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2013-15 PERS Employer Contribution Rates

Employer contribution rates for the Public Employees Retirement System (PERS) will increase substantially for the second biennium in a row, which raises questions about how rates are determined, the success of prior reforms, the prudence of pre-funding liabilities, and the tools the PERS Board uses to control rate increases.

This budget brief focuses mainly on PERS employer contribution rates for state agencies, but the other PERS-participating employers – such as the university system, school districts, and local governments – are facing rate increases of a similar or greater magnitude.

Executive Summary

The primary driver of higher employer rates is the level of unfunded liabilities, which is determined largely by investment earnings. Investment earnings fund about 71% of pension costs. PERS reform has been successful in keeping benefit levels near the rate of inflation (3.4%), but has been overshadowed by investment earnings below the assumed rate of 8%. The PERS Board has had some success in limiting the biennial increase in employer rates through a process known as rate collaring. Employer side or reserve accounts used to offset employer costs have, to date, been a prudent financial decision.

System Demographics

The PERS Board establishes rates for approximately 900 employers including state agencies, universities, judges, school districts, and participating cities, counties, and special districts. The rates also vary for general service and police and fire employees.

Approximately 95% of Oregon's public sector employees are PERS members, which totals an estimated 170,972 active members. School districts are the largest PERS employer group (68,468), followed by local government (57,130), and then state government (45,374).¹

Active members participate in one of three benefit programs, depending upon when they were hired: Tier 1, for members hired before January 1, 1996 (46,882); Tier 2, for members hired on or after January 1, 1996 but before August 28, 2003 (49,130); and Oregon Public Service Retirement Plan (OPSRP), for members hired after August 28, 2003 (74,960). All members started contributing 6% of covered salary to the Individual Account Program (IAP) beginning January 1, 2004. Previously, member contributions were credited to Tier 1 or Tier 2 accounts, which for Tier 1 subjected the funds to the guaranteed rate of return. IAP account earnings, however, vary with actual investment returns and offer no such guarantee.

Oregon's PERS system is classified as a mature system, with 170,972 active members supporting about 118,000 retirees and beneficiaries (1.5 active member per retiree/beneficiary).

Employer Contribution Rates

Employer contribution rates are set by the five-member PERS Board and are calculated as a percentage of an employee's eligible payroll costs.² Based on even-numbered year actuarial valuations, preliminary or

¹ PERS also has 40,507 inactive members, who are no longer employed in a qualified state position or are retired. These totals, and the other demographic figures, are based on the system valuation as of December 31, 2011.

² See ORS 238.225 through 238.231. The PERS Board sets rates using six principles: transparency, predictable and stable rates, protected fund status, equitable across generations, actuarially sound, and Governmental Accounting Standards Board compliant.

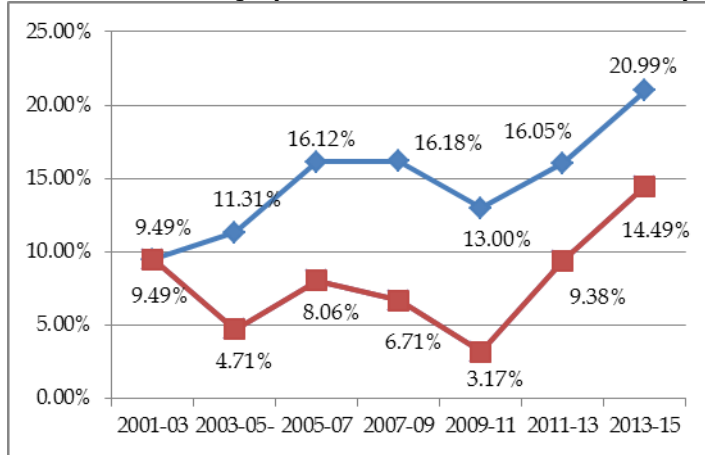
advisory rates are developed for budgeting purposes. Based on odd-numbered year actuarial valuations, individual employer rates are adopted that determine the actual rates to be paid by employers. Actual rates take effect beginning on July 1 for the subsequent biennium.³

For asset valuation purposes, and due to the timing of the budget, actual market values are based on the two most recently concluded calendar year returns. For example, 2013-15 rates are based on market returns from 2010 and 2011, which precedes the implementation of adopted employer rates by 18 months.

