G20J01
State Retirement Agency

Operating Budget Data

($ in Thousands)

	FY 02 Actual	FY 03 Working	FY 04 Allowance	Change FY 03-04	% Change FY 03-04
Special Funds	$19,565	$20,176	$20,566	$389	1.9%
Contingent & Back of Bill Reductions	-	-12	-72	-60	
Adjusted Special Funds	19,565	20,165	20,494	329	1.6%
Adjusted Grand Total	**$19,565**	**$20,165**	**$20,494**	**$329**	**1.6%**

- Personnel expenses increase due to statewide health insurance rate increases, a more realistic agency turnover expectancy, and four new positions. Nonpersonnel related expenses, particularly in computer equipment and services, decline to reflect cost containment efforts and re-evaluation of the agency's information technology strategy.

Personnel Data

	FY 02 Actual	FY 03 Working	FY 04 Allowance	Change
Regular Positions	177.00	168.00	172.00	4.00
Contractual FTEs	29.83	31.50	31.50	0.00
Total Personnel	**206.83**	**199.50**	**203.50**	**4.00**
Vacancy Data: Regular Positions				
Budgeted Turnover: FY 04	4.85	2.82%		
Positions Vacant as of 12/31/02	4.00	2.38%		

- The fiscal 2004 allowance includes four new regular positions, reflecting workload growth. Contractual positions remain constant. Budgeted turnover expectancy reduced to more closely reflect actual vacant positions.

- The agency lost nine positions in fiscal 2003 due to cost containment.

Note: Numbers may not sum to total due to rounding.

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Analysis in Brief

Major Trends

Telephone Customer Service Improves: The agency continues to make improvements in the waiting times and "hang ups" by members who call the agency for service.

Issues

Pension Contribution Rates for the Major Systems Remain Stable Due to 2002 Legislative Action: The State Retirement and Pension System of Maryland suffered approximately $3 billion in investment losses in fiscal 2002. Actions taken by the General Assembly under the Budget Reconciliation and Financing Act of 2002, however, stabilized the system's actuarial methodology and helped to insulate the State from dramatic increases in State pension contributions due to the investment losses.

An Outside Investment Manager Is Under Investigation for His Handling of Maryland Investment Funds: An outside investment manager hired by the pension board is under investigation for his dealings with a submanager to whom he gave State pension funds that were invested back into the manager's stock.

The State Pension System Lost $3 Billion in Fiscal 2002 and Investment Performance Continues to Lag Other Public Plans: The State pension system lost $3 billion in fiscal 2002 and has experienced further investment declines in the first part of fiscal 2003. While virtually all financial market investors have experienced losses during this period, the State system's losses continue to be worse than that of other large pension plans. The system's one-year performance ranked in the bottom quartile compared to other similar pension plans and ranked in the ninety-ninth percentile for ten-year performance.

The System's Computer Procurement Project Is Substantially Behind Schedule and the Base Pension Application May Never Be Implemented: The State Retirement Agency is currently in a dispute with Syscom, the vendor who was contracted to deliver a new benefit processing and administration computer system. Because there is both pending and potential litigation between the agency and Syscom involving this project, the agency, on the advice of the Attorney General's office, has limited its public comments regarding this matter. The little information that is publicly available indicates that the project will certainly not be completed within a reasonable timeframe and that the more likely scenario is that the project, as currently structured, will never be implemented.

Recommended Actions

		Funds	Positions
1.	Delete four new positions in accordance with Spending Affordability Committee guidelines.	$ 224,215	4.0
	Total Reductions	**$ 224,215**	**4.0**

G20J01
State Retirement Agency

Operating Budget Analysis

Program Description

The State Retirement Agency (SRA), under the direction of the Board of Trustees of the State Retirement and Pension System (SRPS), is responsible for administering the State's retirement and pension systems. The agency is divided into four divisions. The administrative division is tasked with administering the payment of benefits, management of employee contributions, and membership counseling. The investment division is charged with the management, control, and implementation of investment policy for approximately $27 billion in assets. The finance division provides accounting and financial reporting, budget administration, and procurement functions. The management information services division provides ongoing computer support and is in charge of the data processing upgrade. In addition to the overall direction of each of these divisions, the executive director's office is responsible for policy development, legislation, internal audits, and legal affairs. The budget of SRA is funded solely through special funds derived from employer and member contributions and investment income.

Performance Analysis: Managing for Results

Put simply, the two primary functions of the State Retirement Agency are (1) to properly administer the retirement system; i.e., to timely and accurately pay pension benefits and collect pension contributions from employers and employees; and (2) to manage the assets of SRPS so as to maximize the system's risk-adjusted return.

Regarding benefit administration, the agency's Managing for Results (MFR) provides various measures showing the accuracy and timeliness of benefit calculation and efficiency in collecting contributions. Frankly, the agency is so efficient and accurate in these capacities (the performance measures are all well over 99%) that there is little purpose in discussing those measures here. It is assumed that the agency will continue to maintain these high standards and that any slippage from those standards would trigger discussion in future Department of Legislative Services' (DLS) analyses.

