

ALASKA LEGISLATURE COMMITTEE FILES, 2005-2006 80 / 2  
11735 SENATE COMMUNITY & REGIONAL AFFAIRS

# FISCAL NOTE

STATE OF ALASKA  
2006 LEGISLATIVE SESSION

Fiscal Note Number: 2  
 Bill Version: CSHB 278(FIN)  
 (H) Publish Date: 3/27/2006

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Revenue  
 Title: Retirement System Bonds RDU \_\_\_\_\_  
 Component: Alaska Municipal Bond Bank  
 Sponsor: Rep. Mike Hawker  
 Requester: \_\_\_\_\_ Component No. 121

**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						
<b>TOTAL OPERATING</b>	*	*	*	*	*	*

<b>CAPITAL EXPENDITURES</b>						
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<b>CHANGE IN REVENUES ( )</b>						
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**FUND SOURCE** (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
Bond Proceeds						
Bond Bank Investment Earnings						
<b>TOTAL</b>	*	*	*	*	*	*

Estimate of any current year (FY2006) cost: 0.0  
 Check 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 278 expands the ability of the Alaska Municipal Bond Bank Authority (Bond Bank) to borrow money for loans to communities for the purpose of prepaying their unfunded accrued actuarial liabilities of the retirement system. The premise of undertaking this type of transaction is providing communities with an efficient means of borrowing to fund all or a portion of their unfunded liability. The difference between the cost of capital and the earnings on the investment of that capital by the retirement system accrue to the participating community.

Should any transaction be undertaken the fiscal impact on the Bond Bank will be an increase in debt issuance costs. These include: rating agency fees, financial advice, bond counsel, printing, cusip

Prepared by: House Finance Committee Phone \_\_\_\_\_  
 Division: \_\_\_\_\_ Date/Time 3/27/06 10:16 AM  
 Approved by: Rep. Kevin Meyer, Co-Chairman Date 3/27/2006  
Rep. Mike Chenault, Co-Chairman

FISCAL NOTE #2

STATE OF ALASKA  
2006 LEGISLATIVE SESSION

BILL NO. CSHB 278(FIN)

**ANALYSIS CONTINUATION**

service, underwriting, and other related expenses. Those costs will be funded from the bond proceeds and Bond Bank investment earnings. The Bond Bank estimates the initial cost associated with a hypothetical transaction of one billion dollars would approximately be \$7 million in the year in which the transaction occurs, with \$40 0 per year in service expenses.

This fiscal note is indeterminate because it is unclear at this time if any transaction will take place.

# Representative Mike Hawker

## Alaska State Legislature



### House Bill 278 Sponsor Statement

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Cardwood  
Portage  
Whitner  
Sunrise  
Hope

### Short Title: Retirement System Bonds

HB 278 provides governmental employers the opportunity to utilize a financial mechanism generally referred to as a "Pension Obligation Bond" (POB) to help reduce the ultimate cost of satisfying the unfunded accrued actuarial liabilities of their retirement systems. A POB is essentially a legal arbitrage transaction where money is borrowed at a lower rate of interest than the money earns when invested by the retirement system.

HB 278 clarifies the ability of municipal entities to include POBs in their strategy to reduce the cost of meeting unfunded pension liabilities and expands the authority of the Alaska Municipal Bond Bank Authority to support governmental employers wishing assistance engaging in such transactions.

This bill does not authorize any debt instruments to be issued. Separate specific action would be required to initiate any transaction under the authority provided by HB 278.

Staff Contact: Juli Lucky 465-6587 Paulyn Swanson 465-6820

Revised 4/6/2006

## House Bill 278 (RLS)

Prepared by Representative Mike Hawker's Office

Updated April 20, 2006

- Section 1:** Allows a Teacher's Retirement System (TRS) employer to make a lump sum payment to prepay all or a part its share of the accrued actuarial pension liability; allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers.
- Section 2:** Outlines how municipalities can join together to issue debt obligations and allows funds diversion agreements between the municipalities and state agencies.
- Sections 3 & 4:** Adds facilitating language to two sections of the accounting statute for the Public Employees Retirement System (PERS) to accommodate the lump sum payments allowed in section five of this bill.
- Section 5:** Allows a PERS employer to make a lump sum payment to prepay all or a part its share of the accrued actuarial pension liability; allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers.
- Section 6:** Adds to the statutory policies established for the Municipal Bond Bank Authority. Provides a directive to assist governmental employers to meet their unfunded retirement system obligations by issuing debt instruments (often generally called Pension Obligation Bonds) on their behalf. Specifies that the bond bank should provide the lowest rates possible without subsidizing the employers beyond their means.
- Section 7:** Grants the Municipal Bond Bank Authority the power to create subsidiary entities to assist governmental employers as outlined in section eight of this bill.
- Section 8:** New statute defining the powers of the Municipal Bond Bank Authority to engage in "Pension Obligation Bond" transactions on behalf of governmental employers.
- Section 9:** Exempts "Pension Obligation Bonds" from the current limit for revenue bonds that the Municipal Bond Bank may issue each year.
- Section 10:** Authorizes the Municipal Bond Bank to issue "Pension Obligation Bonds".
- Section 11:** Exempts "Pension Obligation Bonds" from the current limit for total revenue bonds and notes that the Municipal Bond Bank may have outstanding at any time.
- Section 12:** Adds a definition for "governmental employer" to the definitions section for the Municipal Bond Bank.
- Section 13:** Immediate effective date.

**ALASKA MUNICIPAL LEAGUE**

**RESOLUTION #2006-02**

**A RESOLUTION URGING THE STATE TO PROVIDE FOR A  
STATUTORY MAXIMUM EMPLOYER CONTRIBUTION RATE AND  
ALLOW EMPLOYERS THE OPTION OF REFINANCING THEIR  
PERS/TRS DEBT**

**WHEREAS**, the State of Alaska created the Public Employees Retirement System (PERS) in 1962 to provide a retirement system for state and participating municipal employees; and

**WHEREAS**, many cities and boroughs have participated in PERS for many years; and

**WHEREAS**, the basic premise of a defined benefit pension plan is that employer and/or employee contributions are invested by the plan administrator in accord with sound actuarial principles so that adequate funds are available for retiree pensions and health care benefits; and

**WHEREAS**, the PERS system is seriously underfunded on a statewide basis; the plan's assets are roughly equal to only 70% of the projected plan expenses; and

**WHEREAS**, in response to the underfunding, PERS administrators have indicated that the employer PERS contribution rate will increase by 5% compounded annually every year for many years; and

**WHEREAS**, this past March, the Senate Finance Committee of the Alaska Legislature found the following reasons for PERS underfunding:

- Inaccurate assumptions
- Historical understatement of system liabilities
- Rising health costs
- 3-year "bear" market downturn
- Declining interest rates
- Unfavorable demographic changes
- Timing of the recognition of market losses
- Artificially low contribution rates in good times
- Legislation that has increased benefits
- Awarding of Post Pension Retirement Adjustments

**WHEREAS**, by passage of Senate Bill 141, the State has taken a significant step towards a long-term resolution of the statewide PERS shortfall; effective July 1, 2006, the existing defined benefit plan will become a defined contribution plan for employees hired on or after that

date; under a defined contribution plan the liability of the employer is limited to making contributions; and

**WHEREAS**, all municipalities and local taxpayers face eventual fiscal calamity as the employer rate increases by 5% of total salaries paid per year; and

**WHEREAS**, establishing a maximum employer PERS rate will enable municipalities to afford to continue to provide essential public services; and

**WHEREAS**, the State government has vastly superior revenue resources compared to municipal governments; and

**WHEREAS**, statutory changes to allow municipalities and the state to refinance the existing debt could potentially save several percentage points of interest charges each year.

**NOW, THEREFORE BE IT RESOLVED** that the Alaska Municipal League agrees to the following:

- To avoid penalizing local taxpayers and students, the PERS statutes should be amended to provide for a maximum employer contribution rate of 20%, with any amount above 20% to be paid by the State, as part of the changes to resolve the plan underfunding.
- That the State allow employers the option of refinancing their existing PERS/TRS debt in order to use financing methods that are available at a rate lower than 8.25%.

## City of Soldotna

177 North Birch • Soldotna, Alaska 99669 • Phone: (907) 262-9107

**Soldotna**



Representative Mike Chenault, Co-Chair, House Finance Committee  
State Capitol, Room 502  
Juneau, AK 99801

Re: HB 278 and Other PERS Unfunded Liability Bills

The City of Soldotna supports legislation allowing an option for pension obligation bonds as a tool in dealing with the PERS unfunded liability issue. But, we feel that there are some broader considerations that should be part of this or any bill dealing with this issue. We ask you to submit the following comments to the Finance Committee.

As the Alaska Legislature considers options for reduction of the unfunded liability for PERS and TERS, you should ensure that communities who have taken steps to reduce that liability are not penalized. The City of Soldotna has taken steps to reduce its unfunded liability and should receive credit for this in any plans adopted by the Legislature.

The City of Soldotna, like all other participants in PERS, received notice of an unfunded liability of approximately \$4 million. We were also advised that this liability would effectively accrue interest at 8.25%. That interest charge equaled \$330,000 annually, or \$25,000 a month. At that time, the City's total contribution rate set by the State was about 2.5% and was raised to about 4.5%. With the statutory limit on increases of only 5% of payroll annually, it would have taken until FY 2005-06, the current year, before the City's contribution even equaled the accruing interest.

Faced with this situation, the City Council determined a payment of \$1 million should be made to reduce the unfunded liability. This payment was made in November of 2004. So that you understand the impact of waiting, I want to tell you how the money was applied to the City's liability. Of the \$1 million, \$620,000 went to accrued interest back to the date our unfunded liability calculation was made. Our "principal" owed was only reduced by about \$380,000. The City also elected to apply the legislatively provided offset funding for the current year's 5% increase to be applied to the unfunded liability as well. We absorbed the actual increase in the contribution rate in the City's operating budget.

Many communities asked about our actions. While they saw some benefit, most were concerned that if the Legislature provided assistance, credit would not be given for payments made to reduce the unfunded liability. If the State elected to

pay off the unfunded liability balance in full and did not give credit for earlier efforts to reduce the liability. Soldotna would have paid \$1 million more than other participants. This fear makes it difficult for a community to consider being a good steward of its resources. The Legislature must recognize this and if any relief is given, make sure it is not based on just the unfunded liability on the date relief is given, but also considers the extra payments made prior to that date.

Sincerely,



Thomas R. Boedeker  
City Manager

cc: Representative Kurt Olson  
Senator Tom Wagoner

An Introduction to



# Pension Obligation Bonds

ROGER L. DAVIS

  
ORRICK

## ABOUT THE AUTHOR

Roger L. Davis is chair of the Public Finance Department at Orrick, Herrington & Sutcliffe LLP, the premier bond counsel firm in the country. Mr. Davis is also head of Orrick's Pension Obligation Bond Group and has worked on more than 20 POB issues in various states.

Members of Orrick's Pension Obligation Bond Group are shown on the contact list on the inside of the back cover of this booklet.

**DISCLAIMER:** Nothing in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as an introduction to the general subject of the use of pension obligation bonds, from which better informed requests for advice, legal and financial, can be formulated.

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## CHAPTER ONE

### Introduction

Pension obligation bonds ("POBs") are bonds issued by a state or local government to pay its obligation to the pension fund or system in which its employees (or others for whose pension benefits it is responsible) are members. POBs are an increasingly popular way for state or local governments to accomplish a variety of financial and other (including political) objectives.

According to Thomson Financial, during the past decade there have been at least 275 POB issues by state and local government issuers in at least 22 states.

The purpose of this pamphlet is to introduce interested parties to the reasons why POBs are issued, advantages/disadvantages, structure alternatives, federal tax issues, and representative programs in three states where POBs are particularly popular.

The author is chair of the Public Finance Department at Orrick, Herrington & Sutcliffe LLP and has been bond counsel on more than twenty POBs in various states. Orrick is the nation's premier bond counsel firm, ranked number one for more than a decade,<sup>1</sup> with extensive experience in all types of POB and similar financings.

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<sup>1</sup> Rankings for securities transactions of various types are performed annually by Thomson Financial, which has ranked Orrick number one in the country as bond counsel since prior to 1990. In an average year, Orrick handles more than 500 bond issues, aggregating more than \$20 billion.

<sup>2</sup> Orrick is ranked by Thomson Financial as the number one bond counsel in the country for POBs over the last decade, with more than 4 times as many such issues as the second ranked firm.

## CHAPTER TWO

# Pension Obligations

Pension obligations generally fall into two categories:

### A. Unfunded Accrued Actuarial Liability (UAAL)

The unfunded accrued actuarial liability ("UAAL") is determined by the actuary for the pension fund to be the amount by which the pension fund is short of the amount that will be necessary, without further payments from the state or local government, to pay benefits already earned by current and former employees covered by the pension system. The UAAL is based on assumptions (in some cases established by the actuary and in some cases by the pension system or by the state or local government) as to retirement age, mortality, projected salary increases attributed to inflation, across the board raises and merit raises, increases in retirement benefits, cost of living adjustments, valuation of current assets, investment return and other matters. In order to avoid volatility in the UAAL based on swings in market valuation, the investment gains and losses on assets in the pension fund are often recognized (sometimes referred to as "smoothed") over a 3 to 5 year period.<sup>4</sup> The state or local government is obligated to amortize the UAAL over a period established by law or agreement with the pension system, typically at an assigned interest rate established by the pension system, which assigned interest rate is usually the same as the actuary's assumed rate of investment return on pension fund assets (sometimes referred to as the "Actuarial Rate").

<sup>4</sup> Note that the smoothing methodology referred to may result in "unrealized" or "lagging" unfunded liability. See discussion of POB possibilities in footnote 4.

## B. Normal annual contribution

In addition to making payments toward any UAAL, the state or local government is required to make payments to the pension fund each year in respect of the present value of the benefits being earned by the current employees covered by the pension fund (that is, the amount being earned by those employees with each paycheck necessary to pay future retirement benefits, based on assumptions of mortality rates, salary increases, assumed rate of investment income and the other assumptions referred to in the preceding paragraph), generally referred to as the "normal annual contribution."

## CHAPTER THREE

# Reasons For Issuing POBs

The reasons why state or local governments issue POBs vary from issuer to issuer and from time to time with economic conditions and other circumstances. However, these reasons generally fall into one or more of the following categories.

## A. Interest Rate Savings

As described in Chapter Two, most pension systems assign an interest component to the payments the state or local government is required to make in respect of its UAAL. Assigned interest rates currently generally range from 7½% to 8½% depending on the particular pension system. When taxable bond rates are low, and as of fall 2003 they are roughly 5.95% or less for 30 year debt, then POBs can function like a classic interest rate savings refunding. For example, if the assigned rate is 7.5% on a UAAL of \$100,000,000, the annual all in cost would be roughly \$8,500,000 assuming a 30 year amortization, compared to an all in cost of \$7,300,000 on POBs amortized over the same period assuming a 5.95% interest rate and costs of issuance of 1%. These savings to a degree can be front loaded or otherwise structured to occur when most needed (see Section C of Chapter 5).

On the other hand, because the factors on which the UAAL is based are constantly changing (such as mortality and investment return), the final amount of interest rate savings cannot be determined with certainty. Also, the assigned interest rate may change from time to time during the life of the bond issue, and, at least theoretically, the amount of interest rate savings could become negative (even if all the other factors remain the same) if the assigned interest rate were to drop and remain below

the bond interest rate for a substantial period. So far this has not occurred, even though the assigned interest rate in some cases has dropped by more than one percentage point since the mid 1990s. This possibility is furthermore generally considered to be unlikely, because the assigned interest rate is based on an assumed investment rate of return which reflects investments with a higher risk profile and, therefore, higher projected return than the POBs.

## B. Discounts

In some cases, it may also be possible to negotiate discounts with the pension system for early payment of the normal annual contribution or even the UAAL (which may reflect the pension fund's assumed rate of investment return or even its then current investment opportunity). It may also be an opportunity to renegotiate other terms of the pension obligation.

## C. Arbitrage

Generally, pension funds may invest in a much broader range of investments than the state or local governments, and the size and diversity of the pension fund's portfolio allows for a higher risk profile than the state or local government could prudently sustain with its own investments. As mentioned above, this is why the assumed rate of investment return is generally materially higher than the bond rate. The actual investment performance of most pension systems (at least in most years) has substantially exceeded the assumed interest rate. Therefore, there is the possibility that proceeds of the POBs will be invested by the pension fund at significantly higher return than the interest cost on the POBs (even if interest on the POBs is taxable).

In almost all cases, the benefit of earnings on investment of bond proceeds in the pension fund will be credited to the state or local government issuer either in reduced

UAAL or reduced normal annual contribution or both. In some cases, the allocation of this benefit is subject to negotiation between the state or local government and the pension system and may even be decided by the state or local government each year. This benefit from earnings is why interest on POBs is generally not exempt from federal income tax (see Chapter 6). So this arbitrage is not the typical municipal bond arbitrage derived from borrowing at tax exempt rates and investing at taxable rates, but rather what might be called risk arbitrage derived from borrowing against the credit of the state or local government and participating through the pension fund in a portfolio of investments that is designed to produce a higher yield and manage the higher risk through diversification. Of course, there is no guaranty that such arbitrage will be positive.

## D. Budget Relief

Particularly in the current environment of substantial budget deficits, POBs are being used for budget relief. This may be accomplished by:

- (1) reamortizing the UAAL by replacing the obligation to the pension fund with POBs having a longer term and/or lower payments in the early years (or even no debt service in the early years if capital appreciation bonds (CABs) or capitalized interest is used); and/or
- (2) funding the normal annual contribution for the current (and maybe the next) fiscal year (to the extent permitted by applicable state law)

## E. Labor Relations Benefits

Some state or local governments have used POBs, at least in part, to improve relations (or negotiations) with its employees and their unions by funding unfunded pension liability to those employees.

## F. Better Than The Alternatives

In some cases, POBs are simply better than the alternatives: (i) paying more into the pension fund; (ii) asking employees to pay more into the pension fund; (iii) reducing benefits; or (iv) hoping that gains on pension fund investments will substantially exceed the assumed rate of investment return.

