up to Jan. 1, 2008, will be preserved, but after that date they will not increase. The company already had eliminated traditional pensions for new hires starting last year.

The company said it expects the changes announced Thursday — along with changes it expects to make this year for workers in other countries — to cut worldwide retirement-related expenses by \$450 million to \$500 million this year and by \$2.5 billion to \$3 billion through 2010.

The action adds IBM to a growing list of U.S. employers that have frozen or terminated pension plans to cut costs or, in some cases, to emerge from bankruptcy. Such changes are especially common in industries where foreign competition is tough, such as steel, or where new domestic competitors have arisen — such as airlines and high-tech — that do not offer traditional pensions.

Last month, for example, Verizon, the nation's second-largest phone company, froze its traditional pension plan for 50,000 managerial workers and boosted benefits through its 401(k) plan. Verizon said it expected the change to save it about \$3 billion over the next decade.

Rival Hewlett-Packard decided last year to offer only a 401(k) plan to U.S. workers hired this year and beyond.

A survey last year by the government agency that insures traditional pensions, the Pension Benefit Guaranty Corp. (PBGC), found that 9.4 percent of existing plans are frozen. However, some experts say that the PBGC figure is too low. The trend has been accelerating, they say, and some surveys suggest that 15 to 20 percent of employers with traditional pensions are considering freezing or terminating them.

IBM's change means that some 80,000 employees under the cash-balance plan, as well as 30,000 who were grandfathered into an older plan, will earn no new benefits under those plans, regardless of how much longer they remain with the company. Typically benefits under pension plans increase as the

number of years worked accumulates and as salaries rise.

Instead, IBM employees will be eligible for a 401(k) plan that IBM called "one of the richest in U.S. business." Under it, the company will contribute as much as 10 percent of pay annually to the accounts of current pension-plan participants. IBM plans to double the current company match to dollar-for-dollar on up to 6 percent of salary deferrals, and to make additional automatic contributions into those accounts equal to 1 to 4 percent of employees' pay.

The company will also open accounts for workers who have not elected to participate in the 401(k) plan and will contribute 1 to 4 percent of pay to those accounts.

The changes to the traditional plans will not affect IBM's 125,000 current U.S. retirees, former employees with vested benefits or workers who retire before Jan. 1, 2008, IBM said.

Information about Hewlett Packard provided by The Associated Press.

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The New York Times
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January 9, 2006

More Companies Ending Promises for Retirement

By MARY WILLIAMS WALSH

The death knell for the traditional company pension has been tolling for some time now. Companies in ailing industries like steel, airlines and auto parts have thrown themselves into bankruptcy and turned over their ruined pension plans to the federal government.

Now, with the recent announcements of pension freezes by some of the cream of corporate America - Verizon, Lockheed Martin, Motorola and, just last week, I.B.M. - the bell is tolling even louder. Even strong, stable companies with the means to operate a pension plan are facing longer worker lifespans, looming regulatory and accounting changes and, most important, heightened global competition. Some are deciding they either cannot, or will not, keep making the decades-long promises that a pension plan involves.

I.B.M. was once a standard-bearer for corporate America's compact with its workers, paying for medical expenses, country clubs and lavish Christmas parties for the children. It also rewarded long-serving employees with a guaranteed monthly stipend from retirement until death.

Most of those perks have long since been scaled back at I.B.M. and elsewhere, but the pension freeze is the latest sign that today's workers are, to a much greater extent, on their own. Companies now emphasize 401(k) plans, which leave workers responsible for ensuring that they have adequate funds for retirement and expose them to the vagaries of the financial markets.

"I.B.M. has, over the last couple of generations, defined an employer's responsibility to its employees," said Peter Capelli, a professor of management at the Wharton School of Business at the University of Pennsylvania. "It paved the way for this kind of swap of loyalty for security."

Mr. Capelli called the switch from a pension plan to a 401(k) program "the most visible manifestation of the shifting of risk onto employees." He added: "People just have to deal with a lot more risk in their lives, because all these things that used to be more or less assured - a job, health care, a pension - are now variable."

I.B.M. said it is discontinuing its pension plan for competitive reasons, and that it plans to set up an unusually rich 401(k) plan as a replacement. The company is also trying to protect its own financial health and avoid the fate of companies like General Motors that have been burdened by pension costs. Freezing the pension plan can reduce the impact of external forces like interest-rate changes, which have made the plan cost much more than expected.

"It's the prudent, responsible thing to do right now," said J. Randall MacDonald, I.B.M.'s senior vice president for human resources. He said the new plan would "far exceed any average benchmark" in its attractiveness.

Pension advocates said they were dismayed that rich and powerful companies like I.B.M. and Verizon would abandon traditional pensions.

