A REVIEW OF MONTGOMERY COUNTY PUBLIC SCHOOLS' BUDGET CATEGORY 12

OFFICE OF LEGISLATIVE OVERSIGHT
REPORT NUMBER 2012-2

November 29, 2011

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OFFICE OF LEGISLATIVE OVERSIGHT REPORT 2012-2: EXECUTIVE SUMMARY
NOVEMBER 29, 2011

This Office of Legislative Oversight report responds to the County Council's request for an analysis of the revenue and expenditure trends in Montgomery County Public Schools' Budget Category 12. It includes review of the contributions, spending, and year-end fund balances in MCPS' employee benefit trust funds.

Overview of Budget Category 12, Fixed Charges

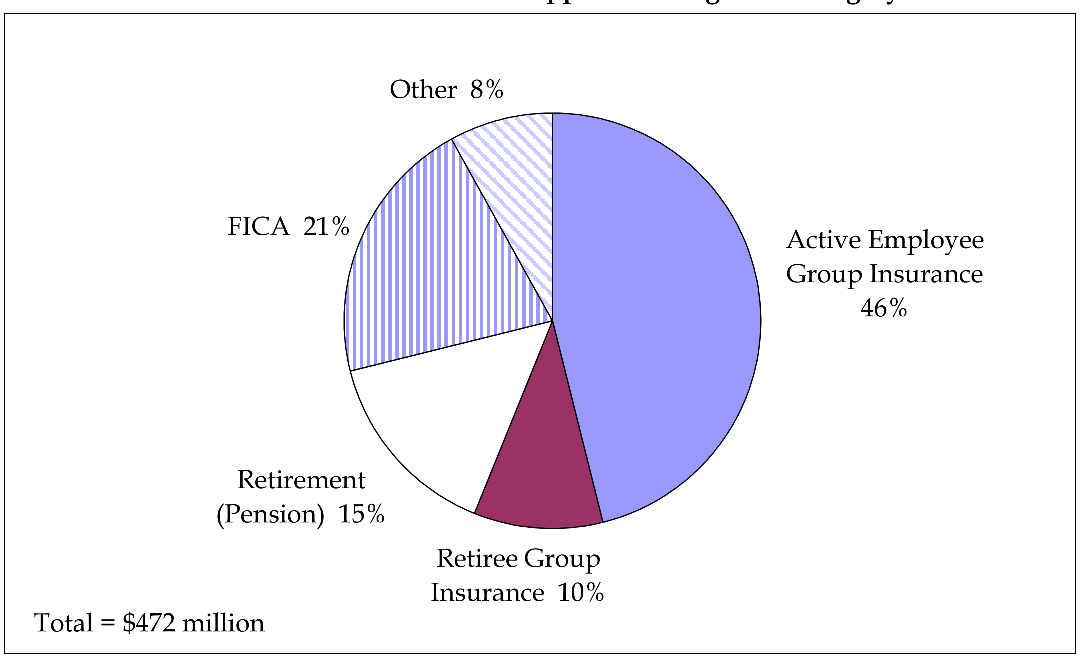
State law requires that the County Council appropriate funds to MCPS in standardized budget categories. One of the standardized categories is Budget Category 12; titled "Fixed Charges." Funds appropriated to Category 12 are primarily for employee benefits, i.e., retirement, health insurance, and social security.

After the Council determines how much to appropriate to each standardized budget category, it is within the Board of Education's purview to make final decisions on how to allocate the funds within each category. The Board of Education allocates Category 12 funds to nine expenditure components:

- Group Insurance (for Active and Retired employees)
- FICA (Social Security and Medicare)
- Retirement (Pension Fund Contribution)
- Non-Tax Supported Grants
- Risk Management
- Tuition Reimbursement
- Partnership Tuition
- Other Post-Employment Benefits (OPEB)
- Miscellaneous

MCPS' approved FY12 budget for Category 12 is $472 million, more than double what it was ten years ago. As shown in the chart below, pension and group insurance benefits account for approximately 71% of all budgeted FY12 Category 12 spending.

FY12 MCPS Board of Education Approved Budget for Category 12*



In FY03, Category 12 expenditures represented 18% of MCPS' total operating budget; in FY12, Category 12 expenditures are 23% of MCPS' total operating budget.

The complete OLO Report 2012-2 is available at: www.montgomerycountymd.gov/olo

Pension Fund Overview

About three-quarters of MCPS' permanent employees (mostly teaching positions) participate in a State-funded "core" pension plan. All other MCPS permanent employees (mostly non-teaching positions) participate in a County-funded "core" pension plan. In addition, all permanent employees (both teaching and non-teaching positions) receive a County-funded "supplemental" pension benefit. Each year, contributions from MCPS and MCPS employees are deposited into MCPS' "pension fund," a fiduciary account established to pay current and future pension benefits and associated expenses.

For FY12, the Board of Education approved a pension fund contribution of $77.8 million. This amount represents a 369% increase over the $16.6 million contribution made in FY03. The growth in pension costs results from multiple factors, including salary increases, growth in workforce size, lower than assumed investment returns, and pension benefit enhancements.

MCPS Pension Fund Contributions: FY03 and FY12

Fiscal Year	Contribution Amount
FY03	$16,639,493
FY12	$77,788,472

Source: FY03 and FY11 Pension System Actuarial Valuations

Funded Ratio

The "funded ratio" of a pension plan measures the extent to which a plan's assets cover the accrued pension benefits of its members. As of June 30, 2011, MCPS' pension fund had assets of $1.02 billion and an accrued liability of $1.45 billion. Because MCPS' pension fund assets are sufficient to cover 70% of its current liabilities, the fund has a funded ratio of 70%. In comparison, the funded ratio of MCPS' pension fund ten years ago (FY03) was 102%. Two primary factors contributed to the decline in funded ratio:

Plan Enhancements. In 2006, the Board increased the core pension benefit (for participants in the locally-funded plan) and made the increase retroactive to 1998. This enhancement mirrored the 2006 changes adopted by the General Assembly for employees in the State-funded pension plan. In addition, the Board increased the supplemental pension benefit (also retroactive to 1998) for all permanent MCPS employees. Concurrent with these enhancements, the Board increased the required employee contributions for both the core and supplemental pension benefits. Even with higher employee contributions, the 2006 enhancements greatly increased MCPS' liability for future pension benefits, causing a decline in the plan's funded ratio.

Investment Performance. MCPS' actuary calculates the agency's annual pension contributions based on the assumption of a 7.5% annual rate of return on investments. In years that investment returns are below 7.5%, the pension fund experiences an increase in its unfunded liability that negatively affects the funded ratio. Similar to other pension funds across the country, MCPS' pension fund incurred large losses during FY08 and FY09. Making up for these losses will affect the annual MCPS pension fund contribution through FY15.

Future Pension Costs

In 2011, the Board of Education raised the employee contribution for the locally-funded core benefit from 5% to 7% of salary. In addition, the Board lowered the cap on pension cost-of-living adjustments and reduced the pension calculation for new hires. According to MCPS' actuary, these modifications will contain the agency's FY13 pension fund payment to an amount similar to the FY12 contribution.

While annual MCPS total pension costs may change little from FY12 to FY13, the historic trend of large annual increases is projected to return, at least in the short term. MCPS' actuary estimates that the agency will need to significantly increase its annual contribution in FY14 and FY15, by as much as 17% over the two-year period. Growth in MCPS' payroll that results from pay increases and/or workforce growth will further increase required pension plan contributions. Moreover, as with any pension system, MCPS pension costs also are subject to change if actual experience differs from other actuarial assumptions, such as retiree life expectancy or investment performance.

Group Insurance Overview

MCPS maintains two separate funds for their active and retired employees' group insurance benefits: the Active Employee Group Insurance Fund and the Retiree Group Insurance Fund. Both funds receive "revenue" from agency and participants' premium contributions. Both funds make "expenditures" that are primarily the health care claims incurred under MCPS' self-insured plans.

Group Insurance Budgeting. MCPS uses projections from an outside health benefits consultant to develop the agency's annual budget request for group insurance (for each fiscal year) and annual group insurance plan premiums (for each calendar year). A number of factors complicate budgeting for group insurance expenditures, all of which can lead to variances between budgeted and actual expenditures. These factors (listed below) are not unique to MCPS, and similarly apply to other County-funded agencies.

- MCPS is largely self-insured and group insurance expenditures result from actual health care use by plan participants. In any given year, health care use can vary unexpectedly for multiple reasons.
- Group insurance plans operate on a calendar year basis while budgets operate on a fiscal year basis.
- MCPS develops its recommended budget for group insurance each fall. By the time the fiscal year for that budget begins the following July, expenditure trends may have changed from the fall projection.

FY11 Active Employee Group Insurance Fund Balance

At the beginning of FY11, MCPS' Active Employee Group Insurance Fund had an $8.5 million balance or "reserve." During FY11, total revenues into the Fund exceeded expenditures by $13.1 million, which led to a FY11 year-end fund balance of $21.6 million. The primary reason for the $13.1 million surplus in the Active Employee Group Insurance Fund during FY11 was the fact that actual health care claims were $9.1 million lower than projected in the approved FY11 budget.

FY11 Beginning Fund Balance (July 1, 2010)	Fund Activity During FY11		FY11 Ending Fund Balance (June 30, 2011)
$8,541,533	Revenues	$263,353,334	$21,598,686
	Expenditures	$250,296,181	
	Difference	$13,057,153	

To be more specific, while total Active Employee Group Insurance Fund expenditures increased by 4% in FY11, the actual increase was less than the budgeted increase. Monthly Fund data indicate that the savings accumulated over the first three quarters of FY11, and that the cumulative expenditures from the Fund were running $7.6 million lower than budgeted midway through the fiscal year (12/31/2010). MCPS reports that in the February/March 2011 time frame, the agency's actuaries advised that the Fund would likely have a significant surplus by the end of FY11. In their comments on the FY11 surplus, MCPS notes that the "pattern of expenditures during FY 2011 differed greatly from previous years," and further that "it paralleled similar unexpected patterns in other governmental organizations."

Fund Balance Policy and Trends

Similar to other agencies, MCPS' practice is to maintain a balance (or reserve) in both the Active Employee and Retiree Group Insurance Funds to protect against unanticipated expenditures in any given year. MCPS has not, however, adopted a formal policy to establish a target fund balance amount in either group insurance fund.

Active Employee Group Insurance Fund

Fiscal Year	End of Fiscal Year Balance	Balance as % of Expenditures
FY08	$11,818,442	5.6%
FY09	$2,797,995	1.2%
FY10	$8,541,533	3.5%
FY11	$21,598,686	8.6%

Compared with recent years, the $21.6 million balance in the Active Employee Group Insurance Fund at the end of FY11 is relatively large both in terms of total dollars and as a percent of expenditures. The balance in the Fund has fluctuated considerably from year-to-year, and in FY08, FY09, and FY10, MCPS increased the ending balance through year-end transfers.

Recommendations for Council Action

The Office of Legislative Oversight's analysis of MCPS' Budget Category 12 evidences opportunities to improve the substance and timing of fiscal information provided by the Board of Education to the County Council. In turn, this additional information will position the Council to enhance its understanding and oversight of the substantial public dollars appropriated to Category 12. OLO recommends the Council:

A. **Request the Board of Education to submit supplemental information to the Council in April and October of each year related to Category 12 revenues and expenditures.**

B. **Integrate this additional information into the Council's annual budget decision making and ongoing oversight of funds appropriated to MCPS.**

The Board of Education already provides certain documents that contain financial information related to the agency's pension and group insurance benefits. However, the timing and substance of these documents do not give the Council a complete and current picture of the financial status, cost drivers, and budgetary impact of MCPS pension and group insurance programs when the Council is required to make budget decisions. OLO recommends the Council request the following Category 12-related information be provided by the Board of Education to the Council by April 1st of each year:

- **Pension Fund:** (1) Estimated future year pension fund contributions, including the major factors driving changes in annual contribution amounts; (2) Any updates to the Board's strategy for achieving a desired funding level for current and future pension liabilities (the "funded ratio").
- **Active and Retiree Group Insurance Funds:** (1) A comparison of budgeted versus actual group insurance fund revenue and expenditures to date; (2) Projected year-end fund balances with an explanation if any projections differ from what was assumed at the beginning of the fiscal year.

In addition, the Council should ask the Board of Education to provide the following information by October 1st of each year: (1) A comparison of budgeted vs. actual expenditures for each Category 12 component; (2) A written summary of any intra-fund transfers that occurred within Category 12 during the previous fiscal year; and (3) An explanation of the financial need or policy decision that led to each transfer.

OLO recommends the Council integrate the supplemental information received in April of each year into its annual operating budget deliberations. OLO recommends the Council use the supplemental information received in October to enhance its ongoing fiscal oversight of funds appropriated to MCPS.

Recommended Discussion Issues

OLO recommends three issues for the Council to discuss with MCPS representatives. While these issues focus on MCPS' Category 12 budget, OLO recommends the Council hold parallel discussions with the other County-funded agencies, i.e., County Government, Montgomery College, M-NCPPC, WSSC.

1. **Category 12 cost drivers and expenditures trends.** The Council and MCPS representatives should discuss the Board's past and present approach to addressing future increases in employee benefit costs, and how projected growth in total compensation costs affects funding for its competing priorities.

2. **Status of the "funded ratio" for MCPS' County-funded pension fund.** The Council should ask MCPS representatives about the Board's strategies to improve the "funded ratio" and whether the current 70% "funded ratio" suggests a need to modify any pension management policies and practices.

3. **Fund balance policy for group insurance funds for active and retired employees.** The Council and MCPS representatives should discuss the school system's reasons for not adopting a fund balance policy, especially since the agency's practice is to maintain a balance in its group insurance funds.

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CHAPTER I. AUTHORITY, SCOPE, AND ORGANIZATION OF REPORT

A. Authority

Council Resolution 17-211, *FY 2012 Work Program of the Office of Legislative Oversight*, adopted July 19, 2011.

B. Purpose and Scope of Report

Maryland state law requires that all counties and Baltimore City appropriate school system funds into 18 budget categories, as defined in the Education Article of the Annotated Code of Maryland. One of those categories, Category 12 Fixed Charges, includes expenditures of "a generally recurring nature which are not readily allocable to other expenditure categories." The primary expenditures in Category 12 are funding for employee benefits such as retirement, health insurance, and social security.

The purpose of this report is to provide information to assist the Council in its ongoing oversight of the MCPS Category 12 budget. Specifically, this report:

- Defines and examines the components of Category 12 and related funds, including those for employee pension and group insurance benefits;
- Tracks the multi-year budget and expenditure trends of these components;
- Summarizes FY11 budgeted and actual revenues and expenditures by Category 12 component; and
- Reviews the underlying assumptions behind MCPS' budget requests in Category 12 and related funds.

C. Organization of Report

Chapter II, Overview of Budget Category 12, provides an overview of MCPS Budget Category 12, including definitions, components, and funding trends.

Chapter III, Retirement Benefit Budget and Pension Fund, presents information on how MCPS budgets and funds annual retirement benefit costs, and provides data on MCPS' retirement benefit expenditure trends. This chapter also discusses the fiscal condition of the MCPS pension fund.

Chapter IV, MCPS Group Insurance Expenditures, details how MCPS budgets and accounts for employee group insurance costs, and provides data on MCPS' group insurance expenditure trends. This chapter also compares budgeted and actual FY11 group insurance fund revenues and expenses.

Chapters V-VI present OLO's **Findings, Recommendations to the Council, and Recommended Discussion Topics with MCPS.**

Chapter VII contains **Agency Comments** received from MCPS on the final draft of this report.

D. Methodology

Office of Legislative Oversight (OLO) staff members Craig Howard, Kristen Latham, and Aron Trombka conducted this study. OLO gathered information through document reviews, data analysis, and interviews with staff from the Montgomery County Public Schools. OLO also solicited actuarial advice from the Council's contract actuarial firm, Bolton Partners.

E. Acknowledgements

OLO received a high level of cooperation from MCPS staff involved in this study. OLO appreciates the significant time commitment, the information shared, and the insights provided by all staff who participated. In particular, OLO acknowledges the following MCPS staff for their assistance: Larry Bowers, Susanne DeGraba, Robert Doody, John Grabel, Carol Hurley, Richard Johnstone, Stephen Russ, Marshall Spatz, and Shafeena Yunus.

CHAPTER II. OVERVIEW OF BUDGET CATEGORY 12

State law requires that all counties and Baltimore City appropriate school system funds into 18 budget categories, as defined in the Education Article of the Annotated Code of Maryland.[1] This report focuses on Category 12, the State-defined budget category titled "Fixed Charges." "Fixed Charges" are expenditures of a recurring nature that are not easily allocable to other budget categories. Employee benefits represent a majority of Category 12 expenditures.

