

MINUTES OF THE HOUSE KANSAS 2000 SELECT COMMITTEE.

The meeting was called to order by Chairperson Kenny Wilk at 1:45 p.m. on February 2, 2000 in Room 526-S of the Capitol.

All members were present except: Representative Susan Wagle - excused

Committee staff present: Alan Conroy, Legislative Research Department
Julian Efird, Legislative Research Department
Gordon Self, Revisor of Statutes
Jim Wilson, Revisor of Statutes
Janet Mosser, Committee Secretary

Conferees appearing before the committee:

Representative Tim Carmody
Representative Phill Kline
Bob Corkins, Kansas Public Policy Institute
Ron Gaches, Fidelity Investment Company
John Cleland, Security Benefit Group
Dan Hermes, Office of the Governor
Andy Sanchez, Kansas Association of Public Employees
Keith Haxton, State Employees Association of Kansas (written)
Jerry Boettcher, Vice-Chair, Board of Trustees, Kansas Public Employees Retirement System
Pat Beckham, Milliman and Robertson

Others attending: See attached list.

Chairperson Wilk opened the hearing on **HB 2718 - Defined contribution plan for state employees.**

The Division of the Budget letter on the status of the fiscal note was distributed.

Chairperson Wilk recognized Representative Tim Carmody, sponsor and proponent, to address the committee (Attachment 1). Representative Carmody began his testimony but, due to the length of the testimony and the number of conferees scheduled to testify, Representative Carmody yielded to other conferees and agreed to complete his testimony at a later date.

Representative Phill Kline, sponsor and proponent, was recognized to address the committee (Attachment 2).

Bob Corkins, Kansas Public Policy Institute, proponent, was recognized to address the committee (Attachment 3).

Ron Gaches, Fidelity Investment Company, proponent, was recognized to address the committee (Attachment 4).

John Cleland, Security Benefit Group, proponent, was recognized to address the committee (Attachment 5).

Dan Hermes, Office of the Governor, proponent, was recognized to address the committee and expressed the Governor's support for developing a defined contribution plan as a retirement option for state employees (Attachment 6).

Andy Sanchez, Kansas Association of Public Employees, opponent, was recognized to address the committee (Attachment 7).

Keith Haxton, State Employees Association of Kansas, opponent, submitted written testimony (Attachment 8).

CONTINUATION SHEET

Jerry Boettcher, Vice-Chair, Board of Trustees, Kansas Public Employees Retirement System, neutral, was recognized to address the committee. Mr. Boettcher explained his educational and professional background and experience. He made several observations on the current debate including: the importance of fees, minimizing fees with every opportunity, and determining exactly what is being paid and by whom; the need for extensive employee education and identification of who is responsible for the education; fiduciary responsibilities and who is responsible; complexity of monitoring and reporting requirements; the need to study and evaluate the pitfalls of converting from a defined benefit to a defined contribution plan (e.g., compliance and taxation, and financial industry consolidation); the need to be as specific as possible and try to do correct the first time. In his opinion, a choice should be offered and consideration should be given to: a match if a defined contribution plan is adopted, a lump sum retirement option, shortening the vesting period, and how to address the unfunded liability.

Pat Beecham, actuary, Milliamp and Robertson, neutral, were recognized to address the committee. She encouraged the committee to study the issue thoroughly including cost ramifications and basic plan design issues. There is a fundamental difference going entirely from a defined benefit to a defined contribution plan and there should be recognition that if more is given to one group it is being taken from somewhere else. She expressed her concern that the cost impact of the change has not been studied. The GRS report dealt with the short-term impact of all new employees going into a defined contribution plan but did not deal with the impact of allowing members to elect out of the current plan and go into the defined contribution plan. If employees are allowed to elect out of the defined benefit plan and into the defined contribution plan, one can expect employees to make decisions that are in their best financial interest. When that happens, it's going to cost more money. She felt there would be value in doing some modeling. She concluded by again encouraging the committee to study the issue further.

Questions and discussion followed testimony. Jack Hawn, Deputy Executive Secretary, Kansas Public Employees Retirement System, was recognized and assisted in answering questions.

Chairperson Wilk recessed the hearing on **HB 2718**.

Chairperson Wilk adjourned the meeting at 3:37 p.m.

The next meeting is scheduled for February 3, 2000.

KANSAS 2000 SELECT COMMITTEE GUEST LIST

DATE: 2-2-00

NAME	TITLE	REPRESENTING
Sharon Boland	Benefit Mgr	SKS
Len Hughes		D of A
John Collins	asst. HR Mgr.	"
Bob Corkius	Exec. Dir.	Ks Public Policy Institute
Keith Maxton	Lobbyist	SEAK
John Douglas	AVP	TIAA
Theresa Ann Wulke	Asst Council	KCC
Jerry Sloan		Judicial Branch
Richard Brenner		myself
Michael Jordan		"
Rik McAllister		SBG
Trish Heim		SBG
Kara Faxon		Johnson County
Don Seifert		City of Olathe
Dave Sterbone	President	Kansas State Firefighters
B. Marwan	Asst. Dir.	DRS / DofA
Karen Watney	Staff	DRS / DofA
Krista Goggin	Staff	DRS / DofA
Brett Round	Dist. Mgr.	Aetna
Bernie Heffernan	Mnging Dir.	Aetna
Kelci Cheedline	CFU	KPERS
Marie Violet		SBG
John		SBG
David Brunker	Asst. Manager	UALIC

KANSAS 2000 SELECT COMMITTEE GUEST LIST

DATE: 2-2-00

NAME	TITLE	REPRESENTING
Leah R. Chesler	Mn. KPERs	KPERs
Jack Hanna		"
Patrice Beckham	Consultant	M+R
Meredith Williams		KPERs
Denny McLeod	HRP II	Dept of Ag
Allen Humphrey	HR Director	KCC
Dennis Pennington		KDA
Karen White	Secretary	PSU
Joyce Endicott	Stakeholder	PSU
Kathy Benard	Secretary	PSU
Andy Sander	KAPF - Exec Asst Pres	KAPF
Rob Woodward	CIO	KPERs
Ron Gables		Fidelity Investments
Don Cauby	 	DOB

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February 2, 2000

Testimony on H.B. 2718

A. What are the concepts behind defined contribution and defined benefit retirement plans?

In a defined benefit plan the retirement benefit is based on a formula similar to the one currently in use in KPERs: Years of covered employment x 1.75% x final average salary = retirement benefit. In a defined contribution plan, the retirement benefit is a fund which has accumulated during the course of employment.