One measure on the administration side that the agency has tried to improve customer service, particularly when active members and retirees call the agency in need of assistance. The agency responded to DLS's recommendation from three years ago regarding telephone waiting periods and now tracks both the waiting times for incoming telephone calls and the number of calls that are abandoned because of lengthy waiting times. The agency recognized that telephone waiting time is an important issue for members and retirees. As illustrated in **Exhibit 1**, after two years, the agency achieved its goals for improved service and should be commended for doing so; it may now wish to raise the hurdle of those measures.

Exhibit 1

Performance Measures – Benefit Administration
State Retirement Agency
Fiscal 2001 through 2004

	FY 2001 Actual	FY 2002 Actual	FY 2003 Estimated	FY 2004 Estimated
Percentage of incoming telephone calls abandoned by the automated telephone system	11.2%	5.4%	8.0%	8.0%
Average telephone waiting time in minutes: seconds	2:44	1:20	2:00	2:00

Note: Agency objective stated as: "On an ongoing basis, no more than 8.0% of incoming telephone calls will be abandoned by the phone system and waiting time for calls to be answered will be less than 2:00 minutes."

Source: State Retirement Agency

Regarding investment performance, the agency offers a variety of MFR measures, most of which are useless in providing any true indication of the agency's performance. The agency and the board, however, did eventually accede to DLS's request to include a comparative performance measure in its MFR response. That measure indicates some serious performance issues, which are discussed at greater length as a budget issue.

Finally, **Exhibit 2** is included to show that the agency's workload continues to grow, as the number of active members and retirees increases, as does total benefit payments. While total plan assets also serve as a measure of agency workload, they unfortunately do not grow every year, and fell significantly again in fiscal 2002.

Fiscal 2003 Actions

Impact of Cost Containment

Fiscal 2003 cost containment reflects the reversion of appropriations to support free transit ridership for State employees, contingent upon enactment of a provision in the Budget Reconciliation and Financing Act (BRFA) of 2003. It should also be noted that between fiscal 2002 and 2003, nine positions and $866,000 were reduced by across-the-board actions. The agency was allowed to count toward that reduction the three specific positions eliminated by the General Assembly for fiscal 2003.

Exhibit 2

Program Measurement Data
State Retirement Agency
Fiscal 2000 through 2004

	Actual 2000	Actual 2001	Est. 2002	Est. 2003	Est. 2004	Ann. Chg. 00-02	Ann. Chg. 02-04
Total participants*	302,873	311,984	321,845	330,000 **	340,000 **	3.1%	2.8%
Benefit payments ($ in Millions)	$1,191.00	$1,238.60	$1,372.30	$1,400.00	$1,550.00	7.3%	6.3%
Market value of invested assets ($ in Billions)	$33.10	$29.50	$26.60	n/a	n/a	-10.4%	n/a

*Includes active employees, retirees, beneficiaries, and former employees with vested benefits.
**Fiscal 2003 and 2004 estimates of membership data by the Department of Legislative Services.

Source: State Retirement Agency; Department of Legislative Services

Governor's Proposed Budget

As illustrated in **Exhibit 3**, the agency's budget is essentially flat between the fiscal 2003 working appropriation and the fiscal 2004 allowance. The exhibit also illustrates, however, that the flat growth masks a large increase in personnel expenditures that is mostly offset by reductions in nonpersonnel expenditures.

Personnel expenditure increases reflect several factors. First, the agency has four new positions in its allowance – three in its information technology division and one its legal division. The additional positions reflect growth in the agency's workload. Second, personnel expenses for its existing staff rebound from fiscal 2003 reductions for cost containment and unrealistically high turnover expectancy. Third, the agency must pay for the statewide increases in employee and retiree health insurance.

To offset these personnel increases, the agency is deferring or canceling many nonpersonnel expenditures. Total computer spending (for hardware, software, services, and training) is reduced by approximately $635,000. This reduction reflects both a cost containment effort and a reflection of the current "holding" status of the agency's data processing procurement (discussed below as a budget issue). Other contractual and office assistance services are reduced, and the agency's project to convert existing paper files to electronic format is delayed by one year. Rent increases according to a formula that reflects market rates for office space in Baltimore.

Exhibit 3

Governor's Proposed Budget
State Retirement Agency
($ in Thousands)

	FY 02 Actual	FY 03 Working	FY 04 Allowance	Change FY 03-04	% Change FY 03-04
Special Funds	$19,565	$20,176	$20,566	$389	1.9%
Contingent & Back of Bill Reductions	-	-12	-72	-60	
Adjusted Special Funds	**19,565**	**20,165**	**20,494**	**329**	**1.6%**

Where It Goes:

Personnel Expenses		
New positions		$224
Turnover adjustment		1,019
Employee and retiree health insurance cost increases		323
Retirement contribution cost increase		22
Elimination of deferred compensation		-62
Other personnel adjustments		-152
Total personnel expenses	**$1,374**	
Other Changes		
Reduced computer equipment and services		-635
Trustee elections – not applicable this year		-195
Other reduced contractual services		-176
Deferral of backfile conversion until fiscal 2005		-100
Reduced office assistance		-75
Rent increase		120
Other Changes		16
Total		**$329**

Note: Numbers may not sum to total due to rounding.