This chapter summarizes MCPS' budget Category 12, organized as follows:

- **Section A, Definition of Category 12** provides Maryland's definition of Category 12;
- **Section B, MCPS Category 12 Budget Components** describes the nine spending components in Category 12;
- **Section C, Total Category 12 Expenditure Trends: FY03 – FY12** reviews <u>total</u> expenditures trends for MCPS' Category 12;
- **Section D, Category 12 Expenditures by Component** reviews expenditure trends for the nine <u>components</u> in MCPS' Category 12 budget; and
- **Section E, Employee Benefit Funding in Other MCPS Budget Categories** explains the small percent of MCPS' benefit costs funded outside of Category 12.

A. Definition of Category 12

The Education Article of the Annotated Code of Maryland outlines financial accountability standards for Maryland public school systems, including the standardized reporting of expenditures. The following outlines the Maryland State budget categories that all school systems must use when budgeting expenditures.[2]

Maryland State Budget Categories[3]

1	Administration	8	Health Services
2	Mid-level Administration	9	Student Transportation
3	Instructional Salaries	10	Operation of Plant
4	Textbooks and Instructional Supplies	11	Maintenance of Plant
5	Other Instructional Costs	**12**	**FIXED CHARGES**
6	Special Education	14	Community Services
7	Student Personnel Services	15	Capital Outlay

[1] Maryland EDUCATION Code Annotated § 5-101 BUDGET AND REPORTING REQUIREMENTS (2011)

[2] MCPS also budgets in the following categories for enterprise funds: (37) MCPS Television Special Revenue Fund; (51) Real Estate Fund; (61) Food Services Fund; (71) Field Trip Fund; and (81) Entrepreneurial Activities Fund.

[3] *Financial Reporting Manual for Maryland Public Schools* (Revised 2009) Resource available online at http://www.msde.maryland.gov/NR/rdonlyres/A0855BEB-5513-4758-8F15-1A0D64C50DBD/21354/FINANCIAL_REPORTING_MANUAL_REVISED_2009.pdf

The Maryland State Department of Education (MSDE) defines each of the budget categories in a document called the *Financial Reporting Manual for Maryland Public Schools.* In this document, MSDE defines Category 12, Fixed Charges, as:

> "Charges of a generally recurring nature which are not readily allocable to other expenditure categories. Included are:
>
> - Local school board contributions to employee retirement and social security;
> - Employee insurance benefits (health, life, accident, disability, etc);
> - Fidelity insurance, personal liability insurance, and judgments (distribute to General Support Services on the Fixed Charges supplemental report group);
> - Interest on current loans; and
> - Personnel tuition reimbursement for all staff (distribute to the proper category on the Fixed Charges supplemental report group)." [4]

B. MCPS Category 12 Budget Components

After the County Council appropriates funds to Category 12, the Board of Education makes final decisions on how to allocate the funds within Category 12. The Board of Education allocates Category 12 fund to nine expenditure components, listed below. A detailed description of each component begins on the next page.

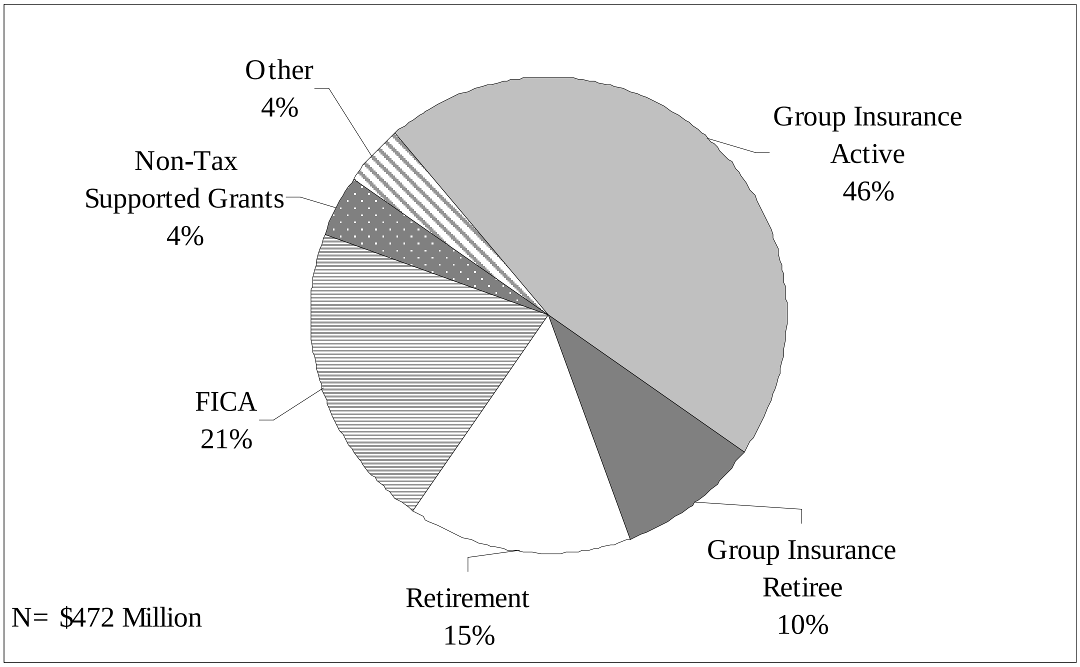
- Group Insurance (Active and Retiree)
- FICA (Social Security and Medicare)
- Retirement
- Non-Tax Supported Grants
- Risk Management/Self-Insurance
- Tuition Reimbursement
- Miscellaneous
- Partnership Tuition
- Other Post-Employment Benefits (OPEB)

Excluding employee pension costs paid by the State, Category 12 contains funding for 97.5% of MCPS' total employee benefit costs.[5] The remaining 2.5% is budgeted in MCPS enterprise funds (e.g., Food Services Fund, Real Estate Fund).

The chart below shows the distribution of FY12 Category 12 budgeted expenditures by category. Retirement and health benefits (for active and retirees) represent approximately 71% of all Category 12 expenditures.

[4] *Financial Reporting Manual for Maryland Public Schools (Revised 2009)*, Page 61.
[5] Approximately 77% of MCPS employees participate in a pension plan funded and administered by the State of Maryland; a more detailed summary of the MCPS pension system is available in Chapter III.

Exhibit 2-1. Category 12 Budgeted Expenditures, FY12



Source: MCPS

The following paragraphs describe each of the Category 12 components (listed in descending order of FY12 expenditures).

GROUP INSURANCE (FOR ACTIVE EMPLOYEES AND RETIREES). This component of Category 12 consists of MCPS' share of group insurance (medical, prescription, dental, vision, and life) coverage for active and retired employees. The amount of the annual MCPS contribution depends on plan premium costs and/or actuarial estimates of projected insurance claims. (Chapter IV discusses MCPS group insurance expenditures in further detail.)

FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA). The FICA component consists of MCPS' federally-required contributions to Social Security and Medicare. The current employer contribution rate for Social Security is 6.2% of an employee's wages (up to a maximum salary of $106,800) and for Medicare is 1.45% of an employee's taxable wages.

RETIREMENT. The retirement component consists of annual contributions to the MCPS pension fund. The MCPS pension plan provides a "Core Benefit" for almost one quarter of the agency's employees.[6] In addition, MCPS provides a "Pension Supplement" to all agency employees. (Chapter III defines the different type of pension benefits and contains additional details about MCPS retirement expenditures.)

[6] Approximately 77% of MCPS employees participate in a defined benefit plan funded and administered by the State of Maryland. The remaining 23% of MCPS employees participate in a locally-funded defined benefit plan that is identical to the State plan.

NON-TAX SUPPORTED GRANTS. This component consists of funding for the health, retirement, and other benefits of employees whose positions are funded through State or Federal grants. For these grant-funded (i.e., non-tax supported) positions, MCPS accounts for all benefit costs together under the component "Non-Tax Supported Grant" instead of allocating the costs among the other Category 12 components such as FICA, group insurance, and retirement.

RISK MANAGEMENT/SELF-INSURANCE. MCPS participates in the Montgomery County Liability and Property Coverage Self-Insurance Program. The Risk Management/Self-Insurance component consists of MCPS' premium payments to the County Government's Department of Finance for general liability, workers' compensation, public official liability, property, and motor vehicle risks. MCPS' premium payments to the fund are actuarially determined each year.

TUITION REIMBURSEMENT. This component consists of funding for MCPS' tuition reimbursement program, a benefit provided to full-time and part-time employees who complete undergraduate or graduate courses to further their professional development.[7] The program reimburses employees for expenses related to maintaining current certification and licensing, as well as tuition for advanced education.

MISCELLANEOUS. This component consists of funding for miscellaneous expenditures such as flexible spending account matches, unemployment compensation, cashed-in annual leave for Montgomery County Association of Administrators and Principals (MCAAP) employees, and automobile allowances.

PARTNERSHIP TUITION. This component consists of funding for MCPS' "higher education partnership" programs that provide tuition assistance for candidates seeking employment in the school system. This program aims to recruit people changing careers to work with MCPS, with a focus on positions with critical staffing needs such as special education or math/science.

OTHER POST-EMPLOYMENT BENEFITS (OPEB). The OPEB component consists of MCPS' contributions to a special trust fund established to finance future retiree health benefits. According to the 2011 MCPS Comprehensive Annual Financial Report, MCPS' unfunded actuarial accrued liability (UAAL) for future retiree health costs was $1.535 billion, as of July 1, 2010. In FY08 and FY09, MCPS made contributions into the agency's OPEB trust fund. Similar to the other County agencies, MCPS did not make OPEB contributions in FY10 or FY11 due to budget constraints.[8]

Effective July 2011, Council Bill 17-11 amended the Retiree Health Benefits Trust to provide a funding mechanism to pay for other post employment benefits for employees of MCPS and Montgomery College. In FY12, the County Council appropriated $20 million to the trust for MCPS OPEB; however these funds no longer appear as an MCPS Category 12 expenditure.

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[7] Board of Education Policy GMG-RA (August 10, 1987; revised March 11, 1997; revised September 29, 2009).

[8] In FY10, County Council passed MCPS' FY10 Budget Appropriation with the following clause: "This resolution appropriates $12,000,000 for pre-funding retiree health insurance consistent with Resolution No. 16-555, which the Council adopted on May 14, 2008. These funds must not be placed in trust before June 30, 2010. Before June 30, 2010, these funds may be transferred, with Council approval, to address any unanticipated revenue shortfall." In FY11, the Council did not appropriate funding for OPEB.

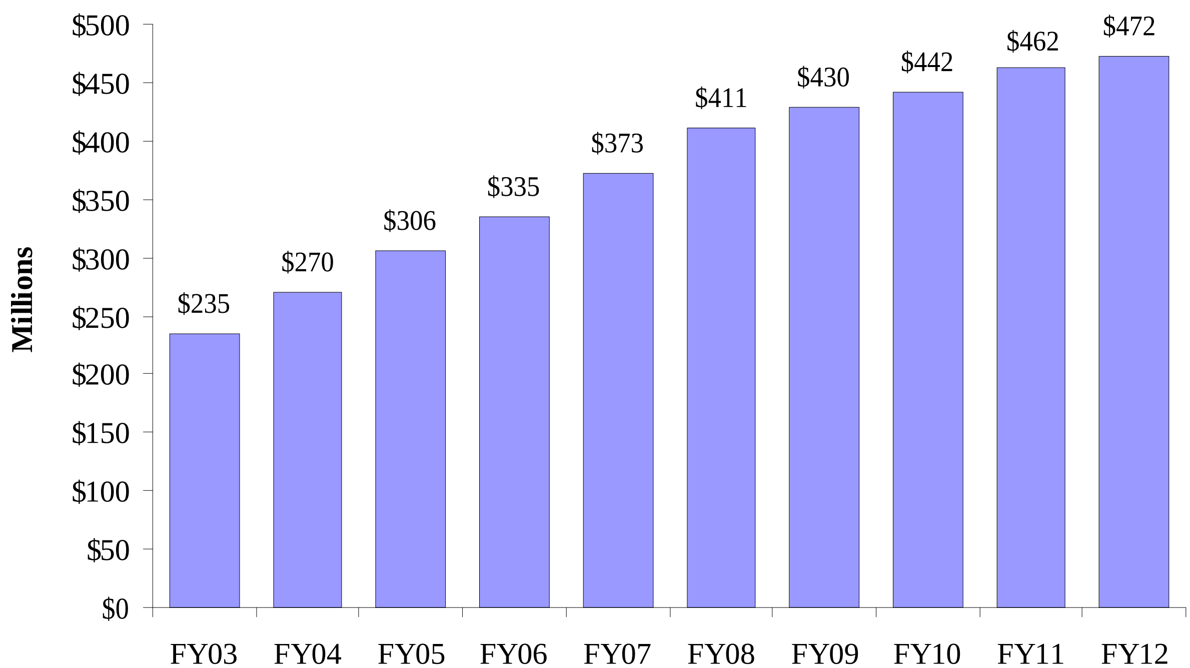
C. Total Category 12 Expenditure Trends: FY03 – FY12

This section reviews the spending trends for total Category 12 expenditures (budgeted and actual, tax supported and non-tax supported) from FY03 through FY12.

Chart 2-2 shows the actual Category 12 expenditures for FY03-FY11 and the approved budget for Category 12 in FY12. The data show:

- Actual Category 12 expenditures increased 97% from FY03 to FY11;
- Category 12 expenditure growth has slowed in recent years, increasing 3% per year on average from FY09 to FY11 compared to 13% per year on average from FY03 to FY08; and
- The $472 million approved budget for Category 12 in FY12 represents a 2% increase over FY11 expenditures, the smallest annual increase over the last ten years.

Exhibit 2-2. MCPS Category 12 Expenditures, FY03 to FY11 Actuals and FY12 Budgeted



% Increase from Prior Year	--	15%	13%	9%	11%	10%	4%	3%	5%	2%

Source: MCPS

Category 12 Compared to MCPS Budget. Since FY03, Category 12 expenditures have increased as a proportion of total MCPS operating expenditures (excluding Enterprise and Special Revenue Fund expenditures). From FY03 to FY12, Category 12 expenditures increased by 101% while total MCPS operating expenditures increased by about 57% (from $1.29 billion to $2.03 billion) during the same period.

As a result, Category 12 expenditures as a percent of total MCPS operating expenditures have increased from 18% in FY03 to 23% in FY12.

Budgeted vs. Actual Category 12 Expenditures. Table 2-1 compares budgeted and actual Category 12 expenditures from FY03 through FY11. While MCPS' actual Category 12 expenditures exceeded the budget in seven of the past nine years, the variance between budget and actual was no more than 2% in each year, with an average variance of 1.2%.

Table 2-1. Category 12 Budgeted vs. Actual Expenditures, FY03-FY12 ($'s in millions)

Fiscal Year	Category 12 Expenditures		$ Variance	% Variance
	Budget	Actual		
FY03	$233.3	$235.1	($1.87)	(0.8%)
FY04	$266.4	$270.0	($3.61)	(1.4%)
FY05	$302.2	$305.9	($3.74)	(1.2%)
FY06	$328.4	$334.6	($6.13)	(1.9%)
FY07	$371.5	$372.8	($1.33)	(0.4%)
FY08	$406.4	$411.4	($5.06)	(1.2%)
FY09	$420.7	$429.6	($8.93)	(2.1%)
FY10	$447.3	$441.9	$5.41	1.2%
FY11	$463.3	$462.2	$1.11	0.2%
FY12	$471.8	--	--	--

Source: MCPS

D. Category 12 Expenditures by Component

This section examines Category 12 expenditures by component. Table 2-2 compares FY03 and FY11 spending by component, breaking out the actual expenditures for the six largest components. In the table, "All Other" includes the remaining components: Tuition Reimbursement, Partnership Tuition, and Miscellaneous.[9]

[9] OPEB was excluded from this table since that component did not exist in FY03 and there were no OPEB contributions made in FY11.

The data show that while the total expenditures in all the components increased between FY03 and FY11, the relative distribution of expenditures within Category 12 changed during the decade. Specifically, from FY03 to FY11, the percent of Category 12 dollars spent on:

- Active employee group insurance increased from 40% to 48%;
- Retirement contributions for active employees increased from 7% to 13%; and
- FICA contributions decreased from 30% to 21%.

The data also show that the four largest components – active employee group insurance, FICA, retirement, and retiree group insurance – accounted for 91% of MCPS' Category 12 expenditures in FY11. This represented a slight increase from the 86% of expenditures for those same components in FY03.

