



## Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #191

### **Unfunded Pension Liability -- Revenue Obligations and Appropriation Obligations (Building Commission)**

[LFB 2003-05 Budget Summary: Page 81, #6]

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#### **CURRENT LAW**

Wisconsin Retirement System (WRS) employers are required to contribute each year at a level sufficient to fund the future retirement obligations being generated by participants for their current year of service. In addition, employers are obligated by statute to contribute each year to liquidate obligations known as "unfunded accrued liabilities." Most typically, these types of liabilities are created when improvements in WRS retirement benefits are authorized by the Legislature and eligibility for these benefit improvements is granted retroactively to WRS participating employees for the years of service earned before the effective date of the benefit improvements. When these types of changes occur, funds to pay for the higher benefit levels applicable to all the years of service prior to the benefit improvement would never have been included in either the employee- or employer-required contributions collected during the period before the benefit change became effective. Consequently, a liability is created and must be paid for ("funded") in some fashion.

Each state agency contributes a percentage of its payroll toward the state's unfunded pension obligation. The funds necessary to make these payments are appropriated each year as part the employer-required WRS contributions included in the fringe benefit funding provided each state agency.

#### **GOVERNOR**

Provide the Department of Administration (DOA) or the Building Commission the authority to pay off all or part of the state's unfunded prior service pension liability through the issuance of up to \$750 million in either revenue obligation bonds or appropriation obligation bonds. Authorize the

issuance of either type of obligation. The revenue obligation bond program would involve the issuance of bonds backed by the state's excise taxes on alcoholic beverages, cigarette and tobacco products. Debt service on these bonds would be first draw on the revenues associated with these excise taxes.

Appropriation obligation bonds would be payable from a GPR appropriation in the amounts appropriated by the Legislature each year. Because repayments each year would be subject to appropriation, the bonds would not be considered public debt of the state. Unlike other long-term debt obligations, which are issued by the Building Commission, the DOA Secretary would have the authority to issue appropriation obligation bonds. Either revenue obligations or appropriation obligations would be backed by the state's moral obligation pledge to appropriate any funds that may be necessary to repay the obligations and maintain the required reserves.

Authorize DOA to lapse or transfer to the general fund, an estimated \$69,200,000 in funds from appropriations from which fringe benefit funding is provided that would otherwise have been expended to make the state's WRS unfunded prior service pension liability payments in the 2003-05 biennium.

## **DISCUSSION POINTS**

### **Background**

1. All WRS unfunded accrued liabilities are treated as an employer cost. These costs are to be amortized through additional contributions paid by employers over an extended period of time (unless the benefit improvement legislation specifies a different funding procedure). These liabilities become an obligation spread across all employers in the system at the time the legislation that generated the liability becomes effective. The current amortization period to pay off the retirement system's unfunded accrued liabilities was last reset on January 1, 1989, for a period of 40 years. For most WRS employers, payments to retire the unfunded accrued liabilities arising from previous benefit improvements will continue through 2029, with a small residual payment in 2030.

2. The unfunded accrued liability balance for all WRS employers totals \$1,727,623,200 as of December 31, 2002, the date of the retirement system's most recent actuarial valuation. WRS employers with unfunded accrued liability balances include the state and many other Wisconsin public employers, including counties, cities, towns, villages, school districts, technical college districts, CESA's, and a variety of special purpose districts. The principal public employers that do not participate in the WRS (and consequently do not have WRS unfunded accrued liabilities) are the City of Milwaukee and Milwaukee County. Each of these employers participates in an independent pension system. Currently, the state's WRS unfunded accrued liability balance is \$729,123,781.

3. The payment schedule for liquidating the state's unfunded accrued liability balance is based on a level percentage of payroll over an extended period. While this approach results in stable payments as a percentage of payroll, the actual annual payment amounts will significantly increase over time due to underlying assumed annual increases to agencies' base payrolls. Consequently, the schedule is not a flat amortization schedule; rather, the payments are effectively

“back-end loaded” with the amounts paid during the early years significantly lower than the later years of the payment schedule. For example, the state's current payment schedule requires agency payments totaling \$40.0 million for calendar year 2003, while payments totaling \$125.7 million are projected in calendar year 2029, the last full year of scheduled payments.

