Date: October 10, 2019  
To: PERA Board of Trustees  
From: Doug Anderson, Executive Director  
Subject: Privatization Benefits & Costs

Minnesota Statutes Chapter 353F defines terms for member benefits and reporting requirements for entities that privatize. A privatizing entity can seek augmentation of benefits for eligible members by requesting an actuarial study measuring the impact to the General Employees Retirement Plan (the Plan). Augmentation of benefits means that an eligible active employee will receive an annual increase made to their accrued benefit from the date of privatization until their retirement date. After retirement they will receive annual adjustments in the same manner as other Plan members.

Under the current statute, if the actuarial study results in a net gain to the Plan, benefits are augmented at the rate of 2 percent. If a 2 percent augmentation results in a net loss to the Plan, the augmentation rate is reduced to 1 percent. If a net loss occurs at the 1 percent augmentation rate, there is no augmentation of benefits. PERA staff shared concerns about the mechanics of the test with the PERA Board at the August 8, 2019 board meeting. Those concerns are briefly summarized again later in this memo.

Eligible active members of entities that privatized prior to 2011 receive larger augmentation rates (See Exhibit 1). For entities that privatized from 2007 through 2010 (and one that privatized after 2010), the augmentation rates are 4 percent until age 55 and 6 percent after age 55. There are 14 entities that provide this level of augmentation to approximately 620 members. For entities that privatized prior to 2007 (and one that privatized after 2006) the rates are 5.5 percent until age 55 and 7.5 percent after age 55. There are 13 entities that provide this level of augmentation to approximately 1,050 employees (See Exhibits 2&3). These augmentation rates have not been adjusted from the time they were initially applicable.

Two significant equity issues exist with the current privatization process. The first is an issue of equitable benefits between the vast majority of Plan members who no longer receive any augmentation (i.e. existing terminated members) and those from privatized entities that continue to receive augmented benefits. In 2012, augmentation for non-privatized deferred members was reduced to 1 percent for members terminating before 2012 and eliminated entirely for members terminating after 2011. The 2018 retirement bill eliminated future augmentation for all terminated members not just for PERA covered members, but also for those covered by MSRS and TRA.

The second equitability issue is a shifting of costs from the privatized employer to the remaining participating employers and active members. Entities that privatize are no longer required to contribute to the Plan despite the Plan being less than fully funded. While privatized employers cease making contributions altogether, the remaining employees and employers are combining to contribute an additional 6 percent of payroll to reduce the Plan's current unfunded liability.
Therefore, not only do active members of privatized entities receive augmented benefits not available to other PERA members, but the cost of those benefits, along with other previously unfunded costs for those members, is born by the remaining active employees and employers.

The test that currently exists in statutes seems to have validated that each privatization resulted in an actuarial gain and that the costs of augmentation was funded. However, as Staff has previously pointed out, that test was deceptive, because it completely ignores the fact that the Plan is currently underfunded. The test also ignores retired or other non-active members from that entity. Retirees or previously terminated employees with benefits are essentially assumed to be fully funded when in reality, the cost of their benefits is only currently about 80 percent funded. Finally, the test does not consider the loss of future contributions from the entity. If the loss of future contributions exceeds the gain from lower future benefit accruals, the Plan will be worse off after the entity privatizes.

Simply put, the Plan is in worse position after an entity privatizes, even before consideration of enhanced benefits via augmentation. Enhancing augmentation further increases the shifting of this cost to current employers and active employees.

Three issues are presented for the board to consider:

1. Should future members of privatized entities receive augmented benefits?
2. Should current members of entities that have privatized continue to receive augmentation?
3. Should future entities that privatize be required to fully fund the unfunded portion of accrued benefits attributable to their current active members?

**Issue 1 – Augmentation for future privatized members**

The notion of augmentation was once commonplace in Minnesota pension plans and was applied as a form of inflation protection for all members that ceased active covered employment whether through a regular termination or through privatization. The practice appears to have used fixed rates in lieu of actual inflation rates with periodic adjustments. Privatized members often had slightly higher augmentation than other terminated members (See Exhibit 1).

Augmentation is extremely rare in public sector plans nationally and non-existent in private plans. When pension plans throughout the State started facing larger unfunded liabilities, the cost of augmenting benefits for members no longer providing public service became a leading target for change. As noted above, augmentation for all non-privatized members is currently being phased out in its entirety for all public employees in the State.

Elimination of augmentation for future privatized members achieves three goals: (1) it would result in equitable benefits for all members no longer providing public service, (2) it would avoid increasing costs that would be assessed to all remaining active employees and employers, (3) it would emphasize that the acquiring entity has the responsibility to provide retirement benefits for their employees.
Current statutes also call for eligible active members to become fully vested upon privatization and that future service continue to be considered for benefit eligibility purposes (i.e. Rule of 90 eligibility). Staff's recommendation only relates to the augmentation component of current statutes.