Chart A shows the composite, or blended, rate history for state government employers over the last seven biennia.⁴ The top line of the chart shows the (gross) state employer rate without the pension obligation bond (POB) or side account offset. The bottom line shows the (net) employer rate with the offset. Both displayed rates exclude the 6% employer “pick-up.”

POBs, side accounts, and the employer pick-up are discussed in detail below.

Chart A: PERS Employer Rates as Percent of Covered Payroll



System-wide, the average employer rate in the 2013-15 biennium will be 15.7%. Rates, however, vary significantly by employer. For example, the average rate for school districts is 18.3%, 12.34% for community colleges, and 29.35% for statutory judgeships.

For the majority of PERS employers (and for 70% of PERS active members), an additional 6% is added for the employee’s contribution paid, or “picked up,” by the employer.⁵ Each employer determines whether to pick-up contributions through its collective bargaining agreement for represented employees or by policy for non-represented employees. Also, PERS employer rates do not include debt service costs on pension obligation bonds, which is discussed below.

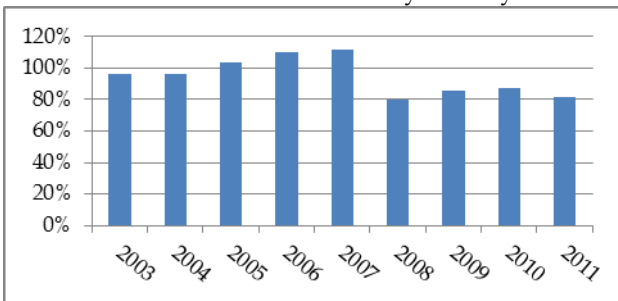
Unfunded Liabilities

A retirement system’s unfunded accrued liability (UAL) is the actuary’s calculation of the amount needed to fully fund the retirement system whenever liabilities exceed assets. PERS’ unfunded liabilities are amortized over a period of 20 years (for Tier 1/Tier 2); or 16 years (for OPSRP); or 10 years (for retiree health care) using the current actuarial methods and assumptions, one of the most important of which is an assumed earnings rate of 8%. 68% of PERS’ total liability is attributable to members no longer in PERS-covered employment (60% for retirees and 8% for vested but inactive members).

Chart B shows the funded status of PERS over the last eight years.

In 2007, at its peak, PERS had \$65 billion in assets (including employer side accounts) and a funded status of 112%. The 2008 market downturn reduced the PERS portfolio by an estimated \$17 billion (negative 27% market “return”).

Chart B: PERS Unfunded Liability History



³ The Legislature reconciles budgeted and actual employer rates when adopting budgets for state agencies.

⁴ A “blended” rate is the rate for general service employees and police and fire eligible employees.

⁵ The estimated “pick-up” for the state and universities is 100% of employees; 80% for community colleges; 55% for school districts; and 85% for local governments.

Since 2007, the funded status has remained at or above 80%, which is considered the minimum level of funding for a financially healthy system.

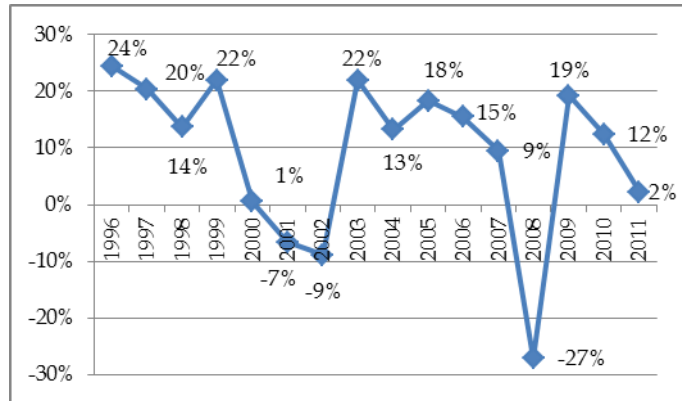
With assets of \$50.2 billion (including employer side accounts) and liabilities of \$61.2 billion, PERS had approximately \$11 billion in unfunded liabilities (82% funded) as of December 31, 2011.