## CHAPTER FOUR

### Possible Disadvantages of POBs

Despite the foregoing benefits of POBs, there are a few possible disadvantages

- A. In some jurisdictions, a state or local government may negotiate or even unilaterally make changes in its pension obligation, perhaps by postponing payments or changing assumptions. POBs replace this potentially flexible pension obligation with a more immutable bond obligation.
- B. As explained in Chapter 3, while unlikely, it is possible that the assigned interest rate will drop below the bond interest rate or that the pension fund will have negative earnings, in each case for a sustained period.
- C. If the pension fund enjoys higher than expected earnings, the pension fund may become overfunded and result in temporary contribution holidays, but also can lead to increases in retirement benefits that may be costly to sustain at some point in the future.
- D. POBs result in payment to and investment by the pension fund of a lump sum amount that otherwise would have been paid and invested in increments over a period of years, concentrating rather than spreading market timing risks.
- E. Almost all POBs are taxable and most taxable bonds with fixed interest rates are sold as noncallable bonds. Adding a redemption feature will ordinarily result in a materially higher interest rate cost than the same redemption feature in tax exempt bonds. Therefore, taxable noncallable bonds may be expensive to refund or defease, although there have been a number of successful tender offer refundings of taxable POBs (that is, a tender offer was made for the prior bonds and the tender price was paid with proceeds of new refunding bonds).

Another way to address this concern is by using variable rate bonds, which may contain redemption provisions without additional interest rate cost, and may be accompanied by a floating to fixed interest rate swap if a fixed rate obligation is desired.

*Note that many of these issues can be addressed in whole or in part by using POBs to fund less than all of the UAAL.*

## CHAPTER FIVE

### Types of POBs

#### A. Security

Most POBs are payable from the general fund of the issuing state or local government. As such, they must either satisfy or be exempt from the debt limitation provisions typically found in the applicable state constitution and, accordingly, generally fall into one of the following three categories:

1. **General obligation bonds**, which term generally refers to bonds that satisfy any constitutional debt limitation and are backed by the full faith and credit and taxing power of the issuing state or local government. An example is the \$10,000,000,000 State of Illinois General Obligation Bonds Pension Funding Series of June 2003 (Taxable), the largest POB issue to date. A variation is full faith and credit limited tax bond: payable from available general funds but without any obligation to levy additional taxes. See discussion in Chapter 10.

2. **Obligations imposed by law**, which term refers to an exception recognized in a few states from the otherwise applicable debt limitation contained in the state constitution. It applies to obligations imposed on the state or local government by the constitution or by statute or, in some cases, by court judgment as distinguished from a voluntary exercise of the borrowing power by the state or local government. Most pension obligations would qualify and, in states in which the obligations imposed by law concept applies, bonds issued to fund those pension obligations (PCOBs) are considered to have the same legal character as the pension

obligations themselves. POBs issued in California during the past decade have all been obligations imposed by law. See discussion in Chapter 9.

POBs issued as obligations imposed by law generally cannot include reserves or capitalized interest because those components of the obligation are not considered to be imposed by law, even on the theory they are essential to marketing the bonds (because so many obligations imposed by law POBs have been issued without them). On the other hand, costs of issuance may be included. The inability to include capitalized interest means that it may be difficult to achieve complete budget relief in the early period following issuance of the bonds without resort to capital appreciation bonds (CABs).

3. **Annual appropriation bonds**, which term refers to bonds that are not considered debt subject to a constitutional debt limitation because the state or local government issuer has no legal obligation to pay them and payment is therefore subject to annual (or other periodic) appropriation of funds for that purpose at the discretion of the legislature or governing body of the state or local government issuer. Examples include the \$773.5 million POBs issued in 1996 for the State of New York and the \$2.8 billion POBs issued in 1997 for the State of New Jersey.

4. **Other.** In the mid-1980s and occasionally since, some cities and counties in California issued POBs as so-called asset-strip lease revenue bonds or certificates of participation (COPs). The city or county leased existing facilities (with a value at least equivalent to the amount of bonds/COPs to be issued) to a joint powers authority or other governmental entity or to a nonprofit corporation, simultaneously leasing them back; the leaseback was assigned to a trustee and bonds/COPs were issued secured by the leaseback payable from the city or county's general fund, and the proceeds of the bonds/COPs were paid to the pension fund net of costs of issuance and reserves and capitalized interest retained by the trustee.

In certain circumstances, it may also make sense to use revenue bonds as POBs (for example, if the issuer is a revenue-producing enterprise authority or district). (See also Chapter 10.)

## B. Credit Ratings/Borrowing Capacity

Because POBs reduce existing pension obligations, they are not generally viewed as adding to the debt burden of the state or local government issuer (much like a conventional refunding).<sup>1</sup> To quote the rating agencies:

Moody's believes the issuance of pension obligation bonds (POBs) is one effective way of addressing an unfunded liability. Since POBs reduce the cost of funding an unfunded liability, their issuance is not by itself a credit weakness. However, the planning and analysis conducted by a local government as part of the decision to grant expanded benefits, the government's plan for funding any unfunded pension liability, and its ability and willingness to budget appropriately for any attendant higher costs, are reflective of the quality of the government's overall financial management. These factors, therefore, will be considered in our assessment of a government's general credit quality.<sup>2</sup>

Standard & Poor's factors the effects of a pension obligation bond strategy into the long-term rating of the sponsor. Standard & Poor's has viewed POBs as a strategy for savings on carrying charges as long as the transaction was structured conservatively and the assumptions were reasonable and attainable. This requires a clear financing plan including reasonable assumptions and manageable leverage. Prudent expectations for investment returns and the cautious use of resultant savings help insure a POB's success. Another positive factor for a POB is, of course, to be fortunate enough to sell the bonds in a low interest rate environment, thereby increasing the spread between interest costs and investment return expectations and lowering the risk of underperformance.<sup>3</sup>

Fitch believes that POBs, if used moderately and in conjunction with a prudent approach to investing the proceeds and other pension assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices with respect to POB proceeds could expose the sponsor to market losses.

<sup>1</sup> Note that to the extent the POBs fund the normal annual contribution, new long-term debt is created which could have an effect on credit ratings not present if the POBs fund only the UAAL.

Because a sponsor's unfunded pension liability is already factored into the rating, the issuance of POBs simply moves the obligation from one part of the balance sheet to another. However, Fitch notes that POBs create a true debt, one which must be paid on time and in full, rather than a softer pension liability that can be deferred or rescheduled from time to time during periods of fiscal stress.

Consequently, POBs can have a significant effect on financial flexibility over time.

The actual ratings on the POBs will depend primarily on legal structure. General obligation bonds and annual appropriation POBs should be rated the same as the issuer's other general obligation or annual appropriation debt. Obligations imposed by law POBs are generally rated in between, a notch below the issuer's general obligation bond rating and a notch above its lease or other annual appropriation debt.

### C. Structures

Because POBs are generally payable directly from the general fund of the state or local governmental issuer, the structure of the bond issue is usually simple and straightforward, varying primarily in interest rate mode, using one or a combination of the following:

1 **Fixed rate bonds.** Because most POBs are issued, at least in part, to achieve interest rate savings, most POBs are issued as fixed rate bonds. The advantages are the same as fixed rate bonds generally; namely, they lock in interest cost, and with interest rates at historic lows, this is a very attractive prospect in itself. The disadvantages are: (i) the assigned interest rate on the pension obligations funded with POBs is not fixed, so interest savings cannot be fixed with certainty (see Section A of Chapter 3), and (ii) fixed rate taxable bonds are usually sold as noncallable, so they cannot be easily refunded or defeased if rates drop or circumstances change (see discussion Section E of Chapter 4).

2 **Variable rate demand bonds.** Variable rate demand bonds are bonds the holders of which may tender them back to the issuer or its agent upon short notice

(usually 7 days, but may be 1 day, 1 month or other periods), for a purchase price equal to par plus accrued interest. As a result, they bear interest at rates like, and have some other characteristics of, short term obligations. Variable rate demand bonds generally require a bank letter of credit, standby purchase agreement or other facility to assure liquidity in the event bonds are tendered and cannot be remarketed. Unless the issuer is highly rated, variable rate demand bonds are typically also credit enhanced with either bond insurance or bank letter of credit or other credit facility. The advantages of variable rate demand POBs are that (i) their interest rates are generally lower than fixed rate bonds, and (ii) they are usually subject to redemption at any time without premium and at no extra interest rate cost for the right to redeem. However, while the interest rate usually starts out lower than fixed rate bonds, the rate is variable and subjects the issuer to interest rate exposure and risk to the interest rate savings objective and to the risk arbitrage pension fund investment objective for issuing the POBs (see discussion in Sections A and C of Chapter 3). Interest rates may be affected not only by market conditions but also by the financial condition of the issuer or the credit provider or liquidity provider. In addition, there are risk costs and aggravation associated with renewal of any bank liquidity or credit facilities, which usually have a term of one to five years, compared to the POBs which typically have a term of more than 20 years.

3 **Auction rate bonds.** Auction rate bonds appear to be the most popular current variable rate mode at this time because they do not require a bank letter of credit, standby purchase agreement or similar liquidity facility required for variable rate demand bonds or commercial paper. This is because auction rate bonds are not puttable back to the issuer but instead are subject to periodic auction (typically every 7, 28 or 35 days) if the holder would like to dispose of its bonds other than by direct sale. The interest rate is reset by the auction price and tends to be materially less than the then current fixed rate (for example, in the fall of 2003, 7-day auction rate taxable POBs bore rates of roughly 1.05%–1.15% compared to 30-year taxable fixed rates of approximately 5.95%). However, there is no assurance that auction rates will not increase to exceed the fixed rate at which the POBs could have been originally issued. If there is an auction with no buyers (*i.e.*, a failed auction), the interest rate

usually goes to the maximum rate (typically 12 to 15%). Failed auctions are rare. The primary reason they may occur is (i) a cloud of some kind on the tax exemption of the bonds (for example, an IRS audit or challenge to the tax exemption of similar bonds), which is not a risk for most POBs because they are taxable, or (ii) a shock to the security for the bonds (for example, bankruptcy of an important source of revenue) which is improbable with general fund obligations like POBs unless the issuer goes bankrupt (which states cannot do under U.S. bankruptcy law, and cities and counties do very rarely).

**4. Indexed bonds.** Indexed bonds are variable rate bonds that are not subject to tender back to the issuer and, therefore, do not require a bank liquidity facility, and bear interest at a fixed spread over a market index (typically either three or six month LIBOR) reset at the end of each accrual period (typically quarterly if three month LIBOR is used or semiannually if six month LIBOR is used). LIBOR refers to the London Interbank Offered Rate and is published daily as page 3750 on the TeleRate Inc. news and information service (referred to as the Official LIBOR Page). Indexed bonds of this type are used primarily to facilitate marketing of POBs outside of the U.S. where investors are more accustomed to LIBOR based investments, but are also attractive to many U.S. investors as well. Like auction rate bonds, index bonds may be subject to redemption without penalty. However, also like auction rate bonds there is no assurance that LIBOR indexed rates will not increase to exceed the fixed rate at which the POBs could have been originally issued. However, unlike auction rates, the LIBOR index is not affected by events affecting the POBs issuer or the POBs. Index bonds may also be swapped to fixed more efficiently and with little or no basis risk compared to auction or other variable rate bonds because the global swap market is primarily LIBOR based.

**5. Capital appreciation bonds.** Capital appreciation bonds (CABs) are bonds that bear no current interest, which instead is accrued, compounded (usually semiannually) and paid at the maturity of the bonds. They are used primarily to reduce debt service in the early years. A variation is convertible CABs that function as CABs for several years and then convert on a certain date to current interest

bonds (with interest paid on the then accrued value of the bonds, being the original principal amount plus the amount of accrued, compounded interest up to the conversion date). The disadvantage of CABs is that higher rates of interest are required in order to market them.

**6. Swaps.** If variable rate bonds are used, the resulting interest rate exposure may be swapped to a fixed rate, in whole or in part, using a floating to fixed interest rate swap. While swaps may often make a great deal of sense in this context, they are complex financial investments and beyond the scope of this pamphlet. It is important to make sure that if a swap is to be used, it is consistent with the issuer's objectives and does not itself expose the issuer to risks or consequences the issuer does not fully understand or are inconsistent with its objectives. For example, if the purpose of using variable rate POBs is to allow for refunding or early redemption if rates drop or other circumstances change, the termination payment that may be due on early termination of the swap may offset the benefit of and effectively prevent refunding or redemption. There are also other circumstances in which a substantial termination payment may be due from the state or local government such as default of the swap provider or downrating of either party, as well as other terms that can be modified to suit the state or local government's objectives. Expert advice should be sought before entering into any swap.

#### D. Payments to the Pension Fund: Whole or Part

POBs may be issued to pay all or any part of the UAAL<sup>1</sup> or (depending on applicable state law) the normal annual contribution.<sup>2</sup> Frequently, issuers choose to use POBs to fund only a portion of the UAAL, generally to avoid or reduce the concerns described in Chapter 4. The portion of the UAAL funded may be (1) a percentage of the total UAAL as of the date of issuance of the POBs, or (2) all of

<sup>1</sup> Depending on state law and financing structure, it may also be possible to finance future year's normal annual contribution and/or unfunded liability created by investment losses not yet realized due to actuarial smoothing methodologies (which phase in investment gains and losses over a period of, usually 3 to 5, years).

certain years contributions to the UAAL. If agreed to by the pension system, the second approach can result in suspension of all UAAL contributions during those years (for example, the next succeeding 10 years). At the end of the period, the UAAL will be recalculated and amortized over the remaining original term of the UAAL. The risk of this second approach to partial payment of the UAAL, which is much less common than the first approach, is that if investment performance of the pension fund is substantially below the assumed rate of return, there could be a significant increase in the amount of UAAL to be amortized over the remaining term. To a degree, that risk can be addressed by subsequent issues of POBs (before or after the date of recalculation).

## CHAPTER SIX

### Tax Issues

#### A. Taxable Bonds

Most POBs are taxable. That is, interest on the bonds is included in gross income for federal tax purposes, although they are usually exempt from income taxes of the state in which the issuer is located. This affects not only the interest rate at which the POBs are sold but also the types of investors to which they are marketed (for example, corporate pension funds, charitable endowments and others not subject to federal income tax and, for some of the larger issues, non-U.S. investors). There are, however, a few circumstances in which POBs may be tax exempt.

Why most POBs are taxable, with these few exceptions, is explained below.

#### B. Tax-Exempt POBs Prior to 1986 Tax Act

Prior to the enactment of the Tax Reform Act of 1986 (the "1986 Tax Act"), POBs that were properly structured could bear interest that was excluded from gross income for federal tax purposes. However, to get tax-exempt treatment, investment of bond proceeds for the benefit of the covered employees and former employees had to be designed so that the issuer/employer did not benefit from the investment in any way other than relieving the issuer of the responsibility of paying its retirees.

If proceeds deposited in the pension fund were expected to be invested in securities or obligations with a yield higher than the yield on the POBs, the issuer's obligation to make additional contributions into the fund would be reduced in the future. A

prohibited anticipated direct benefit from the investment of the bond proceeds by the pension fund.

However, the situation was different where the issuer contracted with someone else to take over the responsibility of making payment to the retirees and paid for that transfer of risk with proceeds of POBs – for example, by purchasing an insurance company annuity whereby the insurance company took over all liability for the payment of the pension benefits. In that case, the insurance company bore the risks and benefits of investment return – the issuer got no benefit from investments made by the insurance company even if the expected investment return was reflected in the price paid by the issuer for the annuity policy. In addition, the purchase of an annuity was not treated as the purchase of a “security” or “obligation” under the tax law. A number of tax exempt POB transactions were consummated in the early 1980’s in which the proceeds were deposited into a pension fund and were used to acquire insurance company annuity contracts.

### C. Tax Reform Act of 1986; Transition Rules

1. **Stopping New Issues of Tax-Exempt Pension Bonds.** As a result of the threat of a proliferation of tax exempt POB issues, Congress decided to amend the tax law to prevent the investment of tax exempt bond proceeds in annuity contracts. New rules were adopted in the 1986 Tax Act. “Investment type property,” including annuity contracts, was added to “securities” and “obligations” as potential arbitrage investments. In addition, because of the urgency with which it viewed the matter, Congress included a special effective date rule in the 1986 Tax Act relating to annuity contracts which applied to all bonds issued after September 25, 1985. The 1986 Tax Act essentially ended the issuance of tax exempt POBs for the purpose of depositing the proceeds into a pension fund or for the purpose of purchasing annuities to replace the issuer’s responsibilities to its retirees, except as described below.

2. **Transition Rules for Refundings of POBs.** The status of refundings of pre-1986 Tax Act POBs was not specifically addressed in the 1986 Tax Act. In connection with two later tax acts, the Technical Corrections Bill of 1988 and Technical and

Miscellaneous Revenue Act of 1988, Congress attempted to clarify its position on refundings. While the statutory language and legislative history are a bit confused, the related House, Senate, and Conference Committee Reports indicate that Congress intended generally to permit one advance refunding of pre-September 25, 1985 POBs (at least where the amount of the refunding is not greater than the amount of prior bonds). Additionally, the legislative history indicates that Congress intended to permit any number of current refundings of pre-September 25, 1985 POBs where the refunding bonds do not additionally burden the tax-exempt market, but merely replace existing tax-exempt debt.

### D. Columbus Case

The State of Ohio created a state fund into which municipal corporations in the State were required to transfer, on January 1, 1967, all existing assets and liabilities of their local pension funds for police and firefighters. Under the State law, all pension liabilities accruing after the transfer would be supported by current employer and employee contributions. However, while the State fund completely assumed the assets and liabilities of a city’s retirement fund, the law mandated the city pay to the fund, either immediately or over time, an amount equal to the present value of the accrued but unfunded liability determined at the time of the transfer. The City of Columbus opted to satisfy its obligation over time together with the required interest.

In 1993, the State modified the law to allow any city still owing money to the fund to extinguish its remaining UAAL in return for a single payment equal to 65% of the then unpaid principal balance. The City decided to prepay its obligation. However, upon hearing that the City was going to issue tax exempt bonds to fund its prepayment, representatives of the Internal Revenue Service notified the City that they would assert that interest on these bonds would be taxable. The City sought a private letter ruling from the Internal Revenue Service and received an adverse ruling which it appealed to the Tax Court.

In the court proceedings the Service argued, among other things, that the discount the City received on the prepayment of its obligation to the fund was a form of

investment return and thus created impermissible arbitrage profit. The Service reasoned that the pricing of the prepayment reflected the expectation of the State fund that it would be able to invest the amount of the prepayment at a yield materially higher than the yield on the City's bonds. As a result, the Service believed that both the City and State fund would benefit from the earnings on the investments. In addition, the Service argued that the prepayment constituted the use of bond proceeds to acquire "investment-type property" at a yield higher than that on the bonds (after taking into account the discount received on the prepayment) in that absent the discount pricing of the prepayment there would be no economic savings for the City.