Table 2-2. FY03 and FY11 Category 12 Expenditures by Component
($'s in millions)

Category 12 Component	FY03 Expenditures		FY11 Expenditures	
	$	% of Total	$	% of Total
Active Employee Group Insurance	$95.6	40%	$216.5	48%
FICA (Social Security/Medicare)	$69.5	30%	$98.9	21%
Retirement	$16.4	7%	$62.0	13%
Retiree Group Insurance	$20.7	9%	$42.7	9%
Non-Tax Supported Grants	$19.8	8%	$21.9	5%
Risk Management/Self Insurance	$9.0	4%	$13.1	3%
All Other*	$4.1	2%	$6.9	1%
Total	**$235.1**	**100%**	**$462.2**	**100%**

*Include Tuition Reimbursement, Partnership Tuition, and Miscellaneous. OPEB was excluded from this table since that component did not exist in FY03 and there were no OPEB contributions made in FY11.
Source: MCPS

FY11 Budgeted vs. Actual Spending by Component. As shown earlier (page 8), MCPS' actual FY11 expenditures in Category 12 were about $1.1 million lower than budgeted, a variance of 0.2%. Table 2-3 compares the budgeted and actual expenditures by component for FY11.

For the largest components of Category 12 spending – active employee group insurance, FICA, retirement, and retiree group insurance – actual expenditures in FY11 were within 1% of the budgeted amounts. Data on each Category 12 component's budgeted and actual expenditures for all years FY03-FY11 are available in the Appendix at ©1.

Table 2-3. Comparison of FY11 Category 12 Budgeted and Actual Expenditures By Component ($'s in millions)

Category 12 Component	FY11		
	Budget	**Actual**	**Difference**
Active Employee Group Insurance	$216.2	$216.5	($0.3)
FICA (Social Security/Medicare)	$99.2	$98.9	$0.3
Retirement	$62.4	$62.0	$0.4
Retiree Group Insurance	$42.7	$42.7	--
Non-Tax Supported Grants	$21.9	$21.9	--
Risk Management/Self Insurance	$13.1	$13.1	--
Tuition Reimbursement	$4.1	$3.8	$0.3
Miscellaneous Expenses	$2.0	$1.9	$0.1
Partnership Tuition	$1.6	$1.2	$0.4
OPEB	$0	$0	--
Total Category 12	**$463.3**	**$462.2**	**$1.1**

Source: MCPS

FY12 Budgeted Expenditures by Component. Table 2-4 shows the FY12 budgeted expenditures for FY12 for each component of Category 12. Overall, the FY12 Category 12 budget increased by 2% over the FY11 budget.

Table 2-4. FY12 Category 12 Budgeted Expenditures ($'s in millions)

Category 12 Component	FY12 Budget	Change from FY11 Budget
Active Employee Group Insurance	$215.5	(0.3%)
FICA (Social Security/Medicare)	$98.8	(0.3%)
Retirement	$65.4	5%
Retiree Group Insurance	$48.1	13%
Non-Tax Supported Grants	$21.8	(0.6%)
Risk Management/Self Insurance	$15.6	18%
Tuition Reimbursement	$3.0	(26%)
Miscellaneous Expenses	$2.0	0.7%
Partnership Tuition	$1.4	(12%)
OPEB	$0*	NA
Total Category 12	**$471.8**	2%

*In FY12, the County Council appropriated $20 million to the consolidated OPEB trust for MCPS OPEB; however these funds no longer appear as an MCPS Category 12 expenditure.
Source: MCPS

E. Employee Benefit Funding in Other MCPS Budget Categories

As noted on page 5, Category 12 does not include the employee benefit costs associated with positions funded through MCPS enterprise funds such as the Food Services Fund and Real Estate Fund.

Table 2-5 shows the total cost of employee benefits (unemployment, workers compensation, employee health benefits, FICA, and retirement) funded through MCPS' enterprise funds from FY03 through FY12. Total expenditures on benefits for enterprise funded positions increased 84% between FY03 and FY12.

Table 2-5. MCPS Enterprise Fund Employee Benefit Expenditures, FY03 to FY11 Actuals and FY12 Budgeted

Enterprise Fund	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12 Budget
Non-Category 12 Benefit Expenditures	$6.4 million	$7.7 million	$8.4 million	$9.0 million	$9.3 million	$9.9 million	$8.6 million	$8.6 million	$10.1 million	$11.8 million

Source: MCPS

CHAPTER III. RETIREMENT BENEFIT BUDGET AND PENSION FUND

In FY12, 14% of MCPS' Category 12 budget funds the annual cost of employee retirement benefits. This chapter discusses how MCPS budgets and funds annual retirement benefit costs, and provides data on MCPS' retirement benefit expenditure trends. It is organized as follows:

- **Section A, Background** provides an overview of MCPS employee retirement benefits and explains the process of determining the annual required contribution to MCPS' locally-funded pension fund;
- **Section B, Pension Fund Contributions, Expenditures, Fund Balance and Funded Ratio** reviews annual contributions (FY03 through FY11) to the pension fund and identifies other factors that affect the fund balance and "funded ratio" of MCPS' pension fund. This section also includes data on the budgeted FY12 employer contribution to the pension fund;
- **Section C, Key Board of Education Decisions** identifies a set of important decisions made by the Board of Education regarding funding, plan design, and pension plan assumptions that affect the required annual contribution to MCPS' pension fund; and
- **Section D, Future Pension Costs** provides the most recent actuarial estimates of future MCPS pension fund contributions, and summarizes comments on MCPS' pension plan assumptions and policies, provided at OLO's request by the Chief Actuary at Bolton Partners, an independent employee benefits firm.

A. Background

Permanent MCPS employees participate in a defined benefit retirement plan, also referred to as a pension plan.[1] Defined benefit plans pay a retiree a set monthly amount from retirement until death. A retiree's annual pension is determined by a formula that takes into account the employee's final salary, years of service, and a pension "multiplier"[2] per year of credited service.

All current permanent MCPS employees participate in a "core" pension plan with a 1.8% multiplier:

- Approximately 77% of MCPS employees participate in a core plan funded and administered by the State of Maryland; and
- The other 23% of MCPS employees participate in a core plan that offers the same benefits as the State plan, but is County-funded and administered by MCPS.

[1] Temporary and substitute employees do not participate in the MCPS pension plan.
[2] A pension multiplier is the percent of wages used to calculate the amount of an annual pension benefit.

In addition to the core pension, all current permanent MCPS employees also receive a locally-funded "supplemental" pension with a 0.2% multiplier. The core pension multiplier of 1.8% combined with supplemental multiplier of 0.2% provide current MCPS employees with an overall 2.0% multiplier per year of credited service.[3]

Beginning in FY12, new permanent MCPS employees receive a core benefit with a 1.5% multiplier and a supplemental benefit with a 0.2% multiplier for an overall 1.7% multiplier per year of credited service.[4]

MCPS core and supplemental pension benefits paid do not change when a retiree reaches Social Security eligibility age.

MCPS' Pension Fund. Funding for MCPS' County-funded defined benefit pensions comes from annual contributions made by MCPS and active MCPS employees to the MCPS Employees' Retirement and Pension Systems Fiduciary Fund[5] (hereafter, "MCPS' pension fund"). Annual contributions into MCPS' pension fund combined with the fund's investment earnings are used to pay for employees' pensions.

In 1995, the Board of Education created the MCPS Board of Investment Trustees to oversee the investment of assets[6] in MCPS' pension fund. Responsibilities of the Board of Investment Trustees include establishing pension fund investment policies and guidelines, selecting investment managers, monitoring the investment performance of pension fund assets, and managing investment expenses.

Process for Determining Annual Contribution to the Pension Fund. Montgomery County Board of Education Policy GIG, *Funding Retirement/Pension System*, establishes MCPS' policy and guidelines for establishing an adequately funded pension plan. The Board of Education's adopted policy is to: ". . . have as a funding goal each year the improvement of the asset to accrued liability ratio toward the 100 percent funded level by the end of the amortization period."[7] In other words, MCPS policy is to make annual contributions to the pension fund in amounts necessary to accumulate assets that equal pension liabilities[8] within 30 years (the current amortization period).

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[3] To be eligible for normal retirement, MCPS employees must have 30 years of credited service or must be age 62 (or older) with at least five years of credited service. The current multipliers are for years of service since 1998. The Core Pension multiplier is 1.4% and the Pension Supplement multiplier is 0.08% for years of service before 1998. Appendix beginning ©12 includes additional details about the MCPS pension plan.
[4] To be eligible for normal retirement, employees hired in FY12 and after must have a combined age and years of credited service that are greater than 90 years or must be age 65 (or older) with at least ten years of credited service.
[5] A fiduciary fund is a fund for which an entity (in this case, MCPS) serves as a trustee for assets that belong to others (in this case, retirees receiving the MCPS pension benefit).
[6] The term assets refers to the value of cash and securities owned by a pension fund.
[7] Board of Education Policy GIG (established by Resolution No. 534-83, June 1983 and amended by resolution No. 449-09, October 26, 2009). A copy of Board of Education Policy GIG appears in Appendix at ©19.
[8] The term liability refers to the monetary value of pension payment obligations undertaken by the pension fund.

MCPS contracts with an actuary to calculate the annual required contribution (also known as, the "ARC") to MCPS' pension fund. Specifically, the Board of Education directs the actuary to calculate an annual required contribution that conforms to the MCPS pension funding policy and other specified assumptions (such as rate of investment return and future liabilities). The actuary calculates the annual required contribution in the fall of each year for MCPS to use in preparing its budget for the following fiscal year.

Every fall, MCPS staff meets with the Board of Education Fiscal Management Committee to review the latest actuarial plan assumptions and the recommended annual contribution to the pension fund for the upcoming fiscal year. The Board of Education approves the assumptions used in developing the calculation of the annual pension fund contribution and the amount is incorporated into MCPS' Category 12 annual budget request.

MCPS' contract actuary also prepares an annual pension fund "valuation report" that updates actuarial estimates of pension fund liabilities and expenses. In addition, as part of the annual valuation report, the actuary calculates the annual required contribution necessary to comply with the Board of Education's approved policies and assumptions. Every three to five years, the actuary re-evaluates the plan's experience and the assumptions used to calculate the fund's accrued liability and future funding needs.

The next two sections of this chapter review ongoing MCPS practices and key decisions that affect the amount of the annual contribution to the pension fund.

Table 3-1. MCPS Pension Fund
FY03-FY11 Actual Balances, Contributions, Expenses and Funded Ratios
FY12 Budgeted Employer Contribution

	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12 Budgeted*
Beginning Balance	$613,019,791	$599,870,936	$673,459,160	$727,894,344	$785,112,495	$929,722,902	$877,327,308	$702,465,603	$805,616,685	$994,130,100
Contributions										
Employer	$16,639,493	$19,866,733	$28,871,207	$36,817,620	$58,000,751	$58,761,275	$61,405,163	$63,080,846	$64,814,364	$77,788,472
Employee	$4,493,106	$4,520,946	$4,811,344	$4,908,325	$8,932,215	$12,791,123	$16,752,846	$16,312,774	$16,897,603	
Investment Earnings (Loss)	$4,711,194	$88,981,263	$63,827,661	$62,207,300	$128,374,337	($69,949,567)	($195,203,801)	$83,972,809	$169,716,298	
Benefits Paid	($35,897,885)	($37,956,887)	($41,090,497)	($44,689,076)	($48,426,240)	($51,675,769)	($54,859,755)	($58,041,590)	($61,029,941)	
Administrative Expenses	($3,094,763)	($1,823,831)	($1,984,531)	($2,026,018)	($2,270,656)	($2,322,656)	($2,956,158)	($2,173,757)	($1,884,899)	
Ending Balance	$599,870,936	$673,459,160	$727,894,344	$785,112,495	$929,722,902	$877,327,308	$702,465,603	$805,616,685	$994,130,100	
Funded Ratio										
Start of FY	102.1%	93.4%	86.8%	80.5%	71.8%	73.5%	74.7%	71.9%	68.9%	
End of FY	93.4%	86.8%	80.5%	71.8%	73.5%	74.7%	71.9%	68.9%	70.1%	

* The FY12 MCPS budget includes funding for the employer contribution to the pension fund. The budget does not include estimates of employee contributions, investments earnings, benefits paid, and administrative expenses.

Sources: MCPS Comprehensive Annual Financial Reports, FY03 through FY11; Montgomery County Public Schools Annual Review and Actuarial Valuation of the Employees' Retirement and Pension Systems as of July 1, 2011, October 2011.

B. MCPS Pension Fund Contributions, Expenditures, and Fund Balance

This section provides information on the annual contributions into MCPS' pension fund as well as the other factors that add to or subtract from MCPS pension fund assets. MCPS' budget Category 12 includes almost all of the funding for MCPS' annual contribution to the MCPS pension fund.

Table 3-1 (page 15) shows actual fund balances, contributions, and expenses for MCPS' pension fund for FY03 through FY11. The last row contains data on the "funded ratio" at the start and end of each fiscal year. The table also shows budgeted pension fund contributions for FY12. Further explanations of the data contained in Table 3-1 are provided below.

Fund Balance. Table 3-1 shows start-of-year and end-of-year fund balances for MCPS' pension fund. The term "fund balance" refers to the amount of assets in a fund at a given point in time. Employer and employee contributions as well as investment gains add to a pension fund balance; pension benefit payments, investment losses, and administrative expenses draw down the fund balance. In most years over the past decade, the net effect of these changes resulted in the MCPS pension fund balance increasing during the course of the fiscal year. However, in FY08 and FY09, years of large investment losses, the pension fund balance declined.

Employer Contributions. As explained earlier (page 14), MCPS determines its annual required contribution to the pension fund based on the recommendations of an actuary. Category 12 of the operating budget includes nearly 90% of funding for MCPS' annual contribution to its pension fund.[9]

To integrate the annual required contribution into the agency budgeting process, the actuary calculates the required annual contribution as a percent of MCPS' total payroll. This calculation allows MCPS to adjust the annual contribution amount to reflect changes in payroll (e.g., changes in workforce size, pay adjustments) that occur between the completion of the valuation report (usually in November of each year) and the Board of Education's approval of the operating budget (the following June).

For example, in November 2010, the actuary calculated that annual required contribution equaled 5.57% of total MCPS payroll. In approving the FY12 budget, the Board of Education set aside an amount equivalent to 5.57% of total payroll as the recommended contribution to the pension fund.

Table 3-2 compares the FY03 and FY12 annual MCPS pension fund contribution as a percent of payroll. The increase in percent of payroll translated into an increase in MCPS' contribution from \$16.6 million in FY03 to \$77.8 million in FY12. This increase of \$51.2 million or 369% in the annual contribution to the fund is a product of multiple factors including higher pension costs per employee/retiree, salary increases, growth in workforce size, lower than assumed investment returns, and changes in actuarial assumptions.

[9] MCPS makes contributions to the pension fund from sources other than Category 12, most notably from personnel costs budgeted in the Food Services Enterprise Fund.

Table 3-2. Percent of Total Payroll and Dollar Amount Contributed by MCPS to MCPS Pension Fund for FY03 and FY12

Fiscal Year	% of Payroll	Contribution Amount
FY03	2.74%	$16,639,493
FY12	5.57%	$77,788,472

Source: MCPS Annual Review and Actuarial Valuation of the Employees' Retirement and Pension Systems FY03 and FY11.

As mentioned above, more than three-quarters of MCPS permanent employees participate in a pension plan managed and funded by the State. For FY12, the portion of the State's contribution to its pension plan attributable to MCPS employees and retirees is estimated at $168 million. In addition, MCPS must contribute $2.8 million in FY12 to cover its share of administrative expenses for the State-run pension program.[10]

Employee Contributions. MCPS employees contribute to the pension fund through payroll deductions. In FY12, MCPS employees will contribute about $20 million to the pension fund.

As of July 1, 2011, employees who participate in the locally-funded pension plan contribute 7% of salary for their core benefit into MCPS' pension fund. Consistent with changes made by the General Assembly for participants in the State-run pension plan, MCPS raised the employee contribution from 5% to 7% at the start of FY12.

All MCPS employees contribute an additional 0.5% of salary to the MCPS pension fund for their supplemental benefit. MCPS did not make any changes to the employee contribution for the supplemental benefit for FY12.

Pension Benefits Paid to Retirees. MCPS disburses (locally-funded) retiree pension benefits from its pension fund. In FY11, MCPS pension payments totaled $61 million, a 37% increase over the FY06 amount.

Administrative Expenses. As with any pension system, MCPS incurs expenses to administer its plan. MCPS pays administrative costs from pension fund assets. Over the past decade, administrative expenses have cost MCPS between 0.23% and 0.50% of plan assets annually.