4. State agencies make monthly contributions to WRS to cover their portion of the state's annual unfunded liability payments. The Department of Employee Trust Funds, credits those monthly payments to the unfunded liability principal amount once a year in the January following the year for which the payments are made.

5. Table 1 shows by calendar year, the state's unfunded accrued liability starting balance, annual required payments, and annual interest assessments over the remaining term of the payment schedule. The payment schedule is based on the current actuarial assumptions governing the WRS. These assumptions provide for an 8.0% interest rate and a 4.5% annual increase to the state's base payroll.

**TABLE 1**  
**Projected Annual State Unfunded Accrued Liability Payments**

<u># of Years</u>	<u>Year</u>	<u>UAL Balance</u>	<u>Payment</u>	<u>Interest</u>
1	2003	\$729,123,781	\$40,030,119	\$55,127,493
2	2004	744,221,155	41,831,474	56,191,175
3	2005	758,580,856	43,713,890	57,189,357
4	2006	772,056,322	45,681,016	58,110,025
5	2007	784,485,331	47,736,661	58,939,894
6	2008	795,688,564	49,884,811	59,664,300
7	2009	805,468,053	52,129,628	60,267,074
8	2010	813,605,500	54,475,461	60,730,403
9	2011	819,860,442	56,926,856	61,034,687
10	2012	823,968,272	59,488,565	61,158,377
11	2013	825,638,084	62,165,550	61,077,803
12	2014	824,550,336	64,963,000	60,766,987
13	2015	820,354,323	67,886,335	60,197,439
14	2016	812,665,426	70,941,220	59,337,936
15	2017	801,062,143	74,133,575	58,154,285
16	2018	785,082,853	77,469,586	56,609,061
17	2019	764,222,328	80,955,718	54,661,329
18	2020	737,927,939	84,598,725	52,266,337
19	2021	705,595,552	88,405,667	49,375,191
20	2022	666,565,075	92,383,922	45,934,492
21	2023	620,115,645	96,541,199	41,885,956
22	2024	565,460,401	100,885,553	37,165,988
23	2025	501,740,836	105,425,403	31,705,235
24	2026	428,020,668	110,169,546	25,428,090
25	2027	343,279,212	115,127,175	18,252,163
26	2028	246,404,199	120,307,898	10,087,704
27	2029	136,184,005	125,721,754	836,980
28	2030	11,299,231	11,299,231	0
			\$2,041,279,538	\$1,312,155,761

6. As indicated in Table 1, under the repayment schedule for the state's unfunded pension liability, the state's annual payments in the early years will not cover the annual interest amounts that accrue on the principal. Not until year 2013, when the unfunded liability reaches \$825.6 million, will the state's annual payment cover the interest on the outstanding principal, at which time the outstanding principal amount on the liability will begin to decline.

7. As part of the biennial budget development process, DOA calculates agency-specific fringe benefit rates which are included as an adjustment to each agency's base funding for payroll fringe benefits. Each state agency uses its assigned rate to determine the amount of fringe benefits funding that must be budgeted for its permanent and project position salary costs. These fringe benefits rates are comprised of certain fixed costs that do not vary with an increase in salary (such as health and life insurance premiums and unemployment compensation payments) and certain variable costs that do vary with a change in salary (such as Social Security, WRS and accumulated sick leave conversion credit program contributions). These latter types of costs are budgeted at uniform percentages of payroll across all state agencies.

8. For each fiscal year of the 2003-05 fiscal biennium, the DOA included a uniform WRS contribution rate of 10.7% of payroll as a component of the fringe benefits rates applicable to all state agencies. Included in this contribution rate is each agency's unfunded accrued pension liability, which is budgeted at 1.3% of payroll for 2003. As a result, the Governor's budget proposal includes \$79,116,000 in funds needed to make the state unfunded pension liability contribution in the 2003-05 biennium. Table 2 indicates by fund source the amounts included in the Governor's budget to make each agency's unfunded accrued liability payments in the biennium.

