IN THE SUPREME COURT OF THE STATE OF OREGON

In the Matter of the Consolidated)	*Strunk* __x__ (S50593) (Control)
Public Employees Retirement System	*Burt* __x__ (S50647)
) (PERS) Litigation)	*Dahlin* __x__ (S50645)
____________________________________)	*Evans* __x__ (S50532)
	Petrillo __x__ (S50687)
	Sartain __x__ (S50686)
	Whitty __x__ (S50685)

SPECIAL MASTER'S WRITTEN REPORT
AND
RECOMMENDED FINDINGS OF FACT

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I. INTRODUCTION

The 2003 Legislative Assembly conferred original jurisdiction on the Oregon Supreme Court to resolve certain challenges to House Bill 2003 (HB 2003), House Bill 2004 (HB 2004), and later enacted amendments to both bills (the 2003 legislation). The court authorized and directed the undersigned to manage the prehearing phases of the cases filed pursuant to that conferral of jurisdiction, hold an evidentiary hearing, and prepare recommended findings of fact based on the evidentiary record. The seven above-captioned cases proceeded to hearing. This report and recommended findings of fact address the factual issues that the parties in those cases have raised.

A. *Explanatory Observations*

First, in my estimation, these are not cases in which sincerity-based credibility findings are appropriate. In my view, each of the witnesses testified forthrightly to the best of his or her understanding of the subject matter of the testimony. The factual disputes that exist stem primarily from the complexity of the Oregon Public Employees Retirement System (PERS or the system) and the diverse institutional and personal perspectives that the witnesses brought to the stand. Most of the parties' factual differences emerged in the context of expert opinion evidence. From a logical perspective, I found some of the competing expert opinion evidence more persuasive than other such evidence. Although I have not always belabored particular witness testimony, the facts found, and those eschewed, reflect those choices.

Second, the parties submitted extensive proposed findings of fact. I considered all the proposed findings. Many of them are incorporated, often in modified form, in this report. I rejected others, not because I necessarily believed them to be inaccurate but, rather, because they appeared to constitute legal conclusions rather than findings of fact. I also did not adopt findings that I considered too argumentative, incomplete, misleading, or conclusory to be of meaningful assistance to the court.

Third, in their objections to proposed findings of fact, the parties frequently asserted that their opponents' proposals were veiled legal conclusions. Those complaints were not surprising, nor was it surprising that the parties making them had difficulty avoiding similar objections to their own proposed findings. In some respects, it is virtually impossible to address the facts in these cases without providing at least some contextual information concerning my understanding of the PERS statutes or rules. In doing so, however, I have attempted to avoid expressing an opinion when the meaning or effect of a statute or rule is uncertain.

Fourth, some of the recommended findings are relevant to the court's decision only conditionally. For example, some of the parties have asked me to "find" whether the 2003 legislation applies, in whole or part, "prospectively," "retroactively," or to "accrued benefits." Leaving aside for the moment whether those inquiries are the proper subjects of factual findings, they would be pertinent only if the court decides that a particular change does not violate a previous legislative promise never to amend that aspect of the PERS contract--that is, they are conditionally relevant. I offer conditionally relevant findings so that the court will have before it an adequate factual basis to resolve the legal issues that it deems necessary to decide these cases.

Fifth, the court may determine that some of the issues in these cases involve mixed questions of law and fact. Again, the determination whether a legislative change affects an accrued benefit, assuming that that term has legal significance, is an example. That determination may depend on two inquiries: (1) the meaning of the term "accrued benefit" in a particular context; and (2) the evidentiary showing about the probable effect of the 2003 legislation on that benefit. The court may conclude that the first inquiry is a legal one and that the second inquiry is one of fact. In view of my limited role in proposing findings of fact, I have attempted to recognize and respect that distinction when it is applicable.

Sixth, when a party proposed a finding of fact to which the opposing parties did not object, I generally have included the finding, or a modified version of it, in this report, even if the relevance of the finding seemed questionable to me. In addition, I sometimes have recommended independent findings when particular petitioners have sought them, even if I have covered the same subject, albeit in somewhat different terms, in the elaboration of findings common to all cases. Those decisions have produced a format that occasionally may jar the reader's sensibilities, but I have taken the position that this report should fairly track the evidentiary issues as the parties have framed them.

Finally, this report, and the recommended findings of fact that it contains, are set out in narrative form and, except in a few instances, without citations to the record. The statutory, administrative, historical, and operational backgrounds against which both the 2003 legislation and the instant claims have arisen are exceedingly complex. I concluded that to set out in numbered paragraphs particular proposed findings of fact--party by party--without undertaking the additional work of organizing those findings into a discussion with context and transitions, would provide the court with a less useable factual foundation upon which to decide the legal questions that these cases present. At the same time, however, I have attempted to arrange the discussion so that the parties can identify with little difficulty when I have recommended a particular finding, or rejected a proposed finding, should they wish to challenge later any of the determinations. And, in those instances in which the parties elect to make such a challenge, I have assumed that they will provide the court with the citations to the record necessary to evaluate that challenge.

B. *Summary of the Claims and Defenses*

The 2003 Legislative Assembly passed, and the Governor signed into law, a series of bills related to PERS. Those laws are known as the PERS Reform and Stabilization Act of 2003.[1] The legislature found, among other things, that past errors in the administration of PERS had resulted in increases in benefits and costs and that

> "unless immediate steps are taken to reform and stabilize PERS, escalating pension costs will undermine the financial security of PERS, force massive cutbacks in essential government services, eliminate the jobs of many public employees and destroy the public's confidence and trust in the governmental institutions of the state[.]"

HB 2003 (Premable). At the same time, the legislature stated that any reform should not

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1 The legislation comprises four primary bills, each enacted during the 2003 Regular Session: HB 2001; HB 2003; HB 2004; and HB 3020. The citations to those bills as enacted are, respectively, as follows: Or Laws 2003, ch 3; Or Laws 2003, ch 67; Or Laws 2003, ch 68; and Or Laws 2003, ch 625. Among other things, HB 3020 made

"reduce[e] any current member's benefit to a level below the level intended by the Legislative Assembly." *Id.*

several amendments to earlier enacted HB 2003 and HB 2004.

Petitioners are current and former public employees who are members of PERS. They brought these proceedings pursuant to the judicial review provisions of Section 37 of HB 2003 and Section 5 of HB 2004, as amended by Sections 17 and 17a of HB 3020 (2003), respectively. Petitioners have named as defendants the State of Oregon and certain state agencies (the state), the Public Employees Retirement Board (PERB), and various other public employers (the nonstate defendants).[2] Petitioners each assert that the 2003 legislation impairs a statutory contract between petitioners and their public employers in violation of Article I, section 21, of the Oregon Constitution, breaches the statutory PERS contract, and takes their property without just compensation in violation of Article I, section 18, of the Oregon Constitution. Some of the petitioners also assert contract impairment and takings claims under the United States Constitution.[3] Petitioners seek to have many of the provisions of the 2003 legislation declared unconstitutional and to enjoin their implementation.

Petitioners in the *Strunk*, *Burt*, and *Evans* cases rely, for the sources of their claims, on the PERS statutes that existed before the enactment of the 2003 legislation and certain PERB administrative rules in effect before the legislation's enactment. Petitioners in the *Dahlin*, *Petrillo*, *Sartain*, and *Whitty* cases also rely on those provisions and, in

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[2] Some of the nonstate defendants are intervenors, rather than defendants, in some of the cases. These proposed findings of fact make no distinction among those parties insofar as their status in a particular case is concerned.

[3] US Const, Art I, § 10, cl 1; US Const, Amends V, XIV.

addition, assert that the PERS contract consists of other terms, including provisions of employee handbooks, oral representations, or documents that PERS officials have provided to them over the years. Those petitioners' claims allege breaches and impairments of contract and takings based on those additional purported terms.

The state has raised several defenses to petitioners' claims. It asserts that (1) the statutory provisions and other materials on which petitioners rely are not part of the obligation of any contract to which they are parties; (2) any impairment of the obligation of petitioners' PERS contracts is insubstantial or nonexistent; (3) any impairment is justified by important public purposes; and (4) petitioners have no property interest that the 2003 legislation affects. The first and fourth of those defenses raise legal issues for the court, although they affect the relevance of some of the parties' factual assertions. The second and third defenses frame some of the factual issues on which the parties presented evidence and to which the following findings relate.[4]

Nonstate defendants present a somewhat different array of defenses. Like the state, they first assert that many of the provisions that petitioners seek to enforce are not *statutory* contractual promises. They also contend that the 2003 legislation did not breach or impair those provisions that constitute statutory contractual promises because it did not

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[4] PERB raised several separate affirmative defenses in its second amended answer to the petitions in each of the cases. Before the hearing, PERB withdrew three of those defenses. PERB presented no separate case with respect to its remaining defenses at the evidentiary hearing. Instead, in effect, PERB presented a joint defense based on the defenses that the other defendants raised.

change substantially the substance of those promises and, in any event, none of the affected provisions was beyond the reach of the legislature's power of amendment or repeal. They assert that the 2003 legislation has "only prospective effects."

In addition, nonstate defendants assert that PERB lacked authority to create binding contractual obligations between themselves and petitioners with respect to PERS benefits. Further, nonstate defendants argue that, even if PERB had such authority, the rules and actions on which petitioners rely were unauthorized or contrary to statute, and petitioners have no right to retain the benefits resulting from them. According to nonstate defendants, the legislature has the exclusive authority to determine PERS benefit levels.

Nonstate defendants also have raised several affirmative defenses to petitioners' breach of contract claims. Assuming that the legislature intended the statutes, rules, and other materials on which petitioners rely to constitute part of the PERS contract, nonstate defendants assert that their performance is excused on the following grounds: (1) mutually mistaken assumptions that PERB would administer the PERS system in a prudent manner to provide benefits in accordance with legislative intent; and (2) impossibility or impracticability based on extreme financial hardship.

II. OVERVIEW

To the extent practicable, the proposed findings of fact that follow are arranged both chronologically (before and after the 2003 legislation) and according to the parties' specific claims. I begin by providing a general description of the operation of PERS. I then discuss both the historic and projected status of the PERS fund before the 2003 legislation, provide an assessment of the reasonableness or prudence of PERB's practices before the 2003 legislation, and address briefly the *City of Eugene* litigation. Thereafter, I describe the 2003 legislation both generally and in the context of the specific claims that the parties have raised, the economic goals and impacts of that legislation, and the evidence that pertains to defendants' economic hardship defenses. Finally, the report addresses the evidence as to the projected impact of the 2003 legislation on the individual petitioners and any evidence specific to particular cases. As will be seen, the report then ends; it reaches no conclusions. Consistent with my charge, I leave that effort to the Supreme Court.

III. THE GENERAL OPERATION OF THE PERS SYSTEM

PERS provides public employees with retirement benefits as part of their compensation packages. PERS benefits are an important part of public employees' total compensation packages.

PERS is managed by the Public Employees Retirement Board (PERB), and its operations are conducted by a director and staff that PERB employs. PERB administers the system in consultation with the system's actuary, and it acts as trustee of the Public Employee Retirement Fund (the fund). In administering the system, PERB sets employer contribution rates, adopts actuarial equivalency factors and assumed earnings rates, establishes reserve accounts within the fund, and allocates annual earnings to accounts and reserves.

PERB holds the fund assets in trust. The Oregon Investment Council (OIC) invests those assets. The OIC has six members, including the State Treasurer; the PERS executive director; and four members, including a PERB member, whom the Governor appoints. Except for variable account funds, which must be invested in the Oregon Equity Fund, all PERS funds are commingled for investment purposes.

PERS is a defined benefit plan designed to produce a monthly retirement allowance for retirees. A defined benefit must be "definitely determinable." 26 CFR 1.401-1(b)(1)(i). A typical defined benefit plan is one in which the benefit provided can be determined by the terms of the plan, usually involving salary and years of service, and a percentage multiplier. In a defined benefit plan, the employer bears the risk of ensuring that there is adequate funding to pay member benefits. The employer funds a defined benefit based on recommendations of an actuary and bears the full risk of investment and other actuarial losses. In a defined benefit plan, the "interest follows principal" principle usually does not apply. Investment income generally is available to offset the cost of providing benefits. However, investment income is allocated according to the provisions of the plan document.

By contrast, in a defined contribution plan, the only defined aspect is the contribution made into the plan. It operates like a savings account, in that contributions are invested, and the benefit at retirement depends on investment performance. In a defined contribution plan, interest generally follows principal, the member bears the risk of investment loss, and the employer bears no risk once it has made its promised contributions.

PERS is not a typical defined benefit plan in that (1) it is partially funded by employee contributions that are credited to employee accounts, to which fund earnings also are credited; and (2) under the currently predominant Tier One payment option, the

Money Match, employers match member account balances at retirement, and the resulting amount is then annuitized. Those distinct features of PERS are at the center of many of the parties' disagreements.

Tier One consists of PERS members who joined the system before January 1, 1996. PERS members who joined the system on or after January 1, 1996, are known as Tier Two members. Tier One members are entitled to a guaranteed minimum rate of return based on the assumed earnings rate.[5] Tier Two members have no earnings guarantee on their member accounts. In addition, unlike Tier One members, Tier Two members do not participate in the fund's gain-loss reserve.[6]

Every PERS member has a member account in PERS. The member account comprises the employee's contributions to PERS and earnings credited on those contributions. If a member participates in the variable annuity program, he or she will have two member accounts--a regular account and a variable account. PERB includes both accounts and the earnings credited to them in calculating member benefits.

A Tier One member's regular account is guaranteed to earn interest at the assumed earnings rate that PERB periodically establishes. In 1969, PERB began investing the fund in equity markets. Since then, the actual earnings of the fund have, on an overall basis, substantially exceeded the assumed earnings rate. Historically, regular accounts have been credited with earnings in excess of the assumed interest rate in years when

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5 *See* discussion of the assumed earnings rate at page 19.

6 *See* discussion of the gain-loss reserve at page 24.

fund earnings exceeded that rate.

In 1967, the legislature enacted an optional variable annuity program for members who want their contributions and benefits to fluctuate with the equity markets and serve as a hedge against inflation. A member who retired with a variable annuity had two annuities; the variable annuity was adjusted annually depending on fund earnings in the previous year. Members who participated in the variable annuity program made contributions that were invested solely in the Oregon Equity Fund.

At the beginning of each calendar year, PERB reviews changes in the value of the fund since the beginning of the previous year. PERS staff determines the fund's value using standard accounting methods. The annual earnings or losses of the fund, as PERB computes them, include both realized and unrealized gains and losses. Based upon the fund's annual growth, PERB allocates earnings to various accounts within the fund.

PERB historically has provided (1) periodic audits and reports to the legislature; and (2) periodic reports to participating employers and employee members that include a summary of fund investments and earnings. *See* ORS 238.660(8); ORS 238.630(2)(e).

A. *Benefit Calculation Methods*

A PERS member is entitled to a service retirement allowance based on the calculation that produces the highest benefit among the following three alternative formulas: (a) Pension Plus Annuity; (b) Full Formula; and (c) Money Match.

In the mid-1950s, PERS was a Money Purchase Plan with an employer matching feature. In 1968, the Money Purchase Plan was repealed, and it was replaced by the Pension Plus Annuity benefit formula. PERB later recognized that one or two members who retired in the interim had received lower benefits than they would have received under the previous system and that such a reduction was not permissible under a retirement plan that is qualified under the Internal Revenue Code (IRC). PERB asked the legislature to enact corrective legislation so that benefits earned by such members would be protected and, in response, the legislature reinstated the matching feature.

The Pension Plus Annuity method is available only to members who made PERS contributions before August 21, 1981. Under that method, PERS calculates a pension equal to 1.0 percent of the member's final average salary (1.35 percent for legislators, and police and fire employees) for each year of service. An annuity calculated by multiplying the member's account balance by an actuarial equivalency factor (AEF) is added to the pension. The retirement allowance is the sum of the formula pension and the member's annuitized account balance. Under the Pension Plus Annuity method, the retirement allowance is fully funded by employers.

In 1981, PERB proposed that the legislature enact a Full Formula benefit to replace the Pension Plus Annuity and that it convert the system to a fully defined benefit plan. The PERS actuary advised legislators that the Full Formula benefit would be roughly equivalent to the benefit provided under the Pension Plus Annuity. The actuary also opined that the Full Formula benefit, when combined with Social Security benefits, would provide 75 to 85 percent of preretirement income for career employees and that it would provide an equivalent standard of living for members after retirement. The 1981 legislature enacted the Full Formula option. In seeking a determination from the Internal Revenue Service that PERS is a qualified defined benefit plan, PERS described itself as a defined benefit plan and the Full Formula as its benefit calculation method.

PERS staff calculates the Full Formula allowance by multiplying the retiring member's final average salary and years of service by a factor. The formula provides 50 percent of final average salary for career employees (25 years of police/fire service, or 30 years of general service). Thus, the Full Formula calculation consists of three components: (1) the member's final average salary; (2) the member's years and months of creditable service as of the date of retirement; and (3) a factor set by statute at 1.67 percent for general service employees and 2.0 percent for legislators, police officers, and firefighters.[7] The member is entitled to an annuity in an amount equal to the member's final average salary multiplied by the length of creditable service multiplied by the applicable statutory percentage factor.

Finally, under the Money Match method, a retired member receives an annuity based on his or her member account balance, which is matched by an equal annuity that the member's employer or employers funds. PERB historically has calculated the Money Match benefit by determining the balance in the member's regular account, adding the balance in the member's variable account, if any, and multiplying the combined balance by an AEF. A benefit in an equal amount is then added and charged to the employer's account. The resulting retirement allowance is therefore twice the amount of the benefit

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[7] The Full Formula benefit for legislators, police, and fire members provides a higher multiplier that allows those members to receive a more favorable retirement benefit, by allowing earlier retirement at a full benefit, than is provided for members in

resulting from the member's own annuitized account balances.

Regardless of the calculation method used to determine a member's retirement allowance, PERS historically has increased the allowance by an annual cost of living adjustment (COLA). The COLA is based on the annual increase in the Consumer Price Index (CPI) and is capped each year at 2.0 percent of the member's allowance. If the CPI increases by more than 2.0 percent in a year, the increase above 2.0 percent is "banked" and may be added to the member's COLA in later years when the CPI increases less than 2.0 percent.

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general service.

In addition to the benefits described above, members with service before 1991 receive an increase in benefits to remedy the taxation as income of benefits attributable to service before 1991.[8]

B. *Replacement Ratios*

In the late 1980s, members who retired with 30 years of creditable service received a service retirement allowance equal to approximately 63 percent of their final average salaries. In the early 1990s, members who retired with 30 years of creditable service received a retirement allowance equal to 66 percent of final average salary. Between 1996 and 2002, the average PERS member with 30 years of service retired with an allowance equal to 85 percent of his or her final average salary. In 2000, the average PERS retiree with 30 years of service retired at the age of 53 with an allowance equal to 106 percent of the retiree's final average salary.

PERS retirees who retired after 1997 have received service retirement allowances that are significantly greater than the service retirement allowance of PERS members who retired before 1997 with comparable salary histories and creditable service. In 2002, PERS staff projected that, by 2017, median retirement allowances would reach 124 percent of final average salary for career employees.

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[8] *See* discussion of HB 3349 (1995) at page 41.

The foregoing percentage ratios are commonly referred to as "replacement ratios." Replacement ratios compare a retiree's first year retirement benefit to his or her last year's salary. The replacement ratio concept is not referred to in the PERS statutes, but PERB historically has used it in various contexts. In 1979, PERB's rules and objectives stated that "[t]he system's retirement benefit for a career employee (30 years of service) retiring at age 62 when added to Social Security benefit, should provide the same standard of living immediately after retirement." PERB goals adopted in 1986 and 1992 also stated an official policy that the retirement benefits for a career employee retiring when the employee is first eligible for Social Security should, when added to Social Security, provide the same standard of living immediately after retirement as enjoyed immediately before retirement. That policy was based on the assumption that a comparable post-retirement income requires a service retirement allowance that, when added to Social Security benefits, replaces 75 to 85 percent of the employee's pre-retirement gross income.[9] Social Security benefits typically replace 20 to 40 percent of preretirement income depending on the income level of the recipient. In 1997, PERB amended its policy to provide that the 75 to 85 percent replacement ratio was not a target but, instead, was a minimum benefit. In 2001, PERB changed its policy to remove any statement from its publications regarding replacement benefit levels.

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[9] According to academic studies, including a study performed by Georgia State University, a generally accepted replacement ratio sufficient for a retiree to maintain the same standard of living in retirement is a benefit somewhere between 70 and 85

percent of preretirement income.

