Evaluation of the Extent Pension Costs Lead to Funding Shortfalls for Privatizing Nursing Facilities

A Report to the Minnesota Legislature

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I. Introduction

Laws of Minnesota, 2008, Chapter 326, Article 1, Section 42, direct the Department of Human Services (DHS) to bring recommendations to the Legislature by January 15, 2009, regarding the reimbursement methodology for pension costs for nursing facilities. The requirement states:

The commissioner of human services shall evaluate the extent to which the alternative payment system reimbursement methodology for pension costs leads to funding shortfalls for nursing facilities that convert from public to private ownership. The commissioner shall report to the legislature by January 15, 2009, recommendations for any changes to the alternative payment system reimbursement methodology for pension costs necessary to ensure the financial viability of nursing facilities. The commissioner shall pay for any costs related to this study using existing resources.

This report is submitted to the Legislature in response to these requirements.

The Minnesota Public Employees Retirement Association contributed data and information necessary for the completion of this report. Nursing Facility Providers and the Nursing Facility Rates and Policy Advisory Committee also contributed data and feedback regarding the reimbursement of pension costs for privatizing facilities. This Advisory Committee includes DHS staff, nursing facility representatives, consumer advocates, and labor representatives. The cost to prepare this report was approximately $2,000.

The following are definitions of terminology used for the purposes of this report.

- Pension: Pension costs not related to the Public Employees Retirement Association.
- Peer Groups: Defined under current law, facilities are classified by county into three geographically based groups; see MN Stat. 256B.441, Subdivision 30.

II. Background

Currently there are 42 governmentally owned nursing facilities in the State of Minnesota required by law to make contributions to the Public Employees Retirement Association of Minnesota (PERA). PERA is a defined benefit plan under which an employee receives a set monthly amount upon retirement, guaranteed for their life. Both the employee and the governmental employer are required to make established contributions to PERA while the individual is publicly employed, but the amount the employer contributes does not go directly into an individual employee's account. Over the past ten years 13 nursing facilities have converted from public to private ownership and subsequently became ineligible for PERA participation.

When a PERA participating nursing facility (NF) privatizes, the employees can no longer participate in PERA and the NF owner no longer contributes to PERA. Minnesota Statutes, Chapter 353F direct the benefits payable from PERA for the employees of public nursing homes that go private. The employees' benefits are determined on the date of the change of ownership, and then PERA accrues at a higher interest rate on the deferred payment of their benefits than what they would pay a public employee who terminates voluntarily. These enhanced termination benefits are at no cost to the privatized facility but they are not at a level that fully replaces to the employee the benefit of continued participation in PERA.

Many of the NFs that have privatized in the past decade have chosen to offer a retirement benefit to their employees. Based on the feedback received from privatized providers, it is a defined contribution plan that is being offered. A defined contribution plan differs from PERA (a defined benefit plan) in that the employer's contribution goes directly into each employee's individual account.

The extent to which a privatized facility's pension costs are reimbursed varies depending primarily upon two factors: the timing of privatization and when the facility switched from Rule 50 to Alternative Payment System (APS) reimbursement. The reimbursement systems and methodologies have changed over time, as a result the treatment of PERA and pension costs and the extent to which they are covered have changed as well.

There are a handful of facilities that have recently privatized that will have their reimbursement rates impacted as early as October 1, 2009 as a result of privatizing under the current reimbursement system. These facilities are seeking to have their pension costs reimbursed in the same manner the facility's PERA costs were reimbursed under the previous governmental ownership. PERA costs are treated as a pass-through cost, meaning all costs associated with PERA are recognized for the purposes of setting reimbursement rates. Non-PERA pension costs are not treated as a pass-through for the majority of facilities. The basis for treating PERA expense as a pass-through cost was two fold. First, it is a mandated cost to the governmentally owned provider that non-governmentally owned facilities are not required to bear. Secondly, PERA is at a greater cost to a provider than a typical pension plan.

During the 2007-2008 legislative session S.F. No. 2884 proposed to have the pension costs of five recently privatized facilities treated as though they were PERA costs. The fiscal note prepared for the third engrossment of S.F. No. 2884 estimated a cost to the state of $73,000 for 2010 and $115,000 for 2011. This was a controversial issue for some of the affected facilities as they were not asking for new funding; rather they were seeking to retain funding that had existed under previous ownership. When a fiscal note is prepared it is the Department of Human Services' and the Department of Minnesota Management and Budget's best estimate of the financial effect of a change in law. If the law needs to be changed in order for a facility's rates to be calculated differently, it will likely affect general fund spending.

