

ALASKA LEGISLATURE COMMITTEE FILES 2007-2008 HSTA 12340

Alaska Legal Issues

- Under Constitution, "debt" must be for capital improvements and approved by voters.
- Restrictions do not apply to "Certificates of Participation" or other obligations subject to appropriation.
- Subject-to-appropriation debt is somewhat more expensive than full faith and credit debt.
- Although some home rule municipalities may be able to issue obligations under their own charter provisions, there is no general statutory authority for the issuance of pension obligation bonds.
- HB13 would provide authority for the issuance of obligations for this purpose.

Oregon Bonding Examples

Date	Issuer	Par Amount	TIC	PV Savings
September 2005	Local Governments- 12 jurisdictions	\$ 186 m	5.04%	\$ 57 m
June 2005	OSBA - 16 school districts	\$ 492 m	4.77	\$ 171 m
June 2005	OCCA - 6 community colleges	\$ 57 m	4.86	\$ 19 m
May 2004	Local Government Pool - 10 cities, counties, special districts	\$ 126 m	6.11	\$ 23 m
February 2004	OSBA - 23 school districts	\$ 400 m	5.49	\$ 120 m
	OCCA - 6 community colleges	\$ 100 m	5.49	\$ 25 m
October 2003	State of Oregon	\$ 2,000 m	5.78	\$ 481 m
April 2003	OSBA - 44 school districts	\$ 927 m	5.73	\$ 230 m
	OCCA - 6 community colleges	\$ 153 m	5.72	\$ 37 m
October 2002	OSBA - 41 school districts	\$ 775 m	5.60	\$ 207 m
March 2002	Local Government Pool - 10 cities, counties, special districts	\$ 238 m	7.00	\$ 21 m
	Total	\$ 5,454 m		\$ 1,391 m ⁽¹⁾

(1) Assumes 8% return.

Miscellaneous other cities, counties and special districts have sold bonds since 1999 at rates ranging from 6.50% to 7.80%, totaling in excess of \$1 billion dollars.



Recent Returns – Lump Sum Accounts

Issuer	Par Amount	TIC	Total Return	Annualized
Series 2005 - Local Government Pool	\$ 186 m	5.04%	19.27%	15.42%
Series 2005 School District Pool	\$ 492 m	4.77%	26.43%	17.62%
Series 2005 Community College Pool	\$ 57m	4.86%	26.43%	17.62%
Series 2004 - Local Government Pool	\$ 126 m	6.11%	46.96%	18.18%
Series 2004 - School District and Community College Pool	\$ 400 m	5.49%	46.06%	16.26%
Series 2003- School District and Community College Pool	\$ 1,080 m	5.73%	79.60%	21.71%
Series 2002 - School District Pool	\$ 775 m	5.60%	88.03%	21.13%
Series 2002 A&B - Local Government Pool	\$ 238 m	7.00%	69.15%	14.56%

NOTE: Earnings reflected through December 31, 2006.



Oregon vs. Alaska: Potential Savings

<u>Oregon</u>		<u>Alaska</u>		<u>PERS</u>	<u>TRS</u>
Par Amount Issued:	\$5.4 billion	Total System Par Amount:	\$5.0 billion		\$2.9 billion
Number of Jurisdictions:	175	Number of Jurisdictions:	All		All
Average TIC %:	5.65% ⁽¹⁾	Assumed TIC:	6.00%		6.00%
Projected PV Savings:	\$1.4 billion ⁽²⁾	Projected PV Savings:	\$1.123 billion ⁽³⁾		\$652 million ⁽³⁾
Projected Savings %:	26% ⁽²⁾	Projected Savings %:	22% ⁽³⁾		22% ⁽³⁾

(1) Issued between 2002 and 2005.

(2) At assumed rate of 8%.

(3) At assumed rate of 8.25%.

Considerations

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

1. Changes in Calculation of UAAL

- Judicial, legislative, regulatory or investment activities can cause future changes to UAAL. Further increases would continue to be responsibility of jurisdiction.
 - Reductions: Lump sum payment would put jurisdiction in surplus. Funds will not be returned to jurisdiction, but surplus is used to reduce payroll rates further.
 - Increases: Lump sum payment would defray total deficit. UAAL would not be as high as would otherwise be the case.

In any case, arbitrage risks remain the same for existing lump sum payment.

Considerations

2. Variations in crediting rate due to changes in payroll growth
 - Rate adjustment will be different in each valuation based upon actual vs. projected growth in payroll.
 - Timing of rate adjustment may cause short-term cash flow mismatch.
3. Bond Related Considerations
 - Bonds are not likely to be subject to early redemption.
 - Rating agencies will scrutinize structure carefully to ensure payment of liability is not further deferred.
 - Changes “soft” liability to “hard” liability, which may put some limitations on financial flexibility.
4. PERS Regulatory and Accounting Issues
 - Adequate protection and proper accounting of lump sum account are critical issues.
 - Oregon statutes and regulations needed to be modified to ensure that the employers making the deposit were the ones getting the credit. HB13 would provide for this in Alaska.

Lessons Learned

- Legislative reforms were necessary to make most significant reductions in cost.
- Pension Obligation Bonding worked to help defray some of the costs, but it is critical to fully understand all risks.

Questions?

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Presentation to the State of Alaska

Pension Obligation Bonds – Overview of Structure and Current Market Opportunities

February 14, 2007



A number of factors have caused a steady growth in unfunded pension and OPEB liabilities nationwide since 2000.

- Funding ratios for Public Pension Funds grew from around an 80% in 1990 to over 100% funded in 2001.
 - Led to the negotiation of more generous benefit contracts with public employees in many states
- Funding ratios fell significantly after 2001, creating an unfunded liability of over \$340 billion nationally by 2005^(a).
 - By 2002, state pension assets nationally fell by \$120 billion – largely as a result of negative investment returns.
 - Over the same period, liabilities grew by 10%
- Exponential growth in Other Post Employment Benefit (OPEB), primarily medical, costs has further contributed to unfunded liabilities of state and local governments.
- *Standard and Poors* refers to the unfunded liability as a crisis because they view the unfunded pension liability the same as they view debt^(a).



Alaska's pension funding experience has been similar to other state pension systems.

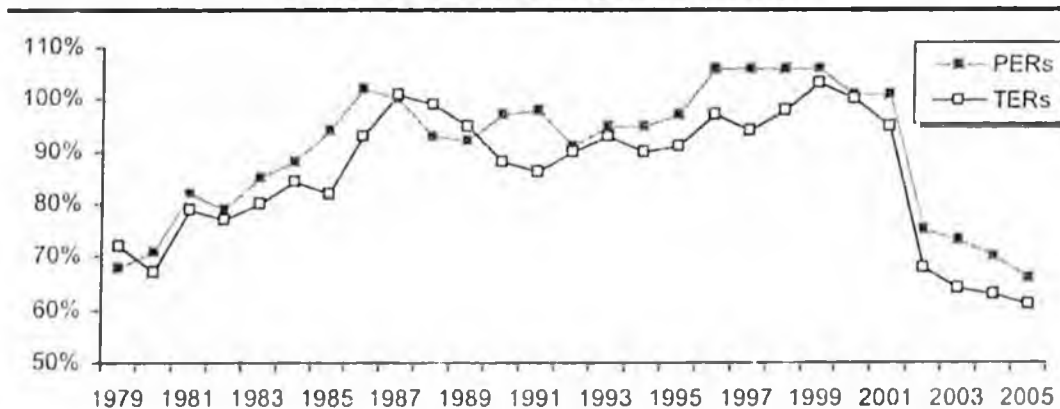
- In 1999 the funding ratios for PERS and TRS were 106% and 103%, respectively.

