87th Legislative Session – 2012

Committee: Joint Appropriations Wednesday, February 08, 2012

P - Present
E - Excused
A - Absent

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

OTHERS PRESENT: See Original Minutes

The meeting was called to order by Chairman Corey Brown.

Department of Transportation

Darin Berquist, Secretary of Transportation, met with the Joint Appropriations Committee to present the department's proposed FY13 budget. Also in attendance were Kellie Beck and Tracy Shangreaux. Documents #1-4 were distributed.

The department's proposed budget totals $585,601,429, including $484,054 in general funds, $377,924,593 in federal funds and $207,192,782 in other funds. This budget represents an overall increase of $4,478,409 (an increase of $13,895 in general funds, a decrease of $2,595,221 in federal funds and an increase of $7,059,735 in other funds). The general funds in this budget are used for state aviation services (i.e. pilot salaries, training, and physicals, and hanger lease payments and utilities).

Major Expansions/Reductions

Salary Policy
- An increase of $13,876 in general funds, $309,419 in federal funds and $2,690,783 in other funds for a total of $3,014,078.

Space/Computer Billings
- An increase of $110,180 in other funds.

Finance & Management
- A reduction of $2,904,640 in federal funds is due to changes in the Federal Transit Program and the elimination of ARRA authority.

Operations
- An increase of $3,000,000 in other funds under Contract Maintenance.
- An increase of $183,264 in other funds under Signs.
- An increase of $956,074 in other funds under Road Salt & Chemicals.
- An Increase of $775,183 in other funds under Motor Vehicle Fuel.
- An increase of $2,051,221 in other funds under Highway Maintenance Equipment.
- An increase of $2,464,098 in other funds under Building/Structure Improvements.

Construction Contracts
- A reduction of $5,038,115 in other funds under Road & Bridge Repair.

Secretary Berquist reminded the Committee the department's share of general funds is 0.04%. The department's source of funds is 64.5% federal, 35.4 % other (state highway funds) and 0.1% general funds.

The biggest component of State Highway Revenue (60%) is motor fuel tax. In FY11 it totaled $131.6 million (8.2% up from FY10); however it is down 16% from last year through the first 6 months. The 3% excise tax on the sale of motor vehicles accounts for 30% and totaled $61 million in FY11 (8.5% higher than FY10 and 9.2% ahead of last year to date). Overall the State Highway fund totals $227 million, 9.2% over FY10 and 6.4% behind last year.

Other state revenues include $1.5-$1.8 million/year from aeronautics fuel tax and registration, and $300,000/year of railroad revenue.

The primary source of the federal funds is Federal Highway funds along with some Transit and FAA funds. Federal funds in 2011 totaled $257 million formula funds. This money can only be used for highway construction and related activities (no equipment, maintenance, or snowplowing).

Secretary Berquist said transportation enhancements have become an issue on the federal level as Congress considers a new highway bill. Since 1991 the FHWA program has included a small amount of money for enhancement projects; however these funds come with a different set of rules and cannot be used for highway purposes, only for bike paths, scenic easements, etc. Funds are awarded to the local entity and they pay the match. Transportation enhancement funds may go away as part of any future federal highway program.

Senator Tidemann asked about the formula that determines the FHWA funding. Secretary Berquist said historically South Dakota's share has been 0.71%. There hasn't been a federal highway bill since 2009, and the state's continues to operate on an extension on the old program. Congress is considering a bill at the present time and hopefully the level of funding will be at the 2009 level and not be reduced. The amount of Federal revenue coming in is not able to support the current program. Secretary Berquist said Congress is pushing to get a bill passed before the end of March when the current extension ends; but it is doubtful.

In response to Representative Wink's question, Secretary Berquist said the reduction in FTEs was mainly maintenance workers and engineers. The department saw a 16% turnover of highway maintenance workers in the past fiscal year and finds it more and more difficult to hire maintenance workers, especially in certain areas of the state. Some are going to work for the counties and small percentage are going to the oil fields in North Dakota.