"With Verizon, we're talking about a company at the top of its game," said Karen Friedman, director of policy studies for the Pension Rights Center, an advocacy group in Washington. "They have a huge profit. Their C.E.O. has given himself a huge compensation package. And then they're saying, 'In order to compete, sorry, we have to freeze the pensions.' If companies freeze the pensions, what are employees left with?"

Verizon's chief executive, Ivan Seidenberg, said in December that his company's decision to freeze its pension plan for about 50,000 management employees would make the company more competitive, and also "provide employees a transition to a retirement plan more in line with current trends, allowing employees to have greater accountability in managing their own finances and for companies to offer greater portability through personal savings accounts."

In a pension freeze, the company stops the growth of its employees' retirement benefits, which normally build up with each additional year of service. When they retire, the employees will still receive the benefits they earned before the freeze.

Like I.B.M., Verizon said it would replace its frozen pension plan with a 401(k) plan, also known as a defined-contribution plan. This means the sponsoring employer creates individual savings accounts for workers, withholds money from their paychecks for them to contribute, and sometimes matches some portion of the contributions. But the participating employees are responsible for choosing an investment strategy. Traditional pensions are backed by a government guarantee; defined-contribution plans are not.

Precisely how many companies have frozen their pension plans is not known. Data collected by the government are old and imperfect, and companies do not always publicize the freezes. But the trend appears to be accelerating.

As recently as 2003, most of the plans that had been frozen were small ones, with less than 100 participants, according to the Pension Benefit Guaranty Corporation, which insures traditional pensions. The freezes happened most often in troubled industries like steel and textiles, the guarantor found.

Only a year ago, when I.B.M. decided to close its pension plan to new employees, it said it was "still committed to defined-benefit pensions."

But now the company has given its imprimatur to the exodus from traditional pensions. Its pension fund, the third largest behind General Motors and General Electric, is a pace-setter. Industry surveys suggest that more big, healthy companies will do what I.B.M. did this year and next.

"There's a little bit of a herd mentality," said Syl Schieber, director of research for Watson Wyatt Worldwide, a large consulting firm that surveyed the nation's 1,000 largest companies and reported a sharp increase in the number of pension freezes in 2004 and 2005. The thinking grows out of boardroom relationships, he said, where leaders of large companies compare notes and discuss strategy.

Another factor appears to be impatience with long-running efforts by Congress to tighten the pension rules, Mr. Schieber said. Congress has been struggling for three years with the problem of how to make sure companies measure their pension promises accurately - a key to making sure they set aside enough money to make good. But it is likely to be costly for some companies to reserve enough money to meet the new rules, and they - and some unions - have lobbied hard to keep the existing rules intact, or even

to weaken them. So far, consensus has eluded the lawmakers.

"If Congress will not do its job and clarify the regulatory environment, then I think more and more companies will come to the conclusion that, given everything else that they've got to face, this just isn't the way to go," Mr. Schieber said of the traditional pension route.

Defined-benefit pensions proliferated after World War II and reached their peak in the late 1970's, when about 62 percent of all active workers were covered solely by such plans, according to the Employee Benefit Research Institute, a Washington organization financed by companies and unions. A slow, steady erosion then began, and by 1997, only 13 percent of workers had a pension plan as their sole retirement benefit. The percentage has held steady in the years since then. The growth of defined-contribution plans has mirrored the disappearance of pension plans. In 1979, 16 percent of active workers had a defined contribution plan and no pension, but by 2004 the number had grown to 62 percent.

For many workers, the movement away from traditional pensions is going to be difficult. Already there are signs that people are retiring later, or taking other jobs to support themselves in old age. Participation in a pension plan is involuntary, but most 401(k) plans let employees decide whether to contribute any money - or none at all. Research shows that many people fail to put money into their retirement accounts, or invest it poorly once it is there.

Even skillful 401(k) investors can be badly tripped up if the markets tumble just at the time they were planning to retire. Mr. Schieber of Watson Wyatt ran scenarios of what would happen to a hypothetical man who went to work at 25, put 6 percent of his pay into a 401(k) account every year for 40 years, retired at 65, then withdrew his account balance and used it to buy an annuity, a financial product that, like a pension, pays a lifelong monthly stipend.

He found that if the man turned 65 in 2000 he would have enough 401(k) savings to buy an annuity that paid 134 percent of his pre-retirement income. But if he turned 65 in 2003, his 401(k) savings would only buy an annuity rich enough to replace 57 percent of his pre-retirement income.

When a company switches from a pension plan to a 401(k) plan, the transition is hardest on the older workers. That is because they lose their final years in the pension plan - often the years when they would have built up the biggest part of their benefit. They then start from zero in the new retirement plan.

