



MANCHESTER ESSEX REGIONAL SCHOOL DISTRICT

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To the Residents of Manchester and Essex:

In the past few years, our budget presentations have included information about "Unfunded Liabilities," specifically employee pensions (excluding teacher pensions, which are funded by the Commonwealth) and retiree health insurance, which is also known as Other Post Employment Benefits (OPEB). This letter is intended to provide:

- A brief explanation of what these liabilities are
- An update on the magnitude of these liabilities for the Manchester Essex Regional School District (MERSD), and
- A summary of steps that MERSD is taking to address these liabilities, which face not only every other governmental entity in Massachusetts, but also most government entities nationwide.

### What Are Unfunded Liabilities?

Pensions and retiree health insurance are benefits that are offered as a requirement of Massachusetts General Law to employees of MERSD. Because these benefits are legally mandated, government entities must include in their financial statements an estimate of the value of future obligations related to these programs.

In the past, MERSD, like most school districts and towns in the state, paid the cost of these benefits as they came due each year. This is often referred to as a "pay as you go" approach. Recently, attention has turned to the growing nature of these costs and the concern that benefit costs will grow faster than municipal budgets can absorb in future years.

A potential solution to this challenge has two main facets. First, cost growth must be contained to ensure that benefits are appropriate and affordable for taxpayers. Second, government employers must begin to move from the "pay as you go" approach towards a strategy that pre-funds future year obligations and invests those funds to ensure that larger obligations due in future years can be afforded without undue pressure on the annual operating budget. Setting aside money for these obligations in advance would begin to render these liabilities "funded" in accounting terms instead of "unfunded," as they are today.

### How Big Are MERSD's Unfunded Liabilities?

Estimates of these liabilities are updated each year and published in MERSD's financial statements which are audited by an outside accounting firm. The financial statements for the most recently concluded fiscal year (which ended on June 30, 2013), contain the following estimates.

#### *Pensions*

The unfunded portion of the pension liability attributable to MERSD is estimated to be \$5,256,948.

Most pension programs require contributions from employees and employers. MERSD teachers and other licensed personnel (e.g. principals and district administrators) participate in the Commonwealth of Massachusetts' Teachers Contributory Retirement System (MTCRS). For these employees, the Commonwealth pays 100% of the employer share of pension expense, and employees also contribute directly by way of an 11% payroll deduction. As a result, MERSD has no expense whatsoever, for pension costs related to licensed employees.

Non-licensed employees (e.g. custodians, and administrative or school building assistants), participate in the county pension program, known as Essex Regional Retirement System (ERRS). In the current fiscal year, MERSD's employer-share obligation totaled \$426,747. ERRS, by way of this contribution, has begun to require its members, including MERSD and the Towns of Manchester and Essex, to pre-fund future pension liabilities and the program is on track to achieve full-funding by 2035, in accordance with Massachusetts General Law. Doing so requires MERSD to increase its annual pension contribution by 7% each year through 2019 and 4% thereafter.

The estimate referenced above for MERSD's unfunded pension liability is based on the following information from ERRS' most recent valuation dated 1/1/13:

- A total pension liability for all of ERRS of \$619 million and assets of \$315 million. The difference between these two figures is the ERRS-wide unfunded liability of \$305 million. Based on these figures, approximately 51% of the plan's total liability is currently funded with assets on hand.
- MERSD represents 1.72% of total ERRS payroll. ERRS applies this percentage to the total annual required contributions from its members to arrive at MERSD's employer share obligation for the year.
- Taking the \$305 million total plan unfunded liability and multiplying it by MERSD's 1.72% share of costs leads to the \$5.3 million estimated unfunded liability for MERSD.

#### *OPEB (Retiree Health Insurance)*

MERSD's unfunded liability for OPEB is \$25,010,077 as of July 1, 2013.

By law, MERSD must provide health insurance to all employees who retire with eligibility for pension. For employees and retirees hired after to July 1, 2013, the district pays 70% of insurance premiums and the remainder is paid by the insured party. For employees hired prior July 1, 2013, the district's contribution rate is 80%. MERSD's annual obligation for insurance payments on behalf of retirees was \$505,801 in the most recently concluded fiscal year. As a relatively new Regional School District, however, MERSD does not yet have many retirees. Our actuary estimates that as this changes and costs continue to rise, our annual obligation for retiree health insurance will grow at an average annual rate of 6.6% through 2043. This is much faster than MERSD's typical budget growth each year, and would put excessive constraints on important educational spending. Our most recent actuarial study estimated that the current value of future year benefits, including benefits not yet earned but likely to be earned in the future, is \$39.5 million. MERSD has not yet begun to set aside assets to cover future year costs, and the actuarial report estimates that an annual contribution of \$2.3 million (or 4.6 times our most recent 'pay as you go' annual expense) would be necessary to do so.