III. Analysis

While it is true that non-governmental facilities are not required to contribute to a pension plan for their employees, the most recent data available (2007 cost report), suggests that most do. The 2007 cost report did not require hospital-attached providers to break out their costs of benefits by benefit type. Therefore we do not have complete data as to the number of facilities that do provide a pension benefit. However, of the facilities that did break out their benefit expenses, 77% reported employee pension costs. Hospital-attached providers make up about 16% of the total nursing facilities in the State. It would be reasonable to assume that at least the same proportion (that is, 77%) of hospital-attached facilities provide some type of pension benefit as well.

Based on the 2007 data, PERA facilities do have a greater cost of providing PERA when compared with pension costs of non-governmental facilities. PERA costs were 4.17% of the total operating costs of all governmental facilities compared to the pension costs of 1.33% of operating for non-governmental facilities. Combined wage and benefit costs for non-governmental facilities were 68.78% of total operating costs compared to 68.89% for governmental facilities, making the gap in expenses seem much smaller. However, as shown in the following table, the combined costs for wages and benefits for PERA participating governmentally owned facilities is higher in dollar terms when compared to the costs of the non-PERA facilities. These are the average costs by Peer Group (as defined in rebasing legislation) per resident day based on the reported 2007 data.

Table 1: Combined Costs for Wages and Benefits

Peer Group	Non-PERA Facilities	PERA Facilities
1	$123.15	$143.13
2	$114.00	$119.26
3	$102.55	$107.55

PERA costs are reimbursed based on the actual costs to the provider rather than as a percentage of the provider's operating costs. Unlike PERA costs, providers with non-PERA pension costs are not necessarily fully reimbursed under current law. Table 2 provides specific examples of the un-reimbursed portion of pension costs for facilities that have never been governmentally owned. These calculations were only completed for a few randomly selected facilities due to the complexity and time required to perform this analysis on an individual facility basis.

Table 2: Estimated Pension Funding Shortfalls for Facilities by Fiscal Year

Facility	Peer Group	Funding Shortfall 2009	Funding Shortfall 2010
A	1	$20,149	$16,168
B	1	$12,543	$5,912
C	2	$4,302	$1,996
D	2	$24,726	$23,609
E	3	$1,632	$1,246
F	3	$35,707	$30,822

If a PERA participating facility were to privatize today under current law their reimbursement rates would be significantly impacted effective October 1, 2011. The facility would no longer receive reimbursement for PERA because they would no longer have any mandated PERA expense. Should the facility choose to offer a pension benefit as a replacement to the PERA, reimbursement for this would be tied to the rebasing formula and phase-in schedule subject to the limits. Effective October 1, 2011, 31% of the rate is cost-based and 69% of the rate is historically based; effective October 1, 2012 it increases to 48% cost-based and 52% historic; effective October 1, 2013 it increases to 65% cost-based and 35% historic, effective October 1, 2014 it is 82% cost-based, and on October 1, 2015 it reaches 100% cost-based reimbursement. The following table demonstrates the potential un-reimbursed portion of post-PERA pension costs for recently privatized facilities.

Table 3: Pension Funding Shortfalls for Recently Privatized Facilities by Fiscal Year

Facility	Peer Group	Funding Shortfall 2009	Funding Shortfall 2010
G	2	$20,585	$89,202
H	2	$33,972	$58,805
I	2	$35,329	$45,429
J	3	$0	$0
K	3	$29,181	$38,030
L	3	$39,099	$39,594

The table above is likely overestimating the funding shortfall for these facilities due to the assumption used that the successor will incur the same costs for post-PERA pension as the facility incurred for PERA costs when governmentally owned. All of the facilities that have privatized in the past ten years were solicited for feedback regarding post-PERA pension benefits for the purposes of this report. Most of these facilities responded, and in the majority of cases, after the change in ownership, the employees of the facility did not receive the same level of pension benefit from the successor. Typically the benefit level is less, and the cost to the employer is less than what PERA costs were.

IV. Options Considered

Following is a list of the options that were considered which are described in detail below:

1. Treat all pension and PERA expenses as operating costs
2. Treat post-PERA pension costs as a component of the historic operating rate
3. Treat post-PERA pension costs as PERA for privatizing facilities indefinitely
4. Treat post-PERA pension costs as PERA for privatizing facilities for a limited time
5. Treat all pension costs as external fixed
6. Maintain PERA level of funding for privatizing facilities for a limited time and then adjust the rate to the actual pension per diem incurred.

