86th Legislative Session – 2011

Committee: Joint Appropriations Thursday, January 20, 2011

P - Present
E - Excused
A - Absent

Roll Call
P Sutton
P Haverly
P Heineman
P Novstrup (Al)
P Peters
P Putnam
P Rampelberg
P Dennert
P Wismer
P Juhnke
P Bolin
P Romkema
P Dryden
P White
P Tidemann
P Carson
P Brown, Vice-Chair
P Wink, Chair

OTHERS PRESENT: See Original Minutes

The meeting was called to order by Representative Dean Wink.

Department of Transportation

Darin Berquist, Secretary of Transportation along with Kellie Beck, Director of Finance and Tracy Shangreaux, Budget Analyst appeared before the Committee to present the department budget request.

Secretary Berquist told the Committee the department is funded with federal funds (65.5%), Other funds (34.4%) and General funds (0.1%). State highway funds are made up of motor fuel tax, motor vehicle excise tax and miscellaneous. Motor fuel tax accounts for 60% of the State highway fund. In FY10 receipts were up 4.8% from FY09 and to date receipts are 3.3% ahead of

FY10. Motor vehicle excise tax accounts for 30% of the fund revenues. In FY10 receipts were up 1.4% from FY09, and to date receipts are 5.9% ahead of FY10. The Miscellaneous category accounts for 10% of the fund. This category includes sign and permit fees, sale of equipment, sale of real property and project reimbursement. Overall state highway fund revenues in FY10 were 25% higher than FY09, to date revenues are 4.8% ahead of FY10. The department receives other revenues including tax on aviation gas and jet fuel and aircraft registration amounting to $1.5-1.8 million per year, and revenue from leases and permits on the state owned rail line and interest on the railroad fund balance.

Secretary Berquist said Federal funds make up two-thirds of the department's funding with most of it coming from Federal Highway funds. South Dakota is a donee state which means we get back $2.00 for every $1.00 of federal fuel tax collected; whether that will continue in the future is yet to be determined. Federal highway funds are vitally important in order to take care of the state highway system. The federal funds can only be used for highway construction. The department's highway construction program is comprised of federal highway funds plus the required state match.

Secretary Berquist said there are two other areas where federal highway funds can be used and they include enhancement funds and state planning and research funds. Enhancement funds can not be used for new highway construction, but rather for the construction of bike paths, scenic easements, etc.

The department does share their allotted federal highway funds with counties and the16 largest cities, and the state pays the required match for local government entities. Representative Wink asked how the distribution to local governments was made. Secretary Berquist said prior to 1992 there was a Secondary Roads Program, within the Federal Highway Program, that designated funds to go to the local governments. That program was subsequently removed; however the Department of Transportation worked with the local governments and reached an agreement to continue to share that percentage of funds.

The department receives federal aviation funds varying from $25-35 million/year. The match requirement for Aviation funds is different. Federal highway funds are matched 80/20, Interstate projects are matched 90/10 and FAA projects require a 5% match. The FAA funds come specific to an airport project. Historically the community pays 3% and the state pays 2%; however, in January of 2010 the Aeronautics Commission switched those percentages around.

The final category of federal funding is Federal Transit funds averaging $10 million/year. These funds are funneled through the department to 23 public transit providers across the state. The funds can be used for operating expenses as well as capital expenses. Matching requirements vary, some are 50/50 and some are 80/20.

The department received $183 million in regular stimulus funding and applied for and received a $10 million TIGER grant to help with the US Highway 18 project and a $16 million grant to upgrade a rail line for a total of $209 million in stimulus funding. South Dakota tied with 5 other states in their ability to get the funds obligated, projects let, and constructed. Senator Haverly asked if the money was spent or obligated. Secretary Berquist said for the most part it is spent; only the $16 million grant to upgrade the rail line remains unspent.

The department is currently budgeted at 1,026.3 FTEs and is not requesting any changes in FTE levels. In FY07 the department was budgeted at 1,075, that number was reduced by 21 in FY08, 14 in FY09, and 14 in FY11 to the current 1,026.3.

The department's overall budget request for FY12 totals $581,123,020, which is a $14,405,502 increase over the FY11 levels. Secretary Berquist said the budget can be broken into two components, construction and general operations.