**TABLE 2**  
**State Unfunded Liability Contributions**  
**by Fund Source**

	<u>2003-04</u>	<u>2004-05</u>	<u>2003-05</u>
GPR	\$16,938,000	\$16,899,000	\$33,837,000
PR	14,640,000	14,842,000	29,482,000
SEG	2,832,000	2,771,000	5,603,000
FED	<u>5,108,000</u>	<u>5,086,000</u>	<u>10,194,000</u>
Total	\$39,518,000	\$39,598,000	\$79,116,000

9. The amounts shown in Table 2 differ from the actuarial payment schedule on the state's unfunded liability presented in Table 1 because the budgeted amounts were included in agency budget requests prior to when the Department of Employee Trust Funds (ETF) updated the unfunded liability payment schedule and also reflect the reductions made to agencies' base payroll amounts under SB 44.

## **Pension Obligation Proposal**

10. Under the proposal, the state would issue up to \$750 million in taxable revenue bonds, the proceeds of which would be used to pay off the state's unfunded accrued prior service pension liability. The bill assumes that the rates on the revenue bonds issued would be lower than the current 8% financing rate on the state's unfunded prior service pension liability and would result in savings associated with the lower interest costs necessary to retire the principal amount of the state's unfunded liability. SB 44 would authorize the DOA Secretary to lapse or transfer to the general fund any amounts budgeted under state operations appropriations to make payments for the state's WRS unfunded prior service pension liability in 2003-05 that would not have to be made as a result of state issuing revenue bonds to pay off that liability. The bill assumes that \$33,100,000 in 2003-04 and \$36,100,000 associated with the savings generated under this pension bond proposal would be deposited to the general fund in the biennium

11. The bill does not include specific information on the bonding transaction, such as the actual amount of bonds to be issued, the projected repayment period or any projection of the interest rates on the bonds. These aspects of the transaction will not be known until the bonds are offered for sale. The actual market conditions at the time the bonds are marketed will impact interest rates on the bonds, which in turn will affect the amount of potential savings associated with the transaction.

12. However, DOA Capital Finance officials have outlined a possible pension bond transaction as an illustration of the type of transaction that could generate the amount of savings in the biennium that are assumed under the bill. Under the transaction, it is assumed the state would issue enough taxable revenue bonds to payoff all of the state's unfunded liability and establish a 30-year repayment schedule on those bonds. The bonds under this example would carry a rate of approximately 5.75%, a rate that would generate savings for the state when compared to the current financing rate on the state's unfunded pension liability.

13. Under the transaction identified by DOA, the bonds would be structured so that no debt service payments would be made in the 2003-05 biennium. In addition, under this proposed transaction, debt service payments on the revenue bonds would continue to be less than the state's current annual unfunded pension liability contributions through 2006-07. After 2006-07, the state would make annual debt service payments that equal the payments under the current repayment schedule on the state's unfunded pension liability payment schedule. Such a debt service schedule would allow the state to maximize the amount of savings in the 2003-05 biennium related to the transaction, and take all of the remaining savings associated with the transaction in the earlier years of the transaction.

14. As indicated earlier, SB 44 includes \$79,116,000 in funds needed to make the state unfunded pension liability contribution in the 2003-05 biennium. Under the proposed pension bond transaction, the state would not have to pay these monies to fund either the unfunded pension liability or debt service on bonds issued to retire that liability; instead, DOA would have the authority to lapse these amounts to the general fund.

15. The \$79,116,000 in estimated unfunded liability payments in the 2003-05 biennium

exceeds the \$69,200,000 lapse estimate used by the administration for the pension bond transaction by \$9,916,000 (\$6,418,000 in 2003-04 and \$3,498,000 in 2004-05). The difference in these amounts relates to the federal monies budgeted for unfunded pension liability. While the bill would provide DOA the authority to lapse these federal contribution amounts, DOA Capital Finance officials indicate that it is uncertain whether the state could lapse the \$5,108,000 in 2003-04 and the \$5,086,000 in 2004-05. It is possible that any savings associated with the federal contribution that result from the state paying off its unfunded pension liability would revert to the federal government or be used for other federal program purposes. Therefore, these amounts are excluded from the GPR-lapse estimate in SB 44.

16. Excluding the \$10,194,000 in federal funds from the estimated GPR-lapse that may result from the pension bond transaction envisioned under the bill would reduce the overall GPR lapse estimate associated with transaction to \$68,922,000 in the biennium, which would be \$278,000 less than the GPR lapse estimates included in the bill (estimated savings would be \$1,310,000 greater in 2003-04 and \$1,588,000 less in 2004-05). However, DOA would continue to have the authority to lapse federal funds that may result from an unfunded pension bond transaction if doing so becomes a possibility, but the state would not be budgeting for these savings at this time.