Impact of Cost Containment

The fiscal 2004 allowance reflects the elimination of the appropriation for matching employee deferred compensation contributions up to $600, contingent upon enactment of a provision in the 2003 BRFA.

Issues

1. Pension Contribution Rates for the Major Systems Remain Stable Due to 2002 Legislative Action

SRPS lost roughly $3 billion in its invested assets during fiscal 2002. This is a 7.6% decline, leaving the system with approximately $26.5 billion in assets as of June 30, 2002. Notwithstanding the reduction in assets, the State's pension system is 94.0% funded on an actuarial basis and remains actuarially sound. Moreover, the nature of a defined benefit pension system such as Maryland's – in which benefits are guaranteed and the employer accepts the funding risk – means that the benefits of current and future retirees will be unaffected by this year's investment losses. For reasons discussed below, the aggregate State employer contribution rate will increase only from 8.01% of payroll for fiscal 2003 to 8.06% of payroll for fiscal 2004. **Exhibit 4** lists the new contribution rates and actuarial funding levels by individual system.

Exhibit 4

Fiscal 2003 and 2004 Employer Contribution Rates

Plan	FY 2003 Rate	FY 2004 Rate	Actuarial Funding Level
Employees	4.73%	4.73%	96.3%
Teachers	9.35%	9.35%	92.0%
State Police	5.78%	7.58%	126.2%
Judges	43.92%	43.74%	87.7%
Law Enforcement Officers	36.10%	35.13%	62.0%
Aggregate	**8.01%**	**8.06%**	**94.0%**

Source: Milliman USA

The General Assembly took action last year under BRFA (Chapter 440, Acts of 2002) to reduce the budgetary impact of volatile pension investment performance. For the employees' and teachers' systems (the two largest subsystems of SRPS), the State will maintain a constant employer contribution rate so long as those systems remain from 90% to 110% funded on an actuarial basis. For fiscal 2004 those systems will remain within their funding "corridors," and no increase in State pension contributions (beyond that reflecting payroll growth) will be required despite the large investment losses. Conversely, in years of investment gains, the contribution rates will remain steady, rather than decline as under prior law. The employer contribution rates for the smaller subsystems, such as the State Police and judges' systems, will increase to reflect the loss of actuarial assets.

This change in actuarial methodology was developed with the assistance of the State's actuary and corrects an anomaly in the previous methodology whereby pension contributions increased in years where the State was least able to afford such increases and decreased in years where the State could likely afford to keep rates steady. Moreover, the system's high level of actuarial funding means that investment performance – more than employer contributions under any methodology – is a greater driver of the system's marginal funding changes. So long as the system does not experience repeated future investment declines such as those in fiscal 2001 and 2002, the system's pension contributions will grow at a moderate rate.

2. An Outside Investment Manager Is Under Investigation for His Handling of Maryland Investment Funds

Given the substantial news coverage of the issue during the 2002 interim, the budget committees are probably aware that Nathan Chapman, an outside investment manager hired by the pension board, is under investigation for his dealings with a submanager to whom he gave State pension funds to invest.

Nathan Chapman was an investment manager hired by the pension board in 1996 as a "fund of fund" manager. At one point in time, Chapman had approximately $242 million of State pension funds under management through his submanagers. In January 1997 Chapman hired Alan Bond as one of the submanagers to invest pension assets on behalf of the pension system. Between 1998 and 2000, Bond used some of his $33 million in "submanager" assets to purchase shares in Chapman's affiliated companies. Investigators are seeking to determine the extent to which there were any illegal conflicts of interest or other violations. Bond was indicted and subsequently convicted in a context outside of Maryland for participating in kickbacks. Bond has also been convicted for a "cherry picking" scheme in which he diverted the proceeds from profitable trades to his own account while steering losses to his clients, one of which was the SRPS.

After Bond's second indictment in August 2001, Chapman fired him as a submanager. At the time of his firing, the $33 million in pension system assets that Bond had invested was worth only $14.2 million. With regard to the approximately $5 million that Bond had invested in eChapman.com, as of March 2002, the stock was selling for 17 cents a share.

In January 2002 the pension board fired Chapman as a fund of funds manager after the board was notified by the Securities and Exchange Commission (SEC) that the SEC was investigating Chapman as a result of Bond's investment of pension system assets in Chapman-controlled companies.

The Joint Committee on Pensions held a briefing on this issue during the 2002 interim. During the briefing, legislators asked the agency investment staff about its responsibilities in monitoring external managers and informing the board about developments affecting these managers. The committee asked whether board members were aware of these developments, and if so, what actions the board took in response.