The Construction budget request is an increase of $32,392,296 involving $7,903,278 in federal funds and $24,489,018 in other funds. Offsetting the increase in the Construction budget is a reduction in the General Operations budget totaling $17,986,794. The involves $4,660,000 in Federal funds, $13,274,554 in Other funds, and $52,240 in General Funds which represents the department's 10% reduction in General Funds. Those General Funds support the aviation services within the department and are the only General Funds in the department.

Other areas of reduction in General Operations include a reduction of $2.9 million in Transit stimulus funding and $1.76 million in enhancement stimulus funding.

Senator Haverly asked for an explanation of aviation funds. Secretary Berquist said the general funds that go into the aviation services fund help cover some of the costs for operating the state aircraft. Primarily it is the personal services associated with that program including salaries, pilot training, and mechanics. Senator Haverly asked what affect this reduction would have on aviation services. Secretary Berquist said it would be minimal because the General Funds amount is so small. The rest of the revenue is generated by use of the planes. Senator Putnam asked why there are General Funds in this category. Secretary Berquist said there is no mandate that requires General Funds in the aviation services program; operation of the aircraft is totally independent of any federal requirements. Department staff will investigate the history of this funding and provide further information to the Committee.

Secretary Berquist said a reduction in contractual services of $1.9 million involves $1 million from data services and $900,000 from other contracts such as consultant and engineering contracts, rest area maintenance contracts, fleet and travel billings, utilities, etc. Another reduction of $600,000 is in the Research Program. These funds were previously used to match federal research funds.

Senator Tidemann asked what percentage of the engineering work is done in-house vs. what is sent out. Secretary Berquist said virtually 90% of the engineering work is done in-house.

Another reduction of $218,000 in anticipated energy costs for heating and electricity is based on energy cap projections. This covers all facilities across the state.

The department proposed to reduce travel by $200,000. Travel has been cut back since 2007, and in FY10 the expenses were 35% less than in FY07.

Secretary Berquist said the biggest reduction is in the area of contract maintenance in the amount of $6.4 million. The department has historically carried extra spending authority in this area because it provided flexibility for unseen expenditures, like flooding or blizzards. The funds were used to meet the emergency needs and road repairs. This reduction brings the fund down to what the spending has been. It does, however, remove the flexibility.

Another area of reduction is in buildings in the amount of $1.25 million. This is an area, much like travel, that the department has significantly cut back on since FY07. Secretary Berquist said this reduction will reduce the amount they spend on maintaining their facilities across the state, which are extensive, and will reduce it to below the current level. A final area of reduction is $2.3 million in the department's equipment budget. As with the building maintenance, this will reduce the expenditures back to the level in FY08. The department uses a sophisticated system to track the equipment needs and the department is aware that it is falling behind. Secretary Berquist said the levels for FY12 in both building maintenance and equipment needs is sustainable for the short term.

Senator Heineman asked who will take over the work involved in the $1.9 million reduction in contractual services. Secretary Berquist some of the work will not be done. The $1 million in data services was funding for computer consultants that the department had not used at the level first anticipated. The department is concerned however about meeting its computer needs.

Senator Putnam asked if the STIP would be updated as a result of the Governor's budget address. Secretary Berquist said no, all reductions are in general operations and will not affect the STIP program. The department is actually proposing an increase in the construction budget of $34.3 million. This increase in the construction budget is not all new construction, but will work on the backlog of jobs that have been awarded and not completed. The reductions discussed today will have a very minimal impact on the scheduling of projects.

Federal Highway Funding

Secretary Berquist said the old FHWA funding program expired in September of 2009. Congress did not have a replacement in place and still does not have one today. Existing revenues in the Federal Highway Trust Fund are not sufficient to support a program at the level it's been at. In order to live within their means, they would have to reduce the amount of federal funding to states by 20%. The federal highway trust fund has been supplemented 3 times in the last 2 years. An $8 billion general fund transfer was made in September 2008, a $7 billion transfer in September 2009 and a $19 billion transfer in March of 2010 just to keep the fund solvent and at current levels.

The Federal Highway Administration has done a number of short term extensions and has provided a piece of what is expected at a pro rata basis. The current extension goes to March 4, 2011. Secretary Berquist said the department has been fortunate that the program has been maintained the level that the department was used to. Indications show that there may be a reduction in federal funding which will have a direct impact on the STIP. There is no timeline for the new program and it is the feeling it will be at least 2013 before there is a new bill. The department's Federal funding now comes in 2-3 month increments. The STIP is based on flat funding.

