TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 1091 (Dille); H.F. 1100 (Newman): PERA Privatized Employees; Adding Hutchinson Area Health Care Employees to the PERA Privatized Employee Chapter

DATE: March 15, 2005

Summary of S.F. 1091 (Dille); H.F. 1100 (Newman)

S.F. 1091 (Dille); H.F. 1100 (Newman) would include Hutchinson Area Health Care under the provisions of Chapter 353F (Privatized Public Hospital, PERA Pension Benefits) if the facility is privatized (sold or leased to a private sector or a non-profit sector entity rather than by a public entity). The act would apply to those employees covered by the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) who transfer to the new for-profit or non-profit corporation following a privatization, and is effective if local approval is provided and if the bill does not create an actuarial loss for PERA-General.

Current Situation of Hutchinson Area Health Care

Hutchinson Area Health Care is a city-owned organization, consisting of Hutchinson Community Hospital with 66 beds, the Burns Manor Nursing Home, and the Dassel Medical Center. Approximately 600 employees would be impacted by a privatization, if one were to occur. These employees currently are covered by PERA-General, a defined benefit retirement plan. According to the city attorney, the city is currently in the early stages of exploring a privatization, and seeks to have legislation in place so that the employees of the privatized organization, if privatization were to occur, would be certain of the treatment to be provided by PERA. As of this writing, no buyer has been identified, and it is not known whether the organization might be purchased or leased to a for profit employer, or to a 501(c)(3) non-profit corporation, or whether any privatization will occur. Under current law, if the Hutchinson Area Health Care employees are privatized, they will not be eligible for continued PERA-General coverage because they will no longer be public employees.

Following a privatization, the new employer may provide the employees with some other form of retirement coverage for their ongoing employment at the facilities. It is not known whether that would be a defined contribution pension plan or a defined benefit plan.

Background Information on Defined Contribution Pension Plans and Defined Benefit Pension Plans

A defined contribution plan is a pension plan where the funding for the pension plan is fixed as a dollar amount or as a percentage of payroll. Fixing this element leaves a variable element, which is the benefit amount that is ultimately payable. Under a defined contribution plan, the plan member bears the inflation and investment risks. If there is poor investment performance, the plan member's pension assets will be depressed. High inflation is another risk, since inflation lowers the real value of the investment returns and the assets in the account. The plan member's benefit will be less adequate in meeting the person's pre-retirement standard of living. With a defined contribution plan, the employee generally owns the assets in the account. Those assets move with the employee if the employee changes employment. A defined contribution plan favors employees who are very employment mobile, where employment changes beyond a single employer or a multiple-employer group. It also favors short-term employees in comparison to defined benefit plans. It also favors employees with very stable and modestly increasing salary histories and employees who work considerably beyond the plan's normal retirement age.

The other general plan type is a defined benefit plan. A defined benefit plan is a pension plan where the pension benefit amount that is ultimately payable is pre-determinable or fixed using a formula. Fixing the benefit amount leaves a variable element, which is the funding required to provide that benefit. Because PERA-General is a defined benefit plan, employing units paying into the plan, rather than the employee, bear the inflation and investment risks. If the investment return on plan assets is poor or if inflation produces ever-increasing final salaries and benefit payouts, that risk is borne by the plan and its associated employers. The member has the turnover risks. If a plan member terminates at an early age, or with modest service, the member will receive either no benefit or an inadequate benefit. A defined benefit plan favors long-term or long-service employees. It also favors employees who receive regular promotions and sizable salary increases throughout their careers or who achieve substantial salary increases in their compensation at the end of their career. It also favors employees who retire at or before the plan's normal retirement age.

Defined contribution pension plans predominate in the private sector, while defined benefit pension plans predominate in the public sector. The U.S. Department of Labor, in a study by the Bureau of Labor Statistics entitled National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002, indicates that 36 percent of all private sector employees are covered by a defined contribution plan and that only 18 percent of private sector employees are covered by a defined benefit plan. In a study entitled Employee Benefits in State and Local Governments, 1998, the Bureau of Labor Statistics reports that 90 percent of public employees are covered by a defined benefit plan and only 14 percent of public employees are covered by a defined contribution plan.

Treatment Under Chapter 353F, PERA Privatized Hospital

When the privatization of a PERA-covered employing unit occurs, the employees no longer qualify as public employees and no longer qualify to continue as active PERA-General members. However, if these employees are made eligible for Chapter 353F, they will have certain benefits that differ from the typical treatment of terminated employees. One justification for this different treatment is that the privatized employees did not choose to leave public service and to end public retirement plan coverage. Their employee status changed from public to nonpublic due to an action by the employer (the transfer from public employer to non-profit corporation status), rather than by an exercise of free will by the employees.