PERB's calculation of replacement ratios understates the extent to which retirement benefits replace a member's preretirement salary because of four factors: (1) employer pick up of members' 6 percent contribution is treated as part of salary even though the pick-up amount is not included in the member's preretirement disposable income;[10] (2) Social Security benefits are not included in the member's retirement income; (3) PERB does not count benefits added by HB 3349;[11] and (4) PERB compares the benefit to "final average salary"--the member's highest three years of salary--rather than the member's salary immediately before retirement.[12]

In at least three additional respects, a careful consideration of replacement ratios must avoid apples to oranges comparisons. First, replacement ratios are most meaningful in considering the benefits of career, that is, 30 year, employees. To say, for example, that a member who left PERS-covered service after 10 years has a particular replacement ratio is of little help in determining whether a career-long replacement ratio standard has been met. Some of the evidence in the record relates to replacement ratios for members who retired with less than 30 years of PERS-covered employment. That evidence must be viewed with special caution.

Second, Social Security retirement benefits, which are not payable until age 62 or later, are not precisely congruent with the PERS assumption that a "typical" 30-year member will retire at age 58. That is, for the first four years of retirement, the typical

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[10] *See* discussion of the pick up at pages 17-18.

[11] *See* discussion at page 41.

[12] Of course, if the member's salary at retirement is higher than the final average salary, then PERB's calculation would overstate the replacement effect.

PERS career retiree may not have the additional cushion of a Social Security retirement allowance to supplement his or her income.

Third, the reasonableness of a particular replacement ratio may depend, in part, on the reasonableness of the salary that it replaces. If a public employee is especially well or poorly compensated in comparison to peer groups from the public sector--or the private sector, for that matter--who perform the same work, the reasonableness of a particular replacement ratio for that employee will be affected correspondingly. However, there was no evidence of peer group salary studies, for example, or other evidence that, in my opinion, would enable a finder of fact to determine that petitioners or other PERS members are either well or poorly compensated in comparison to any peer cohort.

C. *Funding of the System*

The total cost of the PERS system is determined by adding the cost of benefit payouts to administrative costs and subtracting fund growth from that sum. The cost of the system is jointly paid by member and employer contributions and the earnings on those contributions.

When a member retires, his or her account balance, together with funds from the appropriate employer or employers, are paid into a benefits-in-force reserve account for the purpose of funding the member's retirement allowance.[13] Benefits paid at retirement are funded from three sources: (1) employee contributions; (2) employer contributions; and (3) earnings from the investment of contributions.

Member contributions are established at 6 percent of salary and either are withheld

[13] *See* discussion of the benefits-in-force at page 19.

from the member's salary or paid, that is, "picked up," by the employer. The pick up historically has been negotiated separately between public employers and employees. The decision whether to pick up employee contributions generally has depended on the level of employee salaries and other benefits. Before June 30, 2003, employee contributions and the earnings on those contributions were paid into and maintained in individual employee accounts within the system. ORS 238.250 (2001).

Apart from the pick up, employers contribute the amount actuarially determined to be necessary to cover the cost of accrued and projected future retirement benefits. Employer contributions and earnings on those contributions are allocated to "employer accounts," which are used as an accounting device for the purposes of calculating employer contribution rates and allocating unfunded actuarial liabilities among participating employers.

D. *The Role of the PERS Actuary*

The PERS actuary recommends the adoption of employer contribution rates in an "Actuarial Valuation" that usually is issued as of December 31 in odd-numbered years. Employers begin paying newly-established contribution rates on July 1 of the following year.

The actuary also provides interim fund valuations at PERB's request. The actuary conducts an experience study every two years that analyzes the expected trends in investment return as well as demographic data, including mortality rates. Based on the experience studies, the actuary adjusts the assumptions that determine the valuation of the fund. The actuary analyzes the liabilities of the system based on his or her understanding of its features and PERB's administrative policies. Liabilities are comprised almost entirely of accrued and projected future payments to members. The actuary compares the liabilities with the system's assets to determine its funded status. That analysis, in turn, informs PERB's determination of employer contribution rates.

E. *The Benefits-in-Force Reserve*

PERB maintains a benefits-in-force reserve (BIF) from which it pays retirement allowances. When a member retires, PERB transfers the member's account balance to the BIF, along with an additional amount from the employer's accumulated contributions. The amount transferred from the employer's account is the amount determined necessary to pay the member's retirement allowance.

In the biennial valuation process, the actuary "trues up" the BIF by recalculating the funds necessary to pay all expected benefits for retired members. If the actuary determines that the BIF is insufficient to pay those benefits, deductions are taken from all employer accounts in amounts sufficient to true up the BIF. Conversely, if the BIF is overfunded, additions are made to all employer accounts within the system. For accounting purposes, PERB does not make adjustments to individual employers' accounts but, rather, maintains a balancing account that shows the actuary's "trueing up" calculations.

F. *The Assumed Earnings Rate*

In the valuation process, the actuary reviews and, if appropriate, recommends the revision of the assumed earnings rate for the system. The assumed earnings rate is the rate of investment return that the actuary assumes the fund will earn over a 50- to 75-year period. That assumption is pivotal to the administration of the fund, because it facilitates the calculation of BIF funding levels and employer contribution rates needed to maintain the system on an actuarially sound basis. The assumption has changed from time to time. From 1975 through 1978, the assumed earnings rate was 7 percent.[14] In 1979, PERB increased the assumed earnings rate to 7.5 percent. In 1989, PERB increased the assumed earnings rate to its current 8 percent level.

G. *Employer Contribution Rates*

Employer contribution rates are expressed as a percentage of payroll. The current total annual payroll for PERS participating employers is approximately $6.5 billion. One percent of the payroll of participating PERS employers is equal to approximately $65 million. Thus, to give an example the relevance of which will be explained below,[15] an increase in contribution rates of 4.82 percent of payroll costs approximately $328 million per year on a system-wide basis.

The actuary recommends employer contribution rates based on the valuation of the fund and the prevailing actuarial assumptions for the system. PERB typically adjusts employer contribution rates every two years based on the results of the actuarial valuations.

Employer contribution rates consist of two components: the normal cost and the

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[14] PERB has treated the "assumed earnings rate" that it periodically adopts as equivalent to the "assumed interest rate" described in ORS 238.255.

[15] *See* page 43.

amount necessary to amortize any unfunded actuarial liability (UAL). The normal cost component of the rate is based on the actuary's best estimate of the amount needed to pay benefits to current employees in the future. The adjustment of the employer contribution rate for UAL or actuarial surplus is based on the difference between an employer's account balance and the projected future benefits payable to its employee members.

If the assets in the employer's account match its liabilities, the employer pays only the normal cost rate. If there is an actuarial surplus, the employer pays less than the normal cost rate. If the employer has a UAL, an additional charge is added to the employer's normal cost rate. When an employer develops a UAL, PERB amortizes the repayment of the UAL over a period of time at the assumed earnings rate. PERB is gradually reducing the standard amortization period from 30 years to 20 years; the current period is 26 years.

Employer contribution rates often are expressed on a system-wide basis through the use of pooled rates for groups of employers. For example, school districts are pooled and, thus, a single employer contribution rate applies to all school districts. Likewise, the state pays one rate based on the experience of all state agencies. However, in the past, separate contribution rates usually were calculated for each of the approximately 450 local government employers who participate in PERS.

Local government rates historically have been more volatile than the state rate or the pooled school district rate because, for many local governments, especially those with few employees, experience and demographics do not match the overall actuarial assumptions of the system. Since 2001, to provide greater contribution rate stability, local government employers have been permitted to join rate pools. Approximately 55 percent of all local government employers thus far have joined such pools.

Approximately 87 percent, or 140,000 of 160,000, of active PERS members are employed by employers who participate in a rate pool.

IV. THE PRELEGISLATION STATUS OF THE PERS FUND

For the 2001-03 biennium, the state of Oregon's general fund and lottery budget was approximately $11 billion. Oregon's local governments will collect approximately $17.8 billion in own-source revenues in fiscal year 2003-04. In comparison, at the end of 2002, the fund had a total UAL of more than $15 billion.[16] In January 2003, the UAL reached $16.41 billion. During the 2003 legislative session, the UAL exceeded $17 billion, but it had declined to $12.7 billion by July 2003.

Between 1991 and 2000, the nation experienced the longest sustained period of economic growth in its history. During that time, the average investment return on the fund was approximately 15 percent per year. However, over that same period, the system's funded ratio, which compares the value of fund assets to projected liabilties, declined. In 1991, the fund's value equaled the amount of its projected future liabilities. By 2001, the value of the fund's assets equaled 89 percent of its projected future liabilities. In 2002, based on then-current actuarial assumptions, the PERS actuary projected that PERS liabilities would increase from approximately $45 billion in 2001 to approximately $65 billion by 2007. In 2002, the actuary also projected that the funded

[16] The UAL statistics given are based on the fair market value of fund assets rather than PERB's standard valuation method based on the actuarial value of fund assets. For a partial explanation of the difference between the fair market and actuarial values of

ratio would remain below 80 percent until 2010 and that the funded ratio probably would not equal 100 percent until 2027. In early 2003, that ratio declined to 65.4 percent.

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fund assets, *see* the discussion of "smoothing" at page 44.

Until 1997, PERB assumed that member retirement allowances would be calculated under the Full Formula method. Recent and projected future increases in member benefits and employer costs are attributable, in part, to the emergence of the Money Match formula as the predominant calculation method for PERS retirement allowances. The emergence of the Money Match was, in turn, caused by a combination of (1) the structure of the PERS system; (2) dramatically fluctuating investment markets in the late 1990s and early 2000s; and (3) certain PERB administrative practices pertaining to reserves, earnings allocations, and the variable account program.[17] The next section discusses each of those factors in the context of PERB's administrative practices.

A. *The Earnings Allocation Process*

In March of each year, the earnings from fund assets are allocated to the various accounts within the system, effective as of the end of the previous calendar year. PERB must submit a preliminary proposal to the legislature at least 30 days before making any distribution of earnings or crediting earnings to any reserve account within the system. PERB has submitted such statements to the legislature on an annual basis.

In distributing earnings, PERB first deducts administrative expenses, then it funds authorized reserves, and, finally, it allocates funds within the system based on an "equal crediting" policy. Under that policy, every dollar within the fund receives the same percentage share of earnings regardless of the account to which it is designated.

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[17] The issue whether the PERS statutes mandated or authorized any or all of

those practices is beyond the scope of this report.

B. *The Gain-Loss Reserve*

Before the enactment of the 2003 legislation, PERS maintained a "gain-loss reserve" in which it set aside a portion of annual fund earnings to ensure that sufficient assets would be available to pay guaranteed benefits at the assumed earnings rate. In years when fund earnings exceeded the guaranteed amount, PERB deposited a portion of those funds into the gain-loss reserve. The evidence showed that it is reasonable to fund the gain-loss reserve at a level that would fund projected Tier One guaranteed earnings credits for a 30-month period, which, using the current assumed earnings rate of 8 percent, would set the reserve balance at 20 percent of the fund's value.

C. *The Contingency Reserve*

ORS 238.670(1) provides, in part:

> "At the close of each calendar year in which the earnings on the [fund] equal or exceed the assumed interest rate established by [PERB] under ORS 238.255, [PERB] shall set aside, out of interest and other income received through investment of [the fund] during that calendar year, such part of the income as [PERB] may deem advisable, not exceeding seven and one-half percent of the combined total of such income, which moneys so segregated shall remain in the fund and constitute therein a reserve account."

That reserve account is known as the contingency reserve.[18] It is to be used to "prevent any deficit of monies available for the payment of retirement allowances, due to interest fluctuations, changes in mortality rate" or, subject to certain restrictions, "other contingency." ORS 238.670(1). Before 1980, PERB funded a contingency reserve

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[18] The first PERS contingency reserve statute, ORS 237.281, was enacted in 1953. Or Laws 1953, ch 200, § 10(6). It was virtually identical to the quoted wording, except that it (1) limited the amount of the contingency reserve to 5 percent, rather than 7-1/2 percent, of annual fund earnings; and (2) did not restrict the funding of the account to

account. However, PERB has not funded a contingency reserve account since 1979.

D. *The Allocation of Earnings*

1. *Member Statements*

On or about April 15 each year, after earnings have been credited, PERB furnishes annual statements to nonretired members. Those statements set out the value, including earnings on contributions, of the member's account as of December 31 of the previous year. From 1994 through 2001, the annual statements also included an estimate of the member's monthly allowance upon retirement. Annual statements issued for years before 1994 and after 2001 showed only member contributions and credited earnings to date and did not include a monthly benefit estimate.

PERS calculated the benefit estimates in the 1994, 1995, and 1996 statements using the Full Formula method. Beginning in 1997 and continuing through 2002, PERB used the Money Match formula to calculate the projected monthly allowance. For many members, the 1997 annual statements, issued in the Spring of 1998, showed projected monthly retirement allowances in amounts more than twice those shown on the previous year's statements.

2. *Overview of the Historical Allocation of Earnings*

From the inception of the PERS plan, PERB allocated fund earnings, less administrative expenses, first to reserves in amounts that it determined and then, on an equal crediting basis, to member and employer accounts and the BIF. For Tier One regular accounts, if the fund's annual earnings were less than the assumed rate, PERB

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years in which fund earnings equaled or exceeding the assumed earnings rate.

used funds held in reserve to reduce the deficit. PERB annually has credited all variable annuity program accounts and all Tier Two member accounts with the actual earnings attributable to those accounts less administrative expenses.

In 1973 and 1974, PERB allocated all the available earnings to the BIF and nothing remained for distribution to member accounts. In 1975, the legislature enacted a provision that directed PERB to credit members' regular accounts annually with an actuarially-based assumed interest rate, even in years when the fund earned less than that amount. ORS 238.253. From 1975 until 2003, PERB annually credited Tier One regular member accounts with earnings rates equal to or exceeding the assumed rate.

Between 1990 and 2000, the fund earned, on average, 14.75 percent per year, and PERB credited, on average, 13.63 percent per year to Tier One accounts.

Between 1995 and 1999, fund growth exceeded 100 percent. The fund earned 20.78 percent in 1995, 24.42 percent in 1996, 20.42 percent in 1997, 15.43 percent in 1998, and 24.89 percent in 1999.

In 1991, fund assets were approximately $14.7 billion, liabilities were approximately $14.7 billion, and the covered payroll was $3.9 billion. At the end of 1995, fund assets totaled approximately $21 billion, and liabilities were approximately $23 billion. By the end of 2000, fund assets had grown to approximately $42 billion, and liabilities were approximately $43 billion. Covered payroll in 2000 was approximately $6.2 billion.

Between 1991 and 2000, covered payroll increased by approximately 60 percent; at the same time, fund liabilities nearly tripled as did the value of assets to pay those liabilities.

The value of fund assets declined to approximately $40 billion in 2001 and $35 billion in 2002. Fund liabilities increased to approximately $45 billion in 2001, and they decreased to approximately $39 billion as of the end of 2002, after taking into account the effects of the 2003 legislation.

In 2001, for the first time since 1979, the gain-loss reserve was not sufficient to fund fully the assumed earnings rate for Tier One regular member accounts. To credit earnings at that rate, PERB created a deficit reserve. A similar procedure was utilized in distributing 2002 earnings.

Between the end of 1995 and the end of 2002, the fund experienced an overall increase in assets of approximately $14 billion. During that same time, fund liabilities increased by $16 billion after the 2003 legislation was enacted, and would have increased by approximately $24 billion, had the legislation not been enacted.

3. *The Allocation of Earnings: 1989 to 2003*

In 1989, the fund earned 19.74 percent. PERB credited 14.5 percent in earnings to member and employer accounts and the BIF. PERB allocated $506 million to the gain-loss reserve. In the same year, the actuary recommended an increase in the assumed earnings rate from 7.5 percent to 8.0 percent. PERB approved the increase. At that time, approximately 21 percent of retiring members had their benefits calculated under the Money Match formula.

In 1990, the fund lost 1.63 percent in value. PERB credited 8.0 percent to member and employer accounts and to the BIF by debiting $892 million from the gain-loss reserve.

In 1991, the fund earned 22.45 percent. PERB credited 15 percent to member and employer accounts and to the BIF. PERB allocated $762 million to the gain-loss reserve.

In 1992, the fund earned 6.94 percent. PERB credited 8.0 percent earnings to member and employer accounts and to the BIF by debiting $126 million from the gain-loss reserve.

In 1992, PERB revised its statement of goals and objectives. The revised goals retained a benefit goal of 75 to 85 percent of preretirement income, including Social Security benefits, for career employees, and a funding goal for the gain-loss reserve equal to two years' earnings at the assumed rate.

In 1993, the fund earned 15.04 percent. PERB credited 12 percent to member and employer accounts and to the BIF. PERB allocated $398 million to the gain-loss reserve.

In 1994, the fund earned approximately $878 million, or 2.16 percent of its value. In 1995, PERB credited the assumed earnings rate of 8 percent to member and employer accounts and BIF reserves for 1994. That decision required the transfer of approximately $851 million to those accounts from the gain-loss reserve. After the transfer, the balance in the gain-loss reserve was approximately $909 million.

In 1995, the fund earned approximately $4.1 billion, or 20.78 percent of its value. In March 1996, PERB allocated 1995 earnings, and it credited 12.5 percent interest to member and employer accounts and BIF reserves. PERB also allocated $1.2

billion to the gain-loss reserve.

In 1996, PERB reviewed its policies for possible amendment, and it invited comments from interested parties. In February 1997, PERB changed its benefit goal from a target of providing benefits that, when combined with Social Security, would provide 75 to 85 percent of preretirement income to a description of that level as a minimum benefit for career employees. PERB also reduced the gain-loss reserve funding goal from 24 months to 18 months. That change was made after the PERS actuary provided an analysis of the probability that the gain-loss reserve would reach a zero balance depending on whether an 18- or 24-month reserve was maintained.

In 1996, the fund earned approximately $4.4 billion, or 24.42 percent of its value.[19] In March 1997, PERB allocated 1996 earnings; it credited 21 percent to Tier One accounts and BIF reserves. PERB allocated approximately $601 million to the gain-loss reserve.

In 1997, the fund earned approximately $4.6 billion, or 20.42 percent of its value. In March 1998, PERB allocated 1997 earnings; it credited 18.7 percent to Tier One accounts and BIF reserves. PERB allocated approximately $395 million to the gain-loss reserve.

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[19] At least one-quarter of the reported increase in the value of the fund in 1996 was attributable to a federally mandated change in accounting methodology (GASB-25), which resulted in certain types of assets being valued at fair market value rather than investment cost. The fund's earnings were reported at 24 percent under GASB 25, but

they would have been approximately 18 percent under the previous reporting standard.

Because PERB credited a total of almost 40 percent in earnings to Tier One member accounts for 1996 and 1997, projected future benefits for Tier One members grew beyond the actuary's expectations.[20] In 1995, members retiring under the Money Match formula had received an allowance that was on average 5 percent higher than the Full Formula allowance. By 1997, though, the Money Match calculation produced an allowance that, on average, was 29 percent higher than the Full Formula allowance.

In 1998, 87 percent of retiring members retired under the Money Match formula. The growing predominance of the Money Match caused the actuary to adjust his valuation assumptions. The actuary began to assume that growth in the value of member accounts and benefits would accelerate in the future. The actuary also began to assume that Tier One member accounts would be credited with earnings at 8.5 percent.

In 1998, the fund earned approximately $4 billion, or 15.63 percent of its value. In March 1999, PERB allocated those earnings; it credited 14.1 percent interest to Tier One member accounts, employer accounts, and BIF reserves. PERB allocated approximately $321 million to the gain-loss reserve.

In 1998, the OIC commissioned the Frank Russell Company to study its

[20] That increase was augmented by PERB's policy of crediting earnings from the previous year at the "last known rate" (LKR) for members who retired before the next year's interest rate was determined and credited. That practice created an incentive for members to retire shortly before the next crediting date, and it created an imbalance between member accounts and reserves. The LKR problem was resolved by January 2000.

investment policies. The resulting reports (the Russell reports) were provided to PERB in late 1999. The Russell reports showed that market volatility likely would have a detrimental effect on the stability of the PERS system. Based on the Russell reports, PERS staff and the actuary recommended that PERB increase its goal for the gain-loss reserve from 18 months to 30 months' earnings at the assumed earnings rate--a reserve of 20 percent of current assets--as a means of stabilizing employer contribution rates. In February 2000, PERB adopted the 30-month goal.

In 1999, the fund earned approximately $7.5 billion, or 24.89 percent of its value. PERB allocated approximately $1.3 billion to the gain-loss reserve, which left it funded at approximately 72 percent of the new 30-month goal. After PERB allocated 1999 earnings, the gain-loss reserve had a positive balance of $4.744 billion.