Jack VanDerhei, an actuary who is a fellow at the Employee Benefit Research Institute, offered a hypothetical example. If a man joins a firm at 40, works 15 years, and is making \$80,000 a year by age 55, he might expect to have built up a pension worth \$16,305 a year by that time, Mr. VanDerhei said. If he keeps on working under the same pension plan, that benefit will have increased to \$27,175 a year when he retires at 65.

But if instead when the man turns 55 his company freezes the pension plan and sets up a 401(k) plan, the man will get just the \$16,305 a year, plus whatever he is able to amass in the 401(k). It will take both discipline and investment skill to reach the equivalent of the old pension payments in just ten years, Mr. VanDerhei said.

For women, the challenge is even tougher. They have longer life expectancies, so they have to pay more than men if they buy annuities in the open market. It turns out the traditional, pooled pension offered them a perk they did not even know they had.

STATE OF ALASKA

DEPARTMENT OF ADMINISTRATION

DIVISION OF RETIREMENT AND BENEFITS

FRANK H. MURKOWSKI, GOVERNOR

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January 30, 2006

The Honorable Bruce Weyhrauch
Chair, Special Committee on Ways and Means
House of Representatives
State Capitol, Room 421
Juneau, Alaska 99801

Re: Response to Questions from January 27, 2006 Meeting

Dear Representative Weyhrauch:

This letter is written in response to questions received from one of the members of Special Committee on Ways and Means on January 27, 2006. I have re-stated the questions received below in italics with responses immediately following.

1. *What percentage of unfunded liability is attributed to loss of investment income versus rising health care cost and the change in actuarial assumptions?*

In response, it depends on the time frame that is used to review the factors as noted above. The Division's actuary provided information in January of 2005 regarding the changes in the funded status of the retirement systems by using two different the time periods: (1) 2000 to 2003 and, (2) from 1992 to 2003 (see enclosed letters).

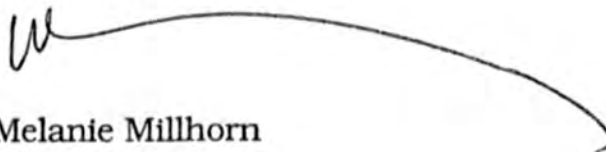
2. *Has the state had any discussion with other states about utilizing drug pools to reduce prescription drug costs?*

The Division has not had these discussions with other states, however, the research indicates that other states are using this opportunity with regard to their Medicaid programs. The state's health plans currently utilize some of the design features that are being implemented by other states. DAW1 and DAW2 are features used within a mandatory generic plan design to facilitate savings. Mandatory generics is a plan design that is being discussed.

Chair Weyhrauch
Special Subcommittee on Ways and Means
January 30, 2006
Page 2

I appreciate the opportunity to provide the members with this information.
Please let me know if you have any questions about this correspondence.

Sincerely,

A handwritten signature in dark ink, appearing to be 'W' followed by a long, sweeping horizontal line that curves slightly upwards at the end.

Melanie Millhorn
Director

Enclosure(s)

cc: Members of Special Committee on Ways and Means

Scott J. Nordstrand, Commissioner
Department of Administration

Kevin Brooks, Deputy Commissioner
Department of Administration

Michael Tibbles, Deputy Commissioner
Department of Administration

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January 5, 2005

Ms. Melanie Millhorn
Director of Retirement and Benefits
State of Alaska
Department of Administration
Division of Retirement and Benefits
P.O. Box 110203
Juneau, AK 99811-0203

RECEIVED

JAN 07 2005

Div. of Ret. & Benefits

Subject:

Changes in Funded Status from July 1, 2000 – PERS and TRS

Dear Melanie:

This letter provides an analysis of the changes in funded status for the PERS and TRS for the time period from July 1, 2000 to June 30, 2003. As you know, the funded percentages shown in the annual actuarial valuation reports are based on the "actuarial value" of assets, which recognizes gains or losses over a 5-year period, rather than recognizing them immediately in the year in which they occur. The analysis in this letter is based solely on the market value of assets. Therefore, the funded percentages in this letter will differ somewhat from those shown in the actuarial valuation reports.

From July 1, 2000 to June 30, 2003, the funded percentage for the PERS declined from 118.7% to 70.0%, while the funded percentage for TRS declined from 106.8% to 61.7%. Unfunded accrued liabilities (UAL) were created equal to \$3.2 billion for PERS and \$2.2 billion for TRS. The total change in funded status for the PERS and TRS from July 1, 2000 to June 30, 2003 was due to asset and liability sources as follows:

	PERS		TRS	
	Change in Funded Status	Unfunded Accrued Liability (millions)	Change in Funded Status	Unfunded Accrued Liability (millions)
Change due to assets	(30.0)%	\$1,882	(26.8)%	\$1,304
Change due to liabilities	(18.6)	1,288	(18.3)	928
Total	(48.6)%	\$3,170	(45.1)%	\$2,232

The effect of asset losses shown here is considerably higher than that shown in other presentation material. The time period reflected in this letter represents a period of large investment losses. Longer look-back periods would incorporate periods of investment gains, and would show investment losses having a much smaller impact on funded status.