17. As mentioned earlier, the state makes monthly contributions to meet the annual obligations on its unfunded pension liability. However, these payments are not credited to the state's unfunded liability balance until the January following the year in which the payments are made. Therefore, in 2002-03, the state will have made payments on its unfunded pension obligation from January, 2003 through June, 2003, but the actual adjustment to the state's unfunded pension obligation balance, including accrued interest, will not be made until January, 2004. Thus, if the state would issue bonds to pay off its January 1, 2003, unfunded pension liability balance prior to January, 2004, the state would have overpaid its unfunded pension liability obligation by the amounts paid between January, 2003, and the date on which the liability is paid off with bond proceeds. It is estimated that the state's unfunded pension liability contributions will total approximately \$20,000,000 from January, 2003, through June, 2003, which is not reflected in the SB 44 GPR-lapse estimates. This modification was proposed by the administration in a memorandum to the Co-chairs of the Committee, dated May 6, 2003.

18. ETF officials indicate that the agency would issue a credit for any over-payment resulting from a participating employer paying off its unfunded liability. The amount of the credit could be used to offset future, budgeted employer-required WRS contributions. Therefore, the state would be able to realize savings attributable to the \$20,000,000 in estimated payments made in the first half of 2003 on its unfunded liability by receiving a credit against each agency's future contributions amounts for current service employees during the 2003-05 biennium.

19. The bill could be modified to allow DOA to lapse funds associated with any credits from agencies current service pension contributions. The pension fund changes made under 1999 Act 11 resulted in similar credits to agency's future pension contributions. Subsequent legislation (2001 Act 16) included a mechanism to allow the state to credit the proper appropriations so as to account for the payroll contribution savings associated with those credits. If the Committee wishes to lapse any amounts that would be credited to state agencies in the 2003-05 biennium associated with the state liquidating its unfunded prior service pension liability, it could provide DOA with the

same authority relating to this transaction that DOA was provided under 2001 Act 16.

20. Any funds lapsed to the general fund under the Governor's proposal to pay off the state's unfunded prior service pension liability would be one-time in nature. While the amount of these funds would be relatively small, the use of non-recurring revenues to support expenditure levels can result in an imbalance between future revenue and expenditure levels.

### **Authorization of Both Revenue Obligation and Appropriation Obligation Bonds**

21. Under the bill, DOA or the Building Commission could issue up to \$750 million of either revenue obligation bonds or appropriation obligation bonds to pay of the state's unfunded prior service pension liability. The revenue obligation bond program would involve the issuance of bonds backed by the state's excise taxes on alcoholic beverages, cigarette and tobacco products. Debt service on these bonds would be a first draw on the revenues associated with these excise taxes. The bonds would also be backed by the state's moral obligation pledge to appropriate any funds that may be necessary to repay the obligations and maintain the required reserves on the bonds. If appropriation obligation bonds would be used, the bonds would be payable from a GPR appropriation in the amounts appropriated by Legislature each year. Under the bill, either type of bonds could only be used to pay off the state's unfunded pension liability and the bonds would not be considered public debt of the state. The revenue obligation bonds would be issued by the Building Commission, while the DOA Secretary would have the authority to issue appropriation obligation bonds.

22. DOA Capital Finance officials indicate that Governor's budget includes both types of bonds, because it is not known which type of bonds would be issued. While it is not certain, issuing appropriation bonds could be more favorable in allowing the state to capture the federal contributions toward the state's unfunded liability. It is believed that because the amounts necessary to retire the appropriation bonds would have to be appropriated each year, the federal government could view this annual expense as being similar to its current annual unfunded pension liability commitment with the state. In addition, unlike revenue obligations that are backed by certain revenues, appropriation obligations involve the appropriation of general purpose revenues and could be viewed by some bond-buyers as similar in nature to general obligation debt, which could lower the reserve requirements needed for the bonds, and have a positive impact on the interest rate paid on the bonds. Providing both types of bond authorizations would allow DOA the flexibility to construct a transaction that could allow for the capture of the federal funds at a lower interest cost.