If a privatization is included under Chapter 353F, those employees who are employed at the time of the transfer to the non-profit corporation receive the following special coverage provisions:

1. Vested Benefit with Any Service Length. The normal three-year PERA vesting period is waived, so a privatized employee with less than three years of PERA-covered service would be entitled to receive a PERA retirement annuity, notwithstanding general law.

2. Increased Deferred Annuity Augmentation Rate. For the period between the date of privatization and the date of eventual retirement, the privatized employee's deferred PERA retirement annuity will increase at the rate of 5.5 percent rather than three percent until age 55 and at the rate of 7.5 percent rather than five percent after age 54.

3. "Rule of 90" Eligibility with Post-Privatization Service. For privatized employees with actual or potential long service who could have retired early with an unreduced retirement annuity from PERA under the "Rule of 90" (combination of age and total service credit totals 90), the employee will be able to count future privatized service with the hospital for eligibility purposes, but not for benefit computation purposes.

Background Information on Health Care Facility Privatizations

A. Privatization Trend. There is a trend among health care facilities to convert from public sector ownership to private sector or quasi-public sector ownership. These conversions have involved selling, leasing, or transferring the facility, along with transferring the existing employees to that reorganized health care facility. The privatization of health care facilities is occurring among both large and small hospitals, clinics, and related health care providers. The privatizations typically increase organizational flexibility and reduce various costs, allowing the privatized organization to be financially competitive. One area of potential savings is the elimination of PERA active member coverage (or coverage by another public pension plan, if applicable), which is eliminated by the privatization.

B. Privatization Impact on Retirement Coverage. When a privatization occurs and employees no longer qualify as public employees for PERA pension purposes, PERA membership terminates and retirement benefit coverage problems may emerge. Under current PERA law, three years of PERA coverage is required for vesting. For employees who terminate PERA membership without vesting, no deferred retirement annuity right typically is available. The member may elect a refund of accumulated member contributions with six percent interest, or the individual may leave the contributions at PERA, perhaps in the expectation that the individual will change employment in the future and again become a covered public employee. For a vested employee who terminates PERA membership with at least three years of service, there is a choice between a deferred retirement annuity right or a refund. The deferred retirement annuity is augmented by three percent per year under age 55 and five percent per year thereafter until retirement.

When a privatization occurs and employees lose the right to continue coverage by the public plan, all of the employees are impacted. The employee may be terminated from employment at the time of the sale, transfer, or reorganization. Those employees will lose both continued employment and continued retirement coverage. For employees who remain employed after transfer to the newly organized health care facility, the privatization interrupts their benefit coverage. If there is no pension plan established by the privatized health care facility, the employees will suffer a loss of overall benefit coverage other than Social Security coverage. If the new employer does provide a plan, portability problems between the old plan and the new plan are likely.

C. Evolution of Privatization Treatment. The Legislature has dealt with privatizations on several occasions over the past few decades, primarily health care privatizations. The treatment has evolved over time. At times, in addition to any benefit that the employee may have been eligible for under a public pension plan as a deferred annuitant, the individual was offered an enhanced refund (employee plus employer contributions) plus interest. On a few occasions, the individuals were permitted to remain in PERA-General. The following summarizes treatments used since 1984:

- In 1984, relating to the privatization of the Owatonna City Hospital, legislation allowed the affected employees to receive a deferred retirement annuity with at least five years of service or to receive a refund of employee and employer contributions, plus interest at six percent, compounded annually.
- In 1986, relating to the St. Paul Ramsey Medical Center reorganization, legislation allowed only a delayed right to withdraw from PERA and receipt of a refund of only member contributions plus interest at five percent, compounded annually.
- In 1987, relating to the Albany Community Hospital and the Canby Community Hospital, legislation allowed the affected employees to receive a deferred retirement annuity with a five-year vesting period or to receive a refund of both employee and employer contributions, plus compound annual interest at six percent.
- In 1988, relating to the Gillette Children’s Hospital employees, legislation continued the membership of the affected employees in the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), but excluded new employees from public pension plan coverage.
- In 1994, relating to the St. Paul Ramsey Medical Center again, legislation continued the PERA membership of existing employees who were PERA members unless the employee elected to terminate PERA membership before July 1, 1995.
- In 1995 through 1998, the approach used for PERA privatizations during this period required PERA coverage to end for all employees at the time of the transfer of the health care facility to the new ownership. The new health care entity was urged but not required to provide a “PERA-like” plan for individuals who are transferred with the facility and remain as employees of the new entity. For individuals who are terminated at the time of the transfer, and who were not vested in PERA, the city was authorized to match any refund with interest that the individual received from PERA. This model was used with the Olmsted County Medical Center privatization (1995), the Itasca County Medical Center (1995 and 1996), Jackson Medical Center, Melrose Hospital, Pine Villa Nursing Home, and the Tracy Municipal Hospital and Clinic (1997), and the Luverne Community Hospital (1998) privatizations.
- In 1996, a different approach was used for the University of Minnesota Hospital-Fairview merger, a procedure which was coded as Chapter 352F. Prior to the privatization, the University employees were covered by a public plan comparable to PERA-General, the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General). This is the model upon which the PERA privatization chapter, Chapter 353F, which was enacted in 1999, is based. In this model, termination of coverage by the public plan occurs at the time of the privatization, but the employees who terminated coverage (even those who were not vested) were permitted deferred annuities from the public plan with an augmentation rate that exceeded that used under general law, and the employees were allowed to use service with the new organization to meet age/service requirements for qualifying for the “Rule of 90” under the public plan.
- In 2004, two different approaches were used. A few groups wished to remain as active PERA members, the new employers were willing to provide that treatment and to cover the resulting PERA-General employer contribution requirements, and PERA did not oppose that proposed treatment. This treatment, allowing the employees to remain as active PERA members following privatization, was extended to Anoka County Achieve Program employees and to Government Training Office employees, despite the changed status of these individuals from public sector to