Investment Gains/Losses. Consistent with other pension funds across the country, MCPS has experienced great volatility in its pension trust investment returns in recent years. As shown in Table 3-1 (page 15), over the past decade, the MCPS pension fund has experienced annual investment gains as high as $170 million (FY11) and investment losses as great as $195 million (FY09). Volatility in investment performance affects the pension fund balance and the funded ratio (see below), and ultimately influences the employer's annual contribution.

[10] Source: Maryland Department of Legislative Services.

As is common among public pension funds, MCPS averages investment gains and losses over a five-year period when calculating its annual required contribution. This practice, known as "smoothing," moderates year-to-year swings in the annual contribution.

Funded Ratio. The "funded ratio" of a pension plan is a term that describes the percentage of the plan's liabilities covered by the current actuarial value of the plan's assets. In other words, the funded ratio measures the extent to which a plan has set aside funds to pay benefits accrued by its members.

At the end of FY11, the MCPS pension fund had assets of $1,020 million and an accrued liability of $1,454 million.[11] As the pension fund held assets equal to 70.1% of current liabilities, the funded ratio for the pension fund is 70.1%.

As shown in Table 3-1 (page 15), the funded ratio of the MCPS pension fund has experienced a downward trend over the past decade. Specifically, the funded ratio declined from 102.1% at the start of FY03 to 70.1% by the end of FY11.

Many other public sector pension funds also experienced significant reductions in their funded ratio over the past decade. In the case of MCPS, two primary factors contributed to the funded ratio decline: plan enhancements and investment performance.

Plan Enhancements. In 2006, the Board of Education approved two pension plan enhancements that significantly raised the plan's unfunded liability with a resulting decrease in the funded ratio.

- MCPS changed the core pension multiplier (for participants in the locally-funded plan) from 1.4% to 1.8% of average final salary for each year of credited service, retroactive to July 1, 1998. This change in the multiplier was identical to the modification made in the same year for participants in the State-run pension plan.

- MCPS increased the multiplier for the locally-funded supplemental benefit for all employees (including participants in the State-run plan) from 0.08% to 0.20 % for each year of credited service, retroactive to July 1, 1998.

These plan enhancements increased MCPS' liability to pay future pension benefits. As a result, the pension fund's funded ratio declined since MCPS had not previously contributed assets to cover this additional liability.

Investment Performance. As mentioned above, the Board of Education has directed MCPS' actuary to calculate annual pension contributions assuming a 7.5% annual rate of return on investments. In years that investments return less than 7.5%, the pension fund experiences an increase in its unfunded liability that negatively affects the funded ratio. As shown in Table 3-1 (page 15), the MCPS pension fund incurred a combined investment loss of more than $265 million during FY08 and FY09. While investment gains in FY10 and FY11 offset most of the losses from the previous two years, nonetheless, the funded ratio has continued to decline, in part,

[11] Source: Montgomery County Public Schools Annual Review and Actuarial Valuation of the Employees' Retirement and Pension Systems as of July 1, 2011, October 2011.

because the average annual investment return (over the past five years) has fallen below the assumed rate of 7.5%.

C. Key MCPS Pension Management Decisions

MCPS has made several pension fund management decisions that have altered the amount of the annual required contribution and/or affected the funded ratio. These decisions directly impacted the value of the fund's assets and adjusted the size of future pension liabilities.

Payment of Annual Required Contribution. As part of the annual budget process, the Board of Education decides how much to contribute to MPCS' pension fund.

- MCPS annually contributes to its pension fund consistent with the recommendations of their actuarial advisors. While this practice may not seem remarkable, it is noteworthy that several states and municipalities have succumbed to budget pressures and failed to meet this basic financial obligation. In contrast, MCPS abided by its pension funding policy and made annual contributions as recommended by its actuaries.

- For FY12, MCPS used non-County funding to meet the actuary's recommendation. The Board of Education elected to use one-time federal grant dollars to cover $4.4 million of its FY12 pension fund contribution. This decision did not change FY12 annual required contribution but reduced the amount of County funds needed to meet this obligation.

Pension Plan Design. In 2006 and 2011, the Board of Education made decisions that affected the design of the MCPS pension plans.

- In 2006, the Board of Education approved pension plan enhancements. As detailed above, the Board increased the core pension multiplier (for participants in the locally-funded plan) retroactive to July 1, 1998. The change in the core pension multiplier was identical to changes made for participants in the State-run plan. In addition, the Board increased the multiplier for the locally-funded supplement benefit for all employees (including participants in the State-run plan) retroactive to July 1, 1998. The 2006 pension enhancements created large unfunded liabilities, which in turn, required MCPS to make significant increases in its annual contribution. As shown in Table 3-1 on page 15, MCPS' annual contribution increased by more than $21 million (or 58%) from FY06 to FY07, primarily as a result of plan enhancements.

- To offset some of the cost of the 2006 plan enhancements, the Board of Education approved a phased-in increase in employee contributions. For the core benefit, the employee contribution was 2% of salary in FY06. The employee contribution was raised to 3% in FY07; 4% in FY08; and 5% in FY09. For the supplemental benefit, the employee contribution increased by 0.1% per year, from 0.2% in FY06 to 0.5% in FY09.

- In 2011, the Board of Education raised the employee contribution for the locally-funded core pension from 5% to 7% of salary (similar to the change made by the General Assembly for the employees in the State-funded core pension). The Board retained the employee contribution rate for the supplemental benefit at 0.5% of salary. This increase in employees' contributions will increase pension fund assets and thereby mitigate the rate of growth for the employer's contribution.

- Also in 2011, the Board of Education amended the design of the locally-funded pension plan to correspond to changes made by the General Assembly to the State-run teachers' pension plan. Specifically, MCPS lowered the cap on annual cost-of-living adjustments for service after July 1, 2011 and modified the plan design for employees hired after July 1, 2011. Changes for new hires include a lower pension multiplier (for each year of credited service), a longer vesting period, a revised formula for calculating average final salary, and more stringent eligibility requirements for both normal and early retirement. These changes should have a positive effect on long-term pension liabilities.

Actuarial Assumptions. Some pension management decisions came from recognition of changing external conditions.

- In 2011, the Board of Education approved revised pension plan assumptions based on a new study prepared by MCPS' actuary. The revised assumptions reflected updated data on pension plan participants retirement ages, sick leave usage, mortality rates, and other factors that affect pension plan contributions and expenses. The new actuarial assumptions indicated that future pension liabilities were higher than previously estimated, and so, necessitated an increase in the employer's contribution.

- In 2006, the Board of Education reduced the assumed annual rate of return on pension plan investments from 8.0% to 7.5% to more closely reflect actual investment experience. This decision necessitated an increase in the annual required contribution.

D. Future Pension Costs

The final section of this chapter provides the most recent actuarial estimates of future MCPS pension fund contributions. It then summarizes comments on MCPS' pension plan assumptions and policies, provided at OLO's request by the Chief Actuary at Bolton Partners, an independent employee benefits firm.

Estimates of MCPS' Future Year Pension Costs. According to the most recent actuarial calculation, MCPS' FY13 contribution to the pension fund (5.42% of payroll) will be slightly lower than the FY12 rate (5.57% of payroll).[12] This decrease in the MCPS contribution as a percent of payroll is primarily a result of the higher employee contribution rate and plan revisions approved in 2011 by the Board of Education (see Section C of this chapter).

[12] Source: Montgomery County Public Schools Annual Review and Actuarial Valuation of the Employees' Retirement and Pension Systems as of July 1, 2011, October 2011.

Table 3-3 shows projected rates of growth for the MCPS pension fund contribution through FY16, as prepared by MCPS' actuary in May 2011. The actuarial estimates show that:

- In FY14 and FY15, pension costs will continue to grow as MCPS continues to absorb the investment losses from FY08 and FY09.
- By FY16, pension costs will stabilize (under the assumption that fund investments will meet their target).

Table 3-3. Projected Rate of Growth for MCPS Pension Fund Contributions [13]

Fiscal Year	Percent Growth over Previous Year
FY14	10.6%
FY15	6.6%
FY16	0.0%

Of course, these estimates will change if MCPS experiences demographic and investment changes that differ from assumptions. Moreover, workforce size and pay adjustments also will affect the actual dollar amount of future year MCPS pension fund contributions.

Assessment of MCPS Pension Policies and Assumptions. OLO asked Thomas B. Lowman, Chief Actuary at Bolton Partners, Inc.,[14] to review past and current information about MCPS' pension plan and to provide his professional observations regarding MCPS' assumptions and policies.

With respect to MCPS' pension plan assumptions and policies, Mr. Lowman concluded that:

> *MCPS generally has adopted practices and assumptions that are common among public sector pension plans and on average reflect better choices than most. Not every method used by MCPS is a best practice and generally adopting more best practices would increase contributions. An example of one additional best practice would be to materially shorten the amortization period to pay for benefit improvements.*

[13] Source: Memorandum from Superintendent Jerry Weast for Board of Education Agenda Item 5.2, May 23, 2011.
[14] Bolton Partners is an independent employee benefits firm headquartered in Baltimore, Maryland. Thomas Lowman has been a Fellow in the Society of Actuaries, an Enrolled Actuary and a member of the American Academy of Actuaries since 1982.

On the specific topic of the risk involved in MCPS' current investment return assumption of 7.5%, Mr. Lowman commented that:

> *It is lower than the rate used by most plans but still involves taking on investment risk to achieve the 7.5% target. Even at 7.5%, the policy shifts these investment risks to future year budgets and future taxpayers. The investment risk is probably the largest pension risk to MCPS other than the possibility of the State assigning the MCPS Teacher's pension cost to MCPS.*

In addition, OLO asked Mr. Lowman for an overall assessment of the MCPS pension plan's funded ratio. Mr. Lowman observed that:

> *The ability of a pension fund to survive is related to (1) the ability of the employer to provide enough future funding and (2) the current funding level. An employer with unlimited resources has little to worry about even if a plan is poorly funded. As an employer's ability to fund in the future is brought more into question, the funded ratio increases in importance. At the end of Fiscal Year 2011, the MCPS funded ratio was 70% (using the actuarial value of assets) or 68% (using the market value of assets). Many other public pension plans have low funded ratios but MCPS' is below average. The most promising way to improve the ratio would be to increase annual contributions.*
>
> *The low funded ratio means that MCPS must use current taxpayer funds to cover the cost of benefits earned in the past. The expected future trend in the funded ratio is a slow erratic increase until 100% funding is achieved.*

CHAPTER IV. MCPS GROUP INSURANCE EXPENDITURES

In FY12, 56% of MCPS' Category 12 budget is for active employee and retiree group insurance benefits. Group insurance costs have consistently represented the largest single budget component in Category 12.

This chapter reviews how MCPS budgets and accounts for these annual group insurance costs, and provides data on MCPS' group insurance expenditure trends. It is organized as follows:

- **Section A, MCPS Group Insurance Overview** summarizes MCPS' group insurance offerings and group insurance benefit fund structure, and outlines the different revenue and expenditures associated with group insurance;
- **Section B, Group Insurance Funding and Expenditure Trends** reviews the FY03-FY12 MCPS group insurance funding and expenditure trends; and
- **Section C, Explanation of FY11 End-of-Year Surplus in the Active Employee Group Insurance Fund** provides more detailed information on the FY11 revenue and expenditures in MCPS' group insurance fund for active employees.

A. MCPS Group Insurance Overview

MCPS offers five types of group insurance benefits to their active employees and retirees: medical, prescription drug, dental, vision, and life insurance. For each type of benefit, employees/retirees have one or more plans to select from. As of July 1, 2011, MCPS has approximately 48,700 total members participating in its active employee insurance programs (19,100 employees and 29,600 related dependents) and 12,200 total members participating in its retiree group insurance programs (8,200 retirees and 4,000 related dependents).

Table 4-1 (on the next page) shows the Calendar Year 2012 plans offered by MCPS, indicates whether each plan is self-insured or fully-insured, and notes which plans are closed to open enrollment or available only for active employees. The distinction between self-insured and fully-insured plans is described in the box below.

> A **self-insured plan** is one where an agency sets aside funding and pays all claims under the plan out of a self-insurance fund. Each year, the agency (with the assistance of actuaries) calculates the total premiums needed to cover the cost of anticipated claims. The agency contracts with a vendor to administer each self-insured plan and pays the vendor a negotiated administrative fee. The vendor provides access to its network of care providers and processes claims payments on behalf of the agency.
>
> A **fully-insured plan** is one where a contracted insurance vendor establishes the total premiums each year and the vendor is responsible for paying all claims under the plan. There is no additional administrative fee apart from the premium paid to the vendor under a fully-insured plan.

Under both self-insured and fully-insured plans, MCPS (not the vendor) determines the agency's "cost share." The cost share refers to the amount, typically expressed as a percent, of an annual premium paid by the employer versus individual employees. For active employees, the Board of Education establishes the cost share based on the results of collective bargaining with MCPS' employee unions. For retirees, the Board of Education establishes the cost share after consultation with retiree representatives.

Table 4-1. 2012 Group Insurance Plans Offered by MCPS

Group Insurance Plans Offered by MCPS	Vendors/Plans Offered	Self-Insured	Fully-Insured
Medical	Carefirst POS (actives only)	✓	
	Carefirst HMO	✓	
	United Healthcare POS (open)	✓	
	United Healthcare POS (closed)	✓	
	United Healthcare HMO	✓	
	Kaiser Permanente HMO		✓
Prescription	Caremark	✓	
	Kaiser Permanente		✓
Dental	Aetna PPO	✓	
	Aetna DMO		✓
Vision	National Vision Administrators	✓	
Life Insurance	Prudential	✓	

Note: "Closed" means that the plan is no longer enrolling new members. "Actives only" means that the plan is not available to retirees.
Source: MCPS

Recent Changes to Retiree Health Benefits. In May 2011, the Board of Education adopted changes to retiree health benefit eligibility and cost share. The specific changes are:

- Future retiree health benefits will be granted only after 10 years of eligible service; and
- The cost share for health benefits will be determined on a service-based scale, meaning that employees with more years of service will pay relatively less.

These changes will affect all new employees hired after July 1, 2011, and all current MCPS employees hired after July 1, 2006 who are younger than 55 years old. MCPS anticipates that these changes will lead to significant long-term cost savings for the agency.[1]

[1] http://www.montgomeryschoolsmd.org/boe/meetings/agenda/2010-11/2011-0523/5.1%20Retiree%20health%20benefits.pdf

1. MCPS Group Insurance Fund Structure

MCPS develops and maintains budget and financial information for group insurance in two separate funds – one for active employees and a separate one for retirees.

- For active employees, MCPS accounts for group insurance costs in an internal service fund, the Employee Benefits Plan Trust Fund. This report will refer to this fund as the **Active Employee Group Insurance Fund.**

- For retirees, MCPS accounts for group insurance costs in a fiduciary fund, the Other Post-Employment Benefits (OPEB) Trust Fund.[2] This report will refer to this fund as the **Retiree Group Insurance Fund.**

In general, an internal service fund is used for operations serving other funds or departments within a governmental agency while a fiduciary fund is used to account for assets held in trust by the government for the benefit of others.

There are two types of funding associated with retiree group insurance costs, pay-as-you-go funding and OPEB pre-funding. Pay-as-you-go funding refers to annual group insurance benefit costs for MCPS' current retirees. OPEB pre-funding refers to contributions toward an OPEB trust fund to pay long-term retiree group insurance liability (i.e., future group insurance costs that will come due for current employees after they retire). **The MCPS retiree group insurance expenditures discussed in this chapter refer only to the annual pay-as-you-go funding.[3]**

Group Insurance Fund Revenues and Expenditures. Each year, MCPS' group insurance funds for active employees and retirees receive revenue and incur expenses. The table on the next page describes the primary revenue sources and expenditures types for each group insurance fund, and indicates the percent of total revenue or total expenditures each represented in FY11.

[2] Prior to FY08, MCPS accounted for both the active employee and retiree costs in the Employee Benefits Plan Trust Fund. In FY08, MCPS created an OPEB Plan Trust to comply with new Governmental Accounting Standards Board financial reporting requirements and began accounting for all retiree group insurance costs within that fund.
[3] See Chapter II, page 6, for information related to MCPS OPEB funding.

