Truth & Consequence

September 25, 2014

Status Report of the New Jersey Pension and Health Benefit Study Commission

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LETTER FROM THE COMMISSION

September 25, 2014

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Executive Order No. 161 creating the New Jersey Pension and Health Benefit Study Commission was signed by Governor Christie on August 1, 2014. The Commission consists of ten members whose backgrounds are described in Appendix 1.

This Status Report ("Report"), dated September 25, 2014, examines the State of New Jersey's existing pension and health benefit systems. Unlike some studies which have looked at these systems from a combined State and local perspective, this Report focuses on the elements for which the State bears financial responsibility. It examines the history and current challenges faced by these systems, and looks at the responses to similar challenges by other state government entities and comparable pension and health benefits in both the public and private sectors.

This Report is designed to be primarily factual and explanatory in nature. As we move forward to our final report, which will recommend solutions for dealing with these challenges, the Commission welcomes comment as to the current situation. We also encourage suggestions regarding pension and health benefit reforms that will strengthen the systems' financial standing and reduce the cost to taxpayers of providing public employees and retirees with an appropriate level of benefits.

All are encouraged to use the Commission's website to respond:
http://www.state.nj.us/treasury/pensionandbenefitcommission.shtml

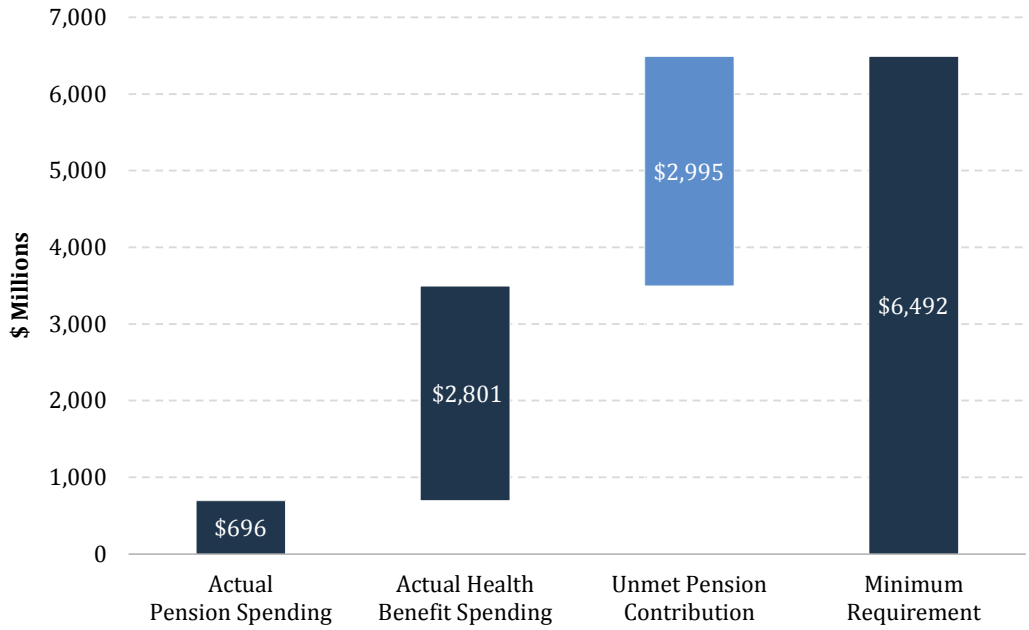
I. EXECUTIVE SUMMARY

The public employee pension and health benefit systems of the State of New Jersey face problems that are dire and likely to worsen unless action is taken. This is a matter of pressing concern to the public employees and retirees who rely on these systems to protect their families' health and provide for retirement. These public servants are our neighbors, friends and families, and they play a vital role in preserving the security, safety and health of our State and in educating our children. The benefit commitments the State has made also play a critical role in attracting and maintaining a stable and highly-qualified public sector workforce, a matter of concern to all the citizens of the State who place their livelihoods and even their lives in the hands of State employees on matters ranging from license renewals to disaster relief.

Both public employees and taxpayers as a whole, however, have been poorly served by a long-standing and bipartisan tradition of increasing benefit levels without adequate funding. Successive Governors and State Legislatures have committed the State to providing these benefits based on relatively optimistic financial assumptions without adequate consideration of the long-term costs to taxpayers if economic reality were to fall short of these assumptions.

The broad parameters of the problem can be seen by comparing what the State actually spent on employee benefits in fiscal year ("FY") 2014[1] against what would have been required to meet in full its employee benefit obligations for that year.

2014 Pension and Health Benefit Spending by the State of New Jersey



This **$3 billion gap** between the annual cost of benefits and the money allocated to pay for them will continue to grow in every budget for the foreseeable future unless significant action is taken.

In round numbers, the $700 million actual pension contribution and $2.8 billion health benefit payment amount to $3.5 billion in employee benefit spending by the State in FY 2014. This was over 10% of its $33 billion budget. It would have taken $6.5 billion, or 20% of the budget, to satisfy fully the funding obligation defined by statute. Unless the $3 billion gap between the cost of benefits at their current levels and the funds allocated to pay for them is reconciled by reducing costs and/or increasing funding, this gap will continue to grow in every budget for the foreseeable future.

The specific cause of the $3 billion gap in FY 2014 is that the State paid less than $700 million of the $3.7 billion it would have had to have paid to meet its statutory annual required contribution ("ARC")[2] to the pension funds for that year. Moreover, as discussed below, it should be understood that $3 billion represents a conservative estimate of the gap given the State's current pension

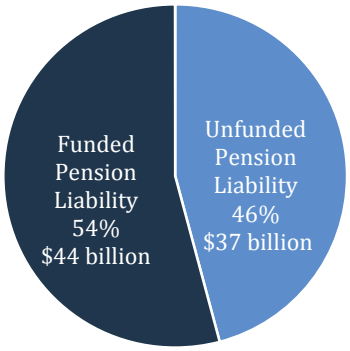
obligations. There are substantial uncertainties underlying this projection. Under many scenarios, this contribution gap would be meaningfully larger, a consideration which bears upon the "Risk" discussion in Section VI of this Report.

The focus of reforms, however, cannot be limited to pensions. The State's employee benefits obligation consists of pension *and* health care expenses. The State spent $2.8 billion on health benefits in FY 2014, and the cost of these benefits, which are high both in absolute terms and relative to what other public and private employers pay, has been growing faster than State revenues. It is crucial that these costs be controlled.

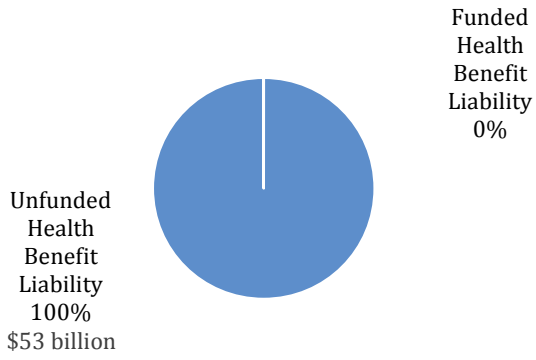
One particular element of health care expenses which is frequently overlooked but deserves closer consideration because of the demand it will place on future budgets is retiree health care costs. Government accounting rules require the costs of both pension and retiree health benefits to be recognized on the State's financial statements as employees earn these benefits each year. However, unlike pensions, New Jersey, like most public and private sector employers, does not put money aside to pay for future retiree health benefits. The *entire* retiree health benefit obligation is left to be paid by future taxpayers as a pay-as-you-go expense. The size of this future obligation is substantial: it represents a $53 billion unfunded liability on top of the ever-growing cost of providing health benefits to current active employees.

Looked at together, the $37 billion unfunded portion of the total pension liability and the $53 billion unfunded retiree health obligation represent a $90 billion drain on future budgets. By improving funding levels and reducing benefit costs, it is possible to reduce the size of this future burden on taxpayers.[3] If we do nothing, it will only grow.

Pension Liability - $81 billion



Post-Employment Health Benefit Liability - $53 billion



The combined unfunded liability for pensions and retiree health benefits is **$90 billion** - almost three times the annual state budget.

This problem, which all major stakeholders had a role in creating, has immediate, real-world implications. In April and May 2014, Standard & Poor's, Fitch and Moody's each downgraded New Jersey's general obligation bonds, citing the State's challenge of "structural budget imbalance exacerbated by rapidly growing pension and OPEB (Other Post-Employment Benefits) costs." Within the last few weeks, Fitch and Standard & Poor's have each again downgraded New Jersey's general obligation bonds.[4] This has the potential to cost the State millions of dollars going forward in higher interest costs.

Summary of Recent New Jersey Rating Actions

	Date	Prior Rating	New Rating
Standard & Poor's	4/9/2014	AA-	A+
Fitch	5/1/2014	AA-	A+
Moody's	5/24/2014	Aa3	A1
Fitch	9/5/2014	A+	A
Standard & Poor's	9/10/2014	A+	A

Persistent Pension Under-Funding

The State pension funds reported a $37 billion unfunded liability as of the end of FY 2013, the last year for which data is available. What this means is the State had on hand $37 billion less than it needed to cover the present value of: 1) the cost of providing pension benefits to current retirees and 2) the pension benefits earned through that date by current employees.[5] Looking at the $37 billion gap another way, the plans' combined "funded ratio," the ratio of their $44 billion in assets to the $81 billion present value of the plans' current obligations, was 54%.[6] It should be noted that this is an average, as the funded ratios of the individual plans vary.

In quantifying the amount of the unfunded liability, the Commission notes that the State is required to report its unfunded pension liability in a format specified by and in accordance with the standards of the Government Accounting Standards Board ("GASB"). These standards, however, reflect actuarial methodologies which can cause reported assets and liabilities to differ significantly from how they would be reported in the private sector. As noted in the "Risks" section below, going forward, revised GASB standards will likely require lower reported values of assets. Similarly, the new standards may require use of lower expected rates of return/discount rates, which will generally increase reported liabilities.[7]

There are many different ways to measure the same underlying unfunded liability. If the market values of assets were used, for example, the unfunded liability as of the end of FY 2013 would have been $42 billion.[8] Similarly, the $37 billion figure reflects a 7.9% expected rate of return set by the State Treasurer. While this figure is within the range currently used by other states, the actuaries for the State's plans have questioned its use going forward. Use of a lower expected rate of return would tend to increase the plans' unfunded liabilities because the plans' assets would be assumed to earn less income in future years.[9] Given the uncertainty surrounding these factors, the best that can be said is that the State's unfunded pension liability at the end of FY 2013 was likely *at least* $37 billion.

By any measure, the amount of the unfunded liability is grievous. To put funding a $37 billion gap in perspective, each of the State's 3.2 million households would have to write a check today for approximately $12,000 to close the gap.[10] If this payment is stretched over time, the cumulative cost per household will be even greater.

To put the severity of this crisis in a national context, NJ ranks as the 4th worst funded state in the nation with respect to funding ratio of its pensions.

Bottom 5 States Based On Funded Level (Fiscal 2013)

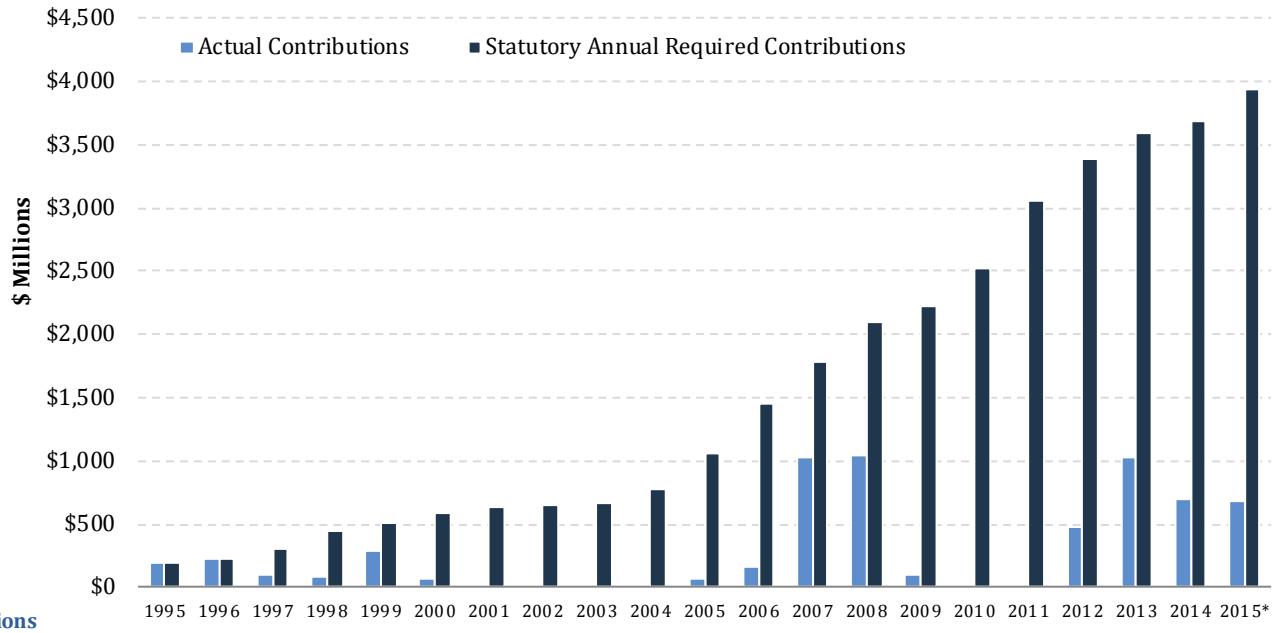
Bottom 5 States	
Illinois	(39%)
Kentucky	(48%)
Connecticut	(49%)
New Jersey	**(54%)**
Alaska	(55%)

New Jersey has the **4th worst funding position in the entire nation**. Funding our $37 billion pension gap would require that each of the State's 3.2 million households write a check *today* for **$12,000**.

As set forth below in Part IV, one cause of the growth of the State pension funds' unfunded liability is the drag on plan asset values caused by the 2008-09 Great Recession and the earlier 2000-02 economic downturn. Another – indeed, the initiating cause – has been elected officials making long-term commitments to provide public employee benefits that would have been affordable only under assumptions that have since proven to be unduly optimistic.

All that being said, however, the failure of the State to make required pension contributions when they have been due has made a bad situation much worse. Local governments participate in the same plans but have made more of their required payments with greater regularity, resulting in the local government share of the funds having a funded ratio of 75%, compared to the State's 54% funded ratio.[11] Under-funding the State's share of the plans has been consistent under the stewardship of both major parties, as shown by the chart on the following page:

Actual Pension Contributions Relative to Statutory Annual Required Contributions (in Millions)[12]



$ Billions	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015*
Actual	0.2	0.2	0.1	0.1	0.3	0.1	-	0.0	0.0	0.0	0.1	0.2	1.0	1.0	0.1	-	-	0.5	1.0	0.7	0.7
ARC	0.2	0.2	0.3	0.4	0.5	0.6	0.6	0.7	0.7	0.8	1.1	1.5	1.8	2.1	2.2	2.5	3.1	3.4	3.6	3.7	3.9
Variance	0.0	0.0	(0.2)	(0.4)	(0.2)	(0.5)	(0.6)	(0.7)	(0.7)	(0.8)	(1.0)	(1.3)	(0.8)	(1.0)	(2.1)	(2.5)	(3.1)	(2.9)	(2.6)	(3.0)	(3.3)
	Whitman - R								McGreevey - D				Corzine - D				Christie - R				
								DiFrancesco - R			Codey - D										

** Projected*

The 2010 and 2011 reforms, while steps toward a solution, were a political compromise, not a complete answer to the unfunded pension liability problem. The 2010 pension reforms trimmed some benefits, especially for new employees. They also established a seven-year phase-in for State employer contributions to bring them up to the full statutory ARC level. But getting the funding level *to* the full statutory ARC, however, is only the first step of the process. Funding would have to be *maintained* at that level – at whatever dollar amount it becomes based on actual future plan performance – for approximately 30 years to substantially increase the plans' funded ratio. Similarly, the 2011 pension reforms made one major change – temporarily suspending cost of living adjustments ("COLAs") – which reduced the unfunded accrued liability by $11.5 billion,[13] but still left tens of billions of dollars in unfunded pension liabilities.