#### **What is MERSD's Plan to Address these Challenges?**

Management of these Unfunded Liabilities is a critical priority for MERSD. In its recently published District Improvement Plan, MERSD identified the need to develop within three years a sustainable, long-term financial plan to address these challenges.

Pensions are a guaranteed contract; benefit levels cannot be changed. Although MERSD did not establish benefit levels, we are committed to paying for them and will continue to make the contributions required by ERRS to achieve full funding by 2035. For the next several years, the 7% increase in our annual pension expenditure will have a noticeable, but manageable impact on the budget. Knowing this allows MERSD to plan ahead and identify funding sources from savings in other areas of the budget. Outsourcing evening custodial services at the new Middle High School when it first opened, for example, not only brought savings in salaries, but also meant that fewer employees will be brought into the pension system, which helps to keep the cost of our contributions down. The proposed outsourcing of evening custodial services at the elementary schools could similarly help to reduce future pension costs.

With regard to OPEB, MERSD has more flexibility, within the confines of Massachusetts General Law, to manage costs and establish a viable plan to set aside funds and ensure that future obligations can be met. Recently, the MERSD School Committee endorsed a "Roadmap for Funding OPEB" with three main components that can put MERSD on a path to fully funding its OPEB liability:

**1. Take Steps Within MERSD's Control To Reduce Costs**

- The recently enacted Municipal Health Reform Law allows MERSD to introduce less expensive plans outside of the collective bargaining process. These plans could lower the long-term OPEB liability by up to 10% and provide additional short-term savings through reduced annual costs that can be set aside for future obligations.

**2. Negotiate Cost Reductions That Must Be Collectively Bargained By Law**

- Contribution rate changes for retirees and/or spouses could lower the OPEB funding gap by an additional 50-60%. To the extent possible, MERSD would seek to exempt current retirees and those near to retirement, focusing instead on those current employees who have more time (and current income) to plan for their eventual retirement.

**3. Increase Budget Funds Over Time To Close Remaining Gap**

- This year, MERSD's School Committee voted to establish a trust fund that can be used to set aside and invest funds to make future obligations more affordable. MERSD's Fiscal 2015 budget includes an initial deposit of \$50,000 into the trust. Savings from exercising the Municipal Health Reform law could bring the total initial deposit up to \$200,000 or more.
- Additionally, the OPEB Roadmap envisions a 5-10 year time frame to gradually ramp up pre-funding to supplement to cost savings generated by the first two components of the plan.

A more detailed presentation of this plan, including calculations of potential savings and the path to full funding can be found on the MERSD website (see address below).

Additional initiatives that MERSD has undertaken to mitigate the cost of OPEB include:

- Annual competitive bidding of insurance programs to get the best rates from the market. Rate increases for the past three years of bids for MERSD plans have been 0%, 3.6%, and 0% respectively. This average increase of 1.2% per year is significantly lower than the 4.5%-7.5% rate assumed by our actuaries in forecasting the future costs. Savings from this bidding process reduce the annual cost of retiree health, and will help to contain growth of the OPEB liability forecasts in future actuarial reports as well.

- All retirees who are eligible for Medicare are now required to enroll, so MERSD will no longer be their primary insurer. MERSD pays for some supplemental insurance for these retirees, but implementing this change reduces MERSD's cost per participating retiree by 43-60%, based on the differential in current rates between the district and Medicare supplemental plans.
- Negotiations between MERSD and META (Manchester Essex Teachers' Association) helped to curtail growth in spending on insurance as well. Prior to 2011, the district paid 85% of premiums. For employees hired after July 1<sup>st</sup>, 2013 the district contribution rate has declined to 70% of premiums and for those hired before that date, the district contributes 80%.
- A new policy beginning July 1, 2013 prohibits retirees from adding insurance coverage after retirement, which will make changes in enrollment levels more predictable.
- A newly enacted provision of Massachusetts General Law enables MERSD to recoup the portion of retiree health costs earned by retirees during previous service to other school systems. MERSD is currently one of the few early adopters, having invoiced fifteen other towns and regional school districts this year to ensure that these entities pay their fair share of the cost.

Additionally, recognizing that legally mandated OPEB costs are a challenge statewide, the Massachusetts state government has begun to get involved. In addition to the Municipal Health Reform Law, a new legislative proposal from the Governor's office could curtail MERSD's OPEB obligation further, by taking into account each retiree's years of service and age. MERSD will continue to monitor these developments and work collaboratively with META and other employee groups to make sure that health insurance costs are affordable to employees, retirees, and the district.

For more information about MERSD's unfunded liabilities, please visit [www.mersd.org](http://www.mersd.org), follow the Quick Link "Budget," and choose the "Unfunded Liabilities" link. This site contains presentations regarding MERSD's plans to address these liabilities, copies of actuarial reports, and other informational resources about this topic.