KBRA KROLL BOND RATING AGENCY

A SIGNIFICANT STEP BUT STILL A LONG WAY TO GO: NEW JERSEY CONTRIBUTES LOTTERY ENTERPRISE TO PENSION FUNDS

Highlights

- In KBRA's view, the State of New Jersey has significantly increased the level of assets in its pension funds through the irrevocable contribution of the Lottery Enterprise for a period of 30 years. The Lottery Enterprise has been valued at $13.5 billion.
- The value of this one-time contribution represents 7.3X the pension contribution made by the State in 2017.
- The contribution of the Lottery Enterprise is a meaningful step towards addressing the State's substantial unfunded pension liabilities. As a result of this transaction, the funded ratio of the State's combined retirement systems has increased from 45% to 59%. The aggregate unfunded actuarial accrued liability has been reduced from $49.1 billion to $36.5 billion, or a reduction of 25.6%.
- The Division of State Lottery will continue operating the lottery games throughout New Jersey. All net revenues, after operating expenses and the distribution of game winnings, will remain in the pension funds. Net revenues in 2018, estimated to be approximately $1 billion, will be used to partially offset the State's annual required pension contribution in 2018. Net revenues of the Lottery Enterprise are projected to increase approximately 1%-2% annually. Over the 30 years, the net revenues of the Lottery Enterprise are estimated to total about $37 billion.
- The annual funding requirements of the state pension funds are still substantial and will continue to put pressure on the State budget. Under the State's post contribution funding plan, which contemplates a ramp up to full funding of the State's determination of its actuarial required contribution, or ARC, in 2023, the State's required annual pension contribution will increase from $1.4 billion in 2018 to $4.9 billion in 2023, an average annual increase of 28.9%. Prior to the contribution of the Lottery Enterprise, net revenues were transferred to the State's General Fund, so this change does not increase revenues for budgetary purposes but rather increases the certainty that a portion of the annual pension contribution will be made.
- Historically, the State's record of annually funding its pension contributions has been poor. In fiscal 2017, the State contributed $1.862 billion to its pension funds, representing only 40% of the ARC.

Lottery Commission Contribution

Effective July 1, 2017, under the Lottery Enterprise Contribution Act (Act), the State of New Jersey contributed the Lottery Enterprise to its three largest state-administered pension funds. After the lottery's operating expenses, including the payment of lottery game prizes, all net revenues will be distributed monthly to the pension funds. The New Jersey Lottery Commission essentially remains intact, with no change to its operations or legal authority. After 30 years, the Lottery Enterprise will revert to the State. In the intervening period, the Lottery Commission will collect an estimated $37 billion of net revenues from the operation of the lotteries.

Although this legislation does not bind future legislatures, it is KBRA's understanding that it would be difficult to reverse. Should the state seek to undo this contribution, the action would be deemed a violation of the exclusive benefit rule of U.S. tax law, according to the State's counsel, and would likely change the tax exempt status of the State's pension funds. In this event, the funds and all of the pension beneficiaries would incur additional federal tax liabilities, an outcome that future legislatures would reasonably seek to avoid.

Under the terms of the Act, the State contributed the Lottery Enterprise to Common Pension Fund L, a common trust fund for the benefit of three of the state's pension funds: the Teacher's Pension and Annuity Fund (TPAF), the Public Employees' Retirement Systems (PERS), and the Police and Firemen's Retirement System (PFRS).

The State Attorney General has reviewed contribution of the Lottery Commission to the three pension funds and found that it comports with the State Constitution and applicable State laws.

Valuation of the Contribution

The State's valuation service provider, Acacia Financial Group, performed a valuation analysis of the Lottery Commission under the terms of the contribution of the Lottery Enterprise to the State pension funds. The valuation method employed a discounted cash flow analysis. Other methods, such as the valuation of comparable private enterprises and an assessment of the price for a potential sale of the Lottery Enterprise, were found to be not suitable because of the Lottery Enterprise's government ownership, monopoly position, and the legal prohibitions against selling the entity. The table below shows the lottery's recent financial results.

Lottery Commission Financial Results

$ in millions	2017
Gross revenues	$3,247
O&M, including prizes	2,271
Net proceeds	976

In projecting the lottery's net revenues, the valuation analysis assumed a 2.5% increase in net revenues for 2018 reflecting nearer term visibility on financial results. Thereafter, the valuation assumes a 1.59% average annual growth from 2018-2029, and an average annual growth of 1.0% from 2030-2047. These forecasted rates of growth appear reasonable compared to the historical growth rates of the Lottery Commission net revenues, which from 1997 to 2012 grew at an average annual rate of 2.12%. These forecasted amounts totaled $37 billion over 30 years, and discounted at 7.65%, provide the basis for a valuation of $13.535 billion.

Effect on Pension Funds

The net proceeds of the Lottery Commission contribution are allocated to three of the state's pension funds: TPAF, PERS, and PFRS. The allocation method factors in, among other things, the level of funding of the pension funds and the extent to which the services provided by the respective pension beneficiaries are consistent with the original intent of the Lottery Commission--to fund education and state institutions. Each fund's allocation under this methodology is as follows: TPAF – 77.8%, PERS – 21.0%, and PFRS – 1.2%.

The contribution, effective July 1, 2017, will be reflected in the June 30, 2016 actuarial valuation of the pension funds. For the purposes of the June 2016 valuation, the July 1, 2017 valuation of $13.535 billion is discounted back one year at the annual discount rate of 7.65% to $12.573 billion, as shown below. The effect of the contribution on the aggregate unfunded actuarial accrued liability for all state pension funds is shown in the table below. The contribution decreases the combined unfunded liability by 25.6%. The change in liability is even more pronounced for the TPAF, where the unfunded liability declined from $30.7 billion to $20.9 billion as of July 1, 2016, or a decline of 32% (not shown in table below).

As a result of this transaction, the funded ratio of the State's combined retirement systems has increased from 45% to 59%.

New Jersey State Retirement Systems
Actuarial Valuations as of July 1, 2016
($ in millions)

Before Contribution			Contribution	After Contribution			
Actuarial Value of assets	Actuarial Accrued Liability	Actuarial Unfunded Liability	Lottery Commission Contribution	Actuarial Value of assets	Actuarial Accrued Liability	Actuarial Unfunded Liability	% Change Unfunded Liability
$39,731.6	$88,800.3	$49,068.7	$12,573[1]	$52,304.8	$88,800.3	$36,495.5	25.6%

Although the lottery contribution will be reflected in the State's actuarial valuation reports developed by the retirement fund's actuaries, the extent to which it will be recognized in the State's audited financial statements is not yet clear. Governmental Accounting Standards Board (GASB) principles do not recognize a change in valuation when a governmental entity moves an asset from one fund to another, as is the case with the State's contribution of the lottery commission to the state's pension funds.

Summary

The contribution of the Lottery Commission represents a significant step in reducing the level of the State's unfunded pension liabilities, which KBRA views as very positive. A consistent pattern of annual contributions that approach and maintain the funding of the actuarially required annual contributions needs to be established in order to fully address the State's pension issues.

[1]Represents the valuation of the Lottery Commission contribution of $13.535 billion as of July 1, 2017 discounted one year back at 7.65% to July 1, 2016, the date of the actuarial valuation.

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