The current funding ratios for the PERS and TRS Programs is 65.7% and 60.9%, respectively. Accordingly, the State has a large Unfunded Actuarial Accrued Liability ("UAAL")

Funding Status as of June 30, 2005^(a)

	PERS		TRS		Total	
	2004	2005	2004	2005	2004	2005
Valuation Assets ^(a)	\$8,030,414	\$8,442,919	\$3,845,370	\$3,958,939	\$11,875,784	\$12,401,858
Accrued Liability ^(a)	\$11,443,916	\$12,844,841	\$6,123,600	\$6,498,556	\$17,567,516	\$19,343,397
UAAL ^(a)	\$3,413,502	\$4,401,922	\$2,278,230	\$2,539,617	\$5,691,732	\$6,941,539
Funding Ratio (Valuation Assets)	70.2%	65.7%	62.8%	60.9%	67.6%	64.1%

PERS and TRS Funding Ratio History



- "Informally, it is believed that an 80% ratio is the demarcation between a serious and a manageable underfunding situation. If a fund's ratio exceeds 80%, it is likely that investment returns combined with increased contributions will be able to restore the ratio to a level much closer to 100%. However, pension funds with ratios below 80% are likely to face a contribution increase that will significantly strain the budget of the underlying government. Further, if the requirement is not met, the problem is compounded. Like a snowball rolling down hill, the pension obligation then becomes difficult to manage and can significantly affect the government's operating budget."^(b)

(a) Figures from Buck Consultants Actuarial Valuation Report dated 9/15/2006. All dollar amounts in thousands

(b) Wisconsin Research Institute Policy Report, "Mounting Cost of Deferred Responsibility in Government", January 2007



An Unfunded Accrued Actuarial Liability (UAAL) is the difference between the assets currently in the pension fund and the present value of the required payments to existing plan participants over time.

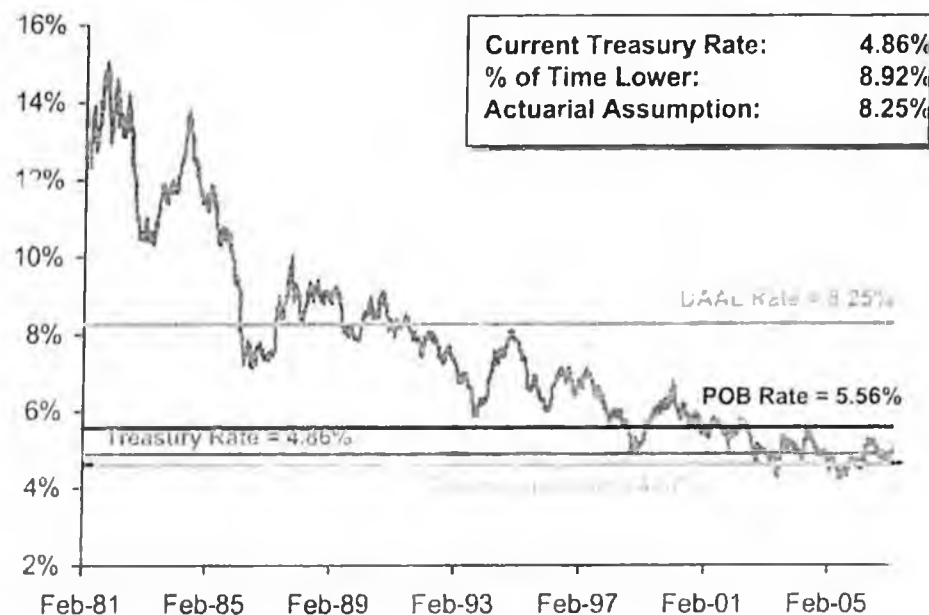
- Each year the State's pension systems review the assumptions in the pension fund actuarial report to determine the required payment stream and compare it to the earnings potential of the assets on hand.
- The pro forma annual shortfall is then discounted at the assumed interest rate (8.25%) to determine the present value of the shortfall known as the UAAL.
- The UAAL, therefore, represents an unfunded liability (i.e. debt) of the State to its plan participants, carrying an interest rate of 8.25% and amortizes like debt.
- This debt obligation to plan participants is constitutionally protected by Article XII, § 7 of the Alaska State Constitution.



Pension Obligation Bonds (POBs) may be used to refinance at a lower cost the State's existing debt to its plan participants.

- This is an ideal time to lock in low rates on POBs and maximize potential cost reductions.
 - Interest rates are near historical lows.
- Taxable POBs would have an all-in True Interest Cost (TIC) of 5.56%^(a) compared to the 8.25% rate on the UAAL liability.
- Potential savings to the State from a POB refinancing are significant.
 - Assuming funding 80% of the UAAL on PERS, the State could issue \$2.1 Bn of bonds for \$626.6 million savings^(b).
 - Assuming funding 80% of the UAAL on TRS, the State could issue \$1.3 Bn of bonds for \$384.2 million savings^(b).

Current 30 Year Treasury and Estimated Yields



Note: As of Close of Business February 9, 2007.



POBs can be used as a single tool or in combination with other strategies to achieve the State's UAAL funding objectives.

■ Factors impacting size of UAAL

- Actuarial assumptions – life expectancy, demographics, etc.
- 8.25% Actuarial Assumed Rate of Return
- Actual Investment Returns
- Changes in contractual benefits
- Benefits cost assumptions vs. actual/experienced, especially medical



- Due to these variables the size of the UAAL is constantly shifting.
- Most pension systems target a funded ratio of 80% to 90% to avoid dramatically under or over-funding^(a).

■ Options for funding UAAL

- Upfront cash contribution from State or employer reserves
- Increased annual employer contributions
- Prefund with Pension Bond proceeds at 5.56%^(b) interest rate



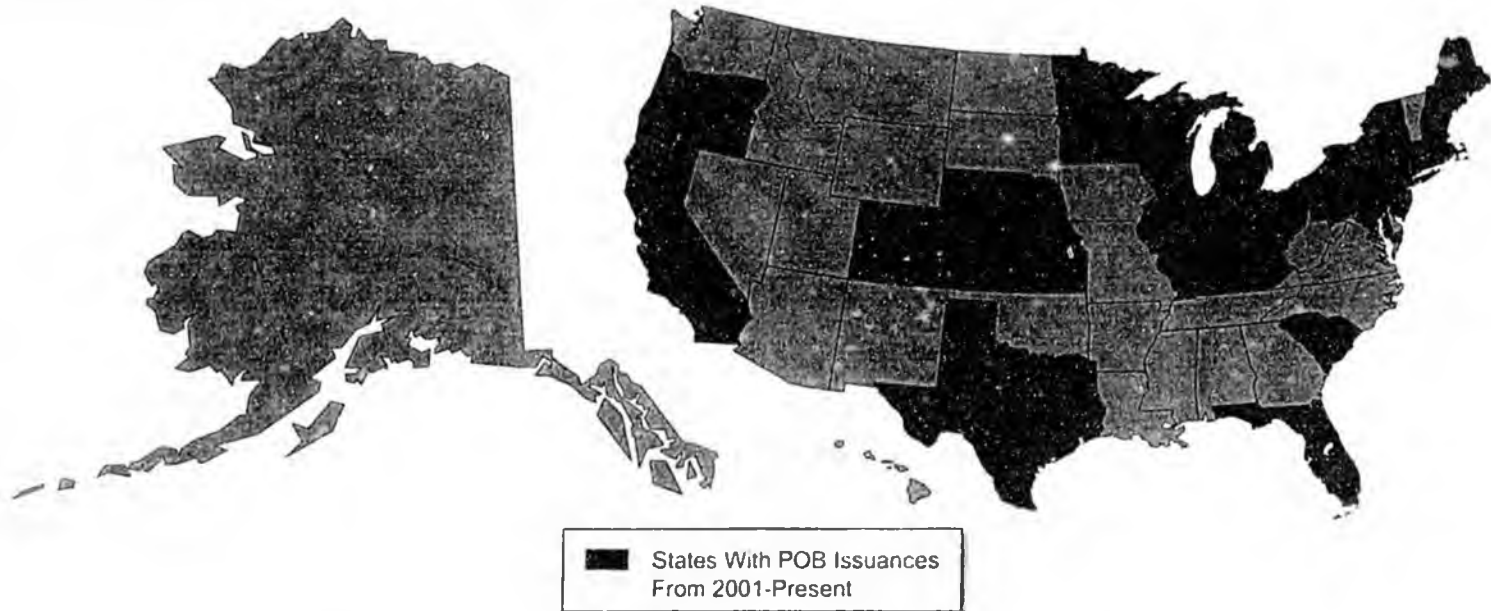
- Pension systems can develop a strategy for reaching the target funding ratio using a variety of funding options.
- Strategies should address both political sensitivities and budget constraints.
- UAAL funding cost savings can likely be achieved through the use of POBs.