23. The bill, by allowing \$750 million of either type of bonds to be issued, would provide \$1.5 billion in bonding. DOA Capital Finance indicates that only \$750 million in total bonding authority would be used to carry out the transaction. Because only \$750 million in bonds would be needed to liquidate the state's unfunded accrued prior service pension obligation, the Committee could specify that any amount of bonds issued under excise tax revenue bond obligations would reduce the amount of authority for the appropriation obligation bonds, and vice versa. This would limit the overall amount of bonds authorized for issuance to \$750 million.

24. Under either type of bonds, the state would be setting a precedent by using a portion of the state's general fund revenues to back bonds that would not be considered general obligation

debt of the state. That is, while debt service on state general obligation bonds is funded as a first draw on state's general fund revenues each year, state revenue obligation bonds are funded by revenues from a specific, non-GPR funding source. Two examples of state revenue obligation bonds include the Clean Water Fund revenue bonds, which are backed by clean water fund loan repayments and transportation revenue bonds, which are backed by motor vehicle registration fees. This would be the first time the state would carve out revenues from existing general fund taxes or appropriate general purpose revenue to support bonds other than general obligation bonds. However, the state does use a master lease program to obtain shorter-term financing for equipment purchases, which involves the use of GPR funding drawn from agency operating appropriations.

25. The Wisconsin Constitution enables the state to issue public debt to "acquire, construct, develop, extend, enlarge or improve land, waters, property, highways, buildings, equipment or facilities for public purposes." The language was deliberately broad, requiring only that bonding be intended to affect physical property directly and be undertaken for public purposes. However, the provision has been interpreted to clearly exclude public debt being issued to fund the annual operation and administration of state government.

26. Due to these constitutional constraints on public debt, the state could not issue general obligation bonds to pay off the state's liability related to the state's pension fund contributions. However, these constitutional requirements do not apply to revenue obligations, which are not considered public debt under the Constitution, because the bonds are not backed by the full faith and credit of the state. For appropriation obligations, the debt service would be funded from an annual sum certain GPR, subject to appropriation by the Legislature and the bill states that such bonds would not be considered public debt.

27. Using general fund revenues to pay off revenue obligation bonds or GPR funding to pay the appropriation obligation bonds authorized under the bill could establish a precedent for the state's debt programs. Such borrowing programs that use state general fund revenues to support debt that is not constitutionally limited in its use or amount, could be statutorily expanded to support bonds that could be issued for any state government operating function or expense.

28. Both the revenue obligations or appropriation obligations would be backed by the state's moral obligation pledge to appropriate any funds that may be necessary to repay the obligations and maintain the required reserves. Providing the state's moral obligation would likely enhance the marketability of any bonds issued, which would improve the financing costs of the bonds. Therefore, providing the state's moral obligation on the bonds may be necessary to achieve the spread between the current 8% rate paid on the state unfunded prior service liability and the rates on the bonds, so as to generate savings to the state associated with the transaction.

29. Providing the state's moral obligation on the bonds could require the state to make payments associated with the debt service on the bonds in the future. However, placing a moral obligation on these pension bonds could be considered to be unlike other moral obligations the state has placed on revenue bond issues in the past. For example, the state has applied its moral obligation on Wisconsin Center District bonds, and if that obligation is exercised, the state could be required to make payments on a facility that would have not otherwise required any state funds. Under the pension bond transaction, the state is bonding to pay off an existing long-term obligation.



Therefore, any state payments resulting from the state's moral obligation on the bonds could be seen as simply replacing funds the state is currently paying on its unfunded liability.

30. Currently, the state's unfunded prior service pension liability is considered a "soft" liability, because it does not show up on the state's annual financial reports. However, if the state would issue bonds to pay off that liability, the outstanding principal associated with those bonds would show up as "hard" liability on the state balance sheet and other financial reports. While it is unknown whether such a liability would have material effect on any financial analysis of the state, bond rating agencies do conduct such an analysis in completing their ratings on state bond issues.

31. Several local governments have issued revenue bonds for all or portions of their unfunded pension liabilities. New Jersey has issued such bonds and several other states are considering doing so. A number of non-state WRS employers have also done so. Of the 1,278 local government employers participating in the WRS, as of January 1, 2003, a total of 526 had completely paid-off their unfunded pension liability obligations.

