Cascade Policy Institute
OREGON

Following in TriMet's Tracks

Defined-Contribution Pensions a Necessary First Step to Oregon's Fiscal Health

by Scott Shepard

February 2018

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INTRODUCTION

As recently as 2012, TriMet faced a pension funding disaster. Indefensibly overgenerous pension benefits granted in the early 1990s threatened to bankrupt the public transit system and to cripple the Portland metro area. While TriMet still has difficult reform ahead of it (regarding its other post-employment benefits promises), it has achieved pension fund stability by replacing its unsustainable defined-benefit pension promises with a well-designed, defined-contribution retirement plan.

"Defined-contribution" (DC) pensions are retirement benefit plans in which monthly payments are made by management into personal accounts owned by employees. Once those payments are made, the employer has no further financial obligations. The eventual pension payouts will be a function of the market performance of whatever investments are chosen by individual employees.

This stands in contrast to "defined-benefit" (DB) programs like Oregon's Public Employees Retirement System (PERS). Under DB programs, employees are promised various levels of retirement payments calculated through arcane formulas that leave management mostly uninformed as to the level of funding obligation to which they have agreed. In many cases, those liabilities turn out to be much larger than expected.

TriMet has brought its pension funding liabilities under control by moving its employees from defined-benefit plans to defined-contribution plans: first its management employees hired after 2002, then its unionized employees hired after 2012. The shift followed the lead of most private sector businesses, the federal government, and an increasing number of states. As a result of the change, TriMet's pension obligations are moving steadily and reliably toward full funding within the near to medium term. This glide path to full funding is allowing the organization to focus on other vital personnel issues such as managing the cost of other post-employment benefits ("OPEBs," which are primarily health care benefits for unionized workers) for current workers and retirees.

Oregon and its municipalities can only envy TriMet in this regard. The defined-benefit PERS funding costs continue to spiral out of control. These unbridled expenses are crushing local governments and school districts, forcing layoffs, hiring and wage freezes, bigger class sizes, reduced government services, and increased taxes. The failure to reform harms younger and more diverse workers at the expense of their older colleagues, and private-industry workers in favor of their government-employee neighbors. Taxpayers have said "enough," voting 60-40 in 2016 against significant state tax hikes that inevitably would have been dedicated to helping to fund the PERS shortfall.

One necessary step toward addressing this problem is for the state of Oregon to follow in TriMet's tracks, moving PERS workers from DB to DC plans. TriMet started down this road fully 15 years ago, while the state has dithered. Oregon must play catch-up by moving all PERS-covered workers to DC plans for work to be performed after the changeover.

This move by itself likely will not be enough to solve Oregon's public pension crisis. The state has already promised more than it can reasonably pay. But moving to DC plans for all work not yet performed is a necessary first step. And the faster the legislature acts, the less severe—and the less upsetting to retirees and current and future employees—will be the other reforms required later.

TRIMET'S PENSION EXPERIENCE

TriMet[1] has spent most of the 21st Century, so far, battling a massive financial crisis, one triggered almost entirely by pension and OPEB unfunded liabilities.

The story is sadly recognizable to anyone conversant with the larger pension funding crisis in Oregon and throughout the United States. In the early 1990s, Governor Barbara Roberts and TriMet General Manager Tom Walsh wanted public approval of a massive expansion of TriMet's responsibilities, services, and funding.[2] They feared that controversy about the management of TriMet, or a union disturbance, could endanger public support.[3] In their efforts to avoid strife, they granted huge and expensive concessions to the Amalgamated Transit Union Local 757 ("the ATU") on behalf of its represented employees.[4] Doing this required them to remove Loren L. Wyss, the long-serving president of TriMet, and much of TriMet's management,[5] who objected to the unaffordability of the concessions. Walsh demanded Wyss's departure;[6] and after a meeting with Governor Roberts, Wyss submitted his resignation.[7] He later explained in *The Oregonian* that "the contract just approved by Tri-Met union employees will protect all its members from additional contributions to their pensions for 10 years. It will also guarantee 3 percent minimum wage increases in the future.…[E]very single dollar of health, welfare, dental and vision plans will be paid for by the public employer; [and] the retirement age will decline to 58 within 10 years…."[8]

"[U]nbridled [PERS] expenses are crushing local governments and school districts, forcing layoffs, hiring and wage freezes, bigger class sizes, reduced government services, and increased taxes."