Ultimately, the City prevailed on appeal as the Court of Appeals concluded that there was an existing obligation of the City to the State fund, the City would not benefit from the investment of amounts by the State fund and the prepayment of the City's own debt obligation to the State fund did not constitute the acquisition of investment-type property by the City. The City was then able to refund its obligation to the State fund by issuing tax exempt POBs.

While the unusual facts in this case have application beyond the City of Columbus, such application is likely to be fairly limited and to attract unfavorable attention from the Internal Revenue Service.

### E. Tax-Exempt Working Capital Bonds

While directly issuing bonds to deposit the proceeds into a pension fund does not appear to be permitted under current tax law governing tax exempt bonds, in certain cases it may be possible for a state or local government to indirectly fund the current year's pension deposit. For example, a state or local government may issue short term tax or revenue anticipation notes or long term working capital bonds to finance a cash flow budget deficit or a so-called structural budget deficit. The deficit analysis would include any cash flow deficit relating to the state or local government's obligation to deposit amounts into its pension fund.

It may be that this type of financing is best done so that the bond proceeds are not required to be deposited in the pension fund, but rather, are used to fund deficits

created by working capital expenditures including the deposit of amounts into the pension fund. In other words, it is important that the bond proceeds not be "traced" into the pension fund or required to be deposited there and the bonds should not be called Pension Obligation Bonds.

Among other things, long term bonds of this type would bring into play the application of some complex federal tax rules relating to when proceeds can be treated as spent, allocation of the deficit in sizing the issue, permitted amortization structure, the application of so-called "other replacement proceeds" rules, applicable yield and other investment restrictions, post-issuance compliance matters, plus the intersection in sizing and in post-issuance compliance with the issuance of normal tax or revenue anticipation notes and any other short term or long term working capital obligations.

### F. Investment of POB Proceeds in Municipal Obligations

The primary tax problem in the use of tax exempt POBs to make a deposit to a pension fund is that the proceeds are not treated as spent, but rather are treated as invested. Moreover, under the so-called "proceeds spent last" rule applicable to working capital financings, these proceeds cannot be treated as paid out to pension recipients until all other available amounts are first expended, which as a practical matter, means that the proceeds will never be deemed expended. Unless the investment yield on the investments in the pension fund is not more than the yield on the bonds, the bonds will become taxable arbitrage bonds. In addition, the "wedge bond" rules would result in the bonds being treated as taxable hedge bonds unless the issuer actually expected to spend the proceeds within a three- or five-year time frame, taking into account the "proceeds spent last" rule.

However, under both the arbitrage rules and the hedge bond rules, interest on the bonds used to fund the pension fund could be tax exempt if the issuer invested the proceeds of the bonds in municipal obligations the interest on which is not subject to the alternative minimum tax (so-called "non-AMT" municipal bonds). Under these provisions as long as the amount of non-AMT municipal bond investments in the

pension fund is at least equal to 95% of the amount of POBs outstanding at any time, interest on the POBs will be tax exempt. As the POBs are amortized, there is a similar reduction in the amount required to be invested only in non-AMT municipal bonds in the pension fund.

While this structure allows for POBs to be issued as tax exempt, the benefit of the tax exemption on the bonds may be outweighed by the limitation on the type of investments allowed with the proceeds.

### G. Other Considerations: Effect on TRANs

Tax and revenue anticipation notes (TRANs), are typically issued by state and governmental units of all sizes to fund the annual cash flow deficit which arises due to the timing mismatch between annual revenues and annual expenses. TRANs are almost always issued as short term notes with maturities of 13 months or less and are repaid at or shortly after the end of the fiscal year by which time it is expected that revenues will have "caught up" with expenses. To the extent the POB proceeds are used to fund a deposit to the pension fund that otherwise would have been made out of current year's revenues, the deficit will be likely be reduced by the same amount, impacting the sizing of any TRANs issued for that year. The one circumstance where this would not happen is if the calculation of the maximum cash flow deficit used in sizing the TRANs shows that it is incurred prior to the time of the pension deposit. In that case, the use of proceeds to make that deposit would not have any impact on the size of the TRAN issue.

## CHAPTER SEVEN

### Federal Reimbursement Issues

Certain costs of state and local government in administering programs under grants from or contracts with the federal government are eligible for reimbursement from the federal government. Such costs include compensation and benefits, including pension benefits, of state or local government employees for the time devoted to the administration of such programs. Such allocable pension benefit costs even include the interest assigned to the state or local government's unfunded liability. The principles governing such reimbursement are set out in Office of Management and Budget Circular A-87. Some states have similar programs for reimbursement of local governments for costs related to the administration of state programs.

POBs replace the state or local government's payment of some or all of these pension costs with payment of the principal of and interest on the POBs. Issuers will want to be comfortable that the federal government will treat debt service on the POBs as the surrogate for the pension obligations funded or refunded with the POBs and will continue to reimburse its allocable share. Statements have been issued by the Office of Management and Budget and the Department of Health and Human Services to the effect that the POBs, including principal (representing amounts paid to the pension fund), interest and costs of issuance, will be allowable as the pension costs funded or refunded thereby, so long as the POBs are not more costly to the federal government than the regular pension costs funded or refunded over the remaining life of the unfunded liability. The same principles should apply to refunding POBs. Further details of federal and state reimbursement programs are beyond the scope of this pamphlet.

## CHAPTER EIGHT

### New York

A greater number of POBs (roughly 95) have been issued by the state and local governments in New York over the past decade than from any other state.

The issuance of POBs by local governments in New York was first authorized in 1989. The State and Local Employees Retirement System of the State of New York ("ERS"), the New York State Police and Fire Retirement System ("PFRS") and the New York State Teachers Retirement System ("TRS"; in the aggregate referred to as the "NYS Retirement System") were all modified in 1989 with respect to the method by which the annual contribution amounts were to be calculated in the future. As a result, each system was significantly underfunded, requiring a "catch-up" payment to return to actuarial full funding. Participating local governmental units were offered the option of (1) amortizing the UAAL amount due by a date certain through a direct loan from the State which carried an 8% (for TRS) or 8 $\frac{1}{4}$ % (for ERS and PFRS) rate of interest until the liability was fully met, or (2) financing the UAAL through the issuance of general obligation bonds over a statutory period (applicable to the particular retirement system), or (3) paying cash by the date certain. Few local governments, except small jurisdictions with few employees, took the third option.

During the period 1989 through 1993, counties, cities and larger school districts, in particular, issued general obligation bonds to pay off their then current balance of unamortized UAAL, whenever interest rates dipped sufficiently to permit a lower net interest cost on their own bonds than the 8% or 8 $\frac{1}{4}$ % rate being charged by the State. During this period, local governments could issue ten year general obligation bonds with net interest costs in the range of 6% to 7.375% depending on their credit rating. The 1989 legislation further provided that at such time as the remaining amortization period was less than five years, local governments could no longer issue

their own debt to pay off the outstanding balances. Thus, with a permit for maximum statutory amortization period of seventeen years for most UAALs, the possibility of financing of the 1989 UAALs ended in the 2001-2002 fiscal year of most local governments.

Beginning in 1995, the State adopted legislation almost every year creating new retirement incentive programs for various categories of State and local government employees, largely to support a goal of efficient downsizing of government. Generally, the legislation establishing these programs did not at the time include provisions for financing of the resulting unfunded liabilities. Such costs, which added to any existing UAAL, were paid either by amortization through the NYS Retirement System or by cash.

Concurrently in this time period, another type of pension-related program was developed by the State legislature which authorized local governments to create service award and defined benefit programs for volunteer ambulance and fire-fighting personnel. The legislation permitted the financing of contributions to certain of such programs attributable to years of volunteer service rendered during the five years prior to adoption of such programs. Such financing cannot be amortized over a period exceeding five years.

In 2003, new legislation was adopted for the purpose of structural reform in the method and manner of employer contributions to the NYS Retirement System, which legislation also included two provisions for the issuance of POBs:

1. Local governments are now permitted to issue POBs for any outstanding obligations to the State for any existing retirement incentive program (*i.e.*, the retirement incentive programs established annually in the years from 1995 through 2002). (This provision was drafted by Orrick attorneys on behalf of the New York State Association of Counties.) The amortization period is limited to five years.
2. Similar to the 1989 legislation, a local government (and the State itself with regard to its own employees) is permitted to amortize a portion of its normal annual contribution for one fiscal year – that is, local governments are permitted

to amortize the amount due on December 15, 2004 to the ERS or PFRS component of the NYS Retirement System (except deficiency payments, adjustments relating to prior year payments, obligations for retirement incentives or other similar amounts) to the extent that such amount exceeds 7% of the estimated "pensionable salary" base for the then current fiscal year (2004-2005). This "amount eligible for amortization" may be amortized over a five year period at 8% with the State, or local governments are authorized to issue their own debt obligations to pay such amount, with maximum maturity not to exceed five years. On or about October 15, 2003, the State Comptroller is to determine the "amounts eligible for amortization."

The only type of financing specifically authorized for POBs in New York State are general obligation bonds (which obligations include a pledge of the full faith and credit and taxing power of the local government). These bonds must be issued in the same manner, under the same procedural requirements and subject to the same debt limits and other constraints as for any capital project of the local government. Mandatory or permissive referendum requirements applicable to general obligation bonds of the particular type of local government apply to bond resolutions authorizing POBs. For example, school districts must receive voter approval before issuing debt for any purpose authorized by the 2003 legislation. (Note that the legislation in 1989 exempted such school district POBs from the voter approval requirement; this omission in the 2003 legislation may be corrected during a future legislative session.) Likewise, the districts would need prior voter approval. The bond resolutions of counties, towns and villages which authorize payment for five years or less are not subject to mandatory or permissive referendum. Similarly, city bond ordinances should not be subject to mandatory or permissive referendum unless specified by applicable special city charter provisions.

Once a bond resolution has been adopted by a local government authorizing the issuance of POBs, it is generally necessary to publish a legal notice of estoppel including a summary of the bond resolution and allow the 20 day estoppel period to elapse prior to the sale of the POBs. The purpose of the estoppel notice is to ensure that debt issued by the local government cannot be challenged on any basis.

procedural or otherwise, except on constitutional grounds once the estoppel period elapses.

The New York State Legislature has also authorized the State itself to borrow in order to fund its UAAL on at least two occasions. In 1996, the State through the Dormitory Authority of the State of New York issued \$773,475,000 of POBs as annual appropriation debt. These bonds had a final maturity in 2003. The 2003 legislation described above also amended the State Retirement and Social Security Law to authorize the State to amortize a portion of the State's contribution bill for the fiscal year ending March 31, 2005. The amortizable portion is calculated in the same manner as that permitted local governments. Likewise, the State may either amortize that portion through the office of the State Comptroller for five years at 8% or issue POBs.

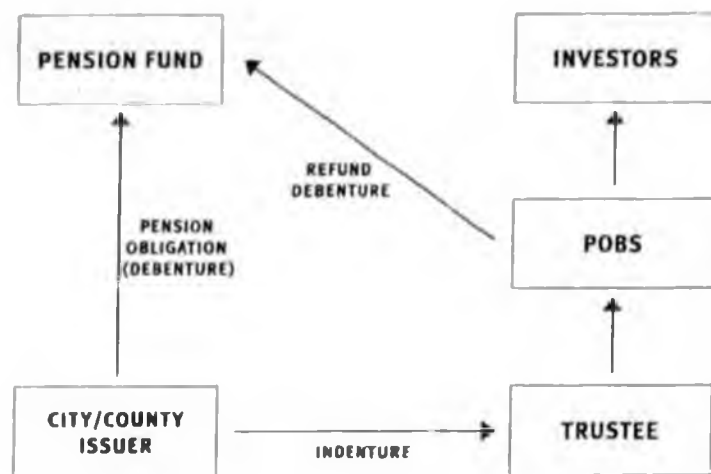
## CHAPTER NINE

### California

Pension obligation bonds had their start with the famous City of Oakland. California pension bond financing in 1985, the first POP in the country, which Orrick helped to invent and for which it served as bond counsel. That financing and a number of copy-cats that rapidly followed were tax exempt and primarily driven by then legal arbitrage possibilities. As explained in Chapter 6, tax exempt POBs largely came to an end with the introduction of tax legislation that became part of the Tax Reform Act of 1986.

A new taxable version of POBs surfaced in late 1993. During the last decade since, thirteen or so cities and seventeen or so counties in California have issued over 60 POBs (second only to New York) aggregating more than \$11 billion (more than from any other state). With the exception of one tax exempt transaction rule (see Chapter 6C) POB transactions issued as lease revenue bonds, all of these POBs have been issued under the local agency refunding law (drafted by Orrick a few years before for other purposes). California cities and counties do not have specific authority to issue POBs.<sup>1</sup> However, the local agency refunding law is available to all local public entities in California to refund prior bonds or "other evidence of indebtedness." The pension obligation to the county pension system, the California Public Employees Retirement System or other retirement system is memorialized as a "debenture," thereby becoming an "evidence of indebtedness," which can be refunded by POBs under the local agency refunding law.

<sup>1</sup> The State of California enacted specific authority for State POBs in 2001.



The POBs are typically structured as obligations payable from the general fund of the city or county issuer. They are not full faith and credit taxing power general obligation bonds backed by the issuer's taxing power, because the California Constitution's debt limitation requires such type of bonds to be approved by two-thirds of the electorate. Instead, California POBs have generally been designed to be valid without voter approval under a judicially created exception to the State Constitution debt limitation, which exception is generally referred to as "obligations imposed by law." See discussion in Section A2 of Chapter 5. Because this exception to the Constitutional debt limit was and is much less developed in the case law (few cases not directly on point) than the other two judicially created exceptions (for lease financing and revenue bonds) each POB issue in California has been validated pursuant to California's validation statute (Code of Civil Procedure §§860 *et seq.*).

While there have been many validation actions for POBs, so far they have all ended with a default judgment and no published opinion, meaning that they have no precedential value or application to any transaction other than the specific transaction(s) validated.

What is validated in such validation actions is not legal principles but the bonds and the other principal legal documents approved in a bond resolution. Before the

validation action is filed, it is necessary for the state or local government issuer to first adopt the resolution and authorize the bonds, the documents and the validation action. The validation action is filed in the superior court of the county in which the issuer is located, and an order for publication of summons is received. Summons can then be published (usually in a newspaper of general circulation in the city or county in which the issuer is located), which takes a minimum of 21 days. If no one answers the complaint by the date specified in the summons, which must be at least 10 days after completion of publication, the clerk can enter a default, and schedule a hearing before the judge for the default judgment (the timing of which will depend on the jurisdiction, and may be a day or two or, in some jurisdictions, at least 15 days after the clerk enters the default).

So assuming the very best case, obtaining a validation judgment takes a minimum of 31 to 46 days (depending on the jurisdiction) after filing the validation complaint. Of course, issuers are at the mercy of the judge and the clerk, and it sometimes takes a week or more to get an order for publication of summons, or longer than 15 days after the clerk enters a default to schedule the hearing. In addition, the judge could take the matter under submission for an indefinite amount of time, or even disagree with the proposed default judgment, and decline to validate the transaction. Once granted, the default judgment may be appealed on jurisdictional grounds within 30 days. Therefore, it is typically assumed that the validation action will take approximately 60 days (not including the appeal period). It is generally considered reasonable to sell the POBs without waiting for the 30 day appeal period to run, assuming no one has answered the complaint, because the grounds for appeal are so narrow, but usually the bond closing does not occur until after the appeal period has expired.

If someone does answer the complaint, then there is true two party litigation on the merits. While some expedited procedures are available, the timing for resolution of the litigation cannot be predicted, and may take many months unless settled or abandoned. So far, no one has answered the complaint and default judgments have been obtained for every city and county POB issuer. However, the same was not true of the State of California, whose validation complaint was answered by the Howard Jarvis Taxpayers Association, and resulted in a decision on September 23, 2003 by

the Sacramento County Superior Court declining to validate the State's proposed POBs, which decision, as of this writing, is being appealed by the State.

The validation actions can and usually do validate not only the POBs to be issued but also any future POBs or refunding POBs. Not all validation actions are as inclusive or as flexible as they could be (some leaving out future new money or refunding POBs or costs of issuance or locking in semiannual interest payment dates, etc.), and must be carefully reviewed before relied on for future POBs or refunding POBs.

Note, as mentioned in Section A2 of Chapter 5, that the "obligations imposed by law" concept that is generally used to support POBs in California does not support reserves or capitalized interest because inclusion of such components in the bond issue are considered volitional not mandatory (as evidenced by the numerous California POBs issued without them) and therefore, not "obligations imposed by law." Costs of issuance, on the other hand, can be included on the theory that they cannot be avoided. The inability to include capitalized interest makes achieving current budget relief more challenging (see discussion of structure options in Section C of Chapter 5). Alternatively, the POBs could be issued as annual appropriation bonds or asset-strip lease revenue bonds (see Section A3 and 4 of Chapter 5), which can include reserves and capitalized interest.

## CHAPTER TEN

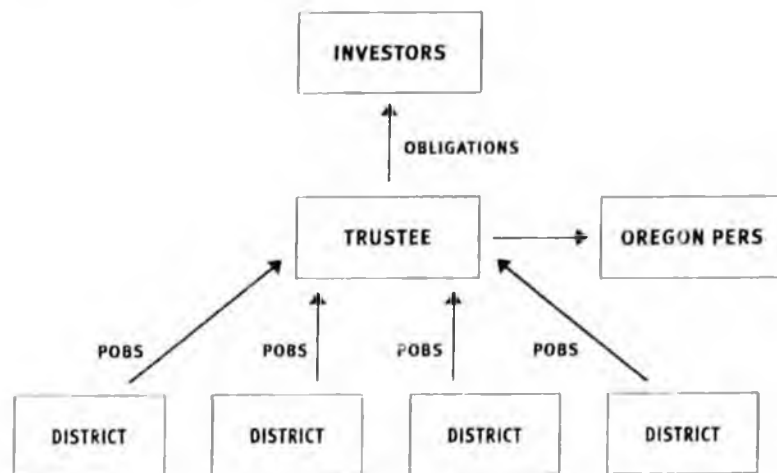
### Oregon

State and local government issuers in Oregon have been among the most active users of POBs to finance their share of unfunded liability to the Oregon Public Employees Retirement System. POBs are issued in Oregon either as limited tax bonds or as revenue bonds.