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Page 2

January 5, 2005

Ms. Melanie Millhorn

State of Alaska

This letter provides further breakdown of the changes in funded status attributable to liabilities.

	PERS		TRS	
	Change in Funded Status	Increase in UAL (millions)	Change in Funded Status	Increase in UAL (millions)
Health experience	(5.1)%	\$351	(2.6)%	\$137
Health assumption changes	(9.6)	665	(4.7)	242
Plan changes	(0.6)	39	(0.6)	27
Demographic experience	(3.3)	233	(10.4)	522
Non-health assumption changes	0.0	0	0.0	0
Total change due to liabilities	(18.6)%	\$1,288	(18.3)%	\$928

I hope this information is helpful. Please call or email if you have questions or need additional information.

Sincerely,



Robert M. Reynolds, ASA, MAAA

RMR/DAK/ws

Copy:
Anselm Staack
Chris Byrnes

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January 3, 2005

Ms. Melanie Millhorn
Director of Retirement and Benefits
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Department of Administration
Division of Retirement and Benefits
P.O. Box 110203
Juneau, AK 99811-0203

RECEIVED

JAN 06 2005

Div. of Ret. & Benefits

Subject:

Changes in Funded Status - PERS and TRS

Dear Melanie:

Part of our December 1 presentation to the Alaska State Pension Investment Board (ASPIB) focused on changes in the funded percentages for PERS and TRS. From July 1, 1992 to June 30, 2003, the funded percentage for the PERS declined from 92.3% to 70.0%, based on the market value of assets. The funded percentage for TRS declined from 91.0% to 61.7%. The dollar amount increases in the unfunded accrued liabilities (UAL) were \$3.2 billion for PERS and \$2.2 billion for TRS. We found that the total change in funded status for the PERS and TRS from July 1, 1992 to June 30, 2003 was due to asset and liability sources as follows:

	PERS		TRS	
	Change in Funded Status	Increase in UAL (billions)	Change in Funded Status	Increase in UAL (billions)
Change due to assets	(3.8)%	\$1.1	(2.7)%	\$0.6
Change due to liabilities	(18.5)	2.1	(26.6)	1.6
Total	(22.3)%	\$3.2	(29.3)%	\$2.2

This letter provides further breakdown of the changes in funded status attributable to liabilities. The percentages have been revised slightly from those quoted in the ASPIB meeting based on further research on the effect of the various factors.

	PERS		TRS	
	Change in Funded Status	Increase in UAL (billions)	Change in Funded Status	Increase in UAL (billions)
Health experience	(6.9)%	\$0.6	(3.0)%	\$0.2
Health assumption changes	(12.5)	1.1	(4.7)	0.3
Plan changes	(4.7)	0.3	(5.3)	0.2
Demographic experience	5.4	(0.1)	(6.8)	0.5
Non-health assumption changes	0.2	0.2	(6.8)	0.4
Total change due to liabilities	(18.5)%	\$2.1	(26.6)%	\$1.6

MERCER

Human Resource Consulting

Page 2

January 3, 2005

Ms. Melanie Millhorn

State of Alaska

Health experience and changes in health assumptions were relatively large contributors to the decline in funded status. Benefit improvements also contributed to the decline. For both Systems, plan changes include benefit improvements enacted by the legislature, as well as ad-hoc Post-Retirement Pension Adjustments (PRPAs).

I hope this information is helpful. Please call or email if you have questions or need additional information.

Sincerely,



Robert M. Reynolds, ASA, MAAA

RMR/DK/ws

Copy:

Anselm Staack

Chris Byrnes

Marcia Chapman

Mandatory Generics / DAW1 and DAW2 Rx Plan Designs

Currently, the State's pharmacy program does not have a Mandatory Generics feature in its plan design - and today in the State's plan 85-90% of the time that a generic is available it is filled with a generic drug. Mandatory Generics is one of the most common features in a pharmacy benefits design today. With Mandatory Generics unless a prescription states that it must be dispensed as written "DAW" the pharmacist has the latitude to dispense a generic drug whenever it's available.

If the State implemented Mandatory Generics in its benefit design three scenarios could be implemented:

Scenario 1 (Without DAW 1 OR 2)

A physician prescribes a prescription for a brand drug that has a generic equivalent - and states on the prescription that it must be filled with the brand drug. The members will be responsible for the **co-pay** difference between the brand and the generic drug and the **cost** difference between the brand and generic drug. Very common plan design but is harder to sell to members because the Dr. says to fill with brand then member has to pay the difference.