If PERB had fully funded the contingency reserve for 1999 by crediting 7.5 percent of the fund's earnings as authorized by ORS 238.670(1) and, if PERB had fully funded the gain-loss reserve according to its 30-month goal, approximately 11.33 percent would have been available for crediting to Tier One accounts.

In 2000, the fund earned approximately $140 million, or 0.63 percent of its value. In early 2001, PERB transferred more than $2 billion from the gain-loss reserve to credit Tier One regular accounts with 8 percent interest for 2000. After that transfer, the gain-loss reserve balance was approximately $2.5 billion.

At the beginning of 2001, the total system UAL was $1.5 billion. In 2001, the fund lost approximately $2.7 billion, or 7.36 percent of its value. In early 2002, PERB credited 8 percent interest to Tier One regular accounts. To accomplish that result, PERB depleted the remaining balance in the gain-loss reserve, and it created a deficit account in the amount of $610 million. PERB allocated the balance of the deficit from the Tier One crediting to a "pending reserve."

At the beginning of 2002, the fund's UAL was approximately $5.6 billion. In 2002, the fund lost approximately $3.5 billion, or 8.22 percent of its value. In early 2003, PERB credited 8 percent to Tier One regular accounts. It did so by creating a second deficit account in the amount of $1.3 billion. PERB placed the balance of the deficit--approximately $2.2 billion--in a second pending reserve.

At the beginning of 2003, the system-wide UAL was approximately $15 billion, and the value of the fund was $35 billion.[21] The total negative balance in the two deficit accounts and the two pending reserves was approximately $6 billion.

In 2003, the fund earned approximately 24 percent. PERB's preliminary earnings allocation credited zero earnings to Tier One employee accounts and 20.83 percent to all Tier Two accounts. Under that allocation, earnings on Tier One accounts will reduce the deficit accounts by about two-thirds. The contingency reserve is expected to receive 7.5 percent, and all other Tier One accounts--that is, employer accounts and BIF reserves--will receive 20.83 percent.

4. *Plan Structure, Market Performance, and Earnings Allocation Practices*

Although the PERS actuary assumes that the fund will earn an average investment return of 8 percent, the fund's earnings vary widely from year to year. In some years the fund earns substantially more than 8 percent, and in other years it earns

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[21] The UAL was approximately $12 million based on the actuarial valuation

substantially less than 8 percent. This volatility in investment earnings can increase member benefits and employer costs.

of fund assets.

The value of benefits provided to retiring PERS members immediately before the enactment of the 2003 legislation was one of the most generous in the nation among both private and public sector retirement plans. Tier One PERS was unusual among public pension plans, because it provided a minimum defined benefit together with an employer-funded benefit that matched employee contributions. Tier One also was unusual in that its general service members who, as discussed, were entitled to a lower benefit than legislative, police, and firefighter members under the Full Formula calculation, received the same benefit as legislators, police, and firefighters under the Money Match.[22] Finally, Tier One was unusual in that PERB credited member accounts at rates approaching actual market earnings in years of good fund performance and, even in poor investment years, it credited member accounts with earnings at the assumed earnings rate.

From 1978 through 2002, PERB allocated earnings to Tier One member regular accounts in amounts that substantially exceeded the assumed earnings rate. When earnings were credited to a Tier One member's regular account, PERB deemed that amount to be firmly credited. In other words, in PERB's estimation, such earnings could not be reduced even if, in later years, the gains in the fund were eroded. Thus, credited gains continued to grow and compound in later years at no less than the assumed earnings rate, even if the fund's assets declined in value.

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[22] Under the Money Match benefit, legislative, police, and fire members must work the same number of years to get the same benefit that an equivalent general service

member would receive.

The conversion of investment gains into benefits by crediting earnings substantially in excess of the assumed earnings rate to Tier One member regular accounts has prevented the fund from benefitting from investment gains to the same extent that it has been affected by investment losses. That is, in strong earnings years, employees receive most of the benefit of returns in excess of the assumed rate, and in years when the fund earns less than the assumed rate, employers' rates have increased to pay the extra cost. Actuaries describe that phenomenon as "asymmetry."

PERB and its staff did not detect the emerging dominance of the Money Match formula until the late 1990s. Its emergence was the result of several factors, three of which stand out. First, the fund had, by 1999, been invested in the equity markets for 30 years. Thus, long term employees were, for the first time, realizing the benefits of career-long investment of their member accounts in stocks. Second, as discussed, the 1990s were a decade of extraordinary market returns, and PERB had credited member accounts with earnings well in excess of the assumed earnings rate. Those earnings, in turn, compounded at high rates of return, thereby raising member account values. Third, the 1990s were a period of relatively low inflation, a condition that reduced upward pressure on salaries. During a higher inflationary period, salaries likely would have increased at higher rates, and Full Formula benefits would have been higher than they were.

Under those conditions, for general service members hired before age 40, any crediting of earnings in excess of the assumed rate would cause the Money Match to be the prevailing benefit calculation. In fact, assuming annual salary growth of 4 percent,[23] any crediting of earnings at a rate in excess of 7 percent would, for general service employees, produce a Money Match allowance in excess of an 85 percent replacement ratio.[24] That benefit level inevitably would surpass a Full Formula allowance.

The use of the gain-loss reserve to provide funds for the earnings guarantee has had a moderating impact on employee accounts and employer rates. However, although much of the recent increase in fund liabilities is attributable to fund investment losses, those liabilities would have been significantly lower if PERB had held more earnings in reserve.

The emergence of the Money Match also presented planning challenges. More than other benefit forms, Money Match allowances cannot reasonably be determined or valued in advance of a member's retirement. That is largely so because the employer matching benefit is calculated at retirement. The value of the benefit is the joint product of market performance, which defies accurate prediction, PERB's administrative practices and, ultimately, the terms of the PERS contract.

E. *PERB Practices Relating to Actuarial Equivalency Factors*

From time to time, after consulting with its actuary, PERB has adopted AEFs for

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[23] The PERS actuary assumes, for actuarial purposes, salary increases at the rate of 4.25 percent per year.

[24] *See* report of Alan Stonewall (Exhibit 573, p 4); *see also* report of Gene Kalwarski (Exhibit 574, p 50).

use in the administration of the fund. AEFs are based on assumptions concerning the future earnings of the fund and members' expected mortality rates. AEFs are used to convert lump sum account balances to monthly payment streams and to change one optional benefit payment form to another. When converting a lump sum to a monthly benefit, the lump sum and the monthly benefit payments are actuarially equivalent if both forms of payment have the same present value. Two of the three types of PERS retirement benefits--Money Match and Pension Plus Annuity--are calculated based on AEFs.

Before 1978, PERB used a substantial number of AEF tables that applied to particular categories of members. In 1978, PERB adopted two simplified sets of actuarial tables, one each for male and female members. The tables for female members produced a lower monthly retirement allowance, because they assumed that females would, on average, have longer life spans after retirement than males.

In *Henderson v. State*, U.S. District Court Case No. CV74-538, the court concluded that the use of separate gender-based calculations was unlawful. In 1978, PERB adopted the male-only actuarial factors for all PERS members. That process commonly was referred to as "topping up" the AEF tables. The topped-up tables increased employer contribution rates by 0.49 percent.

In 1978, PERB adopted a 7 percent assumed earnings rate for the fund. In 1979, PERB increased the assumed earnings rate to 7.5 percent. However, it did not change the system's AEFs because (1) the actuary determined that members generally were living longer after retirement; and (2) new actuarial factors would have blended assumed male and female mortality rates and, therefore, would have been lower than those produced by the use of male-only tables. PERB did not change its AEFs again until 1989.

When PERB increased the assumed earnings rate to 8 percent in 1989, it also adopted revised mortality tables. The revised AEFs were a combination of the pre-existing 7 percent earnings and 1978 male-only mortality assumptions, and new 8 percent earnings and 1989 blended male/female mortality assumptions. PERB used the new factors only if they increased member benefits; otherwise, PERB used the preexisting factors.

In 1993, PERB adopted OAR 459-05-055. That rule provided that PERB's actuary would perform an actuarial equivalency study every two years. The rule required the actuary to "recommend to [PERB] assumptions, factors and the rationale for any recommended changes to the actuarial tables used by [PERS]." OAR 459-05-055(1)(b) (1993). Subsection (2) of the rule provided, in part:

> "(b) All changes to the System's annuity tables shall be prospective only for allowances effective on or after the effective date of the change;
>
> "(c) If the consulting actuary's recommendation to change a factor would produce a lower benefit, [PERB] will not change the current factor."

In the 1995 actuarial study, the actuary reported that continuing improvement in mortality rates would justify an adjustment of the system's AEFs, but he opined that OAR 409-005-0055(5), the renumbered version of the rule quoted above, foreclosed the adoption of factors that would reduce member benefits. The actuary asked PERB to review the rule because mortality rates were expected to continue to improve, and the use of the existing AEFs was a significant cost consideration.[25]

[25] In 1996, PERB amended the rule to provide that a new set of AEFs, including up-to-date mortality assumptions, would apply to members who joined the system after January 1, 1999. The amended rule also provided that the AEFs could be amended from time to time but that a member's retirement allowance would be calculated on a segmented basis. The value of each segmented benefit would be based on the AEFs in effect at the time that the benefit was earned.

In 2001, PERB again reviewed the AEFs for the system. At that time, PERB adopted a policy of using factors based on current mortality assumptions if the factors adequately protected benefits previously earned under former AEFs. PERB reviewed various options for protecting accrued benefits, but it had not completed that process when it became apparent that the 2003 legislature intended to enact legislation on the same subject.[26]

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[26] The version of OAR 459-005-0055 in effect when the 2003 legislation was enacted, provided, in part:

> "(4) * * *
>
> "* * * * *
>
> "(b) All changes to the System's actuarial equivalency factors shall be prospective only for that portion of an allowance attributable to service as an active member beginning on or after the effective date of the change.
>
> "(5) Notwithstanding subsection (4)(b) of this rule, for members who established membership in PERS before January 1, 1999, as described in Oregon Laws 1995, Chapter 654, Section 2, the Board shall not change a factor that would produce a lower periodic or single benefit payment, and

any change of factor(s) shall apply to the total allowance payable."

In sum, before the 2003 legislation was enacted, PERB generally used AEFs that had been in effect since 1978 and that did not match the assumptions that the actuary used to value the system and make projections about system costs. Those factors understated the life expectancy of PERS members. When they were used to convert a member's account balance to a monthly allowance, the aggregate value of the monthly allowance was higher than the value of the account balance. Therefore, unless additional funds were contributed to the system, the account balance would have dissipated before the member's average life expectancy was reached. Put another way, because the AEFs did not match the actuary's life expectancy assumptions for the system, the amount available to pay the BIF upon a member's retirement was, other things being equal, insufficient to cover the projected costs for that member. PERS then had to "true up" the BIF by transferring additional amounts from employer accounts.

In 1995, the actuary estimated that the continued use of a "grand fathered" approach to changes in AEFs cost the system approximately 0.5 percent of payroll per year. As more members retired under the Money Match and the amount of their benefits increased, the financial impact of using outdated factors also grew. In 2002, the actuary estimated that the immediate use of updated mortality tables would decrease employer contribution rates by approximately 2.28 percent of payroll.

F. *PERB Practices Relating to Variable Accounts*

Earnings on variable accounts are first allocated to pay a proportionate share of administrative expenses, and the remainder are credited to member accounts. The PERS system never has funded a reserve from variable account earnings. For many years, PERB added the balances in the regular and variable accounts of members who retired under the Money Match, and it applied the relevant AEFs to calculate their monthly annuities. PERS then required employers to match those annuities. That practice gave members twice the difference between the earnings on their regular and variable accounts.

Historically, employer funds were not invested in the variable account, and, thus, to the extent that the variable account outperformed the regular account, employers were required to contribute additional amounts to match the earnings credited to a member's variable account. In 2000, employers began participating in the variable account. As a result, the potential for mismatched earnings was ameliorated.

G. *Historical PERS Employer Contribution Rates*

Between 1977 and 2001, PERS employer contribution rates ranged from a high of 11.84 percent to a low of 9.15 percent. Between 1975 and 1997, the average normal cost for employers ranged between 7.09 and 9.33 percent of payroll. The normal cost rate in the original 2001 valuation was 9.93 percent of payroll. Between 1975 and 1997, the average rate at which employers paid amortized UAL ranged between zero and 3.24 percent of payroll. The three highest UAL rates occurred between 1975 and 1979.

The system-wide normal cost rate increased from 7.09 percent to 8.64 percent of payroll in the 1997 valuation, an increase of 1.55 percent. PERB issued new rate orders to participating employers in October 1998. The City of Eugene received a rate order showing that its contribution rate would increase from 9.83 to 13.91 percent of payroll. Lane County's rate order showed an increase from 7.82 to 13.73 percent of payroll.

The 1997 actuarial valuation produced generally higher contribution rates for employers, despite the fact that fund earnings during 1996 and 1997 were substantially in excess of the assumed earnings rate. On a system-wide basis, employer contributions increased from 9.42 percent to 11.40 percent after the 1997 valuation. There were two primary reasons for the increase.

The first was the 1995 legislature's enactment of HB 3349. Until 1991, PERS retirement benefits were not subject to income taxation by the state of Oregon. ORS 237.201 (1989). In 1991, the legislature enacted Oregon Laws 1991, chapter 823, which repealed the tax exemption for PERS benefits. Or Laws 1991, ch 823, § 1. In *Hughes v. State of Oregon*, 314 Or 1, 838 P2d 1018 (1992), the Supreme Court held that Section 3 of chapter 823, Oregon Laws 1991, constituted a breach of contract with respect to all retirement benefits attributable to service rendered by PERS members before September 1991.

In *Chess v. State of Oregon*, Marion County Circuit Court Case No. 93C-11180, a class action, PERS retirees sought damages for the breach that *Hughes* recognized. In December 1997, the trial court in *Chess* approved a settlement that awarded damages for that breach to all PERS retirees who were PERS members before September 29, 1991. The legislature adopted the terms of the *Chess* settlement and codified them at ORS 238.375 to ORS 238.387. The implementation of HB 3349 and HB 2034 (1997) resulted in an annual increase in employer contribution rates of approximately 1.4 percent. That cost was a "permanent" annual expense to the system.[27]

[27] PERB assumed that the expense would continue for 30 years.

The second primary reason for the 1997 contribution rate increases was a change in assumptions due to the emergence of the Money Match as the highest likely benefit calculation for retirement allowances. As a result, the PERS actuary began to assume that Tier One member accounts annually would be credited with 8.5 percent interest, rather than 8 percent. Fund liabilities for projected benefits increased by more than $8 billion between 1995 and 1997, the largest two-year increase in the history of the system.[28] Correspondingly, the increase in assets to pay these benefits was also the largest in history.

In the 1997 valuation, the actuary noted that, in addition to the costs associated with the increase in benefits from the Money Match and HB 3349, the fund realized an actuarial gain from the increased value of investments, which partially offset the costs of the benefit increases. The total average rate increase from the 1997 valuation was 1.98 percent of payroll.

In the 1997 valuation, the actuary also noted that, in the judges' retirement system, which is a defined benefit plan with no Money Match element, strong market gains not only completely offset the costs of HB 3349 but also resulted in a decrease in the employer contribution rates, from 24.23 percent to 17.61 percent of payroll.

The 1999 valuation followed two exceptional years of equity market returns. The 1999 valuation showed some moderation in average employer contribution rates due to strong stock market returns in 1998 and 1999. On average, employer rates were reduced

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[28] If the cost attributable to HB 3349 is disregarded, the two-year increase in liabilities is still the largest in the history of the system.

from 11.4 percent to 10.74 percent of payroll. Projected fund liabilities increased by approximately $9 billion, while fund assets increased by more than $10 billion. The UAL of the fund declined from $2.55 billion to $943 million. However, the normal cost rate increased by 1.18 percent of payroll, from 8.64 percent to 9.82 percent. That increase was due, in part, to the actuary's increased earnings crediting assumption in the 1997 valuation.

System-wide employer contribution rates declined because the value of fund assets had increased by more than $10 billion over the previous two years. However, because the fund's actuarial liability for benefits increased by more than $9 billion, the normal cost rate increased. In 1999, every dollar contributed or credited to a Tier One regular account cost participating employers an additional $1.65.[29]

As discussed, the fund suffered overall losses in 2000-01 biennium. In December 2002, the actuary completed the 2001 valuation report. The final report proposed that employer contribution rates increase by an average of 5.74 percent of payroll. Of that amount, 0.92 percent reflected a change in the method of calculating a percentage of payroll by limiting calculations to payroll without pick up. That change had no financial impact on employers. The remaining 4.82 percent represented the increased cost to employers. At its February 2003 meeting, PERB voted to adopt the proposed contribution rates.[30] At about the same time, PERS staff projected that, by 2007,

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[29] The costs that account for the sixty-five cent premium include COLAs, HB 3349 adjustments, and the costs associated with the use of outdated AEFs.

[30] Because the legislature enacted the 2003 legislation, PERB did not, in the end, impose those rate increases.

employer contribution rates probably would increase to 25 percent of payroll and that they would remain at that level for years to come.

The 2001 actuarial valuation marked the first analysis of consecutive poor investment years by the PERS actuary. Before the 2001 valuation was completed, PERB adopted a "smoothing" method of accounting, whereby investment deviations from the assumed earnings rate would be recognized over a period of four years. Such techniques commonly are used to ameliorate the volatility of investment returns, with the goal of stabilizing employer contribution rates.

The use of the smoothing technique produced a 2001 valuation that somewhat exceeded the fair market value of fund assets.[31] The 2001 actuarial study also used a different process for calculating employer contribution rates than had been used in previous studies. Before 2001, contribution rates for employers who picked up employee contributions were expressed as a percentage of payroll that included the pick up. For reasons related to the administration of employer pooling programs, that methodology was changed to exclude the employee pick up from payroll. The change did not increase actual employer contributions, but it caused an increase in employer contribution percentage rates because, for most employers, those rates were now calculated on a lower wage base. On average, the change in calculation methodology resulted in a 0.92 percent increase in system wide contribution rates in 2001.

The fund gained approximately 24 percent in 2003. However, even with the 2003

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[31] Because of the use of smoothing, most of the investment losses from 2000, 2001, and 2002 have not yet been subtracted from the fund's assets and, thus, are not included in the calculation of employer contribution rates.

legislation in effect, employer contribution rates are expected to increase to about 15 percent of payroll and to remain at that level for at least the next 20 years. Employer contribution rates are not expected to return to their historic levels of nine to 11 percent of payroll.

H. *The Financing of UALs: 1999 to 2003*

The Oregon School Boards Association (OSBA) entered into an agreement with Seattle Northwest Securities in 2002, 2003, and 2004, whereby school districts could issue pension obligation bonds for the purpose of paying off all or a portion of their UALs. The OSBA was able to obtain favorable interest rates by using the state's bond rating. Interest rates on pension obligation bonds issued by the state and local governments generally range between 5 and 7 percent, which is a sufficient discount from PERB's assumed rate of 8 percent to make bonding a financially viable option for addressing UALs.

Between 1999 and 2003, more than 100 public employers, including the state, made lump sum payments that eliminated all or portions of their UALs. Those payments totaled approximately $4.75 billion. The payments were primarily funded by the issuance of pension obligation bonds. A payment reducing an employer's UAL generally reduces its contribution rate. However, the issuance of bonds to finance the payment creates a separate debt that the employer must repay to the bondholders. For an employer who has issued bonds to make lump sum UAL payments, pension costs therefore include both the employer's PERS contributions and its bond payments.

In late 2002, participating school districts issued bonds for more than $774 million in two series with 28-year terms. The interest rates were 6.1 percent and 5.49 percent. The total amount of pension obligation bonds issued by school districts in 2002, 2003, and 2004 was approximately $2.17 billion.

In 2002 and 2003, the Portland School District made lump sum payments totaling approximately $488 million to reduce its UAL. In 2003, PERS reduced the district's rate by 11 percent of payroll based on the lump sum payment. Including the debt service for pension obligation bonds that it issued to fund the payments, the district pays 12.64 percent of its payroll to finance PERS benefits. The district's general fund budget for fiscal year 2003-2004 is approximately $483 million. The lump sum payments that the Portland Public Schools made produced an actuarial surplus and resulted in a contribution rate below the normal cost for 2003.