Prior to the passage of the Pension Bonding Act in 2001, the City of Portland, Multnomah County and Josephine County issued significant sized POBs under Oregon's Uniform Revenue Bond Act. In 2001, the Oregon Legislative Assembly approved the Pension Bonding Act (which Orrick attorneys were involved in drafting). The Pension Bonding Act granted authority to "governmental units," including cities, counties, school districts, special districts, public corporations and intergovernmental corporations, to sell full faith and credit obligations for the purpose of refinancing pension obligations. POBs issued under the Pension Bonding Act are not subject to voter approval or annual appropriation and may be issued by local governments individually or jointly.

Significant pooled POB issues have been done by Oregon school districts, community college districts and local governments. In these transactions, the participants pledge their full faith and credit within the limitations of the Oregon Constitution and issue limited tax bonds, payable from available general funds of the issuer. Available general funds include all ad valorem property tax revenues received from levies under each issuer's permanent rate limit and all other unrestricted taxes, fees, charges and revenues legally available to pay debt service on the POBs. The issuers are not authorized to levy additional taxes to pay the POBs.

In the pooled school district and community college district transactions, individual districts issued limited tax POBs in favor of a bond Trustee, which in turn issued obligations that represent a proportionate and undivided interest in and right to receive POB payments pursuant to a Trust Agreement. The POBs were further secured by an Intercept Agreement between the State Department of Education and the school districts and community colleges under which the Trustee was authorized to intercept specific education revenues otherwise paid by the State to the school districts and community colleges in an amount equal to the debt service on each issuer's POBs. Specific examples of recently completed Oregon pooled POB issues include: \$153,582,299.60 Oregon Community College Districts Limited Tax Pension Obligations, Series 2003 (Federally Taxable); \$927,079,763.45 Oregon School Boards Association Limited Tax Pension Obligations, Series 2003 (Federally Taxable); and \$238,743,693.40 Oregon Local Governments Limited Tax Pension Obligations, Series 2002 (Federally Taxable). Each of the pooled transactions have been enhanced by bond insurance. By pooling these transactions, the issuers were able to increase the amount of bonds sold, which increased access to investors, and to lower interest rates and reduce costs of issuance.



Other jurisdictions, including the City of Portland, City of Corvallis, Multnomah County, Marion County, Josephine County, Eugene Water and Electric Board and Portland Community College District have sold POBs on a stand-alone basis.

As an alternative to issuing POBs as limited tax bonds pursuant to the Pension Bonding Act as described above, issuers have the option to issue POBs as revenue bonds pursuant to the Uniform Revenue Bond Act or the Pension Bonding Act. The Uniform Revenue Bond Act allows municipalities to issue revenue bonds for any public purpose secured by designated "revenues," which may include taxes and virtually all other general and special fund revenues and receipts of the municipalities. The Uniform Revenue Bond Act requires notice and a 60-day referendum period during which revenue bonds are normally subject to referral to a vote of the electorate if within the 60-day period 5% or more of the voters file petitions requesting a vote on the bonds. Revenue bonds issued pursuant to the Pension Bonding Act are exempt from this requirement.

In a special election on September 16, 2003, Oregon voters approved an amendment to the Oregon Constitution that authorizes the State Treasurer to issue POBs as general obligation bonds of the State of Oregon for the purpose of paying substantially all of the State's UAAL. The amendment provides that the general obligation of the State must contain a direct promise on behalf of the State to pay the principal, premium, if any, and interest on that indebtedness. The State also will pledge its full faith and credit and taxing power to pay that indebtedness, however, the ad valorem taxing power of the State may not be pledged to pay that indebtedness. The amount of POB indebtedness authorized by the amendment that may be outstanding at any time cannot exceed 1% of the real market value of all property in the State. The State presently expects to issue approximately \$2 billion in POBs and to list them on the Luxembourg Stock Exchange in order to facilitate sales to European investors.

In 2003, the Oregon Legislative Assembly made substantial changes to Oregon PERS. The amount of litigation surrounding PERS in Oregon is increasing, and a

number of challenges to the legislative changes are pending in the courts. Several lawsuits have been filed in the Oregon Supreme Court and in the federal district court in Oregon seeking to have changes that were enacted to PERS enjoined or declared an unconstitutional impairment of contract or unconstitutional taking of property. Although these cases are not directly related to any particular bond issues, their outcome could have far-reaching implications with respect to PERS and related liability.

## CHAPTER ELEVEN

### Similar To POBs

Pension obligations are similar to other state and local government non-bond obligations, which it may be possible to fund in a manner similar to POBs. While this pamphlet is intended to cover primarily POBs, and they are the most frequently used and highly developed of this category, it is useful to note, at least briefly, that there may be other applications of the same concepts discussed above. Several examples (not an exhaustive list) may include such other actuarially based insurance or benefit obligations as workers compensation, health benefits and unemployment insurance or such non-actuarial obligations imposed by law as court rendered judgments for damages against the state or local government and, in California, county obligations under the Teeter delinquent property tax program.

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## Research:

### Pension Obligation Bonds Are Surging After Brief Hiatus

Publication date: 20-Jan-2004

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Pension obligation bonds (POBs), the once-arcaic debt instrument used to finance unfunded pension liabilities, have returned with a vengeance after a brief hiatus, and are again making their mark on the public finance landscape. A number of conditions have fallen into place to spark this resurgence, including:

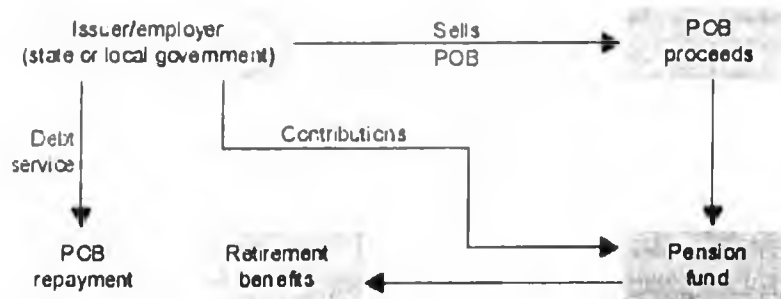
- The rapid growth in unfunded liabilities for public pension funds over the last few years, driven by investment losses, benefit enhancements, and greater longevity of pension plan beneficiaries;
- The relatively low interest-rate environment, which widens the spreads between the POB interest costs paid by the issuer/employer and the assumed investment return rate of the pension systems, which makes the economics of the transaction more attractive; and
- The potential cost savings from a POB, as many state and local employers struggle with budgetary imbalances and other savings alternatives become scarce.

Because of the confluence of these factors, POBs are back. This report details the mechanics of how POBs work, their history, the special risks unique to this debt instrument, the critical rating factors and implications, and future prospects.

#### How POBs Work

While the financial implications of POBs are complex, the actual mechanics are relatively simple. Generally, the municipal employer will use the findings from the most recent actuarial valuation, or have a new valuation completed, to determine the pension system's unfunded actuarial accrued liability (UAAL). Then, it will decide what portion of the UAAL (either all or a part) will be funded with the POB. In the 1990s most employers funded the entire UAAL, but for various reasons discussed below, many now tend to finance less than the full amount. Once the POB is sized and sold, the net proceeds are placed in the pension trust fund to be commingled with the other funds, and usually invested according to the existing asset allocation guidelines (see Chart). Thus, the pension fund experiences a rapid increase in assets resulting in a higher funded ratio (actuarial value of assets divided by actuarial accrued liability). For the POB to generate savings for the employer, the investment return rate on the POB proceeds must be greater than the interest cost of the bonds (and ideally equal to, or exceed the pension system's investment return assumption), and the larger the spread between these two rates the better. The employer, as POB issuer and obligor, would then be projected to achieve lower total pension contribution and debt service costs than it would have if it had not sold the POB.

Pension Obligation Bond Mechanics



## ■ Brief History

While there were a few issues in the 1980s, the first big wave of POBs really came in the early 1990s. By the end of the decade about \$15 billion of POBs had been issued. The years 2000 and 2001 were slow from a POB standpoint, with 2000 correlating to the apex of U.S. public pension funding at an average funded ratios of slightly over 100%, up from only about 80% in 1990. These robust funding gains were fueled by above-average equity returns during the period and a general shift in the weighting of public pension assets to this asset class from fixed-income. The corollary to a high funding level is a lower or nonexistent UAAL. Falling funding ratios, now estimated to be heading towards the 90%, have been exacerbated by a combination of adverse circumstances, some uncontrollable and some self-inflicted. These factors include the decrease in asset values from poor equity returns and the increase in liabilities from benefit enhancements and demographic changes (for example, members living longer). The second wave of POBs, driven by burgeoning unfunded liabilities, has come on strong in 2002 and 2003. As in the first wave, California counties have been leading the pack, and there are a number of repeat borrowers, but there are also significant new players. The state of Illinois, which issued in June of this year, now holds the POB record for sheer size at \$10 billion — almost four times larger than the previous record. Oregon sold a \$2 billion issue last fall, and other states that have recently completed or plan a POB sale include Kansas, Wisconsin, and West Virginia.

## ■ POB Risks

The principal risks to the issuer of a POB fall into a number of categories:

- Arbitrage (investment return/POB interest cost);
- Leverage;
- Market risk; and
- Political.

POBs are essentially an arbitrage play, the success of which is dependent on the premise that the pension fund assets (including POB proceeds) will earn on average more than the interest cost on the POBs and hopefully the assumed investment return rate (generally, about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example the spread could generate handsome savings if the investment returns goals are met over the life of the bonds. The problem is that there is no certainty that the average 8% return will be realized over time, and therein lies the principal risk of the POB to the issuer. If the pension fund earns 8% or more on the POB proceeds, then the result will be success by virtue of having to pay lower pension-related costs (contributions plus POB interest) than without the POB. However, if the investment return is less than the POB interest cost, the transaction becomes a drag on cash flows. Not only will the employer have the new POB debt service costs but also higher contribution rates attributable to new unfunded liabilities from under performing investment returns. If returns are above 6% (as in the example above) but below 8%, the employer will have increasing contribution rate costs, but it would have had them even without the POB. When investment returns are less than the POB interest costs, the POB puts additional strains on financial operations rather than helping.

While the 1990s produced some impressive investment returns, no pension fund consistently earns 8% or higher every year in perpetuity; returns vary dramatically and may (or may not) average the investment return assumption or even the POB interest rate cost. The POB paradigm has a goal to average or beat the 8% investment return assumption over the long-term. With the appropriate asset allocation strategy this goal may be attainable, but market experience over the last several years has led some to believe that an 8% return assumption may be too aggressive.

Another factor in evaluating the success of a POB is that its full effect can only fully be tallied at final maturity of the bonds. Due to market gyrations, a POB may look like a great success for several years, or even a decade, only to see investment gains erode, and at maturity are pronounced a failure. Conversely the exact opposite may be true, with poor results in the early years later overcome to achieve projected benefits in the final analysis.

In any event, we do know that even if projections are met on average over the life of the POBs, there will be years with returns that are higher, and some that are lower (maybe significantly), than the 8%

bogey. We do not have to look back very far to see evidence of such swings: in fiscal 2001 the S&P500 index of domestic equities fell 16%, in 2002 it fell another 19%, but in 2003 it fell only 1.6%. These market declines hurt issuers with POBs outstanding: most had to pay increased contribution rates to cover the new actuarial losses, plus they had the higher debt service costs due to the POB.

The risk of adding too much leverage is another factor for POB issuers to consider. Borrowing for any purpose increases leverage, and incurring debt to pay unfunded liabilities is no different. While the issuer is substituting one type of long-term liability (POB) for another (UAAL), there is a difference. In most cases, bond debt service is a "harder" obligation than the "softer" contribution payments used to amortize the UAAL. Bond debt service must be paid in full and on time or the issue falls into default, with wide ramifications. For certain employers, contribution payments, on the other hand, may be temporarily deferred or reduced without serious negative consequences. Therefore, the size of the POB relative to the total debt structure of the issuer must be measured in terms of what level of debt service can be managed if actual future investment returns do not meet the original POB plan projections.

Because POBs generate very large infusions of funds into the pension system compared with the more steady investment and reinvestment of interest, dividends, and contributions by the fund, the plan for investing POB proceeds must be considered. Should the monies be invested according to the existing asset allocation guidelines, or should POB proceeds have a special allocation strategy because of current market conditions or expectations? If the chief investment officer of the fund believes that international equities, for example, are overvalued, maybe a delay in filling that allocation would be warranted. On the other hand, in that pension funds are long-term investors, most have stuck with their traditional allocations for proceeds, eschewing market timing strategies. Whatever the strategy may be, it should be fully vetted before the POB sale.

Another aspect that few envisioned when this instrument was first initiated is the political risk hidden, almost like a Trojan horse, within the POB structure. As was mentioned in a feature on this subject, ("Pension Obligation Bonds: Unique Rating Documentation", RatingsDirect, March, 4, 1999), POBs can become victims of their own success. For example, if a POB is issued for the full UAAL, resulting in a 100% funded ratio, and subsequent higher-than-average returns push the ratio to 110% or 120%, there will arise tremendous political pressure to distribute the so-called "excess" funding by increasing benefits, thus incurring new liabilities. The excess funding touted in the late 1990s turned out to be illusory. Even systems bolstered by POBs that did not increase benefits found themselves in underfunded positions following the market declines from 2000 to 2003. Those that fell victim to the siren's song and increased benefits have even lower funding levels. Some pension funding ratios declined to the extent that the employers' opted to go back to the market to issue POBs for a second time.

## ■ Analysis

The rating process for POBs basically parallels that of long-term debt with similar security plus with certain additional analytical factors pertinent to the POB and pension system. Most POBs issued to date have a GO or general fund pledge. Also, a high percentage of those sold have been additionally secured by bond insurance. In Standard & Poor's analysis specific to POBs we focus on the effect of the bonds on the issuer's debt structure and its ability to meet its obligations. The financial review includes the impact on both the balance sheet and the operating statement or cash flows. The status of the issuer's pension fund on a pro forma basis is also part of the review as with any similar analysis.

From the balance sheet perspective, we look at how the POB fits into the issuer's total debt plan. Does the POB dramatically alter the issuer's debt profile? We look at total debt with and without the POB so as not to penalize a POB issuer in comparison to another issuer that might have relatively low debt (and no POBs) but sizable unfunded pension liabilities. Also, we evaluate the leverage added by the POB. Does it markedly increase hard, fixed costs (bond debt service) in place of a softer, more discretionary obligation (pension contributions)? If sub par investment returns put upward pressure on contribution rates will they, coupled with the new higher debt service costs due to the POB, put the issuer's budget under greater strain? The issuer must also be cognizant of the effect the POB issuance may have on statutory debt limits. Will the POB use up debt capacity that might be needed for other, more pressing needs?

From a cash flow standpoint, Standard & Poor's reviews projected debt service and contribution costs, with and without the POB, including the validity of the assumptions including those for POB interest

costs and pension fund investment returns. How do the projections compare in total and on an annual basis? The spread between interest costs and investment return generates the savings expected from the transaction. What is the magnitude of annual savings and total present value savings? Where (in what years) are the savings taken? Are the savings front-loaded in an attempt to mask budgetary stress? Will any front-loading lead to higher, unsustainable contribution rates in later years? Do the potential savings from the POB outweigh the risks involved? The analysis of the cash flows is a critical component to understanding the full impact of the transaction.

As part of the POB analysis we also review the current status of the recipient of bond proceeds — the pension system itself. What is the statutory relationship between the issuer/employer and fund? How have the laws and precedents for making contributions affected funding progress and how do they play into the POB strategy? Have funding levels generally been increasing over time? What are the funding goals and how will the POB impact these objectives?

The pension fund's general actuarial methods and assumptions also will be reviewed for comparative purposes. The fund's asset allocation strategy will be studied for consistency with the POB assumptions and for the general risk profile. An aggressive investment strategy may make the POB objectives more difficult to achieve on a consistent basis.

### ■ Rating Implications

Employers looking to help manage their unfunded liabilities through the issuance of a POB should weigh the pros and cons very carefully. Any applicable risks from the above list should be evaluated. There should be a clear POB plan with attainable actuarial and investment assumptions and a conservative structure. Prudent allocation for projected savings over time limits the chances for problems.

It is possible for POBs to have a negative effect on credit quality, especially in the investment environment over the last several years or if they were structured poorly at the outset. Standard & Poor's will continue to evaluate POB risks in light of each employer's individual profile at the time of sale as well as their projected effects over time. POBs may work as planned over the long-term, but short-term fiscal dislocations resulting from these structures are part of their baggage.

### ■ Special Rating Documentation Requirements for POBs

The unique nature of POBs requires certain additional documentation not normally requested for other types of ratings:

- POB financing plan, including its effect on the overall debt plan;
- Projections of UAAL contributions and debt service with and without the POB;
- Latest pension fund annual report;
- Most recent actuarial valuation and experience studies of the fund; and
- Pension fund's current asset allocation strategy and plan for investing POB proceeds.

## Research:

### Managing State Pension Liabilities: A Growing Credit Concern

Publication date: 20-Jan-2005

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State governments have a long history of providing retirement security for their employees--and in many cases certain local government employees--through large, defined benefit pension systems, which, throughout the 20th century, had been successful in meeting their intended goals. However, after state pension funds reached their apex of financial soundness, based on funding levels, in 2000, they have since deteriorated--in many cases precipitously--leaving most funds with the problem of managing new, large unfunded liabilities. The rapid growth and significant magnitude of these liabilities has become an increasing credit concern for many state ratings, reaching crisis proportions in some cases.

This article provides a brief overview of public pension funds in the U.S., along with the factors leading to their current status and some of the options available for managing pension liabilities. In addition, the status of a number of state funds, with a range of funding levels, and some of the strategies states have used to address their respective pension situations, will be examined.

#### ■ Historical Background

Defined benefit pension plans, as used by most states, provide a systematic method for setting aside sufficient monies to pay promised retirement benefits to employees in the future. The benefits are funded by contributions, usually from both employer and employee, and the investment income derived from such contributions. Most states have two principal funds: one for state employees, and possibly certain local government employees, called public employee' retirement systems; and one for teachers, referred to as state teachers' retirement systems. Some have one, monolithic system for all government employees (state and local), while others have multiple systems for individual job specialties, such as judges and safety officers.

Public pension funds in the U.S., of which the lion's share of assets belong to state funds, have come a long way from their humble beginnings--some dating to the beginning of the 20th century. Starting with little or no assets to offset liabilities, and some initially operating on a pay-as-you-go-basis, pension funds gradually improved their funding ratios (actuarial value of assets divided by actuarial accrued liability) to the 50% level in the mid-1970s, and further to around 80% by 1990. Early on, pension assets were invested largely, if not exclusively, in fixed income investments. Gradually, investment strategies became more diversified, however, and by the end of the 1990s public funds had increased their allocations to equities and other higher yielding asset classes significantly. This shift in allocations coincided with, and to some extent was fueled by, the bull markets in domestic equities that lasted from the early 1980s through fiscal 2000. At June 30 (the fiscal year-end for most public pension funds), 2000, the average funding ratio for all U.S. public funds was slightly above 100%, and was even higher for state funds.