private sector. The chief reservation against this treatment is a federal requirement that public plans should not provide coverage to private sector employees, under threat of losing its qualified status and making contributions subject to immediate taxation. However, public plans are permitted to cover a small percentage of private sector employees, providing the percentage is minimal. While the dividing line between an acceptable minimal percentage and an unacceptable percentage is unclear, it was safe to assume that the small number of individuals involved in these two privatizations would not cause a plan qualification problem. Plan qualification concerns may be an issue in the future if this treatment is proposed for other privatizations, causing the percentage of private employees in PERA to grow.

The other model used in 2004 was the model specified in the PERA privatized employee chapter. This approach was used for Fair Oaks Loge, Kanabec Hospital, RenVilla Nursing Home, and the St. Peter Community Health Care Center.

<u>Discussion of S.F. 1091 (Dille); H.F. 1100 (Newman)</u>

S.F. 1091 (Dille); H.F. 1100 (Newman) would include Hutchinson Area Health Care under the provisions of Chapter 353F (Privatized Public Hospital, PERA Pension Benefits) if the facility is privatized (sold or leased to a private sector or a non-profit sector entity rather than by a public entity). The act would apply to those employees covered by PERA-General who transfer to the new for-profit or non-profit corporation following a privatization, and is effective if local approval is provided and if the bill does not create an actuarial loss for PERA-General.

The proposed legislation raises the following pension and related public policy issues:

1. <u>Implications of Using Privatization Model</u>. If privatization occurs, the privatized employees would be better off if the bill were to be enacted because, under Chapter 353F, they receive the enhanced vesting right, enhanced deferred annuity augmentation, and ability to use service with the new employer to qualify for the "Rule of 90." In recent years, bills such as the current one were passed by the Legislature without much controversy. However, it follows that if the bill would make the privatized employees better off, it makes PERA worse off, because PERA will receive less of a gain from the privatization. Given PERA's recent funding condition, and a bill introduced on its behalf to raise contribution rates, the Commission may wish to consider whether to continue this using this privatization model.

2. <u>Special Consideration Due to PERA-General Actuarial Condition and Bills to Address Deferred Annuity Augmentation and Contribution Rate Deficiencies</u>. The issue is whether this bill should be recommended to pass given PERA-General's current funding problems, and the bills that have been introduced to deal with these shortfalls. S.F. 286 (Betzold, by request); H.F. 1755 (Smith) is a PERA bill introduced during the 2005 Session to address the deficiency problem by increasing employee and employer contributions. Other bills would reduce plan costs by reducing the deferred augmentation rates provided to terminated members other than under privatization (S.F. 286 (Betzold, by request); H.F. 1755 (Smith)). If PERA has a contribution deficiency worthy of being addressed by the Legislature, and if PERA is proposing to reduce deferred annuity augmentation rates for the PERA-General plan, this would argue either that the Legislature should not add any further privatizations to Chapter 353F, or the Legislature should consider downsizing the degree to which deferred annuity rates are enhanced under Chapter 353F, consistent with any revision in the deferred annuity augmentation provision in PERA-General, Chapter 353, that the Legislature may enact.

   PERA would be harmed by the proposed legislation because it would reduce the gain that PERA would otherwise receive. The treatment under Chapter 353F, the privatization chapter, shares some of that gain with these employees by providing enhanced deferred annuities and "Rule of 90" rights where applicable. The results from PERA-General's most recent actuarial valuation (July 1, 2004), summarized below, indicate PERA-General's current actuarial condition. The funding ratio is 77 percent and the plan currently has a current contribution deficiency of 1.6 percent of payroll, or $67.3 million.