Scenario 2 (Mandatory Drugs with DAW1) This is the most common feature

A physician prescribes a prescription for a brand drug that has a generic equivalent - and states on the prescription that it must be filled with the brand drug. The members will be responsible for just the brand co-pay. This is the most common design feature. Dr. said to have brand, plan will allow you to pay the brand co-pay, as if there were no generic equivalent available.

Scenario 3 (Mandatory Drugs with DAW1 and DAW2) In our plan twice as often it is the member requesting a brand fill and not the physician.

A physician prescribes a prescription for a brand drug that has a generic equivalent - and states on the prescription that it must be filled with the brand drug. The members will be responsible for just the brand co-pay and if the member requests a brand fill even though a generic fill is available they will be responsible for just the brand co-pay. This is an abnormal plan design. Dr. says it has to be filled, but member can say they want brand (Nexium) then the member pays the brand co-pay only.

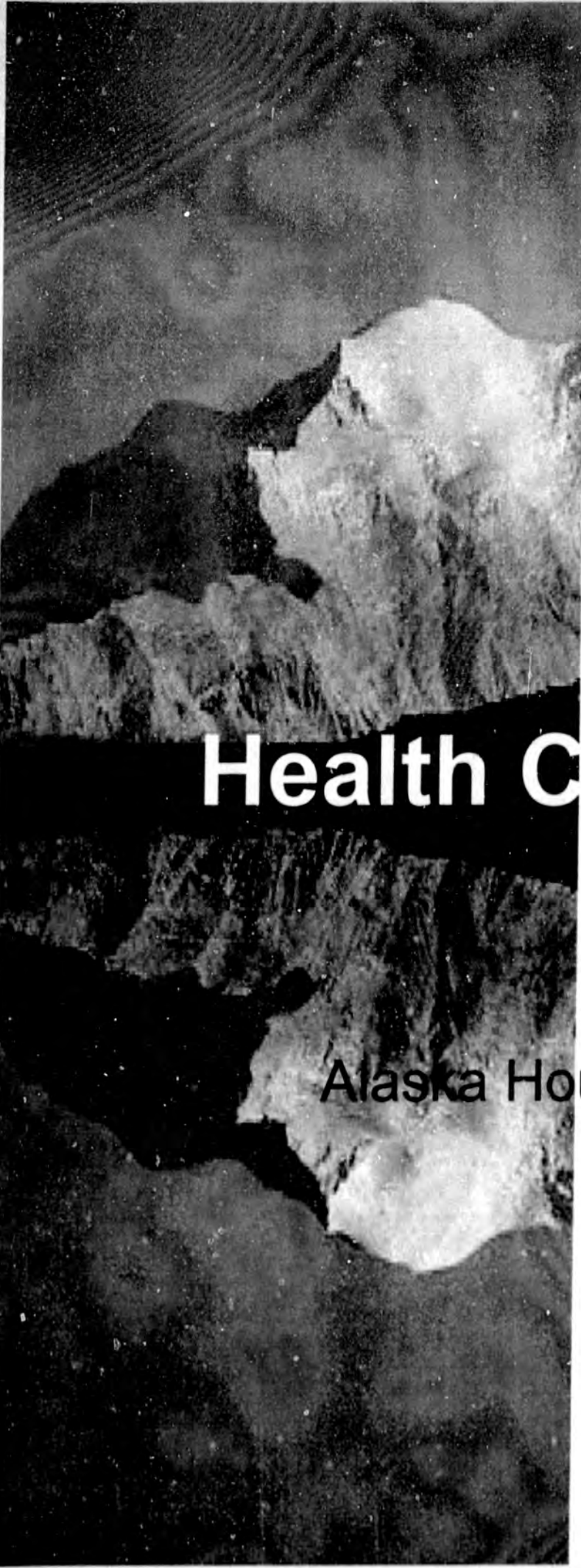
Closed formulary is a list of covered drugs. These would be the only drugs available for purchase with a plan benefit. This is the most restrictive plan design. (Medicaid drug pooling uses this method.)

Note:

The DAW code set was created by the NCPDP (pharmaceutical association) and is used in the pharmaceutical industry and affects the actual payment of claims. These codes are called Dispense as Written (DAW) codes and they refer to:

- 1 = Substitution not allowed by provider
- 2 = Substitution allowed- patient requested generic product dispensed

Difference in design is how it is paid, not what is available. Drug rebates pre-paid (guaranteed) to offset admin fees is an unusual plan design. Although unusual, this feature is integrated in the state's plans currently.