B. What are the primary features of the two plans?

The features of a defined benefit plan are as follows:

- a. The benefit is known and "guaranteed" by the employer.
- b. The benefit is paid for the life of the retiree (or that life and one other) after his or her retirement and cannot "run out".
- c. The employee cannot access the funds unless the employee leaves employment prior to retirement.
- d. The return on investment accrues to the benefit (or detriment) of the plan, not to individual employees or retirees.

The features of a defined contribution plan are:

- a. The retirement benefit is unknown until retirement.
- b. Employer contributions become the employees property.
- c. Return on investment accrues to the benefit (or detriment) of the individual employee/retiree.
- d. Employee can roll out the account balance, which includes both the employer and employee contributions, into another tax qualified plan if employment is terminated.

C. Further questions and answers.

1. Vesting: What is vesting? What is the current law? What if an employee is not vested? What would H.B. 2718 do?

“Vesting” is the right to receive a certain benefit. Generally, under current law, a state/local/school employee must pay into the system for a minimum of ten years in order to acquire the right to a retirement benefit. That retirement benefit is based on the formula referred to above. If an employee is not vested and leaves covered employment, either voluntarily or not, they can withdraw their contributions with 4% interest. The employer contributions are kept within the fund.

There is no minimum period of employment required in order to receive benefits under the plan proposed in H.B. 2718. Upon termination of employment the balance in the account can be withdrawn and that balance includes all employer and employee contributions as well as accumulated income and capital gain (or loss) attributable to the account.

2. How are gains and losses treated in the two plans?

- In a defined benefit plan gains accrue to the benefit of the fund, not directly to the individual employees and retirees although gains act to mitigate the employer contribution rate and reduce the unfunded liability. Losses are not attributable to the employees directly but in order to compensate the fund for any losses, the employer may have to increase the employer and/or the employee contribution rate or obtain a better than anticipated return on investment.
- In a defined contribution plan, the gains and losses are attributable to each account. The employer has no legal obligation to increase the contribution rate if a given employee’s account incurs losses or preforms at less than an anticipated rate of return.

3. What does the term “unfunded actuarial liability” mean, in simple terms?

- In simple terms, in a defined benefit plan, certain assumptions are made about the future based on presently available information. Some of the factors which are considered include: The number of current and future employees, the amount of payroll over the next two to four decades, the length of time the average employee will pay into the system, the rate of return on investment, the employer and employee contribution rates, any cost of living increases and the rate of inflation.

By converting all of these variables into assumptions, one can calculate the anticipated income and expenses of the system over a given period of time, for example, 40 years. If, over that period of time, the anticipated income from investments and employer and employee contribution rates will be less than the costs (administration, benefits paid, etc.) then the resulting figure is a “short fall” or unfunded liability, of the plan. These actuarial assumptions may be reviewed on a one year, three year or longer bases.

It is possible to be “over funded”, that is, anticipated income may exceed anticipated costs. This is currently the situation in the death and disability portion of the KPERs system.

A defined contribution plan cannot be over or under funded. Each employee’s account is credited with the employer and employee contributions and the return on that account’s investments along with deductions for costs of administration, withdrawals and losses on the investments in the account is the retirement benefit. “What you see is what you get”, both at retirement and during the course of the employment.

4. What is the effect of H.B. 2718 on the unfunded liability of the current retirement system?

The current KPERs system can break down its liability into individualized segments. Therefore, any employee staying in the defined benefit plan after the election date can be attributed a figure, based on their age, years of covered employment, assumed rate of return and assumed salary progression and their portion of the fund’s rate of return which is either a liability or an asset on an individualized basis.

Usually, but not always, an employee who has paid into a defined benefit plan for many years and is nearing retirement has a larger liability than a newer employee. Therefore, if the employees with the relatively higher liability remain in the system and the younger ones leave the system, the unit cost of those remaining will probably rise but the total cost in liability, when expressed as a total dollar amount, may decline.

The unfunded liability could rise both in unit cost and in absolute terms for several reasons:

- No new members joining, therefore no new employer and employee contributions into the system.
- No more new “inactive” members (that is, not currently employed, but their money remains on deposit with the system).
- A less than anticipated rate of return
- Enhancement of benefit package for retirees
- Smaller investment base, that is, funds under administration.
- Losses on investments.

However, with the exceptions of the first, second and fifth reasons, all of these are currently factors anyway. The unfunded liability could also decline for several reasons:

- Larger than anticipated number of “high unit cost” employees switch to the new plan.
- Inactive members could be frozen in place in the defined benefit plan and not allowed to make withdrawals.

- A greater than anticipated rate of return for the fund.

5. If there is an unfunded liability, when must that obligation be met, that is, paid for?

The amount of unfunded liability is expressed as the difference between the value of assets and the cost to meet all future obligations. Like any situation which is based on the time value of money, the more money one can set aside in earlier years the easier it is to meet a later obligation. A large liability over 40 years is more easily addressed by funding it at a much smaller amount in the earlier years than waiting until the liabilities actually accrue.

Once an election is made by the current defined benefit plan participants, the unfunded actuarial liability would then be calculated. This liability could be addressed by one or any combination of the following:

- Raise the employer contribution rate for the remaining defined benefit plan participants.
- “Lock in” inactive members or do not allow withdrawal of the employer contribution.
- Lower the employer contribution rate for defined contribution plan participants.
- One time or multi year special appropriation. (“Prime the pump”)
- Raise the projected rate of return (not a recommendation).

6. How are the problems of inflation (and deflation) addressed?

In a defined benefit plan, theoretically, salaries increase with inflation although they do lag behind, especially in government employment. As salaries increase for covered employees, the employer and employee contribution rates, although steady, generate correspondingly greater income to the system. In addition, all of the fund’s investments, being properly diversified, should equal or exceed the rate of inflation. If the real rate of return lagged behind inflation, the unfunded actuarial liability might increase and the taxpayers would have to pick up the difference.