The party to celebrate the final defeat of unfunded pension liabilities was short-lived, unfortunately, as dark clouds soon began to appear. Trends that would adversely affect actuarial balance impacted both liabilities and assets. Liabilities were being inflated not only by normal growth and inflationary pressures but also by overt changes in benefits and actuarial assumptions. The late 1990s saw a number of improvements to pension benefits, which automatically boosted liabilities, and the actuarial consequences of many of these changes really kicked in after 2000 due to the normal delayed reaction in contribution increases. Demographic and lifestyle trends--along with the resultant assumption changes, such as retirees living longer (a global phenomenon) and more employees taking early retirement--had a similar, expansionary effect on liabilities. However, the biggest component in the steep decline in funding levels from fiscals 2001 to 2003 came from the asset side, and was caused by the bottom falling out of the domestic equity markets. The investment return assumption requirement for most public funds to maintain actuarial balance, about 8%, could not be sustained when the average allocation to domestic equities stood at 40%-50% and the annual returns of the S&P 500 Index were

negative 16%, negative 19%, and positive 2% in fiscals 2001, 2002, and 2003, respectively. The net result was that, by June 30, 2003, average funding ratios for state funds had fallen from an average overfunded level in 2000 to an estimated 80%-90% in just three short years. While the S&P 500 saw a 17% gain at fiscal year-end June 30, 2004, public pension fund actuarial results, on average for the year, will not report major funding gains due to the effects of the actuarial smoothing of gains and losses over a period of years used by most. With five-year smoothing, for example, a fund in fiscal 2004 would still be accounting for a portion of the losses (or gains) from the prior four years.

## ■ Alternatives to Improve Funding

The range of options to fix a pension mismatch of assets and liabilities is relatively narrow, and almost all are difficult to implement due to legal, economic, or political impediments. Corrective measures should act to stop or slow pension liability growth or grow assets, or both. From a liability standpoint, most states have constitutional or statutory pension benefit protections that preclude any reductions in benefits already promised to existing employees. One way around these restrictions is to close off the current benefit to new employees and offer new employees a reduced level of benefits. This tactic of creating a new tier of benefits has been used by a number of funds to reduce liability growth. Completely closing existing plans and creating new, less generous defined benefit plans, and even new defined contribution plans, is another option.

Changing actuarial assumptions to reduce liabilities has been used in the past; the current demographic and economic realities related to the major variables, however, make these options difficult. The raising of the actuarial investment return assumption to 8.25% from 8.00%, for example, would automatically lower actuarial liabilities, all other assumptions being equal. However, the investment experience over the past three or four years and current expectations would tend to preclude such a change at this time.

The principal options to improve pension balance by increasing assets fall into three main categories:

- The pension fund may alter its asset allocation strategy to enhance investment returns;
- The pension fund sponsor may sell pension obligation bonds (POBs), placing the proceeds in the pension trust and thus reducing or eliminating the unfunded actuarial accrued liability (UAAL); and
- Annual contribution rates for sponsors or employees may be increased.

Pension funds in the U.S., as major global investors with more than \$2 trillion in assets, have developed sophisticated asset allocation plans over the years, and, with access to professional asset managers, attempt to maximize returns within their prescribed tolerance for risk. For an individual fund to dramatically enhance yields by altering its allocations, there would most likely need to be a sea change in thinking about the fund's view of risk. Minor tweaking of strategies is a more regular occurrence as funds seek to keep up with changing markets, risk profiles, and expected returns of various asset classes, but major strategy changes leading to markedly improved results are rare.

Some states, as sponsors, have opted to pursue the POB route to significantly boost assets in one bold move, while at the same time taking advantage of the projected lower carrying charges this vehicle offers to a sponsor. (For further information, see report titled "Pension Obligation Bonds Are Surging After Brief Hiatus," published Jan. 20, 2004, on RatingsDirect). While no panacea, POBs are basically an arbitrage play based on the premise that, as a result of the bond proceeds being invested at an expected yield above the cost of the bonds, net savings will be achieved by the sponsor over the life of the bonds. In other words, after the issuance of the POB, combined debt service plus pension contribution costs will be lower than they would have been without a POB. The success of this formula depends on the realization of a certain investment return, which is in no way guaranteed. Whether a POB succeeds or fails cannot fully be evaluated until the final maturity of the bond, and it is a given that some years will be winners and others losers. The bad years may add short-term fiscal stress to the POB issuer (pension sponsor), which could be significant based on the amount of leverage the POB exerts. With most POBs having been issued over the past 10 years or so, it would be premature to pronounce them an unqualified success (or failure). The best that can be said to date is that POB results have been mixed, with some having met or exceeded expectations while others have come up short based largely on the vicissitudes of market timing.

The last major option for increasing assets, and the most common alternative used to manage now, unfunded liabilities, is to simply increase annual contribution rates. Indeed, a major principle of an actuarially funded defined benefit plan is that, if assets and liabilities become unbalanced, increasing

(or decreasing if the system is overfunded) contributions will bring the system back into balance. Sometimes employee contributions are increased, but usually it is the sponsor that steps up to the plate: the investment risk of a public defined benefit plan and the burden to make good on benefit promises are ultimately the responsibilities of the sponsor. Thus, the principal byproduct of the current state pension funding crisis has been increasing contribution costs coming at a time when states, in recent years, have been squeezed by weak revenues and burgeoning expenses, including security and health care cost pressures.

## ■ How Are Some States Managing Their Pension Liabilities?

### Arizona.

The Arizona State Retirement System, a multiple-employer defined benefit plan, provides pension benefits for employees of the state, political subdivisions, and public schools, with more than 500 employers and 222,000 active members. The system's funded ratio fell to 98.4% at June 30, 2003, after a decade of more than 100% funding. As reported in the June 30, 2003, actuarial valuation, the major contributor to this decline was investment losses for the year that resulted in a decrease in the actuarial value of assets by \$1.2 billion. In November 2002, the state retirement system board removed the requirement that actuarial assets be within 20% of market value, and changed the period for recognizing investment gains or losses to 10 years from five years. At June 30, 2003, the system's market value of assets (\$18.1 billion) was 77% of actuarial value. The 2003 actuarial valuation developed hypothetical contribution rates for both employees and employers (odd-year calculations are not actually implemented) of 6.96% each, compared with 1.92% each in 2001.

### California.

California has two large state pension funds: one for state and certain local employees—California Public Employees' Retirement System (CalPERS)—with assets exceeding \$170 billion; and the other for teachers—California State Teachers' Retirement System (CalSTRS)—with more than \$115 billion in assets. These systems have been experiencing some of the same pressures as pension funds in other states, and have experienced declines in funding levels. For example, the funded ratio for the state member category of CalPERS had fallen to 84% as of June 30, 2003, compared with 111% in 2000. State contributions to CalPERS for its employees, as actuarially determined, have risen from \$160 million in fiscal 2001 to \$2.2 billion in fiscal 2004. In the same vein, the funded ratio for the CalSTRS defined benefit plan fell from 110% in 2000 to 82% in 2003. However, total amounts contributed to CalSTRS by members, employers, and the state, as set by statute, increased just 10% during the same period.

A number of changes for both pension systems have been proposed over the last year. In relation to CalPERS, the state's 2005 budget included certain pension reforms, such as a two-year delay of contributions into CalPERS from new miscellaneous and industrial employees, thus obviating the state's obligation to make contributions on their behalf over that period. A \$900 million POB was proposed, the proceeds of which would be used to pay a portion of the current contribution payment as opposed to paying a portion of the unfunded actuarial accrued liability like most other POBs. Court validation of the POBs is being sought. The 2005 state budget also included proposals to increase employee contribution rates and lower benefits for new employees to pre-1999 levels.

In December 2004, CalSTRS proposed a number of options to help address the funding deficiency in its defined benefit plan. At June 30, 2003, the system's unfunded actuarial obligation totaled \$23.1 billion. The first option was for the state to issue a POB to pay down the entire liability. Other options included a change in the amortization period of the unfunded liability and a number of changes to how benefits are calculated. One option that could have a large effect on the amortization cost is to eliminate the 2% benefit adjustment. Several alternatives included increases in contribution rates by all three contribution bases: members, employers, and the state.

On July 1, 2003, the state did not make its full contribution payment to CalSTRS' supplemental benefit maintenance account, although it did make the required payment to the system's defined benefit program. The state paid \$59 million of the \$559 million required supplemental benefit maintenance account amount. In October 2003, CalSTRS filed suit in Sacramento County Superior Court to have the \$500 million payment restored. The state is currently defending the action.

Of late, proposals to replace the two California state defined benefit plans with defined contribution plans, and to eliminate state contributions to CalSTRS, have been actively debated.

## Florida.

The Florida Retirement System was created in 1970. The system was created to provide a defined benefit pension plan for participating employees. The plan is administered by the state division of retirement in the department of management services. Participation by local governments in the state is optional, but is generally irrevocable once the government opts to participate in the plan. Currently there are 866 participating employers and 956,875 individual participants. Of the total participants, 23.5% are retirees and beneficiaries. Contrary to trends for most other states, the actuarial value of assets in the system has consistently exceeded the actuarial accrued liabilities in recent years. The funded ratio of the pension system has ranged from 112% in fiscal 2004 to 118% in fiscal 2000. Investment performance in fiscal 2004 was strong, with a return of 16.6% compared with the 7.75% assumed rate of return. The actuarial value of assets at July 1, 2004, was \$106.7 billion. The solid asset position of the Florida Retirement System has provided budget relief in the form of lower contribution requirements for the state and participating local governments.

## Illinois.

Illinois sponsors five defined benefit retirement plans for about 630,000 members and annuitants, including public employees, teachers, university personnel, and judges. By 2003, the funded ratio of the Illinois funds ranked near the bottom compared with other states in the U.S. Contributing to the \$26.9 billion increase in unfunded liabilities from 2000 to 2003 were:

- Contribution shortfalls (\$4.8 billion of the total),
- Investment losses (\$14.1 billion), and
- Benefit improvements (\$3.3 billion).

Adding to the state's pension woes is a 2002 early retirement incentive plan for state employees, which resulted in a liability that, at \$2.5 billion, was quadruple the original estimate. Part of the variance was due to a much larger number of employees (11,032) taking part in the program than originally projected (7,215). Due to the requirement of a 10-year amortization of this liability, the early retirement program contribution for 2005 is \$382 million, compared with the originally projected \$70 million.

In 2003, the state sold a \$10 billion POB, the largest on record, using the proceeds to fund a portion of the UAAL (\$8.1 billion) and to pay (\$1.9 billion) the state's current pension contribution for fiscals 2003 and 2004. The POB increased the combined system's funded ratio by seven percentage points. At the end of fiscal 2003, the funded ratio for the combined systems was 57% (after giving effect to the POB), and the UAAL was \$35.8 billion.

## New York State.

The New York State comptroller is the sole trustee of the state's common retirement fund, which includes all assets of the New York State Retirement System. Members of the system are typically employees of New York State or employees of municipalities in the state (excluding New York City). As of March 31, 2004, there were 2,985 participating government employers in the system. The overall membership in the system exceeds 970,000; this includes 641,721 members and 328,357 retirees and beneficiaries. Overall, membership has expanded continuously, but the growth from retirees has been most significant. Retirees now make up 34% of the system's members, compared with 26% in 1990. Benefit payments continue to rise, reflecting improvements in final average salaries, cost of living adjustments, and benefit improvements. The increased benefit payments, coupled with the performance of the stock market after 2000, have required significant employer contribution increases, with significant increases forecasted for the next two years as well. At March 31, 2004, about 63% of the pension system assets were invested in various stocks. For the largest component in the system--the New York State and Local Employees' Retirement System--employer contributions had averaged 1.75% from fiscals 1996 through 2003. Contributions will increase in fiscal 2004 to 5.9%, totaling \$1.2 billion. This rate is projected to more than double in fiscal 2005 to 12.9%, or a \$2.6 billion contribution, followed by an estimated 11.4% contribution rate in fiscal 2006. Similar increases are forecasted in the New York State and Local Police and Fire Retirement System (PFRS) for fiscal 2004. The contribution rates for fiscals 2005 and 2006 are projected to be even steeper for PFRS, however, growing to 17.6% and 16.3%, respectively. These contribution increases have been, and will continue to be, a significant source of budget pressure for the state and its local governments. The legislature has allowed a portion of the increase to be funded with the issuance of bonds or a loan from the state comptroller. For governments that choose this option, fixed costs to service pension contributions will include an interest component, with the fixed costs extended for up to 10 years. The system uses the aggregate actuarial funding method, which does

not identify or separately amortize unfunded actuarial liabilities. Due to the use of this funding method, there is no disclosure or schedule provided on funding progress.

### **Oregon.**

Oregon has historically delivered pension benefits for state and local employees through a single system called the Oregon Public Employees Retirement System (OPERS). After experiencing relatively high funding levels through the 1990s, the UAAL of OPERS at Dec. 31, 2001, was estimated at \$9.7 billion, almost three times the prior year. With 2002 investment losses, this figure was estimated to be almost \$15 billion—of which about one-third was the state's share. Contributing factors to the increase in UAAL included some of the usual suspects: benefit increases in the late 1990s and poor investment returns. In addition, under the plan, tier-one members were guaranteed a minimum 8% on their regular account assets regardless of actual investment returns earned by the system, and in 2001 and 2002, like most other funds, the system generated negative returns.

In 2003, the state initiated a number of reforms to OPERS, including:

- Modernizing the mortality tables and requiring regular updates;
- Shifting future employee contributions to a defined contribution plan;
- Converting the annual 8% guaranteed rate of return to an assumed 8% to be received over the length of members' service;
- Temporarily suspending future cost of living increases for retirees in certain instances; and
- Creating a new, more independent, retirement system board.

In addition, for new employees hired after Aug. 29, 2003, the state created a new retirement plan called the Oregon Public Service Retirement Plan, which includes both defined benefit and defined contribution components. Employer contributions fund the defined benefit plan, and employee contributions fund the defined contribution plan.

The legislative changes to OPERS resulted in an estimated reduction in the state's UAAL to \$2.2 billion from \$4.6 billion. A number of lawsuits have been filed challenging some of the OPERS changes. The state intends to continue to defend the challenges. In October 2003, the state sold \$2 billion of GO POBs to further reduce its UAAL. The preliminary results of the OPERS 2003 actuarial valuation reported the pension system's funded ratio at about 97%. Employer contribution rates under the valuation showed an increase to 18.27% from 9.96%.

### **West Virginia.**

The West Virginia Teachers' Retirement System (TRS) is a multiple-employer, defined benefit plan for 55 county school systems, certain state higher education employees, and the state boards of education and higher education. The state provides substantially all funding for the system. TRS has occupied the bottom rung among state plans in terms of funded ratios for some time. As of July 1, 2003, the funded ratio was 19%, and the UAAL was \$5.1 billion. The state supreme court has ruled that the UAAL of TRS is a public debt, and has required the state to fund TRS in an actuarially sound manner. This requirement entails the elimination of the UAAL over a 40-year period beginning July 1, 1994, enabling TRS to meet cash flow requirements to fulfill future obligations to members.

While for a number of years West Virginia has attempted to clear the way to issue a POB to help lower or eliminate the UAAL in TRS and other state funds, its efforts have been blocked by legal issues, including the requirement for voter approval. If bonding is not an option, the state may have to pursue other avenues to cure its pension ills.

## **Looking Ahead**

States are under varying degrees of pressure to fund the burgeoning liabilities of their pension systems. The common theme lies in developing strategies to manage increasing contribution rates at a time when other demands are conspiring to break the budget: growing health care, education, and security costs to name a few. Options to reduce pension liabilities or even slow their growth, and thus moderate contribution rates, are few and usually difficult to bring to fruition. Even with adequate investment returns, the pension funding problem will be in the forefront for at least a few more years, and possibly much longer if the markets don't cooperate. As if pension liabilities were not enough to handle, states and other governments will soon have to deal with funding issues related to liabilities from Other Postemployment Benefits (OPEB)—largely retiree health care costs. The GASB has established new accounting rules for reporting on OPEB liabilities. (For further information, see report titled "Reporting &

Credit Implications of GASB 45 Statement on Other Postemployment Benefits," published Dec. 1, 2004, on RatingsDirect.) Both pension and OPEB liabilities will act to constrain ratings over the foreseeable future.

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**Research:**[Return to Regular Format](#)**U.S. Public Pensions Face Uncertain Times**

Publication date: 24-Jun-2003

Credit Analyst: Parry Young, New York (1) 212-438-2120, Nen Bukspan, New York (1) 212-438-1792

Public pension plan costs are becoming a bigger drain on U.S. state and local government resources. Many state and local governments have been hit particularly hard in the past several years as they struggle with their worst deficits in decades.

While current government employees watch their pension and other post-retirement benefit contributions rise sharply, a growing number of retired employees are becoming concerned about the future of their own pensions.

As the various governmental jurisdictions decide how they will raise the money needed to fund these mounting benefit obligations, and how to target the root cause of the funding gap, Standard & Poor's Ratings Services is taking a closer look at pension and other post-employment benefits (OPEB) issues. This article examines the credit implications of pension benefit and OPEB obligations and how accountants are revisiting the way municipalities can best reflect the true benefit obligations.

**■ Credit Implications**

When Standard & Poor's credit analysts determine the credit implications of public pension obligations, they look at these liabilities in the light of an employer's total debt structure with an eye for what the consequences may be on the employer's ability to pay debt service in meeting these benefit obligations.

"We want to have a reasonably current accounting of the retirement system's funding status, and an understanding of how the employer plans to manage these liabilities," said Standard & Poor's credit analyst Parry Young. "Pension liabilities help shape an employer's credit profile, and the magnitude of the current challenge for some could contribute to rating downgrades. While some previously well-funded plans are in a better position to handle the new liabilities driven by poor investment returns and benefit enhancements, most plans and their sponsors are between a rock and a hard place," Mr. Young said.

Other than facing the music and increasing contributions, the options for employers with increased unfunded liabilities to make significant funding progress are very limited. On the liability side of the ledger, reducing benefit levels, which would lower liabilities, is very difficult to accomplish and frequently constitutionally prohibited.

For example, in the state of Oregon's retirement system, member accounts were credited with a minimum 8% annual return even if the fund's market gains fell below that level. The state is trying to reform this and certain other features of the system, which would reduce the system's total liability by billions of dollars. These changes would be tested in the courts.