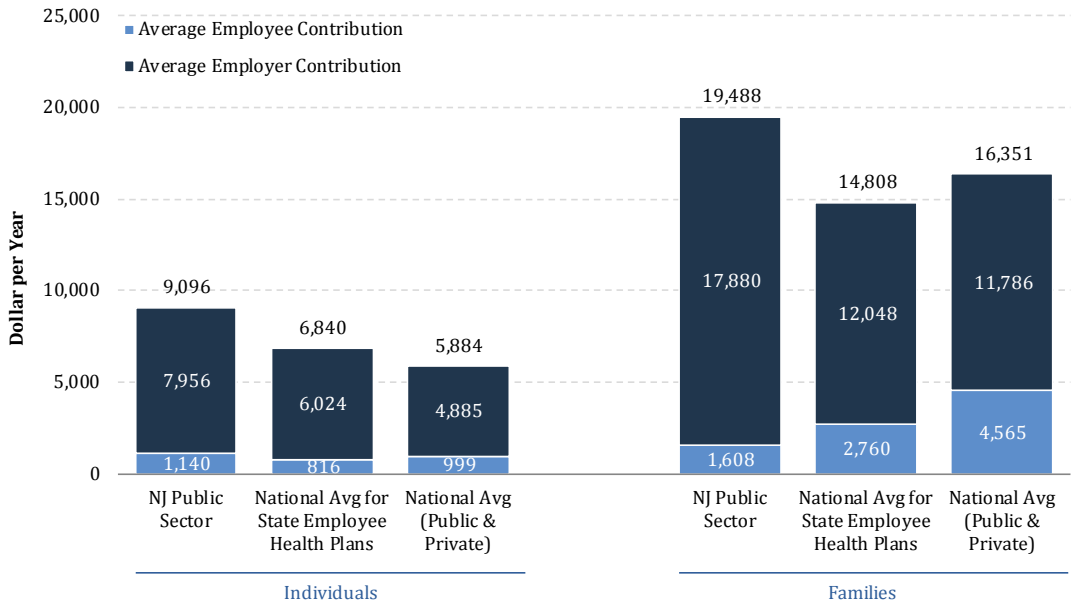
High Cost State Health Programs

The history of the two programs that provide health care coverage to New Jersey public employees and retirees (collectively, the "State Health Programs"[14]), has been one of a long series of benefit enhancements at State expense followed by relatively recent – and largely ineffective – efforts at cost control.

The State Health Programs provide generous benefits with little pricing incentive for employees to select anything but plans with the most comprehensive coverage and highest cost to the State. For example, as shown on the chart on page 26 comparing terms of various plans, over 80% of participants in the State Health Programs are enrolled in the NJDirect 10 and NJDirect 15 plans.[15] These plans provide benefits which approach, and in some ways exceed, the "Platinum" plans available through the exchanges under the Affordable Care Act ("ACA").

The inevitable result of the absence of meaningful incentives for employees to control costs is very high costs to the State.

Cost and Cost-Sharing Comparison: Employer/Employee Health Care Cost for Active Employees [16]



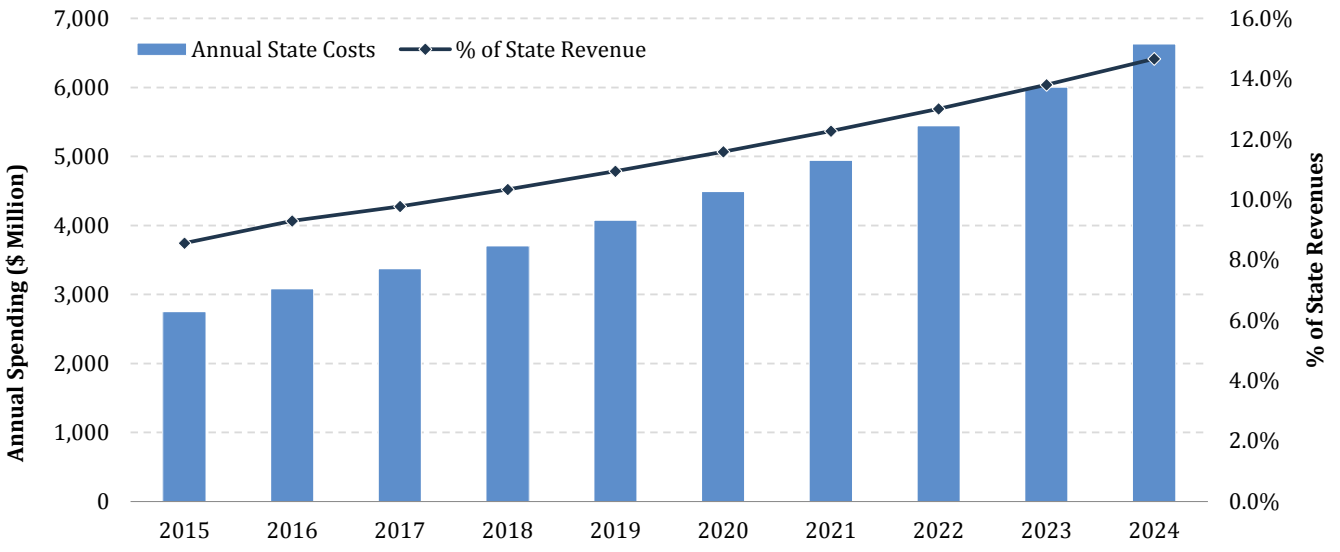
Largely "Gold" or "Platinum" levels of coverage combined with a lack of cost control incentives result in plans that cost **50-60% more than benchmarks.**

Note: NJ figures represent historical averages and do not represent projected employee contributions under Chapter 78 reforms

An additional strain on the State budget will be the 40% excise tax imposed by the ACA on high-benefit/high-cost "Cadillac" plans if they exceed a federal cost threshold. When the excise tax goes into effect in 2018, many of the most popular State plans will be classified as Cadillac plans. This will result in an estimated $58 million tax cost to the State in 2018, rising to $284 million in 2022.[17]

Not only are health benefit costs high, but they also are increasing in both absolute terms and as a share of the budget. In FY 2014, those expenditures were roughly $2.8 billion after offsetting for employee contributions, or just over 8% of the budget. By 2024, unless cost containment is effected, health care benefits are projected to consume over 14% of the budget.

Projected Plan Costs for State-Paid Groups, FY2015 through FY2024 [18]



Without changes, health care costs are projected to consume **over 14% of the State's budget** by 2024.

In Search of Solutions

There is agreement, widespread and across party lines, of the need to reform public employee benefits and the State's funding of them. As former Governor Jon Corzine pointed out, "on pension and health care issues, our career employees, and the public, must recognize that current benefits are financially unsustainable. Without a dramatic increase in taxes or a draconian reduction in services, State and local government cannot meet the benefit obligations on the books."[19] As Governor Christie stated in creating this Commission: "if we don't do more, and we don't do it now, we'll be forced to choose between funding what matters, or a bloated, unaffordable entitlement system we couldn't muster the will to fix once and for all."[20]

This shared understanding of a need for action will be helpful going forward, as there are no easy answers. On the one hand, public employees rely on these benefits for the health and financial security of their families, and the State has made a commitment to them. Furthermore, as a result of legislative changes in 2010 and 2011, employees have already made concessions with respect to reduction of benefits and increases in employee contributions. On the other hand, New Jersey already has the second-highest state and local tax burden – 12.3% of income - in the nation.[21] A tax increase of the size necessary to pay for the ever-increasing cost of benefits at their existing levels is unrealistic.

Also problematic is the option of diverting a greater share of existing revenues to public employee benefits. The state budget has been virtually flat from 2008 through 2013 (declining from $33.6 billion in 2008 to $29.4 billion in 2011 before increasing to $33.0 billion in 2014).[22] Any increase in funding for public employee benefits in this already tight budget would involve taking funding from schools, public safety, infrastructure, higher education and other priorities.

The purpose of this Report is not to propose solutions. It is instead to provide background and highlight issues for informed discussion. Our next report will focus on potential solutions to the State's serious pension and health benefit problems. The Commission welcomes input from stakeholders and the public at large on this issue through its website: http://www.state.nj.us/treasury/pensionandbenefitcommission.shtml.

II. OVERVIEW: THE STATE PUBLIC EMPLOYEE PENSION AND HEALTH BENEFIT SYSTEMS

Composition

The following table outlines, as of 2013, the State's share of the various plans and programs providing pension and health benefits to New Jersey public employees:

Pension Plans[23]

	Acronym	Active Members/Subscribers	Retirees/ Retired Subscribers
Pension Plans (State Funded)			
Public Employees' Retirement System	PERS	85,430	49,876
Teachers' Pension and Annuity Fund	TPAF	153,458	91,576
Police & Firemen's Retirement System	PFRS	7,267	5,809
State Police Retirement System	SPRS	2,513	3,246
Prison Officers' Pension Fund	POPF	0	117
Consolidated Police & Firemen's Pension Fund	CPFPF	0	175
Judicial Retirement System	JRS	417	568
Pension Plans Totals		**249,085**	**151,367**

State Health Benefits Program-State	SHBP	97,114	46,651
School Employees' Health Benefits Program	SEHBP	0	99,062
Health Benefit Programs Totals		**97,114**	**145,713**

Costs

The benefits provided through these plans and programs represent a significant expense, both in absolute terms and as a share of the State budget. The State is responsible for the cost of health care for active and retired State employees and retired school employees. In FY 2014, the total cost of providing this coverage was $3.1 billion, of which $253 million was reimbursed through employee contributions, for a net expense to the State of $2.8 billion.[24]

As set forth in greater detail below, the cost of pension benefits is harder to articulate. In FY 2014, the State actually contributed $696 million. The FY 2014 Appropriations Act had included almost $1.6 billion pursuant to 2011 legislation which called for payment of 3/7ths of the full statutory ARC. The cost of funding the statutory ARC in full would have been $3.7 billion.[25]

The Pension System

Pension benefits are provided through a network of plans created between 1896 and 1973. Some of the pension funds have both State and local employees as members, with financial responsibility for the plans divided between the State and local governments. With two minor exceptions,[26] the pension plans are all traditional defined benefit plans that pay a specified percentage of pre-retirement average salary upon retirement. The plans are capitalized, with funds set aside to pay benefits due in the future.

The terms of each pension plan vary, and, even within a plan, terms applicable to individual members vary based on date of hire. PERS and TPAF, the largest of the State pension plans, currently provide that for a new hire (benefits are greater for participants with earlier dates of hire), an employee retiring at age 65 with at least ten years of service will receive a benefit amounting to 1.67% of the average of the employee's five highest years of compensation for each year of service. The plan permits early retirement with a comparatively modest early retirement penalty, which for new employees is a benefit reduction of 3% a year for each year prior to age 65. It will eventually require employees to contribute 7.5% of annual salary to retirement funding.[27] In addition to their pensions, State employees, unlike public employees in some other states, are also eligible for Social Security. The following information on State pension benefits for employees who retired in 2013 provides one snapshot of the system's participants.

2013 State Pension Plan New Retirees[28]

System	Average Age at Retirement in 2013	Average Annual Benefit	Number of Retirees in FY 2013
Public Employees Retirement System - State	61.5	$30,769	2,543
Teachers Pension and Annuity Fund	61.9	$47,827	4,102
State Police Retirement System*	51.3	$60,297	241
Police and Fire Retirement System*	52	$57,764	418
Judicial Retirement System	66.1	$112,956	28

Note: *Special Retirement (25 years of service)

To fund the portion of pension benefits not covered by employee contributions, New Jersey law requires payment by the State of the statutory ARC. The statutory ARC consists of the "annual normal contribution" (the cost of the current year's accruals for plan participants), and an "annual unfunded accrued liability contribution" intended to make up existing unfunded liabilities.[29] The FY 2014 budget appropriated $1.582 billion for pension payments, 3/7ths of the full statutory ARC of $3.7 billion. As a result of Executive Order 156, the State paid $696 million, the full annual normal contribution portion of the FY 2014 statutory ARC, but did not pay any portion of the annual unfunded accrued liability contribution for that year.[30]

The State Health Programs

There are two State Health Programs. The State Health Benefits Program (SHBP), and the School Employees' Health Benefits Program ("SEHBP"). Together, they cover employees and retirees of the State and over 1,100 local entities, although not all local government or education employers participate in the programs. As is the case with the pension plans, both the State and local governments divide financial responsibility for each of the two programs. Participating local governments are responsible for the health plan costs of their employees included in the SHBP. While participating local education employers are responsible for the health plan costs of active school employees in the SEHBP, the State is responsible for health plan costs for retired school employees, regardless of whether or not their former employers participate in the program.[31]

Combined, the State Health Programs offer more than 20 different medical plans administered by Horizon Blue Cross and Blue Shield of New Jersey and Aetna. They also offer seven dental plans as well as prescription drug coverage. The level of employee contribution and the manner in which that contribution is calculated has varied considerably over time. Currently, employees

contribute a minimum of 1.5% of salary, paying a varying percentage of the premium costs based on their salary (at the lowest, 3% of premium cost for employees earning less than $25,000, rising to 35% for employees earning $110,000 or more). The programs will eventually require some level of contribution from retirees based on date of hire and years of service.[32]

III. PENSIONS

Providing for the retirement of State employees in a way that is both financially sustainable and within taxpayers' means has for decades proven to be an intractable problem. In part this is due to the volatility inherent in defined benefit plans like the State's. A plan's primary liabilities (the benefits paid to employees) are designed to grow over the employees' working careers, while the value of plan assets – particularly those invested in equities - will go up and down. The need to ensure the plan stays adequately funded during the inevitable periods when liabilities are going up while asset values are going down is a risk which must be addressed in proper management of a defined benefit plan.

Although it is possible to buffer a plan from changes in asset value through careful plan design or specially-tailored investment strategies, attaining this level of certainty can require being more modest when defining plan benefits and making and honoring commitments to fund the plan at a higher level. To operate such a plan successfully it is necessary for its stakeholders to remember in the flush years that pension surpluses may be temporary. There needs to be sufficient discipline to retain surpluses from good years as insurance against future bad years. The temptation must be resisted to use surpluses as an excuse for "contribution holidays" or as a justification for expanding benefits that cannot easily be paid for once markets have reversed and the surpluses have disappeared. Failure to follow these prescriptions set the State on an unsustainable course over a decade ago.