As a result of the growth in unfunded pension liabilities and ideal market conditions, there have been a number of POB issuances over the last few years.

■ One study of POBs in 2004 concluded that 84% were profitable to their issuers with another 7% at a breakeven, leaving only 9% that have lost money.

Since 2001 over \$29 billion of POBs have been issued nationwide

- \$800 million Detroit Retirement System Fund (6/06)
- \$2.1 billion State of Oregon (10/03)
- \$10 billion State of Illinois (06/03)
- \$927 million Oregon School Boards Association (04/03)



POB Issues by Year

Year	Amount (\$Mn)	Number of Issues
2006	\$1,408.34	10
2005	3,971.32	37
2004	3,676.42	32
2003	17,685.31	71
2002	2,599.31	25
2001	536.64	9
	\$29,877.33	184

POB Issues by Size

Issue Size (\$Mn)	Amount (\$Mn)	Number of Issues
\$100 and under	\$3,292.09	134
\$100-250	4,275.92	28
\$250-500	4,928.48	13
Over \$500	17,380.82	9
	\$29,877.33	184

Alaska Pension Obligation Bonds



Rating agencies have varying views of pension liabilities and their effect on issuers' credit.

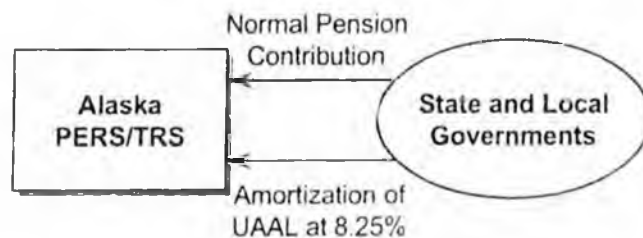
- Moody's generally incorporates a view of the 'soft' cost of unfunded pension liabilities in their debt calculations.
 - Issuing debt to fund the unfunded pension liability is moving a 'soft' cost to a 'hard' cost.
 - Should not have an impact on debt rating
- S&P does not include pension liabilities in the calculation of debt ratios, but incorporates them in the overall rating analysis.
- Implementing a plan to address the existing UAAL and a funding plan for future obligations could be considered a credit positive.
- Issuing pension bonds to pay down UAAL without setting policies for funding liabilities and granting benefits may be viewed as a partial solution by the credit agencies.



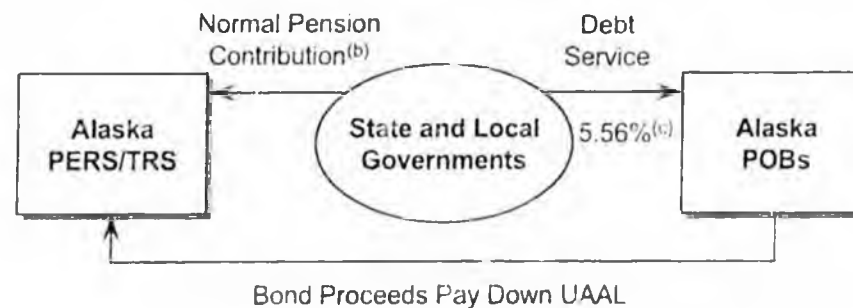
Pension Obligation Bond Mechanics

- Currently the total annual employer contribution for pension liabilities is comprised of two major components:
 - The "normal pension contribution" to meet the annual pension expenses accrued in the current fiscal year;
 - The "UAAL component" is sized to help amortize unfunded liabilities over some period of time.
- As the UAAL has grown in recent years, the second component has become increasingly larger.
- To achieve an 80% funding level the State needs to contribute the following amounts through cash or POBs:
 - \$2.1 billion for PERS^(a)
 - \$1.3 billion for TRS^(a)
- The mechanism could be structured so that employer contributions and debt service do not exceed current contribution levels.

Pension/UAAL Payments Before POBs



Pension/UAAL Payments After POBs



(a) Figures from 2005 Buck Consultants Actuarial Valuation Report dated 9/15/2006.
(b) Assumes 100% funding of the UAAL and no future amortization obligation of UAAL
(c) Bond yield based on current market conditions and structure of bonds.



Recognizing and managing risks is key to POB success.

Benefits

- Arbitrage
 - The broad range of investments utilized by pension funds generally result in returns substantially higher than today's debt rates.
 - Returns above assumed actuarial investment return will produce greater than expected savings from POBs.
 - Returns below assumed actuarial investment return but above POB yield will produce savings, but less than projected.
- Local Government Benefit
 - POBs can be used to improve relations with local governments and political subdivisions by providing more security with a higher funding ratio.
 - POBs will permit more stable budget planning for all participants in PERS and TRS

Risks

- Arbitrage Risk
 - Returns below the bond interest rate will result in negative earnings.
- Conversion of "soft" obligation to "hard" obligation.
- Market risk
 - POBs result in a lump-sum payment into a pension fund, concentrating rather than spreading market timing risk.



Authority to Issue POBs in Alaska

- Since the State Constitution limits the issuance of general obligation debt to capital improvements, POBs cannot be issued as general obligations.
- State issuance of POBs will require new legislative authority. Debt service payment on POBs will be subject to annual appropriation.
- Substantial market demand exists for POBs issued by the State of Alaska and secured by an annual appropriation pledge.
- Alaska could consider a pooled pension obligation program whereby the State's credit serves as backstop to PERS participants or it could create legislative authority for local governments to issue POBs individually, similar to last year's proposed House legislation that would have allowed the Bond Bank to serve as the conduit for such issuers.
- Home rule municipal governments may be able to issue POBs under their charter provisions:
 - Anchorage, Juneau, Sitka, Fairbanks

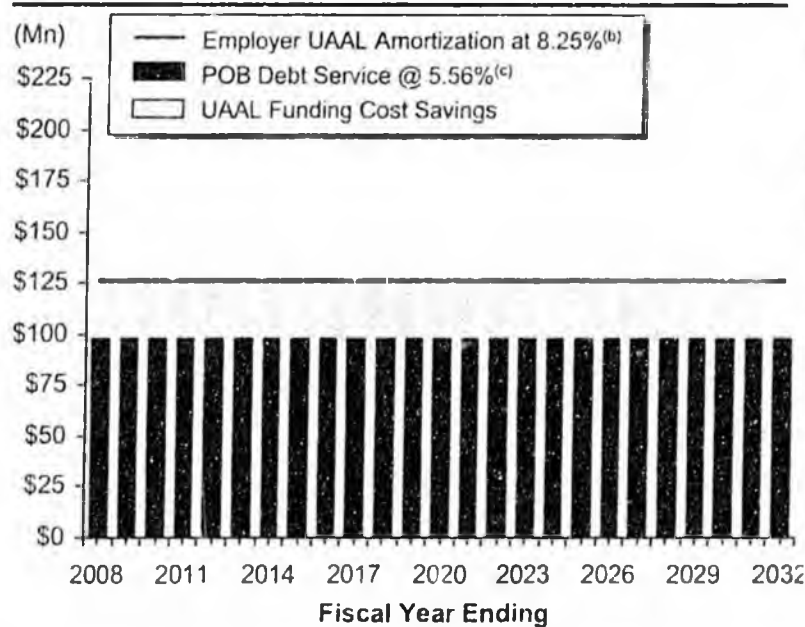


POB proceeds invested in the pension system are expected to have returns that are higher than the POB borrowing rate, creating significant UAAL funding cost savings.