Employer rates are set to restore the system to fully funded status over the amortization period, assuming the existing assets and contributions will be invested and return the assumed earnings rate. Investment earnings represent the largest share of system funding. Since 1970, investment earnings have provided 71% of PERS funding, with employer and employee contributions providing the remaining 29%. Consequently, any shortfall in earnings below the assumed rate will drive up employer rates.

Chart C shows the actual PERS investment returns for the last 16 years.⁶ Over this period, returns have averaged 9.4%.

Since 2008, PERS investments have averaged an 11% return from December 31, 2008 through December 31, 2011. Earnings over the last two-year valuation cycle (2010 and 2011) were a combined 7.4%, which is below the assumed earnings rate of 8%.

Chart C: PERS Investment Returns



2004 PERS Reforms

PERS reform has been successful in reducing benefits and stabilizing the annual growth rate of system liabilities. Estimates showed that employer rates could have exceeded 25% to 30% for the 2013-15 biennium (not including the 6% employee pick-up), if not for the benefit reductions enacted in 2003. However, those long-term cost reductions were almost completely overshadowed in the short-term when the 2008 investment earnings fell far below the assumed rate.

Pre-Funding Liabilities with Employer Side Accounts

Employer side accounts, which hold a total of about \$5.2 billion in employer-issued pension obligation bond proceeds and other lump sum payments, play a major role in pre-funding employer contributions.

The state agency side account had a beginning balance of \$2 billion and was funded through the issuance of POBs in 2004 to fund unfunded liabilities that existed at that time.⁷ The balance as of December 31, 2011 is \$1.86 billion. The bonds will mature and be fully repaid in 2027.

The state agency side account also includes some entities that are not typically considered state agencies, such as the Lottery Commission, Oregon Corrections Enterprises, the State Accident Insurance Fund Corporation, and the Oregon State Bar Association. Combined, these entities comprise about 3.7% of the total POB debt service obligation.

Table D shows the amount of state agency side account offset to PERS employer rates vs. the cost of the POBs, and the difference, for the last six biennia.

Table D: Comparison of Side Account Benefit/Cost

Biennia	Side Account Offset	POB Cost Percent of Payroll	Difference
2003-05	-6.60%	6.45%	-0.15%
2005-07	-8.06%	6.20%	-1.86%
2007-09	-9.47%	5.87%	-3.60%
2009-11	-9.83%	5.96%	-3.87%
2011-13	-6.67%	5.62%	-1.05%
2013-15	-6.50%	6.18%	-0.32%

The projected side account offset that will be applied to the state’s employer contribution rate is 6.50% for the 2013-15 biennium, which is down slightly from the prior biennium offset of 6.67%.

⁶ Based on Tier 2 regular account earnings.

⁷ Oregon voters approved Ballot Measure 29 authorizing the issuance of pension obligation bonds in a special election held on September 16, 2003. See Article XI-O of the Oregon Constitution.

The biennial savings from issuing POBs comes from the difference between the offset and the payment of debt service costs, which is expressed as a percentage of covered payroll. For 2013-15, that difference, or savings, is 0.32% (6.50% employer side account offset and the 6.18% charge to pay debt service on the bonds).

Alternatively, the state employer rate would be 6.50% higher for the 2013-15 biennium, a 45% increase, had Oregon not authorized the issuance of POBs. The state also would not have incurred the associated debt service costs either.