Adding to the technical difficulty of the problem is a lack of shared perspective. Career public employees build a lifetime of financial assumptions around the availability of these retirement benefits, and understandably view any change to them as a threat to their families' security. The emotional impact of this issue leads to it having a symbolic and political force even beyond its considerable fiscal impact, which makes it particularly difficult for public employee representatives to make concessions on pensions. The broader tax-paying public, however, does not look at the issue from this perspective, particularly when they themselves may have to make do without pensions. Instead, the public as a whole experiences the financial burden of paying for the pension programs in the form of higher taxes and/or lower levels of State services. These conflicting perspectives create opportunities for elected officials to have it both ways. They avoid short-term pain by supporting public employee constituents when approving benefits, and taxpayers as a whole when adopting budgets, simply "kicking the can down the road" with respect to long-term financial commitments.

Magnitude of the Problem

The unfunded liability of the State plans reflects a long-term disconnect between the willingness to provide public employees with benefits and the willingness to pay for them. The consequences of this disconnect have now come home to roost.

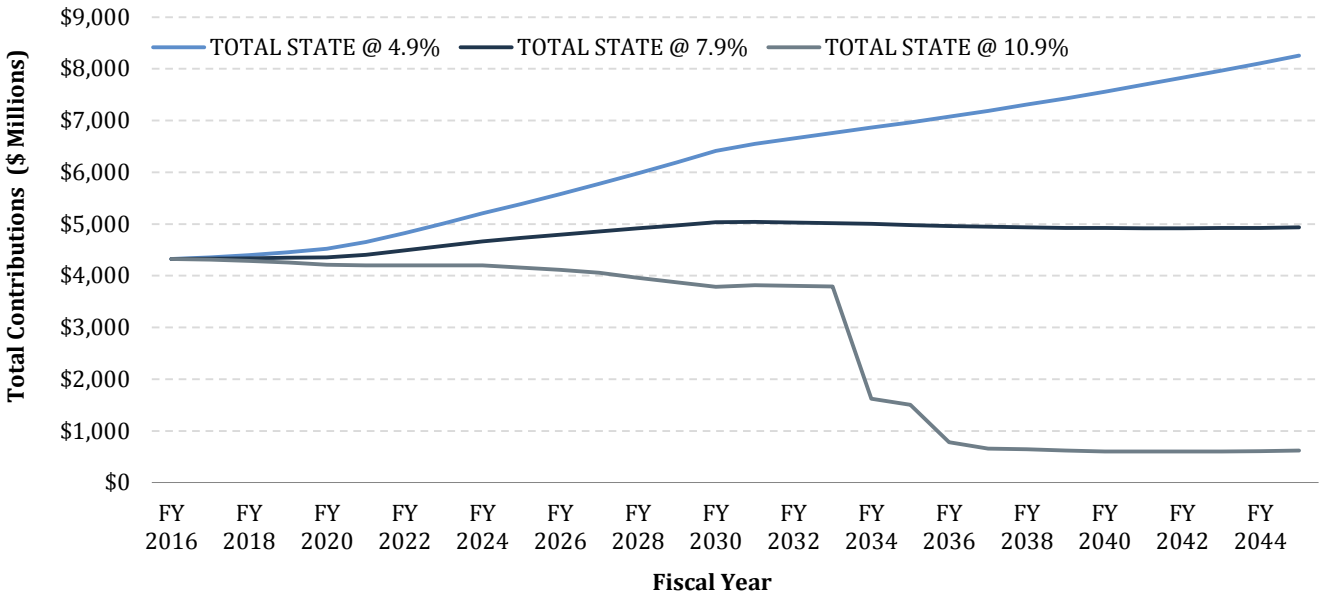
Elected officials supported public employee constituents when approving benefits and taxpayers when adopting budgets. **The consequences of this disconnect have finally come home to roost.**

Pension Fund Actuarial Liabilities and Assets as of July 1, 2013 per GASB 25 and 27 (in Millions) [33]

Pension Plan	Actuarial Value of Assets	Actuarial Accrued Liability Active Portion	Actuarial Accrued Liability Retiree Portion	Total Actuarial Accrued Liability	Unfunded Actuarial Accrued Liability	Funded Ratio	Market Value of Assets
State							
PERS	$9,191.8	$8,700.3	$11,293.7	$19,994.0	$10,802.2	46.0%	$8,639.6
TPAF	30,606.0	19,562.0	34,083.5	53,645.5	23,039.5	57.1%	26,859.6
PFRS	2,033.7	1,541.1	2,647.4	4,188.5	2,154.8	48.6%	1,896.2
CP&FPF	5.6	–	6.1	6.1	0.5	91.5%	5.8
SPRS	1,946.6	836.0	2,034.6	2,870.6	924.0	67.8%	1,832.9
JRS	258.5	184.4	436.0	620.4	361.9	41.7%	244.3
POPF	8.2	–	4.7	4.7	(3.5)	172.1%	9.0
Total	**$44,050.4**	**$30,823.8**	**$50,506.0**	**$81,329.8**	**$37,279.4**	**54.2%**	**$39,487.4**
Local							
PERS	$19,975.2	$12,230.0	$14,775.8	$27,005.8	$7,030.6	74.0%	$18,120.8
PFRS	22,097.0	17,716.9	11,094.8	28,811.7	6,714.7	76.7%	20,734.8
Total	**$42,072.2**	**$29,946.9**	**$25,870.6**	**$55,817.5**	**$13,745.3**	**75.4%**	**$38,855.6**

Keeping the existing unfunded liability from growing depends on plan assets earning a sufficient return on investment. The illustration below projects that if the market generates a 7.9% annual rate of return, the statutory ARC would level out at $5 billion for the foreseeable future. If the annual rate of return slips to 4.9%, the statutory ARC necessary to compensate for the lower rate of return would steadily grow to over $8 billion. In this illustration, only in the scenario projecting a 10.9% rate of return does the State's required contribution finally begin to decline. It should be noted that, to simplify the illustration, the projection assumes the full statutory ARC will be paid each year, an assumption discussed further in the "Risks" section below. It also assumes that the discount rate used to determine the present value of liabilities would remain constant at 7.9%, when in actual practice this rate would be adjusted periodically to reflect market performance.

Required State Contributions Based on Investment Return[34]



Under any likely investment return scenario, the State would need to fund **$4-$6 billion annually for at least the next 20 years** to close the funding gap for pensions at their current level.

How Did We Get Here?

As the table below indicates, largely due to the extremely high investment returns of the late 1990s, at the turn of the century the funded ratio of the plans based on actuarial values approached or exceeded 100%, even during the 2000-02 economic downturn. However, the apparent resiliency of the plans during that downturn is misleading. The actuarial asset values are rolling multi-year averages. For some time after the flush years of high returns, those averages continued to reflect high actuarial asset values for those years even though the market value of the assets was declining. Statutory changes also increased the expected rate of return from 7% to 8.75% and modified the actuarial funding method to allocate more costs to future years, thereby reducing the apparent value of the liabilities. This further reinforced the misperception that the plans were safely and permanently in surplus.

The reported asset values and statutory changes enabled the State, in full compliance with the standards then in place, to discontinue making contributions to the funds. While there were clear warnings then that this could lead to huge fiscal problems in the future, at the time it permitted hundreds of millions of dollars to be diverted to other purposes ranging from education to tax relief. Compounding the problem, during the years when the pension plans were apparently well-funded (but actually lapsing into deficits), the Legislature enacted a series of benefit enhancements, including a retroactive 9% increase in TPAF and PERS pensions in 2001, which increased State pension liabilities by $4.2 billion.[35]

Historical Funding Status[36]

	Actuarial Value of Assets	Actuarial Accrued Liability	Unfunded Accrued Actuarial Liability	GASB Ratio %	Market Value of Assets	Unfunded Market Value Liability
FY 1997	31,948	30,717	1,231	104.0%	32,922	2,205
FY 1998	35,513	33,768	1,745	105.2%	41,540	7,772
FY 1999	40,078	36,752	3,326	109.0%	47,537	10,784
FY 2000	44,023	39,534	4,489	111.4%	51,612	12,078
FY 2001	50,732	46,552	4,181	109.0%	45,279	(1,273)
FY 2002	50,531	50,130	401	100.8%	39,305	(10,825)
FY 2003	49,674	53,914	(4,241)	92.1%	38,340	(15,574)
FY 2004	49,574	58,018	(8,444)	85.4%	41,414	(16,604)
FY 2005	49,755	62,797	(13,041)	79.2%	42,918	(19,878)
FY 2006	50,659	67,266	(16,607)	75.3%	45,780	(21,486)
FY 2007	52,433	71,656	(19,222)	73.2%	50,720	(20,936)
FY 2008	52,718	75,763	(23,045)	69.6%	47,000	(28,763)
FY 2009	50,230	80,956	(30,727)	62.0%	36,540	(44,416)
FY 2010	48,079	73,714	(25,635)	65.2%	37,766	(35,948)
FY 2011	46,698	76,806	(30,108)	60.8%	40,795	(36,010)
FY 2012	45,064	79,434	(34,370)	56.7%	38,271	(41,163)
FY 2013	44,050	81,330	(37,279)	54.2%	39,487	(41,842)

Just as the boom period of the late 1990s came to an end, the Legislature spent the "rainy day" fund built up during those years by **increasing benefits by $4.2 billion and returning to a pattern of contribution holidays**.

Increasing benefits while essentially discontinuing State contributions ultimately resulted in a rapid increase in unfunded liabilities. This increase accelerated even more dramatically as a result of the 2008-09 Great Recession, when not only did rates of return fall short of their expected levels, but substantial loss of principal also occurred. Unfunded liabilities increased at precisely the same time when, due to the economic downturn, the State faced revenue shortfalls. These lower revenues made it difficult to allocate the necessary funds to make up the growing pension shortfalls, only worsening the situation.

The reality is that we arrived at our present position by following a bipartisan course guided by Governors of both parties, as well as by a Legislature controlled by Republicans from 1995 through 2001 and by Democrats from 2004 to the present, with two years of a Democratic Assembly and an equally divided Senate in between. Public sector employees who benefited from and in many cases pressed for the enhanced benefits were in agreement, as, apparently, were the voters, given incumbents' re-election rates. Developing a common understanding of what happened and why, without allocating fault, is necessary to permit stakeholders to better discuss and evaluate potential solutions. What follows is a brief discussion of certain factors which may have had a role in creating the problem and/or might play a role in forming possible solutions.

1. Form of Plan

The State plans, like most public pension plans, are defined benefit plans. As set forth above, if not managed prudently, such plans can quickly slide into deficit if their risks are not properly managed and rigorous funding is not maintained. The defined contribution plans more popular in the private sector do not face this problem, as their obligations – by definition - are always equal to the sum of the participants' account balances. However, in a broader sense, both defined benefit and defined contribution

plans face the risk that assets will be insufficient to provide adequate retirement benefits. What differs between the two designs is who bears the immediate risk of this happening.

In a defined benefit plan the risks are borne primarily by the plan sponsor and felt, in a public sector plan, by the taxpayers who will be asked to make up any unfunded liabilities. In a defined contribution plan, the risks are borne primarily by individuals, and manifest themselves in the form of retirees outliving their retirement assets. This in turn can result in significant direct and indirect costs to family members and/or the public.

Different plan designs can work better for different workforces. In the private sector, as workforces have become more mobile and management has become increasingly unwilling to accept large, hard-to-manage long-term risks, the defined benefit plan has fallen into disfavor. Of private sector workers participating in employer-sponsored retirement programs in 2011, only 7% participated exclusively in a defined benefit plan, compared to 69% who participated in defined contribution plans only (the remaining 24% participated in programs with some combination of the two).[37] In the public sector, where a more stable workforce places less of a premium on benefit portability and the government can take a more long-term view of risks, defined benefit plans remain more common. Boston College's Center for Retirement Research reported that in 2012, 89% of state and local employees nationally enrolled in defined benefit plans, compared to only 2% in defined contribution plans, with the remainder in cash balance plans or "hybrid" plans that combine elements of defined benefit and defined contribution plans.[38]

In recent years as plans have run into difficulties, however, many public employers, like private sector employers, have also become concerned about the large, hard-to-manage long-term risks of traditional pension plans. Whether the risk is due to the form of the plan or the stewardship exercised over it, there is a trend in public pension reform efforts to utilize hybrid plans as a way of fine-tuning the allocation of risk among stakeholders. As set forth in the discussion beginning on page 21, this approach can take myriad forms, and involves supplementing and/or replacing defined benefit plans with hybrid plans, defined contribution plans or both, and doing so on a mandatory or elective basis.

2. Recent State Pension Reform Initiatives

Recent reforms have brought the New Jersey pension program more in line with market norms, at least with respect to new employees. The following table summarizes key changes made in the terms of the two largest plans, PERS and TPAF, which together cover over 240,000 of the 250,000 current public employees for which the State has financial responsibility. These changes all decrease costs, and in total have reduced the State's unfunded liability by approximately $11.5 billion.

Changes In terms of PERS and TPAF Pensions as a Result of Recent Legislative Reforms[39]

Provision	Pre-2010	Post 2011
Normal Retirement Age	Age 62	Age 65
Early Retirement	25 years	30 years
Early Retirement Reduction	1%/ yr.	3%/ yr.
Cost of Living Adjustment	Yes	Suspended
Employee Contributions	5.5%	Phasing into 7.5%
Vesting Period	10 years	10 years
Period for Average Salary	Highest 3 years	Highest 5 years
Formula Multiplier	1.818% (1/55)	1.67% (1/60)

All term changes applicable to new employees; applicability to current employees and retirees vary.

Recent reforms made significant changes to the pension programs going forward but the **unfunded liability was only reduced by ~25%** because most changes had **limited immediate impact on the majority of current employees.**

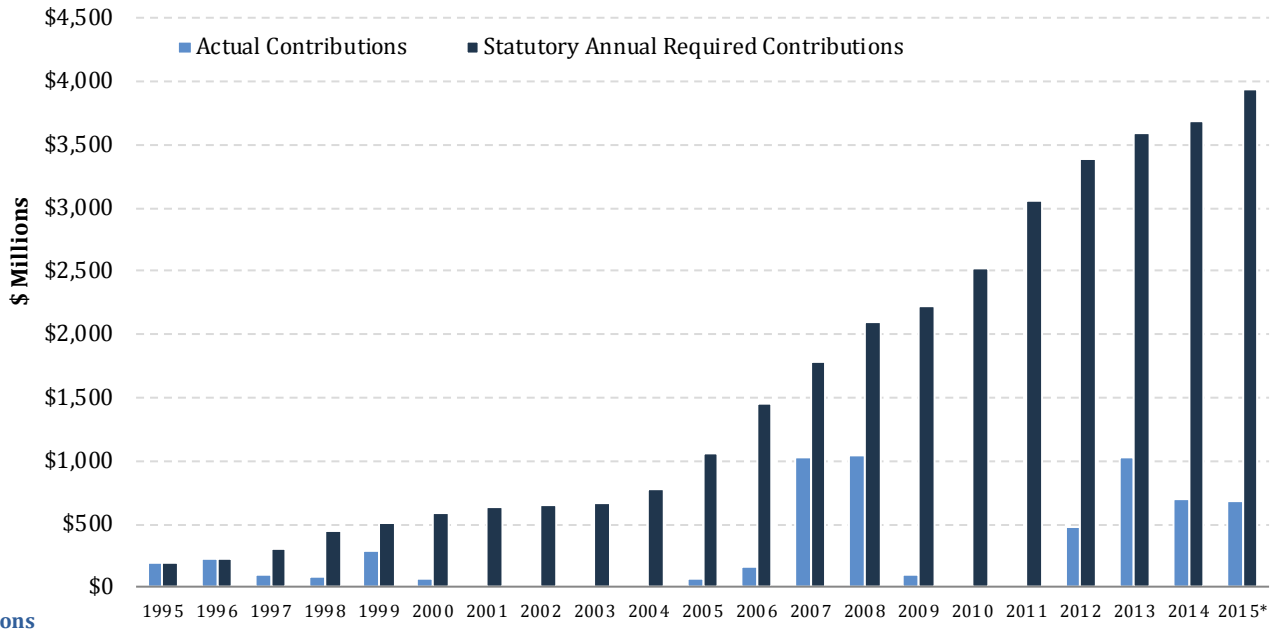
With these and other reforms, some steps toward pension reform have already been taken. One conspicuous holdover from pre-reform years, however, is the minimal per-year penalty for early retirement. A newly-hired State employee who retires five years early, at age 60, would have his or her State pension benefit cut only 3% a year, or 15%. In contrast, under Social Security, for a person born after 1960, retiring five years early – at 62 instead of 67 – would result in a 30% reduction in benefit.[40] Early retirement has a multiplier effect on both pension and health benefit costs.