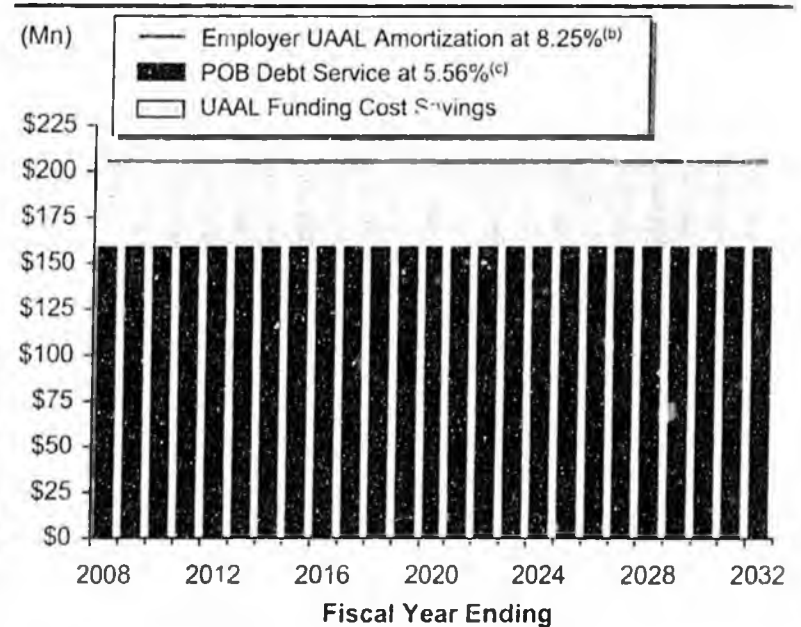
TRS POB Program (000s)	
Target Funding Ratio:	80%
Par:	\$1,320,045
All-in TIC:	5.56%
Assumed Pension System IRR:	8.25%
Estimated Gross Savings^(a)	\$720,166
Estimated PV Savings: ^(a)	\$384,157
Average Annual Employer Contribution Savings:	\$28,806

PERS POB Program (000s)	
Target Funding Ratio:	80%
Par:	\$2,145,330
All-in TIC:	5.56%
Assumed Pension System IRR:	8.25%
Estimated Gross Savings^(a)	\$1,174,594
Estimated PV Savings: ^(a)	\$626,563
Average Annual Employer Contribution Savings:	\$46,984

TRS Payment Structure



PERS Payment Structure



(a) Estimate. Assumes 8.25% earning rate on investment and PV rate of 5.56%. Savings dependent on actual investment performance

(b) Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.

(c) Cost of debt service based on current market conditions.



Summary of Changes in Employer Contribution Rates Teachers' Retirement System – 8.25% Earning Rate UAAL: \$2.5 Billion as of June 30, 2005

- The matrix provides employer contribution rates required to achieve a target funding ratio of 80% by 2032, given corresponding cash contributions and POB issuances.

Status Quo Contribution Rate 44.96%	Pension Obligation Bond			
	\$0	\$500 Mn	\$750 Mn	\$1 Bn
	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
Cash Contribution				
\$0	44.96%	43.84%	43.28%	42.72%
\$250 Mn	41.39%	40.27%	39.71%	39.15%
\$500 Mn	37.82%	36.70%	36.14%	NA
\$750 Mn	34.25%	33.13%	NA	NA
\$1 Bn	30.68%	NA	NA	NA

**Annual
Contribution
Rate
40.27%**

- Through a combination of a \$250 million cash infusion and \$500 million POB issuance, the State can lower their projected annual contribution rate from 44.96% to 40.27% while still achieving a funding ratio of 80% in 2032.
- A decrease of 5% in the employer contribution rate equates to \$31.2 million annually.
- Instead of a one-time up-front payment, the contribution could be spread over a period of years.
 - An annual contribution of \$250 million for 3 years would lower the contribution rate to 35.04%.

Note: Estimate, Savings dependent on actual investment performance
Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006



Summary of Changes in Employer Contribution Rates

Public Employees' Retirement System – 8.25% Earning Rate

UAAL: \$4.4 Billion as of June 30, 2006

- The matrix provides employer contribution rates required to achieve a target funding ratio of 80% by 2032, given corresponding cash contributions and POB issuances.

Status Quo Contribution Rate 29.53%	Pension Obligation Bond		
	\$0	\$1.0 Bn	\$2.0 Bn
Cash Contribution	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
\$0	29.53%	28.84%	28.15%
\$250 Mn	28.36%	27.66%	NA
\$500 Mn	27.18%	26.49%	I.A
\$750 Mn	26.01%	25.31%	NA
\$1 Bn	24.83%	24.14%	NA

**Annual
Contribution
Rate
26.49%**

- Through a combination of a \$500 million cash infusion and \$1 billion POB issuance, the State can lower their projected annual contribution rate from 29.53% to 26.49% while still achieving a funding ratio of 80% in 2032.
- A decrease of 5% in the employer contribution rate equates to \$94.8 million annually.
- Instead of a one-time up-front payment, the contribution could be spread over a period of years.
 - An annual contribution of \$250 million for 3 years would lower the contribution rate to 26.27%.

Note: Estimate, Savings dependent on actual investment performance.

Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006



Sensitivity of Employer Contribution Rates to a 8.1% Earnings Rate Teachers' Retirement System

- The matrix provides employer contribution rates required to achieve the target funding ratio of 80% by 2032 assuming the actual earnings rate achieved is 8.1%.

	Pension Obligation Bond			
	\$0	\$500 Mn	\$750 Mn	\$1 Bn
Cash Contribution	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
\$0	46.09%	45.07%	44.55%	44.04%
\$250 Mn	42.57%	41.54%	41.03%	40.52%
\$500 Mn	39.04%	38.02%	37.50%	NA
\$750 Mn	35.52%	34.49%	NA	NA
\$1 Bn	31.99%	NA	NA	NA

- Lowering the assumed earnings rate on the system from 8.25% to 8.1% increases the projected Employer Contribution Rate by approximately 1% annually.
- All other variables used to calculate and amortize the UAAL are assumed to remain the same.
- A lower actuarial assumed earning rate will increase the size of the UAAL.

Note: Estimate, Savings dependent on actual investment performance
Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.



Sensitivity of Employer Contribution Rates to a 8.1% Earnings Rate Public Employees' Retirement System

- The matrix provides employer contribution rates required to achieve the target funding ratio of 80% by 2032 assuming the actual earnings rate achieved is 8.1%.

	Pension Obligation Bond		
	\$0	\$1.0 Bn	\$2.0 Bn
Cash Contribution	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate	10 yr. Avg. Employer Contribution Rate
\$0	30.48%	29.84%	29.21%
\$250 Mn	29.32%	28.68%	NA
\$500 Mn	28.15%	27.52%	NA
\$750 Mn	27.00%	26.36%	NA
\$1 Bn	25.83%	25.20%	NA

- Lowering the assumed earnings rate on the system from 8.25% to 8.1% increases the projected Employer Contribution Rate by approximately 1% annually.
- All other variables used to calculate and amortize the UAAL are assumed to remain the same.
- A lower actuarial assumed earning rate will increase the size of the UAAL.

