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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.

It is also our hope that through this communication, we can assist the Town of Manchester-by-the-Sea to address requirements raised by Article IX, Section 3 of its bylaws.¹

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.

Currently, MERSD, like most school districts and towns in the state, pays the cost of these benefits mostly as they come 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 each year's operating budget. Beginning to set aside money for these obligations in advance would begin to render these liabilities "funded" in accounting terms instead of "unfunded," as they are today.

¹ This bylaw states: *The annual Town Report shall contain...a summary of Assets and Liabilities with respect to the Town's future obligations regarding retirement and health care benefits of Town and School employees, which include the assumptions involved in the calculation of these matters, and a description of the plan to deal with any surplus or shortfall of assets relative to liabilities based on data of a timely nature.*

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, 2012), contain the following estimates.

Pensions

The unfunded portion of the pension liability attributable to MERSD is estimated to be \$4,314,559.

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 \$385,062. ERRS has begun, however, 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 8% each year through 2020 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 1/1/11:

- A total pension liability for all of ERRS of \$536 million and assets of \$278 million. The difference between these two figures is the ERRS-wide unfunded liability of \$258 million. Based on these figures, approximately 52% of the plan's total liability is currently funded with assets on hand.
- MERSD represents 1.67% 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 \$258 million total plan unfunded liability and multiplying it by MERSD's 1.67% share of costs leads to the \$4.3 million estimated unfunded liability for MERSD.

OPEB (Retiree Health Insurance)

MERSD's unfunded liability for OPEB is \$19,749,807 as of June 30, 2012.

By law, MERSD must provide health insurance to all employees who retire with eligibility for pension. The district currently pays 80% of employee and retiree insurance premiums and the remainder is paid by the insured party. MERSD's annual obligation for insurance payments on behalf of retirees was \$467,595 in the most recently concluded fiscal year. As a new district, however, MERSD does yet have many retirees. Our actuaries estimated 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 2040. This is 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 \$35.7 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 \$2.2 million (or 4.7 times our current '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 a sustainable, long-term financial plan within the next three years.

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 8% 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. Recent outsourcing of evening custodial services at the new Middle High School, 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.

With regard to OPEB, MERSD has more flexibility, within the confines of Massachusetts General Laws, to manage costs. Initiatives that MERSD has undertaken in this regard include:

- Annual competitive bidding of insurance programs to get the best rates from the market. In the past two years, the rate increase for MERSD plans has been 0% and 3.6% respectively, much lower than the 9% rate assumed by our actuaries in forecasting the future costs. The savings from this bidding process has been significant and led to a reduced valuation of our OPEB liability compared to actuaries' previous report.
- 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 helped to bring down the budgeted cost for FY-14 by 13% compared to the prior year.
- 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, instead of 80% currently. For employees hired after July 1st, 2013 the district contribution rate will decline much further to 70% of premiums.
- A new policy beginning July 1, 2013 will prohibit retirees from adding insurance coverage after retirement, which will make changes in enrollment levels more predictable.

Additionally, recognizing that legally mandated OPEB costs are a challenge statewide, the Massachusetts state government has begun to get involved. The recently enacted Municipal Health Reform Law allows MERSD to introduce less expensive plans outside of the Collective Bargaining process. A separate, more recent legislative proposal from the Governor's office would also curtail MERSD's obligation to fund retiree health insurance, by taking into account each retiree's years of service and age. MERSD has been working collaboratively with META to make sure that health insurance costs are affordable to employees, retirees, and the district. We will continue to look at potential programmatic changes in the future.

Additionally, MERSD will begin to look at changing its funding strategy, as we have yet to pre-fund future OPEB liabilities at this time. The first step is to instigate the process of setting up a trust fund that can take in and invest assets much as the pension system does today. We expect to announce more initiatives in this area in coming months and over the next fiscal year.