One of the reasons the reforms described above have had little impact on the unfunded liability is that many of them do not apply to all current employees. Efforts to use changes in plan structure to reduce unfunded liabilities in the near term resemble trying to use a very small tail to wag a very large dog. Illustrating this point, virtually all of the $11.5 billion savings in pension costs effected by Chapter 78 are due to the one reform with the greatest reach beyond new employees – the temporary suspension of COLA payments. This change, of course, was almost immediately challenged in court following the enactment of Chapter 78, and remains on appeal.

3. Effect of Deferred State Contributions

While high benefit levels are one driver of unfunded liabilities, the lack of State contributions is a critical contributing factor. Put simply, if the State cannot find the economic means and discipline to consistently fund its pension obligations, the system will fail. The funding decisions over the last twenty years are telling examples of bipartisan contribution to fiscal distress.

Actual Contributions Relative to Statutory Annual Required Contribution[41]



$ Billions	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015*
Actual	0.2	0.2	0.1	0.1	0.3	0.1	-	0.0	0.0	0.0	0.1	0.2	1.0	1.0	0.1	-	-	0.5	1.0	0.7	0.7
ARC	0.2	0.2	0.3	0.4	0.5	0.6	0.6	0.7	0.7	0.8	1.1	1.5	1.8	2.1	2.2	2.5	3.1	3.4	3.6	3.7	3.9
Variance	0.0	0.0	(0.2)	(0.4)	(0.2)	(0.5)	(0.6)	(0.7)	(0.7)	(0.8)	(1.0)	(1.3)	(0.8)	(1.0)	(2.1)	(2.5)	(3.1)	(2.9)	(2.6)	(3.0)	(3.3)
	Whitman - R								McGreevey - D				Corzine - D				Christie - R				
								DiFrancesco - R			Codey - D										

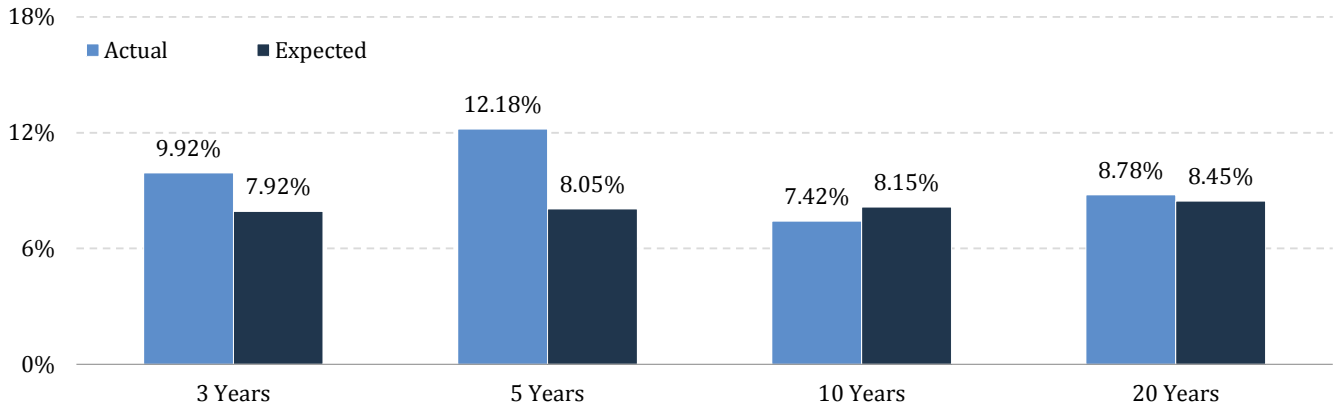
* Projected

Observing that Republicans and Democrats and both elected branches of State government are equal opportunity offenders in under-funding the pension is simply a statement of fact, but the reality is more complicated than a series of isolated decisions. Each Governor and Legislature has inherited the legacy of decisions made by their predecessors. These decisions have generally limited the available remedies while increasing their cost. Subsequent administrations have been left to support expensive benefit obligations after money that should have been set aside to pay for them was spent on other things. Not only is the principal of the contributions which should have been made missing, the investment returns these contributions would have earned have also been lost.

4. Role of Investment Decisions

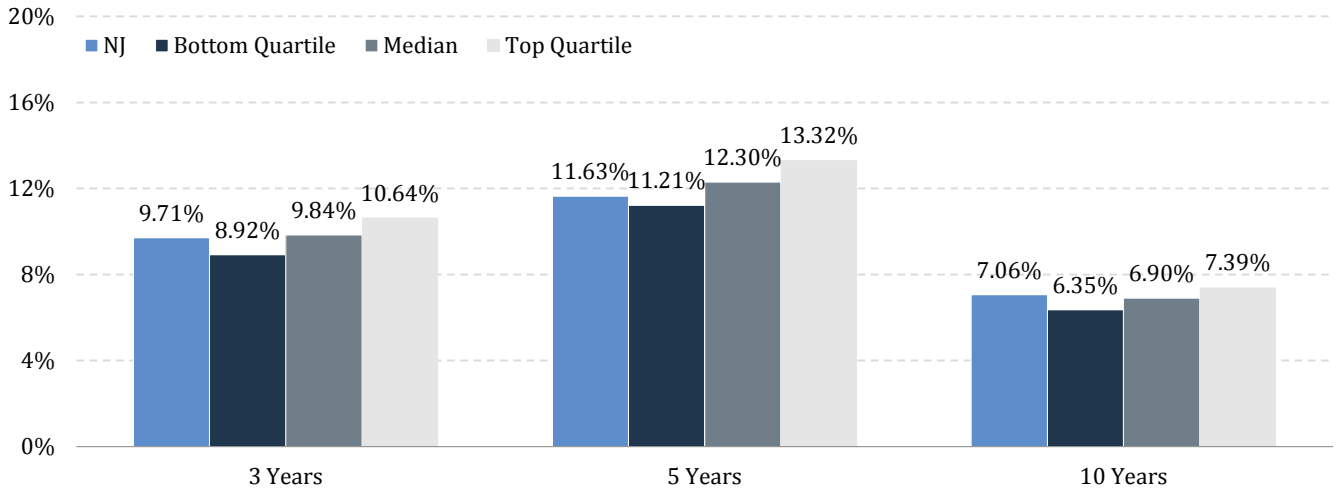
A question which has been raised is whether better decisions in how the plans' assets were invested could have avoided the unfunded liability. As seen in the graph below, while the specific time period selected has a significant impact on performance relative to expected returns, for most time periods, the overall difference between actual and expected returns is relatively small. Due to the magnifying effect of compounding, however, even differences between expected and actual returns that average out over time can have a large influence on asset values. Not only are the anticipated gains lost but the principal available to generate future income is also reduced. For example, a 20% loss on a $100 account reduces the account balance to $80. It would then take a 25% gain to move the account balance back to $100. In other words, it takes a 25% increase to merely break even after a 20% loss.

Actual and Expected Investment Return by Fiscal Year[42]



Another relevant comparison of how New Jersey's funds fared compared to other public funds during this time period reveals that the funds performed roughly in line with peers but delivered that level of performance with less risk in the portfolio.

NJ Pension Investment Performance Relative to Other Large Public Plans as of 12/31/2013[43]



New Jersey's investment performance generally has been **in line with other large pension plans.**

Finally, a few words of history may be worth many bar graphs. Part of the reason New Jersey's investment performance was so high in the late 1990s was that the State's plans had a relatively high exposure to the public equity market. When the 2000-02 downturn occurred, returns decreased accordingly. At the end of FY 2001, when the State's funds had a 63% allocation to public equities, the equities portfolio lagged the S&P 500 Index by 3.3%, losing 16.1% while the S&P 500 Index lost 12.8%, for an overall loss of 9.8%. As a result of this experience, in subsequent years New Jersey's plans followed a more conservative allocation than many peers, with somewhat less exposure to stocks and to alternative assets. This served the State plans very well in the downturn of 2008. In FY 2008, New Jersey lost only 2.6% while the S&P 500 Index lost 13.1%. In FY 2009 (which included the worst part of calendar year 2008), the State plans lost 15.5% while the S&P 500 Index lost 26.2%.[44]

Potential Reforms

Any solution to the employee benefit funding crisis will likely involve tough choices among options that one or more groups of stakeholders may find unpleasant. The menu of options include re-allocating existing revenue from other priorities to pay for benefits, generating new revenue with additional taxes, generating new revenue from other sources such as new gambling activities or asset sales, generating new revenue from increased employee contributions, and/or reducing pension costs, or other employee benefit costs, to free up money for pension funding. Given the tightness of the State's budget, the already high level of taxes, and the legal and political impediments to reducing benefits, there is likely no one magic bullet that will make all the problems disappear.

This is not to say, however, that progress cannot be made. Many jurisdictions have been confronted with significant unfunded pension liabilities and found ways to accomplish meaningful reform.

- One example is the federal government's move to a hybrid defined benefits/defined contribution plan. In 1986 the newly-created Federal Employees Retirement System (FERS) for the first time enrolled federal workers in the Social Security system (a step New Jersey has already taken) to reduce retirement reliance on pensions. It then replaced its full defined benefit pension with a smaller basic annuity, supplemented by a thrift savings plan – essentially, a defined contribution plan. This reform, which had bipartisan support, reduced costs while shielding employees from the full risks of a defined contribution plan.[45]

- The State of Utah also opted to transition to a hybrid plan when its pension plan threatened to violate state law debt limits. The Utah hybrid plan offers employees a choice of participating in a defined contribution plan in which the State would contribute 10%-12% of employee compensation, or a defined benefit plan in which the State would contribute 10% of employee compensation – but participating employees would have to commit to contributing any additional funds required to make the annual required contribution necessary to keep the plan funded. Since a higher level of benefits requires a higher ARC contribution, this approach creates an incentive for employees to limit benefits.[46] The City of Atlanta has also adopted a similar approach.[47]

- In 2013, Kentucky lawmakers passed comprehensive pension reform legislation with a number of different elements. It created a new pension plan for anyone hired after January 1, 2014, required that future COLAs be paid for before they are given, and included a plan that commits the Legislature to full funding of pension promises in future years. An accompanying bill raises additional revenue to help pay down past unfunded pension liability. The pension plan for new hires is a "cash balance" design which provides defined-contribution-like notional accounts but with defined-benefit guarantees. The State credits employees' accounts with a specified percentage of their pay each year and employee contributions are added to the cash balance accounts. This design reduces the risk of under-funding over the long-term by crediting interest on accounts based on the five-year average return on trust assets. Employees making contributions to the plan receive a 4% annual return on accounts plus 75% of excess returns (based on the 5-year average returns).[48]

- In Baltimore, the city began offering a defined contribution option to employees. It also ended a practice in which retirees received the excess of investment earnings over a certain percentage instead of the plan retaining those earnings as a reserve against sub-par years. This practice was replaced with a more modest COLA provision available to some older retirees. This reform recently survived a federal constitutional challenge, but remains subject to state law breach of contract claims.[49]

- The State of Rhode Island, confronted with an unfunded liability problem, responded with a variety of reforms. It excluded certain employees from the existing defined benefit plans in favor of a hybrid plan, and offered incentives for employees not required to participate in the hybrid plan to voluntarily do so. It suspended almost all COLA payments and increased the retirement age of most employees not already eligible to retire.[50]

IV. HEALTH BENEFITS

Magnitude of the Problem

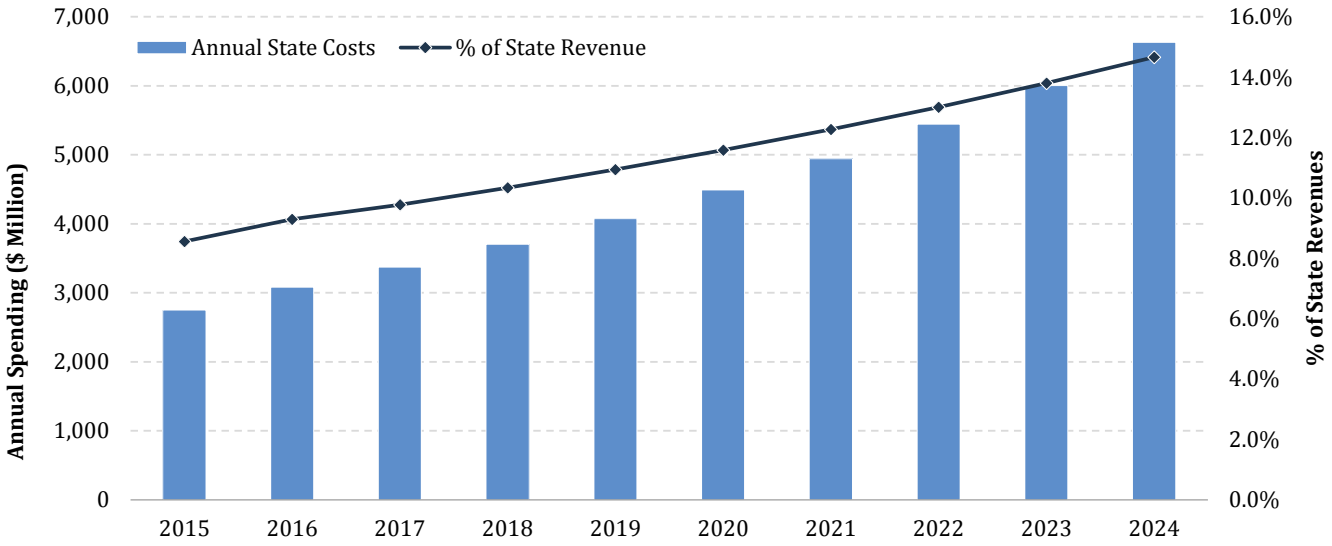
In FY 2014, it cost the State $2.8 billion to meet its obligations for the health care benefits of its own active employees and retirees and their dependents who are members of the SHBP, and for school retirees and their dependents who are members of the SEHBP. The breakdown of costs for the State's share of this expense is as follows:

	FY 2014(millions)[51]
Active Employees	$1,657
Retirees	$1,396
Active Employee Contribution	$(253)
Total Net Cost	$2,801