The board of trustees and agency staff should be prepared to discuss this issue with the budget committees. They should be prepared to answer the following questions: (1) What steps has the

agency's investment staff taken since the joint committee's briefing to alter the way it monitors external managers (and their submanagers)? (2) What steps has the board taken, including any possible changes in its interaction with agency investment staff, to ensure that it is fully briefed regarding developments affecting its external managers? (3) What role will the new investment consultant play in addressing future situations similar to this one? (4) Will the board's ongoing governance study address the issue of the relationship between agency investment staff and the board?

3. The State Pension System Lost $3 Billion in Fiscal 2002 and Investment Performance Continues to Lag Other Public Plans

The State pension system lost $3 billion in fiscal 2002 and has experienced further investment declines in the first part of fiscal 2003. While virtually all financial market investors have experienced losses during this period, the State system's losses continue to be worse than those of other large pension plans. The system's one-year performance ranked in the bottom quartile (seventy-seventh percentile) compared to other public pension plans with more than $1 billion in assets, and ranked in the ninety-ninth percentile for ten-year performance. Actions by the board such as hiring an outside investment consultant should help to identify the best practices of other states and hopefully improve the system's performance.

Board Hires Investment Consultant and Addresses Other Legislative Recommendations

During the 2002 interim the pension board hired an outside investment consultant, EnnisKnupp, to offer advice regarding manager selection, asset allocation, and the setting of appropriate performance measures. The hiring of the consultant was one of several recommendations that had been offered by the Joint Committee on Pensions and the Department of Legislative Services (DLS) in response to the agency's troubled investment performance. **Exhibit 5** lists the legislative recommendations and DLS's evaluation of the board's responses.

Exhibit 5

Pension Board Implementation of Legislative Recommendations

Recommendation	Rationale	Pension Board Response
Hire an outside investment consultant.	To provide an objective investment perspective and offer insights into the best practices of public pension investing, with particular goals of assisting in manager evaluation, selection, and termination; development of asset allocation targets; and development of appropriate asset class benchmarks.	Board has hired EnnisKnupp, a respected investment consulting firm based in Chicago. Consultant is attending board's investment committee meetings.

Recommendation	Rationale	Pension Board Response
Provide articulated asset allocation rationale.	To allow the legislature, system members, and the public to understand the system's investment decisions. The General Assembly has been concerned for several years about SRPS's high allocation for equities, for which no written rationale or justification was ever provided.	The board is updating its "Investment Operations Manual" to provide greater detail on investment rationale. DLS is concerned that this document will be cumbersome and will not provide a straightforward "policy statement." The board briefly reduced its equities allocation (although it remains higher than average) and recently voted to increase it again. This high equities allocation contributed to the system's continued poor performance in fiscal 2002.
Compare SRPS investment performance to that of public plan peers.	To provide a reasonable measuring device to the legislature, system members, the public, and the board itself to determine whether the board is wisely managing plan assets. While peer measures are not perfect, they give some insight into national best practices, particularly where plans rank highly over the long term.	At the recommendation of the investment consultant, the pension board voted to accept the use of a comparative measure of its investment performance in certain circumstances. Previously, the board had expressed skepticism about peer measures, arguing that it has unique goals and characteristics that make peer comparisons irrelevant.

Source: Department of Legislative Services

SRPS Performance Compared to Other Systems

In 2001 DLS reported that the SRPS one-year investment results were the worst among all the public pension plans with more than $1 billion in assets that participate in the Trust Universe Comparison Service (TUCS) survey. This year's one-year results are slightly better, but the system remains in the bottom quartile of one-year TUCS performance. More importantly, the system's ten-year performance – and it is generally agreed that long-term performance is a more important measure – was in the ninety-ninth percentile, meaning only one other TUCS participant did worse than SRPS over the ten-year period. **Exhibit 6** illustrates the system's performance compared to its TUCS peers.

Exhibit 6

TUCS Comparison to Public Funds with Assets Greater Than $1 Billion
Periods Ending June 30, 2002 – Rolling Years

	1 Year	5 Years	10 Years
5th Percentile	0.92%	6.40%	10.22%
25th Percentile	-4.99	5.94	9.82
Median	-5.82	5.13	9.34
75th Percentile	-7.28	4.64	8.84
SRPS Return	**-7.63**	**3.21**	**7.88**
95th Percentile	-8.64	3.84	7.88
SRPS – Percentile Rank	**77th**	**99th**	**99th**
Fiscal 2001 SRPS Rank	**100th**	**92nd**	**94th**

Source: State Street Analytics (*TUCS Master Trust Report*); State Retirement Agency

While the board was initially resistant to the use of peer comparisons, it recently adopted a policy recommended by the independent consultant retained by SRPS. The policy provides for use of the TUCS evaluation (as well as an evaluation by an entity known as Cost Effective Management, Incorporated (CEM)) for the purposes of a "red flag." The "red flag" would identify when the system should review those activities which affect their performance. Of note, similar to the TUCS one-year evaluation, the CEM 2002 evaluation also ranks SRPS in the bottom 20% of plans.

Is the 8% Actuarial Assumption for the System Appropriate?