Department of Administration
Division of Retirement and Benefits

AlaskaCare Health Plan

Health Cost Analysis

**Report to the
Alaska House of Representatives
Special Committee on
Ways and Means**

January 27, 2006



AlaskaCare Health Plan Information

The **Retiree AlaskaCare** (retired members) health plan covers medically necessary expenses at 80% of usual, customary, and reasonable charge after a \$150 individual, \$450 per family deductible. Routine services are not covered. Expenses for travel round trip to the nearest available medical treatment facility is available with pre-certification.

Retail prescription drug copays are \$4 generic and \$8 brand for a 90-day or 100-unit supply. Mail order drugs have no copay. Mental health benefits are available at 50% without pre-certification and 80% with pre-certification.

Certain services require pre-authorization in order to be covered or pre-certification to receive the highest benefit. Coverage offers a network of participating providers and hospitals.

The AlaskaCare retiree health plan became self-funded in 1997. Aetna is the Third Party Administrator for health claims costs and pharmacy benefit management.

I. Retiree Population Demographics

RETIREE AlaskaCare Health Cost Analysis June 2001-December 2005					
Demographics of retiree membership	June 2001- Dec. 2001	2002	2003	2004	January 2004-Dec 2005
Number of Retirees	22,463	23,967	25,345	26,672	28,311
Number of Dependents	22,830	22,881	23,299	24,668	25,335
Ratio of Dependents to Retirees	1.0	0.95	0.92	0.92	0.90
Percent Male Retirees	47.1%	47.1%	47.0%	47.1%	46.9%
Percent Female Retirees	52.9%	52.9%	53.0%	52.9%	53.1%
Average Age – Retiree	63	63	64	64	64

II. Cost Drivers in Alaska

In July 2005, Commonwealth North issued a report titled, "Alaska Primary Health Care: Opportunities and Challenges." Highlights of the report conclude the following (attached):

- Approximately 110,000 Alaskans have no health insurance coverage.
- Thousands are turning to hospital emergency rooms as a source of primary care many without ability to pay.
- Inadequate health care in remote areas is a significant logistical, financial and educational challenge.
- Alaska health care costs are approximately 40% higher than Seattle (per Premiera, corroborated by Providence and Alaska Regional).
- Alaska hospitals are losing tens of millions of dollars from uncollectible accounts arising from excessive emergency room use and they are unable to reduce the amount of emergency room care provided due to Federal law (see attached).

III. Cost Drivers Specific to AlaskaCare Health Plans

Growth in enrollment:

- Retirees with dependents increased from 45,293 members to 53,646 from December 2001 to April 2005.
- Medical enrollment increased 5.3% and Dental-Vision-Audio (DVA) enrollment increased 6.2% on a year over year basis.
- Most of the growth represents retirees who are under the age of 65.
- This population often receives a richer benefit as a retiree than they had as an active employee.
- Between 1,800 to 2,000 members retire annually and receive system-paid medical benefits for themselves and eligible dependents.

Increase in claim costs:

- There continues to be an increase in claims per employee/retiree.
- The largest increases in claim dollars are for medical services and prescription drugs.
- The plan's experience continues to be lower than the national trend averages over the last three year period.
- Utilizing network providers can reduce medical costs, however, Alaska has relatively few providers who are participating.
- Retirees have little incentive to control their drug costs due to minimal cost share by members
- Technological advances in medicine have acted to increase medical costs as the new technology is utilized.
- Seventy-five percent of the retiree medical costs are incurred for pre-65 members. The costs are reduced to 25% for post-65 medical costs because this is when the AlaskaCare Plan coordinates with Medicare.

IV. Authority

Retiree Medical Plan--Authority Source

PERS - AS 39.35.535 Medical Benefits

(a) Except as provided in (d) of this section, the following person are entitled to coverage if a benefits recipient elects major medical insurance coverage under this section:

- (1) a person receiving a monthly benefit from the system.
- (2) the spouse of a person receiving a monthly benefit from the system.
- (3) a natural or adopted child of a person receiving a monthly benefit from the system, if the dependent child as defined in AS 39.35.680.

TRS - AS 14.25.168 Medical Benefits

(a) Except as provided in (c) of this section, the following person are entitled to coverage if a benefits recipient elects major medical insurance coverage under this section:

- (1) a person receiving a monthly benefit from the system
- (2) the spouse of a person receiving a monthly benefit from the system
- (3) a natural or adopted child of a person receiving a monthly benefit from the system, if the dependent child as defined in AS 14.25.220.

The Commissioner of Administration has the authority to determine and make changes to the retiree "AlaskaCare" Health Plan.

Legal Constraints Regarding Making Changes - Retiree Health Plan

Alaska State Constitution, Article 12 Section 7.

Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired. Retired State workers are protected by this section from the loss or reduction of retirement benefits due them.

In 1999, at the request of retirees, the Commissioner approved seven changes to the retiree health plan. Each of the changes had advantages with corresponding disadvantages to the benefits for the retiree membership. The changes were intended to be offsetting and cost neutral to the plan. RPEA (Retired Public Employees' Association), ASEA and NEA brought suit regarding the plan design changes.