In 1999, Multnomah County made a lump sum payment of $180 million to reduce its UAL, and it issued bonds to finance that payment. The payment produced a rate reduction equal to approximately two percent of the county's payroll. Based on the rates that PERB adopted in February 2003, the county's contribution rate was scheduled to increase to 12.85 percent beginning in July 2003.

In October 2002, the Roseburg School District made a lump sum payment to PERS of $20,115,791; that payment reduced the district's employer contribution rate by 4.84 percent of payroll. In 2003-04, the district will pay $914,300--approximately 4.1 percent of its payroll--to service the debt on the bonds that it issued to fund the lump sum payment.

In March 2002, the City of Corvallis made a lump sum payment of $22,696,489 to reduce its UAL, and it issued pension obligation bonds to fund that payment fully. PERB reduced the city's 2003 employer contribution rate by 7.17 percent of payroll based on the lump sum payment. The city's contribution rate was scheduled to increase from 10.61 percent of payroll in 2002 to 20.11 percent in 2003, and the city prepared its budget based on that projection.

In March 2002, the City of Eugene made a lump sum payment of approximately $67 million to reduce its UAL. It issued pension obligation bonds to finance the payment. The payment reduced the city's employer contribution rate by 6.49 percent of payroll. However, after it made the payment, the city's contribution rates continued to increase.

Lane County's general fund budget for 2003-04 is approximately $100 million. In 2002, Lane County made a lump sum payment of approximately $70.3 million; that payment reduced the county's employer contribution rate from 13.91 percent to 7.57 percent of payroll. However, before the enactment of the 2003 legislation, the county's 2003 rate was scheduled to increase again to 13.18 percent.

In February 2000, the Canby Utility Board made a lump sum payment of $1,266,000 to reduce its UAL. That payment reduced the board's 2000 employer contribution rate to 8.67 percent of payroll. The board made its lump sum payment from internal reserves.

The state of Oregon made a lump sum payment of $2 billion to PERS in October 2003. After the enactment of the 2003 legislation, the state's employer contribution rate was reduced by 5.87 percent of payroll--from 17.07 to 11.20 (unadjusted for its lump sum payment)--which is equivalent to approximately $117 million for 2003-04.

V. THE PROJECTED FUNDED STATUS OF THE SYSTEM BEFORE THE ENACTMENT OF THE 2003 LEGISLATION

Logic suggests that investment returns that substantially exceed the assumed earnings rate should improve the funded ratio of the PERS system. When part of such excess returns is distributed to employee accounts, member benefits are increased under the Money Match, thereby increasing employer liabilities. That additional cost is partially offset by two factors. First, to the extent that excess earnings are not allocated to employee accounts, they also will produce higher levels for reserve and employer accounts. Second, a higher return will increase funding of the BIF, which constitutes about half of the total assets of the fund, and, thus, it will inure to the benefit of employers.[32] Accordingly, robust earnings in the fund for 2003 should improve the funded ratio of the system and reduce employer contribution rates. However, the most persuasive evidence showed that, without the 2003 legislation, the PERS funded ratio

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[32] By contrast, if fund returns are poor, employer rates generally will increase. That effect is due in part to the assumed earnings rate, which is guaranteed even when employer accounts suffer losses. However, employer contribution rates also increase when fund returns are poor because, in such circumstances, fund earnings will be insufficient to fund the BIF reserve fully. When fund earnings are weak, the BIF reserve must be "trued up" by drawing from employer accounts, which creates upward pressure on employer contribution rates.

probably would not return to balance in the foreseeable future.

That evidence came from the report and testimony of defense actuarial expert witness, Gene Kalwarski.[33] Kalwarski presented numerous analytical models for the PERS system, including best estimate funding projections with and without the 2003 legislation and stress testing of adverse circumstances to examine the system's vulnerability to short term fund value fluctuations. Although I found much of his analysis logical and persuasive, I mention only two scenarios here. Both scenarios assumed that the 2003 legislation had not been enacted. In one, Kalwarski projected unusually strong market returns for the decade from 2003 through 2012. He projected returns of 24 percent, 20 percent and 16 percent for the first three years, and 8 percent for each of the remaining seven years. That analysis showed that, even under those circumstances, the PERS funding ratio would improve to only 94 percent. In the other scenario, covering the same period, Kalwarski projected unusually poor market returns for the first three years, that is, 9, 12, and 20 percent losses, respectively, followed by 8 percent returns for each of the remaining seven years. That analysis showed a funding ratio of 54 percent in 2012. According to Kalwarski, those two scenarios

> "demonstrate[] well an inherent flaw in the money match benefit provision and the way it was applied in the past. When returns are poor, the [s]tate's contribution doubled as a percentage of payroll, representing an increase of $2.8 billion. But when returns were strong, the [s]tate's contribution rate merely decreased by less than 6 percent of payroll."

Exhibit 574, p 40.

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[33] Kalwarski's report was received in evidence as Exhibit 574. Kalwarski's opinions regarding projected PERS funded ratios were reinforced by the testimony of former PERS director, James Voytko.

The utility of Kalwarski's conclusions arguably is limited in three respects, each identified by petitioners' counsel. First, Kalwarski did not consider the effect of HB 3349 on system liabilities and employer contribution rates beginning in 1997. Second, he did not consider the future dampening effect of HB 2001 (2003),[34] on the crediting of member accounts. Third, there are discrepancies in three of the data points used by Kalwarski and the other defense actuarial expert witness, Stonewall, in reporting historical system-wide employer contribution rates.

Although the first two limitations are real, they do not invalidate Kalwarski's broader conclusions. The annual impact of HB 3349 on contribution rates, although significant, does not begin to explain fully the failure of extraordinary fund growth during the 1990s to improve meaningfully PERS's overall funded ratio. Moreover, petitioners' decision not to challenge HB 2001 does not mean that other PERS members will not do so in separate litigation, perhaps relying on the same legal principles that petitioners advance in these cases.

I discuss the third issue at length to give the court a sense of the level of detail on which the resolution of some of the parties' factual disputes may depend. Kalwarski assumed, for purposes of his analysis, that the system-wide employer contribution rate for 1991 was approximately 15 percent, that the interim 2002 rate was about 16 percent, and that the projected rate for 2003, if the legislation had not been enacted, was approximately 20 percent. Stonewall assumed that the 1991 rate was approximately 10 percent, that the 2002 rate was 11.2 percent, and that the 2003 rate, without legislative changes, would

[34] HB 2001 is discussed in section VIII A on page 59.

have been approximately 16.5 percent. Petitioners' counsel cross-examined Kalwarski at length about those differences. Kalwarski lacked a ready explanation for them, because he had not reviewed Stonewall's assumptions in that regard. Petitioners asserted that, because of the unexplained discrepancy, it is reasonable to infer that Kalwarski's data is flawed and that his conclusions are unreliable.

It is important to understand the asserted discrepancies in the context of Kalwarski's opinions. First, they are not directly pertinent to Kalwarski's discussion of the funded status of the system at various intervals, because that analysis compares over time the ratio between system assets and liabilities. Contribution rates are the product, in part, of system liabilities, but the reverse is not true. Therefore, data errors involving contribution rates do not infect directly Kalwarski's funded status analysis. However, if Kalwarski relied on erroneous data in a portion of his report, his other opinions require close scrutiny to make sure that do not rely on similarly erroneous data.

In that regard, it is important to note that Stonewall and Kalwarski appear to have used different data only for 1991, 2002, and 2003. They used the same historical rates for 1993, 1995, 1997, 1999, and 2001. *See* Exhibit 573, ex 6-1; Exhibit 574, p 31. Therefore, their agreed data points are more numerous than the three apparent discrepancies.

Turning to the discrepancies themselves, there is a logical explanation in the record for the 1991 discrepancy. In fact, depending on the criteria used, the system-wide 1991 employer contribution rate *was* 15.09 percent. The actuarial valuation as of December 31, 1991, included, in part, in Exhibit 569, contains a detail of total PERS contribution rates. Exhibit 569, p 45. The total "actuarial valuation rate" for "retirement, (w/o USL & 6 Month Wait)" was 10.67 percent. However, the total actuarial valuation rate, including unused sick leave, return of contributions, retiree healthcare subsidies, and other components, was 15.19 percent. *Id.* Thus, there is no reason to believe that Kalwarski's figure for 1991 is erroneous simply because it differs from Stonewall's.

There is a reason, though, to consider whether the difference matters. The parties have suggested no logical basis for evaluating that issue. However, it is questionable whether the discrepancy is a significant one, particularly, if, as discussed below, it is the only discrepancy on which Kalwarski is vulnerable to challenge. It is the most remote data in time that Kalwarski used in his discussion of contribution rates. Exhibit 574, p 31. Moreover, Kalwarski's ultimate point is that, in a healthy retirement system, contribution rates should decline when earnings are strong. Because, in his opinion, that was not the case during the 1990s, a decade of extraordinary overall earnings, he opined that the system was dangerously asymmetrical before the 2003 legislation was enacted. If Kalwarski's 1991 contribution rate figure is erroneous, it would appear to understate the validity of his opinion, because, if accurate, that figure demonstrates that, in the period from 1991 through 1993, when the system earned an average return of almost 15 percent per year, the total contribution rate declined by almost 6 percent.[35] Put differently, Stonewall's 1991 figure may better support Kalwarski's ultimate opinion, that strong

[35] The fund earned 21.45 percent in 1991, 6.94 percent in 1992, and 15.04 percent in 1993. The system-wide employer contribution rate for 1993 was 9.19 percent.

earnings did not sufficiently reduce contribution rates in the 1990s, than does Kalwarski's own figure.

The question remains why such apparently significant discrepancies exist for 2002 and 2003. Here, however, the discrepancies are easily explained, and the explanation supports Kalwarski's choice of data. Stonewall obtained his figure for 2002 from the actuarial valuation as of December 31, 2000, and he obtained the 2003 figure from the interim valuation as of December 31, 2002. Exhibit 573, ex 6-1. By contrast, Kalwarski used the 16.5 percent contribution rate amount that Stonewall treated as the 2003 total employer contribution rate, as the 2002 interim contribution rate. That fact suggests that reporting "lag" at least partially explains the difference.[36] And, it does.

The system actuary frequently tracked the system's funded status during the 2003 legislative session. On July 30, 2003, the actuary reported to Director Voytko:

> "I have updated the Funded Status for May and June. For the sake of consistency, I decided to continue to track the UAL without the impact of 2003 legislation."

Exhibit 74, p 1. The accompanying two-page chart showed, among other data, the average system employer contribution rates, on a monthly basis, from January through July 2003, and it also showed the system total contribution rate from the December 31, 2001, actuarial valuation, and the projected contribution rate as of December 31, 2003, without the 2003 legislation. *Id.* at p 2. Consistent with Kalwarski's figures, the December 31, 2001, system total employer contribution rate was 16.5 percent, the July

[36] In fact, although he had not previously seen Stonewall's figures, Kalwarski testified that he suspected that lag was a culprit in the discrepancy. *See* Tr Feb 26, 2004, p 159.

2003 monthly figure was 20.9 percent, and the projected system total contribution rate for December 31, 2003, without the legislation, also was 20.9 percent.[37]

In sum, if anything, a close examination of system employer contribution rate data appears to support, rather than reveal flaws in, Kalwarski's opinions regarding the funded status of the system.

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[37] Again, a clue about the reason for the 1991 discrepancy is found in comparing the data shown on the two pages of the actuary's chart, Exhibit 74, pp 2, 3. The first page shows "system totals." The second page breaks the data down by category, segregating "pension benefit" data from "healthcare plan" data. The "pension only" average contribution rate figures are very similar to the system total figures on the previous chart: 15.8 percent for the December 31, 2001, valuation and 20.2 percent for July and December 2003. *Id.* Thus, it appears that the gap between the pension and healthcare portions of the rates changed over time. In 2003, the statistical difference was far less significant than in 1991.

Although petitioners also challenged Kalwarski's opinions on other grounds, I found those less vexing than the three discussed above.[38] It also struck me as significant that petitioners offered no contradictory opinion evidence on the subjects of Kalwarski's analysis. Instead, petitioners offered rebuttal evidence from actuary Brad Creveling that went to a somewhat different issue, namely, whether the existence of the assumed earnings rate guarantee is, by itself, a design flaw in the PERS system.[39]

Creveling testified that, based on historical data, petitioners in these cases would have received greater earnings credits and accordingly, larger account balances, if the

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[38] For example, petitioners pointed out that system-wide UALs declined from $17 billion, in early 2003, to $12.7 billion, in July 2003. Petitioners suggested that such a precipitous decline in UALs over a few months' time in a year of strong fund returns demonstrates the sensitivity of UALS to positive market forces. It is far from clear what were the cause or causes of that decline or that it reflected a positive trend. For example, as discussed, $4.75 billion in UAL were paid by employers from 1999 to 2003. Those payments, to the extent that they were bonded or otherwise financed, merely shifted the employers' indebtedness to another form. Moreover, some of the investment losses for 2000, 2001, and 2002 have not yet been subtracted from the fund's assets and, thus, are not included in the calculation of UALs, because of the asset smoothing technique instituted by the PERS actuary in 2000.

[39] I do not understand defendants to assert that the guarantee is the sole cause of the prelegislation distress in the PERS system.

assumed earnings rate guarantee had not been in effect. Therefore, he opined, the guarantee did not operate to increase their member benefits. Creveling assumed, in reaching that opinion, that virtually all fund earnings in excess of administrative expenses would have been allocated to member accounts. Creveling did not analyze the effect of such an earnings crediting policy on system costs, nor did he address the effect of the Money Match, together with the guarantee, on the funded status of the system. Thus, his opinion did not undermine Kalwarski's analysis.

Moreover, whether the guarantee, by itself, constitutes a system "flaw," depends on the perspective of the beholder. Although some members have preferred to maximize their variable account contributions, the guarantee offers risk conscious Tier One members the best of two worlds. It insulates their account balances from the downside risks of market volatility and, as administered by PERB, it historically has provided them with the benefits of strong market returns. In other words, as administered by PERB, the guarantee has reduced the aversion of prudent Tier One members to investment risk, whereas it has heightened the risk to employers. Thus, in the milieu of volatile markets, the guarantee promotes asymmetry between the allocation of investment risk and reward in the PERS system.

To recapitulate: Poor fund investment performance in 2000, 2001, and 2002, together with significant growth in fund liabilities, produced large increases in system-wide UALs and employer contribution rates. Because most of the fund's earlier investment gains in excess of the assumed earnings rate had been credited to Tier One regular accounts, thereby converting those gains into increased benefits under the Money

Match, reserves available from the preceding years of exceptional fund performance were insufficient to offset investment losses in 2000, 2001, and 2002.

The structure of the PERS system, as administered by PERB, was especially vulnerable to a market sequence in which several years of exceptional fund performance were preceded or followed by several years of poor fund performance. That combination of factors fueled the acceleration of system costs, and it adversely affected the system's funded status for the foreseeable future.

VI. THE "REASONABLENESS" AND "PRUDENCE" OF PERB PRACTICES

Defendants have proposed a number of findings to the effect that various PERB administrative practices--especially those pertaining to the allocation of earnings and the funding of reserves--were unreasonable and imprudent. *See, e.g.*, Defendants' Joint Supplemental and Revised Proposed Findings of Fact 250, 254-58. Because I have not included extensive findings on that subject in this report, a brief explanation is in order.

Defendants assert that the gain-loss reserve should have been funded at 24- to 36-months' earnings at the assumed earnings rate. I agree. Therefore, I recommend that the court find that PERB's failure to consistently fund the gain-loss reserve at a 30-months' earnings level was unreasonable and imprudent. However, even a 30-month gain-loss reserve level could offset no more than a 20-percent decline in the fund's value or, put differently, two and one-half years of zero earnings. Thus, fully funding the gain-loss reserve at that level would not, without more, have prevented the growth of UALs arising from the 2000-02 downturn.

The question becomes what more PERB should have done to prevent the system's distressed condition. Most obviously, it could have funded the contingency reserve after 1979. PERB offered no explanation for its failure to fund the reserve at all for nearly 25 years, particularly in view of its statutory authority to fund such a reserve so as "to prevent any deficit of moneys available for the payment of retirement allowances, due to interest fluctuations" or "changes in mortality rate." ORS 238.670(1). In fact, PERB's own counsel conceded that it should have done so. Markets fluctuate and mortality rates have changed over time. Accordingly, it makes no obvious sense that PERB failed to fund the contingency reserve for either of the foregoing purposes from 1979 to 2003.

If PERB had funded the contingency reserve in years when annual fund earnings exceeded the assumed rate, the system's funded status probably would have been more nearly balanced in early 2003. Because there is no evidence in the record to suggest that PERB should have funded the reserve at any particular level, though, or what the effect of a particular funding level on system liabilities would have been, I cannot recommend a more precise finding on the subject.

Finally, one of the most prominent disputes among the parties regarding PERB's earnings crediting practices is the legal question of what use can be made of available fund earnings that are not credited to the contingency reserve, the gain-loss reserve, or the BIF. Some of defendants' expert witnesses opined that so-called "excess earnings" above the assumed earnings rate could, and should, be retained to offset future fund losses. Petitioners disagree with that proposition. They assert that such earnings must be credited to member accounts. I leave that question, if it is to be answered in these cases, to the court. I mention it here only because it is implicated in the parties' dispute regarding the reasonableness and prudence of PERB's earnings allocation decisions.

VII. THE CITY OF EUGENE LITIGATION

Three local government employers, including the City of Eugene, challenged their 1998 employer contribution rate orders by filing an action against PERB in Marion County Circuit Court (the *City of Eugene* case). Several employers also challenged PERB's order allocating 1999 earnings, and those claims were consolidated with the *City of Eugene* case.

In October 2000, PERB issued new rate orders to PERS employers. Nine participating employers challenged their 2000 rate orders, and those claims also were combined or consolidated with the *City of Eugene* case. Several individual PERS members intervened in the employers' challenges to the rate orders.

In July 2001, the trial court in the *City of Eugene* case held that PERB had incorrectly calculated retirement benefits for members who had participated in the variable annuity program and retired with a Money Match benefit. The court also held that PERB had abused its discretion by failing to fund a contingency reserve under ORS 238.670(1) (1999). In June 2002, the court concluded that PERB erroneously had adopted OAR 409-005-0055(5) and that it also had erred by calculating retirement benefits so that employers had to match variable account earnings in excess of the assumed earnings rate. The court also held that PERB had abused its discretion in crediting 20 percent interest to Tier One regular accounts for 1999, rather than allocating part of those earnings to reserves. The court remanded the three challenged orders to PERB with instructions to reissue them in a manner consistent with its judgment.

PERB and the intervenors appealed that judgment. The employers and PERB later entered into a settlement agreement, and PERB has moved to dismiss the appeal.

The settlement agreement provides, among other things, that PERB will recalculate the petitioners' employer contribution rates, will comply with the law as interpreted by the Marion County Circuit Court, as modified by the 2003 legislation, and will issue a new and revised order allocating 1999 earnings.

The settlement agreement also provides that PERB will not reduce the value of member accounts as a result of the 1999 earnings allocation if Sections 5 and 10 of HB 2003 are permitted to take effect. If Sections 5 and 10 of HB 2003 are invalidated or otherwise do not take effect, PERB will reallocate 1999 earnings credited to Tier One member accounts from 20 percent to 11.33 percent. Reallocating 1999 earnings credited to member accounts to credit 11.33 percent, rather than 20 percent, would reduce projected future benefits to a greater degree than would the application of Sections 5 and 10 of HB 2003. Under the terms of the settlement agreement, PERB would not use the methods specified in Section 14(b) of HB 2003 to remedy the errors identified by the trial court in the *City of Eugene* case.

VIII. THE 2003 LEGISLATION

A. *HB 2001*

HB 2001 was the first significant PERS legislation enacted by the 2003 legislature. HB 2001 generally provides that no earnings in excess of the guaranteed assumed earnings rate will be allocated to Tier One member accounts until the 30-month funding goal for the gain-loss reserve has been fulfilled for three consecutive years. The

PERS actuary opined that, if enacted alone, HB 2001 would have decreased the system-wide UAL for 2001 by $904 million and that it would have reduced employer contributions rates by 1.49% of payroll in July 2004. Petitioners do not challenge HB 2001.

B. *HB 2003 and HB 2004*

HB 2003 and HB 2004 amended a number of provisions of ORS chapter 238. The following section of this report examines the challenged provisions of HB 2003 and HB 2004 in the context of petitioners' specific claims. It includes recommended findings of fact relating to the effects of those provisions. I preface it with a brief discussion of a legal issue that pervades these cases, namely, whether the challenged provisions operate prospectively or retroactively, that is, whether they affect accrued benefits.