Table 4-2: MCPS Group Insurance Fund Revenue Sources and Expenditure Types

Active Employee Group Insurance Fund		Retiree Group Insurance Fund	
Revenue Sources and % of FY11 Total Revenue			
Category 12 Agency Contribution. MCPS' share of the annual group insurance premiums for all employees holding tax supported positions that are funded in the annual operating budget.	82%	**Category 12 Agency Contribution.** MCPS' share of the annual group insurance premiums for all enrolled retirees.	57%
Employee Contributions. Employees' share of annual group insurance premiums that is deducted from employees' bi-weekly paychecks.	8%	**Retirees Contributions.** Retirees' share of the annual group insurance premiums that is deducted from retiree's pension payments or billed directly to retirees.	35%
Non-Category 12 Agency Contribution. MCPS' share of the annual group insurance premiums for employees holding positions funded through: the capital budget; non-tax supported enterprise funds; and grants.	7%	**Medicare Part D Reimbursements.** Prescription drug cost reimbursement received from the federal Center for Medicare and Medicaid Services' Medicare Part D program.[4]	6%
Miscellaneous. Revenue from investment earnings, optional coverage purchased by employees, and rebates from vendors.	3%	**Miscellaneous.** Revenue from investment earnings and rebates from vendors.	2%
Types of Expenditures and % of Total FY11 Expenditures			
Claims. All expenditures paid out based on the actual insurance claims incurred under MCPS' self-insured plans.	78%	**Claims.** All expenditures paid out based on the actual insurance claims incurred under MCPS' self-insured plans.	84%
Premiums. Payments to vendors that provide and administer fully-insured plans to MCPS employees.	17%	**Premiums.** Payments to vendors that provide and administer fully-insured plans to MCPS retirees.	11%
Administrator Service Fees. Per month, per member fees paid to vendors that administer MCPS' self-insured plans.	4%	**Administrator Service Fees.** Per month, per member fees paid to vendors that administer MCPS' self-insured plans.	5%
MCPS Administrative Expenses. Expenditures for MCPS staff whose personnel costs are charged to the group insurance fund and trustee fees.	1%	**MCPS Administrative Expenses.** Expenditures for MCPS staff whose personnel costs are charged to the group insurance fund and trustee fees.	<1%

[4] Medicare Part D reimbursements are available to employers who provide their Medicare-eligible retirees with prescription drug benefits that are at least actuarially equivalent to those that otherwise would be provided by Medicare.

2. Group Insurance Fund Balance (or Reserve)

Similar to other agencies, MCPS' practice is to maintain a balance (also known as a reserve) in both the active employee and retiree group insurance funds to protect against unanticipated expenditures in any given year. However, MCPS does not have a formal written policy that establishes a target reserve amount.

In practice, at the end of each fiscal year, any surplus or deficit between revenue and expenditures is added to or subtracted from the fund balance coming into the year; this action is reported by MCPS in its Comprehensive Annual Financial Report (CAFR). MCPS staff report that year-end fund balances remain in the respective funds and are not transferred for other uses.

Through FY07, the fund balance reported in MCPS' CAFR was for the active employee and retiree group insurance funds combined. In FY08, the CAFR begin reporting fund balance information separately for the Active Employee Group Insurance Fund and the Retiree Group Insurance Fund. Fund balance data since FY08 are available in Section B of this chapter.

3. Budgeting for Group Insurance

MCPS' develops its annual budget for group insurance expenditures using estimates and projections from a health benefits actuarial consultant. Each year, the consultant provides MCPS with group insurance expenditure projections for each plan. The projections take into account numerous factors and assumptions, including:

- Actual expenditure trends for each of MCPS' plans;
- Overall health care cost trends based on an annual industry survey of medical, dental, pharmacy, and vision vendors;
- Current plan enrollment and any projected changes in enrollment; and
- Adjustments for expected changes in coverage requirements, e.g., mandates related to Federal Health Care Reform legislation.

MCPS utilizes group insurance expenditure projections to develop its annual budget request for the group insurance funds (on a fiscal year basis), and to develop its annual group insurance plan premiums (on a calendar years basis).

MCPS staff note that several factors complicate budgeting for group insurance expenditures, any and all of which can lead to variances between budgeted and actual group insurance expenditures. The primary factors, which are listed below, similarly apply to the other County-funded agencies.

- **MCPS is largely self-insured and group insurance expenditures each year result from actual health care use by plan participants.** In any given year, health care use can vary unexpectedly for multiple reasons. Self-insured plans bear the immediate financial "risk" for unanticipated expenditures and the immediate "benefit" from unanticipated savings.

- **Group insurance plans operate on a calendar year basis while budgets are approved on a fiscal year basis.** As a result, changes during the fiscal year (such as how many employees choose to switch health plans during open enrollment) may not have been fully anticipated at the time cost projections were prepared for the budget.

- **Many months elapse between budget development and the beginning of the fiscal year.** When MCPS develops its recommended budget for group insurance each fall, it uses cost projections based on the actual expenditures and experience over the most recent twelve months. By the time the fiscal year begins in July, expenditure trends may have varied from the projection prepared the previous fall.

B. Group Insurance Funding and Expenditure Trends

This section reviews funding and expenditure trends in the Active Employee Group Insurance Fund and the Retiree Group Insurance Fund. The information provided includes:

- Trend data on actual group insurance expenditures;
- A summary of group insurance fund revenue, expenditures, and fund balance; and
- A comparison of budgeted versus actual group insurance revenue and expenditures.

1. Active Employee Group Insurance Fund

Table 4-3 contains FY03 to FY11 data on annual expenditures and average expenditures per enrollee[5] for MCPS' Active Employee Group Insurance Fund; for FY12, the data reflect budgeted expenditures.

In sum, during the past decade, active employee group insurance expenditures and expenditures per enrollee increased every year. The rate of expenditure growth, however, slowed during the past two fiscal years, FY10 and FY11. Specifically, between FY03 and FY11:

- Annual group insurance expenditures increased 90%, from $131.4 to $250.3 million;
- After averaging annual expenditure growth of 10% from FY03 to FY09, the rate of growth slowed to 5% in FY10 and 4% in FY11;
- Plan enrollment increased by 13%, from 17,078 to 19,226 employees; and
- Average expenditures per enrollee increased 69%, from $7,695 to $13,019.

MCPS' FY12 budget includes a 4% increase in Active Employee Group Insurance Fund expenditures. This budget amount translates into a 5% increase in average expenditures per enrollee.

[5] Average expenditures per enrollee controls for changes in workforce size and plan enrollment. The enrollment data used for this calculation does not include covered dependents.

Table 4-3. MCPS Active Employee Group Insurance Fund Expenditures, FY03-FY12

Group Insurance	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12 Budget
Enrollment*	17,078	17,211	17,537	17,960	18,456	18,993	19,163	19,123	19,226	19,081
Expenditures	$131.4 million	$147.0 million	$165.2 million	$181.1 million	$191.9 million	$209.4 million	$229.5 million	$241.5 million	$250.3 million	$260.7 million
Change from Prior Year	**--**	**12%**	**12%**	**10%**	**6%**	**9%**	**10%**	**5%**	**4%**	**4%**
Average Expenditures per Enrollee	$7,695	$8,539	$9,419	$10,084	$10,396	$11,026	$11,975	$12,627	$13,019	$13,664
Change from Prior Year	**--**	**11%**	**10%**	**7%**	**3%**	**6%**	**9%**	**5%**	**3%**	**5%**

*Medical plan enrollment of MCPS active employees as of July 1st each year. Does not include dependents.
Source: MCPS and OLO

Revenue, Expenditures, and Fund Balance. Table 4-4 contains data on the annual Active Employee Group Insurance Fund revenues, expenditures, and resulting year-end fund balance from FY08 to FY11; for FY12, the table reflects budgeted data.

In FY11, the Fund's revenues exceeded expenditures by a sizable amount ($13.1 million); this resulted in an unusually large year-end fund balance of $21.6 million, or 8.6% of FY11 actual expenditures. Additionally, the data show:

- The actual year-end fund balance ranged from 1.2% to 8.6% of expenditures;
- Three years where revenue exceeded expenditures (FY08, FY10, and FY11) and increased the Fund's ending balance;
- Considerable fluctuation in the difference between revenue and expenditures from year to year. For example, a $5 million surplus (i.e., revenue exceeded expenditures) in FY08 followed by a $9 million deficit (i.e., expenditures exceeded revenue) in FY09; and
- MCPS' FY12 budget projects maintaining the $21.6 million fund balance through the end of FY12, although the balance as a percent of expenditures would decline slightly to 8.3%.

Table 4-4. MCPS Active Employee Group Insurance Fund Revenue, Expenditures, and Year-End Fund Balance Levels

Active Employee Group Insurance Fund	FY08	FY09	FY10	FY11	FY12 Budgeted
Beginning Balance	$6,757,570	$11,818,442	$2,797,995	$8,541,533	$21,598,686
Revenue	$214,475,114	$220,456,493	$247,207,362	$263,353,334	$260,714,366
Expenditures	$209,414,242	$229,476,940	$241,463,824	$250,296,181	$260,714,366
Difference	$5,060,872	($9,020,447)	$5,743,537	$13,057,153	--
Ending Balance	$11,818,442	$2,797,995	$8,541,533	$21,598,686	$21,598,686
Percent of Expenditures	**5.6%**	**1.2%**	**3.5%**	**8.6%**	**8.3%**

Source: MCPS

Comparison of Budgeted vs. Actual Revenue. Table 4-5 compares annual budgeted and actual revenue for the Active Employee Group Insurance Fund from FY08 to FY11. In this table, a variance that is "more than budget" represents extra revenue to the Fund. The data show that for these years:

- The actual revenue deposited each year into the Active Employee Group Insurance Fund was greater than budgeted. The amount of additional revenue ranged from $2.8 million (or 1%) to $6.3 million (or 3%) more than budgeted;
- MCPS' Category 12 contribution to the Active Employee Group Insurance Fund exceeded the budgeted amount in FY08, FY09, and FY10, but not in FY11. The amount of additional contributions ranged from $3 million (or 2%) to $5.5 million (or 3%) more than budgeted.

Table 4-5. Budgeted vs. Actual Revenue: MCPS Active Employee Group Insurance Fund ($'s in millions)

Group Insurance Fund Revenue	FY08		FY09		FY10		FY11	
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual
Category 12 Contrib.	$171.8	$174.8	$175.0	$180.3	$198.6	$204.1	$216.3	$216.3
All Other	$39.9	$39.7	$39.2	$40.2	$43.2	$43.1	$43.1	$47.1
Total Revenue	**$211.7**	**$214.5**	**$214.2**	**$220.5**	**$241.8**	**$247.2**	**$259.4**	**$263.4**
Actual Revenue Variance from Budget	**$2.8 million more than budget**		**$6.3 million more than budget**		**$5.4 million more than budget**		**$4.0 million more than budget**	

Source: MCPS

Comparison of Budgeted vs. Actual Expenditures. Table 4-6 compares budgeted and actual group insurance expenditures for the Active Employee Group Insurance Fund from FY08 to FY11. In this table, a variance that is "less than budget" represents a savings to the Fund and a variance that is "more than budget" represents a shortfall to the Fund. The data show:

- Actual expenditures exceeded the budgeted amount in FY08 and FY09, were slightly lower than budgeted in FY10, and substantially lower than budgeted in FY11;
- The actual expenditures ranged from $9.1 million (or 4%) less than budgeted to $4.9 million (or 2%) more than budget; and
- Insurance claims were primarily responsible for expenditures exceeding the budget in FY08 and FY09, and for the expenditures savings compared to budget in FY11.

Table 4-6. Budgeted vs. Actual Expenditures: MCPS Active Employee Group Insurance Fund ($'s in millions)

Group Insurance Fund Expenditures	FY08		FY09		FY10		FY11	
	Budget	**Actual**	**Budget**	**Actual**	**Budget**	**Actual**	**Budget**	**Actual**
Claims	$145.6	$149.7	$174.9	$177.2	$187.7	$188.9	$205.0	$196.4
All Other	$58.9	$59.7	$52.1	$52.3	$54.0	$52.6	$54.4	$53.9
Total Expenditures	**$204.5**	**$209.4**	**$227.0**	**$229.5**	**$241.7**	**$241.5**	**$259.4**	**$250.3**
Actual Expenditures Variance from Budget	**$4.9 million more than budget**		**$2.5 million more than budget**		**$0.2 million less than budget**		**$9.1 million less than budget**	

Source: MCPS

Variation in Category 12 contributions. As noted in Table 4-5, the Category 12 contributions to the Active Employee Group Insurance Fund exceeded budgeted levels in FY08, FY09, and FY10. MCPS' year-end categorical transfer request memorandums (prepared for approval first by the Board of Education and the County Council, as required by law) report that the additional Category 12 contributions between FY08 and FY10 were made in order to increase the end-of-year fund balance.

In FY08 and FY09, the additional Category 12 contribution was funded through categorical transfers from other MCPS budget categories. In FY10, the additional contribution was funded through savings within other Category 12 components. Specifically:

- In FY08, MCPS contributed an additional $3 million to the Active Employee Group Insurance Fund. MCPS' FY08 year-end categorical transfer request explained that: "Actual costs for the Employee Benefit Plan (EBP) were at budgeted levels. However, increased cost projections make it prudent to increase the contribution to the EBP reserve, as recommended by the County Council benefits consultant . . . These resources will be available in future years to offset unexpected cost increases."[6]

[6] *FY 2008 Operating Budget Categorical Transfer* memorandum, July 28, 2008. Attached at ©22.

- In FY09, MCPS contributed an additional $3 million to the Active Employee Group Insurance Fund. MCPS' FY09 year-end categorical transfer request explained that: "Actual costs for the Employee Benefit Plan (EBP) were 2.5 percent higher than budgeted levels. In addition, increased costs projections make it prudent to increase the contribution to the EBP reserve by $3,000,000, as recommended by the County Council benefits consultant. These resources will be available in future years to offset unexpected cost increases."[7]

- In FY10, MCPS contributed an additional $5.5 million to the Active Employee Group Insurance Fund. MCPS' FY10 year-end categorical transfer request explained that: "Actual net costs for the Employee Benefit Plan (EBP) were 0.3 percent higher than budgeted levels. In addition, increased cost projections make it prudent to increase the contribution to the EBP reserve by $5,500,000, as recommended by the County Council benefits consultant."[8]

Explanation of MCPS reference to County Council benefits consultant. In April 2003, Bolton Partners (an employee benefits consulting firm under contract to the County Council) issued a report for the Council's Management and Fiscal Policy Committee that reviewed group insurance programs offered by the County and bi-County agencies. The Bolton Partners' report made several recommendations, including a recommendation that each agency maintain a 5% fund balance in their respective group insurance funds.

In December 2003, the Council approved Resolution No. 15-454, *Policy Guidance for Agency Group Insurance Programs*, which endorsed four recommendations from the Bolton report; including that the agencies adhere to the proposed fund balance targets. The complete report by Bolton Partners and the approved resolution are in the Appendix (beginning at ©37).

2. Retiree Group Insurance Fund

Table 4-7 contains FY03 to FY11 data on annual expenditures and average expenditures per enrollee[9] for MCPS' Retiree Group Insurance Fund; for FY12, the data reflect budgeted expenditures. In sum, during the past decade, retiree group insurance expenditures and expenditures per enrollee increased every year through FY10 before declining in FY11. Specifically, between FY03 and FY11:

- Annual group insurance expenditures increased 80%, from $39.9 to $72.0 million;
- Plan enrollment increased by 31%, from 5,657 to 7,424 retirees; and
- Average expenditures per enrollee grew by 38%, from $7,054 to $9,702.

MCPS' FY12 budget includes a 17% increase in Retiree Group Insurance Fund expenditures. Combined with an 11% increase in retiree plan enrollment, this budget amount translates into a 6% increase in average expenditures per enrollee.

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[7] *FY 2009 Operating Budget Categorical Transfer* memorandum, July 27,2009. Attached at ©27.
[8] *Fiscal Year 2010 Operating Budget Categorical Transfer* memorandum, July 26, 2010. Attached at ©32.
[9] Average expenditures per enrollee controls for changes in number of retirees and plan enrollment. The enrollment data used for this calculation does not include covered dependents.

Table 4-7. MCPS Retiree Group Insurance Fund Expenditures, FY03-FY12

Group Insurance	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12 Budget
Enrollment*	5,657	5,942	6,161	6,382	6,583	6,858	7,011	7,131	7,424	8,266
Expenditures	$39.9 million	$43.3 million	$47.7 million	$54.7 million	$59.8 million	$63.0 million	$66.5 million	$73.9 million	$72.0 million	$84.6 million
Change from Prior Year	--	**9%**	**10%**	**15%**	**9%**	**5%**	**5%**	**11%**	**(2%)**	**17%**
Average Expenditures per Enrollee	$7,054	$7,285	$7,745	$8,412	$9,077	$9,190	$9,481	$10,358	$9,702	$10,235
Change from Prior Year	--	**3%**	**6%**	**9%**	**8%**	**1%**	**3%**	**9%**	**(6%)**	**6%**

*Medical plan enrollment as of July 1st each year. Does not include dependents.
Source: MCPS and OLO

Revenue, Expenditures, and Fund Balance. Table 4-8 contains data on the annual Retiree Group Insurance Fund revenue, expenditures, and resulting year-end fund balance from FY08 to FY11; for FY12 the table reflects budgeted data.