In a defined contribution plan, again, although contribution rates might remain steady, the total contributions would increase with the salary base. However, because each employee account may vary in its range of investments, a given account may exceed, equal or fall behind the rate of inflation. Since there is no unfunded actuarial liability in a defined contribution plan, there would be no liability to the taxpayers to make up the difference.

In a deflationary cycle, wages would stagnate although government employee salaries have not historically decreased in relationship to the decline. In a defined benefit plan

the rate of return on total investments may fall and, if so, the taxpayer might have to make up the difference, usually through higher contribution rates. In a defined contribution plan wages, and hence contribution rates, would not in all likelihood fall but account balances could fall. All of the risks in this case would fall upon the employee and none upon the employer since there is no "shortfall" that would have to be made up.

7. What are some of the tax implications in this defined benefit/defined contribution plan discussion?

On the federal level, in both defined benefit/defined contribution plans, income tax on both the employer and employee contributions are tax deferred. Taxes are paid when funds are distributed.

In the current KPERS plan, the employee does pay state income tax on the contributions in the year in which the contributions are earned. However, benefits are exempt from state income tax when distributed. (This is similar to the relatively new Roth IRA).

Under H.B. 2718, the new defined contribution plan participants would be taxed for state income tax purposes the same as under the federal law, that is, contributions would not be subject to income tax at the time they were paid into the system but the benefits would be taxed on all plan distributions unless rolled over into another tax qualified plan. This bill would necessitate amendments to the tax code.

Any defined benefit plan participants converting to the defined contribution plan would have their contributions treated the same as under federal law, that is, prior contributions under the defined benefit plan would not be taxed at distribution under Kansas law. There is a precedent for this since before 1981 the law in Kansas was the same as the federal and, therefore, there are currently KPERS retirees whose distributions are taxed in two different ways, depending on when they were contributed to the system.

In 1998, Kansas income tax on employee KPERS contributions was \$8.7 million. This would drop since all defined contribution plan participants after October 1, 2001, would have their contributions tax deferred. All employees continuing to contribute to the defined benefit plan would continue to pay Kansas income tax on their contributions but not on distributions. Although revenue would drop, it would not forever disappear. Due to that "time value of money" idea, the tax deferred accrual in the defined contribution plan participants' accounts could generate significantly more revenue than under current tax policy. This is certainly proving to be the case now as the WWII and baby boom generations move into retirement and start taking distributions of their tax qualified plans.

8. **What about death and disability provisions?**

Currently there are two death provisions and one disability provision in KPERs dealing with non-duty injuries. For active employees, the basic death benefit is equal to 150% of the annual rate of compensation and a return of contributions plus 4% interest. For retirees there is a lump sum payment of \$4,000 and return of unused contributions plus 4% interest. As for disability, the system provides two-thirds of the annual rate of compensation with a 180 day waiting period, reduced however, by the amount of worker's compensation and social security that the retiree receives. It is important to note that this is funded separately from the retirement system with an employer contribution rate of .6% of payroll. There is no employee contribution for this program.

Under the defined contribution plan, the current death and disability plan could be continued or modified with group life or group disability options with any savings reallocated to reduce the defined benefit plan's unfunded liability.

Payout options on retirement would also differ significantly between the two plans. Under a defined benefit plan there are currently options for a life certain, joint and one-half, joint and full, and joint and three-fourths to survivor selections. Once the retiree selects an option, which is done at the time of retirement, the benefit is frozen in place. It is not unusual for retirees to guess wrong, that is, they outlive their "survivor" and there are also situations where neither one lives long enough to recoup the employee contribution, much less the employer contribution. In fact, if one stops and thinks, odds are (that is speaking actuarially) that many of the retirees will not recoup the employer and employee contributions that they have accrued over their lifetime.

In a defined contribution plan, the balance in the retiree's account is fully the property of the retiree. The retiree can die the day after retirement, or 40 years later, but whatever is in the account is theirs. The funds in the account will presumably continue to grow after retirement thus providing some hedge against inflation. The retiree can designate any beneficiary for the account upon his or her death.

One of the conferees did mention the "longevity risk" which is the risk that a retiree might "outlive" the funds in his or her defined contribution plan account. However, with the Social Security and Medicare continuing for the life of a retiree, and with proper planning (for example, long term care insurance) this scenario is unlikely unless the retiree did not participate in the plan for very many years or began covered employment late in life. However, these are problems not unique to state or local employees but are risks shared by anyone in the private sector.

9. What are the relative costs of administration of defined benefit and defined contribution plans?

Generally speaking, a defined benefit plan “costs” less. One reason is that there is no need to manage individual retiree/employee accounts and therefore the paperwork involved is less. The defined contribution plan can negotiate lower fees for its plan participants due to the relative size of the fund, but the fees would probably still be higher in the aggregate. To compare, the current cost of administration for KPERS is .057% of assets under investment vs. .8% for the State 457 plan.

I would point out that the rate is somewhat deceptive. In a defined contribution plan the administrative costs have a direct effect on the rate of return. However, in KPERS the lower administrative cost does not have any direct effect on the retirement benefit of any particular employee. Instead, it increases the “spread” between costs and return on investments and the benefit accrues indirectly by reducing the need for higher contribution rates or rates of return.

10. What are the relative protections for employees and retirees under both systems?

Under a defined benefit plan the full faith and credit of the State of Kansas guarantees the benefits. The losses incurred in the early 1990's had no effect on retiree benefits since those benefits are backed by the state. However, even public defined benefit plans which are under funded can be terminated and participants “cashed out” with available assets. Although legal, this might not be politically feasible. At one time, the teachers retirement system in Kansas was practically bankrupt and it continues to be the reason for the unfunded liability currently being addressed by KPERS almost 30 years after it was incorporated into KPERS.

Under the defined contribution plan, the state does not guarantee any minimum amount or return. House Bill 2718 requires that any fund manager be preselected by the KPERS Board of Trustees. All investment managers would, of course, be regulated by the U.S. Securities and Exchange Commission and regulated under the Securities Act of 1940.