Senator Peters asked about the increased balance in the State Highway Fund. Secretary Berquist said the stimulus funds had an impact on the balance of the fund because there was no match required for stimulus funds. The stimulus funds were used first, making the fund balance grow. Additionally, it has grown in part because of the spending cuts the department imposed on themselves and the department has been very conservative in managing this fund because of the Federal Highway situation and the need to match all federal funds.

Senator Heineman asked if any of the stimulus funds were spent on STIP projects. Secretary Berquist said virtually all of the stimulus funds went to projects in the STIP, advancing some projects such as resurfacing projects.

Representative Bolin asked what the funding source was for Federal Highway funds. Secretary Berquist said it is not income tax funds; it has always been a user based fund, predominately funded by federal fuel tax. Congress wants to stick to that; however, they recently changed some of the procedural rules to potentially reduce the level of funding to match what is coming in.

Representative Wink asked for an update on federal funds. Secretary Berquist said South Dakota gets $2 for $1, we get double what we pay in. Representative Wink asked if federal aviation funds could be used for the aviation services. Secretary Berquist said FAA funds are limited to airport improvement projects. Aeronautics funds are also limited by statute, and Secretary Berquist will provide additional information on that issue.

Representative Wismer asked why funds are building up in the aviation fund. Secretary Berquist said the Aeronautics Commission has plans for the funds but this has also been managed conservatively. The Federal Aviation program is working on a new program and will increase their matching fund requirements.

South Dakota Retirement System

Mr. Rob Wylie, Executive Director/Administrator for the South Dakota Retirement System (SDRS); and **Mr. Elmer Brinkman**, Chair of the Retirement System Board of Trustees; introduced board members present at the meeting – **Ms. Louise Loban**, **Ms. Laurie Gustafson**, **Mr. Eric Stroeder, Mr. James Hansen**, and **Mr. Matt Clark**.

Mr. Brinkman stated that the South Dakota Retirement System (SDRS) covers most public employees in the state – counties, cities, state, and districts. Over 460 employers participate in the system with over 70,000 members. As of June 30, 2010, SDRS has eliminated a significant portion of the deficit and are nearing the long-term funding goals of the Retirement System Board of Trustees.

Mr. Wylie informed the committee that SDRS is funded from the SDRS Trust Fund Pool and does not use state general funds. The Trust Fund Pool provides the funding for SDRS to carry-out the administrative services to all service employees across the state. Currently, the SDRS system has $7.4 billion in assets and pays out $35 million in benefits to all members across the state. He noted that 90% of the benefits paid remain in South Dakota.

For FY2012, the Governor recommends a budget of $3,340,610 in other funds and 33.0 FTEs. This is a decrease of $395,266 (10.6%) from the FY2011 budget. Mr. Wylie noted that SDRS made cuts to the FY2012 budget by trying to be as efficient as possible without diminishing the services to the members. The budget cuts include:

- Personal Services –a cut of $79,000 (4%) in other fund expenditure authority;
- Travel –a cut of $13,000 (17%) in other fund expenditure authority;
- Contractual Services –a cut of $227,266 (17%) in other fund expenditure authority;
- Supplies and Materials – a cut of $41,000 (13%) in other fund expenditure authority; and
- Capital Assets – a cut of $35,000 (84%) in other fund expenditure authority.

Mr. Wylie commented that the budget cut in capital assets will almost completely eliminate the funding for those items.

Mr. Wylie reminded the committee that of the 39,014 active SDRS members, 9,202 (24%) will be, or are currently eligible for, full retirement benefits within five years. Almost 40% of the active SDRS members will be eligible for retirement in the next ten years.

In response to **Representative H. Paul Dennert's** questions, Mr. Wylie stated that SDRS provides regional meetings and workshops every month across the state to help members address any retirement questions or issues. This is one area that may need to be scaled back due to a 17% reduction in the travel budget. Therefore, SDRS is looking at utilizing new technology that would allow for distance communication. However, the members prefer that a SDRS representative talk to them one-on-one.

Senator Bruce Rampleberg asked about the services that will be impacted by the budget cut to contractual services. In response, Mr. Wylie explained three areas that will be impacted. They are:

- The elimination of the contract with CEM Benchmarking Inc. which is the only company providing comparative benchmarking and administration evaluation in the defined industry for public retirement plans;
- A significant reduction for the Actuarial Services budget will reduce the expenditure authority for the reports and special projects SDRS relies on for legislative issues; reports to the Board of Trustees, Legislature, and Governor; and studies required from Class Action lawsuits against SDRS and the state; and
- A reduction in the written mass communication (benefit publications and newsletters) with the members.

