EAST VALLEY WATER DISTRICT
Administrative Policies & Programs

Policy Title: Unfunded Accrued Liability Management Policy			
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Section 1. Purpose

The purpose of this Unfunded Accrued Liability Management Policy (the "Policy") is to strategically address the existing and any future unfunded accrued liability (the "UAL") associated with the East Valley Water District's (the "District") California Public Employees' Retirement System (CalPERS) pension plans (the "Pension Plans"). This Policy also addresses some of the principal elements and core parameters central to the policy objectives discussed in this Policy. In the development of this Policy, the District strives to reduce its UAL and the associated financing costs in the most cost-efficient and fiscally responsible manner possible.

The District is committed to fiscal sustainability by employing long-term financial planning efforts, striving to maintain appropriate reserve levels, and employing prudent practices in governance, management, budget administration, and financial reporting. This Policy is intended to make all relevant information readily available to decision-makers and the public to improve the quality of decisions and transparency, identify policy goals, and to demonstrate a commitment to long-term financial planning. Development of this Policy signals to rating agencies and capital markets that the District is willing to set policies that improve its ability to meet its obligations in a timely manner.

The Policy is intended to reflect a reasonable and conservative approach to managing UAL costs associated with the Pension Plans. This Policy recognizes that the Pension Plans are subject to market volatility, and that actual economic and demographic experience of the plans will differ from the actuarial assumptions. Accordingly, it is intended to allow for adaptive responses to changing circumstances, providing flexibility to address such volatility in a financially sound manner. As such, the District will be required to continually monitor its Pension Plans and the corresponding UAL.

Section 2. Policy Goals and Objectives

The overarching goals and objectives of this Policy are as follows:

- Establish, attain, and maintain targeted pension plan funding levels
- Provide sufficient assets to permit the payment of all benefits under the Pension Plans

- Seek to manage and control future contribution volatility to the extent reasonably possible
- Strive to make Annual Discretionary Payments to accelerate UAL pay-down, reduce interest costs, and stabilize future payments
- Maintain the District's sound financial position and creditworthiness
- Provide guidance in making annual budget decisions
- Create sustainable and fiscally sound future budgets
- Demonstrate prudent financial management practices
- Ensure that pension funding decisions protect both current and future stakeholders
- Create transparency as to how and why the Pensions Plans are funded

Section 3. Background and Discussion

A. In General. Each Pension Plan is a multiple-employer defined benefit pension plan administered by the CalPERS. All full-time and certain part-time District employees are eligible to participate in the CalPERS retirement and disability benefits, annual cost of living adjustments and death benefits offered to plan members and their beneficiaries. CalPERS acts as a common investment and administrative agent for participating public entities within the State of California. Benefit provisions and all other requirements are established by state statute.

The financial objective of a defined benefit pension plan is to fund the long-term cost of benefits provided to the plan participants. In order to assure its financial soundness and sustainability, the plan should accumulate adequate resources in a systematic and disciplined manner to ensure sufficient resources are available to meet employee benefit requirements. This Policy outlines the practices the District will utilize to address its actuarially determined contributions to fund the long-term cost of benefits to the Pension Plan participants and annuitants.

B. Pension Costs and Liabilities. In order to fund its employees' pension benefits, the District is required to make contributions (a portion of which may come from the employees) to CalPERS. CalPERS then invests these contributions to generate returns to help fund the pension benefits. The regular required contributions, known as the "Normal Cost," are calculated as a percent of salaries and represent the annual cost of service accrual for the upcoming fiscal year for active employees. If, for any reason, the actual Pension Plan experience and investment performance fall short of the actuarial assumptions, the Pension Plan can become underfunded, (i.e. the Pension Plan's Total Accrued Liability exceeds the Plan's Market Value of Assets). This shortfall is known as the Unfunded Accrued Liability (the "UAL") and usually has to be covered by the District through a series of UAL Payments, which are above and beyond the "Normal Cost" contributions. The UAL Payments are calculated in total dollar amounts, not as a percent of salaries.

The UAL can be caused by multiple factors, including but not limited to, changes to CalPERS' actuarial amortization policy, retroactive pension benefit enhancements, investment underperformance, actuarial assumption changes, demographic factors, and discount rate reductions.

C. UAL is Debt. The UAL balance at any given point in time is a debt of the District owed to CalPERS which is amortized over a set period of time with interest accruing at the then current CalPERS discount rate (the "Discount Rate"). However, this debt can be prepaid at any time without penalties. Recognizing the UAL as debt helps the District identify proper steps to address it and minimize the associated financing costs.

D. Ongoing CalPERS Practices. Every year CalPERS prepares updated actuarial valuation reports for each of the District's Pension Plans wherein it calculates the District's total pension liability as of the end of the prior fiscal year (each a "Valuation Report"). If the investment performance during that fiscal year was different from the Discount Rate, or if CalPERS made any changes to its actuarial assumptions, or if the actual demographic or compensation experience within the Pension Plans was different from the actuarial assumptions, new line items, or UAL amortization "bases," may be added to the plan and result in a change to the UAL balance. Such UAL amortization bases may be positive (indicating funding shortfall for the Pension Plans) or negative (indicating funding surplus for the Pension Plans). Since CalPERS can add new UAL amortization bases every year, the Pension Plans must be monitored annually and managed continually – there is no one-time solution.