These and other concessions left TriMet with a problem that now, through PERS, bedevils the entire state: generous but poorly funded pension and other retirement benefits extending to all of its workers.[9] Like PERS, TriMet's accounting techniques assumed unreasonably high rates of return on investment, and used other methods that left pension funding highly vulnerable to any downturns in the financial markets. When those downturns came with the dot-com crash in 2000 and in the wake of the 9/11 attacks,[10] TriMet's pension-funding ratios began to plummet. "A series of short recessions affected the bottom line," said Neil McFarlane, General Manager of TriMet.

Additionally, "TriMet was an early adopter of new accounting standards that increased agency understanding of [TriMet's] cost structure." That cost structure was grim. In the decade from 1994, "salaries and wages…increased 72 percent; annual pension costs [went] up 160 percent; and health care benefits [rose] 116 percent."[11] These increases, plus stagnant revenues in the latter half of the period, resulted in a tripling of unfunded pension liabilities, from $38 million in 1993 to $112.4 million in 2002.[12]

TriMet met this crisis with resolution, even if its resolution protected current employees at the expense of future hires. In 2002 it closed the DB pension fund to all management employees hired after that year, with new employees eligible only for a DC plan.[13] "TriMet has always tried to lead with management workers," explained McFarlane, "to show equity and to show the union and arbitrators that there were good facts to support a change."

The change radically limited pension costs for these workers, so that as of mid-2017 the total unfunded liability for these pensions has fallen to about $15 million.[14] A decade after this policy was adopted, funding of the DB pensions that remained stood at 72 percent.[15] It has since risen to nearly 90 percent.[16] TriMet's financially viable goal is to reach full funding within the next five years, at about the same time as materially all employees covered by the management DB plan will have retired.[17] Thereafter, pension contributions to TriMet management employees will be made out of current accounts each year into the employees' DC accounts.

Resistance from the ATU[18] kept TriMet from moving its new unionized workers from a DB to a DC plan until mid-2012, by which time a citizens' committee of Portlanders had issued a report declaring TriMet "on the brink" of fiscal disaster.[19] As TriMet CFO Beth deHamel testified at a union mediation hearing at the time,

> "TriMet's union defined-benefit plan would be placed on critical status and under federal oversight if it were a private pension plan subject to ERISA." She also stated that unless something is done to shore up the plan, "TriMet could be forced to default on its pension obligations or its other financial obligations in the future."[20]

McFarlane remembers the process taking two contracting cycles and a change of leadership at the ATU. "It was a very difficult process. Binding arbitration was introduced by the Oregon legislature in 2007. Then in the great recession of 2007-08, hardship layoffs and other cuts were occurring throughout the public transit properties. These added pressure" to the negotiations, which nevertheless still dragged on through arbitration and follow-on negotiations until a settlement in 2013. The contract changes broadly applied backward to 2012, though only employees hired after the resolution were moved to DC pensions.

As a result of this delay, the union workers' DB fund remained only 59 percent funded in 2013.[21] Also because of the later changeover, many more current unionized employees than management employees remain in the DB program; and TriMet does not expect full funding to be achieved for another decade.[22] Nevertheless, the trends are in the right direction. The number of active employees still accruing DB pension benefits fell from 1,580 to 1,460 from 2016 to 2017 alone.[23] In 2017 the unionized workers' DB account reached nearly 80 percent funding, with unfunded liability falling by nearly $50 million in a single year; its future now looks sustainable as well.[24]

“The shift [to DC pensions] has been a success,” McFarlane said. “TriMet is paying more than the required annual contribution every year right now” because the system is closed. “We will be fully funded within the next few years: five to ten for the union plan, fewer for the non-union.”

The DC plan to which TriMet moved new workers has been recognized as one of the best in the country.[25] It features low costs, high returns, and a guaranteed employer contribution that is paid irrespective of employee matching contributions.[26] As a DC plan it does not create open-ended, unpredictable public liabilities to be paid by generations as yet unborn, and as a good DC plan it spends current-account public funds wisely so that TriMet employees have reasonable and affordable safety nets awaiting them in their later years.