In FY11, the Fund's revenue exceeded expenditures by $3.3 million; this resulted in a year-end fund balance of $8.8 million, or 12.2% of FY11 actual expenditures. The data also show:

- The ending fund balance ranged from 7.5% to 14.8%; and
- MCPS' FY12 budget projects maintaining the $8.8 million fund balance through the end of FY12, although the balance as a percent of expenditures would decline to 10.4%.

Table 4-8. MCPS Retiree Group Insurance Fund Revenue, Expenditures, and Year-End Fund Balance Levels

Retiree Group Insurance Fund	FY08	FY09	FY10	FY11	FY12 Budgeted
Beginning Balance	$5,801,619	$8,958,799	$9,827,017	$5,513,231	$8,785,180
Revenue	$66,181,591	$67,339,627	$69,547,481	$75,297,003	$84,603,576
Expenditures	$63,024,411	$66,471,409	$73,861,267	$72,025,056	$84,603,576
Year-End Surplus/(Deficit)	$3,157,180	$868,218	($4,313,786)	$3,271,947	--
Ending Balance	$8,958,799	$9,827,017	$5,513,231	$8,785,180	$8,785,180
Percent of Expenditures	**14.2%**	**14.8%**	**7.5%**	**12.2%**	**10.4%**

Source: MCPS

Comparison of Budgeted vs. Actual Revenue. Table 4-9 compares annual budgeted and actual revenue for the Retiree Group Insurance Fund from FY08 to FY11. In this table, a variance that is "less than budget" represents a shortfall to the Fund. The data show that for these years:

- Revenue going into the Fund was lower than budgeted each year to varying degrees, however the Category 12 contribution was at the budgeted level each fiscal year; and
- Actual revenue ranged from $0.2 million (or 0.3%) less than budgeted to $2.7 million (or 3%) less than budgeted.

Table 4-9. Budgeted vs. Actual Revenue: MCPS Retiree Group Insurance Fund ($'s in millions)

Group Insurance Fund Revenue	FY08		FY09		FY10		FY11	
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual
Category 12 Contrib.	$37.3	$37.3	$38.4	$38.4	$37.8	$37.8	$42.7	$42.7
All Other	$29.1	$28.9	$30.4	$28.9	$32.4	$31.7	$35.3	$32.6
Total Revenue	**$66.4**	**$66.2**	**$68.8**	**$67.3**	**$70.2**	**$69.5**	**$78.0**	**$75.3**
Actual Revenue Variance from Budget	**$0.2 million less than budget**		**$1.5 million less than budget**		**$0.7 million less than budget**		**$2.7 million less than budget**	

Source: MCPS

Comparison of Budgeted vs. Actual Expenditures. Table 4-10 compares budgeted and actual group insurance expenditures for the Retiree Group Insurance Fund from FY08 to FY11. In this table, a variance that is "less than budget" represents a savings to the Fund and a variance that is "more than budget" represents a shortfall to the Fund. The data show that for these years:

- Actual expenditures ranged from $3.3 million (or 5%) more than budgeted to $7.3 million (or 9%) less than budgeted; and
- Insurance claims were primarily responsible for expenditures exceeding the budget in FY10 and for the expenditure savings compared to budget in FY08 and FY11.

Table 4-10. Budgeted vs. Actual Expenditures: MCPS Retiree Group Insurance Fund ($'s in millions)

Group Insurance Fund Expenditures	FY08		FY09		FY10		FY11	
	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual
Claims	$54.1	$51.7	$55.4	$55.5	$59.2	$62.5	$67.0	$60.2
All Other	$10.7	$11.3	$11.1	$11.0	$11.4	$11.4	$12.3	$11.8
Total Expenditures	**$64.8**	**$63.0**	**$66.5**	**$66.5**	**$70.6**	**$73.9**	**$79.3**	**$72.0**
Actual Expenditures Variance from Budget	**$1.8 million less than budget**		--		**$3.3 million more than budget**		**$7.3 million less than budget**	

Source: MCPS

C. Explanation of FY11 Surplus in the Active Employee Group Insurance Fund

As outlined earlier, MCPS' Active Employee Group Insurance Fund ended FY11 with a $21.6 million fund balance. The final section of this chapter provides greater detail on the FY11 revenue and expenditure line-items, the variance between actual and budgeted amounts, and the reasons for those differences.

Chronology of Final FY12 Budget Actions. On May 26, 2011, the County Council approved the FY12 budget appropriation for MCPS that, among other changes, reduced the Category 12 appropriation from the Board of Education's request.[10]

The Council's reductions to the Category 12 budget assumed $18.7 million in FY12 savings from potential MCPS changes to employee health and retirement benefits, with $7 million of the savings from potential changes to health premium cost share. The Council President's May 16th memorandum to the Council recommending a package of budget actions related to employee benefits explained this action as follows:

> The Council fully recognizes that decisions regarding the benefits offered to MCPS employees are the Montgomery County Board of Education's to make. The Council's package identifies the savings that would result if the Board of Education takes certain actions regarding the structure of employee retirement and health benefits. Specifically, the Council's package identifies savings associated with implementing changes to MCPS' locally-funded pension plans (Core and Supplement) that parallel those made by the State to the teachers' pension plan, and potential savings from adjusting the current 95/5 and 90/10 employer/employee health premium cost shares by five points.[11]

On June 16th the Superintendent recommended and the Board of Education approved a series of reductions from the Board's initial budget request to align the final FY12 operating budget with the Council's appropriation.

In meeting the revised Category 12 budget, the Superintendent recommended a $21.2 million reduction in employee benefit costs for FY12, with $14.5 million of this amount coming from MCPS' budget for group insurance. Specifically, the Superintendent reported that the group insurance funds had achieved "significant savings" that allowed for a budget reduction in health benefit costs without changes to the premium cost share. A memorandum from the Superintendent to the Board of Education explained this action as follows:

> Reductions in the cost of the Employee Benefit Plan, comprising employee health and life insurance plans for active and retired employees, total $14.5 million. Savings result from a combination of participant usage patterns, health care prices, and participant plan selection. Employee health awareness, savings resulting from combined bidding of administrative services, and incentives designed to encourage employees to select more cost-effective health plan options have contributed to a significant savings. The dependent eligibility audit also had a positive effect

[10] Montgomery County Council Resolution 17-150, Adopted May 26, 2011.
[11] Memo from Valerie Ervin, Council President, to County Council. *Council's Package: An Alternative to the Executive's Proposal on Employee Benefits*, May 16, 2011. Attached at ©63. Additional related FY12 budget correspondence between the County Council and the Board of Education is included in the Appendix (©67-101).

on plan experience. This enables MCPS to moderate health care costs without shifting increased costs to plan participants. [12]

The rest of this section details the savings that occurred in the Active Employee Group Insurance Fund during FY11.

FY11 Revenue and Expenditures Detail. For FY11, Table 4-11 breaks down the budgeted and actual revenue and expenditures in the Active Employee Group Insurance Fund by the different sources of revenue and types of expenditures.

As noted in the previous tables comparing budgeted vs. actual data, a revenue variance that is "more than budget" represents extra revenue to the Fund. Conversely, an expenditure variance that is "less than budget" represents a savings to the Fund.

Table 4-11. FY11 MCPS Active Employee Group Insurance Fund: Budgeted vs. Actuals by Revenue Sources and Types of Expenditures

Active Employee Group Insurance Fund	FY11 Budget	FY11 Actual	Actual Variance from Budget
Revenue			
Category 12 Contribution	$216,252,358	$216,252,358	--
Other Categories and Grants	$17,611,140	$18,359,305	$748,165
Employee Contributions	$20,841,998	$21,365,140	$523,142
Miscellaneous	$4,651,762	$7,376,532	$2,724,770
Subtotal	**$259,357,258**	**$263,353,334**	**$3,996,077 more than budget**
Expenditures			
Claims	$205,015,842	$196,411,062	$8,604,780
Premiums	$44,401,800	$42,635,164	$1,766,636
Administrative Services Fees	$9,037,800	$9,605,944	($568,144)
MCPS Admin. Expenses	$901,816	$1,644,011	($742,195)
Subtotal	**$259,357,258**	**$250,296,181**	**$9,061,077 less than budget**
Total FY11 Fund Surplus (Actual Revenue minus Actual Expenditures)			**$13,057,154**

Source: MCPS

[12] June 16, 2011 Memorandum from Jerry D. Weast, Superintendent of Schools, to Members of the Board of Education. *Final Adoption of the Fiscal Year 2012 Operating Budget*. Attached at ©66. Additional related FY12 budget correspondence between the County Council and the Board is included in the Appendix (©67-101).

End-of-Year Revenue Higher than Budgeted. Table 4-11 shows that the FY11 end-of-year revenue surplus was close to $4 million, which equates to actual revenue that was 1.5% higher than budgeted.

Of this $4 million, $2.7 million (or 68%) occurred within "Miscellaneous" expenditures. More specifically, Fund data indicate that the line-item largely responsible for the revenue surplus was "Caremark rebates." This line-item accounts for contractual rebates MCPS receives from its prescription drug vendor (currently Caremark) based on prescription drug usage by those enrolled in the Caremark prescription drug plan. In FY11, MCPS anticipated receiving approximately $3.3 million in Caremark rebates but instead received $6.0 million.

At OLO's request, MCPS provided a written explanation (on 10/25/2011) for the additional rebate revenue in FY11 that is reproduced below in its entirety:

MCPS' Explanation for Additional Rebate Revenue in FY11

The revenue surplus was a result of two items related to prescriptions. The first was a $1,750,000 drug rebate from a prior period not previously recorded, and the second was $1,000,000 from the Retiree Drug Subsidy (RDS) also from a prior period. RDS is the Medicare reimbursement subsidy established for retiree pharmacy programs.

Rebate revenues are budgeted based on the expectation that Caremark rebates and RDS funding will be distributed within the year they are earned. Caremark rebates are allocated between active and retiree plan budgets according to expected prescription utilization in each plan. Total rebates paid by Caremark of $6,418,000 for the four quarters of Fiscal Year (FY) 2011 were $400,000 greater than the projected amount for FY 2011; however, the payment from the prior period in FY 2010 of $1,750,000 also was included in FY 2011.

RDS funds collected within a fiscal year can include prior year funds if prior year reconciliations were not available during that fiscal year. There was close to $1 million collected during FY 2011 from a prior year. The RDS was created in 2005, and the ability to project the anticipated receipts during the first few years were limited by lack of data as well as prior experience with the systems and processes used by the federal government to generate the subsidy payments.

End-of-Year Expenditures Lower than Budgeted. Table 4-11 shows that the FY11 end-of-year expenditure savings was nearly $9.1 million, which equates to actual expenditures that were 3.5% lower than budgeted.

Of this $9.1 million, $8.6 million (or 94%) resulted from lower than anticipated claims. More specifically, Fund data indicate that the line-items with the largest surplus in claims were MPCS' United Healthcare POS and HMO plans. Actual claims for each of the United Healthcare plans came in around $4 million (or 8%) less than budgeted.

At OLO's request, MCPS provided a written explanation (on 10/25/2011) for the expenditure savings in FY11 that is reproduced below in its entirety:

MCPS' Explanation for Expenditures Savings in FY11

The surplus for FY 2011 came late in the fiscal year, after the implementation of "open season" enrollment shifts. The pattern of expenditures during FY 2011, as shown in the previous analysis, differed greatly from previous years. This difference meant that the reliability of positive expenditure information was in doubt until late in the fiscal year. Health benefit consultants continued to project that claims experience would increase during the second half of the fiscal year and warned that the apparent surplus was unlikely to continue. Only in February and March did the consultants revise projections to show a significant surplus for the full fiscal year. This fact is explained in memoranda written by the president of the Board of Education after County Council questions were raised. The pattern of positive claims experience by MCPS paralleled similar unexpected patterns in other governmental organizations including the county government and the federal government.

End-of-year expenditures were lower than budgeted for a combination of reasons. Expense surpluses were derived from $4–6 million in reduced trend and utilization, $500,000 from Caremark contract changes, and $450,000 in fixed cost savings from plan marketings and ASO fee reductions.

The majority of the surplus is accounted for in the United Healthcare medical plans. Trend and utilization during FY 2011 in these United Healthcare plans were lower than expected. Trends used to set projections were 7.5 to 10 percent while the actual trend for active employees was less than 5 percent. This resulted in an estimated impact of $3 to $4 million.

Inpatient admissions were down 2.4 percent resulting in an 8.5 percent reduction in inpatient net paid per member per month (PMPM) expenses. CareFirst utilization also was less than expected and actual trend rates were below 5 percent compared to expected trends of 7 to 8 percent resulting in an estimated impact of $1 million.

Caremark prescription drug contract terms were negotiated during this time, resulting in approximately $500,000 savings in FY 2011 that would not have been accounted for when the FY 2011 budget was established. In addition, actual trend rates were lower than expected, resulting in further reduced claims.

Finally, medical, dental, vision, and life insurance plans were negotiated through the procurement process with new fixed fees effective January 1, 2011. The FY 2011 budget assumed no increases with maintaining the current fee structures. Actual negotiated fees resulted in over $900,000 savings, half of which impacted the FY 2011 budget.

FY11 Expenditures by Quarter. At the beginning of each fiscal year, based on the budget for each line-item in the Active Employee Group Insurance Fund, MCPS develops a schedule of projected monthly revenue and expenditures. During the fiscal year, MCPS tracks the actual revenue into and expenditures from the Fund each month. As noted above, during FY11, actual expenditures totaled less than budgeted expenditures, a trend which resulted in an end-of-year variance of about $9.1 million or 3.5%.

Table 4-12 contains quarterly data that tracks how actual expenditures were lower than projected expenditures throughout the fiscal year. The final line of the table tracks the cumulative savings at the end of each quarter. A review of the monthly Fund data indicates that:

- At the beginning of the fiscal year, Fund expenditures were projected to be $2.2 million lower than originally budgeted;
- The rest of the expenditure savings accumulated over the first three quarters of FY11; and
- The largest dollar savings occurred in the 2nd Quarter (October-December) of FY11 when expenditures were $4.5 million lower than projected.

As a result, the cumulative expenditures from the Active Employee Group Insurance Fund were running $7.6 million lower than projected midway through the fiscal year (12/30/2010).

Table 4-12. MCPS Active Employee Group Insurance Fund FY11 Expenditures by Quarter ($ in millions)

Expenditures	Initial Projected Savings	1st Quarter (July-Sep.)	2nd Quarter (Oct.-Dec.)	3rd Quarter (Jan.-March)	4th Quarter (April-June)
Projected	--	$62.3	$63.2	$64.7	$67.0
Actual	--	$61.4	$58.7	$63.3	$67.0
Difference	**--**	**+$0.9**	**+$4.5**	**+$1.4**	**--**
Cumulative Savings	**+$2.2**	**+$3.1**	**+$7.6**	**+$9.0**	**+$9.0***

*Cumulative savings does not add up to $9.1 million due to rounding.
Source: MCPS

CHAPTER V. FINDINGS

This chapter presents the Office of Legislative Oversight's (OLO) findings. The organization parallels the structure of OLO's review of MCPS' Budget Category 12 in previous chapters:

- Overview of Budget Category 12;
- Retirement Benefit Budget and Pension Fund; and
- Group Insurance Expenditures.

Chapter VI (begins on page 48) contains OLO's recommendations for Council action and issues for discussion with representatives of MCPS.

OVERVIEW OF BUDGET CATEGORY 12

Finding #1: MCPS' Budget Category 12 consists of nine expenditure components, primarily to fund employee benefits.

State law requires that the County Council appropriate funds to MCPS in standardized budget categories. This report focuses on one of these categories: Category 12, Fixed Charges. The box below contains the definition of Category 12 from the Maryland State Department of Education.

> **Category 12: Fixed Charges.** Charges of a generally recurring nature which are not readily allocable to other expenditure categories. Included are:
>
> - Local school board contributions to employee retirement and social security;
> - Employee insurance benefits (health, life, accident, disability, etc);
> - Fidelity insurance, personal liability insurance, and judgments;
> - Interest on current loans; and
> - Personnel tuition reimbursement for all staff
>
> Source: Maryland State Department of Education, *Financial Reporting Manual for Maryland Public Schools (Revised 2009)*, pg. 61.