For the 2011-13 biennium, the debt service on pension obligation bonds will cost state agencies, the university system, and other non-state entities \$304 million, and will increase to \$330 million, an increase of \$26 million (or 8.5%) during the 2013-15 biennium. POB debt service will continue to increase 8.7% each biennium until the debt is paid off in 2027. Again, POB debt service is completely separate from the PERS employer rate, with debt service being paid by each state agency/entity.

The financial viability of issuing POBs to fund side accounts exists only if investment earnings exceed the cost of borrowing the funds over the long-term. For the state, investment earnings must consistently exceed the interest rate on the bonds, which is on average 5.78%. The trailing 10-year return for the PERS fund through July 31, 2012 was 8.03%, which compares favorably to the state's POBs that were issued in 2004. However, the trailing five-year return through July 31, 2012 was only 2.2%. With a much smaller differential between investment returns and the interest cost of bonding, or a negative differential, another POB issuance appears impractical at this time.

Those employers with side accounts, however, are assumed to have less ability to make account contributions or lump sum payments to fund their side accounts given the current tight budget environment.

Finally, some PERS employers have not opted to issue POBs or fund a side account and, therefore, pay the entire employer cost each period without offset.

PERS Employer Rate Management

The key objective of the PERS Board is to fund long-term liabilities and maintain the solvency of the PERS system.⁸ The Board uses an approved actuarial method termed "rate collaring" to help manage short-term (biennial) rate fluctuations caused principally by investment return volatility.

Rate collaring spreads out the potential budget impact of rate changes (increase or decrease) by deferring a portion of a rate change to future biennia. The size of the rate collar depends on the funded status of the rate pool or employer (i.e., a graduated scale). The policy limits the change (increase or decrease) in employer contribution rates to no more than the greater of three percentage points or 20% of the current contribution rate, doubling to the greater of six percentage points or 40% of the current contribution rate if that employer's funded level drops to 70% or below.

The PERS Board rate collar policy has been in place since 2004, but was only first triggered during the 2011-13 biennium in response to the 2008 market downturn (i.e., based on actual investment returned from calendar years 2008 and 2009).

Employer rates also generally increase in the biennium following a rate collar limitation unless there is a substantial offsetting recovery in market returns compared to the assumed rate of return. There are no special reserves set aside to pay for the rate collar, or to otherwise manage rate volatility, because the PERS Board has determined that rate collaring is more effective, particularly for large investment downturns.

The rate collar will reduce the state's employer rates in 2013-15 by an estimated 1.70%. In the 2011-13 biennium, the rate collar reduced the state's employer rate by 3.95%. The deferred employer rate increases will need to be made up with future rate increases, unless investment returns exceed

⁸ The Oregon Investment Council, rather than the PERS Board, makes investment decisions for PERS funds.

assumptions over the intervening biennium. The reduction in the rate collar in 2013-15 is one of two major contributors to the increased employer rates, with the other being the level of unfunded liabilities.

2013-15 Preliminary Employer Rate for State Agencies

Preliminary employer contribution rates for the 2013-15 biennium for state agencies and universities will rise from 9.60% to 14.49%, which is a 51% increase over the current biennium. Almost 90% of this increase is driven by unfunded liabilities for Tier 1 and Tier 2 members that were not reflected in the prior biennium by operation of the rate collar.

Because the state participates in the State and Local Government Rate Pool, funded liabilities are allocated among all participating state and local government employers in that pool. The rate pool lessens rate volatility for participating individual employers; however, not all of PERS employers participate in a rate pool, other than state government.

The following table illustrates the change in each component of the state's employer rate from the prior biennium, which is comprised of: (A) Unfunded Actuarial Liability Amortization Rates pay off the unfunded liabilities over the specified amortization periods; B) Normal Cost Rates fund the benefits being accrued with each additional year of service; (C) employer side account offset, if available; and (D) the rate collar.