The concept of "accrued benefit" does not fit neatly with a plan such as PERS, which is an employer funded defined benefit plan that is enhanced by employee contributions and an employer matching benefit. In fact, the parties disagree as to whether, in a plan like PERS, the concept of "accrued benefit" has any meaning at all and, if it does, what it means. Those issues were the subjects of testimony and argument at the evidentiary hearing.

Petitioners assert that the term has no application to PERS. The Internal Revenue Code defines the term "accrued benefit." *See* IRC § 411(7). However, according to the expert opinion evidence presented in these cases, government pension plans are exempt from the provisions of the IRC relating to accrued benefits. In fact, the PERS actuary does not use that term in his reports. Instead, PERS considers, where appropriate, a different concept, namely, the present value of projected future benefits.

Petitioners assert that, even if the accrued benefit concept applies to PERS, for certain changes effected by the 2003 legislation, the protection of accrued benefits would require the future crediting of interest on their member account balances after the effective date of the change, a feature that the challenged provisions fail to provide.

By contrast, defendants assert that the concept is meaningful in the PERS context and that, because PERS is a defined benefit plan, accrued benefits arising under it must be definitely determinable. Because the assumed earnings rate is subject to prospective change, defendants assert that future earnings credits to employees' member accounts are not definitely determinable before their retirement. Therefore, defendants reason, earnings credited to account balances after the effective date of the challenged provisions were not accrued when the provisions took effect. Defendants also argue that the savings projected from the implementation of the 2003 legislation will be accomplished by reducing projected future member benefits; they assert that the legislation does not reduce any member's account balance or reduce any benefits that any member earned before the effective date of the legislation.

If the terms "prospective" and "retroactive" are substituted for "accrued benefits," the parties' arguments appear to remain the same. I have concluded that this particular dispute primarily involves a question of law, rather than one of fact. Therefore, I hazard no opinion as to the correct legal conclusion. However, I have attempted to make predicate findings of fact in connection with those provisions concerning which there is a dispute as to their effect, if any, on accrued benefits.

1. *Claims Made by All Petitioners*

a. HB 2003, Section 1--Elimination of Employee Individual Accounts (*e.g.*, *Strunk* petitioners' claims 1-4)

Before the enactment of HB 2003, all active PERS members contributed, either directly or by employer pick up, 6 percent of their salaries to their member accounts. Earnings from those contributions also were credited to the members' accounts. *See* ORS 238.200(1)(a) and (b) (2001); ORS 238.205 (2001); ORS 238.250 (2001). Sections 1 and 13 of HB 2003 provide that all participant contributions made after January 1, 2004, will be placed into an Individual Account Plan (IAP), which at one point was referred to as a "transitional account," and no longer will be credited to member accounts. ORS 238.200(4) (2003).

The diversion of member contributions to the IAP will reduce members' future account balances for purposes of employer matching under the Money Match formula. On a system-wide basis, the elimination of employee contributions from the Money Match calculation probably will cause the Full Formula option to overtake the Money Match as the most common retirement formula. Although members will receive balances held in the IAP, those balances will not be matched by employer contributions, enhanced by cost of living increases, or annuitized at the assumed earnings rate as part of a defined benefit package.

HB 2003 changes the current system by eliminating employee contributions as of January 1, 2004. Section 1(4). Sections 1 and 13 of HB 2003 do not affect all PERS members uniformly. Long term members who have accumulated substantial account balances and who will retire in the near term will suffer relatively small reductions in their retirement allowances. By contrast, many mid-career Tier One members who expected to retire under the Money Match formula will revert to the Full Formula benefit because of the cessation of contributions to their member accounts. New members, on the other hand, including many Tier Two members who have not accumulated substantial member account balances, actually will receive increased benefits under Sections 1 and 13. They will receive a Full Formula benefit funded by their employers in addition to their IAP balances. Sections 1 and 13 have no effect on the pick up of members' contributions by employers.

Sections 1 and 13 do not affect members' retirement benefits for work performed before January 1, 2004.

If upheld, Sections 1 and 13 will reduce the UAL of the PERS system, as determined in the 2001 valuation, by $1.9148 billion, with a corresponding reduction of 6.98 percent in employer contribution rates.

b. HB 2003, Section 5--Redefinition of Assumed Earnings Rate Guarantee (*e.g.*, *Strunk* petitioners' claims 5-8; *Petrillo* petition)

Before the enactment of section 5 of HB 2003, all Tier One members were guaranteed that earnings would be credited annually to their member accounts at a rate no lower than the assumed earnings rate. *See* ORS 238.255 (2001). Since January 1, 1990, the assumed earnings rate has been fixed at 8 percent. Section 5 amends ORS 238.255 by prohibiting the allocation of earnings to Tier One member accounts, including the undistributed accounts of deceased members, in any year in which a deficit exists in the gain-loss reserve or the allocation of earnings would result in a deficit in the gain-loss reserve, unless the allocation is necessary to increase a retiring member's account balance to 8 percent per year on a compounded basis for the member's total years of creditable service. ORS 238.255 (2003).

Section 5 affects the annual crediting of earnings to Tier One member accounts beginning in calendar year 2003, but it will not affect the crediting of earnings to member accounts for any member who retires before April 1, 2004. Section 5 appears to affect two categories of annual earnings crediting for active and inactive Tier One members: (1) the future crediting of earnings at the assumed rate based on contributions for work performed before its effective date; and (2) the future crediting of earnings at the assumed rate based on contributions made after its effective date for work not yet performed as of that date.

Section 5, together with section 8 of HB 2003, will limit future earnings crediting when the fund's reserves are low or in deficit, but, as discussed below, regular Tier One accounts will be credited with at least the assumed interest rate, compounded over the life of the account, on the member's retirement. HB 2003, § 8, *as amended by* HB 3020, § 12 (*codified at* ORS 238.258).

The precise effect on the future accumulation of benefits for any particular member is indeterminable because the future performance of fund investments is unknown. However, the probable effect of section 5 is to reduce the future growth of Tier One members' regular accounts.

Section 5, if upheld, will reduce the total UAL of the PERS system, as calculated in the 2001 valuation, by a total of $4.5987 billion, with a corresponding decrease in employer contribution rates of 4.32 percent.

c. HB 2003, Sections 5 and 6--Repayment of Deficit (*e.g.*, *Strunk* petitioners' claims 9-12)

Before the enactment of Sections 5 and 6 of HB 2003, PERB was authorized to create a reserve to offset the deficit created for years in which fund earnings were less than the assumed earnings rate, and the reserve account could not be maintained in a deficit position for more than 5 years. *See* ORS 238.255 (2001). After five years of deficit, participating employers were required to pay any deficit in the reserve. *Id.* The latter feature is commonly known as "the call." Sections 5 and 6 of HB 2003 eliminated those statutory requirements.

There never has been a five-year deficit in the reserve account, and the "call" provision never was implemented. The parties presented no evidence as to what, if any, economic impact to system stakeholders, including employers and members, will result from those amendments. However, the elimination of the call provision does not render the fund actuarially unsound.

d. HB 2003, Section 8--Change in Method of Crediting Accounts (*e.g.*, *Strunk* petitioners' claims 13-16)

Before the enactment of Section 8 of HB 2003, regular member accounts had to be credited annually with an amount equal to the assumed earnings rate for that year. ORS 238.255 (2001). Section 8 provides that the crediting of member accounts at the assumed earnings rate must occur on a career-long, not an annual, basis.

Section 8 affects the future annual crediting of earnings to Tier One member accounts for members who retire on or after April 1, 2004. ORS 238.258(3)(a)

(2003). There is no evidence in the record as to the economic impact of Section 8.

e. HB 2003, Sections 9 and 10--Elimination of COLA (*e.g.*, *Strunk* petitioners' claims 17-20)

Before the enactment of Sections 9 and 10 of HB 2003, PERS retirees were entitled to annual cost of living adjustments (COLA), not to exceed a maximum of 2 percent, based on changes in the Consumer Price Index. ORS 238.360 (2001). Sections 9 and 10 provide that members who retired on or after April 1, 2000, and before April 1, 2004, will not receive COLAs until their monthly allowances equal or exceed the allowances they would have received had their member accounts been credited with 11.33 percent, rather than 20 percent, interest, for calendar year 1999. Under Sections 9 and 10, COLA benefits for retirees in that cohort probably will be reduced or eliminated for several years.

In defendants' view, Sections 9 and 10 merely change a projected future benefit, rather than reduce any member's account balance. In petitioners' view, Sections 9 and 10, by suspending COLAs, reduce the future value of contributions credited to the member accounts of subject retirees based on work performed before retirement. However, the issue whether those sections affect accrued benefits may depend on the determination whether the adjustments properly offset benefits credited, but not lawfully creditable, to the recipients.

If Sections 9 and 10 are upheld, the UAL of the PERS system, as calculated in the 2001 valuation, will be reduced by $413.7 million, with a corresponding reduction of 0.39 percent in employer contribution rates.

f. HB 2003, Section 3--Elimination of Variable Account (*e.g.*, *Strunk* petitioners' claims 21-22)

Before the enactment of Section 3 of HB 2003, PERS members could elect to have 25, 50 or 75 percent of their employee contributions allocated to variable accounts, and they were entitled to purchase a variable annuity at retirement with their variable account balances. ORS 238.260 (2001). Section 3 of HB 2003 provides that, after December 31, 2003, members no longer are permitted to direct contributions to the variable account. ORS 238.260(3)(b) (2003).

Section 3 does not affect contributions credited to member accounts before its effective date. There is no evidence in the record as to the economic impact of Section 3.

g. HB 2003, Section 14b(1)(a)--Elimination of COLA as Remedy for City of Eugene Judgment (*e.g.*, *Strunk* petitioners' claims 23-25)

Before the enactment of section 14b(1)(a) of HB 2003, PERS retirees were entitled to receive annual COLA adjustments. ORS 238.360 (2001). In section 14b(1)(a), the legislature directed PERS to immediately suspend COLAs for all members who retired between April 1, 2000 and March 31, 2004, until the benefits that the trial court in the *City of Eugene* case found to have been erroneously credited to member accounts are recovered. The change affects more than 20,000 retirees. The suspension of the COLA probably will not repay fully any excess earnings crediting to member accounts for 1999.

Section 14b(1)(a) affects the value of contributions credited to the member accounts of subject retirees based on work performed before retirement. However, the issue whether that section affects accrued benefits may depend on the determination whether the adjustments properly offset benefits credited, but not lawfully creditable, to the recipients.

As discussed, under the terms of the settlement agreement in the *City of Eugene* case, PERB would not use any of the methods specified in Section 14(b) to remedy the errors identified by the trial court in that case. Therefore, if Sections 5 and 10 of HB 2003 are permitted to take effect and the settlement agreement is upheld, section 14b(1)(a) will be inoperative.

h. HB 2003, Section 14b(1)(b)--Reduction of Current Employee Accounts to Enforce *City of Eugene* Judgment (*e.g.*, *Strunk* petitioners' claims 26-29)

Before the enactment of HB 2003, section 14b(1)(b), active PERS members were guaranteed that earnings on their individual accounts, minus allocations for administrative expenses and properly constituted reserves, would be credited to their member accounts. ORS 238.255 (2001); ORS 238.610 (2001); ORS 238.670 (2001). Under section 14b(1)(b), the present value of benefits that the trial court in the *City of Eugene* case determined were erroneously credited to retirees are to be treated as an administrative expense of the system and charged against future fund earnings on active Tier One members' accounts. The treatment of such payments as administrative expenses will have the effect of reducing the amount of earnings credited to Tier One members' accounts for calendar year 1999. However, that treatment does not affect accrued benefits if the court determines that it properly recovers benefits credited, but not lawfully creditable, to the recipients.

The total amount recoverable from active members is approximately $4 billion. However the separate economic impact of section 14b(1)(B) was not integrated into the actuary's overall analysis of the impact of the 2003 legislation.

As discussed, under the terms of the settlement agreement in the *City of Eugene* case, PERB would not use any method specified in section 14(b) to remedy the errors identified by the trial court in that case. Therefore, if Sections 5 and 10 of HB 2003 are permitted to take effect and the settlement agreement is upheld, section 14b(1)(b) will be inoperative.

i. HB 2003, Section 14b(2)--Employers Not Responsible for Mistakenly Paid Benefits (*e.g.*, *Strunk* petitioners' claims 30-33)

Before the enactment of HB 2003, participating employers were required to fund the PERS system in amounts determined to be actuarially necessary to adequately fund the promised benefits. ORS 238.225 (2001). HB 2003, section 14b(2), provides that employers' responsibility to fund the system excludes any benefits that the trial court in the *City of Eugene* case determined were mistakenly paid. There was no evidence as to the economic impact of section 14b(2).

As discussed, under the terms of the settlement agreement in the *City of Eugene* case, PERB would not use any method specified in section 14(b) to remedy the errors identified by the trial court in that case. Therefore, if Sections 5 and 10 of HB 2003 are permitted to take effect and the settlement agreement is upheld, section 14b(2) will be inoperative.

j. HB 2004, Section 4--Change to Actuarial Equivalency Factor Tables (*e.g.*, *Strunk* petitioners' claims 34-36)

Before the enactment of HB 2004, members' retirement benefits were based on AEFs that PERB adopted pursuant to OAR 459-005-0055. As discussed, that rule, as amended, provided that the benefits of members who joined the system before 1999 could not be reduced by the application of new AEFs. The life expectancies of PERS members have increased since PERB adopted the prelegislation AEFs.

For employees who became members before 1999 and retire on or after July 1, 2003, and before January 1, 2005, section 4 requires PERB to calculate the annuity in two ways, and then pay the higher of the two amounts. The first amount is calculated based on the member's effective retirement date. PERB is required to use AEFs based on the mortality assumptions of the PERS actuary's 2001 experience study. PERB then must apply the new AEFs to the retiree's entire member account balance as of the effective retirement date. PERB also must calculate a second amount by creating an account balance as of June 30, 2003, that consists only of employee contributions and earnings accrued as of that date. Based on that account balance, PERB is required to determine the retiree's annuity using the AEFs in effect on June 30, 2003. The retiree is entitled to receive the higher of the two calculations.

Subsection (3) of section 4 of HB 2004 requires PERB to adopt new AEF tables to become effective January 1, 2005. For employees who became members before 1999 and retire on or after January 1, 2005, Section 4 requires PERB either to (1) apply the AEFs in effect on the effective date of the member's retirement to all of the member's contributions and earnings on those contributions; or (2) apply the AEFs in effect on June 30, 2003, but determine the member's annuity based only on employee contributions and earnings accrued on or before June 30, 2003.

Section 4 includes a "look back" provision for the application of new actuarial equivalency factors. Under that provision, retirees will receive no less than the benefit they would have received had they retired on June 30, 2003, under the AEFs in effect on that date. However, section 4 probably will produce an annuity that is lower than the annuity payable under OAR 459-005-0055, at least for members who retire within a few years after January 1, 2005. The old AEFs probably will wear away over a period from one to three years, depending on a member's retirement age. For younger retirees, the switch to updated AEFs will have a smaller effect on benefits.

The issue whether section 4 reduces a benefit accrued for work performed before June 30, 2003, may depend, in part, on the legal question whether the protection of that benefit requires the accrual of interest on a member's account balance from June 30, 2003, until the member's effective retirement date or some other date. That feature, which section 4 does not include, is sometimes described by actuaries as "look back with interest."

The percentage changes in projected future retirement benefits for Tier One employees, based on age, resulting from the adoption of new AEFs, are set out in the following table:[40]

<u>Average Age</u>	<u>Tier One</u>

[40] The table was included in the report of expert witness Alan Stonewall. (Exhibit 573, table 11-2).

22	-1.84%[41]
27	-2.76%
32	-3.50%
37	-4.51%
42	-5.09%
52	-5.39%
57	-5.63%

If upheld, section 4 will reduce the UALs of the PERS system, as calculated in the 2001 valuation, by $1.588 billion, with a corresponding reduction in employer contribution rates of 2.09 percent.

k. Violation of Contract and Takings Clauses of the United States Constitution (*e.g.*, *Burt*, *Dahlin*, and *Evans* petitions)

The petitioners in the *Burt*, *Dahlin* and *Evans* cases allege that each of the challenged provisions of HB 2003 and HB 2004 violate the Fifth and Fourteenth Amendments to the United States Constitution.

l. HB 3020, Sections 17 and 17a--Unreasonable Limitation for Filing Claims (*Sartain* petition)

Petitioner Sartain alleges that Sections 17 and 17a of HB 3020 have deprived her of due process in violation of Article I, section 10, of the Oregon Constitution by limiting to 30 days the time within which she could seek relief from the 2003 legislation. The parties presented no evidence on that issue.

m. HB 2003 and HB 2004–Discrimination Against Older Workers (*Dahlin* petition)

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[41] Because Tier One was closed in 1996, there is no reason to believe that any Tier One members are in this age category.

Petitioner Dahlin alleges in his Sixth Claim for Relief that the challenged provisions of HB 2003 and HB 2004 impermissibly reduce the retirement benefits of older workers in violation of Article I, section 20, of the Oregon Constitution.

n. Impact of HB 2003 and HB 2004 on Tax-Qualified Status of PERS Plan (Fifth and Seventh Claims of *Dahlin* petition)

Petitioner Dahlin alleges that HB 2003 and HB 2004 impair or breach his PERS contract by changing his benefits in such a manner that those benefits no longer are "definitely determinable" or free from employer discretion as required by the Internal Revenue Code. He also seeks a declaratory judgment that HB 2003 breaches and impairs his PERS contract and impermissibly takes his property by changing the method of funding the PERS trust and diverting trust assets without the consent of all trust beneficiaries.

IX. THE ECONOMIC GOALS AND IMPACTS OF HB 2003 AND HB 2004

Before the enactment of the 2003 legislation, PERS already had structural inequities. Therefore, designing a reform package with equalized impacts would have been extremely difficult. The proponents of the legislation set goals that would substantially reduce escalating costs but that would not reduce average employer rates to their historical levels. They sought to level out average employer contributions rather than reduce them to 10 to 12 percent. They also stated goals of protecting retirees and mitigating the legislation's impact on current employees. The legislation's cost savings have been used to help balance the state's budget.

A. *Effect of the 2003 Legislation on Member Benefits*

Projected future benefits are determined by the PERS actuary by computing the benefit earned to date plus the benefits expected to be earned in the future. The 2003 legislation will slow the growth of future PERS retirement benefits and employer costs. Some PERS members' projected future benefits, including those of Tier Two members, will be higher than they would have been without the legislation. Other members' future benefits, especially those of mid- and late-career Tier One general service members, generally will be lower as a result of the legislation. As discussed, Section 4 of HB 2004, pertaining to the use of AEFs, has the most economic impact on older workers.

The Governor's policy team anticipated that, in general, the 2003 legislation would reduce the benefits of members approaching retirement by 5 to 10 percent. The policy team anticipated that mid-career employees--that is, those within 10 years of retirement--would experience greater impacts on their future benefits. The policy team anticipated that shorter term, newly hired employees, actually would receive an increase in their benefits due to the 2003 legislation.

PERS Tier One is a closed system with an aging population. The overall projected changes, based on age, in future retirement benefits for Tier One members resulting from the legislation, is set out in the following table:[42]

Average Age	Tier One
22	17.98%[43]
27	1.28%
32	-4.70%
37	-11.91%
42	-17.14%

[42] This table also appears in Stonewall's report. *See* Exhibit 573, table 17-1.

[43] *See* footnote 41, p 71.

47	-19.35%
52	-20.56%
57	-11.31%

The projected future benefits of all petitioners in these cases probably will be reduced as a result of the legislation. However, as restructured by HB 2003 and HB 2004, PERS will not provide less than a Full Formula benefit to any member. All Tier One and Tier Two members will receive more than a Full Formula benefit, because their account balances will continue to grow and be credited with no less than the assumed interest rate over their careers, and their future contributions will accumulate in the IAP and supplement their monthly retirement allowances.

B. *Effect of the 2003 Legislation on Employer Costs*

The immediate combined effect of HB 2003 and HB 2004 was to reduce average employer contribution rates by approximately 6 percent and reduce the system's UAL by $8.5 billion. However, average employer contribution rates are expected to increase to about 17 percent of payroll and to remain at that level for at least the next 20 years. Employer contribution rates are not expected to return to historic levels of 9 to 11 percent of payroll. If the investment income of the fund exceeds the actuary's assumed earnings rate, employer contribution rates will be lower than projected. If the investment income of the fund is less than the assumed earnings rate, employer contribution rates will be higher than projected.