Senator Juhnke asked how the mild winter was affecting the department's budget. Secretary Berquist said the department will see a savings in overtime and fuel. Generally the department expects to spend $17-18 million on winter maintenance and that will not be the case this year. Because winter maintenance is part of the overall maintenance budget, this savings will free up funds for other maintenance work. Excess federal or other funds accumulate in the State Highway fund and are available for highway construction work in the coming year.

Secretary Berquist told the Committee the department was requesting a $3 million increase in Contract Maintenance. This item was reduced $6.4 million last year; however, the department now feels they need to restore $3 million.

Representative Wismer asked for clarification on the $2.9 million decrease in transit and ARRA funds. Secretary Berquist said the federal transit program is part of the FHWA program. Transit funds include discretionary grants and the department is unsure of the future of these discretionary grants. In response to Representative Wismer, Secretary Berquist said transit means public transit/bussing, and that would mean less money to public transit providers. However, Secretary Berquist said there are indications in the transit program currently working its way through Congress that South Dakota may fare fairly well in the new bill.

The department is also requesting an $183,000 increase for signing material. New federal requirements make it necessary for South Dakota to upgrade its signing materials and this work will be done over a 4-year period.

Secretary Berquist explained the department's request for an increase in Road Oil/Asphalt and Road Salt/Chemicals. The increases are based on average quantities used with a 10% inflation factor. Motor Highway Maintenance Equipment – talked about the use of fuel is also based on 3 year average use and did not include an inflation factor.

The department continues to use the Equipment Management System to guide the department in terms of when to replace a piece of equipment. The backlog of replacement needs keeps growing and is currently at $49 million. At this time the department is requesting $2 million which would restore last years cut and would give them a $10 million equipment budget. This $10 million budget will keep the department status-quo.

The Building & Structure Improvements budget was cut $1.25 million last year and the department is asking to restore $1 million. The department is part of a proposed project in Rapid City regarding the Highway Patrol and Drivers Licensing Office. Those agencies have outgrown their current facility which is owned by the Department of Transportation. There is a proposal to sell the building and use the funds to add space to the existing Department of Transportation facility. It is the department's goal to make this project "a wash"; however, because discussions are ongoing and are far from a permanent solution, the department is requesting this increase.

Secretary Berquist said the department is proposing a $5 million reduction in state funds under Construction Contracts.

Senator Juhnke asked about the $4 million for the railroad fund mentioned in Governor Daugaard's State of the State speech. Secretary Berquist said the $4 million would be transferred from the general fund to the railroad fund overseen by the Railroad Board. The primary use of these funds has been for loans issued to regional rail authorities who then issue loans for improvements to rail lines for economic development. The $4 million is a restoration of a portion of the funds from the sale of the core line in 2006 and will provide the Board with funds for making further improvements.

Senator Juhnke commented on diversions from the State Highway Fund and asked if there was a gas tax increase in the near future. Secretary Berquist said no, there is not a need for a gas tax increase. Secretary Berquist explained there are 2 categories of diversions: (1) The tax on fuel that is collected that is not used on roads (ag producers, boats, snowmobiles). Those funds never make it to the State Highway Fund and the state can not collect from Tribal members on the reservation. (2) There are the expenditures from the fund that don't go to the highways, i.e. Game, Fish & Parks roads, the Highway Patrol, etc. These diversions totaled $44 million in 2007 and $38 million in 2011.

South Dakota Retirement System

Mr. Rob Wylie, Executive Director and Administrator of the South Dakota Retirement System (SDRS), introduced the board members present – Dr. James Hansen, Mr. Eric Stroeder, Ms. Laurie Gustafson, Mr. Matt Clark, and Mr. Jason Dilges.

For FY2013, the Governor recommends a budget of $3,564,697 (comprised entirely of other fund expenditure authority) and 33.0 FTEs. This request is a total increase of $224,087 (6.7%) in other fund expenditure authority from the FY2012 budget.

Mr. Wylie stated that South Dakota and other pension plans have not been immune to the downturn of the market. The SDRS was down nearly 30% but through conservative practices and corrective measures, the system is now fully funded. As of June 30, 2011, the present value of the marketable assets (fair value of SDRS assets) was greater than the present value of all future benefits payable to the members of the system.