The employer rate breakdown in the table excludes the additional 6% for the employee's contribution that is assumed and paid (picked up) by the employer and, as noted, does not include POB debt service.

Table E: Composite Rate Calculation Comparison

	Composite ("Blended") Employer Contribution Rate for State Government	2011-13 Actual	2013-15 Projected	Difference
A	Unfunded Liability (UAL) Amortization Rates			
	Tier 1/Tier 2 and State and Local Government Rate Pool	11.85%	13.95%	+2.10%
	Oregon Public Service Retirement Plan	0.08%	0.18%	+0.10%
	Retiree Healthcare	0.61%	0.73%	+0.12%
B	Normal Cost Rates (Benefits)			
	Tier 1/Tier 2/OPSRP	7.54%	7.66%	+0.12%
	Retiree Healthcare	0.14%	0.17%	+0.03%
C	Employer Side Account Offsets	-6.67%	-6.50%	-0.17%
D	Deferred Costs ("Rate Collar")	-3.95%	-1.70%	+2.25%
	Composite Rate for State Employers	9.60%	14.49%	+4.89%

What can be concluded from the table is that the level of unfunded liabilities and a reduced rate collar, rather than benefit level increases, are driving the state employer rate increase for the 2013-15 biennium.

Fiscal Impact of State Employer Rate

System-wide, employer contribution rates for the 2013-15 biennium are based on a projected annual PERS-covered payroll of \$17.2 billion per biennium.⁹ The state government's share, including the university system, of that projected payroll amount is \$5.4 billion per biennium (31%). For state agencies only, the estimated total is \$4.2 billion per biennium.

For the 2011-13 biennium, PERS employer contributions for state agencies (excluding the university system) will total an estimated \$683.6 million (excluding the portion from the side account offset). For the 2013-15 biennium, state agency employer contributions (excluding the portion from the side account offset) are expected to total over \$854.8 million. This is a \$171.2 million (or 25%) increase over the prior biennium. These figures include the 6% employee pick-up.

As noted previously, for the 2011-13 biennium, the debt service on pension obligation bonds will cost state agencies and the university system \$304 million and will increase to \$330 million, an increase of \$26 million (or 8.5%) during the 2013-15 biennium. State agencies (excluding the university system) share of debt service is estimated to be \$240.9 million for the 2011-13 biennium and \$249.1 million for the 2013-15 biennium.

⁹ Based on 2011 calendar year data adjusted for an actuarial assumed increase of 3.75%.

Together, state agencies employer contributions and POB debt service total \$924.5 million and comprise 1.5% of the total 2011-13 legislatively approved budget of \$59.9 billion.

The state's General Fund will pay an estimated 42% of these costs, with Lottery Funds paying 1%, Other Funds paying 42%, and Federal Funds paying the remaining 15%.

Future Employer Rates

According to the latest PERS actuarial report of August 2012, unless future investment performance is above the assumed earnings rate, employer rates are more likely than not to be at 2013-15 levels (or higher) for the foreseeable future. The key variables to monitor will be:

- Actual level of investment returns as compared to the assumed 8%
- Future rate collaring constraints, should future increases be deferred
- Reserve account balances, funding, and the allocation of reserves
- Collective bargaining trend away from the employer pick-up to salary increases
- Investment earnings below the interest cost of the state's POBs
- Oregon Investment Council investment strategy changes
- Investment and administrative costs
- Unmet actuarial assumptions (e.g., assumed earnings, retirements, payroll changes, etc.)
- Statutory plan design changes
- PERS Board's spring 2013 review and potential adjustment of the assumed earnings rate
- Rate of change in covered payroll (e.g., cost-of-living and merit increases, furloughs, etc.)
- PERS implementation of General Accounting Standards Board accounting changes to reporting of assets and liabilities
- Less than full contributions by employers
- Legal costs and judgments

**For additional information, contact:
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The full report is available on the Legislative Fiscal Office website at www.leg.state.or.us/comm/lfo