After the County Council appropriates funds to Category 12, the Board of Education makes final decisions on how to allocate the funds within Category 12. Under the State's definition, the Board of Education budgets the following nine expenditure components in Category 12:

- Group Insurance (Active and Retiree)
- FICA (Social Security and Medicare)
- Retirement
- Non-Tax Supported Grants
- Risk Management/Self-Insurance
- Tuition Reimbursement
- Miscellaneous
- Partnership Tuition
- Other Post-Employment Benefits (OPEB)

Category 12 contains funding for 97.5% of MCPS' locally-funded employee benefit costs.[1] The remaining 2.5% is budgeted in MCPS enterprise funds.

[1] Excluding employee pension costs paid by the State.

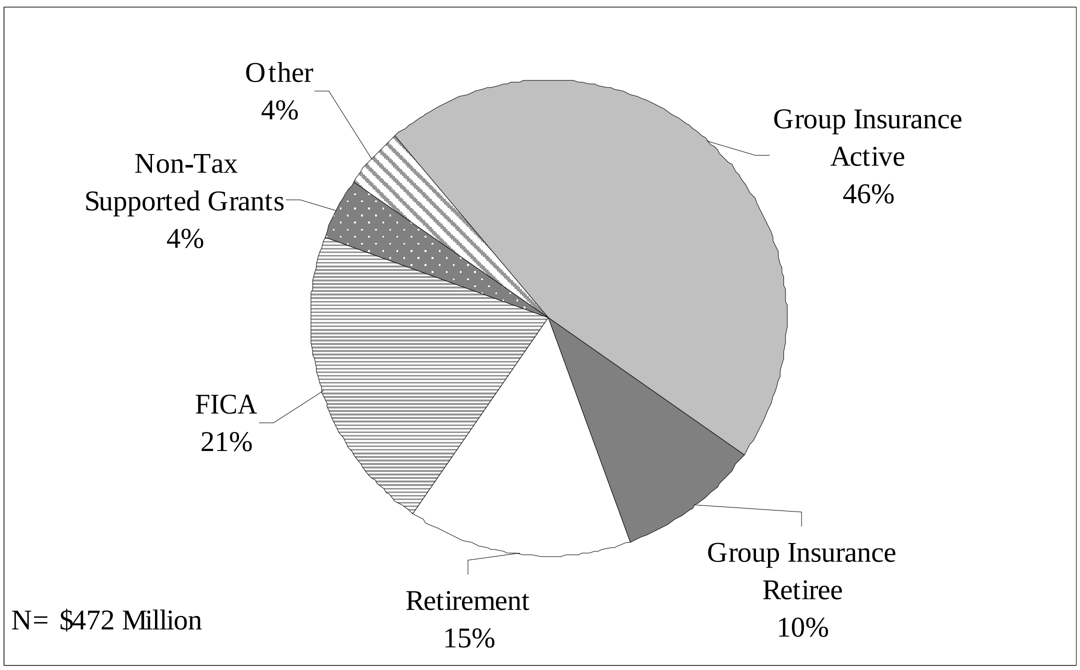
Finding #2: During the past decade, MCPS' Category 12 budget expenditures doubled and the relative portions of the various expenditure components changed.

MCPS' approved FY12 budget for Category 12 is $472 million, more than double what it was ten years ago. In FY03, Category 12 expenditures represented 18% of MCPS total budget (excluding enterprise funds); in FY12, this percent has increased to 23%.

A review of Category 12 expenditures since FY03 shows that:

- Actual expenditures increased 101% between FY03 and FY12, with a reduced rate of annual growth in recent years. The Category 12 budget for FY12 is the smallest annual increase (2%) in the past decade.
- Costs for retirement benefits and group insurance benefits are expected to account for approximately 71% of all Category 12 spending in FY12.
- The relative distribution of expenditures within Category 12 shifted during the last decade. Today, the portions for group insurance and retirement are larger and the portion for FICA (social security and Medicare) is smaller.

Category 12 Budgeted Expenditures FY12



Comparison of Actuals to Budgeted Expenditures. Although MCPS' <u>total</u> actual Category 12 expenditures exceeded the budgeted levels in seven of the past nine years, the variance between budgeted and actual expenditures was no greater than 2% in any given year. When examined by component, the largest percent variations (between budgeted and actual expenditures) occurred in the smaller components of tuition reimbursement and partnership tuition. For the largest components of Category 12 spending, (active employee group insurance, FICA, retirement, and retiree group insurance) actual expenditures in FY11 were within 1% of the budgeted amounts.

RETIREMENT BENEFIT BUDGET AND PENSION FUND

Finding #3: In FY12, MCPS will contribute $77.8 million to its County-funded pension fund. This is a 369% increase from the $16.6 million contribution made a decade ago.

Permanent MCPS employees participate in a defined benefit retirement plan, also known as a pension plan. Nearly one quarter of permanent employees (mostly non-teaching positions) receive a County-funded "core" pension benefit. In addition, all permanent employees (both teaching and non-teaching positions) receive a County-funded "supplemental" pension benefit.

Pension contributions from MCPS and its employees are deposited in the "pension fund," a fiduciary account established to collect money needed to pay pension benefits and associated expenses. MCPS contracts with an actuary to calculate its annual required contribution to the pension fund. The actuary recommends the annual required contribution based on a series of assumptions (such as rate of investment return and future pension liabilities) approved by the Board of Education.

For FY12, the Board of Education approved the actuary's recommendation that MCPS make a pension fund contribution of $77.8 million. In addition, MCPS employees will contribute an estimated $20 million in FY12 to the locally-funded pension fund.

The FY12 MCPS contribution of $77.8 million represents a 369% increase over the $16.6 million contribution made in FY03 (ten years ago). This sharp growth in pension costs is a function of multiple factors including benefit enhancements, salary increases, lower than assumed investment returns, and growth in workforce size.

Finding #4: The most recent valuation (October 2011) reports that MCPS' pension fund assets are sufficient to cover 70% of its current liabilities.

The "funded ratio" is a common measure of the financial status of a pension fund. The funded ratio refers to the percentage of a pension plan's liabilities covered by the current actuarial value of the plan's assets. In other words, the funded ratio measures the extent to which a pension plan has funds set aside to pay the accrued pension benefits of its members.

MCPS' most recent pension valuation (October 2011) includes a calculation of the funded ratio of the pension plan as of June 30, 2011. This valuation reports that the funded ratio for MCPS' pension fund is 70.1%. This calculation is based upon assets of $1.02 billion and an accrued liability of $1.45 billion. A decade ago (FY03), the funded ratio of MCPS' pension fund was 102.1%.

Two primary factors contributed to the decline in MCPS' funded ratio: pension benefit enhancements and investment performance.

Plan Enhancements. In 2006, the Board of Education increased the "core" pension benefit (for participants in the locally-funded plan) and made the increase retroactive to 1998; this enhancement to the County-funded pension plan was identical to the one made that same year for participants in the State-funded pension plan. In addition, the Board increased the "supplemental" benefit (also retroactive to 1998) for all permanent employees, including participants in the State-run plan.

Concurrent with the 2006 plan enhancements, the Board increased the amount that employees must contribute for the "core" benefit" from 2% to 5% of salary (phased in over three years). The Board also raised the employee contribution for the "supplemental" benefit from 0.2% to 0.5% of salary (phased in over three years). Notwithstanding this increase in employee contributions, the 2006 plan enhancements greatly increased MCPS' liability for future pension benefits. As a result, the pension fund's funded ratio declined since MCPS had not previously contributed to cover this additional liability.

Investment Performance. As directed by the Board of Education, MCPS' actuary calculates the agency's annual pension contributions based on the assumption of a 7.5% annual rate of return on investments. In years that investments return an amount less than 7.5%, the pension fund experiences an increase in its unfunded liability that negatively affects the funded ratio.

Similar to other pension funds across the country, MCPS' pension fund incurred large losses during FY08 and FY09. While investment gains in FY10 and FY11 offset most of the losses from the previous two years, the funded ratio has continued to decline, in part, because the average annual investment return (over the past five years) has fallen below the assumed rate of 7.5%.

Finding #5: In 2011, the Board of Education made changes to reduce its future pension plan liabilities. Even with these reforms, MCPS' required annual pension contributions are likely to continue to increase at least in the short-term.

In 2011, the Board of Education made two important changes to the MCPS pension plan. The Board raised the employee contribution for the locally-funded "core" benefit from 5% to 7% of salary. In addition, the Board lowered the cap on cost-of-living adjustments and reduced the pension benefit for new hires. This package of changes mirrored action taken by the General Assembly for the employees in the State-funded system. According to MCPS' actuary, these modifications will result in a FY13 pension fund contribution that is similar to the FY12 amount.

While annual MCPS pension costs may change little from FY12 to FY13, the historic trend of large annual increases is projected to return. MCPS' actuary estimates that the agency will need to significantly increase its annual contribution in FY14 and FY15 (by as much as 17% over the two-year period).

Any increases in MCPS' payroll that result from workforce growth and/or pay increases will further increase required pension plan contributions. Moreover, as with any pension system, MCPS pension costs also are subject to change if other actuarial assumptions (such as retiree life expectancy or investment performance) differ from what actually occurs.

Group Insurance Expenditures

Finding #6: At the end of FY11, MCPS had a $21.6 million (or 8.6%) fund balance in its Active Employee Group Insurance Fund.

At the beginning of FY11 (July 1, 2010), the MCPS Active Employee Group Insurance Fund had an $8.5 million balance (or reserve). During FY11, total revenues into the Fund exceeded expenditures by $13.1 million. The beginning year balance of $8.5 million combined with the $13.1 million "surplus" during the year resulted in an end of fiscal year (June 30, 2011) balance of $21.6 million.

MCPS Active Employee Group Insurance Fund

FY11 Beginning Fund Balance (July 1, 2010)	Fund Activity During FY11		FY11 Ending Fund Balance (June 30, 2011)
$8,541,533	Revenue	$263,353,334	$21,598,686
	Expenditures	$250,296,181	
	Difference	$13,057,153	

FY11 Surplus. The $13.1 million surplus in FY11 resulted from a combination of higher than budgeted revenue and lower than budgeted expenditures. Actual revenue into the Fund exceeded MCPS' budget by about $4 million (1.5% of total budgeted revenue). About 68% of this amount came from greater than anticipated prescription drug rebates or reimbursements. According to MCPS, the revenue surplus resulted from prescription drug rebate and Retiree Drug Subsidy revenue from FY10 that was recorded in FY11. (See page 37 for more details).

Actual expenditures from the Fund were lower than MCPS' budget by about $9.1 million (3.5% of total budgeted expenditures). About 94% of this amount resulted from lower than anticipated claims. According to MCPS, this trend of reduced utilization was unexpected and paralleled similar unexpected patterns in other governmental organizations. MCPS also noted reduced inpatient admissions as a cost savings factors. (See page 37 for more details).

Fund Balance Levels. Compared with recent years, the $21.6 million balance in the Active Employee Group Insurance Fund at the end of FY11 is larger in terms of total dollars and as a percent of expenditures. As summarized in the table below, the balance in the Fund has fluctuated considerably from year-to-year, reflecting years where revenues exceeded expenditures and years where expenditures exceeded revenues.

Active Employee Group Insurance Fund	FY08	FY09	FY10	FY11
End of Fiscal Year Balance	$11,818,442	$2,797,995	$8,541,533	$21,598,686
Balance as % of Expenditures	5.6%	1.2%	3.5%	8.6%

Finding #7: Monthly FY11 data show that total Active Employee Group Insurance Fund expenditures were trending lower than projected. In February/March, MCPS was advised that a significant end-of-year Fund surplus was likely.

At the beginning of each fiscal year, based on the budget for each line item in the Active Employee Group Insurance Fund, MCPS develops a schedule of projected monthly revenue and expenditures. During the fiscal year, MCPS tracks the actual revenue into and expenditures from the Fund each month.

While total Active Employee Group Insurance Fund expenditures increased by 4% in FY11, the actual increase was less than the budgeted increase. Specifically, as noted in Finding #6, actual expenditures from the Fund were lower than budgeted by about $9.1 million in FY11. A review of the monthly Fund data indicates that:

- At the beginning of the fiscal year, Fund expenditures were projected to be $2.2 million lower than originally budgeted;
- The rest of the expenditure savings accumulated over the first three quarters of FY11; and
- The largest dollar savings occurred in the 2nd Quarter (October-December) of FY11 when expenditures were $4.5 million lower than projected.

As a result, the cumulative expenditures from the Active Employee Group Insurance Fund were running $7.6 million lower than projected midway through the fiscal year (12/31/2010).

MCPS notes that while savings were accumulating in the first half of the fiscal year, "health benefit consultants continued to project that claims experience would increase during the second half of the fiscal year and warned that the apparent surplus was unlikely to continue. Only in February and March did the consultants revise projections to show a significant surplus for the full fiscal year." (See page 38 for more detail).

MCPS Active Employee Group Insurance Fund FY11 Expenditure Savings by Quarter
($'s in millions)

Expenditures	Initial Projected Savings	1st Quarter (July-Sep.)	2nd Quarter (Oct.-Dec.)	3rd Quarter (Jan.-March)	4th Quarter (April-June)
Budgeted	--	$62.3	$63.2	$64.7	$67.0
Actual	--	$61.4	$58.7	$63.3	$67.0
Difference	**--**	**+$0.9**	**+$4.5**	**+$1.4**	**--**
Cumulative Savings	**+$2.2**	**+$3.1**	**+$7.6**	**+$9.0**	**+$9.0***

*Cumulative savings does not add up to $9.1 million due to rounding.

Finding #8: MCPS develops its annual budget for group insurance based upon projections prepared by a health benefits consultant. MCPS has not adopted a fund balance policy for either the Active or Retiree Group Insurance Fund.

MCPS uses projections from a health benefits actuarial consultant to develop its annual budget request for group insurance (for each fiscal year) and its annual group insurance plan premiums (for each calendar year). The projections take into account numerous factors and assumptions, including plan enrollment, actual plan expenditures, and industry-wide health care cost trends.

Similar to other agencies, MCPS' practice is to maintain a balance (or reserve) in both the Active Employee and Retiree Group Insurance Funds to protect against unanticipated expenditures in any given year. However, MCPS has not adopted a formal policy to establish a target fund balance amount in either group insurance fund.

MCPS staff note that several factors complicate budgeting for group insurance expenditures, any and all of which can lead to variances between budgeted and actual expenditures. The primary factors, listed below, similarly apply to the other County-funded agencies.

- **MCPS is largely self-insured and group insurance expenditures each year result from actual health care use by plan participants.** In any given year, health care use can vary unexpectedly for multiple reasons. Self-insured plans bear the immediate financial "risk" for unanticipated expenditures and the immediate "benefit" from unanticipated savings.

- **Group insurance plans operate on a calendar year basis while budgets are approved on a fiscal year basis.** As a result, changes during the fiscal year (such as how many employees choose to switch health plans during open enrollment season) may not have been fully anticipated at the time cost projections were prepared for the budget.

- **Many months elapse between budget development and the beginning of the fiscal year.** When MCPS develops its recommended budget for group insurance each fall, it uses cost projections based on the actual expenditures and experience over the most recent 12 months. By the time the fiscal year begins in July, expenditure trends may have varied from the projection prepared the previous fall.

Given the budgeting complications noted above, it is not unexpected that actual MCPS Active Employee and Retiree Group Insurance Fund expenditures vary to some degree from budget projections. Because the largest single cost driver in self-insured plans is health care claims, it is not surprising that a variance between budgeted and actual expenditures is attributable to claims being higher or lower than projected.

Finding #9: In FY08, FY09, and FY10, MCPS increased the ending balance in the Active Employee Group Insurance Fund through year-end transfers into the Fund.

In FY08, FY09, and FY10, MCPS' Category 12 contribution to the Active Employee Group Insurance Fund exceeded the total approved budgeted amounts for each year. MCPS' year-end categorical transfer request memorandums (prepared for approval first by the Board of Education and the County Council, as required by law) report that the additional Category 12 contributions in these years were made in order to increase the end-of-year fund balance.[2] Specifically:

- In FY08 and FY09, MCPS contributed an additional $3 million (each year) to the Active Employees Group Insurance Fund. These additional contributions were funded through end-of-year categorical transfers from other MCPS budget categories. In FY09, the transfer was necessary to prevent the Fund from ending the year with a deficit due to higher than budgeted expenditures.