Senator Corey Brown requested that SDRS provide an electronic copy of the latest CEM report. Mr. Wylie stated that SDRS will provide a copy of the executive summary.

In response to **Representative Dean Wink's** question, Mr. Wylie explained the three different classifications of SDRS employees. They are:

- Group A – consists of most SDRS members. Retirement age is 65 for normal retirement but a member can retire up to 10 years earlier if the years of service and age of the member total 85. The average age of retirement is between 61 and 62 years old;
- Class B – consists of the police, fire, criminal investigators, corrections, and others that have positions with more physical design; and
- Class C – consists of the Supreme Court judges, magistrate judges, and circuit court judges.

Retire/Rehire – In 2004, SDRS made a concerted effort to control the retire/rehire practice because some members recognized that retiring and rehiring would be a method to enhance their total compensation. However, this activity was at a cost of about $5 million annually to the SDRS system. Changes in the 2010 Legislative Session placed requirements for members that want to retire and rehire. The requirements include:

- Three continuous calendar months minimum termination period;
- 15% benefit reduction during reemployment;
- Continued COLA elimination during reemployment;
- No second SDRS benefit;
- Member contribution to SRP;
- Employer contribution to SDRS; and
- Class B Public Safety Member Rehired as Class A,
  - No COLA elimination and no 15% benefit reduction during reemployment, and
  - All other provisions apply.

Mr. Wylie noted that although the benefit changes have only been in effect for 10 months, SDRS has noticed an 80% decrease in the number of members retiring and rehiring.

Representative Susan Wismer asked about cutting contributions from state and local government employers to capture savings for the general fund. Mr. Wylie responded that state law is very specific as to the contribution rates, and those rates have been in existence for 35 years.

Mr. Wylie distributed a handout entitled "Cement Plant Retirement Fund: Fact Sheet and Funded Status Summary, June 30, 2010" (Document #1) and updated the committee on the Cement Plant Retirement Fund (CPRF). It was established in 1968 and sold to a private entity on March 16, 2001. At that time, no new entrants were allowed on to the plan and all the members became 100% vested. Since the plan is very mature, is closed to new members, and has a negative cash flow, it will be difficult for the investment performance alone to support the fund. Currently, the CPRF has between $40-$45 million in the plan and has a payout of $3.5 million annually in benefits. It is estimated that the liabilities of the plan are about $55 million; which results in about $10 million in liabilities that are greater than the plan assets. As of June 30, 2010, the plan is about 80% funded. The actuary estimates that the plan will be 50% funded in 10 years. Mr. Wylie stated that SDRS may need additional state help to fund the CPRF.

The Cement Plant Commission is being sunseted in July 2011, and therefore the oversight of the CPRF was transferred to SDRS.

Mr. Wylie informed the committee that with the benefit changes made during the 2010 Legislative Session, there is a possibility that SDRS may need to ask for additional funds to address the additional costs associated with the current lawsuit.

South Dakota Investment Council

Mr. Matt Clark, State Investment Officer, and Mr. Haven Stuck, Chairman of the South Dakota Investment Council (SDIC), distributed a handout explaining the SDIC budget. (Document #2) Council members present at the meeting include: **Mr. Joseph Anglin**, **Mr. Wes Techetter**, **Mr. Hugh Bartels, Mr. Jon Hunter, Mr. Jarrod Johnson, Mr. Richard Sattgast**, and **Mr. Rob Wylie**. Staff members present at the meeting include: **Mr. Brett Fligge, Mr. Chris Nelson, Ms. Tammy Otten**, and **Ms. Laurie Riss**.

The agency is funded out of interest and investment earnings derived from the managed funds. For FY12, the Governor recommends a total budget of $8,699,288 in other fund expenditure authority and 28.0 FTEs. The recommendation is a decrease of $218,594 from FY11.

Mr. Stuck stated that as of December 31, 2010, South Dakota’s assets are estimated to be $9.434 billion. The South Dakota Retirement System comprises 78.6% ($7.4 billion) of the state’s assets.

Mr. Stuck briefed the members on the SDIC budget process and long-term plan. The budget is approved by the Legislative Research Council (LRC) Executive Board before presenting the budget to the Bureau of Finance and Management (BFM) and Joint Committee on Appropriations pursuant to SDCL 4-5-22. There are no general funds appropriated to the agency. Page 4 of Document #2 shows the projected budget through 2021.