Employee health care costs are already 8% of the State's annual budget and are projected to **exceed $6 billion by 2024.**

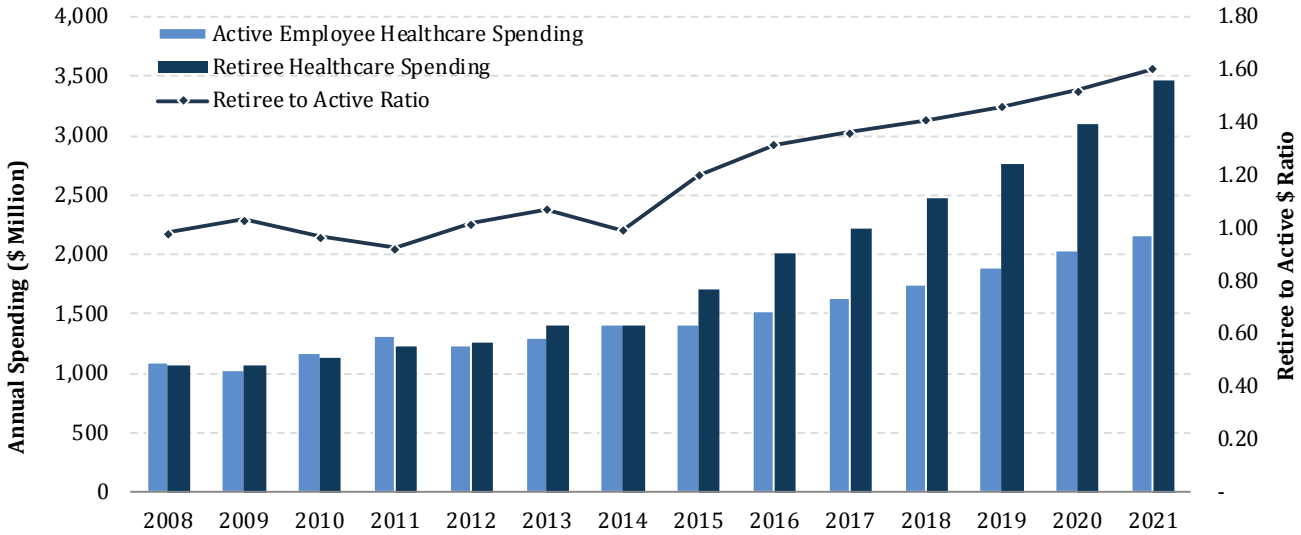
These expenses (including the ACA excise tax starting in 2018) are expected to more than double and exceed $6 billion by 2024, consuming an ever-increasing share of State revenues.[52]

Projected Plan Costs for State-Paid Groups, FY2015 through FY2024[53]



Retiree health expense is a particular area of concern, as this cost is borne by the State for an indefinite period. Moreover, the cost of retirement health care is not funded at the time the employee works, but when the expense is incurred after retirement – meaning future taxpayers will pay for the retirement health benefits of current employees. As set forth above, this future debt, while not due now, represents a $53 billion liability.[54] Heightening concerns that these costs will be a burden on the next generation, the ratio of retirees – who contribute less to their health care costs – to active employees has been increasing. The State's total cost of providing coverage to retirees now exceeds the cost of providing coverage to active employees, and is increasing at an even faster rate.

Total State Cost of Active Employee and State and School Retiree Health Coverage[55]



Note: Projected spending levels shown are pre-reimbursement so will not tie to other summary charts

By 2021, $1.60 will be spent on retiree medical benefits
for every dollar spent on active member medical benefits.

How We Got Here

Prior to 1961, public employees had the option of purchasing, at their own expense, health care coverage through New Jersey Blue Cross/Blue Shield. In 1961, the SHBP was created to provide, at State expense, individual coverage for State employees through Blue Cross/Blue Shield and Prudential. School employees were also initially included in the SHBP, which was later expanded to include retirees and local employees and provide coverage to dependents. In 2008, the SEHBP was spun off from the SHBP to provide coverage for school employees and retirees and their dependents.

At that time, employees paid either 25% of premium cost as a health benefit plan contribution for the Traditional Plan (a non-network based indemnity plan), 5% of the premium cost of an HMO, or no premium contribution at all for the NJ Plus network-based Point of Service option. In 2007, the State employee contribution provisions changed to require a contribution of 1.5% of salary regardless of benefit plan or level of dependent coverage selected,[56] an approach that eliminated any meaningful financial incentive for employees to select a less expensive plan.

In parallel with the expansion of coverage available to employees, medical coverage to retirees has also expanded. As of 1972, health benefits coverage was extended to State retirees and their dependents. In 1987, the Legislature extended this post-retirement medical (PRM) coverage to school retirees. In 1997, the obligation to make some contribution for PRM was added to the terms of retirement for State employees and some local employees. Depending on their year of retirement, years of service and former employer (school retirees receive full reimbursement), retirees are also reimbursed for their Medicare Part B premiums in full (currently $104.90/month) or up to a capped amount (currently $46.10/month). Some retirees are reimbursed by the State for the income-based surcharge imposed by Medicare on high income individuals. All told, this is an annual $162 million expense. [57]

While recent years have seen a host of efforts to reduce the cost of the State Health Programs, the success of these efforts has been mixed. The alternative Medicare Retiree prescription program offered in 2012 has been a success that has saved $150 million a year. However, as the plans are structured, there is in general not enough of a difference in cost to the employee to make electing a lower-cost plan worthwhile. For example, in 2014, for an employee earning $60,000, there is only a $44 difference in monthly cost

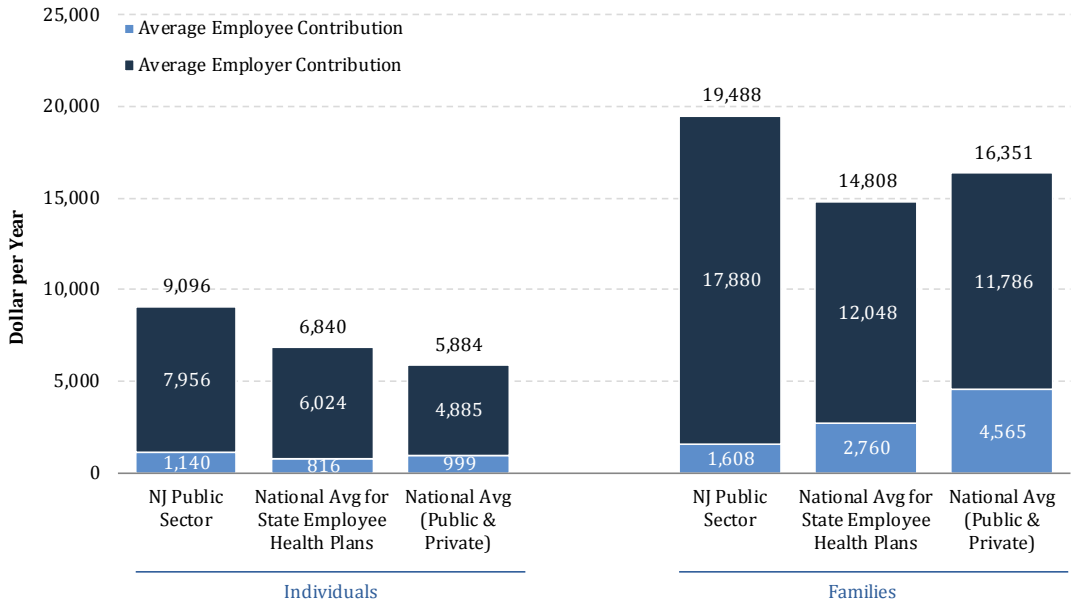
to the employee between NJ DIRECT15 and NJ DIRECT2035 – a plan which over the course of a year would cost the State thousands of dollars less.[58]

Similarly, to date, there has been minimal enrollment in the NJWELL program.[59] It remains to be seen whether the relatively modest rewards ($100 gift cards and possible reduction of the participating employers' insurance premiums) are of sufficient magnitude and personal relevance to make participation worthwhile to individuals.

The High Cost of the State Health Programs

The costs of the State Health Programs are far above average by any measure, as shown by this comparison of national costs, and percentage of costs paid by the employer to those of the State Health Programs.

Employer/Employee Health Care Cost Breakdown (Active Employees) [60]



According to Pew Charitable Trust data, **only two States had higher average costs than New Jersey.**

Note: NJ figures represent historical averages and do not represent projected employee contributions under Chapter 78 reforms

Other data point to the same conclusion. For example, a study of public health care plans conducted as part of the Pew Charitable Trust Report found that the average per-employer per-month premium for coverage of employees and dependents was $959. The cost for NJ was $1,334, or more than 39% higher than the average. Based on the report, only two States – Alaska and New Hampshire – had higher average costs than New Jersey. [61]

The reasons for this are varied. Some of the increase in costs over time is due to the general rise in medical care costs nationally. Some of the difference in State and national costs is driven by the generally high cost of obtaining medical care in New Jersey. A large part of the high and increasing costs of the State Health Programs, however, appears to be due to the extensive benefits and relatively low cost to employees of the plans most frequently selected by State Health Program enrollees. A fourth driver of cost increases – the excise tax on Cadillac plans under the ACA, is looming on the horizon.

1. Benefit and Enrollment Patterns of State Health Programs

The tendency of plan members to select the benefit options with the highest cost to the State has become a hallmark of the State Health Programs. While this tendency predates the 2011 creation of the Plan Design Committees, they have had little success altering it. The Committees are composed of an equal number of labor and employer representatives who frequently deadlock. This predisposition to inertia has inhibited changes in plan terms and pricing that would alter enrollment patterns and make the programs more efficient and cost-effective. For example, nationally, **17%** of enrollees in public and private health plans elect high-deductible plan options. But among the State Health Programs, the participation rate in high-deductible plans is only **0.06%** (only 137 of 242,827 State active and retiree and education retiree enrollees have selected the HD4000 or HD1500 high-deductible options).[62]

Well over **80%** of the participants in the State Health Programs are enrolled in plans that **exceed the benefits of the "Gold" plan** available through the ACA exchanges.

Similarly, as set forth on the chart on the following page, of 242,827 State active employees and State and education retirees participating in the State Health Programs, 209,506 are enrolled in plans that exceed the benefits of the "Gold" plan available through the federal health care exchange under the ACA, and approach or exceed terms of the "Platinum" ACA option.[63]

Comparison of State Health Programs and ACA Exchange Plans

Coverage	Platinum	Direct & Freedom 10		Legacy HMO		Direct & Freedom 15		Gold	Direct & Freedom 1525		Direct & Freedom 2030		Silver	Bronze	HD 4000	
Deductible		(out of network)				(out of network)			(out of network)		(out of network)					
Individual	$0	$100		$0		$100		$1,000	$100		$200		$1,500	$2,500	$4,000	
Family	$0	$250		$0		$250		$2,000	$250		$500		$3,000	$5,000	$8,000	
Out-of-Pocket Maximum		In Network	Out of Network	In Network	Out of Network	In Network	Out of Network		In Network	Out of Network	In Network	Out of Network			In Network	Out of Network
Individual	$4,500	$400	$2,000	$6,350	N/A	$400	$2,000	$2,500	$400	$2,000	$800	$5,000	$6,350	$6,350	$1,000	$2,000
Family	$9,000	$1,000	$5,000	$12,700	N/A	$1,000	$5,000	$5,000	$1,000	$5,000	$2,000	$12,500	$12,700	$12,700	$2,000	$4,000
Primary Care	$15 copay	$10 copay		$15 copay		$15 copay		$15 copay	$15 copay		$20 copay		$30 copay	$30 after deductible	20% after deductible	
Specialist	$25 copay	$10 copay		$15 copay		$15 copay		$30 copay	$25 copay		$30 copay		70% after deductible	50% after deductible	20% after deductible	
In-Patient Doctor and Facility	$300 copay per day	No Charge		$15 copay		No Charge		80% after deductible	No Charge		No Charge		70% after deductible	50% after deductible	20% after deductible	
Emergency Room	$75 copay	$25 copay		$35 copay		$50 copay		$100 copay plus 80% after deductible	$75 copay		$125 copay		$100 copay plus 70% after deductible	$100 copay plus 50% after deductible	20% after deductible	
Prescription Drug																
Generic	$10	$12		$7		$12		$10	$7		$3		70% after deductible	50% after deductible	20% after deductible	
Preferred	$40	$25		$14		$25		60%	$17		$19					
Non-Preferred	$60	$50		$27		$50		50%	$37		$49					
2014 Premiums																
Single, Age 47	$16,440	n/a		$9,592		$9,599		$14,520	$9,195		$8,792		$11,994	$11,066	$5,097	
Single, Age 62	$15,720	$11,438		$11,356		$12,789		$12,072	$11,746		$11,256		$10,260	$9,156	$6,503	
Family, Age 62	$33,264	$28,366		$28,147		$31,716		$29,376	$29,129		$27,915		$24,492	$22,380	$16,127	
Percent of Plan Participants	n/a	41%		12%		46%		n/a	0%		0%		n/a	n/a	0%	

* Direct & Freedom 10 is currently only available to education retirees and certain state retirees

* Premiums stated in the State plans are for active and retirees, except premiums for education retirees for the Direct & Freedom 10 Plan.

* This chart represents Horizon and Aetna Plans (premiums are roughly equal)

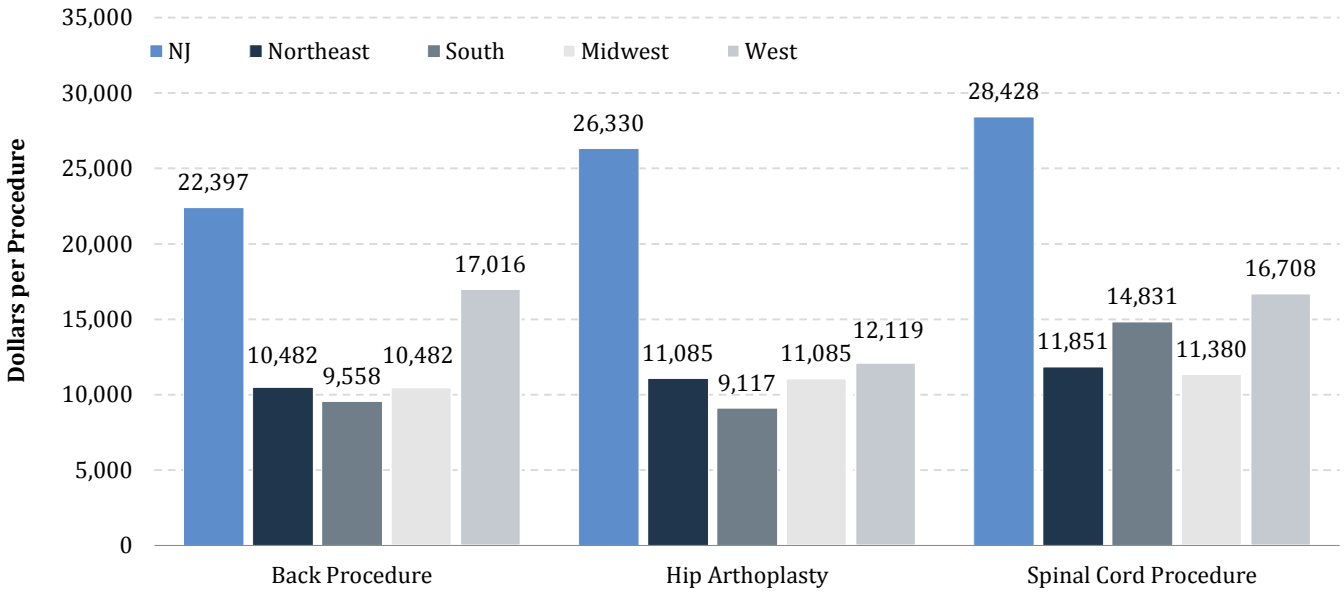
* Retiree premiums are based on non-Medicare retirees

* The following plans are offered to members but not included in this presentation because they are relatively similar and contain little, to no member participation: HD1500, 1525 HMO, 2030 HMO, 2035 HMO, Freedom & Direct 2035

2. Relative Expense of Health Care in New Jersey

While factors intrinsic to the benefit offerings and enrollment patterns of the State Health Programs have contributed to their high and increasing costs, it should be noted that even a well-designed program in New Jersey is likely to have higher than average costs due to the higher cost of care in the State. This is illustrated by the relative cost of certain common procedures in New Jersey compared to the cost of those procedures in other geographic areas, a problem whose causes transcend the scope of this Commission's charge.