The switch to DC pensions has not had a marked effect on retention of TriMet employees. Retention rates of non-union employees have fallen somewhat in the very tight current labor market but has not been noticeable in previous, slacker markets. DB pensions “were golden handcuffs for long-term employees, which is great for the highest performers, but not necessarily great with the rest of employees,” said McFarlane. He has noted no problems hiring or retaining union employees, even in current tight markets. “Anecdotally, it appears that [DC] pensions remain a fairly significant recruitment tool” for union employees, as many are coming from the service sector where no pensions are available. TriMet has been replacing many retiring baby-boomer employees, and has “been able to meet all hiring requirements quite handily.” He added the caution that because the DC plan has only been in place for about five years, “the jury's still out” about long-term retention.

“The [defined-contribution] plan to which TriMet moved new workers has been recognized as one of the best in the country. It features low costs, high returns, and a guaranteed employer contribution that is paid irrespective of employee matching contributions.”

TriMet has not fully banished the ghosts of unsustainable employee-benefit promises past. It still faces a massive and escalating OPEB unfunded liability driven by health care costs. The health care benefits that TriMet granted away in the 1994 contract debacle have been described as “universal health care into the afterlife.”[27] The description is only a minor exaggeration. The plan offered TriMet's unionized employees health care without premiums and with mere $5 copays, and benefits that ran not only throughout retirement, but to the employees' spouses and dependents for fully 16 years after the employees' deaths.[28] While a new tier (Tier 3) of health care benefits was instituted in 2014 for all employees hired after October 25 of that year,[29] the reform came too late to avoid an unfunded liability crisis. OPEBs cost TriMet nearly $23 million dollars in 2017, a figure that will essentially double in the next ten years.[30] Total unfunded liability for OPEBs has reached an astonishing $769 million dollars.[31]

COMPARE: STATE PARALYSIS ON PERS

While TriMet, then, is not entirely out of the woods, and still must make hard decisions (and likely face down opposition from the ATU as it does), its pension reform efforts still offer a valuable model and guide to the Oregon legislature, in this session and beyond, of how to contain and reverse the spiraling PERS disaster.

For Oregon and its municipalities, pension costs stand in the same dismal state as do OPEB costs for TriMet: While a Tier 3[32] of reasonable (and reasonably affordable) benefits has recently been created for new workers, this measure has proven, by itself, too little and too late to keep costs for older workers and retirees from spiraling out of control. PERS Tier 3, like its TriMet OPEB counterpart, does nothing to rein in the overgenerous benefits offered to employees and retirees hired before Tier 3 was introduced. PERS Tier 3 just cannot curb the growth of state and local government pension obligations in time to save the system.

Already PERS' unfunded liabilities have grown from $16 billion[33] to more than $25 billion in less than ten years, even with the dampening (accounting) effects of collaring and a still far-too-optimistic 7.2 percent assumed-savings rate (i.e., discount rate) in place.[34] Were the rate adjusted down to its actuarially appropriate level, PERS' unfunded liability would explode to $50 billion or more at a stroke.[35] Even at the current recognized rate, funding status has fallen below 70 percent even while mandatory payments to PERS by government employers have passed 26 percent of payroll.[36]

The state is already scrambling to cover massive budget deficits each biennium.[37] Municipalities already face freezing hiring, laying off current workers, depleting public services and raising fees in order to fund the present, muted level of recognized PERS unfunded liabilities.[38] Oregonians have already overwhelmingly rejected an effort to institute a tax increase that, while massive, nevertheless still would not have come close to retiring the true PERS shortfall, even if it had been wholly dedicated to that end.[39]

Full recognition of the actual unfunded liability would render the debt obviously unpayable, while the continuing failure to recognize it just saves up more trouble for the not-very-distant future. Deep and significant changes in pension benefits are coming, one way or another. All parties will benefit from an orderly and thoughtful effort to reform pension benefits in careful and equitable ways while there is still time.