PERA-General

	2004
<u>Membership</u>	
Active Members	138,164
Service Retirees	46,470
Disabilitants	1,760
Survivors	6,550
Deferred Retirees	33,915

		2004
Nonvested Former Members		102,265
Total Membership		329,124
Funded Status		
Accrued Liability		$14,959,464,879
Current Assets		$11,477,960,861
Unfunded Accrued Liability		$3,481,504,018
Funding Ratio	76.73%	
Financing Requirements		
Covered Payroll		$4,220,502,712
Benefits Payable		$687,124,293
Normal Cost	7.78%	$328,196,111
Administrative Expenses	0.21%	$8,863,056
Normal Cost & Expense	7.99%	$337,059,167
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Amortization	4.25%	$179,371,365
Total Requirements	12.24%	$516,430,532
Employee Contributions	5.10%	$215,425,739
Employer Contributions	5.54%	$233,675,208
Employer Add'l Cont.	0.00%	$0
Direct State Funding	0.00%	$0
Other Govt. Funding	0.00%	$0
Administrative Assessment	0.00%	$0
Total Contributions	10.64%	$449,100,947
Total Requirements	12.24%	$516,430,532
Total Contributions	10.64%	$449,100,947
Deficiency (Surplus)	1.60%	$67,329,585

3. Actuarial Cost of the Special Benefit Provisions and Gain/Loss Issues. The Commission's standard practice in recent years has been to approve the proposed treatment, providing that PERA received at least some gain due to the privatization. In some cases the actuary was able to provide that analysis in time for the Commission's consideration. In cases where the information was not available at the time of Commission consideration, the legislation's approval was conditional upon the receipt of actuarial analysis by the Commission-retained actuary indicating that a gain to the applicable pension plan, rather than a loss was expected due to the combination of the privatization and the enhanced benefits provided by Chapter 353F. This bill is consistent with Commission practice by including language in the effective date making the legislation conditional upon the receipt of actuarial work, and certification by PERA that the analysis indicates that at least some net gain to the fund is expected.

4. Local Support/Covering Cost of Actuarial Work. The bill requires that the cost of the actuarial work must be covered by the city of Hutchinson or the purchaser of Hutchinson Area Health Care. The issue is whether the city supports this legislation and whether the city or prospective employer is willing to cover that cost. The city did pass a resolution requesting a bill to be drafted, but as of this writing Commission staff is unsure whether the city understands that it may be liable to cover the cost of actuarial work, and whether it is willing to cover that cost, given the preliminary nature of the privatization discussion in Hutchinson. The Commission may wish to have brief testimony on this matter from a city official or from a bill author.

Potential Amendments for Commission Consideration

Amendment LCPR05-088 removes considerable language from the effective date section, language stating that actuarial work must occur, must be paid for by the city or the purchaser of the facilities, and that the actuarial work must indicate that PERA is expected to receive some net gain from the privatization. This language is unnecessary if the actuarial work has already been provided and paid for, and if due to that actuarial analysis PERA certifies that some gain is expected for PERA due to the privatization. If these conditions have already been met, then the Commission may wish to consider using LCPR05-088.

Amendment LCPR05-089. The Commission supports the use of this privatization model, and if amendment LCPR05-088 is not used, the Commission should consider Amendment LCPR05-089. Amendment LCPR05-089 is a technical amendment indicating that the actuarial work shall be performed by the actuary jointly retained by the pension fund administrations, rather than by the actuary retained by the Commission. Due to legislation enacted in 2004, the Commission no longer retains an actuary.

Amendment LCPR05-090 is a delete-all amendment which allows the Hutchinson Area Health Care employees to remain in PERA-General following a privatization. This is the treatment used last year in a few cases (Anoka County Achieve Program employees and Government Training Office employees), at the request of the new employers, who were willing to have the privatized employees remain in PERA-General and to make the required employer contributions. This amendment is included because it is possible that when the Commission hears this bill the local privatization discussion may have progressed to the point where a buyer has been identified and that buyer is willing to meet the financial obligations of having the employees remain in PERA-General. There are a few arguments against adopting Amendment LCPR05-090. One argument is that the Commission may need more time to explore the implications of allowing non-public employees to remain in public plans. If the Commission continues to allow privatized employees to remain in PERA-General, at some point the issue of continued plan qualification may need to be addressed, as the proportion of privatized employees in PERA may no longer be de minimus. Another argument for not considering amendment LCPR05-090 is that if the privatization is in the exploratory stage, retaining PERA-General coverage may discourage potential buyers.