11. Could KP&F members participate in the defined contribution plan under H.B. 2718?

No, not as currently drafted, although it could be amended to give those plan members the option. Since benefits under KP&F are significantly more generous than under standard KPERS, and contribution rates are therefore higher, it would seem unlikely that a current KP&F member, especially one who had been paying into the plan for some time, would elect to go into the defined contribution plan.

Not all police and firemen are in KP&F. Most smaller employers (county and city) have elected regular KPERS for their police and firemen, rather than KP&F. H.B. 2718 as drafted would allow those members to convert to the new system and all new hires would be put into the defined contribution plan.

12. Can the employer contribution rate be varied?

Yes. Under KPERS the state employer contribution rate, not including death and disability, has fluctuated from a high of almost 8% to a low of 3.1%. Under the proposed defined contribution plan the employer contribution rate cannot be decreased during a term of employment but could be decreased for new hires after a given date. As always, under either plan, the employee contribution rate can be increased or decreased, with certain restrictions.

13. Would the plan established by H.B. 2718 be compatible with other retirement plans in which an employee (for example, a teacher) might participate?

There is no flat prohibition on participation in other plans. There are maximum contribution limits on various plans and combinations of plans. (See Attachment A.)

14. What investment advice is available to employees and retirees?

Under the current defined benefit plan, KPERS designates an employee to be the local KPERS agent for a given employer. This agent is not paid by KPERS but is offered training by KPERS staff. The ability of these agents varies considerably from outstanding to poor. KPERS does have a telephone information line so that employees and retirees can submit inquires and receive advice. To be fair, investment advice to plan participants is simply not required in a defined benefit plan. However, due to the complexity of the defined benefit rules KPERS does spend a significant amount of staff time handling inquiries.

Under H.B. 2718, one factor in selection of a fund provider is that it provide education and “continuing investment counseling and retirement decision counseling” to plan participants.

15. What about legislator retirement plans?

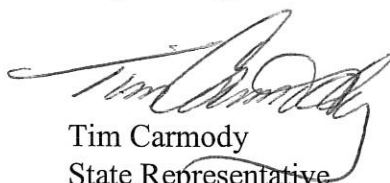
Because legislators participate in KPERS, they will also have the option to convert to the new plan.

16. **What are some “intangible” factors in H.B. 2718?**

- A defined contribution plan should be more beneficial in the hiring and retention of government employees than the current system.
- A defined contribution plan provides a much greater degree of portability of benefits than a defined benefit plan.
- A defined contribution plan may reduce or eliminate constant disputes over post-retirement employment and levels of compensation and issues associated with multiple employers.
- KPERS is older than much of the tax code. As such it has a “Rube Goldberg” complexity. A defined contribution plan is simple to understand, both in concept and in operation.
- Over time a new defined contribution plan will wean retirees from agitating for post-retirement cost of living adjustments which, as I have no need to remind you, are never funded by either the employer or the employee during their years of employment. This is like granting a retiree more money because they didn’t put enough away during the term of employment. This concept is alien to a defined contribution plan. After all, Regents unclassified employees have not rallied on the courthouse steps for a cost of living adjustment for their retirees since they converted to a defined contribution plan many years ago.
- Please maintain a “one-time” option to convert to the defined contribution plan for current plan participants. As the plans develop over time there will be agitation to reopen the window. To reduce the possibility, consider establishing a penalty to discourage transferring.

Conclusion - H.B. 2718 is a win - win bill. It is a win for the government employees and it is a win for taxpayers. I urge your support.

Respectfully,



Tim Carmody
State Representative
16th District

TC:jb

1-10

SNAPSHOT COMPARISON OF GOVERNMENTAL RETIREMENT PLANS UNDER INTERNAL REVENUE CODE

Code Section	Taxation	Contribution Limits	Benefits Limits	Distribution Forms
401(a) Defined Benefit	<ul style="list-style-type: none"> • No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits 	Employee contributions limited to lesser of \$30,000 or 25% compensation	\$135,000 year, but can pay more through QEBA	<ul style="list-style-type: none"> • Rollovers to IRA or qualified plan • Lifetime annuity guaranteed by Fund • Lump sum available • Disability Benefits • Death Benefits • Health Benefits Account
401(a) Defined Contribution	<ul style="list-style-type: none"> • No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits 	Lesser of \$30,000 or 25% compensation for employees <u>and</u> employer contribution	N/A	<ul style="list-style-type: none"> • Rollovers to IRA or qualified plan • Lump sum • Periodic payments available • Guaranteed lifetime benefit available through commercial annuity • Health Benefits Account

Code Section	Taxation	Contribution Limits	Benefits Limits	Distribution Forms
401(a) Hybrid Plan	<ul style="list-style-type: none"> • No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits 	Contribution limits will apply to defined contribution-like features	Generally structured to use defined benefit limits	Rollovers to IRA or qualified plan <ul style="list-style-type: none"> • Lifetime annuity guaranteed by Fund • Lump sum available • Disability Benefits • Death Benefits • Health Benefits Account
403(b) Tax Sheltered Annuity	<ul style="list-style-type: none"> • No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits 	<ul style="list-style-type: none"> • \$10,500 on voluntary employee contribution (salary reduction) • Lesser of \$30,000 or 25% compensation for employee <u>and</u> employer contribution • Maximum exclusion allowance for employee and employer contribution 	N/A	<ul style="list-style-type: none"> • Rollovers to IRA or 403(b) plan • Lump sum • Periodic payments • Guaranteed lifetime benefits available through commercial annuity • Can add periodic payments
457(b) Deferred Compensation Plan	<ul style="list-style-type: none"> • No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits 	\$8,000 or 33 ^{1/3} % of includible compensation for employer <u>and</u> employee contribution	N/A	<ul style="list-style-type: none"> • Transfers to other 457 plans • Lump sum • Periodic payments • Guaranteed lifetime benefits available through commercial annuity

February 2, 2000

Representative Kenny Wilk
 Chairman, Kansas House 2000 Select Committee

Dear Mr. Chairman and Members of the Committee

Thank you for the opportunity to appear before you today in support of HB 2718. This legislation will allow all state employees to participate in a benefit program now enjoyed by those in the private sector and a select few state employees. The issue before you today is one of fairness, faith and opportunity. Fairness in treating all state employees equally, having faith in our state employees and the decisions they make and allowing the opportunity of greater choice regarding the allocation and use of the assets of our employees.