The total UAL for school districts before enactment of the 2003 legislation was approximately $3 billion. The 2003 legislation saves school districts approximately $2.3 billion annually. The school districts used a 28-year payment schedule for the bonds that they issued to pay their UALs. Disregarding lump sum payments made by individual school districts, contribution rates for all school districts were reduced from 18.11 percent to 11.11 percent of payroll.

As a result of the 2003 legislation, the contribution rate for the Portland Public Schools was reduced by 6.83 percent of payroll--from 18.11 to 11.28 percent (unadjusted for its lump sum payments)--which resulted in savings of approximately $15.7 million for 2003-04. The district is holding approximately $8 million in a reserve account pending the outcome of this litigation. The general fund budget for Portland Public Schools for fiscal year 2003-04 is approximately $483 million.

The 2003 legislation reduced the Roseburg School District's employer contribution rates by 6.83 percent of payroll, which saved the district $1,587,495 for fiscal year 2003-04. If the district had to pay higher employer contribution rates, it would lose approximately five teachers for every percent increase of payroll.

The 2003 legislation reduced the employer contribution rate of the Canby Utility Board by 6.16 percent of payroll, or approximately $53,000, for fiscal year 2003-04. That savings will allow the Canby Utility Board to absorb increases in power costs without increasing its customers' rates.

Before 1997, the City of Corvallis's employer contribution rate ranged from 8 to 9 percent. The city joined the local government PERS pool in January 2002. In March 2002, the city made a UAL payment of $22.7 million with pension obligation bonds. As a result of the 2003 legislation, the contribution rate of the city was reduced by 5.08 percent of payroll--from 20.11 percent to 15.03 (unadjusted for its lump sum payment)--

which represents a savings of $1.3 million to its 2003-04 fiscal year budget.

Based on the 2003 legislation, PERB reduced Lane County's contribution rate by 7.09 percent of payroll, or $4,860,000, for fiscal year 2003-04. As a result, Lane County will be able to reinstate some positions that were cut to accommodate rising PERS costs.

After the legislation was enacted, Multnomah County's contribution rate was reduced by 5.72 percent of payroll--from 12.85 to 7.13 (adjusted for its lump sum payments)--which is equivalent to approximately $12 million for fiscal year 2003-04.

The City of Eugene's employer contribution rates ranged from 8 to 10 percent for a 20-year period. In 2001, the rate increased to 13.2 percent. In 2002, the gross rate remained at level, but it was reduced to 7.55 percent based on a lump sum UAL payment financed by the sale of pension bonds. Before the 2003 legislation was enacted, the city's rate was projected to increase to 20.06 percent. Based on the 2003 legislation, PERB reduced the City of Eugene's contribution rate by 5.85 percent, to 14.15 percent of payroll (unadjusted for its lump sum payment). The city has reserved the savings pending the outcome of this litigation.

After the enactment of the 2003 legislation, the state's employer contribution rate was reduced by 5.87 percent of payroll--from 17.07 to 11.20 (unadjusted for its lump sum payment), which is equivalent to approximately $117 million for 2003-04.

X. ECONOMIC HARDSHIP DEFENSES

A. *Overview*

During the early 1990's, Oregon ranked in the upper 10 to 14 states in the nation in terms of overall tax burden.[44] Oregon's state tax burden currently is approximately .7 percent less than the national average. Composite tax rates--state and local--are slightly lower, for example, than they were in 1989. Even with a .4 percent increase in personal income tax rates, Oregonians still would be taxed at slightly lower overall rates than prevailed at that time.[45]

However, there is little voter willingness to raise taxes to provide additional government revenues. According to a recent public opinion survey, Oregonians believe that only about 39 cents out of every tax dollar are well spent. Moreover, the recession that began in 2000 caused the largest decline in state tax revenues since the 1930s. Between 2001 and 2003, general fund revenues decreased for the first time since the 1930s. The state's bond ratings recently have been downgraded, and it now has one of the lowest ratings in the nation. Oregon's unemployment rate is among the highest in the nation. From 2000 to 2003, Oregon lost 45,000 jobs. State and local governments have

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[44] "Tax burden is usually measured by summing up all taxes and dividing by the total amount of personal income for all the residents in a state." *See* 2003 Oregon Public Finance: Basic Facts, Research Report #103," published by the Legislative Revenue Office. Exhibit 54, p A2.

[45] The quoted statistics are taken from the testimony of the Oregon State Economist, Thomas Piotowsky, and Exhibit 54. A .4 percent increase in income taxes would yield $422 million in annual revenue, which is the projected amortized first year cost of invalidating HB 2003 and HB 2004.

been forced to make substantial cuts in important government services, including higher education, primary and secondary education, health and human services, public safety and the justice system. State employees currently are subject to a freeze on wage increases--both merit and COLA increases--and have suffered layoffs because of the state's poor fiscal condition.

There is no single common definition of a fiscal crisis in the context of state government finance. However, some historical perspective is helpful in analyzing the issue. According to the Oregon State Economist,[46] the state has experienced two distinct types of recessionary pressures during the last twenty-two years. A "supply shock" recession occurred in Oregon in the 1981-83 biennium. During the 1981-83 recession, employment in Oregon dropped by 15 to 17 percent. During the early 1990s, Oregon experienced another supply shock recession.

Most recently, beginning in 2000 and continuing through 2002, Oregon experienced a different type of recession, described by the state economist as a "capital downturn." That recession caused a greater impact on state tax revenues than previous economic downturns over the past two decades. However, it did not compare in magnitude or duration to the Great Depression of the 1930s. It also had less severe overall effects than the 1981-83 recession. For example, unemployment rates during the 2000-02 recession were lower than rates experienced during the 1981-83 downturn.

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[46] The Oregon State Economist routinely makes quarterly economic and revenue forecasts for the state, using generally accepted forecasting models. The economic and revenue forecasts of the state economist's office are, generally speaking, accurate to within 8.2 percent of predicted values, based upon a 95 percent confidence level.

Oregon's economy currently is slowly recovering from the 2000-02 recession. The state economist predicts that Oregon will experience a 15.5 percent increase in general fund revenues for the 2003-05 biennium.

The recent history of Oregon's economic cycles must be evaluated in light of the state's tax structure. Oregon's tax structure, and its resulting revenue stream, are highly dependent on personal income taxes. Because income tax revenues can vary greatly with the general economic climate, they are highly volatile in nature. In addition, Oregon's kicker law dampens the state's ability to reserve or save funds during periods of greater revenue flow. Because of Oregon's tax structure, it is foreseeable that it will, in future recessions, experience sharper revenue downturns than states with less volatile tax structures.

Because much of the state general fund is spent on constitutional and federal mandates and other legally compelled expenditures, reductions in the general fund affect education, health and human services, and the discretionary portion of the public safety budget. At the end of the 1990's, the state's budget was not structurally sound, because projections of future revenues were insufficient to support current programs and services at their current levels.

Compared to the 2000-01 biennium, Oregon now has 15,000 more students in its K-12 public school programs; 54,000 fewer people covered by health care insurance under the Oregon Health Plan; 99,000 more people receiving food stamps; and 2,800 more inmates in its prisons, primarily because of the implementation of Ballot Measure 11 (1994).

As a result of the failure of Measure 30 (2004), effective in the spring and summer of 2004, $544.6 million will be disappropriated from programs related to education, human services, and public safety. This will reduce the 2003-04 appropriation to K-12 education by $284.6 million in addition to $14.3 million that will be lost directly from property tax reductions.

The state's 2003-04 budget assumed approximately $300 million in savings resulting from the 2003 legislation. If the legislation is invalidated, the school appropriation will be reduced by approximately $200 million, going forward, and the discretionary portions of the human services and public safety general fund budgets will be reduced by approximately $100 million, going forward, to pay for increased PERS costs. The $100 million dollar general fund savings represent about one-third of 1 percent of the total fund budget. The total annual savings represents about 1 percent of the state's total fund budget.

The PERS System Model has been updated to reflect all of the 2003 legislative changes to the system, as well as actual PERS data and returns through December 2003. The model shows that, measured over a 25-year period, the expected cost of invalidating the challenged provisions is $8.187 billion in present value, discounted to June 30, 2004.[47] Expressed in levelized terms, employer contribution rates over the next 25 years under the 2003 legislation, on average, would be 15.43 percent of payroll, and levelized rates over the next 25 years if the challenged provisions of the legislation are invalidated

[47] That projection has a standard deviation of $2.710 billion. The interval within which there is a 90 percent probability that the cost of invalidation would lie is from $4.053 billion to $12.678 billion.

would be approximately 28.78 percent of payroll. In other words, employer rates would be 13.35 percent of payroll higher if the challenged provisions of the legislation are invalidated. Those projections are based on an assumption of approximately 8 percent earnings for the PERS fund. If fund performance exceeds that assumption, rates will be lower than projected.

The expected $8.187 billion cost of invalidating the challenged provisions of the 2003 legislation, when expressed as a share of annual state and local government revenue, totals 46.1 percent of the $17.8 billion state and local governments are expected to collect in 2003-04 from their own revenue sources.

If the expected cost of invalidating the legislation is amortized over 25 years, the first annual payment is $422 million. The annual payments to retire the cost of invalidation would equal about 2.4 percent of state and local own-source revenue and remain at that level for the next 25 years. That additional cost probably would cause structural deficits in state and local government budgets for years to come.

If the challenged portions of the 2003 legislation were invalidated and taxes were necessarily raised to pay the cost of invalidation, the increase in taxes required would have a dampening effect on Oregon's economy. The state would need to experience revenue growth rates well in excess of those currently projected to avoid that effect. Future growth would need to equal the extraordinary growth in revenue experienced during the 1990s.

The impact of invalidation of the 2003 legislation would not be uniform for all Oregon government bodies. PERS employers with high contribution rates and high

UALs would bear a disproportionate share of the financial impact.

The ability of local governments to raise taxes is limited by the Oregon Constitution. It is likely that the state and local governments would rely primarily on reductions in expenditures to finance the costs resulting from the invalidation of the legislation. Requiring state and local governments and schools to absorb the additional PERS costs that they would have incurred without the 2003 legislation probably would require substantial further cuts in school funding, health care services, public safety, and other government services. Requiring state and local governments and schools to absorb those costs probably would cause significant loss of employment in the public sector. It also probably would impair the bonding capacity of Oregon government bodies. By contrast, the 2003 legislation helps restore the financial soundness and stability of PERS.

B. *Schools*

With the passage of Measure 5 (1990), which amended the Oregon Constitution, the state's general fund became the primary funding source for K-12 public schools. Beginning with the 1990-91 biennium, the state's general fund has funded approximately 75 percent of all K-12 education. On average, 25 percent of school district budgets derive from property taxes and other local revenues.

Approximately 80 percent of school district costs relate to personnel. Of the 198 Oregon school districts, approximately 74 percent pick up employees' PERS contributions. The Oregon School Board Association regarded the 2003 legislation as a means to bring PERS system costs under control and, yet, still provide a benefit that would allow schools to recruit and retain employees.

Approximately 52 percent of the state's general fund is directed to school districts for kindergarten through 12th grade education. On average, school districts annually spend approximately $4,800 to $4,900 per student. The recent Measure 30 disappropriation likely will cost school districts about $285 million, or $400 a student. School districts have some capacity to increase local property taxes based on limits imposed by Measures 5 and 50 (1997), but the amount that each district lawfully can appropriate under those measures varies.[48] A reduction of $285 million from the K-12 school appropriation equates to the loss of 19 school days or the loss of 3,950 teachers and other licensed personnel.

Current estimates show that Congress has funded the "No Child Left Behind" mandate at approximately 58 percent. The cost to Oregon taxpayers associated with meeting that mandate is approximately $1.2 billion per year.

1. *The Roseburg School District*

The Roseburg School District's 2002-03 general fund budget was approximately $42,992,000. Its total budget was $68,665,000. The district's annual payroll is approximately $22,300,000. The district picks up its employees' 6 percent PERS contribution. The district has made significant personnel reductions over the last three years. In 2000-01, it lost six teachers. In 2001-02, it lost six teachers and three administrators. In 2002-03 through 2003-04, another 57 positions, including 33 teaching positions, were lost.

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[48] School districts are authorized to ask voters to approve a local option to increase revenue for the school district. However, any amounts raised by the local option in excess of $750 per student reduces the current appropriation for school funding from

By June 30, 2003, the district had only a $16,000 ending fund balance. However, the district anticipated the failure of Measure 30, and it targeted an ending fund balance of 4 percent of revenue for 2004. In the current fiscal year, the district has a contingency fund of approximately $500,000 and an unappropriated ending fund balance of about $1.3 million.

The district last was adequately funded in 1998. Thereafter, state school support began to level out and decrease. In 2002-03, the district saved approximately $1.3 by reopening negotiations with its classified and certified employees and reducing seven contract workdays. The alternative would have been additional layoffs. Before Measure 5 was passed, the district had approximately 372 teachers; today it has approximately 332. The district's health insurance costs have tripled in the past 12 years. Employees share in rising health care costs; they pay 50 percent of health cost increases. A 17 to 22 percent increase in health insurance costs is expected in the next fiscal year.

Without the 2003 legislation, the immediate impact on the district's budget would be approximately $1.5 million (equivalent to 30 teachers), and projected contribution rates would rise to 25 percent of payroll (equivalent to 70 teachers).

2. *The Portland Public School District*

The Portland Public School District serves approximately 48,000 students and, in 2002-03, it employed approximately 4,200 employees. In 2003-04, the district employed approximately 4,169 employees. The district's general operating budget for 2002-03 was $447 million; in 2003-04, it increased to $483 million. Approximately 80

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the state's general fund.

percent of the district's budget is expended for personnel costs.

The district has had to engage in budget cuts since the mid-1990s. In fiscal year 2002-03, when state funding was cut mid-year, and the district was faced with mid-year budget cuts, the district was able to complete the school year as planned because the teachers took an immediate, one-time 5 percent pay cut and the City of Portland contributed $15 million to the district's budget. The passage of the three-year Multnomah County income tax has added approximately $50 million per year to the district's budget and has allowed it to avoid service cuts in fiscal year 2003-04.

The 2003 legislation reduced the district's PERS costs in the 2003-04 fiscal year by approximately $15 million. The district included about half of those savings in its current budget to preserve services and avoid teacher layoffs that otherwise would have resulted. The other half has been placed into reserves pending the outcome of the challenges to the legislation.

C. *Local Governments*

The ability of local governments to raise taxes is limited by the Oregon Constitution. Local governments have had limited success in obtaining voter approval for additional tax measures.

1. *Lane County*

At the end of the 2002-03 fiscal year, Lane County had approximately 1,549 employees. In the current fiscal year it has 1,495 employees. Most of the reductions resulted from the failure of Ballot Measure 28 (2003) and the loss of state public health funding. Lane County's total budget for 2002-03 was $427 million. In

2003-04, its total budget was $458 million, with an operating level of about $286 million. The total general fund revenue for 2002-03 was approximately $98 million and, for 2003-04, it is about $100,829,000.

Lane County experienced a $2 million deficit in its general fund in the 2003-04 fiscal year which resulted, in part, in the closure of 48 beds at the Lane County jail. Lane County is forecasting deficits in its general fund budget for the next 10 years. Because of the 2003 legislation, Lane County's PERS costs were reduced by approximately $4 million in the 2003-04 fiscal year. Lane County has put approximately one-half of those savings in reserves pending the outcome of the challenges to the 2003 legislation, and it has used approximately one-half of those savings to provide additional services in the 2003-04 fiscal year. If the challenged provisions of the 2003 legislation are invalidated, Lane County's strategic plan calls for further service cuts affecting public safety, jail facilities, juvenile facilities, and mental health.

The county frequently has tried, without success, to raise revenues by means of tax levies. Moody's bond rating service has given Lane County a negative outlook based on the probability that its reserves will not grow appreciably. The county currently has an AA-3 rating.

Lane County government last was adequately funded in the strong timber years of the late 1970s. At that time, Lane County had about 1,800 full time employees and another 500 temporary employees. However, in 1984, the county had 870 employees. In the 1980s, Lane County froze salaries for a number of years, and it sometimes reduced services by implementing a four-day work week.

2. *The City of Eugene*

The City of Eugene had approximately 1,467 full time employees in 2002-03 and, primarily because of a successful local option tax levy, it has been able to retain virtually all of those positions in 2003-04. The city's total payroll is approximately $70 million. The city's general fund budget slightly exceeds $102 million. Its total budget was $349.6 million in 2002-03. In 2003-04, its total budget is $356 million.

For the last several years, the city has been reducing its level of services because of increased costs. Over the last four years, the city has reduced services each year by amounts ranging from $350,000 to $1.5 million. In 2003-04, the city experienced $1.5 million in service reductions. The immediate impact of the 2003 legislation to the city is approximately $4.2 million, which would allow the city to maintain current service levels and restore previously reduced services.

The city bargains with four unions. During the past ten years, each of the bargaining units has received salary increases in excess of the average consumer price index. To be competitive in hiring, the city believes that it needs to pay a market rate for prospective employees. The city never has gone to interest arbitration with its firefighters, and it has arbitrated only once with police officers.

Before Ballot Measures 47 (1996) and 50 (1997) were passed, the city's administrators believed that the city was addressing the public's service demands adequately. However, the city has not, over the past 20 years, ever reached its goal of adequate police funding.

3. *The City of Corvallis*

In 2002-003, the City of Corvallis employed 419 full time employees and, in 2003-04, it had 412. The total city budget in 2002-03 was $61.75 million, with $29.95 million in the general fund. The city reduced its budget by $2.5 million in 2003-04. If it had to pay higher contribution rates, service reductions would ensue, including the possible loss of a property tax subsidy for the city's swimming pool, library budget cuts, transit service cuts, and employment freezes for firefighters and police officers.

The city generally has given COLAs to its bargaining unit members. It has gone to arbitration with its police and fire unions. Its general fund has emergency reserves of 2 percent of its revenues, and it has unappropriated reserves of between 5 and 8 percent of current revenues. The city's undesignated general fund balance for 2003-04 is approximately $3.4 million out of a total general fund budget of approximately $15 million. For the current fiscal year, the city has budgeted approximately $561,000 in contingency funds.

In its current budget document, the city cites a League of Oregon Cities' study concluding that Oregon's local governments are trapped in a tax system that, in effect, cannot be repaired without external intervention.

The 2003 legislation reduced the city's PERS costs by approximately $1.2 million in the 2003-04 fiscal year. That money is being held in reserve to pay either for the costs associated with the invalidation of the legislation, or for the increasing PERS costs the city is predicted to experience going forward even if the legislation is upheld. Even with the 2003 legislation in effect, the city expects an increase in its PERS contribution rates of five percent of payroll in both July 2005 and again in July 2007, bringing its contribution rate to approximately 17 percent.

4. *Multnomah County*

Over the last several years, Multnomah County has cut its service levels by about $60 million. The causes include increased PERS and other personnel costs, the failure of property values to increase a full 3 percent of assessed value, and declines in business tax revenues attributable to the economic downturn. The county's total operating budget for 2002-03 was approximately $945 million. For 2003-04, the operating budget is approximately $1 billion. The 2003-04 budget includes $128 million in personal income tax revenues approved by a voter levy.

Multnomah County is forecasting that its costs will continue to grow faster than its revenues over the next five years, especially after the expiration of the county income tax in the 2005-06 fiscal year. The county is forecasting a $45 million budget deficit in fiscal year 2006-07. If the voters were to extend the county income tax, the budget deficit in 2006-07, before considering increased PERS costs resulting from the invalidation of the 2003 legislation, would be approximately $20 million.

The 2003 legislation reduced the county's PERS costs in fiscal year 2003-04 by approximately $12 million. The county placed $6 million in reserves awaiting the outcome of the challenges to the legislation, and it spent $6 million to add back previously cut public services. As a result of those savings and the revenue generated by the county income tax, the county was able to add back approximately $38 million in services previously eliminated from or reduced by the current budget, including jail beds, other public safety services, health and human services including mental health evaluation and treatment, drug enforcement, and hazardous materials programs.

The county last enjoyed reasonable economic health in the mid-1990s, immediately before Ballot Measures 47 and 50 were implemented. Last year, unrepresented county employees received a wage freeze.

5. *Canby Utility Board*

The savings in PERS costs experienced by the Canby Utility Board as a result of the 2003 legislation allowed the board to absorb rising costs without raising electric utility rates. Invalidation of the legislation and the resulting increases in the board's PERS costs, both immediately and over time, would require increased electric utility rates and eventually make it difficult for the board to compete in the market or remain in existence as a locally-controlled utility.