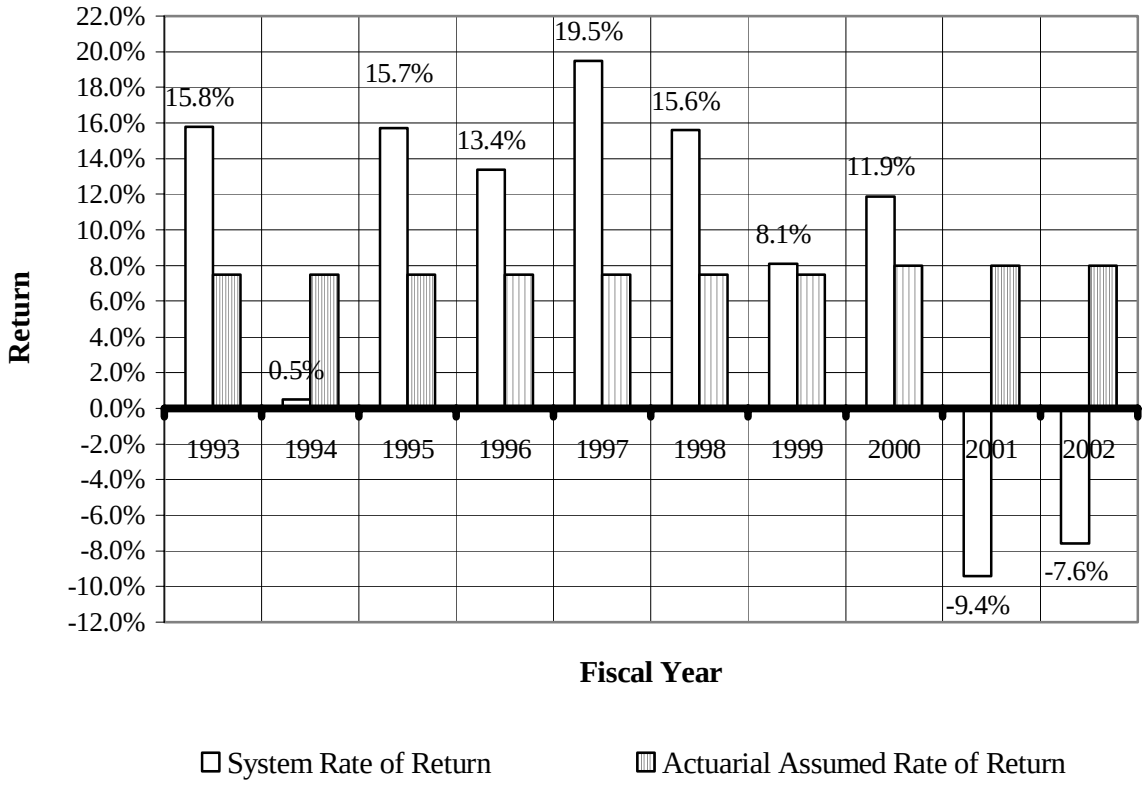
The actuarial assumptions of a soundly administered plan should be subject to periodic actuarial experience investigation. An experience investigation is a comparison of actual experience of the system with the actuarial assumptions used. Maryland law requires the actuary designated by the system to perform an experience investigation at least once every five years. The actuary advises that an experience investigation was performed in 1998 and that one is currently underway. Although the results of the current experience investigation are not available at this time, the experience of the system in the last five- and ten-year period raises the question of whether the designated actuarial assumption should be reviewed and modified.

In determining the State's contribution rate, the actuary estimates projected investment gains. The assumption for the projected gains of the system are based on a fixed actuarial target that is expected to be achieved over the long run. Prior to fiscal 1999, the system's actuarial target was 7.5%. In fiscal 1999

and thereafter, the actuarial target was raised to 8%. This increase was done in conjunction with the 1998 pension benefit enhancement, which was initiated by the SRPS board. As shown in **Exhibit 7**, at the time the increase was made, the system's returns had significantly exceeded the 7.5% assumption in every previous year except 1994.

Exhibit 7

Ten-year History of Time Weighted Annual Returns
Fiscal 1993 through 2002



Source: State Retirement Agency

The 8% assumption adopted by the Maryland system is consistent with the assumptions adopted by other public pension plans. Out of 93 public pension plans reviewed, 43 plans have adopted an 8% assumption, 19 plans have a assumption below 8%, 28 plans have a assumption higher than 8%, and no plans have exceeded a 9% assumption.

Unfortunately, the board's raising of its assumption to 8% roughly corresponded with the top of the stock market, so that for the past two fiscal years (and likely fiscal 2003 as well) the system has not

achieved the 8% measure. As illustrated in **Exhibit 8**, the experience of the system over the most recent five- and ten-year periods also shows a failure to exceed an 8% return. Moreover, one analysis of the expected long-term return and risk for the system's investment portfolio based on the system's asset allocation estimates that the expected long-term return of the portfolio will be 7.1%.