1. **Treat all pension and PERA expenses as operating costs**. Provide reimbursement for PERA, post-PERA and pension in the operating rate and eliminate the reimbursement for PERA as a pass-through cost. This option subjects PERA facilities to the same reimbursement limitations as non-public nursing homes. This puts the PERA and post-PERA facilities at a disadvantage in that they will not have any of the pension costs built into the historic portion of their blended rate. In other words, these facilities will have a much smaller portion of their costs reimbursed until the full phase-in of rate rebasing when the historic portion of their rate is no longer used to calculate rates. By placing all PERA and post-PERA pension costs in operating rather than as a pass-through cost the State does not dictate how the provider must spend these funds. Rather than being limited to use that portion of their rates for pension they would have

the flexibility to use that portion of their rates for any expenditure that they choose. It is likely that this option comes with savings to the State but further analysis would be needed to project the fiscal impact.

2. **Treat post-PERA pension costs as a component of the historic operating rate.** For facilities that privatized on or after October 1, 2006 and prior to being fully rebased, the reimbursement for their post-PERA pension costs will be determined by the following formula. Post-privatization pension costs as a percent of salary would be determined from the cost report for the first full reporting year occurring after privatizing. This percentage would be applied to the salary costs of their APS base rate year to determine the allowable amount. This allowable amount from their base year would then be rolled forward, adjusting for inflation, just as pension costs were for facilities that were never governmentally owned. This adjusted amount would be added to their operating rate effective the first rate year they no longer had any PERA as a pass-through. This would require a manual, one-time facility specific rate setting process for each facility that privatized during the specified time period. October 1, 2006 was chosen as the effective date because the rate impact for facilities that privatized prior to this date was much more modest. If the past history of privatization is any indication, the number of facilities that would have their rates calculated in this manner is limited. This option alleviates much of the funding shortfalls for privatizing facilities and makes the pension cost funding equitable amongst all non-PERA facilities. See Appendix A for suggested bill language.
3. **Treat post-PERA pension costs as PERA for privatizing facilities indefinitely.** Continue PERA as pass-through and add post-PERA pension as a pass-through for privatizing facilities. With pension benefits allowed as a pass-through for some and not others it skews the limits (the median.) This option is the most disadvantageous for the facilities that have always been privately owned. This option provides additional revenue for very few providers. The majority of facilities will be ineligible, which is an equity issue. Most of these privately owned facilities historically have and continue to provide pension benefits for their employees. Under the current reimbursement system these facilities do not get their full pension costs reimbursed. It may be viewed as unfair to reimburse the full pension costs for a few and not the others. A fiscal analysis was done to determine the cost to implement this option for five of the facilities that most recently privatized. The estimated State Share for 2010 is $73,000, and for 2011 is $115,000. These costs will likely increase with the privatization of any additional facilities in the near future.
4. **Treat post-PERA pension costs as PERA for privatizing facilities for a limited time.** Provide for the post-PERA pension to be treated temporarily as a pass-through. The post-PERA pension could be treated as a pass-through until we reach a pre-defined threshold (e.g. 75% rebased), or, for a specified amount of time after the privatization occurs, or, until a pre-determined future date. At the end of the temporary pass-through period the post-PERA pension costs would go into operating for all providers, regardless of when privatization occurred. This alternative makes the post-PERA facilities "more whole" than facilities that were never governmentally owned but for a shorter period of time than option number two above. The non-governmental facilities would not get their full pension costs reimbursed until the time at which we become fully rebased, whereas the privatized facilities would get their full pension costs reimbursed through-out the temporary period and upon full rebasing. The cost to the State for this option

depends upon the number of additional facilities that privatize under the current reimbursement system and when on the rebasing timeline they privatize. Due to the time limiting nature of this option it should be less costly to the State than options three and five.