Changing actuarial assumptions could also result in decreased liabilities, however, the trends affecting some of the major assumptions are going in the wrong direction. For example, with employees generally living longer, demographic assumption changes usually serve only to increase liabilities. Some sponsors have delayed the implementation of updated mortality tables, but this only delays the inevitable impact on liabilities.

On the asset side, because of the weak investment performance over the last several years, the upside potential for higher investment return assumptions is rather slim. The only recent changes to investment return assumptions have been downward adjustments, which again increases liabilities.

Another option for states is to defer or adjust contributions. In many cases, however,

the states must make the full payment. Partial payments may be possible in any one year, but anywhere from 70% to 90% of employers generally make the full actuarially required contribution. Illinois has a continuing appropriation: once the actuary decides on the rate, the state has to make that contribution. In several California counties, if the board of supervisors does not make the contribution set by the actuary, the county's independently elected auditor must take available county funds and place them in the pension trust fund.

"It's a pretty strong mechanism," Mr. Young said. "Omitting or reducing contributions may be a short-term budgetary fix, but it does not solve the unfunded liability problem."

#### ■ The Pension Obligation Bond Solution

Another solution to funding pensions is for states to issue pension obligation bonds (POBs), the proceeds of which are used to fund the plan and reduce the liability.

"But you are left with a bond on your balance sheet," Mr. Young said. "The primary risk is that you do not achieve a high enough investment return to cover the POB debt service cost or the actuarial investment return assumption, in which case the shortfall results in new unfunded liabilities. Under this scenario, which has been the experience over the past several years, POB issuers are incurring new unfunded liabilities, and higher contribution rates related to that, on top of the additional expense of POB debt service," he added.

Over the long-term, a POB might still be a workable solution, but in the short-term, they may add to fiscal stress, according to Mr. Young. A number of California issuers that issued POBs in the 1990s experienced poor returns, enhanced benefits, and adverse legal decisions, have reached reduced funding levels to the point where they are issuing POBs again. Hundreds of millions of POBs have been sold since May 2002, mainly by California counties, along with more than \$15 billion during the 1990s. Several large POB issues are planned or have been completed, including one by Illinois for \$10 billion.

#### ■ The Evolution of Pension Accounting

Pension accounting has been dormant for many years, but the weak economic conditions are bringing it to light again, according to Standard & Poor's Chief Accountant Neri Bukspan. Worldwide, accounting standard setters, including the Government Accounting Standards Board (GASB), the U.S. Financial Accountants Standards Board, the International Accounting Standards Board (IASB), and the U.K. Accounting Standards Board have all announced, or are in the process of declaring numerous standard-setting activities related to accounting for pension and OPEBs, including changes to the required disclosures.

For example, the IASB will decide whether "smoothing," a feature that makes it appear that a company is experiencing gains when they are actually recording losses, is acceptable. By 2005, all EU-listed companies are required to adopt International Accounting Standards, and expected to reflect pension and OPEB obligations and related assets.

The recently issued GASB OPEB Exposure is important because OPEB liabilities previously were not required to be reflected as an obligation by governmental equity. However, once the exposure draft is finalized, accounting for OPEBs will substantially conform to the accounting for pensions. Pension and OPEB obligations are difficult for analysts to monitor due to the inherent uncertainties associated with the estimation process, the complexity and inconsistency of the applicable accounting models, and the lack of sufficiently robust and timely disclosures.

To complicate matters, employers use an assortment of plans: defined benefit, defined contributions, insurance contracts, pay-as-you-go, single-employer and multiple-employer arrangements, or any combination of these programs.

The funding requirements also change; the government dictates some and local funding regulators dictate others. "Many times the actual funding to a plan could exceed the minimum funding rules, and different jurisdictions have different objectives

when establishing the minimum funding requirements," Mr. Bukspan said.

Unlike pensions, OPEBs are generally funded on a pay-as-you-go basis, which has a cash stream that is very different from a pre-funding cash stream. However, cash outlays, even in a pay-as-you-go program, can become extensive, particularly because of early retirement and downsizing.

Due to the changing economic circumstances, sponsors are revisiting their pension assumptions, curtailing benefits in many circumstances, and revisiting funding needs and policies. "There are near-term liquidity implications, as evidenced by pension obligation bond issuance, sale of noncore assets, and contributions of noncore assets to the pension plans," said Mr. Bukspan.

Although plan surpluses may be beneficial from a credit perspective, they cannot be viewed as cash equivalents, since the employer's practical ability to tap them directly is generally limited.

In its analysis, Standard & Poor's considers the ability of an entity to actually use the surplus, whether or not it is reflected in its financial statements. Depending on the local laws, when a surplus exists, the employer can curtail contributions, or may use a portion of the surplus to fund other benefits. An employer may also be able to enrich pension benefits in lieu of wage increases and fund downsizing through early retirement programs.

For public pension funds, any "excess" funding advantages flow to a sponsor through the pension contribution mechanism in the form of lower or temporarily omitted future contributions ("contribution holidays"). Laws and regulations do not allow sponsors to directly remove such excess funds from a pension trust fund.

#### ■ The Future of Public Pension Plan Scrutiny

For Standard & Poor's, the challenge is — as it always has been — to collect the most accurate information possible about the potential implications of a benefit plan on the entity's financial position and cash flow to understand the potential exposure involved. Standard & Poor's will be paying close attention to actual and potential liabilities and cash flow requirements of state and local governments arising from pension and other post-employment benefits.

By Will Siss



**Research: Pension Obligation Bonds: Were They A Good Bet?**

Publication date: 08-Nov-2001

Credit Analyst: Parry Young, New York (1) 212-438-2120, Steven J Murphy, New York (1) 212-438-2066

What do the volatility in equity prices and the decline in market indices over the past year or two mean for the security of public pension investments and, further, what is their effect on the strategy, used by a number of governmental pension sponsors over the last decade, of selling pension obligation bonds to fund the unfunded liability of their pension funds? Specifically, given the current and expected market conditions, was the POB strategy a good idea and, if so, does it still have validity, and does this technique represent a viable opportunity for governmental sponsors who may find themselves wrestling with unfunded liabilities as a result of the declines in equity performance?

**Brief History**

While a few POBs were done in the 1980s, they really came into their own in the 1990s with more than \$10 billion being sold. Over the last two years, only a few, relatively small, POBs have been floated. The average principal amount for POBs ranged from \$100 million to \$300 million with a few exceeding \$1 billion or more. Most POBs issued to date have been general obligation or general fund secured, capitalizing on the credit quality of the pension system's sponsor.

**The POB Experience Through 2000**

With this kind of debt instrument, timing is very important and issuers of POBs in the early- to mid-1990s could not have had better timing. While public pension funds during the 1990s were boosting their average allocations in domestic equities from 33% to almost 50%, the returns on this asset class were sustained at levels well above the historical experience. The average annual increase in the S&P 500 index for the 10 fiscal years ended June 30, 2000 (most public pension funds have June fiscal years), was almost 16%, compared to a historical average of about 10%. The five-year total portfolio return for public funds has averaged more than 13%. These performances should be viewed in the context of average investment return assumptions for public pension systems of only about 8%.

Following the issuance of POBs to increase the funding status or to fully fund a system, this excess return phenomenon could easily result in funded ratios greatly exceeding 100%. However, in that actuarially funded pension systems tend to be self-balancing, this overfunding imbalance would have been corrected by actions taken to affect either the pension fund's assets or liabilities, or both. In these circumstances, pension fund sponsors would, upon the recommendation of their actuaries, decrease or temporarily eliminate pension contributions (contribution holiday), thus slowing the growth of assets. On the liability side, some sponsors made the decision to improve employee benefits, instantly increased liabilities but also balancing overfunding. Regardless of how the "problem" of overfunding was managed by sponsors or pension funds that used POBs prior to fiscal 2000, POBs produced, as promised, an economic benefit and in most cases it was substantial.

### **2001: Harbinger of Tough Times for POBs?**

For the fiscal year ended June 30, 2001, the S&P 500 declined 15.8% (and fell a further 15% in the next quarter), which was its worst performance since fiscal 1982. This fiscal 2001 result followed the below-average performance of positive 6% for fiscal 2000. Following two decades of above-average equity returns, it is probable that these returns will approach the historical pattern going forward.

While a long-term environment of weak investment returns will lower pension funding levels, it may be premature for issuers of POBs and pension funds in general to adjust investment expectations based on the most recent results. As more data become available, if it is apparent that a trend is developing, some reactive changes may be needed. Regardless of the causes, any investment underperformance over an extended period of time will lead to actuarial losses and new unfunded liabilities, resulting in the need to increase contribution rates to bring the systems back into balance. It should be kept in mind that such a need would be in sharp contrast to recent years, when a decrease in the needed contribution rates actually provided budgetary flexibility for fund sponsors. Many funds now use smoothing methods for actuarial purposes in valuing assets to spread investment gains and losses over up to five years. This practice would temper the effects of the fiscal 2000 and 2001 investment return experience. With five-year smoothing, for example, only 20% of the fiscal 2001 losses would be included in the June 30, 2001 valuation, which would still be taking into account prior year gains as far back as 1997.

No matter how sponsors who utilize a POB strategy choose to manage their actuarial gains from the excess investment returns following POB sales (lower contributions or increased benefits), most are likely still fully funded, albeit with a lower cushion. In a long-term lower return environment with declining funding levels, those systems that have taken the bulk of their excess funding out of their POB structure may see trouble ahead.

For example, say a state sold POBs in 1985 with a 30-year amortization to fully fund its retirement system and had average annual investment returns of 12% against its investment assumption of 8%. However, instead of permitting the natural increase in the funded ratio that these conditions would have caused, the state managed its funding ratio, through contribution holidays and benefit improvements, to maintain the ratio at around 100%. If we are in fact heading into a lower return period (the average annual increase in the S&P 500 for the 16 years from 1966 to 1982 was a meager 2.7%, for example), the state may have already reaped all its gains from the transaction structure and be headed for losses. If actuarial losses start to be incurred, contributions will have to increase. If returns fall below the interest cost on its POB that will mean that the POB will have become a net financial drain. If investment yields fall below POB interest cost, total debt service, including that on the POB, plus normal and new unfunded actuarial accrued liability (due to low returns) contributions, will now be higher than if the POB had not been sold. To judge the full effect of a POB, however, any future losses have to be weighed against prior period gains. With a POB, its ultimate success, or failure, can only be judged at its final maturity is approached. The financial dynamics may be a winning formula for 25 years, for example, and then a losing one in the last five years (or vice versa).

### **POBs Going Forward**

Standard & Poor's factors the effects of a pension obligation bond strategy into the long term rating of the sponsor. Standard & Poor's has viewed POBs as a strategy for savings on carrying charges as long as the transaction was structured conservatively and the assumptions were reasonable and attainable. This requires a clear financing plan including reasonable assumptions and manageable leverage. Prudent expectations for investment returns and the cautious use of resultant savings help insure a POB's success. Another positive factor for a POB is, of course, to be fortunate enough to sell the bonds in a low interest rate environment, thereby increasing the spread between interest costs and investment return expectations and lowering the risk of underperformance. The long-term expectations for investment returns have not yet changed because of the recent return experience or current economic and political conditions and public funds will rely on diversification of investments to maintain necessary total returns. Thus, a sound POB plan today should be as viable as it was 10 years ago. The 2000 Public Pension Coordinating Council Survey of State and Local

**HB**

**293**

# Alaska State Legislature

SENATOR  
GENE THERRIAULT

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## Sponsor Statement Senate Bill 161

I have introduced Senate Bill 161 to eliminate any barriers in state law that might prevent borough governments from instituting local tax exemptions and avoid the "stacking of taxes".

This action is in keeping with Article X, Section 1. Of the State Constitution that, *"provides for maximum local self-government with a minimum of local government units, and to prevent duplication of tax-levying jurisdictions."*

If a borough determines it is in the best interest of the local government to equalize taxes by providing an exemption for a tax already levied by a city within their boundaries they should be able to do so.

Without this option, the flexibility needed to maintain a reasonable revenue source for programs and services throughout the municipality could be seriously jeopardized.

# Alaska State Legislature

Senator Gary Stevens, Chair  
Alaska State Capitol, Room 103  
Juneau, Alaska 99801-1182  
Phone 907-465-4925  
Fax 907-465-3517



Committee Members:  
Senator Bert Stedman  
Senator Tom Wagoner  
Senator Johnny Ellis  
Senator Albert Kookesh

## Senate Community and Regional Affairs Committee

# Agenda

Monday, April 13, 2005, 1:30 – 3:30 p.m.  
Beltz Committee Room 211

- **SB 161** Relating to a borough sales tax exemption for a source that is taxed by a city in that borough

There is no CS. It will be introduced by Dave Stancliff <sup>+</sup> for Sen. Therriault. It has a further referral to the Finance Committee. There is a zero fiscal note. The department (DCCED) will not be testifying.

On teleconference is Renee Broker with the Fairbanks North Star Borough who will provide a background on a FNSB election (to raise the alcohol tax that exempted the local govts. That election resulted in a challenge by the Interior CHARR – who are trying to negate the tax by challenging the Borough's power to partially exempt cities within Borough's.

- **Overview: Taxation of mining property; contracts approved by municipalities for payment in lieu of taxes (Pending introduction)**

- **SB 120 Exempting the state and its political subdivisions from daylight saving time**

Sponsored by Sen. Olson, (plus Wagoner, Dyson and Stedman). This bill has a further referral to the Labor and Commerce Committee. The House companion bill (HB 176) is sponsored by Rep's. Salmon, Kohring, Croft and Gruenberg).

There will be several people online to testify.

There is a zero fiscal note from the department (DCCED).

TABLE 1

## 2004 Municipalities: Class, Populations and Tax Types - continued

Municipality	Type of Municipality	Population	Property Tax	Sales Tax	Special Tax
Hoonah	First Class City	850	No	5%	No
Hooper Bay	Second Class City	1,109	No	4%	No
Houston	Second Class City	1,351	Yes	2%	No
Hughes	Second Class City	64	No	No	No
Huslia	Second Class City	284	No	No	No
Hydaburg	First Class City	369	No	4%	No
Juneau, City & Borough of	Unified Home Rule	31,246	Yes	5%	7% Bed Tax/ 3% Liquor Tax/ \$.30/pack Tobacco Tax
Kachemak	Second Class City	478	Yes	No	No
Kake	First Class City	683	No	5%	No
Kaktovik	Second Class City	295	No*	No	No
Kaltag	Second Class City	223	No	No	No
Kasaan	Second Class City	57	No	No	No
Kenai	Home Rule City	7,123	Yes	3%	No
Kenai Peninsula Borough	Second Class Borough	51,398	Yes	2%	No
Ketchikan	Home Rule City	7,989	Yes	3.50%	6% Bed Tax
Ketchikan Gateway Borough	Second Class Borough	13,533	Yes	2%	4% Bed Tax
Kiana	Second Class City	408	No	2%	No
King Cove	First Class City	725	No	4%	4% Seafood Proc/Business impact tax-flat rate
Kivalina	Second Class City	388	No	NR	No
Klawock	First Class City	847	No	5.50%	6% Bed Tax
Kobuk	Second Class City	125	No	No	No
X Kodiak	Home Rule City	6,113	Yes	6%	5% Bed Tax
X Kodiak Island Borough	Second Class Borough	13,797	Yes	No	9.25 mill Severance Tax/5% Bed Tax
Kollik	Second Class City	605	No	3%	No
Kolzebue	Second Class City	3,070	No	6%	6% Bed Tax/ 6% Alcohol Tax
Koyuk	Second Class City	341	No	2%	No
Koyukuk	Second Class City	108	No	No	No
Kupreanof	Second Class City	30	No	No	No
Kwethluk	Second Class City	709	No	5%	No
Lake & Peninsula Borough	Home Rule Borough	1,627	No	No	2% Raw Fish Tax/Guide Fees/6% Bed Tax
Larsen Bay	Second Class City	96	No*	3%	No
Lower Kalskag	Second Class City	267	No	NR	NR
Manokotak	Second Class City	405	No	2%	No
Marshall	Second Class City	365	No	4%	No
Matanuska-Susitna Borough	Second Class Borough	67,526	Yes	No	5% Bed Tax
McGrath	Second Class City	405	No	No	No
Mekoryuk	Second Class City	205	No	2%	No
Metlakatla	Federal Law	1,397	No	No	No
Mountain Village	Second Class City	753	No	3%	No
Napakiak	Second Class City	380	No	3%	No
Napaskiak	Second Class City	424	No	No	No
Nenana	Home Rule City	385	Yes	4%	No
New Stuyahok	Second Class City	491	No	No	No
Newhalen	Second Class City	171	No	2%	NR
Nightmute	Second Class City	229	No	2%	No
Nikolai	Second Class City	123	No	No	No
Nome	First Class City	3,414	Yes	5%	4% Bed Tax
Nondalton	Second Class City	216	No	NR	No
Noorvik	Second Class City	648	No	3%	No
X North Pole	Home Rule City	1,609	Yes	4% <del>3%</del>	No (raised to 4% 2004)
North Slope Borough	Home Rule Borough	7,228	Yes	No	No
Northwest Arctic Borough	Home Rule Borough	7,293	No	No	No
Nuiqsut	Second Class City	416	No*	No	No

Note: Municipal populations are from the State Department of Labor

\* Indicates that City does not levy property tax, but Borough in which City is located does

