TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 1352 (Neuville); H.F. 920 (Cox): PERA Privatized Employees; Adding Northfield Hospital Employees to PERA Privatized Employee Chapter

DATE: March 15, 2005

Summary of S.F. 1352 (Neuville); H.F. 920 (Cox)

S.F. 1352 (Neuville); H.F. 920 (Cox) would include Northfield Hospital 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 nonprofit 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 non-profit corporation that will be created, and is effective if local approval is provided and if the bill does not create an actuarial loss for PERA-General.

Current Employment Situation

Northfield Hospital (and its associated facilities) is owned by the city of Northfield, and its approximately 370 employees are covered by the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), a defined benefit retirement plan. The medical facilities include a hospital, an outpatient rehabilitation center, long-term care and hospice facilities, and a sports medicine clinic. Northfield Hospital is expected to transfer from being a public employer to a 501(c)(3) non-profit corporation. That transfer is expected to occur in late 2005. Once the non-profit corporation is created, the city would then lease the existing facilities to the non-profit corporation. If Northfield Hospital becomes a 501(c)(3) corporation, the employees will no longer be public employees, and thus will not be eligible for continued PERA-General coverage under existing law.

The new employer may provide the employees with some other form of retirement coverage for their ongoing employment at the facilities. Commission staff's current understanding is that the employees who remain with the hospital facilities will be provided with a defined contribution pension 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

S.F. 1352 (Neuville); H.F. 920 would amend law to provide PERA privatization chapter coverage (Chapter 353F) for the existing Northfield Hospital employees if that facility is privatized. 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.

Discussion of S.F. 1352 (Neuville); H.F. 920 (Cox)

S.F. 1352 (Neuville); H.F. 920 (Cox) would include Northfield Hospital 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 nonprofit 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 non-profit corporation that will be created, and is effective if local approval is provided and if the bill does not create an actuarial loss for PERA-General.

The city and the new employer support legislation to revise the PERA privatization chapter to include the Northfield Hospital privatization. They would not support legislation allowing the employees to remain as active PERA members.

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

1. Implications of Using Privatization Model. 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.

2. Special Consideration Due to PERA-General Actuarial Condition and Bills to Address Deferred Annuity Augmentation and Contribution Rate Deficiencies. The issue is whether S.F. 1352 (Neuville); H.F. 920 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 marginally 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
Membership	
Active Members	138,164

Service Retirees		46,470
Disabilitants		1,760
Survivors		6,550
Deferred Retirees		33,915
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 a gain due to the privatization. The Commission may wish to consider whether to continue that policy. In some prior privatization 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 actuary retained by the Commission 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. (Due to legislation enacted in 2004, an actuary is no longer retained by the Commission but rather by the joint pension fund administrations.) S.F. 1352 (Neuville); H.F. 920 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.

   The actuarial work for this privatization (attached) was completed after the bill was introduced. The actuarial work suggests that the privatized employee group has an accrued liability of $16.3 million as ongoing active employees. If the group were to terminate PERA coverage without being included in the privatization chapter, the accrued liability is estimated to be $10.7 million. Thus, PERA would have a gain of $5.6 million due to privatization if the provisions of Chapter 353F are not extended to these individuals. If they are included in Chapter 353F, the accrued liability for the group is estimated to be $15.2 million. Thus, $4.7 million of the gain that would otherwise go to PERA is captured by the enhanced benefits provided under the privatization chapter, leaving a minimum expected net gain to PERA. The Commission might choose to conclude that this cushion is not sufficient to ensure that PERA will not be harmed, given possible inaccuracies in the estimates. The actuarial work indicates that Northfield hospital provided information on 390 employees to the actuary retained jointly by the larger Minnesota public pension fund administrations, The Segal Company. Of those 390 employees, the actuary was able to match 360 individuals to PERA's data file for the last valuation, July 1, 2004. The Commission may wish to ask PERA about the 30 employees for which no match was found. This might indicate a problem of individuals not being reported for PERA coverage when hired, or that some or all of these individuals are PERA members but for some reason were not picked up in the tape. Another possibility is that these individuals were hired after July 1, 2004. If some of these 30 employees are PERA members, the basic results should hold if these individuals are typical of other individuals who were included in the analysis. If they are not typical employees, it is possible that the slim net gain computed for PERA could evaporate.

4. Local Support/Covering Cost of Actuarial Work. S.F. 1352 (Neuville); H.F. 920 requires that the cost of the actuarial work must be covered by Northfield Hospital. The issue is whether the city supports this legislation and whether the existing or prospective employer is willing to cover that cost. Commission staff's under-standing is that the city does support this legislation and has paid for the actuarial work.

Potential Amendments for Commission Consideration

Amendment LCPR05-067 removes considerable language from the effective date section, language stating some of the conditions for the bill to be deemed effective. The amendment removes language stating that actuarial work must occur, must be paid for by the Northfield Hospital, and that the actuarial work must indicate that PERA is expected to receive some net gain from the privatization. The Commission might conclude that part of this conditional language is not needed since the actuarial work has occurred and it suggests that a net gain, although a modest one, will occur. If the Commission is comfortable with the results of that study, the Commission may wish to consider using LCPR05-067.

If Amendment LCPR05-067 is not used, the Commission should consider Amendment LCPR05-068. Amendment LCPR05-068, which is a technical amendment, indicates that the actuarial work is to 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.