THE WAY FORWARD

The state of Oregon should—soon—follow the tracks laid by TriMet, by moving its employees from defined-benefit to defined-contribution plans as soon as possible. As TriMet has demonstrated, this move will begin to stanch the fiscal wounds that have been inflicted by a generation of recklessly overgenerous pension benefit promises and begin to bring PERS spending back under some sort of control.

Unfortunately for all parties concerned, PERS reform has been hamstrung for more than 20 years by a wayward state supreme court, which has thwarted previous attempts at thoughtful change with erroneous interpretations of the federal Contract Clause.[40] This interference has given the state legislature less room to maneuver in its reform efforts. The legislature will be obliged to make bigger changes than would have been required years ago, as the TriMet example demonstrates. TriMet was able to begin the switch to DC pensions more than 15 years ago (for new management hires) and to extend it more than five years ago to all new hires. As a result, it could limit the effect of its reforms, applying them only to new hires while leaving then-current workers in their already established DB plans.

> "[T]he Oregon legislature can and must move down the track that TriMet has laid out. Moving all PERS employees to defined-contribution plans for work not yet performed will reduce the true unfunded liability of the system by billions of dollars."

Because of supreme court mistakes, the legislature will have to enact more extensive reforms. It will have to move *all* current workers, whenever they were hired, to DC plans for all work performed after the date of the effective legislation. Only this will have a meaningful, current effect on runaway PERS costs. It will, in effect, cauterize the wound.

While this reform will be significant, it also will be deeply equitable. Right now, older workers are receiving higher benefits for each hour worked than will ever be available to younger workers or to almost any taxpayers, who nevertheless will be expected to pay off the unfunded liabilities created by these benefits for decades to come. This simply isn't fair and may violate civil rights laws. Younger workers are more diverse than their older peers, which means that benefit reductions that affect only new workers have a disparate impact on women and minorities.[41]

The reform will also pass constitutional muster. As the Oregon Supreme Court finally recognized in its *Moro* decision,[42] correcting its long-held error, the legislature may change, without any question of constitutional difficulty, any benefits obtaining to work not yet performed, even for current employees. Thus, a switch to DC pensions for all workers for all work performed after the date of the legislation should easily survive any challenge. (Nevertheless, the legislature should save time and resources by directing any facial suit on the question directly to the Oregon Supreme Court.[43])

Another way that TriMet has led the way for the state is in adopting a well-respected, low-cost, high-benefit DC plan.[44] The legislature need not look far for a model in designing its own plan. (The federal government's long-adopted DC plan for its employees provides another fine model.[45])

CONCLUSION

Over the past six years, TriMet has made substantial progress in reforming its pension system, with dramatic consequences for the agency's future solvency. Though it's getting a late start, the Oregon legislature can and must move down the track that TriMet has laid out. Moving all PERS employees to defined-contribution plans for work not yet performed will reduce the true unfunded liability of the system by billions of dollars. While more reform eventually may be required, this would constitute a vital first step. The sooner it is taken, the less pressing and drastic any later, less palatable steps will be. While TriMet General Manager McFarlane did not wish to give legislators any specific advice as they grapple with their PERS funding crisis, he did report that “it doesn't get any easier with passing time.”

ENDNOTES

1. TriMet is the Tri-County Transportation Metropolitan District. It provides regional transit service to the three main counties of the Portland region. *See* TriMet General Manager's Budget Task Force, TriMet on the Brink: A Recommendation for Long-Term Financial Stability (April 19, 2012) p. 2. Cited below as "TriMet on the Brink."

2. *See, e.g.,* Gordon Oliver, *Tri-Met Board President Wyss Resigns*, The Oregonian (Aug. 8, 1994). A 1994 bond measure sought an additional $475 million in public funding for extension of TriMet from Clackamas County into Vancouver, Washington. Cited below as Oliver, *Wyss Resigns*.

3. *See id.*

4. *See, e.g.,* Gordon Oliver, *Who's Running Tri-Met Anyway?* The Oregonian (date unknown).

5. *See, e.g., Tri-Met: Management Union Views Differ on Misconduct Allegations*, The Oregonian (Nov. 8, 1995).