D. *The Union Perspective*

AFSCME represents approximately 21,000 Oregon public sector employees. The state employs 30 percent of AFSCME's members. The state employees bargained for their PERS pick up when inflation rates were at the 12 to 13 percent level. In employee bargaining processes, the state considers the pick up in making comparisons to salary levels in other states. Employers generally bargain in light of total compensation packages. When PERS rates increase, public employers are less able to pay compensation. Conversely, if PERS benefits were reduced, members would pressure the unions to bargain for higher wages.

The Oregon Education Association (OEA) represents about 40,000 Oregon public employees. Education funding has been difficult for decades in Oregon. Oregon teachers have been making wage concessions for decades in order to keep PERS benefits.

The Oregon Public Employees Union (OPEU) represents approximately 35,000 employees in the state of Oregon, and, of those, 16,000 work directly for the state. State bargaining unit members recently took a 24-month wage freeze as well as step increase freezes. This is the first time that the union ever has agreed to a step freeze. It did so because the state indicated that it was out of funds, and it pointed to other areas where benefit costs were increasing, such as health insurance and PERS. Health care and retirement packages are priorities for state employee bargaining units. Public employers cost out all wage and benefit increases. When they spend more on PERS benefits, less is available for wages. In public employment bargaining contexts, the 6 percent pick up is traded off for wage and other benefits.

XI. PETITIONER-SPECIFIC INFORMATION

Petitioners' actuary, Brad Creveling, projected future benefits of various petitioners, both with and without considering the effects of the 2003 legislation. Defendants' actuary, Alan Stonewall, generally agreed with those estimates. Both actuaries used assumptions concerning salary growth and retirement dates and other factors to arrive at their estimates. The estimates are contingent; actual benefits cannot be calculated with precision until retirement. However, the estimates illustrate the general benefit levels projected to be paid by PERS before the 2003 legislation was enacted.

A. *Strunk Petitioners*

1. *Facts Common to Some Strunk Petitioners*

The *Strunk* petitioners are all active Tier One PERS members or Tier One

PERS retirees. Under HB 2003, section 3, petitioners Strunk and Smee will not be permitted to continue their elections to have portions of their account balances invested in the variable account program. Under HB 2003, section 14b(1)(b), the retirement benefits of all the *Strunk* petitioners, except petitioners Jacobsen and Booker, would be reduced further in an amount as yet undetermined to offset payments to retirees that the trial court in the *City of Eugene* case determined were paid erroneously.

a. Petitioner Richard Strunk

Petitioner Richard Strunk is currently employed by North Douglas School District as a high school teacher. Strunk joined PERS in 1980. His birth date is December 23, 1950. Strunk expects to retire from PERS employment at age 56. As of July 22, 2003, Strunk's annual salary was approximately $47,600, and his PERS account balance as of December 31, 2002, was $102,504.35, of which $37,701.00 was invested in the PERS variable account.

Before the enactment of HB 2003 and HB 2004, Strunk's projected monthly retirement benefit under PERS actuarial assumptions was $2,564. Strunk's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$114 per month (4.45%)
HB 2003, Sections 5, 6, 7, 8	$316 per month (12.32%)
HB 2004, Section 4	$115 per month (4.49%)
TOTAL:	$462 per month (18.02%)[49]

b. Petitioner William Smee

[49] Because, for all petitioners, the three changes overlap in economic impact, their total effect is less than the sum of their individual effects.

Petitioner William Smee is currently employed by the University of Oregon as a kiosk attendant. Smee joined PERS in 1979. His birth date is August 13, 1951. Smee expects to retire from PERS employment at age 62. As of July 22, 2003, Smee's annual salary was approximately $23,496, and his PERS account balance, as of December 31, 2002, was $106,018.80, of which $2,634.49 was invested in the PERS variable account.

Before the enactment of HB 2003 and HB 2004, Smee's projected monthly retirement benefit under PERS actuarial assumptions was $5,077. Smee's projected retirement benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 304 per month (5.99%)
HB 2003, Sections 5, 6, 7, 8	$ 924 per month (18.20%)
HB 2004, Section 4	$ 425 per month (8.37%)
TOTAL:	$1,529 per month (30.12%)

Before the enactment of the 2003 legislation, Smee's projected future retirement benefit was approximately 155 percent of his projected final salary at age 58, after 29.83 years of service. If he worked until age 62, his projected future benefit would reach 172 percent of his final salary. If he worked until age 65, his projected future benefit would reach 211 percent of his final salary.

c. Petitioner Donald Reed

Petitioner Donald Reed is currently employed by Deschutes County as an appraiser. Reed joined PERS in 1989. His birth date is April 18, 1953. Reed expects to retire from PERS employment at age 62. As of July 22, 2003, Reed's annual salary was approximately $46,675, and his PERS account balance, as of December 31, 2002, was $68,272.07.

Before the enactment of HB 2003 and HB 2004, Reed's projected monthly retirement benefit under PERS actuarial assumptions was $3,629. Reed's projected retirement benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$532 per month (14.66%)
HB 2003, Sections 5, 6, 7, 8	$595 per month (16.40%)
HB 2004, Section 4	$255 per month (7.03%)
TOTAL:	$845 per month (23.28%)

d. Petitioner Larry Blumenstein

Petitioner Larry Blumenstein is currently employed by the City of Salem as a fire captain-paramedic. Blumenstein joined PERS in 1987. His birth date is March 5, 1955, and he expects to retire from PERS employment at age 55. As of July 22, 2003, Blumenstein's annual salary was approximately $80,000, and his PERS account balance as of December 31, 2002, was $146,935.23.

Before the enactment of HB 2003 and HB 2004, Blumenstein's projected monthly retirement benefit under PERS actuarial assumptions was $4,981. Blumenstein's projected retirement benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$461 per month (9.26%)
HB 2003, Sections 5, 6, 7, 8	$904 per month (18.15%)
HB 2004, Section 4	$190 per month (3.81%)
TOTAL:	$732 per month (14.70%)

e. Petitioner Alan Lively

Petitioner Alan Lively is currently employed by the Oregon

Department of Transportation as a transportation engineer. Lively joined PERS in 1983. His birth date is April 6, 1956. Lively expects to retire from PERS employment at age 55. As of July 22, 2003, Lively's annual salary was approximately $62,904, and his PERS account balance as of December 31, 2002, was $168,238.12.

Before the enactment of HB 2003 and HB 2004, Lively's projected monthly retirement benefit under PERS actuarial assumptions was $5,989. Lively's projected retirement benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 460 per month (7.68%)
HB 2003, Sections 5, 6, 7, 8	$1,109 per month (18.52%)
HB 2004, Section 4	$ 229 per month (3.82%)
TOTAL:	$1,704 per month (28.45%)

f. Petitioner Merlene Martin

Petitioner Merlene Martin is currently employed by South Lane School District as an educational assistant. Martin joined PERS in 1990. Her birth date is October 16, 1953. Martin expects to retire from PERS employment at age 58. As of July 22, 2003, Martin's annual salary was approximately $17,500, and her PERS account balance as of December 31, 2002, was $24,566.18.

Before the enactment of HB 2003 and HB 2004, Martin's projected monthly retirement benefit under PERS actuarial assumptions was $1,386. Martin's projected retirement benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$232 per month (16.74%)
HB 2003, Sections 5, 6, 7, 8	$223 per month (16.09%)
HB 2004, Section 4	$ 98 per month (7.07%)

TOTAL:	$403 per month (29.08%)

g. Petitioner Susanna Rhodes

Petitioner Susanna Rhodes is currently employed by Oregon Health Sciences University as a registered nurse. Rhodes joined PERS in 1978. Her birth date is November 13, 1953. Rhodes expects to retire from PERS employment at age 55. As of July 22, 2003, Rhodes' annual salary was approximately $67,000, and her PERS account balance as of December 31, 2002, was $305,821.68.

Before the enactment of HB 2003 and HB 2004, Rhodes' projected monthly retirement benefit under PERS actuarial assumptions was $8,412. Rhodes' projected retirement benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 292 per month (3.47%)
HB 2003, Sections 5, 6, 7, 8	$1,665 per month (19.79%)
HB 2004, Section 4	$ 321 per month (3.82%)
TOTAL:	$2,178 per month (25.89%)

Before the enactment of the 2003 legislation, Rhodes's projected future retirement benefit was approximately 133 percent of her projected final salary at age 55, after 30.42 years of service. If she worked until age 65, her projected future benefit would reach 247 percent of her final salary.

h. Petitioner Denise Jacobsen

Petitioner Denise Jacobsen was employed by Portland State University as an adjunct assistant professor until August of 2003. Jacobsen joined PERS in 1994. Her birth date is September 12, 1936. Jacobsen retired from PERS employment effective September 1, 2003. As of July 22, 2003, Jacobsen's annual salary was approximately $21,000, and her PERS account balance as of December 31, 2002, was $17,774.13. Before the enactment of HB 2003 and HB 2004, Jacobsen's projected monthly retirement benefit under PERS actuarial assumptions was $379.

Jacobsen is damaged by HB 2003 and HB 2004, in two ways: (1) she will not begin to receive COLA adjustments for a period of several years; and (2) she will lose approximately $9 per month because her retirement allowance was calculated based on the new AEFs adopted under section 4 of HB 2004.

i. Petitioner Carol Booker

Petitioner Carol Booker retired from PERS employment in 2003. Before she retired, Booker was employed by Portland Public Schools. Under HB 2003, Sections 9 and 10, Booker will not receive COLA adjustments for several years, and she always will receive lower benefits under the 2003 legislation than she would have received under previous law.

B. *Burt Petitioners*

1. *Facts Common to All Burt Petitioners*

The petitioners in the *Burt* case are all current Tier One PERS participating employees. Under HB 2003, Section 14b(1)(b), the retirement benefits of all *Burt* petitioners would be reduced further in an amount as yet undetermined to offset payments to retirees that the trial court in the *City of Eugene* case determined were paid erroneously.

a. Petitioner Pamela Burt

Petitioner Pamela Burt joined PERS in 1981. Her birth date is July 25, 1953. She plans to retire from PERS employment at age 60. Burt's 2003 salary was $33,311.74. As of December 31, 2002, Burt's PERS account balance was $116,190.57. Before the enactment of HB 2003 and HB 2004, Burt's retirement benefit as projected pursuant to PERS actuarial assumptions was $5,456 per month.

Burt's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 384 per month (7.04%)
HB 2003, Sections 5, 6, 7, 8	$ 956 per month (17.52%)
HB 2004, Section 4	$ 438 per month (8.03%)
TOTAL:	$1,662 per month (30.46%)

Before the enactment of the 2003 legislation, Burt's projected future retirement benefit was approximately 130 percent of her projected final salary at age 60, after approximately 32 years of service.

b. Petitioner Nori J. McCann Cross

Petitioner Nori J. McCann Cross joined PERS in 1982. Her birth date is March 6, 1950. Cross plans to retire from PERS employment at age 62. Her 2003 salary was $81,303. As of December 31, 2002, Cross's PERS account balance was $176,753.28. Before the enactment of HB 2003 and HB 2004, Cross's retirement benefit as projected pursuant to PERS actuarial assumptions was $8,176 per month.

Cross's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 684 per month (8.37%)

HB 2003, Sections 5, 6, 7, 8	$1,317 per month (16.11%)
HB 2004, Section 4	$ 871 per month (10.65%)
TOTAL:	$2,645 per month (32.35%)

c. Petitioner Gerald Frost

Petitioner Gerald Frost joined PERS in 1976. His birth date is April 26, 1951. Frost plans to retire from PERS employment at age 58. His 2003 salary was $65,884.77. As of December 31, 2002, Frost's PERS account balance was $266,078.64. Before the enactment of HB 2003 and HB 2004, Frost's retirement benefit as projected pursuant to PERS actuarial assumptions was $8,181 per month.

Frost's projected retirement benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 472 per month (5.77%)
HB 2003, Sections 5, 6, 7, 8	$1,600 per month (19.56%)
HB 2004, Section 4	$ 339 per month (4.14%)
TOTAL:	$2,266 per month (27.70%)

Before the enactment of the 2003 legislation, Frost's projected future retirement benefit was approximately 117 percent of his projected final salary at age 58, after approximately 33 years of service.

d. Petitioner Claudia L. Howells

Petitioner Claudia L. Howells joined PERS in 1981. Her birth date is November 4, 1949. Howells plans to retire from PERS employment at age 58. Her 2003 salary was $78,183.80. As of December 31, 2002, Howells's PERS account balance was $235,821.64. Before the enactment of HB 2003 and HB 2004, Howells's retirement benefit as projected pursuant to PERS actuarial assumptions was $6,454 per month.

Howells's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 373 per month (5.78%)
HB 2003, Sections 5, 6, 7, 8	$1,269 per month (19.66%)
HB 2004, Section 4	$ 280 per month (4.34%)
TOTAL:	$1,801 per month (27.91%)

e. Petitioner Vicky J. Johnson

Petitioner Vicky J. Johnson joined PERS in 1984. Her birth date is April 1, 1960. Johnson plans to retire from PERS employment at age 55. Her 2003 salary was $60,993.13. As of December 31, 2002, Johnson's PERS account balance was $105,683.47. Before the enactment of HB 2003 and HB 2004, Johnson's retirement benefit as projected pursuant to PERS actuarial assumptions was $5,989 per month.

Johnson's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 228 per month (3.81%)
HB 2003, Sections 5, 6, 7, 8	$ 611 per month (10.20%)
HB 2004, Section 4	$ 938 per month (15.66%)
TOTAL:	$1,234 per month (20.60%)

f. Petitioner Stephen D. Krohn

Petitioner Stephen D. Krohn joined PERS in 1984. His birth date is January 2, 1950. Krohn plans to retire from PERS employment at age 58. His 2003 salary was $88,607.96. As of December 31, 2002, Krohn's PERS account balance was $219,709.84. Before the enactment of HB 2003 and HB 2004, Krohn's retirement benefit as projected pursuant to PERS actuarial assumptions was $6,160 per month.

Krohn's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 355 per month (5.76%)
HB 2003, Sections 5, 6, 7, 8	$1,196 per month (19.42%)
HB 2004, Section 4	$ 309 per month (5.02%)
TOTAL:	$1,738 per month (28.21%)

g. Petitioner Nancy B. Miller

Petitioner Nancy B. Miller joined PERS in 1983. Her birth date is February 16, 1953. She plans to retire from PERS employment at age 55. Her 2003 salary was $93,931.57. As of December 31, 2002, Miller's PERS account balance was $159,668.82. Before the enactment of HB 2003 and HB 2004, Miller's retirement benefit as projected pursuant to PERS actuarial assumptions was $4,490 per month.

Miller's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 172 per month (3.83%)
HB 2003, Sections 5, 6, 7, 8	$ 848 per month (18.89%)
HB 2004, Section 4	$ 341 per month (7.59%)
TOTAL:	$1,256 per month (27.97%)

h. Petitioner Bradd A. Swank

Petitioner Bradd A. Swank joined PERS in 1977. His birth date is July 8, 1949. He plans to retire from PERS employment at age 58. Swank's 2003 salary was $86,324.56. As of December 31, 2002, his PERS account balance was $334,779.69. Before the enactment of HB 2003 and HB 2004, Swank's retirement benefit as projected pursuant to PERS actuarial assumptions was $8,806 per month.

Swank's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$ 508 per month (5.77%)
HB 2003, Sections 5, 6, 7, 8	$1,756 per month (19.94%)

HB 2004, Section 4	$ 264 per month (3.00%)
TOTAL:	$2,378 per month (27.00%)

Before the enactment of the 2003 legislation, Swank's projected future retirement benefit was approximately 104 percent of his projected final salary at age 58, after approximately 30 years of service.

i. Petitioner Linda Zuckerman

Petitioner Linda Zuckerman joined PERS in 1979. Her birth date is June 8, 1950. She plans to retire from PERS employment at age 55. Her 2003 salary was $88,418.37. As of December 31, 2002, Zuckerman's PERS account balance was $268,736.20. Before the enactment of HB 2003 and HB 2004, Zuckerman's retirement benefit as projected pursuant to PERS actuarial assumptions was $5,575 per month.

Zuckerman's projected benefit probably will be reduced by the following sections of HB 2003 and HB 2004, in the following approximate amounts:

HB 2003, Section 1	$213 per month (3.82%)
HB 2003, Sections 5, 6, 7, 8	$510 per month (9.15%)
HB 2004, Section 4	$ 97 per month (1.74%)
TOTAL:	$786 per month (14.10%)

C. *Petitioner Dahlin*

Petitioner David Dahlin is a Tier One PERS member. When Dahlin began employment, he had no expectation as to what his retirement benefit would be or how long he would work for the state. The PERS handbook that Dahlin read when forming his first impressions about PERS included a statement that "[t]he retirement system is intended to provide you with an income source after you retire. If you are a career public employee, your retirement benefit, plus social security, should provide between 75 and 85 percent of your pre-retirement gross earnings." Dahlin's 1985 annual statement stated that "[t]he majority of retirees receive a larger benefit under a full formula computation."

However, Dahlin relied on the PERS statutes, rules, handbooks, annual statements, and web site estimates in planning his retirement. Dahlin believed that the Full Formula option, when coupled with Social Security benefits, would provide a minimum retirement benefit of 75 to 85 percent of his salary. Dahlin believed that the Money Match would produce a greater retirement benefit than the Full Formula. Dahlin's understanding that the Money Match calculation would exceed the value of the Full Formula benefit was confirmed by annual statements that he received from PERS beginning in 1998.

The PERS handbooks provided to Dahlin stated that PERS benefits are paid from three sources: member contributions, employer contributions, and investment earnings. Since 1981, the handbooks have stated that the member contribution rate was 6 percent of salary. The 1992 handbook stated that "PERS members are guaranteed an annual interest rate on their regular accounts of 8 percent (as of 1/1/90)." In later handbooks, that statement was revised to read: "Tier One members are guaranteed an annual interest rate on their regular accounts that is equal to the year's actuarially assumed interest rate. Since January 1, 1990, the assumed interest rate has been 8 percent." PERS handbooks also stated that "Retirement law permits members to place up to 75 percent of their contributions in a stock investment program." Before 1997, PERS handbooks further provided:

> "Your monthly benefit will be adjusted each year based on changes in the cost of living. The legislature has established a 2 percent per year maximum adjustment, which is included in your August 1 payment."

Beginning in 1998, PERS handbooks changed the word "will" to "may" in the quoted provision.

At all relevant times, the PERS handbooks stated that the PERS plan is qualified under Section 401(a) of the IRS Code and that its related trust is exempt from taxation under Section 501(a). The handbooks also stated that "'vesting' means you cannot lose your benefit rights, even if you stop working in covered employment."

The 1998 PERS handbook stated that members are entitled to receive benefits in excess of those permitted under federal retirement law. It further stated that federal law limits contributions to and benefits from retirement plans.[50] A PERS Benefits Equalization Fund exists to pay members and beneficiaries the difference between the retirement benefit provided by Oregon law and the maximum benefit allowed under IRC Section 415.

At no time did the PERS handbook provide that a member's right to retirement benefits could be amended or changed to his or her detriment.

In Dahlin's 1996 annual statement, PERB estimated that, if he continued working until age 58, he could retire with a monthly benefit of $1,817.60. In his 1997 statement, the estimated monthly benefit was $5,231.64, or 288 percent of the previous year's estimate.

Dahlin's 2001 annual statement showed an estimated retirement allowance at age 58 in the amount of $6,164.81 per month. Dahlin's 2002 annual statement showed an estimated allowance at age 58 in the amount of $6,257 per month. The 2003 legislation

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[50] If a member's total retirement benefits exceed the IRC Section 415 limit for

probably will reduce Dahlin's monthly allowance in the following approximate amounts:

HB 2004, Section 4	$ 361 per month (5.77%)
HB 2003, Sections 5, 6, 7, 8	$1,162 per month (18.57%)
HB 2003, Section 1	$ 459 per month (7.34%)
TOTAL:	$1,982 per month (29.6%)

D. *Evans Petitioners*

Petitioner Daniel Evans is employed as a police officer by the City of Grants Pass. Evans is a vested Tier One member. He currently is the president of the Grants Pass Police Officers' Association. Under Section 11.3 of the Collective Bargaining Agreement (CBA) between the City of Grants Pass and the Grants Pass Police Officers' Association, city employees took a "6 [percent] raise" and assumed the obligation of making their own PERS contributions, which the city formerly had picked up. Evans had designated 75 percent of his contributions to the variable account before the 2003 legislation took effect. Evans plans to work for more than 10 years before he retires from PERS-covered employment.

Petitioner Wayne Dykes was employed as a deputy sheriff by Josephine County. Dykes is a vested member of Tier One. He retired on November 1, 2003. Under section 20.2 of the CBA between Josephine County and the Josephine County Sheriffs' Association, Dykes took a "6 [percent] raise" and assumed the obligation of making his own PERS contributions, which the county formerly had picked up.

