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To the Residents of Manchester-by-the-Sea and Essex:

This letter provides an annual update on the status of "Unfunded Liabilities" for the Manchester Essex Regional District (MERSD), 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).

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 (i.e., liabilities) related to these programs.

In the past, most school districts and towns in the State paid the cost of these benefits as they came due each year. This approach is often referred to as "pay-as-you-go," and does not include any pre-funding of future obligations. This lack of pre-funding is the origin for the term "unfunded" liabilities. Pre-funding is considered important by many because actuarial estimates indicate that the cost of these obligations could potentially grow faster over time than taxpayer funded budgets can absorb.

There are two common approaches to reducing unfunded liabilities. First, pension and OPEB 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.

In recent years, MERSD has increased its pre-funding of pension and retiree health insurance obligations, and has also restructured its health insurance plans considerably, putting the district on a clear path to full funding over time.

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 ended June 30, 2023, contain the following estimates.

Pensions
The unfunded portion of the pension liability attributable to MERSD is estimated to be $6,935,222.

Most pension programs require contributions from employees and employers. The large majority of MERSD employees are teachers and other licensed personnel (e.g. principals and district administrators), who 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, nor any liability, for pension costs related to licensed employees, including teachers and administrators.

A smaller number of employees, who are not licensed by the Commonwealth (e.g. facilities staff, and administrative, school building and teaching assistants), participate in the regional pension program, known as Essex Regional Retirement System (ERRS). In the current fiscal year, MERSD's employer-share obligation for ERRS annual contributions totaled $728,883. ERRS 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 6.5% each year through 2029, and by 4.0% thereafter. ERRS has adjusted this funding schedule on several occasions with a general trend of increasing the number of initial years with required higher percentage contribution growth, in order to achieve the full funding target. As of the most recent ERRS actuarial valuation, the pension program's liabilities were 67% funded, up from 52% in 2014.

The estimate referenced above for MERSD's portion of ERRS' unfunded pension liability is based on applying 1.50% of ERRS' $347 million unfunded liability to MERSD. This percentage represents MERSD's percentage 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.

Because pensions, by law, are guaranteed contracts, benefit levels cannot be changed. Although MERSD does not establish benefit levels, we do have the ability to manage pension costs by carefully controlling staffing levels for pension eligible positions. For example, outsourcing custodial services at the new middle high school when it first opened and at the elementary schools in subsequent years has helped to lower MERSD's percentage of ERRS payroll and, as a result, MERSD's percent of ERRS' pension obligations. MERSD has also outsourced all food service and transportation positions, which further mitigates its future pension liability.

OPEB (Retiree Health Insurance)
MERSD's unfunded liability for OPEB is $23,396,040 as of June 30, 2023.

By law, MERSD must provide health insurance to all employees who retire with eligibility for pension. The district contributes 70-80% (based on retirement date) of the cost of insurance premiums throughout the duration of retirement, with retirees paying the remaining 20-30%. MERSD's annual obligation for insurance payments on behalf of retirees was $977,679 in the most recently concluded fiscal year. This cost has grown at an average annual rate of 7.0% over the past five years, reflecting both industry trends of growth in health care costs, and an increasing number of retirees that MERSD is obligated to cover by law. MERSD now covers nearly 20% more retirees (182) than active employees (150) with health insurance coverage.

Overall growth of retiree health care has slowed, due to introduction of less costly plans and increasing contribution rates from covered retirees. In FY09, retirees contributed just 15% of the cost of health plans annually. By contrast, retirees currently contribute 20-30% of the annual cost. A ll new hires now required to contribute 30% of the annual cost. The average retiree contribution percentage is expected to continue to rise in the coming years, which will help to decrease the rate of budgetary growth for MERSD.

Last fiscal year's "pay-as-you-go" expense, MERSD also contributed $578,666 towards pre-funding future year obligations, in attempt to reduce its unfunded OPEB liability. This additional contribution is funded from savings generated by a negotiated agreement with the Manchester Essex Teachers Association (META) to change benefit levels. The result of this agreement was a $1.6 million reduction in the annual gap between pay-as-you-go costs and full pre-funding of annual OPEB contributions. This gap reduction has improved in recent years, from 66% of the actuarially determined annual contribution needed to achieve full funding in fiscal year 2017 to an annual average of 84% over the past five years.

Additionally, the agreement migrated all employees to an insurance program with lower monthly premiums (which are split between MERSD and employees, based on contribution percentages referenced above) in exchange for introduction of deductibles and/or higher co-pays. The negotiated agreement stipulates that in return, all savings from these changes will be placed into an OPEB trust fund for the sole purpose of paying future OPEB costs.

OPEB trust funds can be invested in accordance with restrictions in Massachusetts General Law to earn higher rates of return, thereby reducing future required contributions from MERSD, staff and taxpayers.
In FY-17, MERSD established a relationship with the Pension Reserve Investment Management Board (PRIM) to invest the district's OPEB trust funds in the same diversified portfolio used for the State's pension system, MCTRS, and the large majority of regional retirement systems as well, including ERRS. By sending OPEB trust funds to PRIM, MERSD is able to outsource investment risk to specialized professionals with significant experience in long-term investing. By earning a return on its OPEB trust fund investment, MERSD can further reduce the contribution it needs to make from budget funds each year.

As of June 30, 2023, MERSD has contributed a total of $3,966,612 to its OPEB trust, and based on estimates, MERSD is on track to contribute $4.6 million to its OPEB trust fund in 10 years, setting the district on a path to fully fund its OPEB obligation.

Other initiatives that MERSD has undertaken over time also help to mitigate the cost of OPEB including:

- All retirees who are eligible for Medicare are now required to enroll, so MERSD will no longer be their primary insurer. MERSD pays for supplemental insurance for these retirees, but implementing this change reduces MERSD's cost based on the differential in current rates between the district and Medicare supplemental plans.
- MERSD's most recent contract with META included a move to higher deductible plans, with corresponding savings in the cost to MERSD and employees of monthly premiums. A portion of these savings have been set aside for an employer funded Health Reimbursement Account (HRA). MERSD has seen a significant improvement in claims/utilization from these plans, which helps to control costs and limit rate increases in subsequent years. Today, nearly 10% of retirees (those who have not yet aged into Medicare), and all active employees participate in the HRA plan, which costs nearly 20% less, or nearly $9K annually per retiree, than the legacy pre-Medicare retiree healthcare plan.
- A policy that began on July 1, 2013 prohibited retirees from adding insurance coverage after retirement, which will make changes in enrollment levels more predictable.

For more information about MERSD's unfunded liabilities, please visit www.mersd.org, and follow the Quick Link, "Budget." This site contains presentations regarding MERSD's plans to address these liabilities, and copies of audited financial statements and actuarial reports.

Sincerely,

Michelle Cresta

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