In 2003, the Alaska Supreme Court held that (1) health insurance benefits are benefits protected from diminishment or impairment by the Alaska Constitution; (2) Constitution protects health insurance benefits themselves rather than the costs of those benefits; and (3) when determining if changes were reasonable to pass constitutional muster, *comparative analysis of disadvantages and compensating advantages of changes to health insurance benefits must be made* [Emphasis added] by focusing on the entire group of employees rather than the individuals.

This case has been remanded back to the Superior Court to analyze the plan changes based on the Supreme Court's ruling and determine damages, if any, regarding these changes (trial started January 17, 2006).

V. Cost Containment Initiatives

The Health Benefit Subcommittee was a subcommittee of the PERB and TRB boards. This group would discuss options regarding the Retiree AlaskaCare plan with Division staff, Deloitte and Aetna. One initiative was the generic drug campaign, a collaborative effort between Division staff, the Health Benefit Subcommittee, Deloitte and Aetna was the generic drug educational initiative to move members from Brand name drugs to generic drugs. The Alaska Retirement Management Board (ARMB), which replaced the PERB and TRB, has a Cost Containment Health Subcommittee for retirees.

AlaskaCare Retiree Health Plan

The AlaskaCare Retiree plan faces challenges in containing health care costs due to the provisions noted under **Section III and IV**. There are two primary vehicles to manage health plans: (1) plan design changes and (2) plan eligibility audits. Noted below are several of the initiatives undertaken to manage costs and ensure fiduciary responsibility for a qualified plan.

2004 - Retiree AlaskaCare members were required to submit proof of full-time student status at an accredited educational or technical institution recognized by the Department of Education and Early Development for their dependents between the ages of 19 and 23. Prior to this date, coverage was extended to dependents up to age 23 regardless of full time student status. Approximately 1,000 dependents were removed from eligibility on January 1, 2005, when members failed to provide supporting student documentation.

- The potential savings to the plan based on \$3,034.20 claim dollars paid per dependent in FY04 is **\$3.03M**.

2005 - Retiree Eligibility Verification is scheduled to begin November through January 2006 and become effective January 2006. The State has never required dependent eligibility verification for retirees covered under the AlaskaCare Plan.

- Estimated that this initiative will result in annual cost savings of **\$16 million**.

Generic Drugs - For the retiree plan, generic drug utilization increased from 35% in 2001 to 45% in 2005 (most plans do not rise above 50% for generic drug usage). Continued education and encouragement to the membership to utilize generic equivalent drugs is an ongoing campaign. For the retiree plan every 1% movement from Brand name drugs to generic represents a \$1 million savings to the plan.

- Estimated annual savings for from increase in generic drug usage in CY2004 at the 41% compared to CY2005 at 45% is approximately **\$4 million**.

Network Savings – Aetna as the Third Party Administrator for the State of Alaska's health plans has established a comprehensive network system with providers and health facilities. Members who receive services from preferred providers or facilities that are in the network system represent millions of dollars of savings to both plans each year. The State has negotiated with Aetna to meet certain performance guarantees through the use of network providers and facilities in order to increase the savings amount.

- For 2003 the network savings was \$22.2 million and for 2004 the savings amount was **\$25.8 million** for FY2005 the network savings amount was **\$35.2 million**.

Pharmacy Rebate

The retiree health plan receives an annual prescription drug rebate Aetna as a result of the pharmacy negotiated discounts received by Aetna.

- The annual pharmacy rebate is approximately **\$4.0 million**

Medicare Part D - The Retiree Drug Subsidy, part of the Medicare Modernization Act of 2003, will provide a 28% subsidy of qualified retiree drug costs back to the plan if the plan maintains the same level of drug benefit available today. Because the AlaskaCare health plan provides a better benefit than Medicare's Part D drug plan, CMS will pay the State up to 28% of eligible costs for maintaining prescription drug coverage for Medicare participants.

The Division has been successfully approved to participate in the subsidy program. In CY2005 the pharmacy cost was approximately \$96 million.

- The estimated savings to the plan is projected to be **\$7 million** annually.

Total estimated savings to AlaskaCare Retiree Health Plan based on initiatives noted above for CY2006 is estimated at \$69.2 million.

Noted below are the retiree health plan premium Increases, trend projections, and Aetna corporate trends:

	CY04	CY05	CY06
Plan Actual Percentage Premium Increase	12.0%	5.5%	3.0%
Retiree AlaskaCare Plan	13% Medical 15% Rx	6-10% Medical 12-14% Rx	3-5% Medical 20-22% Rx
Aetna Corporate Trend		15-16% Medical 15% Rx	18% Medical 14.5% Rx
Section 2.3 Actuarial Assumption Health Cost Trend		9.5% Medical 14% Rx	9% Medical 13% Rx

Noted below are the retiree plan claims costs for FY2005 through FY2001.