The FY2013 budget proposal from the Board of Trustees maintains the reset of the budget base established in the FY2012 budget. Mr. Wylie noted that SDRS has an issue from outside influences that is a concern and SDRS needs to make adjustments with the financial reporting needs for the South Dakota pension plan and all separate employers throughout the 470 public employers in the state. The new design for pension accounting will change dramatically for both SDRS and local government entities. The new standards will take effect in June 2012.

Mr. Wylie told the committee that SDRS is funded from the SDRS Trust Fund Pool (other funds) and does not use state general funds. The SDRS Trust Fund pool provides the funding for SDRS to carry out the administrative services to all member employees across the state. Currently, the SDRS system has $7.9 billion in assets.

There are 75,000 members of SDRS. Currently, 40,000 members are employed in South Dakota public service, 14,000 were employed previously in public service, and over 21,000 members receive benefits. The average benefit is over $16,000 (about $1,400 per month). The average active member of SDRS is 46 years old and has worked for the system for about 10 years with an average salary of $38,000.

Mr. Wylie explained the major budgetary changes for FY2013. They are:

- Personal Services- Increase of $94,239 in other fund expenditure authority for the Governor's recommended salary policy;
- Interagency Billings - Increase of $9,848 in other fund expenditure authority due to changes in space billing and computer service billings;

- Professional Audit Services – An increase in expenditure authority of $10,000 is recommended for ongoing professional audit services. The current contract contains an escalator clause which must now be honored; and
- Professional Actuarial Services – An increase in expenditure authority of $110,000 is recommended for costs associated with the professional actuarial services. Pending Governmental Accounting Standard Board (GASB) changes have increased actuarial usage and actuarial services are required by law and are critical to meeting the fiduciary responsibilities of the Board of Trustees.

Mr. Wylie noted that for the past 30 years, the actuarial standard and the audit/accounting standard have been equivalent. The new standards will change the previous method and require two separate valuations.

Mr. Wylie said that SDRS has not been able to quantify the cost and the impact of performing the second audit. Based on the language in the GASB changes, SDRS will need to redo all of the note disclosures. All of the local governments will have to do this, and he is anticipating that SDRS will be the information resource location.

A 10 page summary of the proposed changes will be presented to the committee.

Representative Fred Romkema asked about the Dakota Cement Plant Trust Fund. Mr. Wylie said that two years ago, SDRS took over the administration of the Dakota Cement Plant Trust Fund. It was established in 1968 and sold to a private entity on March 16, 2001. Since that time, no new entrants have been allowed into the plan and all the members are 100% vested. Because 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. Mr. Wylie said that the plan is 91% funded, but over the next 20 years, the funds will be used up.

In response to Senator Putnam's questions, Mr. Wylie said that any fiscal decisions about the Dakota Cement Plant Trust Fund will be brought before the Appropriations Committee and decided by the full Legislature.

Senator Tidemann asked about alternative options to fund the Dakota Cement Plant Trust Fund. Mr. Wylie responded that the fund is different from other SDRS plans and cannot be melded together. The other options are for the state to fully fund the base or to have a private entity take over management of the fund.

My Wylie said, in response to Representative Carson's question, that there is no absolute number to make the Dakota Cement Plant Trust Fund whole because of the volatility of the market. There is also $49.4 million of assets with a fund liability of $54.5 million; which makes the plan 91%

funded. For 2011, the fund was short about $5 million, but because of the volatility of the market, the fund value has diminished since that time.

Representative Bolin asked about the expected number of retirees in the future. Mr. Wylie replied that 10% of the public employee population is currently eligible for full retirement benefits. Within five years, 25% of the people who are in public employment will be eligible for full retirement. In ten years, the number of public employees who will be age 50 or older will be about 40%.

In response to Representative Bolin's question, Mr. Wylie stated that in 2011, the number of retirees returned to about the normal level after the decline with the recession. There was a savings to the plan in 2008-2009 because of the economy and a lower number of retirements. Currently, 25% of the population will be eligible to retire in the next five years, which will create a workforce issue across the state in both the public and private sectors.