TABLE 1

2004 Municipalities: Class, Populations and Tax Types

Municipality	Type of Municipality	Population	Property Tax	Sales Tax	Special Tax
Adak	Second Class City	74	No	3%	2% Fuel Transfer Tax
Akhiok	Second Class City	51	No*	No	No
Akiak	Second Class City	346	No	No	No
Akutan	Second Class City	787	No	NR	NR
Alakanuk	Second Class City	663	No	No	No
Aleknagik	Second Class City	235	No	5%	5% Bed Tax
Aleutians East Borough	Second Class Borough	2,688	No	No	2% Raw Fish Tax
Allakaket	Second Class City	95	No	No	No
Ambler	Second Class City	291	No	3%	No
Anaktuvuk Pass	Second Class City	319	No*	No	No
Municipality of Anchorage	Unified Home Rule	273,565	Yes	No	8% Bed Tax & Car Rental/15% Tobacco Tax/Aircraft (R&M)
Anderson	Second Class City	377	No	No	8% Utility Tax
Angoon	Second Class City	507	No	3%	3% Bed Tax
Aniak	Second Class City	541	No	2%	No
Anvik	Second Class City	105	No	No	No
Atka	Second Class City	94	No	No	2% Raw Fish Tax/ 10% Bed Tax
Atkasuk	Second Class City	228	No*	No	No
Barrow	First Class City	4,412	No*	No	No
Bethel	Second Class City	5,886	No	5%	3% Bed/5% Alcohol/5% Gaming/MVRT
Bettles	Second Class City	32	No	No	\$ 02/gal. Fuel Transfer Tax
Brevig Mission	Second Class City	313	No	3%	No
Bristol Bay Borough	Second Class Borough	1,103	Yes	No	3% Raw Fish Tax/10% Bed Tax
Buckland	Second Class City	409	No	6%	No
Chefornak	Second Class City	434	No	2%	2% Raw Fish Tax
Chevak	Second Class City	883	No	NR	No
Chignik	Second Class City	91	No	No	1% salmon tax/1% other seafood
Chuathbaluk	Second Class City	102	No	No	No
Clarks Point	Second Class City	66	No	NR	No
Coffman Cove	Second Class City	164	No	No	No
Cold Bay	Second Class City	95	No	No	8% Bed Tax/\$ 04/gal. Fuel Tax
Cordova	Home Rule City	2,298	Yes	6%	6% Bed Tax/6% Vehicle Rental Tax
Craig	First Class City	1,495	Yes	5%	6% Liquor Tax
Deering	Second Class City	131	No	3%	No
Delta Junction	Second Class City	963	No	No	No
Denali Borough	Home Rule Borough	1,917	No	No	Sev. Tax: \$ 05/tyd gravel; \$ 05 ton-coal; \$ Bed Tax: 7%
Dillingham	First Class City	2,390	Yes	6%	10% Bed Tax / 10% Liquor Tax/6% Gaming
Diomedes	Second Class City	137	No	3%	No
Eagle	Second Class City	126	Yes	No	No
Eek	Second Class City	290	No	2%	No
Egegik	Second Class City	82	No	No	2% Raw Fish Tax
Ekwook	Second Class City	128	No	No	No
Elim	Second Class City	342	No	2%	No
Emmonak	Second Class City	758	No	NR	No
X Fairbanks	Home Rule City	29,002	Yes	No	8% Bed Tax/ 5% Alcohol Tax/ 8% Tobacco Tax
X Fairbanks North Star Borough	Second Class Borough	62,131	Yes	No	8% Bed Tax + 5% Alcohol = 2004 Vote
False Pass	Second Class City	69	No	2%	6% Bed Tax
Fort Yukon	Second Class City	560	No	3%	No
Galena	First Class City	744	No	3%	No
Gambell	Second Class City	647	No	3%	No
Golovin	Second Class City	156	No	No	No
Goodnews Bay	Second Class City	244	No	No	No
Grayling	Second Class City	162	No	No	No
Gustavus	Second Class City	473	No	2%	4% Bed Tax as of 4-1-04
Haines Borough**	Home Rule Borough	2,319	Yes	5.5%	4% Bed Tax/4% Tour Tax
Holy Cross	Second Class City	204	No	No	No
Homer	First Class City	5,865	Yes	3.50%	No

Note: Municipal populations are from the State Department of Labor

\*Indicates that City does not levy property tax, but Borough in which City is located does

\*\* The City of Haines and the Haines Borough consolidated in 2002, into a single Home Rule Government

JuneauEmpire.com



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## Empire editorial: An untimely tax proposal

Sunday, August 22, 2004

Bar owners and anti-alcohol forces are loading their verbal weapons for a showdown Monday night at the Juneau Assembly meeting.

Some would like to see a ballot measure this October that would boost the alcohol sales tax from the 3 to 5 percent. That's in addition to the existing sales tax on all items, which means drinkers would be paying a 10 percent tax for a libation.

The arguments for and against stopping the ills of society through taxation are already flying. But moral arguments aside, this simply isn't the right time to hoist the tax on spirits.

First of all, the city could end up spending a sizable chunk of change fighting for the tax in court, if the increase wins voters' approval. Fairbanks North Star Borough is tangled up in such a case that has made its way to the Alaska Supreme Court. Borough voters approved a 5 percent liquor tax last October, but business owners challenged the legality of it, based on a state law that restricts the imposition of taxes on alcohol.

Already, City Attorney John Hartle has recommended that revenue from a 5 percent alcohol sales tax in Juneau be set aside, rather than spent, because of the legal ambiguity. So it doesn't make sense to impose such a tax when it's unclear whether it will even fly in court.

Nor will the city be able to immediately benefit from this revenue. While alcohol-tax supporters say that this money could be used to offset the problems created by excessive drinking, the city does not know at this time if it's legally possible to use the increased funds for those purposes.

Second, the city has already put local bars through one major transition in the next few years - making them totally smoke-free by 2008. Banning smoking in all bars was the right thing to do, but it has many bar owners nervous they're going to struggle to keep customers.

Since three out of four Juneau residents don't smoke, it seems more likely that clientele in bars may shift from smokers to nonsmokers. But it's not going to be easy for bar owners to convince nonsmokers to frequent their newly smoke-free taverns if drink prices have jumped because of a tax hike.

This simply isn't the time to hit up one segment of Juneau's businesses for revenue that the city ultimately may not be allowed to touch.

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## Municipal Sales Taxes

Alaska Statutes 29.45.650-710 authorize the levy of sales and use taxes at the municipal level. The statutes give broad authority to municipalities to levy taxes on sales, rents and services provided within the municipality. There are only a couple of limitations placed upon municipalities in regards to levying a sales tax. Orbital space facilities are exempt from the levy of sales tax and alcohol may not be taxed unless other items are similarly taxed. A borough may not levy a sales tax on food coupons, food stamps, or other types of certificates issued under the federal Food Stamp Act. A borough may not levy or collect a sales or use tax on (1) physical transfer of refined fuel, unless in connection with a sale or use in the borough, or (2) wholesale sales or transfers of fuel refined in the borough. A sale is in the borough if the fuel is delivered to the buyer in the borough. Local ordinance may grant other exemptions.

A general law municipality that levies a sales tax may levy a use tax on the storage, use or consumption of tangible personal property; however, the use tax rate must equal the rate of sales tax and may only be levied on buyers. These limits do not apply to home rule municipalities.

There are no limits by statute on the rate of levy for sales or use taxes for a municipality. Such taxes are defined in Title 43 as taxes imposed with respect to transfer for a consideration of ownership, possession or custody of tangible personal property or rendering of services measured by the price of the tangible personal property transferred or services rendered and which is required by state or local law to be separately stated from the sales price by the seller or which is customarily separately stated from the sales price, but does not include a tax imposed exclusively on the sale of a specific commodity or article or class of commodities or articles.

Title 29.45.810, exemption from municipal taxation, states that for a party to a contract approved by the legislature as a result of submission under the SGA, the property, gas, products and activities associated with such approved, qualified project are exempt, as specified in the contract, from all taxes identified in the Act that would be levied and collected by a municipality under state law as a consequence of the participation by the party in the approved project.

### Revenues by Tax Type

At an April 16, 2004 MAG meeting, there was general discussion of sales and use taxes and the differences between municipalities' taxes and tax rates, exemptions, administrative procedures, and transaction caps. There was discussion about sales/use tax restrictions during construction and/or operations. Finally, there was discussion about whether the administrative complexity or the administrative costs would be balanced by potential savings to a successful applicant.

The following tables show each municipality's tax types, tax revenues and percentage of total tax revenue by type. The information was taken from Alaska Taxable 2003.

#### Municipality of Anchorage

Tax	Tax Revenues	% of Total Tax
Property Tax	\$315,874,931	
General Sales Tax	0	
Bed Tax	\$ 11,007,248	
Alcohol Tax	0	
Tobacco Tax	\$ 5,349,091	
Other Special Use Tax	\$ 4,682,406 (car rental tax)	
Other Special Use Tax	\$ 202,860 (aircraft tax)	

**City of Delta Junction**

No sales or special taxes

**City of Fairbanks**

Tax	Tax Revenues	% of Total Tax Revenues
Property Tax	\$8,076,192	
General Sales Tax	0	
Bed Tax	\$1,786,026	14.46%
Alcohol Tax	\$1,162,927.83	9.41%
Tobacco Tax	\$799,567	6.47%
Other Special Use Tax		

**Fairbanks North Star Borough**

Tax	Tax Revenues	% of Total Tax Revenue
Property Tax	\$68,013,870	
General Sales Tax	0	
Bed Tax 8%	\$1,305,822	2%
Alcohol Tax 5%	Effective July 1, 2004	
Tobacco Tax 8%	Effective July 1, 2004	
Other Special Use Tax		

**Haines Borough**

Tax	Tax Revenues	% of Total Tax Revenue
Property Tax	\$1,818,643	
General Sales Tax 5.5%	\$1,899,249	
Bed Tax 4%	\$ 101,683	
Alcohol Tax		
Tobacco Tax		
Other Special Use Tax 4%	\$ 191,192 (Tour Tax)	

**Kenai Peninsula Borough**

Tax	Tax Revenues	% of Total Tax Revenue
Property Tax	\$41,693,443	
General Sales Tax 2%	\$14,370,582	
Bed Tax	0	
Alcohol Tax	0	
Tobacco Tax	0	
Other Special Use Tax	0	

**City of North Pole**

Tax	Tax Revenues	% of Total Tax Revenue
Property Tax	\$ 755,335	
General Sales Tax 3%	\$1,336,630	
Bed Tax	0	
Alcohol Tax	0	
Tobacco Tax	0	
Other Special Use Tax	0	

### North Slope Borough

Tax	Tax Revenues	% of Total Tax Revenue
Property Tax	\$199,653,165	100%
General Sales Tax*	0	
Bed Tax	0	
Alcohol Tax	0	
Tobacco Tax	0	
Other Special Use Tax	0	

\*NSB receives a payment in lieu of taxes for economic development

### City of Seward

Tax	Tax Revenues	% of Total Tax Revenue
Property Tax	\$ 712,175	
General Sales Tax 3%*	\$2,165,586	
Bed Tax 4%	\$ 217,482	
Alcohol Tax	0	
Tobacco Tax	0	
Other Special Use Tax	0	

Effective April 1, 2003 the sales rate is 4%

### Skagway

Tax	Tax Revenues	% of Total Tax Revenue
Property Tax	\$1,148,146	
General Sales Tax 4%	\$2,531,977	
Bed Tax 8%	\$ 91,782	
Alcohol Tax		
Tobacco Tax		
Other Special Use Tax		

### Valdez

Tax	Tax Revenues	% of Total Tax Revenues
Property Tax	\$20,260,164	
General Sales Tax	0	
Bed Tax 6%	\$ 256,803	
Alcohol Tax	0	
Tobacco Tax	0	
Other Special Use Tax	0	

### Transactions Limits/Exemptions for General Sales Tax

Evaluating the cost/benefit of sales taxes requires discussing the various transaction limits and exemptions municipalities have in their sales tax code. A complete list of exemptions for all municipalities that levy a sales tax is attached.

**City of North Pole:** seventeen exemptions from sales tax. The transaction cap amount is \$200.00. With a 3% sales tax, the maximum tax per transaction is \$6.00.

**Haines Borough:** 31 exemptions from sales tax, no transaction limits, with the exception of the sale of construction materials and services exceeding \$10,000.00. Construction materials are defined as those items becoming a permanent part of the structure. Contractors may apply for a numbered sales tax exemption permit which exempts the purchaser from paying sales tax on the particular project.

The Haines Borough defines "retail sale" as any sale of real or tangible personal property, including barter, credit, installment and conditional sales, for any purpose other than resale in the regular course of business. The delivery of property in the Borough by a seller whose principal place of business is outside the Borough to a buyer or consumer is a retail sale made within the Borough if such retailer maintains any office, distribution, or sales house, warehouse or any other place of business, or solicits business or receives orders through any agent, salesperson, or other type of representation within the Borough.

**City of Skagway:** 22 exemptions from sales tax in code, no specific transaction limit. However, sales of building and construction materials exceeding \$2,500 for use on any one construction project approved by a city building permit and paid for by any one purchaser during any 12-consecutive month period is exempt from sales tax. In addition, contracts and subcontracts for any new construction and reconstruction services on projects and structures for industrial, commercial, residential, and nonprofit purposes are exempt.

**City of Seward:** 15 exemptions from sales tax. The sales tax is applied only to the first \$500 of each separate sale, rent or service transaction. A transaction involving payment for services or personal property to be rendered or delivered over a period of more than one month for a consideration in excess of \$500 shall be treated as several separate transactions.

**Kenai Peninsula Borough:** approximately 22 exemptions from sales tax. Taxes are assessed on the first \$500 per transaction. KPB has an exemption for sales of building construction materials for owner/builders and only if the materials become part of the permanent structure. The borough charges a fee of \$100 for a tax exemption certificate for owner/builders.

On taxing jurisdiction, KPB code states the rate of tax to be added to the sale price is based on the place of sale, which for goods and merchandise is the location of the retail outlet; the same rule applies if the invoice includes a charge for installation. When goods are delivered into the borough from outside of the borough and the seller maintains an ongoing physical presence in the borough, the location of the seller's in-borough presence will determine the place of sale. If a seller has no ongoing physical presence in the borough but has established nexus with the borough, the point of delivery will determine the place of sale. If the seller has no ongoing physical presence in or nexus with the borough the sale is not subject to the borough sales tax. Nexus means the seller has established a connection within the borough by use of marketing techniques or sales, which establish or maintain a market for its goods in the borough.

#### **Other Points of Discussion**

In order to determine the cost/benefit of eliminating or modifying municipal sales/use taxes for purposes of a contract under the SGA, the following are items that may warrant further discussion:

- Materials/goods particular to gas pipeline project
- Point of sale for materials/goods
- Likely tax amount for applicant given sales tax rates, exemptions and transaction limits
- Cost of administration of modifying or exempting gas pipeline materials/goods/services from existing taxes
- Ease of expanding existing exemptions, i.e. construction materials, for gas pipeline materials/goods/services

# FISCAL NOTE

**STATE OF ALASKA**  
**2005 LEGISLATIVE SESSION**

Fiscal Note Number: \_\_\_\_\_  
 Bill Version: SB161  
 () Publish Date: \_\_\_\_\_

Revisor: Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Commerce  
 Title: Borough Sales Tax Exemption RDU: Comm Assist & Ec Dev (405)  
 Component: Community Advocacy  
 Sponsor: State Affairs  
 Requester: Senate Community & Regional Affairs Component No.: 2703

**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						
<b>TOTAL OPERATING</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

<b>CAPITAL EXPENDITURES</b>						
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<b>CHANGE IN REVENUES ( )</b>						
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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)						
<b>TOTAL</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

Estimate of any current year (FY2005) cost: 0.0  
 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)

This legislation allows that a borough may wholly or partially exempt a source from a borough sales tax if it is already taxed by a city in the borough

It would not create a fiscal impact on the operations of the department.

Prepared by: Michael Black, Director Phone 269-4535  
 Division: Community Advocacy Date/Time 4/11/05 6:11 PM  
 Approved by: Edgar Blatchford, Commissioner Date 4/11/2005  
 Agency: Commerce, Community, and Economic Development

**HB**

**334**

Representative Jay Ramras  
Co-Chair, House Resources  
V-Chair, Economic Develop.  
Tourism & Trade  
House State Affairs

119 N. Cushman St. Suite 207  
Fairbanks, Alaska 99701  
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## Alaska State Legislature



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e-mail  
Representative\_Jay\_Ramras  
@legis.state.ak.us  
House District 10

### House of Representatives

## MEMO

To: Senator Bert Stedman  
Chair, Senate Community and Regional Affairs Committee  
Fm: Jim Pound, Chief of Staff

Cc:

Date: April 7, 2006

Re: Request for hearing of CSHB 334

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Please accept this Memo as a request for the Senate Community and Regional Affairs Committee to hear CSHB 334, "An Act relating to an exemption from and deferral of municipal property taxes for certain types of deteriorated property." CSHB 334 will allow developers an opportunity to seek commercial financing to refurbish deteriorating structures by giving them a specific timeline for tax deferred status.

Thank you in advance for scheduling HB 334 before the Senate Community and Regional Affairs Committee.

Attachments: Sponsor Statement, CSHB 334 (FIN), HB 334, Fiscal Notes, AS 29.45.050, Support letters, Minutes of 21<sup>st</sup> AK Legislature HCRA re: HB 76, CSHB 76 (CRA), CSHB 76 (RLS) am S

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Thank you

Representative Jay Ramras  
Co-Chair, House Resources  
V-Chair, Economic Develop.  
Tourism & Trade  
House State Affairs  
119 N. Cushman St. Suite 207  
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## Alaska State Legislature



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House District 10

### House of Representatives

## Sponsor Statement CSHB 334(Fin)

**"An Act relating to an exemption from and deferral of municipal property taxes for certain types of deteriorated property."**

In several communities around the state we have seen private properties go from prosperous offices and residential building in the boom cycle to empty eyesores in our busts. Today, our economy is returning, on a more stable footing than ever before, and new developers are looking as the shells of a building as an opportunity to refurbish without complete reconstruction, revitalizing neighborhoods and cities.

How CSHB 334 will help with this plan is by revising existing tax deferral language, making it clearer. It also places a deadline on the exemption that coincides with existing tax deferral sunsets.

The primary difference in the language allows for the development of condominium or office type buildings to be established in what are currently referred to as deteriorated structures. At the discretion of the local government the tax deferral is spelled out. The deferral ends either when the developer transfers ownership of part or all of the property or on a previously agreed upon date. This clearer language allows a developer more stability and an ability to secure the necessary loans for the reconstruction.

# FISCAL NOTE

**STATE OF ALASKA**  
**2006 LEGISLATIVE SESSION**

Fiscal Note Number: 1  
 Bill Version: HB 334  
 (H) Publish Date: 2/1/06

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: Commerce  
 Title: Municipal Property Tax Deferral/Exemption RDU: Comm A. sist & Ec Dev (405)  
 Component: Community Advocacy  
 Sponsor: Ramras  
 Requester: House Community & Regional Affairs Component No.: 2703

**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						
<b>TOTAL OPERATING</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

<b>CAPITAL EXPENDITURES</b>						
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<b>CHANGE IN REVENUES ( )</b>						
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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)						
<b>TOTAL</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

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)

This legislation relates to an exemption from and deferral of municipal property taxes for certain types of deteriorated property. It does not impact the operations of the department.