Health Claims Cost by Fiscal Year	Number of Members	Amount
FY2005	28,311	\$256 Million
FY2004	26,672	\$226 Million
FY2003	25,345	\$205 Million
FY2002	23,967	\$148 Million
FY2001	22,463	\$128 Million

How does the Alaska Retiree Health Plan compare with other state retiree health plans?

The short answer is "favorably". The Division's retained actuary conducted a robust analysis in 2004 as part of the Tier redesign study associated with the medical plan and the resultant costs to provide medical coverage to eligible retirees. The actuary concluded that the benefits provided to retirees are "rich" when compared to their other clients.

Workplace Economics conducted a study that was issued in 2004. The study reviewed the 50 states regarding retiree medical coverage. The report (attached) indicates what percentage of states and what level of retiree medical coverage is provided. The percentage noted below are for the pre-65 health care coverage.

- 24% or 12 States provide access only to health care; the retirees must pay 100% of the premium
- 44% or 22 States cost share with employees (i.e., low plan \$159 per month to \$925 per month)
- 32% or 16 States pay the entire premium costs for members

SB 141 Addresses Future Medical Costs

- Establishing eligibility criteria that aligns with national trends
- Over 50% of pension systems establish the normal retirement date at age 65
- The normal medical cost for new Tier IV members is 1.75% compared with 8.68% PERS "all Tiers" and 9.07% TRS "all Tiers"
- Medical cost trends will be reviewed annually by the retained actuary and a second actuary
- **Seventy-five percent of the retiree medical costs are incurred for pre-65 members. The costs are reduced to 25% for post-65 medical costs because this is when the AlaskaCare Plan coordinates with Medicare.**

VI. Trends by National Government and Employers/ Plans to Reduce Claims Costs

On a federal or national level there are things like EMR/EHR (Electronic Medical/Health Records - CMS is giving physicians free software), and review/accreditation organizations trying to provide information (AHRQ, NCQA-HEDIS, JCAHO, URAC, Leapfrog, eValue8, etc).

On an Employer/Plan perspective, some initiatives would include:

- Prescription Drug Initiatives
 - Increase generic usage via education or voucher programs*
 - Specialty drug network for serious/chronic conditions, typically injectables
 - Step Therapy or prior approval for certain drugs **
 - Further restricting formulary **
- High Deductible Health Plan (HDHP) with Health Savings Accounts **
- Disease Management and enhanced disease management (expanding conditions managed) for active members ** can be part of HDHP
- Incentives for Wellness Programs (i.e. Health Risk Assessments) ** can be part of HDHP
- Centers of Excellence (Transplant, Cardiac, Bariatric Surgery, Cancer)**
- Further restricting networks (most often using Tiered Networks)
- Health Advocate Programs
- Consumer Education (Transparency of Costs) **

The State of Alaska has implemented the items identified above by *. Further, the items identified above as ** are in the process of being researched/studied for possible future implementation.

Future cost containment initiatives being researched for future implementation include:

- Hospital PPO for retirees. Steerage to preferred hospitals in the municipality of Anchorage and in the lower 48 has the potential for an undetermined amount of savings through negotiated network.
- Closed formulary. This would reduce drug costs without limiting the drugs available to members, but would steer members to utilize cost effective medications as an alternative to using the most costly drug.
- DAW – Stands for Dispense as Written. This is a way for the doctor to write the script to allow the pharmacy to substitute a less expensive drug for a more expensive drug if it is available and safe for the patient.
- Wellness programs.

Managed Care: What is it?

A healthcare system and ideology based on prepaid membership instead of fee-for-service payment each time service is delivered. Main characteristics: 1. The system usually includes a set group of providers and is associated with a certain health plan. 2. Patients must be enrolled in the relevant health plan and pay the set premium in advance. 3. The health plan and the providers share financial responsibility for care delivery.

Why doesn't it work in Alaska like it does in the Lower 48?

The fee-for-service delivery system we see in operation in Alaska currently has no true managed care component. The components necessary for successful managed care delivery is an adequate number of providers to participate in a capitated arrangement (set fees are paid per employee per month whether the employee obtains services or not in that month) and competition between doctors to provide those services.

In Alaska, it is the patients who are competing for doctors, not the doctors who are competing for patients, which is the dynamic that is juxtaposed to a successful managed care type of health delivery arrangement we see in other areas of the Lower 48 states. It is not impossible, but it is more difficult to implement managed care delivery if the physicians and allied health professionals in the service area have more patients than they need to maintain their practice's current economic strategies using traditional fee-for-service arrangements.