Senator Tidemann asked about the computer system. Mr. Wylie said that SDRS is having the same issue that the Bureau of Finance and Management is having with the support for the current computer system which will end in 2014. This is a future project for SDRS.

Representative Wismer asked about the current status of the SDRS lawsuit involving the change in the COLA. Mr. Wylie said that similar legislation was passed in both Minnesota and Colorado. The Minnesota and Colorado courts have expedited that process and the case has gone through the first circuit court level. The judges ruled in favor of the pension plan in both cases. The Minnesota case is not being appealed, but the Colorado case is being appealed to the Supreme Court. South Dakota is working on the court case and had the first court appearance on January 31, 2012. The judge has not returned a consideration at this time.

The following documents were distributed:

- "SDRS Public Employees Nearing Retirement" (**Document #5**);
- The department's responses to the Budget Call letter (**Document #6**); and
- The SDRS 2012 Annual Report (**Document #7**).

South Dakota Investment Council

Mr. Matt Clark, State Investment Officer, and **Mr. Joe Anglin**, Chair of the South Dakota Investment Council (SDIC), introduced the council members present at the meeting - Mr. Wes Tschetter, Mr. Rob Wylie, Mr. Hugh Bartels, Mr. Jim Means, Mr. Jon Hunter, Ms. Tammy Otten, Mr. Jarrod Johnson, Mr. Richard Sattgast, Mr. Chris Nelson, Laurie Risk, and Brett Fliggy.

Distributed to the committee was an overview of the agency and the agency's FY2013 budget request. (**Document #8**)

The agency is funded out of interest and investment earnings derived from the managed funds. For FY2013, the Governor recommends a total budget of $8,784,383 in other fund expenditure authority and 28.0 FTEs. The recommendation is an increase of $85,095 from FY2012. Major budget changes include:

- An increase in other fund expenditure authority of $314,563 for personal services. This reflects an increase for promotional development, performance-based incentives, benefits, and salary adjustments based on the SDIC's long-term compensation plan; and
- A decrease in other fund expenditure authority of $229,468 for contractual services. This is mostly due to the anticipated decrease in bank custodian fees and charges.

Mr. Anglin 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 #8 shows the projected budget through 2021.

Mr. Anglin stated that the cost of running the office has always been extremely low. South Dakota's internal cost for management fees are $0.91 per $1,000 of interested fund. The total cost for SDIC internal and outside manager management fees is $3.66 per $1,000. South Dakota's cost is below the $1 billion median pension fund of $4.93 and the benchmark of $8.95.

In response to Senator Billie Sutton's question, Mr. Anglin stated that the cost difference between the SDIC cost of $3.66 and the benchmark of $8.95 is approximately $52 million per year.

Mr. Clark stated that the SDIC was appropriated about $8.9 million in FY2011 and actual expenditures were under $7 million. Therefore, the agency is reverting $1.9 million. Two of the biggest contributors of the reversion were unused incentive payments ($1.2 million) and contractual services for a custodial bill ($400,000). Because of the $1.9 million reversion in FY2011, the SDIC was able to lower the FY2012 the charge needed from underlying assets to meet the budget need.

Representative Wismer asked about the factors in determining if an account is managed in house or contracted. Mr. Clark stated SDIC needs to have expertise in the area to have success. Most of the contractual services relate to real estates, private equity, and distressed mortgage debt; all of which are areas people in SDIC do not have expertise in and it is more cost efficient to contract out.

Mr. Anglin stated that page 8 of Document #8 is the SDIC FY2013 budget request summary. The Investment Council concurs with the Governor's FY2013 budget recommendation utilizing budget Version A. The budget recommendation is for $8,784,383 in other funds – which is an overall increase of 1% from the FY2012 budget.