Note: Estimate, Savings dependent on actual investment performance.

Assumed level amortization of UAAL based on the Department of Administration of PERS and TRS report dated 2/2/2007. All other assumptions based on the Buck Consultants Actuarial Valuation Report dated 9/15/2006.

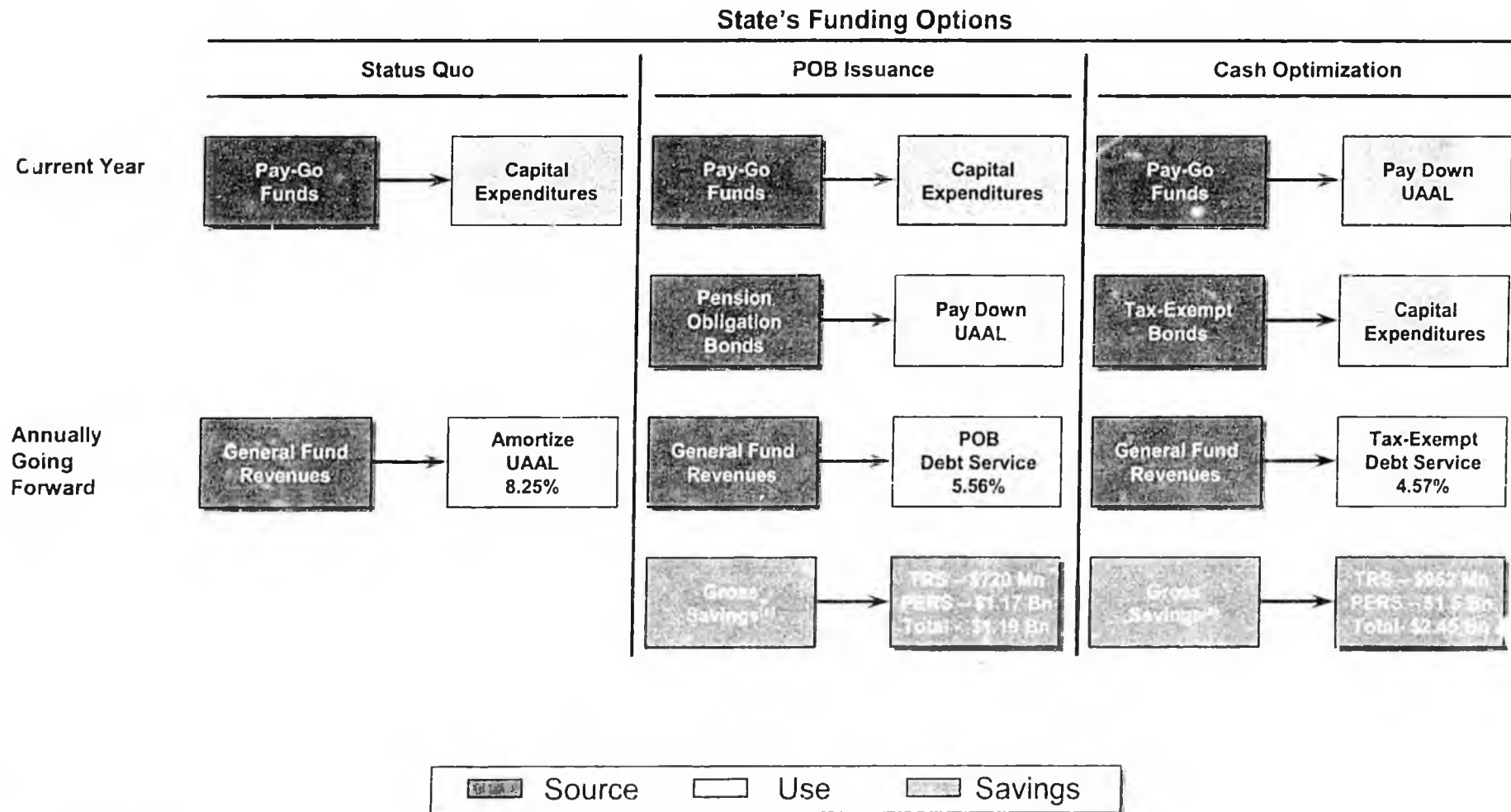


A Cash Optimization Program could provide a cost-effective strategy to reduce the State's overall portfolio cost.

- Under a Cash Optimization Program, the State re-deploys General Fund revenues, currently projected to be used for current Capital Expenditures, to make contributions to the pension system to reduce the UAAL.
- Capital Expenditures that would otherwise have been funded with current funds are funded with tax-exempt bonds.
- Revenues from the General Fund are re-deployed to pay debt service on tax-exempt bonds.
- The net effect is a reduction in borrowing costs for the State's overall portfolio and an increase in the benefit of funding the UAAL.



Using Cash Optimization, the State achieves all of its policy goals at an overall lower net cost.





A Cash Optimization Program provides a cost-effective strategy to reduce the State's cost to amortize the UAAL of the TRS program.

- A Taxable Pension Obligation Bond decreases the State's imputed cost of capital of 8.25% to 5.56%.
- A cash optimization program with tax-exempt financing results in a borrowing cost for the State on its debt of 4.57%.
- Assuming a \$1.2 billion issuance, the net benefit of the lower cost to the State translates into an increase in gross savings of \$232 million, which is equivalent to a 1.49% reduction to the average annual employer contribution rate.

TRS Program (000s)	
Target Funding Ratio:	80%
Par:	\$1,247,015
All-in TIC:	4.57%
Assumed IRR:	8.25%
Estimated Gross Savings:	\$951,890
Estimated PV Savings: ^(a)	\$560,544

(a) Estimate. Assumes 4.57% PV Rate. Savings dependent on actual investment performance



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Representative Mike Hawker

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Legislative Budget
& Audit Committee

House District 32

Eagle River
Anchorage
Rainbow
Indian
Bud
Cradwood
Portage
Whitner
Sunrise
Hope

To: Representative Bob Lynn
Chairman, House State Affairs Committee

From: Representative Mike Hawker



Date: March 7, 2007

Re: House Bill 13

I request that House Bill 13, which would allow public employers to utilize Pension Obligation Bonds (POBs), be scheduled for a hearing in the House State Affairs Committee at your earliest convenience.

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. POBs are a proven and acceptable tool to manage pre-existing liabilities for state and local pensions. Bond market participants are receptive to POBs, including bond insurers, rating agencies and investors.

This bill does not authorize any debt instruments to be issued. The state or a municipality would need to take a separate specific action to utilize this option.

Please feel free to contact me, or my legislative aide, Juli Lucky, if you need any additional information.