Procedure Cost by Geography[64]



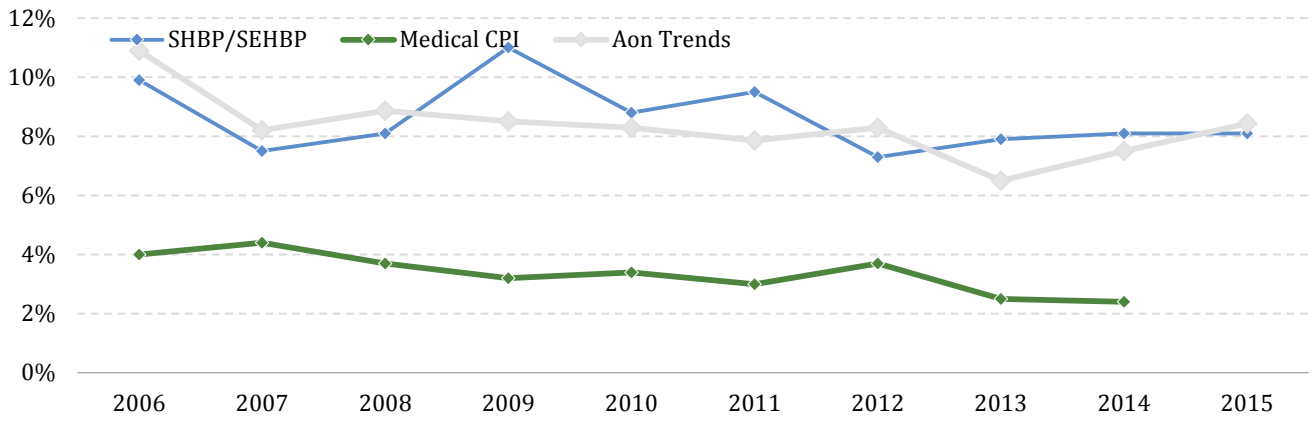
Some common medical procedures cost the State **more than twice** the cost of the same procedure elsewhere.

3. Increases in Cost of Medical Care

As the following chart indicates, it is not a question of if medical costs will increase, but how quickly this will happen. The lowest indicator of medical cost inflation, the national Medical CPI index, shows annual medical costs increasing at a rate varying between 2% and 4%. Medical costs tend to increase faster than the Medical CPI on account of new procedures and medications with higher costs, the aging of the insured population (especially as the baby boomers retire), and increased use of services as rising medical costs decrease the efficacy of fixed deductibles and co-pays as cost-control devices. The fact that costs will be increasing due to factors beyond the State's control only underscores the importance of taking action on drivers of costs the State *can* control.

The fact that costs will also be increasing due to factors beyond the State's control underscores the importance of taking action on drivers of costs the State *can* control.

Medical Cost Inflation Over 10 Years[65,66]



4. Impact of the ACA Excise Tax

Also as noted above, starting in 2018, a 40% ACA excise tax will be imposed on the aggregate value of plans in excess of an indexed threshold. The thresholds are currently set at $10,200 for individual coverage and $27,500 for family coverage in 2018, with slightly higher thresholds for early retirees and high-risk occupations like police and fire. Due to the nature of the plans offered by the State Health Programs, and because New Jersey is a relatively high-cost state (the ACA excise tax is not adjusted for geographic differences within the United States), some plans offered by the State Health Programs will be subject to the excise tax as soon as it goes into effect, and virtually all current plans will be subject to the excise tax by 2022. It is projected that the ACA will increase the State Health Programs' costs by an additional $58 million in PY 2018, rising to $284 million by 2022.[67]

Potential Reforms

While recommending specific reforms is outside the scope of this Report, as a general matter, the plan structure and enrollment patterns of the State Health Programs need to evolve to reflect the realities of the 21st century. Among the approaches others have used to bring the costs of their public employee health plans more in line with those of the private sector are:[68]

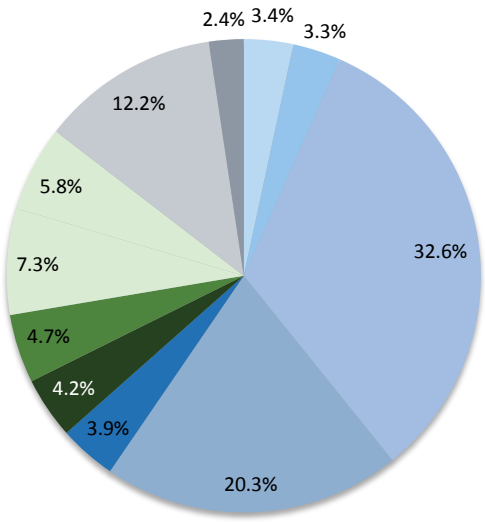
Reference Based Pricing	High Deductible Plans	Tobacco Surcharge	Spousal Surcharge	Dependent Eligibility Audit	Value Based Insurance Design	Onsite Clinics
States that have implemented:						
CA	GA	AL	AL	CA	CA	GA
SD	IN	GA	GA	CT	SD	IN
	KS	IN	WA	IL		KS
	KY	KS		IN		KY
	NE	KY		KS		NE
	NJ	MO		MN		NJ
	NV	NC		NE		NV
	SD	OK		NJ		SD
	VA	SC		NY		VA
	WI	SD		SC		WS
		WV		VA		

V. PENSION AND BENEFIT COSTS IN THE CONTEXT OF THE OVERALL BUDGET

As background for future discussion of how to reconcile potential employee benefit funding remedies with existing budget constraints, the major categories of expenditures and revenues are displayed below.

FY 2015 Appropriations Act Details (% of Total Spending)[69]

	$ (billion)	% of total
Children and Families	1.1	3.4%
Corrections	1.1	3.3%
Education	10.6	32.6%
Human Services	6.6	20.3%
Higher Education	1.3	3.9%
Transportation	1.4	4.2%
Treasury	1.5	4.7%
Other*	2.4	7.3%
Interdepartmental and General Obligation Debt Service	1.9	5.8%
Total Pensions and Health Benefits (State, local educatio	4.0	12.2%
Legislature/Judiciary	0.8	2.4%
Total	$ 32.5	100.0%

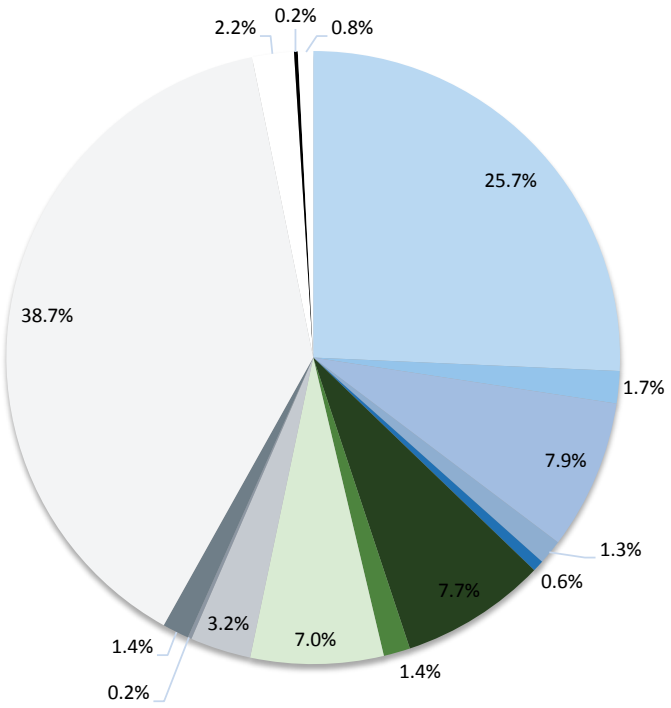


Notes: *Combines all other Executive Branch agencies (e.g., Agriculture, Banking and Insurance, etc.,).

This list of line items, taken from the FY 2015 budget, suggests the hard choices which would have to be made regarding possible services to cut in order to allocate more of existing revenues to public employee health benefits. At the risk of being simplistic, without additional revenues, funding an expense like the $1.56 billion unfunded liability payment originally scheduled for FY 2015 would, within the FY 2015 budget, require something as drastic as cutting the Corrections, Higher Education and Transportation budgets in half. Funding the full statutory ARC would be even more difficult.

FY 2015 State Revenue Sources (% of Total Revenues)

	$ (billion)	% of total
Net Sales and Use Tax	8.4	25.7%
Motor Fuels Tax	0.6	1.7%
Corporation Taxes	2.6	7.9%
Motor Vehicle Fees	0.4	1.3%
Cigarette Tax	0.2	0.6%
Other Major Taxes	2.5	7.7%
Medicaid Uncompensated Care	0.5	1.4%
Fees and Revenues	2.3	7.0%
Lottery Funds	1.0	3.2%
Tobacco Litigation Settlement	0.1	0.2%
Other Transfers	0.5	1.4%
Gross Income Tax	12.6	38.7%
Property Tax Dedication	0.7	2.2%
Casino Control Fund	0.1	0.2%
Casino Revenue Fund	0.3	0.8%
Total	**32.5**	**100.0%**



Even if the voters can be persuaded to provide some additional revenue, there is a limit to the extent the problem can be solved by simply directing more money to it. Currently, employee benefits are approximately 10% of the budget. This percentage would have to be raised to 20% to fund the current annual gap. Raising the equivalent of an additional 10% of existing revenues by increasing the amount of revenue raised through one or more of these sources would be painful and difficult, particularly if taxpayers react in ways that decrease the activities to be taxed.

Moreover, even finding an additional 10% of revenue would not solve the problem for long. Pension and health costs are growing faster than the projected 4% growth of State revenues. The budget projections in Appendix 3 estimate that by 2024, the share of employees' benefits would increase further to almost 25% of the State budget. This would require even more additional revenue to close the widened gap.

VI. RISKS

The success of any solution to the benefit funding crisis will be affected by a number of risks:

- **Non-payment.** Two decades of history underscore the possibility that the State, through legislative and/or executive action, may not fund its employee benefit obligations. Experience has shown that unfunded obligations, if not corrected, have the potential to grow so large they *cannot* be made up. In addition to the financial risk, the lack of trust resulting from successive government failures to make payments will make any long-term solution more difficult to achieve.

- **Investment under-performance.** The current expected rate of return on State pension funds (which serves as the discount rate for reducing future liabilities to present value) is 7.9%. In its recent construction bond disclosures, the State noted that the independent actuary for all the State pension funds other than TPAF found that 7.9% was at the high end of an acceptable expected rate of return. The independent actuary for TPAF considered 7.9% to be outside a reasonable range, and recommended use of a reduced expected rate of return. Elsewhere, the disclosure notes that the new GASB Standards may require the use of a discount rate lower than the 7.9% rate currently used.[70] Whatever expected rate of return is used, there continues to be the risk future returns may fall short of that rate, resulting in growing unfunded liabilities and plan contribution requirements. The higher the expected rate of return, the greater exposure to this risk.

- **Health care cost inflation.** Health care costs are projected to increase at an annual rate of 7.5%, and aggregate cost increases will be even higher due to the ACA excise tax. These costs are growing at a rate faster than the expected rate of growth of State revenues. If actual costs increase in accordance with these trends, maintaining the same level of benefits will consume an ever-increasing share of State revenues.

- **Interest rates.** One of the costs competing with employee benefits for scarce State resources is debt service. At present, interest rates are extraordinarily low. Any increase in those rates – and it is likely a question of *when* rather than *if* the increase will occur - will increase debt service demands that will place considerably more tension on an already tight budget.

- **Legal.** The current $37 billion unfunded pension liability reflects a reduction of $11.5 billion due to the Chapter 78 reforms – mostly due to the temporary suspension of COLAs to current and future retirees. If that suspension is overturned as a result of ongoing litigation, it will make a deep hole even deeper, and have a significant long-term impact on funding requirements of the plans. There is also currently pending a lawsuit that challenges the State's decision not to remit the entirety of the statutory ARC for FY 2014 and FY 2015.

VII. A CALL TO ACTION

This Report has examined the nature, scope and causes of New Jersey's public employee pension and health benefits problem. This issue is particularly important to State employees and retirees and their families, but also significantly affects all New Jersey citizens as taxpayers and as beneficiaries of State services. There is no choice: New Jersey must make its public employee pension and health benefits program affordable and sustainable.

The Commission's final Report will recommend possible solutions to this problem for consideration by the Governor and the Legislature. In the coming weeks we will be considering proposed solutions, and we will continue to review actions taken by other states and municipalities to solve similar problems. We will study reports of policy experts and consider all suggestions and comments from citizens and groups interested in this problem. We welcome all ideas, which can be submitted to us through the Commission's website: http://www.state.nj.us/treasury/pensionandbenefitcommission.shtml

This problem is dire and will only become much worse if meaningful steps are not taken quickly.

APPENDIX 1 — BIOGRAPHIES OF COMMISSION MEMBERS, STAFF AND COUNSEL

Commission Members

Thomas J. Healey, CFA, Partner, Healey Development LLC
Tom Healey is coordinating the work of the Study Commission. He is a Senior Fellow at Harvard University's John F. Kennedy School of Government, where he taught a course in Financial Institutions and Markets. In 2010 he received the Mossavar-Rahmani Center for Business and Government's Distinguished Service Award. He is a retired partner of Goldman, Sachs & Co. While at Goldman Sachs, he created the Pension Services group, the first of its kind in financial services, servicing the top 100 leading Pension and Endowment Clients globally. Tom also chaired Goldman Sachs' own Pension Plan and served as CIO of the Central States Teamsters Pension Plan. Prior to joining Goldman Sachs, he served as Assistant Secretary of the U.S. Treasury for Domestic Finance under President Ronald Reagan. Tom is a chartered financial analyst and graduated from Georgetown University and Harvard Business School.