I will not diminish some of the complex considerations involved with this bill, however, the workings of the bill are really rather simple – state employees will be allowed the irrevocable choice of participating in a defined contribution plan or a defined benefit plan. Each plan holds its own benefits and risks and I am confident with adequate education that our employees are capable of making the correct choice for their future, just as they do with innumerable decisions everyday.

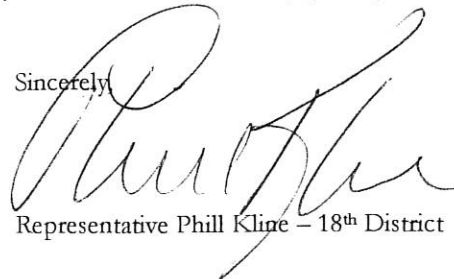
I share with you a concern about the actuarial soundness of the current KPERs defined ^{benefit} contribution plan, which now is 86% funded. But numerous states with greater unfounded liabilities have afforded this choice to their employees with programs that are meeting with success and which protect current participants in defined contribution plans. Furthermore, there are several ways to address concerns regarding adverse selection and the existing unfounded liabilities, including adjusting the time frame for vesting, reducing the state contribution percentage for the defined contribution plan and other adjustments as well.

In short, the concerns can be addressed while the benefits are tangible. Long-term investment directed by citizens with a direct financial interest in the outcome of the investment, has consistently, by any measurement, outperformed defined benefit portfolios. Quite frankly, it is wrong to tell our state employees they cannot have the choice to use their funds as they deem fit. Regardless, in many ways, the vagaries of the market have not been as burdensome as the vagaries of the political process.

This bill will also solidify the state's financial position. The current unfounded liability demonstrates how political expedience does not fit an actuarial table – in the future, as in the past, the soundness of the defined contribution plan is undermined by short-term political thinking. Conversely, although some may make mistakes, citizens generally have a longer-term mindset regarding the health of their families than the outlook of elected officials facing reelection.

Mr. Chairman, I know that you have been diligently reviewing this issue now for the past year and have had numerous experts appear before your committee. There is not a need for me to exhaustively review the bill. I simply urge your support so that the employees of our state can fully participate in the dynamic opportunities now afforded to millions.

Sincerely,



Representative Phillip Kline – 18th District

Kansas 2000 Select Committee

Meeting Date 2-2-00

Attachment 2



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Washburn University

February 2, 2000

Testimony before the Kansas Legislature
House 2000 Select Committee
Re: Defined-contribution Option for KPERS

by
Bob L. Corkins
KPPI Executive Director

Honorable Chair and Members of the Committee:

My name is Bob Corkins, president and executive director of the Kansas Public Policy Institute. KPPI is a nonpartisan, nonprofit research firm that educates people about free-market economic principles in the context of today's important public policy debates. KPPI was founded in Wichita in 1996, is now based in Topeka, and continues to decline any government funding of our work.

KPPI's direct involvement with the Legislature is minor, but our substantial research into the topic of "defined-contribution" reform for public pensions warrants my appearance today to explain our reasons for promoting the concept. The proposal before you now embraces that idea, as do other bills introduced this session. I will limit my comments to the general issues in question rather than the specific language of any given bill.

The Kansas Public Employees Retirement System (KPERS) is a traditional *defined benefit* (DB) pension plan which is very common among governmental units throughout the U.S. However, such plans have begun to give way to the popular *defined contribution* (DC) system, like 401(k) plans, which millions of private sector employees have embraced for many years.

While the current unfunded liability of KPERS (now roughly \$1.4 billion) is an impetus for change, there are many other reasons why taxpayers and government workers would be better served with a new optional DC program.

I do not downplay the tremendous value from the employers' perspective (i.e. state and local governments' management concerns). With a DC plan, there is no unfunded liability for any covered workers, there is no need or reason to adjust benefits for inflation, and the budgeting process is greatly simplified and stabilized.

But the other advantages of DC — those which I emphasize most strongly and which are all to the gain of employees — include: greater *portability* of retirement plans when changing from one job to another; greater retirement *benefits* for most workers; faster *vesting* by workers in employer contributions; employee *ownership* of funds in their retirement accounts (and the advantages which come with that ownership); substantially reduced *discrimination* that stems from inherent limitations with any DB program; and the *de-politicization* of retirement security.

(more, over)

Kansas 2000 Select Committee

Meeting Date 2-2-00

Attachment 3

I'll elaborate on the discrimination issue. This is the nature of a DB program: an annuity benefit for every year an individual lives past retirement age. As a result, DB programs most greatly favor white females who have continuous work histories. Statistically, such people have the longest life expectancies. On the other hand, black males receive the lowest retirement returns as a group because they have the shortest average life expectancies.

Adding to this discrimination, DB plans are also regressive in nature. According to a 1998 federal government report, longevity is directly related to income level. The poorest workers have the shortest life spans and each successive economic group has a longer life expectancy. Although every employee pays the same percentage of salary into the retirement fund for each year of employment, those who live the longest enjoy the greatest return. This factor characterizes DB pensions as essentially being wealth transfers, transferring money from poorer to wealthier individuals, from men to women, and from blacks (in particular) to all other racial categories.

Even healthy workers who are likely to beat the life expectancy odds must consider whether they will eventually be entitled to DB benefits. At question is their probability of working at least 10 full years in KPERS to become vested in the plan. In fact, official KPERS projections show that the majority of those who start working today at the state and local level will never become vested. This means when they leave their government jobs, they will receive the equivalent of their personal contributions to KPERS plus four percent interest — no entitlement to pension benefits, no employer contributions, and no market earnings on their money.

Certain categories of employees are much less likely to vest than others. Those least likely to remain at work after ten years are females starting now under age 25 in state employ. The latest statistics indicate that only 11% of these women will vest in KPERS. Even the group most likely to vest, females beginning work today for a local Kansas school at age 45 and above, will still lose over 40% of their ranks before ten years have gone by.