Prepared by: Mike Black, Director Phone: 269-4535  
 Division: Community Advocacy Date/Time: 1/30/06 3:34 PM  
 Approved by: William C. Noll, Commissioner Date: 1/30/2006  
 Agency: Commerce, Community and Economic Development

# FISCAL NOTE

**STATE OF ALASKA**  
**2006 LEGISLATIVE SESSION**

Fiscal Note Number: 2  
 Bill Version: CSHB 334(FIN)  
 (H) Publish Date: 2/22/06

Revision Date/Time (Note if correction): \_\_\_\_\_ Dept. Affected: All  
 Title: Deferral of municipal property taxes RDU: \_\_\_\_\_  
 Component: \_\_\_\_\_  
 Sponsor: Rep. Ramras  
 Requester: House Finance Committee 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						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
<b>TOTAL OPERATING</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

<b>CAPITAL EXPENDITURES</b>						
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<b>CHANGE IN REVENUES ( )</b>						
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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)						
<b>TOTAL</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

Estimate of any current year (FY2006) cost: 0.0

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

**POSITIONS**

Full-time						
Part-time						
Temporary						

**ANALYSIS:** (Attach a separate page if necessary)

This legislation would not have a significant fiscal impact on any state agency.

Prepared by: Jack Kreinheder, Senior Analyst  
 Division: Office of Management and Budget  
 Approved by: Cheryl Frasca, Director  
 Agency: Office of Management and Budget

Phone 465-4676  
 Date/Time 2/17/06 4:22 PM  
 Date 2/17/2006

Sec. 29.45.050. Optional exemptions and exclusions.

Statute text

- (a) A municipality may exclude or exempt or partially exempt residential property from taxation by ordinance ratified by the voters at an election. An exclusion or exemption authorized by this subsection may be applied with respect to taxes levied in a service area to fund the special services. An exclusion or exemption authorized by this subsection may not exceed the assessed value of \$20,000 for any one residence.
- (b) A municipality may by ordinance
- (1) classify and exempt from taxation
    - (A) the property of an organization not organized for business or profit-making purposes and used exclusively for community purposes if the income derived from rental of that property does not exceed the actual cost to the owner of the use by the renter;
    - (B) historic sites, buildings, and monuments;
    - (C) land of a nonprofit organization used for agricultural purposes if rights to subdivide the land are conveyed to the state and the conveyance includes a covenant restricting use of the land to agricultural purposes only; rights conveyed to the state under this subparagraph may be conveyed by the state only in accordance with AS 38.05.069(c);
    - (D) all or any portion of private ownership interests in property that, based upon a written agreement with the University of Alaska, is used exclusively for student housing for the University of Alaska; property may be exempted from taxation under this subparagraph for no longer than 30 years unless the exemption is specifically extended by ordinance adopted within the six months before the expiration of that period;
  - (2) classify as to type and exempt or partially exempt some or all types of personal property from ad valorem taxes.
- (c) The provisions of (a) of this section notwithstanding,
- (1) a borough may, by ordinance, adjust its property tax structure in whole or in part to the property tax structure of a city in the borough, including but not limited to, excluding personal property from taxation, establishing exemptions, and extending the redemption period;
  - (2) a home rule or first class city has the same power to grant exemptions or exclude property from borough taxes that it has as to city taxes if
    - (A) the exemptions or exclusions have been adopted as to city taxes; and
    - (B) the city appropriates to the borough sufficient money to equal revenues lost by the borough because of the exemptions or exclusions, the amount to be determined annually by the assembly;
  - (3) a city in a borough may, by ordinance, adjust its property tax structure in whole or in part to the property tax structure of the borough, including but not limited to exempting or partially exempting property from taxation.
- (d) Exemptions or exclusions from property tax that have been granted by a home rule municipality in addition to exemptions authorized or required by law, and that are in effect on September 10, 1972, and not later withdrawn, are not affected by this chapter.
- (e) A municipality may by ordinance classify and exempt or partially exempt from taxation privately owned land, wet land and water areas for which a scenic, conservation, or public recreation use easement is granted to a governmental body. To be eligible for a tax exemption, or partial exemption, the easement must be in perpetuity. The easement is automatically terminated before an eminent domain taking of fee simple title or less than fee simple title to the property, so that the property owner is compensated at a rate that does not reflect the easement grant. The

municipality may provide by ordinance that, if the area subject to the easement is sold, leased, or otherwise disposed of for uses incompatible with the easement or if the easement is conveyed to the owner of the property, the owner must pay to the municipality all or a portion of the amount of the tax exempted, with interest.

(f) A municipality may by ordinance exempt from taxation all or part of the increase in assessed value of improvements to real property if an increase in assessed value is directly attributable to alteration of the natural features of the land, or new maintenance, repair, or renovation of an existing structure, and if the alteration, maintenance, repair, or renovation, when completed, enhances the exterior appearance or aesthetic quality of the land or structure. An exemption may not be allowed under this subsection for the construction of an improvement to a structure if the principal purpose of the improvement is to increase the amount of space for occupancy or nonresidential use in the structure or for the alteration of land as a consequence of construction activity. An exemption provided in this subsection may continue for up to four years from the date the improvement is completed, or from the date of approval for the exemption by the local assessor, whichever is later.

(g) A municipality may by ordinance exempt from taxation all or part of the increase in assessed value of improvements to a single-family dwelling if the principal purpose of the improvement is to increase the amount of space for occupancy. An exemption provided in this subsection may continue for up to two years from the date the improvement is completed, or from the date of approval of an application for the exemption by the local assessor, whichever is later.

(h) A municipality may by ordinance partially or wholly exempt land from a tax for fire protection service and fire protection facilities and may levy the tax only on improvements, including personal property affixed to the improvements.

(i) A municipality may by ordinance approved by the voters exempt from taxation the assessed value that exceeds \$150,000 of real property owned and occupied as a permanent place of abode by a resident who is

(1) 65 years of age or older;

(2) a disabled veteran, including a person who was disabled in the line of duty while serving in the Alaska Territorial Guard; or

(3) at least 60 years old and a widow or widower of a person who qualified for an exemption under (1) or (2) of this subsection.

(j) A municipality may by ordinance approved by the voters exempt real or personal property in a taxing unit used in processing timber after it has been delivered to the processing site from up to 75 percent of the rate of taxes levied on other property in that taxing unit. An ordinance adopted under this subsection may not provide for an exemption that exceeds five years in duration. In this subsection "taxing unit" means a municipality and includes

(1) a service area in a unified municipality or borough;

(2) the entire area outside cities in a borough; and

(3) a differential tax zone in a city.

(k) A municipality may by ordinance approved by the voters exempt from taxation pollution control facilities that meet requirements of the United States Environmental Protection Agency or the Department of Environmental Conservation. An ordinance adopted under this subsection may not provide for an exemption that exceeds five years in duration.

(l) A municipality may by ordinance exempt from taxation an interest, other than record ownership, in real property of an individual residing in the property if the property has been developed, improved, or acquired with federal funds for low-income housing and is owned or

managed as low-income housing by the Alaska Housing Finance Corporation under AS 18.55.100 - 18.55.960 or by a regional housing authority formed under AS 18.55.996. However, the corporation may make payments to the municipality or political subdivision for improvements, services, and facilities furnished by it for the benefit of a housing project, and this subsection does not prohibit a municipality from receiving those payments or any payments in lieu of taxes authorized under federal law.

(m) A municipality may by ordinance partially or totally exempt all or some types of economic development property from taxation for up to five years. The municipality may provide for renewal of the exemption under conditions established in the ordinance. However, under a renewal, a municipality that is a school district may only exempt all or a portion of the amount of taxes that exceeds the amount levied on other property for the school district. A municipality may by ordinance permit deferral of payment of taxes on all or some types of economic development property for up to five years. The municipality may provide for renewal of the deferral under conditions established in the ordinance. A municipality may adopt an ordinance under this subsection only if, before it is adopted, copies of the proposed ordinance made available at a public hearing on it contain written notice that the ordinance, if adopted, may be repealed by the voters through referendum. An ordinance adopted under this subsection must include specific eligibility requirements and require a written application for each exemption or deferral. In this subsection "economic development property" means real or personal property, including developed property conveyed under 43 U.S.C. 1601 et seq (Alaska Native Claims Settlement Act), that

(1) has not previously been taxed as real or personal property by the municipality;

(2) is used in a trade or business in a way that

(A) creates employment in the municipality;

(B) generates sales outside of the municipality of goods or services produced in the municipality;

or

(C) materially reduces the importation of goods or services from outside the municipality; and

(3) has not been used in the same trade or business in another municipality for at least six months before the application for deferral or exemption is filed; this paragraph does not apply if the property was used in the same trade or business in an area that has been annexed to the municipality within six months before the application for deferral or exemption is filed; this paragraph does not apply to inventories.

(n) A municipality may by ordinance classify as to type inventories intended for export outside the state and partially or totally exempt all or some types of those inventories from taxation. The ordinance may provide for different levels of exemption for different classifications of inventories. An ordinance adopted under this subsection must include specific eligibility requirements and require a written application, which shall be a public document, for each exemption.

(o) A municipality may by ordinance partially or totally exempt all or some types of deteriorated property from taxation for up to 10 years beginning on or any time after the day substantial rehabilitation, renovation, demolition, removal, or replacement of any structure on the property begins. A municipality may by ordinance permit deferral of payment of taxes on all or some types of deteriorated property for up to five years beginning on or any time after the day substantial rehabilitation, renovation, demolition, removal or replacement of any structure on the property begins. However, if the ownership of property for which a deferral has been granted is transferred, all tax payments deferred under this subsection are immediately due and the deferral

ends, or, if ownership of any part of the property is transferred, all tax payments are immediately due. The amount deferred each year is a lien on that property for that year. Only one exemption and only one deferral may be granted to the same property under this subsection, and, if an exemption and a deferral are granted to the same property, both may not be in effect on the same portion of the property during the same time. An ordinance adopted under this subsection must include specific eligibility requirements and require a written application for each exemption or deferral. In this subsection, "deteriorated property" means real property that is commercial property not used for residential purposes or that is multi-unit residential property with at least eight residential units, and that meets one of the following requirements:

- (1) within the last five years, has been the subject of an order by a government agency requiring environmental remediation of the property or requiring the property to be vacated, condemned, or demolished by reason of noncompliance with laws, ordinances, or regulations;
- (2) has a structure on it not less than 15 years of age that has undergone substantial rehabilitation, renovation, demolition, removal, or replacement, subject to any conditions prescribed in the ordinance; or
- (3) is located in a deteriorating or deteriorated area with boundaries that have been determined by the municipality.

(p) A municipality may by ordinance partially or totally exempt from taxation a private leasehold, contract, or other interest held by or through an applicant or proposed applicant in any property, assets, project, or development project owned by the Alaska Industrial Development and Export Authority under AS 44.88. Nothing in this subsection prohibits a municipality from entering into an agreement and receiving payments in lieu of taxes authorized under AS 44.88.140(b).

(q) A municipality may by ordinance partially or totally exempt from taxation land from which timber is harvested that is infested by insects or at risk of being infested by insects due to an infestation in the area in which the land is located. A municipality may provide that an exemption for land under this subsection applies only to increases in assessed value that result from the timber harvest. A municipality may by ordinance partially or totally exempt from taxation improvements to real property, including personal property affixed to the improvements, if the improvements are

- (1) located on land from which timber is harvested that is infested by insects or at risk of being infested by insects due to an infestation in the area in which the land is located; and
- (2) used for or necessary to the harvest of the timber that is infested by insects or in danger of insect infestation.

(r) A municipality may by ordinance exempt from taxation an amount not to exceed \$10,000 of the assessed value of real property owned and occupied as a permanent place of abode by a resident who provides in the municipality volunteer (1) fire fighting services and is certified as a fire fighter by the Department of Public Safety, or (2) emergency medical services and is certified under AS 18.08.082. If two or more individuals are eligible for an exemption for the same property, not more than two exemptions may be granted.

#### History

(§ 12 ch 74 SLA 1985; am § 1 ch 103 SLA 1985; am § 5 ch 70 SLA 1986; am § 1 ch 151 SLA 1988; am § 2 ch 73 SLA 1989; am § 1 ch 98 SLA 1989; am § 15 ch 93 SLA 1991; am § 107 ch 4 FSSLA 1992; am § 1 ch 66 SLA 1993; am § 1 ch 7 SLA 1994; am § 1 ch 65 SLA 1994; am § 1 ch 40 SLA 1995; am § 1 ch 70 SLA 1998; am §§ 1, 2 ch 8 SLA 1999; am § 4 ch 117 SLA 2000;

am § 1 ch 54 SLA 2002; am § 1 ch 64 SLA 2002; am §§ 2, 3 ch 140 SLA 2004; am § 40 ch 56 SLA 2005)

#### Annotations

Delayed repeal of subsection (o). Under sec. 2, ch. 8, SLA 1999, as amended by sec. 1, ch. 102, SLA 2002, and sec. 4, ch. 140, SLA 2004, subsection (o) is repealed July 1, 2010.

Revisor's notes. Subsection (h) of this section was enacted as AS 29.53.025(h). Renumbered in 1985. Chapter 103, SLA 1985 also enacted, in § 2, AS 29.63.066, which provides an exemption identical to that set out in (h) of this section from taxes levied under former AS 29.63, repealed by § 88, ch. 74, SLA 1985. The provisions of former AS 29.63 were substantially incorporated in AS 29.45, and the addition of subsection (h) to AS 29.45.050 makes it unnecessary to codify § 2, ch. 103, SLA 1985 to achieve the legislature's purpose.

Subsection (r) was enacted as (q); relettered in 2002.

Cross references. For authority to make an ordinance adopted under subsection (q) retroactive to January 1, 2001, see § 2, ch. 64, SLA 2002.

Effect of amendments. The 1992 amendment, effective July 1, 1992, rewrote subsection (l). The 1993 amendment, effective September 22, 1993, in subsection (n), deleted the former second and third sentences.

The first 1994 amendment, effective July 5, 1994, added paragraphs (b)(6)-(b)(9) and made a related stylistic change.

The second 1994 amendment, effective August 23, 1994, added former subparagraph (b)(2)(D).

The 1995 amendment, effective August 23, 1995, rewrote subsection (b).

The 1998 amendment, effective July 1, 1998, added subsection (o).

The 1999 amendment, effective July 1, 1999, in subsection (o), inserted "or totally" in the first sentence, inserted "beginning on or any time" in the first and second sentences, substituted "any" for "only", deleted "attributable to that part" following "tax payments" near the end of the third sentence, substituted "The amount deferred each year is a lien on that property for that year" for "and the deferral attributable to that part ends", added "and, if an exemption and a deferral are granted to the same property, both may not be in effect on the same portion of the property during the same time" at the end of the fifth sentence, and added the next-to-last sentence.

The 2000 amendment, effective July 1, 2000, added subsection (p).

The first 2002 amendment, effective January 1, 2003, added subsection (r).

The second 2002 amendment, effective June 20, 2002, added subsection (q).

The 2004 amendment, effective September 28, 2004, in subsection (a), inserted the second sentence, and substituted "subsection" for "section" and "\$20,000" for "\$10,000" in the last sentence; and, in subsection (o), substituted "10 years" for "five years" in the first sentence, inserted "demolition, removal" three times, added "meets one of the following requirements:" at the end of the introductory language, and inserted "within the last five years" and "environmental remediation of the property or requiring" in paragraph (1).

The 2005 amendment, effective June 25, 2005, updated a federal reference near the end of the introductory language in subsection (m).

Editor's notes. Section 3, ch. 64, SLA 2002, provides that subsection (q) is retroactive to January 1, 2001.

Legislative history reports. For legislative letter of intent in connection with the enactment of (m) and (n) of this section by ch. 98, SLA 1989 (SCS CSHB 272(Fin) am S), see 1989 Senate Journal 1866.

## NOTES TO DECISIONS

City may not exempt property without express authority. - The authority of a municipal corporation to allow exemptions of particular property from taxation, unless expressly conferred by law, has very generally been denied. *Valentine v. City of Juneau*, 36 F.2d 904 (9th Cir. 1929), decided under former, similar law.

Ordinance definition of "residential property" reasonable. - Definition of "residential property," imposed by an ordinance, that residential property meant the owner's primary residence, was a narrow but reasonable interpretation of subsection (a) of this section. *Stanek v. Kenai Peninsula Borough*, 81 P.3d 268 (Alaska 2003).

Cited in *City of Valdez v. State, Dep't of Community & Regional Affairs*, 793 P.2d 532 (Alaska 1990).



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January 19, 2006

Jay Ramras  
House Representative  
State Capital, Room 104  
Juneau, AK 99801-1182

RE: HB 334

Dear Representative Ramras,

As a business owner in the downtown area, and a longtime resident of Fairbanks. I am in support of House Bill 334, "An Act relating to an exemption from and deferral of municipal property taxes for certain types of deteriorated property". If this bill will help to improve the core downtown area the benefits to the community will be substantial. Having the Polaris building apartments will help keep downtown vital.

Your support of this bill will be a benefit to the downtown residents and businesses.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark Thomas", written over a horizontal line.

Mark Thomas  
748 Gaffney Rd. Suite 206  
Fairbanks, AK 99701  
Compensation Risk Consultants  
JC

**MARC A. MARLOW**

229 Whitney Road  
Anchorage, AK 99501  
1-907-229-8176

January 13, 2006

Rep. Jay Ramras  
State Capitol  
Room 104  
Juneau, AK 99801

RE: HB 334

Dear Representative Ramras,

Last year I began investigating the possibility of renovating the Polaris Building in Fairbanks using the same process that I am using to renovate the McKinley Tower (MacKay Building) in Anchorage. The plan is to make the Polaris Building apartments again.

I asked the Fairbanks Northstar Borough to pass legislation that would provide a ten year property tax exemption followed by a five year property tax deferral using the authority the borough has per AS 29.45. An ordinance was passed that accomplished such a property tax package except the ordinance requires that the deferred tax would need to be paid within 180 days from the end of the deferral period. The borough attorney felt that AS 29.45.O was not clear when any deferred tax needed to be paid.

When AS 29.45 was amended in 1998 by adding subsection O the intent was for the deferred tax to be paid the next time the property sells or is transferred. Requiring the deferred tax to be paid any sooner is very problematic because the renovated property would very likely still have a mortgage encumbering the property and there would be no way to get to the equity developed to that point to pay the tax.

The logical time to pay the deferred tax is when the property sells the next time, which is when the equity would be harvested.

I have included excerpts from testimony offered by myself and Steve Van Sant. Mr. Van Sant was the state assessor at the time. This testimony establishes the intent. HB 334 would make the intent clear and allow me to continue my effort to renovate the blighted property known as the Polaris Building.

Sincerely,

  
Marc A. Marlow