Total compensation for the investment position is expected to consist of two-thirds in the form of base compensation and one-third in return-linked incentive compensation. The total maximum incentive budget is funded at 85%. Base salaries in the FY2013 budget recommendation include a 4.8% increase for the 22 investment positions, according to the long-term plan, and a 3% increase for the accounting and administrative positions. The newer and intermediate level team members increase an additional 1% to 15.2% for promotion increases as they continue transitioning through the steep learning curve from entry level to senior investment team members. The investment accounting positions are increase an additional 2% or 3% to more closely reflect industry compensation levels for accountants with CPA designations and their increased years of experience.

Mr. Anglin said that the overall operating expense budget decreased by 12.69% in the recommended FY2013 budget. The recommendation includes the following changes:

- Consulting fee decrease of $20,000, leaving $30,000 for consulting fees for compensation analysis or other issues as determined by the SDIC board members'
- Contractual services for all investment research to net an increase by $53,364;
- Computer services increasing by $5,668 per expected costs provided by the Bureau of Information and Telecommunication;
- Legal fees for the Attorney General's office budget at $16,000. Legal services of the Attorney General office has been used for many years, but SDIC agreed to begin paying for the legal assistance primarily with respect to limited partnership agreements; and
- Bank fees decreasing by $288,250 due to a re-negotiation of bank custodian fees with BNY/Mellon.

Senator Sutton asked about the differences between the two FY2013 budget plans. Mr. Clark stated that Version A was created with the goal of using the normal long-term plan increases. Then the SDIC would address the 5% pay cut employees received in FY2012. Version B was created with the goal of getting the budget fully restored immediately and increase the incentive fund from 85% to 100%. It was determined that Version B was not realistic due to the current economy and budget. SDIC will try to get the employee's salary back over three years.

Mr. Clark noted that SDIC has money in the FY2012 budget from unused incentives to pay for the 5% bonus to state employees if the legislation is approved. However, SDIC will need approval from the Legislature because it was agreed prior that the incentive funds would not be used for any purpose other than the incentive payment.

Senator Kent Juhnke asked about the average number of years of service for employees and the rate of turnover. Mr. Clark stated that in 2010, SDIC lost an accountant; however, no investment employees have left for about six years. The investment employee that left went to a prestigious fixed income manager in Los Angeles.

Mr. Anglin said that there is concern about the SDIC's long-term ability to sustain the compensation adjustments made in FY2012. It is hoped that the announced plan for a one-time payout in this fiscal year and a compensation increase in FY2013 will buy SDIC some time until the compensation study is performed in the spring of 2013.

Mr. Anglin noted that a detailed chart of the SDIC operating expense budget for FY2012 and the recommended budget for FY2013 is shown on page 11 of Document #8.

In FY2011, the SDRS investment return was 25.84%; which resulted in a $1.654 billion earnings. SDRS assets at the beginning of FY2011 were valued at $6.488 billion and the assets were valued at $7.926 billion at the end of FY2011.

Health Care Trust Fund – As of December 31, 2011, the principal value was $85,631,024, the amount adjusted for inflation was $107,190,656, and the fair market value was $101,151,012. Mr. Clark noted that the state will receive a 4% payout from the trust fund – an estimated distribution for FY2013 will be $3.8 million.

Education Enhancement Trust Fund – As of December 31, 2011, the principal value was $329,329,930, the amount adjusted for inflation was $412,858,001, and the fair market value was $367,821,428. Mr. Clark that the state will receive a 4% payout from the trust fund – an estimated distribution for FY2013 will be $14 million.

Dakota Cement Trust Fund – As of December 31, 2011, the principal value was $238,000,000, the amount adjusted for inflation was $305,236,346, and the fair market value was $235,771,870. The state will receive the annual $12 million payout required by the constitution. There will not be a secondary distribution for education in FY2012.

School and Public Lands – As of December 31, 2011, the fair market value was $181,989,503. In FY2012, K-12 education will receive a distribution of $7,433,191. The Board of Regents will receive a distribution of $1, 500,000 in June 2012.

MOTION: ADJOURN

Moved by: Juhnke
Second by: Dryden
Action: Prevailed by voice vote.

Barb Bjorneberg and Lisa Shafer
Committee Secretary

Corey Brown, Chair