Something is profoundly wrong with a DB pension set-up that relies for its solvency upon most of its participants forfeiting their money or dying prematurely. In contrast, a DC program that allows workers to quickly and fully establish personal ownership of their own accounts is profoundly more just. Even upon an untimely death, the workers' estates would pass to their families for the betterment of future generations.

Much debate has, appropriately, centered on the idea of investment security. Dr. Lawrence Kochard, who authored KPPI's latest study and who we brought here to testify last week, provided extensive advice about how to fashion investment options to make this risk even more negligible than it already is. I'll defer to expertise.

Finally, I'll remark on the benefits of taking politics out of KPERS to the greatest extent possible. If individuals are making their own investment choices, then the possibility of having state-favored politically targeted investments is gone. Also gone, or at least substantially lessened, would be the state's latitude to alter rates, benefits or economic assumptions in a way that — although perhaps unintended — might jeopardize the program's future solvency. Furthermore, workers would no longer need to picket the Statehouse and expend their political capital year after year in demand for a modest inflationary adjustment to retirement benefits. With all due respect to lawmakers, workers would no longer need to rely on the Legislature's benevolence in order to brighten their own retirement futures.

Thank you for this opportunity to share our Institute's findings.

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**McGILL
GACHES**



& ASSOCIATES INC.

GOVERNMENT AFFAIRS & PUBLIC RELATIONS

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Testimony of Ron Gaches
McGill, Gaches and Associates

On behalf of Fidelity Investment Public Institutions Services

In support of HB 2718
Relating to Defined Contribution Plan for KPERS Members

Submitted to Kansas 2000 Committee
February 2, 2000

Kansas 2000 Select Committee

Meeting Date 2-2-00

Attachment 4

Thank you Chairman Wilk for this opportunity to appear before your committee regarding House Bill 2718. I am Ron Gaches, President of McGill, Gaches and Associates and I appear today on behalf of the Fidelity Investments mutual fund company.

We have closely watched the deliberations regarding the Defined Contribution retirement plan develop over the past two sessions. During that time there have been some excellent conferees before the Joint Committee on Pensions, Investments and Benefits and the House Kansas 2000 Committee.

Those conferees and other presenters have not been in total agreement. That's not surprising since they have represented several different stakeholders in the discussion about state retirement programs. Still, there are several common themes that have started to appear that are consistent with the positions of the Fidelity Investments Company. I would like to review those with you today.

First, we believe that employee choice is fundamentally a good thing. It has been said one way or another by virtually every conferee that not all employees have the same needs, and that some types of retirement plans are a more logical fit for certain categories of workers than others.

In effect, a one-size fits all approach is not the best approach for all state employees.

Of course the state must decide which of its employees is the KPERS retirement system intended to serve. The current system is clearly designed to benefit the long-term employee, the employee who works a minimum of ten years or more in the KPERS system.

That may have been a great plan design when the primary motivation of the state was to hire and retain workers for long-term assignments in state government.

In the current fast-paced, rapidly changing, technology environment, the employment needs of state government seem to be changing. More employees are needed for shorter-term assignments or for positions that are expected to grow and change over the years.

The needs of many employees seem to be changing as well. Fewer employees seem content to work for the same employer for a long period of time, making portability of retirement benefits a growing concern for many employees.

Based on the many of the comments by various conferees, a defined contribution plan should be one of the choices available to KPERS plan members.

Second, a defined contribution plan should probably be optional for both existing and new employees. This is not the position of all defined contribution supporters, but it seems to reflect the interests of most of the stakeholders in the retirement discussion.

An optional program allows the state to avoid the painful and expensive issues associated with elimination or phase-out of the current defined benefits program. Also, it allows the marketplace to determine which type of retirement plan meets the needs of most employees. If you believe

fundamentally that employee choice is a good thing then it seems consistent that a defined benefits option like the current KPERS plan ought to be one of those choices.

Thirdly, KPERS should take the lead in controlling and implementing any plan to introduce the defined contribution option.

Meredith Williams and his staff already have established expertise in the selection of sound investment options. A simple and efficient implementation of a defined contribution plan should allow KPERS to select the best investment options for each major asset class, ranging from the least aggressive fixed return and index funds to the most aggressive funds.

The experience in other public and private sector plans indicates that a range of 9 to 14 different investment options is probably an appropriate number. If KPERS does a good job of identifying the major asset classes and a good job of selecting among the best performing options in each class it isn't necessary to offer multiple options within each asset classes.

Keeping the plan simple with a limited number of investment options keeps the administration of the plan simple and holds down the cost of the plan. As several conferees have observed, with the purchasing power of the state, KPERS should be able to leverage the size of a DC plan to extract very competitive fee structures from the fund companies.

Fourth, KPERS and the KPERS Investment Board should maintain the fiduciary responsibility for on-going investment performance. KPERS should monitor the long-term investment performance of the funds in the DC plan and when an investment option has demonstrated that it is no longer performing at the top of its asset class for an appropriate time it should be replaced.

Creation of a DC plan should not be an open invitation to create a new class of day traders. Rather, the intentions should be to encourage long-term investments in sound investment choices and educate employees how their asset allocation should evolve over time.

A plan that encourages frequent transfer of assets among investment choices will generate additional and unnecessary administration and transaction fees.

Fifth, KPERS should maintain control over the Pension Choice education effort as well as the on-going education program for the overall retirement system. KPERS made decide to outsource the "Pension Choice" education program, and it should have discretion to do so.

However, it is not in the best interest of the state or plan participants to allow each of the different investment options to mount its own employee "education" program. That scenario would promote unnecessary employee confusion.

KPERS should create an education environment not a sales environment. KPERS' members don't need commissioned sales persons calling on them selling the alternative investment options within a DC plan. Rather they need an unbiased education program that is fact-based and even handed. Only then will they be able to make the best-informed selection between a Defined

Benefit and a Defined Contribution plan, and select the best investment options for themselves within a DC plan.