Exhibit 8

State Retirement and Pension System of Maryland
Fund Investment Performance for Periods Ended June 30, 2002

			Time Weighted Total Returns				
	$ Millions	**% Total**	**1 Yr.**	**3 Yrs.**	**5 Yrs.**	**7 Yrs.**	**10 Yrs.**
Equities	$16,958.4	63.9%	-14.5%	-6.6%	1.2%	7.4%	8.8%
Fixed Income	7,933.9	30.0%	6.5%	7.0%	7.1%	7.2%	8.0%
Real Estate	1,620.4	6.1%	10.3%	11.7%	9.6%	11.5%	8.5%
Total Fund	**$26,512.6**	**100.0%**	**-7.6%**	**-2.2%**	**3.2%**	**6.8%**	**7.9%**

Note: Revised real estate returns to March 31, 2002. Returns beyond one year are annualized. Returns are before fees. Alternative investments are included in the equities category.

Source: State Retirement Agency

Similar to the concerns regarding corporate pension plans, to the extent the 8% rate of return assumption for the Maryland SRPS is inflated, the funding status of the system is also inflated. If the rate of return assumption for the system were lowered, however, the plan's actuarial assets would decline and, in turn, the required State contribution amount could increase significantly. This is an issue that the General Assembly may wish to monitor and periodically discuss with the pension board.

4. The System's Computer Procurement Project Is Substantially Behind Schedule and the Base Pension Application May Never Be Implemented

The State Retirement Agency is currently in a dispute with Syscom, the vendor who was contracted to deliver a new benefit processing and administration computer system. Because there is both pending and potential litigation between the agency and Syscom involving this project, the agency, on the advice of the Attorney General's office, has limited its public comments regarding this matter. The little information that is publicly available indicates that the project will certainly not be completed within a reasonable

timeframe and that the more likely scenario is that the project, as currently structured, will never be implemented.

Background

The retirement agency began its efforts to procure a new computer system in 1991 and has sought legislation from the General Assembly several times to authorize spending authority for the project, and then to extend and increase that spending authority. In 1997 a vendor abandoned its contract award for a new system. The value of the agency's contract at the time was approximately $15 million. Subsequently, Chapter 556 of 1998 provided up to $37.1 million in spending authority over three years (in addition to the agency's statutory spending limit for ongoing administrative operations). The spending authority expired at the end of fiscal 2001. The current contract was awarded in May 1998 to Syscom, Inc., a Baltimore-based company acting as prime contractor for the project. The original time frame of the contract ran from May 1998 to April 2003, with an original "go live" date of October 2000.

New System Is Intended to Improve Member Service

The agency is currently operating with a mainframe computer system that dates to the early 1970s. Because of the limitations of the current system and subsequent statutory and administrative changes, a large number of agency functions (including certain benefit calculations) must be performed manually. These manual functions slow the agency's operations and increase the likelihood of error. It was intended that the new system would improve the level of customer service of the existing system by providing the following:

- improved document management;
- web-enabled access to system services;
- real time membership credit for clients;
- increased efficiency in processing data; and
- ready access to client's imaged documents.

The agency's goal is to ultimately provide 24-hour turnaround for any customer-related inquiry or transaction, with 95% of those services provided immediately on-line.

Chronology: Project Delay I – Completion Delayed from October 2000 to October 2001

In the summer of 2000 the agency received permission from the board to delay the project's go live date from October 2000 to October 2001. In late 1999 the agency became aware there was slippage in the work schedule and certain project milestones would be delayed. The delays resulted from problems with one of Syscom's subcontractors, Standard Data Corporation (SDC), which was responsible for the base retirement application, i.e., the software that computes the projected retirement benefits for active members and the actual benefits for retirees and beneficiaries. SDC underestimated the level of effort, particularly as regards staffing of programmers, needed to complete its contractual commitments. Because accurate computerization of these computations is integral to the agency's operations, the delay in this piece of the project interfered with progress in the other phases of the project (including creation of a computerized paperless workflow within the agency and computer-imaging of the agency's substantial paper documentation). To address these delays, the vendor team nearly doubled the number of employees assigned to the project. Subsequently during the summer of 2000, Syscom took over responsibility for the base retirement application.

The problems with the subcontractor coincided with project management issues within the agency. The agency's internal staff, particularly in the administrative division, were overwhelmed by the dual tasks of administering the pension benefits and reviewing programming "deliverables" from the vendor. The agency is also disputing whether those deliverables were provided in a format that actually allowed the reviewers to evaluate them. Further, it was later revealed that members of the agency's information services division were not adequately trained in the computer languages on which the new system was based and were, therefore, not able to adequately review the deliverables. Finally, it was clear that to the extent these issues were known to the information technology management at that time, they did not make these problems known to other members of the project steering committee or to the board.

The prime contractor, Syscom, Inc. of Baltimore, absorbed its additional costs for this one-year delay. These costs were estimated to be approximately $5 million. In addition, the delays resulted in additional costs to the agency, including retention of contractual staff for the duration of the project and increased computer audit expenses.

In October 2000 at the recommendation of the project's steering committee, the agency terminated the then Chief Information Officer who had served as project director from July 1993 to October 2000. At the advice of its legal counsel at that time, the agency would not discuss what specifically led to the dismissal of the leadership team. The agency subsequently hired a Chief Information Officer on loan from the University System of Maryland. Other actions taken by the board in light of the delay included a mandatory monthly briefing by agency staff on the project's status to the executive committee of the board.