- In FY10, MCPS contributed an additional $5.5 million to the Active Employee Group Insurance Fund. This additional contribution was funded through reallocating funds from other components within Category 12, and did not require a categorical transfer.

Explanation of MCPS' reference to County Council benefits consultant. In the categorical transfer memorandums, MCPS refers to the increased contribution to the group insurance fund balance as "recommended by the County Council benefits consultant." This reference is to an April 2003 report issued by Bolton Partners to the Council's Management and Fiscal Policy Committee. The Bolton Partners report made several recommendations related to County and bi-County agency group insurance programs, including a recommendation that each agency maintain a five percent fund balance in their respective group insurance funds.

In December 2003, the Council approved Resolution No. 15-454, *Policy Guidance for Agency Group Insurance Programs*, which endorsed four recommendations from the Bolton report; including that the agencies adhere to the proposed fund balance targets. The complete report by Bolton Partners and the approved resolution are in the Appendix (beginning at ©37).

[2] The year-end categorical transfer request memorandums for FY08, FY09, and FY10 are included in their entirety in the Appendix beginning at ©22.

CHAPTER VI. RECOMMENDATIONS AND DISCUSSION ISSUES

The Office of Legislative Oversight's review of Montgomery County Public Schools' budget Category 12 evidences opportunities to improve the substance and timing of fiscal information provided by the Board of Education to the County Council. The Council's ongoing attention to the status of revenues and expenditures in Category 12 is especially warranted because:

- Substantial public dollars are allocated to Category 12 spending - $472 million in FY12;
- Over the past decade, Category 12 spending increased by $237 million, growing from 18% to 23% of MCPS' total tax-supported operating budget; and
- The primary Category 12 cost drivers are expenditures for group insurance and pension benefits, which are significant fiscal and policy issues across all County-funded agencies.

This chapter outlines OLO's recommendations for Council action and issues for Council discussion with MCPS representatives.

RECOMMENDATIONS FOR COUNCIL ACTION

A. Request the Board of Education to submit supplemental information to the Council in April and October of each year related to Category 12 revenues and expenditures.

B. Integrate this additional information about Category 12 into the Council's annual budget decision making and ongoing oversight of funds appropriated to MCPS.

The Council should formally request that the Board of Education provide supplemental information in April (to integrate into annual operating budget decisions) and October (to integrate into ongoing year-end financial oversight) about the status of revenues and expenditures in budget Category 12.

Additional Information for Operating Budget Worksessions. The Board of Education already provides certain documents to the Council that contain financial information related to pension and group insurance. These documents include:

- The Board of Education's annual operating budget request in January;
- Year-end categorical transfer request(s) in June; and
- The annual Comprehensive Annual Financial Report, typically completed in September.

The data provided in these documents are valuable, but do not necessarily provide a complete and current picture of the financial status, cost drivers, and budgetary impact of MCPS pension and group insurance programs at the time when the Council is required to make budget decisions.

In exercising its budget oversight responsibilities, the Council would benefit from receiving updated financial information on the pension and group insurance funds (which together account for $329 million or 71% of Category 12 spending). As the fiscal condition of pension and group insurance funds can vary over the course of the year, this information would allow the Council to base its budget decisions on the most current measures of actual revenue and spending.

OLO recommends the Council request the Board of Education to provide the following Category 12-related information on April 1st of each year:

Pension Fund

- Estimated future year MCPS pension fund contributions. This summary should identify and explain the major factors that drive changes in annual contribution amounts, such as investment performance, plan changes, or changes in actuarial assumptions.
- The Board's current strategy to achieve a desired pension funding level ("funded ratio") and the short- and long-term effects of this strategy on the Category 12 budget.

Active Employee and Retiree Group Insurance Funds

- A comparison of budgeted versus actual group insurance fund revenues and expenditures to date for both the Active Employee and Retiree Group Insurance Fund.
- The projected year-end balance for both group insurance funds with an accompanying explanation if the projected balance differs from what was assumed at the beginning of the fiscal year (e.g., claims experience, plan enrollment, etc.).

OLO recommends the Council request similar pension and group insurance financial information from the other County-funded agencies.

Additional Year-End Financial Information. The Board of Education annually submits for Council approval an end-of-year categorical transfer request to align budgeted appropriations with actual expenditures. In these annual requests, MCPS provides information on each budget category's status and transfer needs, sometimes including information on intra-category transfers.

In exercising its financial oversight responsibilities, the Council would benefit from a more detailed year-end update on Category 12 expenditures. The Council should request that the Board of Education provide the following Category 12-related information on October 1st of each year:

- A comparison of budgeted vs. actual expenditures for each Category 12 component;
- A written summary of any intra-fund transfers that occurred within Category 12 (i.e., transfers between Category 12 components) during the prior fiscal year; and
- An explanation of the need or policy decision that led to each transfer.

This information will enhance the Council's ability to track trends in Category 12 spending by component. Given the size of certain Category 12 components (in particular group insurance, retirement, and FICA), even a small percent variation from the budget can have a large bottom-line dollar impact.

Recommended Issues for Council and MCPS Discussion

OLO recommends three Category 12-related issues for the Council to discuss with MCPS representatives. Although the following issues focus on MCPS' Category 12 budget, OLO recommends the Council hold parallel discussions with the other County-funded agencies.

Issue #1: Category 12 cost drivers and expenditures trends

During the past decade, Category 12 expenditures increased $227 million, growing from 18% to 23% of MCPS' total tax-supported operating budget. The primary cost drivers within Category 12 are expenditures for group insurance (for active and retired employees) and pension benefits. When combined, these health and retirement benefits account for approximately 71% of the total FY12 Category 12 budget.

OLO recommends the Council and MCPS representatives discuss the Board of Education's past and present approach to controlling projected future increases in employee benefits costs. This should include discussion of actions to mitigate overall increases in health and retirement benefits costs as well as decisions regarding how benefit costs are shared between MCPS and its employees. An example of Board actions that affected total benefit costs as well as the employer/employee cost share occurred in May 2011 when the Board of Education: (1) changed the eligibility and cost share for retiree health benefits for new hires; (2) increased employees' annual pension contribution; and (3) lowered the cap on pension cost-of-living adjustments.

Specific recommended discussion questions include:

- Looking ahead, how does MCPS see the projected growth in employee benefits costs affecting the school system's ability to fund competing priorities?
- What type of group insurance and/or pension benefit changes are currently being considered by MCPS for implementation in FY13 or future years?
- What specific employee benefits issues should be identified for ongoing discussion between the Council and MCPS representatives?

Issue #2: Status of the "funded ratio" for MCPS' County-funded pension fund

Over the past ten years, the "funded ratio" for the MCPS pension fund has declined from 102% to 70%. In other words, a decade ago MCPS' pension fund had sufficient assets to cover all of its liabilities; today, the Fund holds only about 70 cents for every dollar it is obligated to pay MCPS retirees.

OLO recommends the Council and MCPS representatives discuss the marked decline in the "funded ratio" that occurred over the past decade. Recommended discussion questions include:

- Does the current 70% "funded ratio" suggest a need to modify any of MCPS' pension management policies and practices?
- What are the Board of Education's strategies to improve the "funded ratio" over both the short- and long-term?

Issue #3: Fund balance policy for group insurance funds for active and retired employees

As reviewed earlier, the Board of Education has not adopted a formal policy to establish a target fund balance (or reserve) in the Active Employee Group Insurance Fund and/or Retiree Group Insurance Fund. The purpose of maintaining a fund balance in a group insurance fund is to protect against unanticipated expenditures in any given year. The County Council's 2003 resolution of policy guidance for agency group insurance programs recommended that agencies adhere to a fund balance target of 5% (see Appendix at ©60).

The Council should discuss with MCPS representatives the school system's reasoning for not adopting a formal fund balance policy, especially since the agency's practice has been to maintain a fund balance in both group insurance funds. Recommended discussion questions include:

- What are the advantages and disadvantages from either a practical or financial perspective to adopting a formal fund balance policy?
- How would having a formal fund balance policy affect MCPS' decision-making regarding whether to make additional contributions (or not) to the Active Employee Group Insurance Fund at the end of each fiscal year?

In sum, OLO recommends that the Council designate at least two specific times each year to sit down with MCPS representatives to discuss supplemental information compiled by MCPS regarding budget Category 12. Remaining current with the changes that occur with Category 12's revenues and expenditures throughout the fiscal year will better position the Council to ask timely questions, exercise their fiscal oversight responsibilities, and make informed budget decisions.

CHAPTER VII. AGENCY COMMENTS

The Office of Legislative Oversight circulated a final draft of this report to the Chief Operating Officer of Montgomery County Public Schools. OLO appreciates the time taken by agency representatives to review the draft report and provide comments. OLO's final report incorporates technical corrections provided by MCPS staff.

The written comments received from MCPS are attached in their entirety, beginning on the following page.

MCPS **MONTGOMERY COUNTY PUBLIC SCHOOLS**
www.montgomeryschoolsmd.org MARYLAND

November 16, 2011

Ms. Karen Orlansky, Director
Office of Legislative Oversight
Stella B. Werner Council Office Building
100 Maryland Avenue, Room 509
Rockville, Maryland 20850

Dear Ms. Orlansky:

Thank you for providing Montgomery County Public Schools (MCPS) staff with the opportunity to review and comment on the draft Office of Legislative Oversight (OLO) Report Number 2012-2, *A Review of Montgomery County Public Schools' Budget Category 12*. Comments and suggestions for technical changes were provided and incorporated into the draft report. MCPS staff members who participated in this review appreciate the collaborative process used throughout the study and review of the report.

Since comments and suggestions provided by MCPS staff during the technical review were incorporated, the following comments are offered upon final review:

Management Improvements

Category 12 expenditures have been a major driver of budget increases over the past 10 years (fiscal years 2003–2012). This is particularly the case for group insurance (health and life insurance) for both active and retired employees and for retirement contributions. Previous OLO reports have noted that the pattern of increased employee benefits expenditures is common for other county agencies and for employers in general.

During the same period, the Board of Education has implemented a variety of management actions, with the active cooperation of employee associations and the retiree association, which have introduced cost-saving improvements and mitigated cost increase trends. Major cost-saving improvements include the following:

- Finding #5 notes that the Board of Education has made changes to reduce future pension plan liabilities and taxpayer obligations. In 2011, the Board raised the employee contribution for the locally-funded "core" benefit from five percent to seven percent of salary. This meant that employees who participate in the locally funded plan received the equivalent of a two percent take-home pay reduction. These employees also face the prospect of an additional two percent pay reduction when current FICA tax rates increase as scheduled on January 1, 2012. These employees also have received no pay increases for the last two years and no negotiated general wage increase for three years. The Board also reduced the defined benefit as a percentage of salary and lengthened the minimum vesting period for new employees. The cap on cost-of-living increase was tightened for all employees for service credits earned after July 1, 2011. These changes reduce required local contribution and future contribution growth.

- In 2005, the Board of Education reduced the assumption of future investment earnings from 8 percent to 7.5 percent annually (Finding #4). This reflects the likelihood of lower investment performance. The Board of Education acted to adopt a more conservative approach before many other public pension plans. This prudent approach resulted a decrease of the funded ratio of the MCPS pension fund of approximately six percent and an increase of $3.0 million in required budget contribution. The report notes the connection between the change in the assumption of investment earnings and the increase in required local contribution.
- MCPS also has undertaken major cost containment steps in group insurance with the active leadership of the Joint Employee Benefits Committee, which includes MCPS's employee associations. MCPS provides a valuable incentive for employees to choose lower-cost health plans by providing a higher percentage of premium support. As a result, 64 percent of plan participants have enrolled in Health Maintenance Organizations (HMOs). In contrast, only 33 percent of County Government employees are enrolled in HMOs. This reduces the total health care costs for MCPS and means that the contribution by MCPS per employee is approximately the same as for county government.
- MCPS has undertaken a variety of other plan design changes in recent years that reduce the increase in health care costs. These steps encourage the use of generic and mail order prescription drugs, reduce incentives to visit hospital emergency rooms for nonemergency care, and increase incentives to use lower-cost urgent care centers. MCPS also has acted to promote employee wellness through "MCPS On the Move," in-house wellness activities, and discount memberships for external wellness programs. The goal is to reduce costs while increasing employee productivity through reduced absenteeism.
- MCPS has limited the use of expensive lifestyle drugs, including erectile dysfunction drugs, eliminating coverage for retirees entirely.
- MCPS has taken the lead to reduce health care administrative costs through joint bidding with other county agencies. Joint bidding in Fiscal Year (FY) 2011 realized $914,000 in annual administrative savings. MCPS undertook a dependent audit in 2009 to verify the eligibility of all dependents. Annual savings are estimated at $2.5 million.
- County officials have repeatedly praised the Board of Education for its aggressive and collaborative actions to limit the growth of group insurance costs and have suggested that other county agencies can benefit from adopting some of the best practices already implemented by MCPS.

Retirement Plan

- MCPS agrees with Finding #3 that county contribution to the Pension Fund has increased significantly over the last decade. The report clearly demonstrates (Table 3-1) that the main factor behind the increased contribution was the enhanced benefits retroactive to 1998 that were adopted in 2006 based on state legislation. This change helped to reduce the funded status of the plan from 80.5 percent in FY 2005 to 71.8 percent in FY 2006. Since FY 2006, despite the difficult investment environment beginning in 2008, the funded status of the plan decreased only from 71.8 percent in FY 2006 to 70.1 percent in FY 2011. Since MCPS has to maintain equity for employees between state and local core plans, this change was necessary and not initiated by MCPS.

Group Insurance

- MCPS agrees with Finding #2 that actual Category 12 expenditures have varied only slightly from budgeted expenditures. This is a challenging goal for group insurance expenditures, primarily because large claims in self-insured plans are unpredictable and can vary greatly from year to year. In seven of the last nine years, the variance between budgeted and actual expenditures in Category 12 was no more than two percent in any year (Table 2-1).
- MCPS agrees with Finding #8 that several factors complicate budgeting for group insurance expenditures, including the extended amount of time that elapses between when the budget must be developed and the subsequent changes in expenditures. Costs vary because of actual health care use and price changes, because group insurance plans operate on a calendar year basis, and because trends can change after the budget is developed and adopted. The internal service fund operates as a valuable management control tool for providing the possibility of a fund balance that can handle unavoidable "shocks." Finding #9 notes that MCPS has worked to increase the reserve in the internal service fund and has informed the County Council of planned reserve increases through year-end categorical transfer requests.
- Finding #6 notes that the group insurance fund balance has fluctuated based on actual expenditures and generally has fallen below desired levels. The Council's consultant has suggested that MCPS should increase its "shock reserve" to be able to absorb unexpected changes.
- MCPS agrees with Finding #6 that FY 2011 was a very atypical year for group insurance expenditures. Because actual expenditures remained lower than the FY 2011 budget, the fund balance in the internal service fund increased to 8.6 percent of expenditures, the highest percentage during the decade. Many other employers, including the Montgomery County Government, federal government agencies, and Frederick County Public Schools, also had unusually favorable experiences during FY 2011. Consultants have offered a variety of reasons for the favorable experiences. A recent federal Government Accountability Office review of Veterans Administration (VA) health costs examined a variety of possibilities for the causes of similar experience during FY 2011 and concluded that "budgeting for VA health care is inherently complex because it is based on assumptions and imperfect information used to project the likely demand and cost of the health care services VA expects to provide." Other group insurance plans face similar complexity in predicting health care costs.
- The surplus for FY 2011 came late in the fiscal year, after the implementation of "open season" enrollment shifts. The pattern of expenditures during FY 2011, as shown in the previous analysis, differed greatly from previous years. This difference meant that the reliability of positive expenditure information was in doubt until late in the fiscal year. Health benefit consultants continued to project that claims experience would increase during

the second half of the fiscal year and warned that the apparent surplus was unlikely to continue. Only in February and March did the consultants revise projections to show a significant surplus for the full fiscal year. This fact is explained in memoranda written by the president of the Board of Education after County Council questions were raised.

MCPS agrees with the report's recommendations for Council actions. The Board of Education can submit supplemental information, including information on the Pension and Group Insurance funds, to the County Council in April and October of each year. This can include updated information on the pension and group insurance funds similar to the information requested by OLO and supplied by MCPS during preparation of the OLO report. This information can be integrated into budget decision making and ongoing oversight. MCPS staff will work with OLO staff to make changes in the format of this information to address County Council needs and is ready to provide requested information to County Council staff.

Thank you again for the opportunity to review the draft report and discussion topics. I believe the collaborative work between MCPS and OLO will result in improved information and budget decision making for Category 12.

Sincerely,

Larry A. Bowers
Chief Operating Officer

LAB:mcs

Copy to:
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