MERCER

Human Resource Consulting

September 22, 2004

Presentation to the Tier Committee of PERS/TRS Boards

State of Alaska
PERS & TRS
Tier Redesign Study

MMC Marsh & McLennan Companies



Contents

- Introduction and Overview
- Descriptions of Proposed Programs
- Medical Program – Proposed Method and Assumption Changes
- Medical Program – Medicare Reform
- Alternative 1 – Valuation Results and Cost Projections
- Alternative 2 – Valuation Results and Cost Projections
- Next Steps
- Appendix



1. Introduction and Overview



Introduction and Overview

Meeting Objectives

- Review revised effect of proposed assumption and method changes for valuing post-retirement medical benefits, including impact of Medicare reform
- Review cost implications of two proposed tier alternatives



Introduction and Overview

Key Objectives

- System benefits should favor longer-service members
- Increase predictability and stability of employer contributions
- Share investment risk between employers and members
- Medical program
 - Offer access
 - Decreased cost & risk associated with pre-Medicare-eligible
 - Offer increased benefits after Medicare eligibility
 - Decrease healthcare inflation risk
 - Increase cost sharing & retiree responsibility
- Reduced employer cost relative to current Tiers



Introduction and Overview

Proposed Tier Alternatives

- Alternative 1
 - Basic defined benefit component
 - Defined contribution component
 - Post-retirement medical program
- Alternative 2
 - Defined contribution component
 - Post-retirement medical program
- Member contributions under both alternatives are higher than the current tiers
- Post-retirement medical program is the same for both alternatives



Introduction and Overview

Target "Normal Cost" Rates

- As discussed at the July meeting, Alternative 1 targets approximate normal cost rates as follows:

	<u>Normal Cost Rates</u>	
	<u>TRS</u>	<u>PFRS</u>
Medical normal cost rate	4.50%	4.00%
Defined benefit normal cost rate	6.00%	6.00%
Defined contribution rate	8.25%	6.00%
Gross normal cost rate	18.75%	16.00%
Member contribution rate	<u>(10.00)%</u>	<u>(8.00)%</u>
Employer normal cost rate	8.75%	8.00%



Introduction and Overview

Target "Normal Cost" Rates

- Alternative 2 targets approximate normal cost rates as follows:

	<u>Normal Cost Rates</u>	
	<u>TRS</u>	<u>PERS</u>
Medical normal cost rate	4.50%	4.00%
Defined contribution rate	14.25%	12.00%
Gross normal cost rate	18.75%	16.00%
Member contribution rate	<u>(10.00)%</u>	<u>(8.00)%</u>
Employer normal cost rate	8.75%	8.00%



Introduction and Overview

Social Security “Opt-Out”

- Both PERS and TRS alternatives 1 and 2 satisfy the Social Security minimum requirements through the defined contribution component (together with 1.5% of member contributions for PERS Alternative 1)
 - A combination of employer and member contributions must exceed 7.5% of compensation



Introduction and Overview

Employer Rates

- As for the current tiers, employer rates can be expected to vary over time from the normal cost rates
- Differences between actual experience and that predicted by the actuarial assumptions will result in funding deficits or surpluses
- Alternative 1 and 2 can be expected to produce rate volatility that differs by source and magnitude
- Sources of volatility
 - Alternative 1: Medical and defined benefit components
 - Alternative 2: Medical component only
- For both alternatives, there is no volatility associated with the defined contribution component



2. Descriptions of Proposed Programs



Descriptions of Proposed Programs

Defined Benefit Alternative

Key features of Alternative 1 defined benefit program

- 1 percent of final average pay
- Five-year averaging period
- Base pay only
- Normal retirement at the earlier of
 - (1) age 60 with 5 years of service (8 years for TRS), or
 - (2) 25 years of service (30 years for PERS “others”)
- Post-retirement pension adjustments similar to current tiers
- No 10 percent Alaska cost-of-living adjustment (COLA)



Descriptions of Proposed Programs

Defined Contribution Alternatives

Key features of defined contribution components

- Individual accounts are maintained for each member
- Contributions are a percentage of total pay
- Various investment options (member-directed)
- 100% vested
- Terminating or retiring member takes account (eligible for rollover)

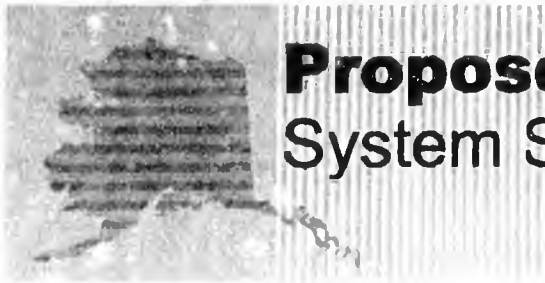


Proposed Medical Program

Key Features

Key features of post-retirement medical program

- Members must retire directly from the System to be eligible
- System sponsored health plan with varying levels of subsidy or cost to members
- Early retirees get “access only” prior to normal retirement eligibility
- Defined dollar benefit from normal retirement to Medicare eligibility (currently age 65)
- Defined health benefit after Medicare eligibility, similar to the current program with the following key exceptions:
 - Method of coordination with Medicare
 - Retired members will share in the cost through premium contributions



Proposed Medical Program

System Sponsored Health Care Plan

- System sponsored health plan available to all eligible retirees, but with varying levels of subsidy
- Basic plan design elements

	Current Plan	Alternative Plan
Medical		
▪ Coordination with Medicare	Total Allowable	Maintenance of Benefits
▪ Deductible	\$150/person, \$450/family	\$250/person, \$750/family
▪ Out of Pocket	\$800	\$2,500
▪ Outpatient Surgery Coinsurance	100%	80%
Prescription Drug		
▪ Retail	90 day supply	30 day supply
- Generic	\$4	\$5
- Brand Formulary	\$8	\$15
- Brand Non-Formulary	\$8	\$30
▪ Mail Order	90 day supply	90 day supply
- Generic	\$0	\$5
- Brand Formulary	\$0	\$15
- Brand Non-Formulary	\$0	\$30
Dental, Vision, Audio	No Change	



Proposed Medical Program Eligibility

- Normal retirement eligibility for medical benefits will be defined as the earlier of
 - (1) age 60 with 10 years of service
 - (2) 25 years of service (30 years for PERS “others” retirees).
- Disabled participants will be eligible
- Terminated vested participants are not eligible. A member must retire directly from active service in order to receive coverage



Proposed Medical Program

Early Retirement

- Early retirees who have not reached normal retirement eligibility
 - Receive “access only”
 - Will not be eligible for subsidized retiree health plan costs
 - Pay 100% of the pre-age 65 per member per year (PMPY) claim costs
- Dependent spouses of early retirees will pay 100% of the appropriate pre-Medicare or Medicare eligible PMPY claim cost



Proposed Medical Program

Normal Retirement to Medicare Eligibility

- Members who retire (or early retire) directly from the Systems will be eligible for a “defined dollar” benefit upon reaching eligibility for normal retirement
- Fixed dollar subsidy toward system sponsored health coverage
- Access to system sponsored retiree medical plan as outlined above
- Subsidy amount is based on length of service
- Subsidy amount indexed each year by healthcare inflation up to a maximum of 5 percent (with a “catch-up” provision based on years when healthcare inflation is less than 5%)



Proposed Medical Program

Normal Retirement to Medicare Eligibility

- Upon becoming eligible for Medicare (currently age 65), such members will become eligible for the “defined health” benefit
- Pre-Medicare dependent spouse is eligible for the same subsidy as retiree
- Medicare eligible dependent spouse is eligible for the after Medicare eligible benefit level, with contribution percentage based on retiree length of service



Proposed Medical Program Defined Dollar Subsidy Projection

- Subsidy Projection Assumptions
 - Pre Medicare retiree, 25 years of service
 - Year 1 assumes plan cost and subsidy base are equal
 - Average plan cost increases with blended medical, Rx trend of 11%
 - Subsidy base increases at healthcare inflation rate up to 5%

	Plan Cost	Subsidy Base	Retiree Subsidy	Retiree Contribution	Percent Increase	Contribution Percent
Year 1	5,962	5,962	4,472	1,491	N/A	25%
Year 2	6,618	6,260	4,695	1,923	29%	29%
Year 5	9,051	7,247	5,435	3,616	21%	40%
Year 10	15,251	9,249	6,937	8,314	17%	55%
Year 15	25,699	11,804	8,853	16,846	14%	66%



Proposed Medical Program After Medicare Eligibility

- Defined health benefit similar to current program
- Retirees who were previously eligible for 100% subsidy of retiree health plan costs will now participate in the premium cost.
- Contributions are per covered individual
- Pre-Medicare dependent spouses are eligible to receive a defined dollar subsidy with percentage based on retiree length of service
- Medicare eligible dependent spouses are eligible to receive the same defined health benefits as the retiree and pay the same contributions