Project Delay II – Completion Delayed from October 2001 to October 2003

During the summer of 2001 the agency described further problems in implementing its new computer system. These problems centered on a dispute with the vendor as to the appropriate amount of

testing the system requires. Discussion over the scope of testing pushed the completion target from October 2001 to October 2003.

Project Delay III – Completion Delayed from October 2003 to Never?

Since the fall of 2001, the agency has been advised by the Attorney General's office to limit its public comments regarding this matter given the pending and potential litigation between the agency and Syscom. What we do know is this. Shortly after the agency announced the two-year delay due to the testing dispute discussed above, the agency believed that there were "gaps and/or deficiencies" between the agency's requirements and the vendor's deliverables. The agency demanded an "assessment, recovery and remediation" (ARR) plan from Syscom. The agency has reviewed the submissions which Syscom made as part of the ARR plan, and has also conducted its own review and assessment of Syscom's work. The agency believes that there are significant problems with the work that Syscom has completed.

Syscom, meanwhile, is arguing that these gaps are not due solely to the vendor's performance and that many of them reflect change orders by the agency that are outside the scope of the RFP. The vendor intends to charge the agency for these changes above the original contractual payment schedule, and it demands payment for performance of the ARR plan. The agency indicates that it will deny any further payments to Syscom. Moreover, the agency does not have sufficient spending authority in its administrative budget to fund any substantial change orders.

Current Status

Exhibit 9 provides a current accounting of the agency's spending authority and actual expenditures for this project. As indicated below, of the $37 million contract, $27 million has already been paid to Syscom. Another $10 million has yet to be paid, which includes approximately $3 million in "holdbacks" pending the agency's acceptance of the completed project. Syscom is demanding payment of $5.8 million that it claims reflects submitted deliverables and work claimed to be out of scope. Finally, the agency holds an $8.2 million performance bond should it be found that Syscom failed to perform according to the contract.

Of the $27 million already spent by the agency, a portion represents three components of hardware and software delivered by Syscom that are currently being used by the agency. First, in 1998 the agency purchased new network hardware and software through Syscom to provide a platform for the new system. While the system has not been implemented, the network computers are operational and support the agency's current personal computer network. Second, the agency purchased its Lotus Notes e-mail software through Syscom and is currently using that software. Finally and perhaps most importantly, the agency and Syscom have implemented an imaging system that allows the agency to store member forms and other "hard-copy" data electronically. The agency currently has 6.2 million images in its data storage, and adds an additional 2,500 to 3,000 images per working day.

Exhibit 9

Strategic System Project – Financial Summary
As of January 31, 2003

Item	Cost/Amount
Project Spending Authority (the "Legislated Cap")	$37.096M
Authority Expired June 30, 2001	
Original Contract Value @ Inception May 13, 1998	32.649M
Total Current Contract Value including Approved Change Orders[1]	37.313M
Total Paid to Syscom to Date	27.291M
Balance of Contract Value	10.022M
Cumulative Contract Holdback (Retainage) Payable at System Acceptance (10% of Billing Allowed Less Certain Exclusions)	2.927M
Syscom Claims for Submitted Deliverables and Work Claimed to Be Out of Scope as of November 22, 2002 (Approximate)	5.752M
Performance Bond (International Fidelity Insurance Company)	8.162M
Amounts Paid to Other Sources (Direct Support of the Project)	
Brown and Company (Internal Controls Review)	0.869M
Mercury Software Testing Tool	0.152M
Training (Including In-state/Out-of-state Travel)	0.089M
Amounts Paid to Other Sources (Legacy System Support)	
Year 2000 (through June 30, 2001)	2.291M
Staff Augmentation (through June 30, 2001)	0.456M
State Contractual Payroll Costs (through June 30, 2001)	0.408M

[1] Funds have been allocated from the administrative budget to cover the difference between total project costs and the spending authority. Funds were encumbered for the project at the conclusion of fiscal 2001.

Source: State Retirement Agency

Unfortunately, another significant portion of the $27 million reflects the base pension application, which is the "heartbeat" of the agency's data processing because it calculates pension benefits and other provisions. It is this base pension application that is the center of the dispute with Syscom and is critical to any new information technology system at the agency. For the time being, the agency must rely on its mainframe computer plus various manual calculations in order to tabulate retirement benefits.

Part of the dispute is currently before the Board of Contract Appeals. Litigation has already commenced between the parties regarding the authority of the agency's procurement officer to have issued her December 2001 directive requiring Syscom to stop development and to undertake the ARR plan. The remainder of the dispute – over whether the delivered product meets the RFP's specifications – is also likely to be litigated.

In light of the problems plaguing the project, the Joint Committee on Pensions voted in fall 2001 to request a performance audit of the procurement be performed by the Office of Legislative Audits. The chairmen of the joint committee subsequently determined that a performance audit was not appropriate at that time, given that much of what would be subject to the performance audit could also be subject to the litigation between the vendor and the agency.