6. *See, e.g., Rein in Tri-Met Chief*, The Oregonian (Aug. 17, 1994). "Walsh…told the governor, through a memo to Robert Stacy, a policy adviser, that 'Tri-Met needs either a new board president or a new general manager.' The governor met with both men separately, and she accepted Wyss' resignation." *Memos Shed More Light on Conflict at Tri-Met*, The Oregonian (Aug. 13, 1994); *Tri-Met GM Threatened to Quit*, The Oregonian (Aug. 9, 1994).

7. *See* Oliver, *Wyss Resigns*.

8. Loren L. Wyss, Tri-Met's Union Agreement is Going to Cost the Public Plenty (letter to the editor), The Oregonian (Dec. 1994). *See also, e.g.,* John A. Charles, Jr., *Legislature Should Reject TriMet Tax Request* (March 18, 2003), available at http://www.cascadepolicy.org/quickpoints/legislature-should-reject-trimet-tax-request/ (cited below as "Legislature Should Reject"); John A. Charles, *The Next PERS-Type Pension Fiasco*, Brainstorm NW, available at http://brainstormnw.com/News/TheNextPERS-typePensionFiasco.html (cited below as "Brainstorm NW"); *Pay Climbs for Tri-Met Employees*, The Oregonian (Dec. 16, 1994); Joseph Rose, *TriMet Workers, Management Appear Headed for a Major Collision Over Benefits*, The Oregonian (May 12, 2012) (cited below as "Major Collision").

9. *See* Nina M. Lantz & Brent J. Langland, TriMet defined-benefit Retirement Plan for Management and Staff Employees, July 1 GASB 67 and 68 Valuation, p. A-1 (August 2017) ("FY2017 Pension Non-Union" under Pension/OPEB Valuations menu).

10. *See* Brainstorm NW, *supra* note 8.

11. Legislature Should Reject, *supra* note 8.

12. *See* Brainstorm NW, *supra* note 8 ("Unfortunately, the economy began tanking in 2000. TriMet's payroll tax revenues peaked in FY 2000-01, then declined by three percent the following year. Revenues increased by only 1.1 percent in FY 2002-03.").

13. *See* Management DB Valuation 2017, p. A-1 (the eligibility period actually extended slightly further, to April 27, 2003).

14. *See* id., p. 2 (August 2017).

15. *See* TriMet Resolution 14-02-06, Exhibit A "TriMet defined-benefit Retirement Plan for Management and Staff Employees: Pension Funding Policies and Objectives," p. 3, available at https://trimet.org/about/accountability.htm#financial ("Management DB Pension Funding Policy" under Board Approved Policies menu). Cited below as "Management DB Exhibit."

16. *See* Management DB Valuation 2017, p. 2.

17. *See* Management DB Exhibit, p. 4. One factor that may delay this schedule is that TriMet still uses a 6.3 percent discount rate in determining the future value of its present pension funds, a rate that, in the current low-interest-rate era, likely remains significantly too high. *See*, e.g., Jeremy Bulow, *The "California Rule" and Public Pensions*, Stanford Institute for Economic Policy Research Working Paper No. 17-018, p. 17 (Sept. 2017), Scott Andrew Shepard, *A Lost Generation but Renewed Hope: Oregon's Pension Crisis and the Road to Reform*, Mercatus Center Working Paper pp. 8, 51-54 (Aug. 1, 2017) (both explaining that the high-quality, long-term bond rate applied to the current "liquidation" cost of a pension fund is the only appropriate discount rate to employ in this setting). If real-world circumstances eventually require TriMet to adopt a one-percent lower discount rate (of 5.3 percent) for its investments, its management DB unfunded liability would rise by about $15 million. *See* Management DB Valuation 2017, p. 10. Even if TriMet's current assumed discount rate remains too high, though, TriMet's management DB fund discount rate is still nearly a percentage point lower than the newly adopted PERS discount (or "assumed savings") rate.

18. Amalgamated Transit Union, Local 757. The ATU is division of the AFL-CIO. *See* TriMet, *Pension Plan for Bargain Unit Members of TriMet: Pension Funding Policies and Objectives*, p. 1, available at https://trimet.org/about/accountability.htm#financial ("Union DB Pension Funding Policy" under Board Approved Policies menu). Cited below as "Union DB Policy."