32. ETF officials indicate that a state pay-off of its unfunded liability would not have a significant effect on the WRS pension fund. ETF would likely keep some or all of the funds in short-term investments in order to meet payments to pension fund annuitants rather than liquidate other assets to make those payments. They further indicate that while the 8% return associated with state's pension liability may not be matched in the short term, in the long term, the pension fund may be able to out-perform the current 8% rate.

### **Impact of Transaction on Future Biennia**

33. Under the proposal, the pension bonds are being repaid with general fund dollars; general fund excise tax revenues would support the excise tax revenue obligations and a GPR sum certain appropriation would support the appropriation obligations. Conversely, the pension bond proceeds would be used to pay off an unfunded liability that is currently being funded from GPR, PR, SEG, and FED funding sources. Therefore, beginning in 2005-07, a liability that was funded from all funding sources would be funded 100% from general fund revenues.

34. An alternative would be to charge each PR and SEG account, and FED account, if federal funds are involved in the transaction, for the percentage of debt service costs that are associated with the share of the unfunded liability that would have otherwise been paid by those funding sources. DOA could be required to include in their biennial fringe benefit calculations the percentage each fund source's contribution to debt service on the pension bonds in that biennium, based on each fund source's percentage of the state's unfunded liability at the time the liability is liquidated. In order capture these monies for the general fund in the future, the authority provided under the bill that would allow the DOA Secretary to lapse or transfer each agency's unfunded liability payments in the 2003-05 to the general fund could be extended until the pension bonds are retired.

## ALTERNATIVES

1. Approve the Governor's recommendation to issue of up to \$750 million in either revenue obligation bonds or appropriation obligation bonds. Reestimate the GPR-Lapse amount to be \$68,922,000, which would be \$278,000 less than the GPR lapse estimates included under the bill (estimated savings would be \$1,310,000 greater in 2003-04 and \$1,588,000 less in 2004-05).

<u>Alternative 1</u>	<u>GPR-Lapse</u>
<b>2003-05 FUNDING</b> (Change to Bill)	- \$278,000

2. Modify the Governor's recommendation as reestimated in Alternative 1 by doing one or more of the following;

a. Direct the DOA Secretary to determine for each state agency, other than for ETF and the State of Wisconsin Investment Board, the amounts credited by ETF to each agency's nonfederal PR, PR-S, SEG and SEG-S appropriations during 2003-04 associated with the state liquidating its unfunded accrued prior service pension liability. Direct the DOA Secretary, in making the calculation, to determine the amounts credited by ETF for the payment of unfunded pension liability contributions under the WRS since the last principal payment was credited to that liability. During 2003-04, direct the Secretary of DOA to transfer the amounts calculated from each affected state agency's nonfederal PR and PR-S appropriations to the general fund. Similarly, direct the Secretary to lapse the amounts calculated from each affected agency's nonfederal SEG and SEG-S appropriations to the appropriate segregated fund. After making this lapse, direct the Secretary to transfer an amount equal to the amounts lapsed from the appropriate segregated funds to the general fund. This action would result in an estimated additional GPR-lapse of \$20,000,000 in 2003-04.

<u>Alternative 2a</u>	<u>GPR-Lapse</u>
<b>2003-05 FUNDING</b> (Change to Bill)	\$20,000,000

b. Require that the any amount of bonds issued under excise tax revenue bond obligations would reduce the authority under the appropriation obligation bonds, and vice versa. This would statutorily limit the overall amount of bonds authorized to \$750 million.

c. Direct the DOA Secretary to assess each PR and SEG account, and FED account, if federal funds are involved in the transaction, for the percentage of debt service costs that are associated with each fund's share of the unfunded pension liability that would have otherwise been paid by those funding sources. In making this determination, require the DOA Secretary to include in their biennial budget fringe benefit calculations the percentage each fund source's contribution to debt service on the pension bonds in that biennium, which would be based on the percentage that each fund source makes up of the state's unfunded liability at the time liability is liquidated. Extend, until the pension bonds are retired, the authority provided under the bill that would allow the DOA secretary to lapse or transfer each agency's unfunded liability payments to the general fund.

3. Delete provision.

<u>Alternative 3</u>	<u>BR</u>	<u>GPR-Lapse</u>
<b>2003-05 FUNDING</b> (Change to Bill)	- \$750,000,000	- \$69,200,000

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