The Joint Committee on Pensions originally scheduled a briefing by the agency on the project during its 2002 interim schedule. Due to scheduling conflicts, and more pressing matters such as the Chapman issue, the briefing had to be cancelled. Nevertheless, the joint committee, in its 2002 interim report, expressed its concern about the project's difficulties.

Going forward, DLS believes that the board and the agency must pursue a two-pronged strategy. On the one hand, the board is still reviewing the viability of the current project and related matters and must make a final decision regarding the future of this contract. On the other hand, if the current procurement is not viable, the agency must determine how to go forward in upgrading its existing system while avoiding the pitfalls of the recent past. Given the age of the legacy mainframe system, which dates from the early 1970s, the agency must pursue alternatives for bringing its data processing into the current era and must begin such long-term planning without waiting until the current contractual dispute is finally resolved.

The agency should comment on the implementation status of the computer system. In the future, DLS recommends that the State Retirement Agency consult with and provide regular briefings to the General Assembly, legislative staff, and the Department of Budget and Management and the statewide Chief Information Officer on all public developments regarding the current procurement and any other alternative planning for overhauling the agency's data processing systems.

Recommended Actions

		Amount Reduction		Position Reduction
1.	Delete four new positions in accordance with Spending Affordability Committee guidelines for new positions.	$ 224,215	SF	4.0
	Total Special Fund Reductions	**$ 224,215**		**4.0**

Appendix 1

Current and Prior Year Budgets

Current and Prior Year Budgets
State Retirement Agency
($ in Thousands)

	General Fund	Special Fund	Federal Fund	Reimb. Fund	Total
Fiscal 2002					
Legislative Appropriation	$0	$20,172	$0	$0	$20,172
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	-488	0	0	-488
Reversions and Cancellations	0	-119	0	0	-119
Actual Expenditures	**$0**	**$19,565**	**$0**	**$0**	**$19,565**
Fiscal 2003					
Legislative Appropriation	$0	$19,776	$0	$0	$19,776
Budget Amendments	0	400	0	0	400
Cost Containment	0	-12	0	0	-12
Working Appropriation	**$0**	**$20,165**	**$0**	**$0**	**$20,165**

Note: Numbers may not sum to total due to rounding.

Object/Fund Difference Report
State Retirement Agency

Object/Fund	FY 02 Actual	FY 03 Working Appropriation	FY 04 Allowance	FY 03 - 04 Amount Change	Percent Change
Positions					
01 Regular	177.00	168.00	172.00	4.00	2.4%
02 Contractual	29.83	31.50	31.50	0	0%
Total Positions	**206.83**	**199.50**	**203.50**	**4.00**	**2.0%**
Objects					
01 Salaries and Wages	$ 10,301,185	$ 9,661,563	$ 11,095,536	$ 1,433,973	14.8%
02 Technical & Spec Fees	1,478,000	1,419,544	1,403,888	-15,656	-1.1%
03 Communication	1,040,444	907,525	1,017,266	109,741	12.1%
04 Travel	97,252	127,043	122,284	-4,759	-3.7%
07 Motor Vehicles	175,437	181,166	137,148	-44,018	-24.3%
08 Contractual Services	4,629,008	5,645,557	4,743,322	-902,235	-16.0%
09 Supplies & Materials	187,300	358,573	210,773	-147,800	-41.2%
10 Equip - Replacement	52,037	137,650	48,188	-89,462	-65.0%
11 Equip - Additional	51,031	48,415	0	-48,415	-100.0%
13 Fixed Charges	1,553,440	1,689,257	1,787,189	97,932	5.8%
Total Objects	**$ 19,565,134**	**$ 20,176,293**	**$ 20,565,594**	**$ 389,301**	**1.9%**
Funds					
03 Special Fund	$ 19,565,134	$ 20,176,293	$ 20,565,594	$ 389,301	1.9%
Total Funds	**$ 19,565,134**	**$ 20,176,293**	**$ 20,565,594**	**$ 389,301**	**1.9%**

Note: Fiscal 2003 appropriations and fiscal 2004 allowance do not include cost containment and contingent reductions.

Fiscal Summary
State Retirement Agency

Unit/Program	FY 02 Actual	FY 03 Legislative Appropriation	FY 03 Working Appropriation	FY 02 - 03 % Change	FY 04 Allowance	FY 03 - 04 % Change
01 State Retirement Agency	$ 19,565,134	$ 19,776,291	$ 20,176,293	3.1%	$ 20,565,594	1.9%
Total Expenditures	**$ 19,565,134**	**$ 19,776,291**	**$ 20,176,293**	**3.1%**	**$ 20,565,594**	**1.9%**
Special Fund	$ 19,565,134	$ 19,776,291	$ 20,176,293	3.1%	$ 20,565,594	1.9%
Total Appropriations	**$ 19,565,134**	**$ 19,776,291**	**$ 20,176,293**	**3.1%**	**$ 20,565,594**	**1.9%**

Note: Fiscal 2003 appropriations and fiscal 2004 allowance do not include cost containment and contingent reductions.