Margaret S. Berger, FSA, EA, FCA, Principal, Mercer
Margaret Berger is a consulting actuary and Principal in Mercer's Retirement Practice. She manages actuarial project teams and provides actuarial consulting on defined benefit plans, nonqualified plans and retiree medical and life insurance plans. Based in Princeton, Margaret is also a member of Mercer's Actuarial Resource Network, which helps consultants solve complex technical actuarial problems and recommends and implements pension valuation standards throughout the firm. Margaret has 24 years of experience consulting in the area of retirement benefits. She has helped clients on a wide range of assignments, such as performing annual actuarial valuations of pension and postretirement welfare plans including the review and development of actuarial assumptions and methods, preparing financial statement footnote disclosure information, designing/redesigning retirement benefits. Margaret is a member of the American Academy of Actuaries Pension Committee and the Actuarial Standards Board Pension Committee. Margaret received a BA in Mathematics from Yale University. She is an Enrolled Actuary, a Fellow of the Society of Actuaries and a Fellow of the Conference of Consulting Actuaries.

Tom Byrne, Managing Member, Byrne Asset Management LLC
Tom Byrne is managing member of Byrne Asset Management LLC in Princeton, an investment advisory firm that manages $150 million for a variety of clients. In the 1990s and before, he worked at two major New York law firms and later in the securities industry in Manhattan. He has served in a number of volunteer and non-profit capacities as well. He is currently vice chairman of the New Jersey State Investment Council. He is also a trustee and treasurer of The Fund for New Jersey. Tom served as chairman of the New Jersey Democratic State Committee in 1994-97. He also served on the staff of The Presidential Task Force on Market Mechanisms, which reported to President Reagan on the causes of the 1987 stock market crash. He is a 1976 graduate of Princeton University's Woodrow Wilson School and has served on its graduate advisory board. He has a law degree from Fordham University.

Raymond G. Chambers
Ray Chambers is a philanthropist and humanitarian who has directed most of his efforts towards helping children. He is the United Nations Special Envoy for Financing the Health Millennium Development Goals. Ray was the Chairman of Wesray Capital and began his career as a CPA with Price Waterhouse Coopers. He is the founding Chairman of the Points of Light Foundation and co-founder, with Colin Powell, of America's Promise — Alliance for Youth. He also co-founded the National Mentoring Partnership and the Millennium Promise Alliance. Chambers is the Co-founder of Malaria No More. He is the Founding Chairman of the New Jersey Performing Arts Center.

Leonard W. Davis, CFO, Revelation Holdings, Inc.
Len has organized and managed private equity, technology, and natural resource companies. He has been the principal financial manager in a private equity company and has been the Chief Financial Officer to the lead investor of a natural resource company active in metals and energy. His experience spans a wide range of businesses including private equity, investment banking, leveraged buyout, and M&A. His management experience includes due diligence on acquisition investments, acquisition and exit strategy, and investment analysis. Before entering private equity, Len was a CPA in public practice at Price Waterhouse, LLP ("PW") in New York (now PriceWaterhouseCoopers) in their

Personal Financial Services Group. He provided tax planning and general business advice to wealthy individuals and their companies while at PW. Prior to joining PW, he was employed in the Private Banking Group of J.P. Morgan Services, Inc. He received his B.S. in Accounting from Spring Garden College.

Carl A. Hess, FSA, CERA, Managing Director, Towers Watson

Carl Hess has served as Managing Director, The Americas of Towers Watson since February 1, 2014, and is a member of the firm's Executive Committee. Prior to that, he served as the Managing Director of Towers Watson's investment business since January 1, 2010. Before that, he worked in a variety of roles over 20 years at Watson Wyatt, lastly as Global Practice Director of Watson Wyatt's investment business. Carl is a fellow of the Society of Actuaries and the Conference of Consulting Actuaries, and a Chartered Enterprise Risk Analyst. He has a B.A. cum laude in Logic and Language from Yale University, and is a director of HLC Holdings and its subsidiaries and affiliates.

Ethan Kra, Ph.D., FSA, EA, CERA, Ethan E. Kra Actuarial Services

Dr. Ethan Kra is an independent and highly respected consulting actuary. Previously, he was a Senior Partner and Chief Actuary-Retirement of Mercer. He specializes in analyzing the economic and accounting implications of financing strategies and vehicles for employee and executive benefits. For over 17 years, he chaired Mercer's Actuarial Resource Network, a committee of the senior technical actuaries throughout the United States. Ethan is a Fellow of the Society of Actuaries, a Member of the American Academy of Actuaries, a Fellow of the Conference of Consulting Actuaries, a Member of ASPPA, an Enrolled Actuary and a Chartered Enterprise Risk Analyst. He has served on the American Academy of Actuaries Board of Directors, as its Vice President, Pensions and Chair of its Pension Practice Council. He is a Summa Cum Laude graduate of Yale University, where he earned his B.A. in Mathematics and was elected to Phi Beta Kappa. He holds M.A. and Ph.D. degrees in Mathematics from Yale University, where he was both a Woodrow Wilson Fellow and a National Science Fellow.

Kenneth F. Kunzman, Partner, Connell Foley

Kenneth F. Kunzman was Chairman of the Connell Foley Executive Committee from 1995 to 2002. He has been a partner in the firm since 1968 and has been responsible for a variety of areas of law. Ken is a graduate of The College of the Holy Cross and Fordham University Law School. He is Chairman of the Board of the Bonner Foundation, former Chairman of the District Ethics Committee, Trustee Emeritus of Caldwell College, former Trustee of St. Peter's Prep, and Co-Chairman Emeritus of the Seton Hall University Pirate Blue Fund. He served as Captain, US Air Force from 1962-1965. Ken has been Co-Counsel since 1978 of the Pension and Welfare Funds for Locals 472 and 172 Heavy and General Laborers Fund of New Jersey. He has been elected to the Super Lawyers and Best Lawyers of America since inception.

Lawrence J. Sher, Partner, October Three

Lawrence J. Sher is a partner, consulting actuary, and member of the Senior Leadership Team at October Three, which is a full service, actuarial, consulting and technology firm that is a leading force behind the reemergence of defined benefit plans across the country. With over 35 years of consulting experience, Larry served as chief actuary at other leading consulting firms, has frequently advised government officials on retirement issues and has been a speaker at numerous professional and industry conferences. As a nationally recognized expert on cash balance and other hybrid pension plans, he is a highly sought-after consultant and advisor to retirement plan sponsors. In addition, he provides critical support as a consulting and testifying expert in disputes related to cash balance plans and other retirement programs. Larry is a Fellow of the Society of Actuaries (FSA), a Fellow of the Conference of Consulting Actuaries (FCA), a member of the American Academy of Actuaries (MAAA), and an Enrolled Actuary (EA) under ERISA. He has been a Board Member and Vice-Chair of the Actuarial Standard Board, a Board Member of the American Academy of Actuaries and the Conference of Consulting Actuaries, and he was recently President of the Conference of Consulting Actuaries.

Raj Tatta, Retired Senior Partner, PricewaterhouseCoopers LLP

During his 30-year career at PricewaterhouseCoopers LLP, Raj Tatta served some of the firm's largest global clients and managed different businesses, including serving as the partner-in-charge of Europe for the U.S. Tax practice. Raj took early retirement from PwC to volunteer for organizations focused on the mentoring and development of inner city youth, like the Big Brothers Big Sisters and the All Stars Project. Raj has also been involved in global health issues: he was part of the senior leadership team charged with restructuring the Geneva-based Global Fund to Fight AIDS,

Tuberculosis and Malaria; and more recently, assisted the UN Secretary General's Special Envoy for Financing the Health Millennium Development Goals. Raj serves on a few corporate and volunteer boards, including as President of the Park Avenue Club in Florham Park, which benefits 10 local charities. Raj holds CPA and MBA qualifications.

Executive Director

Matthew W. King
Matthew W. King is a private investor. Previously, he was a Director at Kohlberg, Kravis, Roberts and Co. as well as KKR Capstone, where he focused on building new lines of business for KKR, due diligence on new investments and improving the operating performance of KKR's portfolio companies. He previously served on the Board of Directors for Sealy Corporation and Corporate Capital Trust. He received a B.S. summa cum laude from North Carolina State University in Mechanical Engineering and Economics.

Commission Counsel

George H. Kendall, Partner, Drinker Biddle & Reath LLP
George H. Kendall is a partner in Drinker Biddle & Reath LLP's Florham Park, New Jersey office. George serves as the Vice Chair of Drinker Biddle's Health Care Practice Group. He represents hospitals, hospital systems, home health agencies, physician groups, pharmaceutical, medical device and medical equipment companies in a broad range of transactional and regulatory matters. George received his A.B. from Franklin & Marshall College and his J.D. from the Villanova University School of Law. He has been recognized by Chambers USA as one of the top health care lawyers in New Jersey.

Kenneth J. Wilbur, Partner, Drinker Biddle & Reath LLP
Kenneth J. Wilbur is a partner at Drinker Biddle & Reath LLP's Florham Park, New Jersey office. He represents a variety of life science and real estate clients in commercial, products liability and appellate litigation. He received a B.A. summa cum laude from Lehigh University and a J.D. cum laude from the University of Pennsylvania School of Law, and clerked for the Hon. Alan B. Handler, Associate Justice, Supreme Court of New Jersey.

Thomas F. Campion, Partner, Drinker Biddle & Reath LLP
Thomas F. Campion is a partner at Drinker Biddle & Reath LLP's Florham Park, New Jersey office. He specializes full-time in litigation at the trial and appellate level for life science companies and other businesses and professions. He received his A.B. egregia cum laude from Fordham University and his LL.B. from Cornell Law School.

APPENDIX 2 — GLOSSARY

Actuarial Accrued Liability (AAL)

The present value of future benefits attributable to service rendered to date. That would include the present value of all future pensions payable to current retirees, beneficiaries and vested terminations, plus the present value of a portion of the projected benefits for active employees.

Actuarial Value of Assets (AVA)

The actuarial value of a plan's assets. This amount spreads recognition of investment gains and losses in accordance with an adopted asset valuation method.

Annual Normal Contribution

The portion of the ARC reflecting the cost of the benefits accrued during the current year by plan participants.

Annual (or Actuarial) Required Contribution (ARC)

The ARC equals the amount that would need to be paid during the current fiscal year to fund benefits earned in that year (the normal cost) plus a specified portion of any unfunded liability from past years.

Annual Unfunded Accrued Liability Contribution

The portion of the ARC reflecting the cost of funding a specified portion of any unfunded liability from past years.

Defined Benefit Plan (DB)

For defined benefit (DB) plans, benefits are generally expressed and paid as life annuities beginning at retirement, based on one or more specified benefit formulas. These formulas generally incorporate years of service, salary and a multiplier factor. Specific benefit formulas vary among plans, and often within plans dependent on an employee's start date and/or employee classification (public, safety, general, management, etc.). Some more recent defined benefit plans express benefits in terms of a current lump sum value (similar to a defined contribution plan) rather than a retirement age annuity, although these plans too must offer life annuities. Defined benefit annuity payments can either be constant for the life of the payment, adjusted annually for cost of living, or adjusted occasionally for cost of living increases as seen fit by the overseeing party. The plan sponsor is responsible for funding this liability no matter what returns it achieves on its investments.

Fiscal Year (FY)

The State budgets on a fiscal, not calendar year basis. FY 2014 began on July 1, 2013, and ended on June 30, 2014.

Defined Contribution Plan (DC)

For defined contribution (DC) plans, the plan sponsor makes contributions into individual employee accounts under the plan and sometimes employees also make contributions to their accounts. A common example of a DC plan is a 401(k) found in the private sector. The actual benefit received by participants is subject to market returns on the plan's assets. The sponsor has no liability to make up for investment losses.

Funded Ratio

The percentage of the Actuarial Accrued Liability that is currently funded through the Actuarial Value of Assets. This is calculated by dividing AVA by the AAL. A ratio of less than 100% indicates that the plan has an unfunded liability. If over 100%, the plan has a surplus.

Market Value Method of Asset Valuation

Under the market value method, plans recognize the full amount of actual gains or losses at the end of each fiscal year.

Plan Year (PY)

The State Health Programs operate on a Plan Year which coincides with the calendar year.

Smoothing Method of Asset Valuation

Smoothing spreads changes in reported asset values due to deviations between expected returns and actual results over a period of years. Assuming a rolling five-year smoothing period, 20% of any variation between expected and actual results for a given year would be incorporated into the AVA in the valuation year.

Unfunded Actuarial Accrued Liability

The AAL minus the AVA – unfunded if positive and surplus if negative.

APPENDIX 3 — PENSION AND HEALTH BENEFIT SPENDING PROJECTION RELATIVE TO STATE REVENUES ($ THOUSANDS)

	Approp. Act FY2015	Estimate FY2016	Estimate FY2017	Estimate FY2018	Estimate FY2019	Estimate FY2020	Estimate FY2021	Estimate FY2022	Estimate FY2023	Estimate FY2024	CAGR
DB Pensions (a)	$680,634	$4,326,657	$4,332,598	$4,339,231	$4,346,817	$4,352,833	$4,407,312	$4,490,389	$4,575,372	$4,666,857	23.9%
Defined-Contribution Pensions	$170,295	$174,702	$179,589	$184,639	$189,890	$195,322	$200,976	$206,832	$212,933	$219,263	2.8%
Active Health Benefits (b)	$1,415,975	$1,522,673	$1,629,850	$1,754,987	$1,892,353	$2,029,359	$2,161,574	$2,303,163	$2,454,814	$2,616,381	7.1%
Retired Health Benefits (b)	$1,700,864	$2,004,037	$2,223,103	$2,475,727	$2,760,314	$3,089,942	$3,465,549	$3,889,404	$4,367,766	$4,905,807	12.5%
Gross Pensions and Health Benefits Costs	**$3,967,768**	**$8,028,069**	**$8,365,139**	**$8,754,584**	**$9,189,374**	**$9,667,456**	**$10,235,411**	**$10,889,788**	**$11,610,886**	**$12,408,309**	**13.5%**
Federal and College Recoveries	($453,916)	($699,199)	($734,572)	($775,356)	($820,995)	($869,294)	($922,571)	($986,414)	($1,056,386)	($1,134,980)	10.7%
School District Recoveries	($24,636)	($71,799)	($74,147)	($76,775)	($79,688)	($83,009)	($87,429)	($92,316)	($97,664)	($103,523)	17.3%
Total Fringe Recoveries	**($478,552)**	**(770,998)**	**($808,719)**	**($852,131)**	**($900,683)**	**($952,302)**	**($1,009,999)**	**($1,078,730)**	**($1,154,050)**	**($1,238,502)**	**11.1%**
Net Pensions and Health Benefits Costs	**$3,489,216**	**$7,257,071**	**$7,556,420**	**$7,902,453**	**$8,288,692**	**$8,715,154**	**$9,225,411**	**$9,811,058**	**$10,456,835**	**$11,169,806**	**13.8%**
Net Health Benefit Cost	*$2,638,287*	*$2,755,712*	*$3,044,234*	*$3,378,583*	*$3,751,985*	*$4,166,999*	*$4,617,123*	*$5,113,837*	*$5,668,530*	*$6,283,686*	*10.1%*
FY2015 State Revenues Net of Fringe Recoveries	$32,147,727										
State Revenue Assuming a 2% Increase Annually (c)	$0	$32,507,807	$33,135,662	$33,771,137	$34,415,051	$35,069,746	$35,732,490	$36,398,609	$37,072,836	$37,752,921	
State Revenue Assuming a 4% Increase Annually (c)	$0	$33,160,333	$34,479,865	$35,847,996	$37,267,449	$38,742,555	$40,272,652	$41,855,228	$43,497,265	$45,198,866	
State Revenue Assuming a 6% Increase Annually (c)	$0	$33,812,858	$35,850,168	$38,006,289	$40,289,243	$42,709,019	$45,271,001	$47,979,131	$50,847,282	$53,882,909	
Defined Pensions and Health Benefits as a % of State Revenue (2% Incr.)	**10.9%**	**22.3%**	**22.8%**	**23.4%**	**24.1%**	**24.9%**	**25.8%**	**27.0%**	**28.2%**	**29.6%**	
Defined Pensions and Health Benefits as a % of State Revenue (4% Incr.)	**10.9%**	**21.9%**	**21.9%**	**22.0%**	**22.2%**	**22.5%**	**22.9%**	**23.4%**	**24.0%**	**24.7%**	
Defined Pensions and Health Benefits as a % of State Revenue (6% Incr.)	**10.9%**	**21.5%**	**21.1%**	**20.8%**	**20.6%**	**20.4%**	**20.4%**	**20.4%**	**20.6%**	**20.7%**	
Increase in DB Pensions and Health Benefits Costs		$4,060,301	$337,071	$389,445	$434,790	$478,082	$567,955	$654,378	$721,098	$797,423	
% Increase in DB Pensions and Health Benefits Costs		102.3%	4.2%	4.7%	5.0%	5.2%	5.9%	6.4%	6.6%	6.9%	

Notes:

(a) FY 2015 funds the normal employer contribution for the State defined benefit pension plans. FY 2016 and beyond reflects the full actuarially recommended contribution (ARC) based the June 30, 2013 valuation, and a 7.9% investment return assumption.