Dykes selected retirement option 2(a), which resulted in an estimated benefit of $2,807.58. However, he recently was informed by PERS staff that his estimated gross

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governmental plans, qualified plan benefits must be reduced.

monthly allowance would be $2,685.07. As a consequence of section 4 of HB 2004, it is probable that any contributions made to Dykes's member account between June 30, 2003, and the date of his retirement will not increase his retirement benefits.

James Michaud was employed as a police officer by the City of Eugene. Michaud is a vested Tier One member. He retired effective June 1, 2003. Article 24(c) of the CBA between the City of Eugene and the Eugene Police Employees' Association required the city to pick up Michaud's PERS contributions. If the City had not agreed to pick up the contribution, the union would have negotiated for higher salary benefits. Based on section 14b(1)(a) of HB 2003, Michaud probably would not receive the annual two percent COLA for one to three years following his retirement.

Michaud decided to retire based on the benefit estimates contained in his annual statements and a personalized estimate of benefits that he received from PERS shortly before he retired. Those estimates included all the contributions initially allocated to his account for 1999 earnings, including earnings in excess of 11.33 percent per annum. According to those estimates, Michaud's member account earnings for 1999 were approximately $40,000.

In Michaud's 1996 statement, PERB estimated that, if he continued working until age 55, he could retire with a monthly benefit of $3,431.87. In the 1997 statement, the estimated monthly benefit was $7,312.89, or 213 percent of the previous year's estimate.

James Botwinis was employed as a senior trooper by the Oregon State Police from October 1978 until his retirement in 2004. Botwinis is a vested Tier One member. He was the president of the Oregon State Police Officers' Association when he retired. The

CBA between the Oregon State Police and the Oregon State Police Officers' Association requires the department to pick up employee PERS contributions.

Charles French has been employed as a deputy district attorney by Multnomah County since September 23, 1981. French is a vested Tier One member. He intends to retire on February 10, 2011. French is an officer of the Multnomah County Prosecuting Attorney's Association. The CBA between Multnomah County and the Multnomah County Prosecuting Attorney's Association requires the employer to pick up employee PERS contributions.

In French's 1996 annual statement, PERB estimated that, if he continued working at his current job until age 58, he could retire with a monthly benefit of $2,646.42. In his 1997 statement, the estimate was $6,898.69 per month, or 260 percent of the estimate in 1996.

Gary Harkins has been employed as a corrections sergeant by the Oregon Department of Corrections since November 1, 1980. Harkins is a vested Tier One member. He is the current president of the Association of Oregon Corrections Employees. The CBA between the Department of Corrections and the Association of Oregon Correction Employees requires the employer to pick up employees' PERS contributions.

Harkins intends to retire on December 31, 2005. He is concerned that the AEFs adopted under section 4 of HB 2004 will freeze the value of his benefits as of June 30, 2003, and that his employment for the next two and one-half years may not increase his retirement allowance.

In Harkins's 1996 annual statement, PERB estimated that, if he continued working until age 55, he could retire with a monthly benefit of $2,271.74. In his 1997 statement, the estimated monthly benefit was $4,880.35, or 215 percent of the previous year's estimate.

E. *Petitioner Petrillo*

1. *Claim Relating to PERS Account of Susan Warren Converse*

Susan Warren Converse was a Tier One member of PERS. She died on October 28, 2002. Her death benefits consisted of her PERS member account, employer matching death benefit, and earnings thereon. Petitioner Samuel Petrillo is the husband and beneficiary of Susan Warren Converse. Petrillo is entitled to receive Susan Converse's PERS death benefits and the earnings thereon.

Before the enactment of the 2003 legislation, earnings on the death benefits of Tier One members accrued at no less that the assumed earnings rate. In February 2002, PERS notified Petrillo that, pursuant to applicable Internal Revenue Service regulations and Oregon Administrative Rules, he was entitled to defer distribution of his wife's death benefit "until no later than December 31 of the calendar year in the last day of the year in which Susan Converse would have attained 70 years of age. According to PERS records that would be December 31, 2020." PERS further informed Petrillo that "the interest rate currently authorized by the PERS Board for PERS death benefits is eight percent simple interest from the date of death to the date of distribution if distributed in a partial or total lump sum payment." Based on those statements, Petrillo deferred the distribution of his wife's death benefit.

In July 2003, PERS notified Petrillo that no interest would be credited to his wife's undistributed death benefit after January 31, 2003. Among other things, PERS stated:

> "House Bill 2003 supercedes any PERS Board action or existing Oregon Administrative Rules and mandates that beneficiaries of Tier One members will not receive interest for calendar year 2003 or for any subsequent year in which a deficit exists in the PERS fund.
>
> "* * * * *
>
> "House Bill 2003 was effective July 1, 2003, but is retroactive to January 1, 2003, and provides that interest will no longer accrue on a simple interest basis calculated on the Board's actuarial assumed earnings rate. The assumed rate is currently 8 percent, but as a result of House Bill 2003 no interest will be credited after January 1, 2003 until the deficit in the PERS fund is eliminated."

In August, Petrillo notified PERS that he believed that he was compelled to accept the distribution of his wife's death benefit to preserve the integrity of the benefit and mitigate his damages. Petrillo also advised PERS that his request for distribution of the death benefit was made under duress created by the 2003 legislation. Petrillo asked PERS to provide the information necessary to process the distribution of Susan Converse's death benefit.

On August 14, 2003, Petrillo executed the documents necessary to receive the death benefit. In September 2003, PERS distributed Converse's account balance, totaling $268,643.47, to Petrillo. On October 7, 2003, Petrillo placed the proceeds in his Individual Retirement Account (IRA) pending the outcome of this litigation. Petrillo has invested the death benefit in a mutual fund IRA whose return is based largely upon United States Treasury Bills. He regards that investment as comparably secure to the financial security of a PERS member account.

Petrillo earned no interest on the death benefit from January 1, 2003, through October 7, 2003. From October 7, 2003, through February 13, 2004, Petrillo earned approximately 1 percent interest per annum on the death benefit. Because of the enactment of Sections 5 and 6 of HB 2003, Petrillo has lost interest earnings on the death benefit.

2. *Claims Relating to Petrillo's PERS Account*

Petrillo has been employed as an administrative law judge by the Oregon Public Utility Commission since September 1981. Petrillo became a PERS member in April 1982. He is a Tier One member. Petrillo plans to retire at age 58. His current annual salary is approximately $77,683. Petrillo reached the top step for his position 15 years ago. His salary decreased from 1994 to 1996, remained unchanged in 1997, increased due to COLAs in 1998 and 1999, and has remained unchanged from 2000 through the present.

Since 1976, PERB has represented to its members that the contributions made to their member accounts are guaranteed annually to earn at least the assumed earnings rate. When Petrillo was hired in September 1981, his employer represented to him that employee contributions and earnings placed in regular member accounts were guaranteed annually to earn at least the assumed earnings rate.

All of Petrillo's member account balance is invested in the regular account. On December 31, 2002, Petrillo's total member account balance was $284,953.87. Because he was hired after August 1981, he is eligible only for the Full Formula and

Money Match calculations. Before the enactment of the 2003 legislation, Petrillo's optimal monthly PERS retirement allowance at age 58 would have been produced by the Money Match calculation. Petrillo's 2001 PERS Annual Member Statement estimated that his retirement benefit under the Money Match at age 58 would be $7,899.71 per month. Assuming annual salary growth at the rate of 4.25 percent--the assumption that the PERS actuary uses--Petrillo's estimated monthly retirement benefit before the enactment of HB 2003 and HB 2004 would have been $7,995 per month. That benefit would have approximated 101 percent of Petrillo's projected final salary at age 58, based on approximately 26 years of service.

Petrillo's retirement allowance probably will be reduced by $462 per month, or 5.78 percent, because of the new AEFs adopted under HB 2004. His allowance probably will be further reduced under Section 5 of HB 2003 by $1,575 per month, or 19.70 percent. That calculation assumes that no interest will be credited to Petrillo's retirement account for calendar years 2003 through 2005, as set out in the May 1, 2003, memorandum that PERS Executive Director James Voytko authored. Finally, as a result of HB 2003, Section 1, Petrillo's retirement allowance probably will be reduced by $301 per month, or 3.76 percent. The total probable reduction in Petrillo's monthly retirement allowance that is attributable to those three changes is $2,196 per month, or 27.47 percent.

Petrillo read and understood that the PERS handbook "is not a legal reference and it is not a complete statement of the laws or PERS administrative rules, and any conflict between this handbook and Oregon laws or administrative rules shall prevail." However, Petrillo has made several financial decisions in reliance on the statements that PERS and his employer made about his retirement benefits.

If no employee contributions are credited to Petrillo's member account after January 1, 2004, and no earnings are credited to the account for the five-year period from January 1, 2003, through December 31, 2007, the balance in his account will not grow after January 1, 2004. If, because of the effects of HB 2003 and HB 2004, Petrillo decides to terminate his position with the state before age 55 to preserve the value of his retirement account, he would be ineligible to receive a Money Match benefit. If, because of the effects of HB 2003 and HB 2004, Petrillo decides to terminate his position to preserve the value of his retirement account, he would be ineligible to assume any full-time public sector job in Oregon, thereby precluding him from working as an administrative law judge specializing in public utility litigation.

Petrillo participated in the variable annuity program from 1994 through 1998. For each of those years, Petrillo directed 50 percent of his employee contributions into the variable account. In 2000, Petrillo was eligible to make a one-time transfer of his variable account balance to his regular account. A member who makes such transfer may not thereafter participate in or make contributions to the variable annuity account. PERS represented to Petrillo that the one-time variable annuity transfer is a conservative investment vehicle that was worthy of consideration by members approaching retirement age. The stated advantage of making the one-time transfer was that the regular account, unlike the variable account, was guaranteed annually to earn at least the assumed earnings rate.

In December 2000, Petrillo elected to make the one-time variable annuity transfer. Effective January 1, 2001, PERS transferred the entire balance in Petrillo's variable account into his regular account. Petrillo made the election based on his understanding that all funds in his member account were guaranteed to earn interest at the assumed earnings rate until his retirement.

Section 5 of HB 2003 provides that no interest shall be credited to Tier One member regular accounts until the deficit in the PERS reserve account is eliminated. Because Petrillo elected the one-time variable annuity transfer, all of his member account balance is now invested in the regular account. If no interest is credited to the regular account for 2003, Petrillo will lose substantial interest earnings for that year alone.

In 1979, Petrillo's employer agreed to pick up the full amount of his 6 percent employee contribution. Petrillo's employer has paid the 6 percent pick up since April 1, 1982. Effective January 1, 2004, Sections 13, 13a, and 13b of HB 2003 require Petrillo to make payments equal to 6 percent of his salary into the IAP. The diversion of his contributions to the IAP will reduce Petrillo's retirement benefit because, after January 1, 2004, no employee contributions or interest thereon will be credited to his member account. In January 2004, Petrillo's salary was $78,636 per year. Six percent of his salary is $4,718.16. If Petrillo's salary does not increase in the future and, if he retires at age 58, Section 13 will reduce Petrillo's retirement allowance substantially because his regular account will not be credited with the employee contributions made to the IAP.

The 2002 interim valuation that the PERS actuary prepared projects that no interest earnings will be credited to Tier One member regular accounts for 2003 through

2007. If no interest is credited to Petrillo's member account for those years, Petrillo will lose substantial earnings that otherwise would have been credited at the assumed earnings rate to his member account.

Petrillo's 1999 annual statement showed an aggregate account balance of $215,253.58 in his regular and variable accounts. Of that amount, approximately $59,000 represented contributions made on his behalf by his employer and approximately $155,000 represented earnings credited to his account. Under the Money Match, Petrillo's employer would have been required, upon his retirement, to match that aggregate amount, and it also would have been required to contribute an additional $129,152 (.6 times $215,253) to cover the estimated costs of HB 3349, COLA, and the use of prelegislation AEFs. Therefore, if Petrillo had been eligible to retire at the end of 1999, his employer would have been required to contribute $344,405 to the BIF to match Petrillo's $215,253 account balance.

Section 8 of HB 2003, as amended by Section 12 of HB 3020, provides that the regular account balance of a Tier One member cannot be lower than the amount it would contain if the account had been credited with earnings at the assumed interest rate in every year that it existed. Put differently, Section 8, as amended, authorizes the suspension of future annual interest crediting to Petrillo's account, provided that his account must, at his retirement, be credited with earnings at the assumed rate for every year that Petrillo was employed. Petrillo's total expected retirement account balance under Section 8 probably will be substantially lower than his account balance under the previous statutory scheme. However, even with no earnings over the next five years, Petrillo's member account balance would still earn more an 8 percent return over its lifetime.

F. *Petitioner Sartain*

Petitioner Martha Sartain joined PERS in 1960. She is a Tier One retiree. Her birth date is March 20, 1942. Sartain was employed by the Oregon Highway Department from December 1960 through June 1964. She was employed as a Bridge Management System Manager by the Oregon Department of Transportation (ODOT) and the Oregon Highway Department from November 1973 through November 2002. Her position shifted between ODOT and the Highway Department during that period. Sartain retired from PERS employment effective December 1, 2002. Sartain retired under the Money Match formula. Her PERS benefits are fully vested.

Before she retired, Sartain reviewed Oregon statutes regarding PERS, and she reviewed written materials from PERS including her annual statements, PERS manuals, PERS newsletters, and PERS correspondence and e-mails. Before she retired, Sartain submitted estimated benefits request forms to PERS, and she communicated with PERS employees via e-mail regarding her anticipated retirement benefits.

In August 2002, Sartain sent an e-mail to an attorney asking whether she should be concerned about the wording of a written authorization form for the automatic deposit of PERS retirement payments. In particular, Sartain was concerned that the authorization permitted debits as well as deposits. In arguing that the debit authorization was unnecessary, Sartain stated that "we all know that overpayments must be returned."

In October 2002, Sartain contacted PERS by e-mail. She stated that she was contemplating retirement effective November 30, 2002, based on a benefit estimate made on October 10, 2002. On October 17, 2002, PERS responded by stating "Do not retire based on that estimate." The e-mail stated that "Judge Paul Lipscomb issued a final opinion in the City of Eugene versus PERS trial on October 7" and that, "[i]f we have to carry out that, it will affect your retirement, maybe even if you were retired previously to when we carried out."

PERS mailed a Notice of Entitlement dated December 12, 2002, to Sartain. The notice stated that her monthly retirement allowance would be $5,426.22. In January 2003, Sartain began receiving a monthly allowance in that amount. When Sartain retired, her member account balance was $289,633.41. If Sartain had been credited in 1999 with only 11.33 percent of earnings, rather than 20 percent, her monthly allowance would have been approximately $5,159.

Sartain based her decision to retire in December 2002 on the amount of her member account balance and the amount of her estimated monthly benefits. In addition to those factors, Sartain based her decision on her understanding that she would receive an annual COLA increase of up to 2 percent of her monthly allowance. Sartain understood that, if inflation is greater than 2 percent, the excess would be placed into a "COLA bank" for use in years when inflation is lower than 2 percent.

In July 2003, PERS sent Sartain a letter stating that her COLA increases temporarily had been suspended because of the enactment of the 2003 legislation. According to the letter, the COLA suspension applied to all Tier One members who retired on or after April 1, 2000, under the money match calculation. The COLA suspension has caused a measurable financial loss to Sartain. The COLA suspension erodes her purchasing power due to the effects of inflation.

Under the terms of HB 2003, Sartain probably will not receive a COLA increase for a period of one to three years. Under the PERS statutes in effect before the enactment of HB 2003, Sartain would have received a COLA increase with her August 1, 2003, payment. Since August 2003, Sartain has received a lower monthly retirement allowance than she would have received but for the enactment of the 2003 legislation.

COLAs have substantial value to retirees. That is true, in part, because the COLA amount compounds so that, after a number of years, the difference between an annual retirement allowance with, rather than without, COLA can amount to tens of thousands of dollars. When the COLA suspension ends, COLAs will accrue on a retirement allowance sum that is smaller than the allowance that would have been paid if the 2003 legislation had not been enacted. The suspension thus will create a greater gap than might be readily apparent between retirement allowances payable under the 2003 legislation and allowances that would have been paid under the former statutes.

G. *Whitty Petitioners*

SAIF Corporation has not received any general fund tax revenues from the state of Oregon since before 1984. The following SAIF Corporation policy was in effect before September 1984, and it was in effect when the 2003 legislation was enacted. It provides:

> **"Retirement Total Compensation:**
>
> **"Retirement**
>
> "Eligible SAIF employees participate in an established and secure retirement program through the **<u>Public Employees Retirement</u>**

> **System (PERS) <http://www.pers.state.or.us/>**. Regular full-time and part-time employees become members of PERS after completing six calendar months of service. If you are an existing PERS member at time of hire, your membership will continue without interruption. Contributions into your personal retirement annuity account are fixed by PERS and equal six percent of your gross earnings each month. SAIF also contributes approximately 8 ½ percent of PERS-subject payroll into a PERS pension reserve pool each year. This guarantees that funds will be available to pay your benefits at the time you retire. If you terminate employment with SAIF, you may leave your PERS funds on deposit to continue earning interest, withdraw them and pay any applicable taxes, or immediately roll your account over into an Individual Retirement Account (IRA). The PERS Handbook contains complete details on the retirement program. A copy is provided at time of hire. PERS makes new handbooks available every two years. Please direct any questions you may have to (503) 603-7777. Click here to access more information from PERS <http://www.pers.state.or.us>"

Petitioner Dennis Ulsted has been employed continuously by SAIF since September 1984. Petitioner H. Thomas Andersen has been employed continuously by SAIF since April 1986. Petitioner Michael Whitty began employment with SAIF in April 1989, retired on April 30, 1998, and was reemployed by SAIF from March 1, 2002, through the present. The policy set out above has been in continuous force and effect throughout the employment of Ulsted, Anderson, and Whitty. SAIF has delivered copies of the PERS Handbook to each of the *Whitty* petitioners annually.

Ulsted intends to retire at age 58. PERS sent Ulsted an annual statement in 2001 showing an estimated monthly retirement allowance of $9,931.77 if he continued to work in a PERS-covered position until age 58. As a result of the 2003 legislation, Ulsted's monthly retirement allowance at age 58 will be $5,350, a reduction of 46 percent from the 2001 estimate.

Whitty has been contributing 75 percent of his 6 percent contribution into the variable account. Over the years, PERS variable accounts have produced a greater return than the regular account. Because of the elimination of the variable account, Whitty's retirement allowance likely will be reduced for each of the two to four years that he expects to continue his employment.

Andersen intended to retire at age 58. PERS sent Andersen an annual statement in 2000, showing an estimated monthly retirement allowance of $5,742.95 if he continued to work in a PERS-covered position until age 58. The 2003 legislation will reduce Anderson's monthly retirement allowance amount by 25 to 33 percent.

XII. RULINGS ON POST-HEARING OBJECTIONS TO EVIDENCE

Paragraph 9 of the Status Conference Order dated February 9, 2004, provided:

> "All objections to evidence, testimonial or otherwise, except objections on the ground of legal relevance, shall be deemed waived if not made at the time the evidence is offered. Any relevance objection to evidence shall be deemed waived if not made in connection with an objection to another party's proposed findings of fact that relies on that evidence. The foregoing notwithstanding, a party may make a relevance objection at the time that evidence is offered during the hearing."

That order later was expanded to permit the parties also to reserve for the post-hearing process objections to evidence on other substantive grounds. All objections to evidence made at the evidentiary hearing were ruled on at the hearing. The evidentiary record reflects those rulings. Pursuant to paragraph (9) of the February 9 order, as supplemented, the parties have made additional substantive objections to evidence in connection with their post-hearing objections to the proposed findings of fact submitted by opposing parties.

Closing argument was held in these cases on March 26, 2004. During closing argument, I advised the parties that I intended to rule on all post-hearing evidentiary objections in summary fashion, overruling *en masse* relevance and other substantive objections to evidence that supports my recommended findings of fact, and declaring moot all post-hearing objections to evidence that does not support those findings. The parties did not object to that procedure. Therefore, subject to the court's review, all post-hearing relevance and other substantive objections to evidence received at the hearing that supports the findings recommended in this report hereby are overruled.[51] Again, subject to the court's review, I declare all other such objections moot.

DATED this 8th day of April, 2004.

/s/ David V. Brewer
Hon. Judge David V. Brewer, Special Master

[51] Defendants made post-hearing hearsay objections to Exhibit 121 and Exhibit 122, which the *Burt* petitioners had offered. Those objections hereby specifically are overruled.