**Staff Recommendation**

Staff recommends that augmentation of future benefits be eliminated for active members of entities that privatize in the future.

**Issue 2 – Continuation of augmentation for current privatized members**

Since 1991 there have been 37 entities that have privatized. Not a single one of those occurred during a time when the Plan was fully funded. In every single case, liabilities for member benefits was shifted from the privatized entity to active employees and employers.

Eligible active members for those privatized entities continue to receive augmentation, some at annual rates as high as 7.5 percent. Those members do not make annual contributions. At the same time, augmentation has been eliminated for all other members and employee and employer contribution rates have reached historically high levels (6.5 percent and 7.5 percent respectively).

Discontinuation of augmentation would have both a benefit impact on those receiving it and a cost impact (savings) for those paying for it. Previous staff estimates placed the potential savings in the range of $50M to $75M. The majority of the potential savings would be attributable to the impact of eliminating augmentation for those in the category of receiving 5.5 percent before age 55 and 7.5 percent after age 55.

Because augmentation rates have never been adjusted for inflation, the continuation of augmentation at 5.5 percent and 7.5 percent rates has been extremely valuable for those members. For comparison purposes, a privatized member at age 55 with 30 years of service would receive an annual 7.5 percent increase in their accrued benefit, regardless of their pay increase. A similarly situated non-privatized member receiving a 2 percent salary increase would only receive a 5.4 percent increase in their accrued benefit.

Thus a privatized member may very well receive a larger increase in benefit accrual than a non-privatized member despite not being required to pay contributions to the system (as compared to the 6.5 percent requirement for the non-privatized member). There is also the possibility that the privatized member may receive some other form of retirement compensation from their employer.

Examples of the impact of augmentation at the lower 2 percent rate are less egregious. Nevertheless, the fact that privatized employees receive augmentation without requiring to contribute to the Plan is clearly an advantage over other terminated plan members.

Staff does not recommend any retroactive changes. Only changes prospectively should be considered. Furthermore, staff suggests that phasing in changes would be appropriate to allow
privatized employees time to consider the impact on their retirement plan and for employers to consider alternative approaches to manage the retention of their employees.

Staff Recommendation

Staff recommends that all current augmentation rates be changed to 2 percent effectively immediately and that augmentation be eliminated entirely for eligible active members effective December 31, 2023.

Issue 3 – Payment of withdrawal liability for future privatizing employers

As noted earlier, upon the privatization of an employer there is a shift of costs from that employer to the remaining participating employers and active members. Entities that privatize are no longer required to contribute to the Plan despite the Plan being less than fully funded. While privatized employers cease making contributions altogether, the remaining employees and employers are combining to contribute an additional 6 percent of payroll to reduce the Plan’s current unfunded liability.

Allowing entities to voluntarily withdraw from a plan without fully funding benefits for their members is a highly unusual practice. In most States, the opportunity to withdraw is extremely limited, and then can only occur if the withdrawing entity fully funds the benefits for their members. Amongst private plans, not only is a withdrawing employer required to fully fund their member benefits, but they typically are required to have that calculation done using very conservative assumptions. This practice is in place to recognize the shifting of risk from withdrawing entities to the remaining entities.

A different perspective is to consider PERA’s past practice for entities merging into the Plan. In each instance of an entity merging its assets and benefit obligations with PERA there was consideration of any unfunded component. The result was the entity continuing to contribute to the Plan to make up that shortfall. Typically this is done in the form of regularly occurring amortization payments over a period of 10 to 20 years.

Ideally, the Plan would be fully funded and there would be little or no unfunded liability. However, until that time occurs, it seems prudent to require full funding of benefits for a privatizing entity.

The process of privatization may take up to two years. As a result, staff recommends a delayed effective date so no currently ongoing privatization process is impacted by a change.

Staff Recommendation

Staff recommends that for any privatization occurring on or after July 1, 2022, the unfunded actuarial accrued liability for an entity’s eligible active members be determined using current actuarial assumptions and the plan funding ratio from the most recent actuarial valuation. That amount would then be amortized using current plan assumptions to develop an annual contribution sufficient to reduce the unfunded actuarial accrued liability to zero over a period of not more than 10 years.
**Exhibit 1: Privatization Example & Rate History**

- **Example**
  - $1,000 benefit based upon age, service, high 5
  - Terminates age 45, defers to age 65
  - $1,000 \times (1.02)^{20} = 1,486$

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A soon-to-be privatizing employer must seek inclusion under Chapter 353F, and demonstrate that the enhanced benefits do not result in a net loss to the plan. The rates have varied based upon when the entity privatized, or in the case of Hutchinson Area Healthcare, if special legislation was enacted.
As of June 30, 2018, the General Employees Retirement Plan had 61,066 vested deferred members. Those covered under Chapter 353F represent about 6 percent of the total inactive vested members.
Exhibit 4: Privatized Members by Current Age Group

- 5.5% and 7.5%
- 4.0% and 6.0%
- 2.0%