Sixth, KPERS should have the opportunity to outsource the administration functions it deems appropriate for the proper implementation of a new DC option. This may include the selection of a master record keeper or a common remitter for payroll consolidation. Leveraging the size of the KPERS system should promote very competitive bids for this "back of the house" functions.

Seventh, if portability is an important criterion for KPERS members then real portability should be provided. Although there may be appropriate reasons to limit the frequency of asset transfers, such transfers should be allowed without financial penalty. There should be no cost restrictions or penalties for exchanges between investments or transfers among investment providers.

Similarly, withdrawals or rollovers from participant accounts should be subject to no penalties or restrictions other than those imposed by federal law.

The retirement needs of KPERS members are nearly as varied as the employees themselves. Just as importantly, their needs change over time. Similarly, the employment needs of the State and other KPERS employer participants are evolving.

These ever changing needs cannot be met by offering employees only a defined benefits option. It makes sense for the state and for KPERS members to offer employees a choice of a defined benefit or defined contribution plan.

Fidelity Investments encourages your favorable consideration of a Defined Contribution plan and passage of House Bill 2718 incorporating the recommendations we have described today.

Thanks you Mr. Chair

Date: February 2, 2000

To: Members of the Kansas 2000 Select Committee

From: John Cleland
Senior Vice President and
Chief Investment Strategist
Security Benefit Life Insurance Company

Subj: Defined Contribution Pension Plans

My name is John Cleland and I am Senior Vice President and Chief Investment Strategist for Security Benefit Life Insurance Company. I also serve as President and Director of the Security Fund Group. Security Benefit has nearly \$10 billion of assets under management. Our Company's primary business consists of annuities, mutual funds, retirement plans and institutional markets. We currently manage 18 public mutual funds and 17 series of variable annuity products.

Security Benefit is a Kansas domestic company licensed either directly or through its subsidiaries to do business in all 50 states. It employs nearly 600 people, most of whom reside in Kansas. It has annual sales in excess of \$1 billion with a net worth of over \$530 million.

I appear before you today to address the subject of defined contribution pension plans. This is an area in which I have worked for more than 40 years.

I wish to address three primary areas concerning defined contribution plans. They include investment risk, participant education and fund regulation.

1. Risk of unfavorable Investment Returns:

Opponents to the conversion of governmental defined benefit (DB) retirement plans to defined contribution (DC) plans often focus on supposed great risk of bad investment returns in plan participants' investment accounts. In the short run, some equity investment funds can be volatile and some participants will do better than others. With carefully selected, diversified equity investment options, over the longer term appropriate for retirement planning, returns are much more predicible and short term differences between participants tends to even out.

- ◆ Historically, stocks have shown a positive return over any 30 year term selected from 1802 through the present, on both a nominal basis and on a “real,” inflation adjusted basis.
- ◆ Also, since the Civil War, stocks have consistently outperformed bonds over any 30 year period examined.
- ◆ Even if a participant gets caught in a down market at the time of retirement, he or she may be able to take distributions from the accounts in installments or rollover the account balance into an IRA, in either case recouping short term losses.

2. *Participant Investment Education:*

Differences between plan participants and the risk of bad participant investment decisions can be greatly reduced through effective participant investment education. Fund providers are generally very good at providing participants with basic investment education, such as the importance of diversification, portfolio establishment and management over time and in different life circumstances. If a uniform “base” of investment education is desired, the KPERS Board of trustees, with the assistance of staff and consultants, could develop a basic program of educational materials, training, portfolio models, and updates or reminders, with fund providers supplementing that effort with their own materials and training.

- ◆ The quality of participant investment education programs could be part of the fund selection and contracting process, with fund providers required to also provide post retirement investment planning materials, even after accounts are rolled over from KPERS plan accounts.
- ◆ Many plan distribution options, like lump sum, installment, and variable and fixed annuities, with or without survivor protection, can be offered to accommodate a wide variety of participant needs and investment preferences. Although maximum participant flexibility should be offered, a partial annuity pay out can be mandated.
- ◆ Although investment restrictions can be provided in the form of maximum percentages of investments in aggressive funds and restrictions on fund transfers, etc., restrictions can increase administrative costs and effect participant satisfaction. Successful experiences in the exploding private DC plan market should serve as a guide to the wisdom of restrictions.

3. *Regulation of Fund Providers.*

Private DC fund providers are extensively regulated. KPERS DC plan fund provider selection and review would only be needed as a minimal addition to very heavily regulated entities.

- ◆ All publicly offered investment funds, including mutual funds and variable annuities, are extensively regulated and supervised by the Securities Exchange Commission

(SEC) under the Securities Act of 1933 and the Investment Company Act of 1940, while their investment advisors are regulated by the Investment Advisors Act of 1940.

- ◆ These funds and their distributors are universally regulated by an even more exacting network of member rules established by private organizations, such as the National Association of Securities Dealers and the North American Securities Administrators Association.
- ◆ In addition to federal and association rules and regulations, fund providers are regulated by State Securities Administrators and State Insurance Commissioners, who also monitor the solvency of Insurance Company fund providers.
- ◆ The cost of management fees and distribution expenses required by these multiple layers of rules and regulations is a large portion of the claimed additional expense of private fund providers in a DC plan, as well as the additional cost of individual account management. Yet no one suggests that this regulatory scheme ought to be circumvented—it provides invaluable protection for plan participants and actually increases, not decreases, participant satisfaction with and trust of the system compared to many State DB retirement systems.

I appreciate the opportunity to present my views on this today. I would be glad to respond to any questions you might have.

STATE OF KANSAS

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OFFICE OF THE GOVERNOR LEGISLATIVE TESTIMONY

TO: Chairman Kenny Wilk and Members of the Kansas 2000 Select Committee
FROM: Dan Hermes, Director of Governmental Affairs
DATE: February 2, 2000
SUBJECT: HB 2718

Mr. Chairman and members of the committee, thank you for the opportunity to appear today to express the Governor's support for developing a defined contribution plan as a retirement option for state employees.

As you are aware, defined contribution plans are available for select unclassified employees such as myself and cabinet secretaries, as well as for unclassified employees of the Board of Regents and Regents Universities. Defined contribution plans are also the overwhelming choice for retirement plans in the private sector. This bill provides this option for other state employees.