Mr. Stuck stated that the cost of running the office has always been extremely low. South Dakota’s internal cost for management fees are $1.06 per $1,000. The total cost for SDIC internal and outside manager management fees is $3.81. South Dakota’s cost is below the $1 billion median pension fund of $4.93 and the benchmark of $8.95.

Mr. Stuck said that additional wealth to the SDIC system can be obtained by cost advantage. Even without considering the potential for continuing superior SDIC performance, future wealth grows an extra $1.3 billion over 30 years by keeping the SDIC costs low.

Page 7 of Document #2 illustrates the budget summary for FY2010 and FY2011. A total of $2.5 million in unspent funds was reverted back to the fund and used to balance the FY2011 budget.

Mr. Clark stated that most of the reversion results from a decrease in incentive payouts – decreased from an average of 50% to 25%.

Mr. Stuck commented that pages 9 and 10 of Document #2 outline the FY2012 budget request for SDIC. The budget request submitted by SDIC is considered Version A which is in accordance with the agency's long-term plan including salary increases and promotions. In recognition of continuous economic tough times and a zero state salary policy, a Version B budget request was also provided. Version C is a budget recommendation reflecting the reductions from Version B recommended by the Governor and the Bureau of Finance and Management. Both budget recommendations Version A and Version B include an increase in total operating expenses of 15.86%. The entire increase is in the contractual services budget, with the most significant increase of $250,000 for bank fees. Mr. Stuck noted that SDIC does not have control over the increased contractual obligation.

As of June 30, 2010, the South Dakota Retirement System (SDRS) return for last year was 18.7% above the median of 13.2%. SDIC substantially outperforms from the peers and is placed in the top 1% in the state fund universe. The extra outperformance meant that for FY10, the total SDRS earned $1.05 billion. SDRS earned $1.851 billion over the last six years and $2.475 billion over the last 10 years.

Mr. Clark commented that the SDIC performance for the last 37 years has been .81% annualized versus benchmark. By the 2031, a continued .81% outperformance would earn an extra $4.0 billion. Outperformance of even half that amount would result in additional earnings of $1.95 billion. In contrast, a .81% underperformance would cost the retirement systems $3.5 billion relative to average returns.

Mr. Clark stated that he encourages the committee to approve the Version B budget recommendation. He noted that neither Version A or Version B budget recommendation include the continuation of a contact with Mr. Steve Meyers. The current contract will end on June 30, 2011, and will not be reapproved unless the Legislature wants it approved. Mr. Clark stated his concern that the removal of the Mr. Meyer contract could be harmful to the system and would like it reinstated.

One of the SDIC key responsibilities is to prepare the next generation to take over operating the SDIC. Mr. Clark believes that it takes 20 years to successfully prepare and train staff. He does not think that the Version C budget recommendation will retain the key people in the pipeline that will maintain the future of the system. In response to committee questions, Mr. Clark stated that due to the economic times, he recommends approving Version B. This budget recommendation would help sustain the future of the system. If there needs to be symbolic cut, he suggested cutting his salary and not make the other staff at SDIC suffer.

<u>Health Care Trust Fund</u> – As of December 31, 2010, the principal value was $85,631,024, the amount adjusted for inflation was $104,120,259, and the fair market value was $101,678,000. Mr. Clark noted that the state will receive a 4% payout from the trust fund – an estimated distribution for F12 will be $3.9 million.

<u>Education Enhancement Trust Fund</u> – As of December 31, 2010, the principal value was $329,329,930, the amount adjusted for inflation was $401,031,990, and the fair market value was $368,600,000. Mr. Clark that the state will receive a 4% payout from the trust fund – an estimated distribution for F12 will be $14.5 million.

<u>Dakota Cement Trust Fund</u> – As of December 31, 2010, the principal value was $238,000,000, the amount adjusted for inflation was $293,962,308, and the fair market value was $239,142,000. The state will receive the $12 million payout required by the constitution. There will not be a secondary distribution for education in FY2011.

<u>School and Public Lands</u> – As of December 30, 2010, the fair market value was $178,256,000. In February 2011, K-12 education will receive a distribution of $8,273,930. The Board of Regents will receive a distribution of $1,725,000 in June 2011.

<u>MOTION:</u> ADJOURN

Moved by: Peters
Second by: Bolin
Action: Prevailed by voice vote.

Barb Bjorneberg and Lisa Shafer
Committee Secretary

Dean Wink, Chair