5. **Treat all pension costs as external fixed.** Include all pension and PERA costs in external fixed for all providers. While this option solves both the under-funded pension and reimbursement inequality issue amongst providers it is likely the option that comes with the greatest expense to the State. Pension costs that are currently under-funded for the majority of the facilities in the State would be fully funded. Taking the average annual unfunded pension costs of the facilities from Table #2 above, $16,510, multiplying that by the number of non-governmental facilities in the State (343), results in an additional State Share cost of over $1,000,000 annually. Much further analysis would be required to determine a more refined estimate of the potential fiscal impact of this option to the State. Once these pension costs become a pass-through the reimbursement for pension costs becomes limitless and facilities may spend more. As a pass-through cost the related reimbursement is included in the rates as incurred; if this portion of the rate is not used to provide retirement benefits to employees it will not remain in the rate the following year. However, the number of employees that receive this benefit and to what level are not dictated, meaning most or all could go to upper management. Some providers may be opposed to the restricted use of this reimbursement and would rather see it in their operating rates so that they may choose how to spend it. Lastly, by making pension costs a pass-through and not treating other benefits in the same manner there is an incentive for employers to choose to provide more in the way of pension benefits over other benefits such as health insurance. Establishing reimbursement for only pension benefits in this manner tends to send the message that we support or promote retirement benefits over any other type of employee benefit.
6. **Maintain PERA level of funding for privatizing facilities for a limited time and then adjust the rate to the actual pension per diem incurred.** Funding for pension will remain at the PERA level until privatizing facilities have the opportunity to build actual costs into their rate. Facilities privatizing on or after October 1, 2006 do not have any historic pension costs built into the APS portion of their rate. This option builds pension costs into the APS portion of their rates based on the actual pension costs incurred during the first year post-privatization. Under this option, for the year of privatization and years one through three post-privatizing these facilities receive funding equal to what they were receiving while they were publicly owned. In year four post-privatizing the rate would be reduced to the actual per diem pension costs incurred during year two post-privatization. This option not only alleviates the funding shortfall but would likely result in a minor windfall for several consecutive years for these privatized facilities. This is due to the strong likelihood that pension costs will not remain at the PERA level. Facilities that have always been privately owned will be at a disadvantage with this option because their pension funding is based on historic costs while the privatizing facilities will be based on current costs.

V. Conclusion and Recommendation

In conclusion, it has been confirmed that a funding shortfall for pension costs does exist for many of the facilities that were privatized. The degree of this shortfall depends primarily upon two factors; the timing of privatization and the level of pension benefit provided to employees post-privatizing. It is also true that a funding shortfall for pension costs exists for many of the facilities that have always been privately owned, but typically not to the same degree as privatizing facilities. The extent of the lack of funding related to pension costs was only calculated for a sample of facilities for this report due to the time required to perform this calculation on an individual facility basis. It would not be reasonable to extrapolate the results of these sample facilities and expect to get any accurate or meaningful average or median for the industry.

It is important to note that any recommendations made for changes to the alternative payment system reimbursement methodology for pension costs will not ensure the financial viability of nursing facilities; there are just too many other factors that play into this. That being said, five of the six options explored in this report would provide for a higher level of funding for pension costs than what is provided for under current law. Options three, five, and six provide for the highest level of reimbursement for pension costs but come with the largest cost to the state. Given the current state budget situation it is unlikely these more costly options could or would be funded. Additionally, options three and six create an inequitable funding mechanism.

The more cost effective options are one, two and four. Option one would not provide any material pension funding for privatizing facilities for many years and would drastically decrease reimbursement for governmentally owned facilities. Option four is merely a band-aid, providing cost coverage for pension for a limited number of years. While option four provides for funding at a higher level than option two initially, it is only temporary, perhaps leading to funding shortfalls in future years and providers returning to seek facility specific legislation. Option two is the most cost effective method of providing some level of pension funding to these privatizing facilities. Option two will come at a cost to the state, but these costs appear generally far less than the pension costs the state incurred for these facilities while governmentally owned and less than what the state would incur under most other options considered. Based on the preceding information, option two is being recommended as the most equitable and cost effective means of closing the gap on the funding shortfall of pension costs.

Section 1. Minnesota Statutes 2008, section 256B.434, is amended by adding a subdivision to read:

Subd. 21. **Payment of post-PERA pension benefit costs.** Nursing facilities that convert or converted after September 30, 2006 from public to private ownership shall have a portion of their post-PERA pension costs treated as a component of the historic operating rate. Effective for the rate years beginning on or after October 1, 2009 and prior to October 1, 2016, the commissioner shall determine the pension costs to be included in the facility's base for determining rates under this section by using the following formula: post-privatization pension benefit costs as a percent of salary shall be determined from either the cost report for the first full reporting year after privatization or the most recent report year available, whichever is later. This percentage shall be applied to the salary costs of the APS base rate year to determine the allowable amount of pension costs. The adjustments provided for in 256B.431, 256B.434, 256B.441, and any other law enacted after the base rate year and prior to the year for which rates are being determined shall be applied to the allowable amount. The adjusted allowable amount shall be added to the operating rate effective the first rate year PERA ceases to remain as a pass-through component of the rate.

Minnesota Department of Human Services
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