3. Current Medical Program – Proposed Method and Assumption Changes



Proposed Method and Assumption Changes

Objectives

- Independent review of claims development methodology
 - Potential refinement on going forward basis
- Update claims basis used in the valuation with more recent experience.
 - Update for experience through May 2004
 - Valuation claims were based on experience through August 2003
- Refinement of current valuation assumptions in advance of next formal assumption review
 - Current assumptions were last reviewed in 2000
 - Based on access to and detailed analysis of claims data



Proposed Method and Assumption Changes

Primary Changes

- We are recommending changes to the following elements:
 - Claims cost methodology
 - Claims costs
 - Medicare offset
 - Aging factors
 - Trend



Proposed Method and Assumption Changes

Claims Cost Methodology

- Current Methodology
 - Total rate for all retirees equals current premium rate
 - Pre-65 cost and (lower) post 65 claim cost per retiree are determined
 - Pre and post 65 costs increased with appropriate trend
- Proposed Methodology
 - Analysis of claims is completed based on claims information from Aetna and enrollment information from the State
 - Paid claims for June 2001 – May 2004 are tabulated and an average annual claim amount is determined. Next, four adjustments are applied.
 - Participation adjustment to account for differences in exposures between the experience period and current census.
 - Trend factor to trend historical claims from the midpoint of the experience period to the midpoint of the valuation period.



Proposed Method and Assumption Changes

Claims Cost Methodology

- Proposed methodology (*continued*)
 - Incurred claims adjustment to restate paid claims on an incurred basis. This assumes claims are paid on average three months after the incurred date.
 - Adjustments to paid claims to account for changes in the plan
- Administrative costs are added to arrive at total projected costs for the valuation period
- Distribution of per capita claims cost is developed by allocating total projected costs to the population census used in the valuation. The allocation is separate for medical and prescription drug costs.



Proposed Method and Assumption Changes

Chart of Claims Development

Detailed Development of Claims Cost

For the period 7/1/2003 through 6/30/2004

		Medical	Rx
Paid Claims (6/01 - 5/02)		115,904,729	42,174,073
Paid Claims (6/02 - 5/03)		133,794,131	49,761,201
Paid Claims (6/03 - 5/04)		143,042,729	61,583,420
Estimated annual paid claims		130,913,863	51,172,898
Population adjustment	1	1.052	1.039
Trend Adjustment (13.0 months)	2	1.109	1.163
Incurred Adjustment	2	1.024	1.000
Projected incurred claims		156,334,142	61,856,358
Administrative costs	3	7,540,731	0
Projected Plan Costs		\$163,874,873	\$61,856,358



Proposed Method and Assumption Changes Claims Cost

<u>Average Claim Cost</u>	<u>Current PSPM</u>	<u>Revised PSPM</u>	<u>Revised PMPM</u>	<u>Age 65* PMPM</u>
Pre Medicare	\$1,016	\$971	\$553	\$709
Medicare eligible	\$387	\$442	\$253	\$212
Composite	\$777	\$738	\$425	N/A

*Note: Age 65 costs represent pre- and post-Medicare medical and prescription drug costs for an age 65 participant

- Current claims cost are on a Per Subscriber (Retiree) Per Month (PSPM) basis
- Revised claims cost are on a Per Member Per Month basis (PMPM)
- Revised pre-65 costs are less, post-65 costs are greater



Proposed Method and Assumption Changes

Medicare Offset

- Revised offset of 85%
- Based on experience study of pre- and post-65 members
- Currently no explicit Medicare offset assumed



Proposed Method and Assumption Changes

Aging Factors

- Aging factors represent the expected incremental increase in claims cost as an individual ages 1 year
- The following table shows proposed aging factors:

Age	Medical	Rx
00-44	2.0%	4.5%
45-54	2.5%	3.5%
55-64	3.5%	3.0%
65-74	4.0%	1.5%
75-84	1.5%	0.5%
85+	0.5%	0.0%

- For example, this means we expect medical claims to be 3.5 percent higher for a member age 57 compared to a member age 56
- Currently no explicit aging factors assumed

Proposed Method and Assumption Changes

Chart of Claims Costs by Age

Claims cost per member per year by age band

<u>Age</u>	<u>Medical Cost</u>	<u>Medicare Offset</u>	<u>After Offset</u>	<u>Rx Cost</u>	<u>Total Cost After Offset</u>
45	\$3,884	N/A	\$3,884	\$786	\$4,670
50	\$4,395	N/A	\$4,395	\$934	\$5,328
55	\$4,972	N/A	\$4,972	\$1,109	\$6,081
60	\$5,905	N/A	\$5,905	\$1,286	\$7,191
65	\$7,014	\$5,961	\$1,052	\$1,491	\$2,543
70	\$8,533	\$7,253	\$1,280	\$1,606	\$2,886
75	\$10,382	\$8,824	\$1,557	\$1,730	\$3,287
80	\$11,184	\$9,506	\$1,678	\$1,774	\$3,451



Proposed Method and Assumption Changes Trend

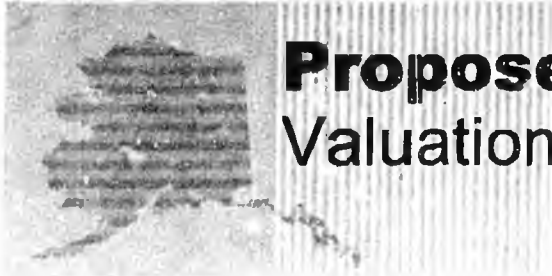
- Factors used to determine current and ultimate trend levels include:
 - Most recent 36 months of claims experience by claims cost category
 - Examined rolling 12 month averages and multiple regression models
 - Mercer's Actuarial and Financial Steering Committee retiree medical trend guidelines by claims cost category
 - Medicare trend forecasts
 - Current market observations



Proposed Method and Assumption Changes Trend

The following table shows our proposed changes to assumed health care cost increases

Year	Current Medical/Rx	Proposed Medical	Proposed Rx
FY04	12.0%	10.0%	15%
FY05	12.0%	9.5%	14%
FY06	11.5%	9.0%	13%
FY07	11.0%	8.5%	12%
FY08	10.5%	8.0%	11%
FY09	10.0%	7.5%	10%
FY10	9.5%	7.0%	9%
FY11	9.0%	6.5%	8%
FY12	8.5%	6.0%	7%
FY13	8.0%	5.5%	6%
FY14	7.5%	5.0%	5%
FY15	7.0%	5.0%	5%
FY16	6.0%	5.0%	5%
FY17 and later	5.0%	5.0%	5%



Proposed Method and Assumption Changes Valuation Results

- The proposed assumption changes produce the following percentage changes in medical liabilities:

	<u>Percentage Change</u>
Accrued Liability (medical only)	11.1%
Normal Cost (medical only)	0.8%



Proposed Method and Assumption Changes

Cost Projections

The following pages show the effect the proposed medical assumption changes would be expected to have over time on actuarial calculated contribution rates

