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Looking Through the Credit
Five PERSpectives

October, 2012

AQUILA®
Tax-Free Trust of Oregon

On September 28, 2012, the Oregon Public Employees Retirement System ("PERS") Board approved a 45% net contribution rate increase for the 2013-15 biennium, potentially impacting the repayment ability of PERS employers across the state, including most Oregon municipal bond issuers. Rates were increased to reduce the $16 billion unfunded actuarial liability, which has been primarily attributed to investment losses in 2008. While the level of increase is significant, what many find surprising, and perhaps more relevant, is the variance of contribution rates and pension liability funding status amongst employers participating in PERS. What has not been conveyed in the news reports is that several PERS employers do not face extraordinary contribution rates, and there is a significant difference in the funding level of pensions within Oregon. This rate variance has increased in significance as a factor in the analysis of municipal issuers for the Aquila Tax-Free Trust of Oregon.

Individual employer contribution rates vary based upon a variety of factors, but are primarily influenced by an employer's funded status and side account utilization. Rates also vary by actuarial pool, which includes separate pools for school districts, the State and Local Government Rate Pool ("SLGRP") and independent (non-pooled) employers. To illustrate the impact of the 2013-15 rate increase and the varied rate structure of PERS, five employers were selected, including two small non-rated cities, two school districts and a relatively large highly-rated city. Comparison criteria consisting of a variety of economic and demographic metrics was collected based upon a variety of characteristics, outlined below, to provide an analytical framework for comparison of employers on a relative basis.

	Underlying Bond Rating [1]	Population	Budgeted Resources [4]	Valuation Payroll [5]	Valuation Payroll as a Percent of Budget
City of Condon	Non-Rated	690 [2]	$ 5,507,250	$ 216,844	3.94%
City of Heppner	Non-Rated	1,290 [2]	$ 5,800,471	$ 259,914	4.48%
City of Lake Oswego	Aaa/AAA	36,716 [2]	$ 243,684,322	$ 23,614,999	9.69%
Lincoln School District	Aa3	46,192 [3]	$ 115,653,566	$ 19,480,794	16.84%
Willamina School District	Non-Rated	6,114 [3]	$ 10,783,959	$ 4,411,585	40.91%

	Number of Employees [6]	Net Employer Contribution Rate 7/1/11 to 6/30/13 [7]	Net Employer Contribution Rate 7/1/13 to 6/30/15 [7]	Percent Increase	Net Unfunded Pension Actuarial Accrued Liability [5]
City of Condon	8	27.70%	30.87%	11.44%	$ 527,538
City of Heppner	8	0.59%	3.73%	532.20%	$ (165,793)
City of Lake Oswego	363	16.13%	20.96%	29.94%	$ 27,865,396
Lincoln School District	471	0.59%	0.59%	0.00%	$ (23,650,987)
Willamina School District	93	16.14%	22.84%	41.51%	$ 7,003,983

[1] Moody's/Standard & Poor's.
[2] PSU Population Research Center.
[3] National Center for Education Statistics based upon 2010 Census data.
[4] Employer's 2012-13 Budget.
[5] 12/31/2010 Actuarial Valuation Report dated November 18, 2011 as prepared by Mercer (US) Inc.
[6] Individual Employer.
[7] Tier 1/Tier 2 contribution rates from Summary of PERS Employer Contribution Rates as of September 18, 2012.

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A Tale of Two Cities

We included two small cities, the Cities of Heppner and Condon, in this analysis to demonstrate the significant difference in rates amongst two seemingly similar entities. Both cities have a similar budget size, payroll, number of employees and populations of approximately 1,000 residents. However, their PERS contribution rates are very different. The City of Heppner has a PERS contribution rate for 2012-13 of 0.59% compared to City of Condon's contribution rate of 27.70%. The primary reason for this wide disparity is a significant unfunded pension liability of $527,538 that the City of Condon is carrying, relative to the City of Heppner, which is overfunded by $165,793. PERS balances are driven by a variety of factors including when the employer joined PERS, the level of returns experienced by PERS and the amount of contributions made by the employer. What is most striking in this case is the change in rates between the two employers, with the City of Heppner facing a 532% increase in contribution rates relative to an 11% increase in rate for the City of Condon. Although 532% is a huge rate increase, Heppner's contribution rates remain low relative to their peers at 3.73% of payroll. The similarity of the two entities on the surface compared to the stark difference after reviewing their retirement funds is a telling example of how two seemingly similar entities can harbor surprisingly different pension liabilities.

Nevertheless, while Condon may face a contribution rate that seems overwhelming, its payroll consumes a lower percentage of budget resources than Heppner. PERS rates are applied against an employer's valuation payroll, which is the portion of the employer's payroll that includes those employees participating in PERS, since not all employees are eligible to participate. In the case of Condon, while they may have a high contribution rate at 27.7%, the eligible payroll is approximately 4% of budgeted resources, resulting in an estimated impact of 1.1% of Condon's budgeted resources.

Two Different Schools of Thought

The PERS school district pool has the highest system-wide contribution rate. For this reason, we conducted another comparison of two school districts, Lincoln School District and Willamina School District. Both districts are moderately sized and contribute to the same PERS school district pool. Lincoln School District has a contribution rate of 0.59% of payroll while Willamina contributes at a rate of 16.14%. What is notable is that Lincoln School District's contribution rates did not increase for the 2013-2015 period, while Willamina School District's rates increased by over 40%. The primary difference in this case is the funding level of Lincoln School District's side account; however, a side account does not come without costs. In this case Lincoln School District has approximately $40 million of outstanding pension obligation bonds which have resulted in the District having an overfunded PERS account balance of $23.65 million. When analyzing PERS rates it is essential to also consider any related liabilities and the associated debt service that may be lowering those balances. Another form of pension relief many PERS employers use is a PERS reserve fund. However, reserve funds are typically less stable than side accounts since the PERS accounts are held by PERS while reserve funds could potentially be leveraged or re-appropriated to other purposes, such as operations.

Credit Quality

The City of Lake Oswego is one of very few entities to have received the highest credit rating of AAA from both Moody's and Standard and Poor's, based upon its unenhanced underlying credit. However, the city has a higher PERS contribution rate than both the non-rated City of Heppner and the AA3 rated Lincoln School District. While pensions are not the prime determinant of credit worthiness, it should not be assumed that highly rated entities will have lower pension obligations than lower or non-rated entities. In their most recent reports, neither Moody's nor Standard & Poor's commented on Lake Oswego's unfunded pension liability of $27.9 million. While the excellent credit quality of the city is not in question, it should be noted that national credit rating agencies are not a substitute for local credit research familiar with Oregon issuers and Oregon's specific pension issues.

Conclusion

In recent years, government pension funding has received increased attention from investors and the financial press as the significance of local pension liabilities have increased due to dwindling investment returns and declining revenue sources. For many local governments across the country, unfunded pension liabilities remain a significant issue in addition to debt obligations. While certain conclusions can be drawn from PERS information when it is distributed, further investigation is required to understand the potential impact to a specific issuer. Although the PERS system is underfunded, many Oregon local governments are not overburdened by pension liabilities and in some cases have overfunded PERS accounts. For PERS employers with significant unfunded pension liabilities, credit research and due diligence can put pension liabilities into context to determine the extent to which the employer is impaired, which on an overall basis varies greatly from employer to employer. Nevertheless, high profile pension concerns and the complexities and nuances of PERS heighten the importance of local credit analysis and selective portfolio management.

Timothy Iltz
Vice President, Municipal Bond Analyst
Kirkpatrick Pettis Captial Management