ENDNOTES

19. *See* generally TriMet on the Brink, *supra* note 1.

20. John A. Charles, Jr., *Why Cities and Counties Should Consider Leaving TriMet*, Cascade Policy Institute White Paper (Jan. 2014) (quoting Adam S. Collier, *Employer's Post Hearing Brief*, Amalgamated Transit Union 757 and TriMet Interest Arbitration (June 25, 2012).

21. *See id.,* p. 3.

22. *See* Union DB Policy, *supra* note 18 at 4.

23. Nina M. Lanz, Brent J. Langland & John Q. Rowland, *Pension Plan for Bargaining Unit Employees of TriMet, July 1, 2017 GASB 67 and 68 Valuation*, p. 2 (Aug. 2017), available at https://trimet.org/about/accountability.htm#financial ("FY 2017 Pension Union" under Pension/OBEP Valuations menu).

24. This goal is also somewhat undermined by the discount rate assumptions made from the Union DB fund; in fact, the problem is slightly greater, as the Union DB fund's discount rate is higher than that of the management plan, at 6.75 percent. *See id.,* p. 3; *supra* note 18 (discussion of appropriate discount rate). This rate, too, though, remains materially below the newly lowered PERS discount rate.

25. *See, e.g.,* Brent Hunsberger, *Here's What a Great Retirement Plan Looks Like*, The Oregonian (Dec. 27, 2014). Hunsberger is "an [i]nvestment [a]dvisor [r]epresentative in Portland." *Id.* Cited below as "Great Retirement Plan."

26. *See id.*

27. Major Collision, *supra* note 8.

28. *See id.*

29. *See* Nina M. Lantz & William H. Clark-Shim, GASB 45 Actuarial Valuation of Postemployment Benefits Other than Pensions for TriMet as of January 1, 2017, at Appendix A, p. 17 (Apr. 28, 2017).

30. *See id.* at p. 4-5.

31. *See id.* at p. 12.

32. Tier 3 of PERS is often also referred to as the Oregon Public Service Retirement Plan ("OPSRP"). *See, e.g.,* Shepard, *supra* note 17, p. 56 n. 169.

33. *See Moro v. State,* 357 Or. 167 (2015), at p. 172.

34. *See, e.g.,* Ted Sickinger, *PERS: Oregon Pension Deficit Climbs to $25.3B, Meaning Higher Costs Going Forward*, The Oregonian (Sept. 27, 2017). Cited below as Sickinger, *Higher Costs*.

35. *See, e.g.,* Ted Sickinger, *PERS: 9 Myths About Oregon's Public Pension Fund*, The Oregonian (Feb. 12, 2017).

36. *See, e.g.,* Sickinger, *Higher Costs, supra* note 34.

37. *See, e.g.,* Mike Rogoway, *Oregon's Economy Soars Yet State Budget Gap Grows: Here's Why?*, The Oregonian (Apr. 9, 2017).

38. *See, e.g.,* Ted Sickinger, *Looming PERS Vote on Key Rate Will Set Pension Fund's Direction*, The Oregonian (July 26, 2017); *Editorial Board, Legislative Countdown: Rising PERS Costs Affect Portland Community College Students* (March 9, 2017); Ted Sickinger, *PERS Costs May Force Dramatic Cuts in Public Jobs, PSU Study Finds*, The Oregonian (Feb. 17, 2017).

39. *See, e.g.,* Hillary Borrud, *Oregon Corporate Tax Measure 97 Defeated: Election 2016 Results*, The Oregonian, (Nov. 8, 2016).

40. *See* Shepard, *supra* note 17, *passim*.

41. *See, e.g., id.,* p. 15 & n. 49.

42. *See Moro, supra* note 33. For an extended discussion of *Moro* and its ramifications for future PERS reforms, see Shepard, *supra* note 17, at section I.C. and *passim*.

43. *See* Shepard, *supra* note 17, at 41 & n. 144 (discussing the power of the Oregon legislature to certify questions directly to the Oregon Supreme Court in its original jurisdiction).

44. *See* Great Retirement Plan, *supra* note 25.

45. *See id.*