(b) Funds pay-as-you-go active and retiree medical, prescription drug, and dental benefits. FY 2016 retiree health benefit expenses includes restorations of $96.4 million from FY 2015 budget reductions. Projected costs for FY 2019 and beyond do not include the cost of the Excise Tax, required by the Affordable Care Act, for plan coverage that exceeds certain premium thresholds.

(c) State revenues were adjusted to deduct fringe benefit recoveries.

APPENDIX 4 — SUMMARY OF PENSION FUNDING PROJECTION CASES BASED ON VARYING LEVELS OF INVESTMENT RETURN ON ACTUARIAL ASSETS ($ MILLIONS)

Summary of Pension Funding Projection Cases Based on Varying Levels of Investment Return on Actuarial Assets

	Statutory ARC Contribution				Phased in Contribution			Normal Contribution Only			No Contribution		
Valuation Date	**7/1/2013**	**7/1/2018**	**7/1/2023**	**7/1/2028**	**7/1/2018**	**7/1/2023**	**7/1/2028**	**7/1/2018**	**7/1/2023**	**7/1/2028**	**7/1/2018**	**7/1/2023**	**7/1/2028**
Fiscal Year	**FY 2015**	**FY 2020**	**FY 2025**	**FY 2030**	**FY 2020**	**FY 2025**	**FY 2030**	**FY 2020**	**FY 2025**	**FY 2030**	**FY 2020**	**FY 2025**	**FY 2030**
	Base Year				*FY16 is 4/7ths ramping to full in FY19.*								
TOTAL STATE @ 4.9%													
Assets at Market Value	$ 38,612	$ 43,853	$ 47,120	$ 51,672	$ 40,663	$ 44,604	$ 49,803	$ 28,844	$ 6,634	$ (25,832)	$ 26,310	$ 174	$ (37,585)
Valuation Assets	$ 43,619	$ 48,319	$ 53,517	$ 59,381	$ 44,901	$ 50,652	$ 57,164	$ 32,631	$ 10,002	$ (25,132)	$ 29,984	$ 3,061	$ (37,966)
Accrued Liability	$ 80,040	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485
Unfunded	$ 36,421	$ 42,714	$ 48,894	$ 55,104	$ 46,133	$ 51,759	$ 57,321	$ 58,402	$ 92,409	$ 139,617	$ 61,049	$ 99,351	$ 152,451
AVA Funded Ratio	54.5%	53.1%	52.3%	51.9%	49.3%	49.5%	49.9%	35.8%	9.8%	-22.0%	32.9%	3.0%	-33.2%
Employer Contribution	$ 681	$ 4,524	$ 5,389	$ 6,414	$ 4,840	$ 5,669	$ 6,653	$ 626	$ 717	$ 719	$ -	$ -	$ -
Annual Benefit Payments	$ 5,783	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956
TOTAL STATE @ 7.9%													
Assets at Market Value	$ 38,612	$ 48,653	$ 59,132	$ 71,526	$ 45,301	$ 55,898	$ 68,463	$ 33,393	$ 16,434	$ (12,972)	$ 30,788	$ 9,279	$ (27,098)
Valuation Assets	$ 43,619	$ 50,231	$ 60,530	$ 72,899	$ 46,777	$ 57,292	$ 69,877	$ 34,609	$ 17,101	$ (12,558)	$ 31,943	$ 9,830	$ (26,838)
Accrued Liability	$ 80,040	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485
Unfunded	$ 36,421	$ 40,802	$ 41,881	$ 41,586	$ 44,257	$ 45,119	$ 44,608	$ 56,425	$ 85,310	$ 127,043	$ 59,091	$ 92,582	$ 141,323
AVA Funded Ratio	54.5%	55.2%	59.1%	63.7%	51.4%	55.9%	61.0%	38.0%	16.7%	-11.0%	35.1%	9.6%	-23.4%
Employer Contribution	$ 681	$ 4,353	$ 4,730	$ 5,037	$ 4,672	$ 5,045	$ 5,357	$ 626	$ 717	$ 719	$ -	$ -	$ -
Annual Benefit Payments	$ 5,783	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956
TOTAL STATE @ 10.9%													
Assets at Market Value	$ 38,612	$ 53,923	$ 75,001	$ 104,218	$ 50,379	$ 70,759	$ 98,928	$ 38,384	$ 29,409	$ 9,414	$ 35,706	$ 21,469	$ (7,673)
Valuation Assets	$ 43,619	$ 52,299	$ 69,606	$ 94,818	$ 48,783	$ 65,788	$ 90,220	$ 36,722	$ 25,805	$ 6,165	$ 34,037	$ 18,169	$ (9,853)
Accrued Liability	$ 80,040	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485	$ 91,033	$ 102,411	$ 114,485
Unfunded	$ 36,421	$ 38,735	$ 32,806	$ 19,667	$ 42,250	$ 36,623	$ 24,265	$ 54,311	$ 76,606	$ 108,320	$ 56,997	$ 84,243	$ 124,338
AVA Funded Ratio	54.5%	57.4%	68.0%	82.8%	53.6%	64.2%	78.8%	40.3%	25.2%	5.4%	37.4%	17.7%	-8.6%
Employer Contribution	$ 681	$ 4,215	$ 4,159	$ 3,784	$ 4,521	$ 4,481	$ 4,128	$ 626	$ 717	$ 719	$ -	$ -	$ -
Annual Benefit Payments	$ 5,783	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956	$ 6,914	$ 7,912	$ 8,956

END NOTES

[1] See Appendix 2 Glossary for definition of fiscal year.

[2] As further defined in the Appendix 2 Glossary, ARC refers to the "actuarial" (the term generally used in pension literature) or "annual" (the term used in New Jersey statutes defining this obligation) required contribution. ARC is the amount that would need to be paid during the current fiscal year to fund benefits earned in that year, plus a portion of any unfunded liability from past years. The "statutory ARC" is the payment amount as defined by formula set forth in New Jersey statutes).

[3] Treasury Data. New Jersey pre-funds pensions to, in a broad sense, fund the liabilities at the time the underlying benefits are earned. Virtually all states use a similar approach. This creates "generational fairness" – future generations do not have to pay for liabilities they did not create. New Jersey, like most other states and private corporations, does not pre-fund retiree health care liabilities, although this future expense is reported as a liability. This has the effect of transferring the expense of funding one generation's retiree health benefits to the following generation. Theoretically these policies are inconsistent, but it is how the practice has evolved.

[4] Available at: http://www.nj.com/politics/index.ssf/2014/09/citing_christies_pension_payment_cuts_and_budget_problems_sp_downgrades_nj_debt_rating.html

[5] Treasury Data compiling actuarial plan asset and liability data from Milliman, Inc. (actuaries to TPAF) and Buck Consultants (actuaries to all other State pension funds).

[6] Id. A plan's "funded ratio" is the percentage of the present value of the funds' liabilities (pension payments to current and future retirees and associated expenses) covered by the present value of the assets of the fund (comprising of employer and employee contributions and interest on the funds' assets). A plan with a funded ratio of 100% has enough funds on hand to pay 100% of its anticipated liabilities for benefits attributable to benefits rendered to date - assuming its investments earn the expected rate of return. To the extent a plan does not have enough funds to cover its anticipated liabilities, it has an "unfunded liability." *See* Appendix 2 Glossary.

[7] State of New Jersey September 2014 Construction Bond Disclosure, pp. I-66-67.

[8] Division of Pensions and Benefits internal document. The actuarial values reported by the State in accord with Government Accounting Standards Board ("GASB") standards, are "smoothed" to average values over a number of years. This reduces the impact of year-by-year value fluctuations on pension funding.

[9] State of New Jersey September 2014 Construction Bond Disclosure, pp. I-54, 67.

[10] Data available at: http://quickfacts.census.gov/qfd/states/34000.html

[11] Treasury Data compiling actuarial plan asset and liability data from Milliman, Inc. (actuaries to TPAF) and Buck Consultants (actuaries to all other State pension funds).

[12] Division of Pensions and Benefits internal document.

[13] Treasury Data.

[14] The two programs are the State Health Benefits Program ("SHBP"), and the School Employees Health Benefits Program ("SEHBP").

[15] Aon Data. The NJDirect10 plan is only available to current education retirees and some State retirees.

[16] Figures for the NJ and National Average for State Employee Health Plans are from The Pew Charitable Trusts and the MacArthur Foundation, State Employee Health Plan Spending Report (August 2014) ("Pew Report"), available at: http://www.pewtrusts.org/~/media/Assets/2014/08/StateEmployeeHealthCareReportSeptemberUpdate.pdf Figures for National Average (Public and Private) are from The Kaiser Family Foundation and Health Research & Education Trust, Employer Health Benefits 2013 Summary of Findings, ("Kaiser Report") available at: http://kff.org/private-insurance/report/2013-employer-health-benefits/ Due to differences in assumptions and methodologies, there may be inconsistencies in figures between these sources.

[17] Aon Data.

[18] Treasury Data.

[19] 2007 State of the State Address, available at: https://dspace.njstatelib.org/xmlui/bitstream/handle/10929/15595/Corzine2007.pdf?sequence=1&isAllowed=y

[20] Daily Record, August 2, 2014, available at: http://www.dailyrecord.com/picture-gallery/news/local/new-jersey/jersey-thing/2014/08/01/gov-christie-to-create-nj-pension-and-health-benefit-study-commission/13481711/

[21] Data available at: http://taxfoundation.org/sites/taxfoundation.org/files/docs/Burdens_2014_Final.pdf

[22] Treasury Data.

[23] Treasury Data. The apparent disparity between there being approximately 400,000 active and retiree members of the pension system but only 240,000 active and retiree participants in the health plan is that certain active local employees, such as teachers, have the option to participate in a locally-sponsored health plan.

[24] Treasury Data.

[25] Treasury Data.

[26] The Alternate Benefit Program is a defined contribution system for higher education employees, and the Defined Contribution Retirement Program is a defined contribution system for elected and appointed officials and employees subject to a pensionable salary cap for wages above the cap.

[27] L. 2011, c. 78.

[28] Treasury Data.

[29] See Glossary, Appendix 2.

[30] Treasury Data.

[31] N.J.S.A. 52:14-17.32f; N.J.S.A. 52:14-17.32f2.

[32] PL 2007, c. 62; PL 2011, c. 78; SHBP/SEHBP Summary Program Description, page 10.

[33] Treasury Data. For TPAF, market value does not include $136.1 million in CGIPF assets. For liabilities, TPAF includes NCGI and CGIPF.

[34] Treasury Data compiling actuarial plan asset and liability data from Milliman, Inc. (actuaries to TPAF) and Buck Consultants (actuaries to all other State pension funds). .

[35] L. 2001, c. 133.

[36] Division of Pensions and Benefits internal document.

[37] Employee Benefit Research Institute, 1979-2011 data, available at http://www.ebri.org/publications/benfaq/index.cfm?fa=retfaq14

[38] Boston College Center for Retirement Research, available at: http://crr.bc.edu/wp-content/uploads/2014/04/SLP_37.pdf.

[39] L. 2010 c. 1; L. 2011 c. 78.

[40] Data available at: http://www.ssa.gov/oact/quickcalc/earlyretire.html

[41] Division of Pensions and Benefits internal document.

[42] Treasury Data.

[43] Wilshire Data. Any inconsistency in the return rate figures depicted here and in the previous graph is due to the previous depicting fiscal year data and this graph depicting calendar year data.

[44] Data available at: http://www.state.nj.us/treasury/pensions/annrprts-archive.shtml

[45] Richard G. Schreitmueller, The Federal Employees' Retirement System Act of 1986, Transactions of Society of Actuaries, 1988 Vol. 40 Pt. 1, at 543, 551-53 (1988).

[46] Ronald Snell, State Defined Contribution and Hybrid Pension Plans, National Conference of State Legislatures, at 5, 8 (2010).

[47] Mark Bergen, Nipping at the Sacred Cow: Major Cities Take on Pension Reform, Forbes (2011).

[48] The Pew Charitable Trusts, Kentucky's Successful Public Pension Reform, pp. 46-48 (2013), available at: http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2013/09/27/kentuckys-successful-public-pension-reform

[49] *See* Cherry v. Mayor and City Council of Baltimore City, Nos. 13-1007, 13-1115, 13-1116, 2014 WL 3844078, at *1-*2 (4th Cir. Aug. 6, 2014) (discussing plan changes).

[50] Executive Summary to H-6319 and S-1111, at 1 (2011), available at http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf. .

[51] Treasury Data.

[52] Treasury Data.

[53] Treasury Data.

[54] Treasury Data.

[55] Treasury Data (historical); Aon Data (projections).

[56] Aon Hewitt Plan Year 2008 Rate Renewal Recommendation Report, p. 7; PL 2011, c. 78; Pew Charitable Trusts, State Employee Health Plan Spending, (August 2014).

[57] Treasury Data.

[58] Aon Data.

[59] Aon Data.

[60] See note 17.

[61] Pew Report, pp. 2, 38.

[62] Kaiser Report, p. 2, Aon Hewitt SHBP Plan Year 2015 Rate Renewal Recommendation Report-State Employee Group, pages 39-40; Aon Hewitt SEHBP Plan Year 2015 Rate Renewal Recommendation Report 41-42, pages 39-40.

[63] Aon Hewitt SHBP Plan Year 2015 Rate Renewal Recommendation Report-State Employee Group, pages 39-40; Aon Hewitt SEHBP Plan Year 2015 Rate Renewal Recommendation Report 41-42.

[64] Aon Data.

[65] Aon Data.

[66] SHBP/SEHBP represents changes in year-over-year claim cost per employee for the total group, normalized for plan changes. Aon Trends include historical as well as projected health care cost trends. Medical CPI is based on changes in the All Urban Consumers Medical CPI.

[67] Aon Data.

[68] Aon Data.

[69] Treasury Data.

[70] State of New Jersey September 2014 Construction Bond Disclosure, pp. I-54, 67.