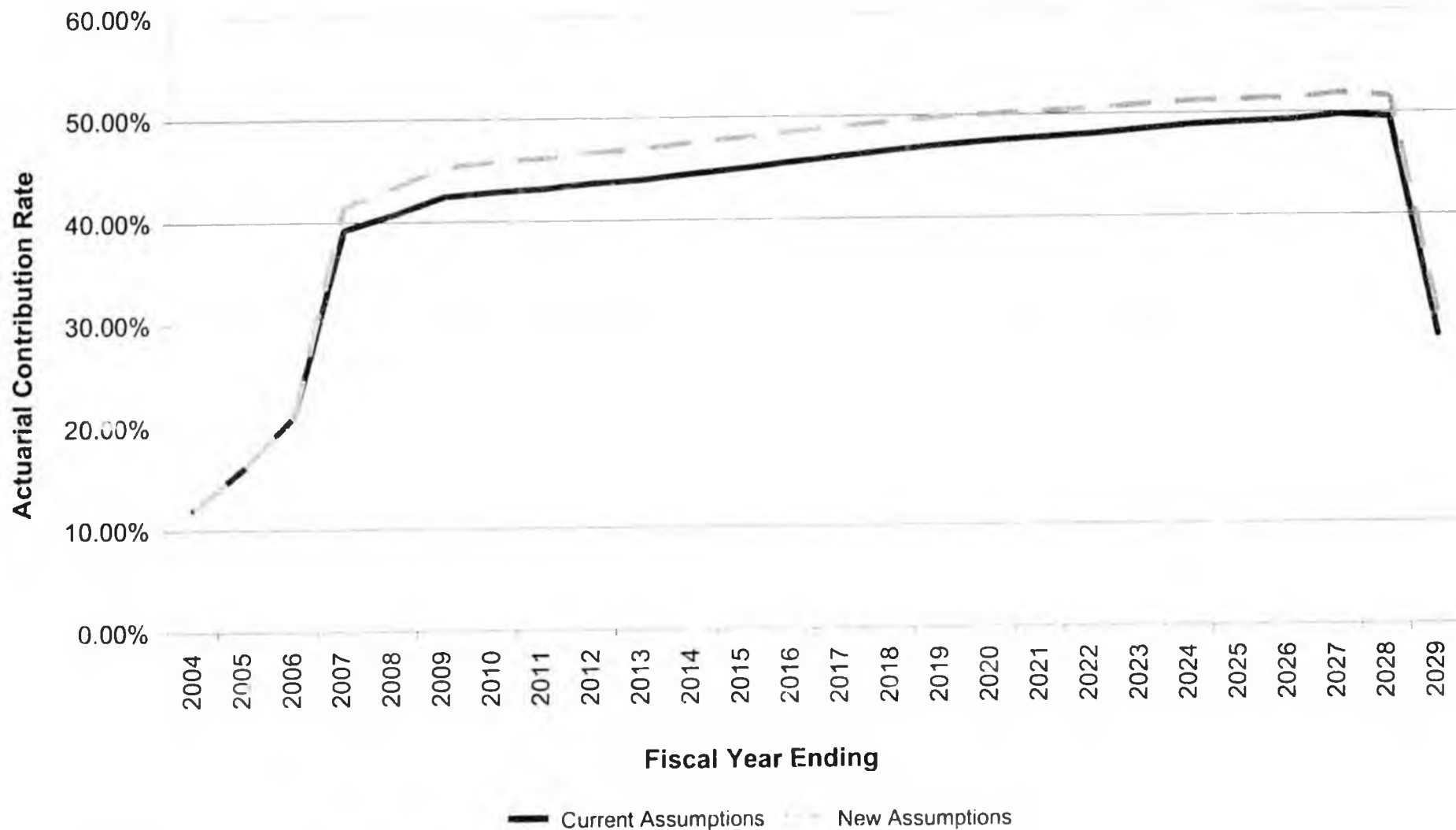
- For purposes of isolating the effect of the proposed medical assumption changes, non-medical benefits have been kept unchanged from the current program
- Data, assumptions and methods are as described in the Appendix



Proposed Method and Assumption Changes

Cost Projections - TRS

Contribution Comparison – TRS

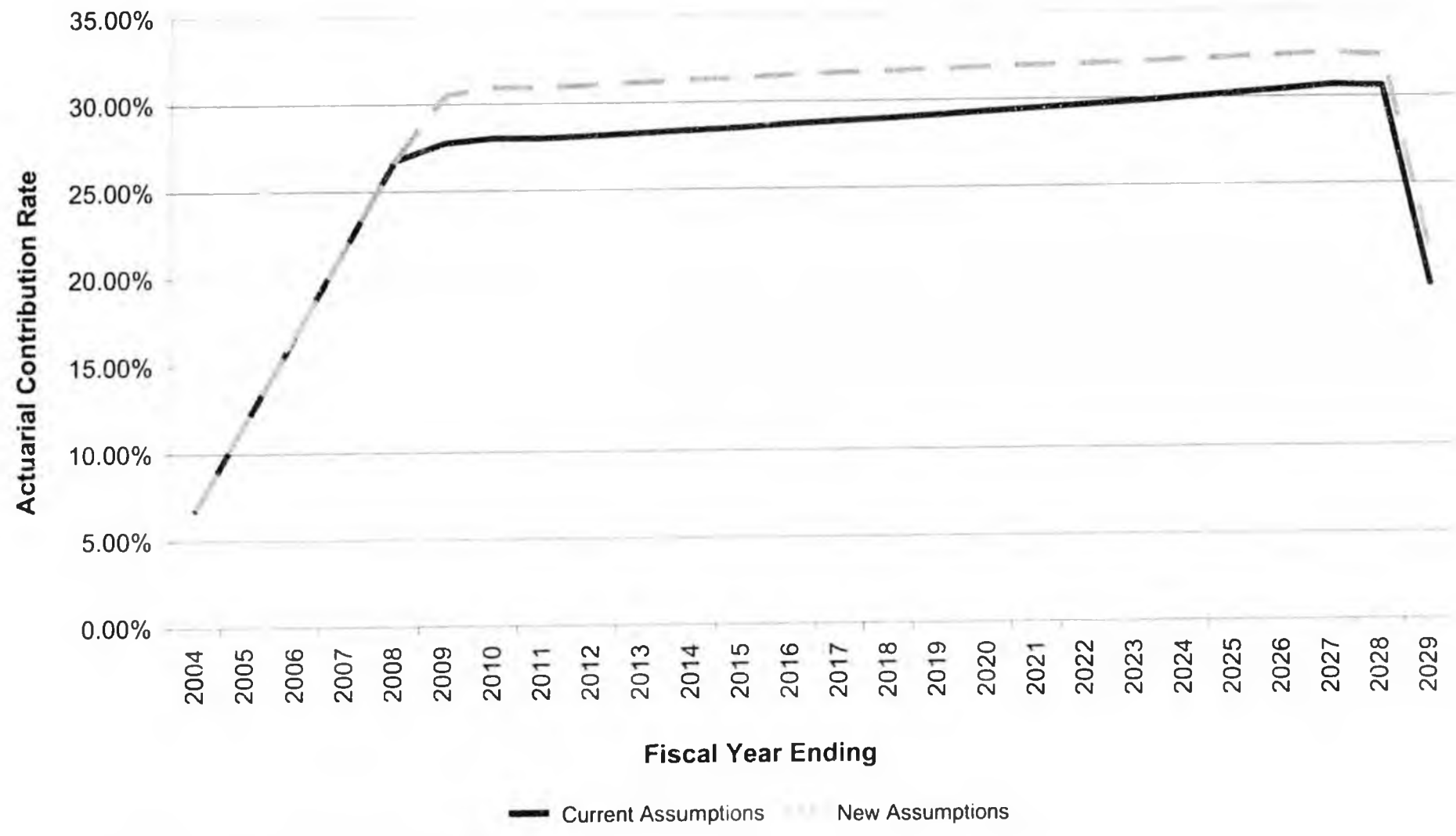




Proposed Method and Assumption Changes

Cost Projections - PERS

Contribution Comparison – PERS





4. Medicare Reform



Medicare Reform Update

- CMS issued proposed regulations on July 26, 2004
- Proposed regulations do not reach a final conclusion
 - Broad array of possible actuarial equivalence tests given
 - Solicit comments on the tests under consideration
- Written comments to CMS are encouraged; must be received by October 4, 2004, to receive consideration
- Final regulations are expected in the first quarter of 2005