The reason for the Governor's support for broader use of defined contribution retirement plans is simple: state employees should be in charge of the management of their retirement dollars, not the government.

The existing KPERS defined benefit plan, to be clear, has been generally well managed and has served the state well. It is time, however, for change. As we have seen in other states, there is a strong movement to develop employee managed plans and the Governor supports moving in that direction in Kansas.

I would be happy to respond to any questions.

Kansas 2000 Select Committee
Meeting Date 2-2-00
Attachment 6

Testimony of Andy Sanchez, Executive Assistant to the President
The Kansas Association of Public Employees, KAPE/AFT, AFL-CIO
Before the Kansas 2000 Select Committee
On HB 2718

Delivered February 2, 2000

My name is Andy Sanchez and I am the Executive Assistant to the President of the Kansas Association of Public Employees. As a public employee organization, it is one of our goals to take an active role in regards to issues affecting public employees. Retirement is no exception. KAPE has many retirees as members of our organization. This testimony on HB 2718 is to provide you with an up to date sentiment since much more information has been relayed and deliberated upon. This committee, the joint committee, and KPERS deserve high praise for the considerable research, history, and projections provided to the public. Though much of the information provided attempted to address the speculative nature of a defined contribution retirement plan, KAPE believes the possibility for gain or loss under such a plan can not compare with the predictability and security of the current defined benefit retirement plan.

KAPE members put great value in the inherent security and the elimination of uncertainty in the current defined benefit plan. It is a constant that can be calculated early in the employee's public service career, throughout their public service career, and at the time of retirement. The current defined benefit plan is built on preciseness, security, and even flexibility. Preciseness in the formula used for calculation, security in the guarantee of a fixed benefit amount, and flexibility to utilize an optional deferred compensation program with yet more options.

As one speaker related to this committee you are in effect, a trustee. As a committee member you assume a huge responsibility. Thus, it is easy to understand your interest in reducing the state's future liability. KAPE understands your sincere intention to invest in the state's most valuable commodity, our public service employees. KAPE believes this dilemma is best addressed with a defined benefit plan because a defined contribution plan is based on too many assumptions.

First, that the market will be favorable to earn 8% or better. KPERS can predict an 8% return on investments long term. With KPERS, advantages enjoyed such as administrative costs and "purchasing power" in the investment market now become disadvantages in a defined contribution plan. If it is in question whether individual employees can meet or exceed an 8% rate of return over the long term, the option of a

defined contribution plan surely would not be a responsible and prudent choice of this committee.

Second, that the political aspect can be removed from the process by moving to a defined contribution plan. This may not be necessarily so, as employer contribution can and may be fluctuated as some information relates. In addition, a COLA (Cost of Living Adjustment) still may be a possibility and this is almost always political. This is especially true if plans are tailored to reflect neither a full-fledged defined benefit or defined contribution plan, but a combination of both.

Third, the defined contribution plan will help the state compete in the job market for young better qualified professionals. I have not seen any data to support this or the opposite contention. A similar case can be made that young people are uninterested in retirement and don't care about future pension benefits. In fact, in many cases quite the opposite, they want the money now. This in fact could promote a revolving door in the quality state workforce in place today. A proponent of a defined contribution plan describes this as a highly mobile workforce, and KAPE agrees. A change from defined benefits to defined contributions would further encourage that mobility leading to great instability in the workforce and the programs they administer.

In summary, KAPE favors the current defined benefit plan administered by KPERs. KAPE is not opposed to amending the current plan to include matching the employee's contribution to fully fund the plan. KAPE would also support granting automatic COLA's to correspond with inflation. KAPE supports elements of the bill that provide education for employees with regard to retirement issues. This would be true under any plan. And, not just issues affecting their own future and personal investments, but to raise consciousness on all issues, such as ETI's (economically targeted investments) and discrimination issues, especially women who leave work to raise a family. KAPE believes it is admirable to address lengthy vesting problems and to raise this consciousness. KAPE supports the continuance of death and disability benefits as provided for in the defined benefits plan. KAPE disagrees with a plan that may permit in-service access, such as loans, hardship distribution, and withdrawals. In current times priorities between wants and needs often become confused and vision becomes resolving immediate issues verses planning for the golden years. Since a traditional defined contribution plan is always fully funded in theory, there is no future liability for the employer. A change from our current defined benefit to a traditional defined contribution is viewed by many KAPE members as the transfer of investment risk from employer to employee and the elimination of complete assurances.

Thank you for allowing me to express KAPE's position on this matter and I'll be happy to answer any questions you might have.

STATE EMPLOYEES ASSOCIATION OF KANSAS

February 1, 2000

Chairman Kenny Wilk
Kansas 2000 Committee
State Capitol
Topeka, Ks. 66612

re: HB 2718

Dear Chairman Wilk,

Due to scheduling conflicts and illness, the *State Employees Association of Kansas* will not be able to offer testimony regarding HB 2718. I am, therefore, writing you to advise the committee that the Association has strong reservations concerning the aforementioned bill.

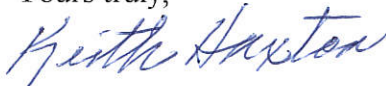
Our chief concern is that allowing current KPERS members to opt out of the current defined benefit system will deplete its funding base and increase further the unfunded liability of the system. As you are aware, a significant source of funding would be lost if younger workers were allowed to leave the plan. The only source SEAK is aware of that would makeup for lost funding without increasing benefits would be increased employer contributions. The Legislature historically has been reluctant to fully fund its obligation to KPERS.

The faith state employees had in the operation of their retirement system was badly undermined by the investment scandals that rocked KPERS in the last decade. For the Legislature to deliberately create a significant change in the retirement system which would undermine its funding resources without compensating with greater employer contributions is unthinkable and unacceptable to state employees.

SEAK sees no advantage to state employees from converting to a defined contribution plan. The liberal stock purchase options that have benefited private employees are obviously not available to public employees. *SEAK*, therefore, would urge defeat of the bill.

Thank you for your consideration.

Yours truly,



Keith Haxton
SEAK President

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Kansas 2000 Select Committee

Meeting Date 2-2-00

Attachment 8