CalPERS has adopted the UAL amortization methods that were meant to help public agencies "ease into" paying for the UAL increases. New UAL amortization bases are implemented incrementally, with a five-year ramp-up period, and at times include additional small increases in each of the subsequent years. The ramp-up period, while reducing the cash flow impact in the near term, increases the overall UAL repayment costs for the District by delaying repayment. Since the UAL balances accrue interest at the rate that is equal to the then current Discount Rate, the delayed payments prior to the commencement of the amortization and the reduced payments during the ramp-up period that do not fully cover the interest costs result in negative amortization, causing further increases to the UAL balance. To help reduce the overall costs of the UAL repayment, this Policy encourages level annual payments (i.e., no ramp-up) whenever possible.

Section 4. Policy

A. Funding Level Objective. It is the District's policy to strive to achieve and maintain a Pension "Funded Ratio" (being the ratio by which the Market Value of Assets—as set forth in the most recently published Valuation Report—compares to the Entry Age Normal Accrued Liability or "Total Accrued Liability"—as set forth in the most recently published Valuation Report) for each Pension Plan of 85% (the "Funding Level Objective").

Funding Level Objective = 85%

Achieving and maintaining the 85% Funding Level Objective ensures that the ongoing contributions of the District and its employees are properly and adequately funding the retirement benefits of today's workers. The reason for a Funding Level Objective of 85% rather than 100% is to allow some cushion for the possibility that good investment returns by CalPERS in a given year might push the funded level of a Pension Plan above 100% (commonly referred to as "superfunded status"). The District will strive to manage the 15% differential (i.e., the difference between 85% and 100%) through its own investment process by virtue of a "115 Trust Pension Fund" discussed herein.

Guidance: To achieve the Funding Level Objective and ensure compliance with best management practices, this Policy provides the following guidance:

1. Pre-Pay the Entire Annual UAL Payment by July 31st of each year. On or before July 31st of each year, the District receives its annual CalPERS UAL invoice. The District has two payments options. The invoice can (1) be paid in equal monthly increments, or (2) be fully pre-paid at the beginning of the fiscal year by July 31st. By prepaying the entire invoice amount due by July 31st, the District can concurrently save approximately 3.5% compared to making the monthly payments. As such, every effort should be made to pre-pay the UAL payment upon receipt of the annual invoice.

2. Pre-Pay UAL from Reserves, One-Time Revenues and Fund Surpluses. Reserves normally do not earn returns that can offset the interest rate that CalPERS charges on the outstanding UAL balance. Supplemental contributions into the Pension Plans and/or the 115 Trust Pension Reserve Fund (see Section 4C below) from available reserves, one-time revenues and fund surpluses can generate substantial long-term net savings. Each supplemental contribution, referred to by CalPERS as an Additional Discretionary Payment (ADP), reduces the UAL balance, the Annual Required Contributions (ARC) for future years, and the total interest costs associated with the UAL. Therefore, during each budget cycle, the District staff shall review all available reserves, one-time revenues and fund surpluses to determine whether any such funds could be used to make an ADP to pay down the UAL, keeping in mind operational and capital budgetary constraints while maintaining adequate reserves and balancing the fiscal soundness of eliminating the high-interest UAL debt. Every effort should be made to make an ADP during years with added bases to avoid ramp-up periods and the associated costs. ADPs should not adversely affect the general operations and fiscal soundness of the District.

3. Capital Financing. When considering capital improvement projects, staff regularly reviews and plans for reserving cash to fund some or all of these capital improvement projects. When considering how to pay for current and future capital improvement projects, staff should review the current tax-exempt market to assess if it would be more cost effective to borrow at tax-

exempt rates to pay for the capital projects and redirect the reserved cash (and/or such other appropriate funds of the District) to make ADPs to CalPERS.

If there are projected cost savings by using this method, and a capital financing strategy is to be implemented, the Board would need to approve of the ADPs being paid to CalPERS prior to the financing to ensure that the once reserved capital project funding is applied to UAL paydowns.

4. <u>Utilize Savings Achieved from Refunding Outstanding Non-Pension Related Debt to Pre-Pay UAL.</u> During each budget cycle, the District staff should review all outstanding long-term non- pension related debt of the District to determine whether a refunding of such debt might result in net present value (NPV) savings of greater than 3%, and if so, consider a structure and strategy that frontloads the savings from such debt refunding, which can then be used to pay down the UAL or make a contribution to the 115 Trust Pension Reserve Fund discussed herein. This strategy should only be used if the interest rates on the currently outstanding debt is sufficiently below the then-current Discount Rate to ensure that overall NPV savings of greater than 3% are achieved by the District.

5. <u>Sources of Revenue.</u> All fees, rates and charges should incorporate full allocation of pension costs for employees providing associated services. While some funds cannot contribute more than their fair share, they should not contribute less than their fair share. District staff shall review allocation of labor costs to proprietary and other funds to ensure full reimbursement of the pension cost burden.

6. <u>Pension Obligation Financing.</u> The District shall consider issuing taxable municipal debt obligations (Pension Obligations) to refinance the UAL, in part or in whole, if such bond obligations are expected to produce minimum cash flow savings of at least 8%. Pension Obligations shall not utilize swaps or derivatives of any kind and should be structured with reasonable and flexible call provisions (with a maximum of 10- year call provision). Pension Obligations shall be used only to prepay the UAL liabilities, and shall not be used to finance

Normal Cost payments. The issuance of Pension Obligations must be voted upon and approved by the Board.

To the extent directed by the Board after due consideration, annual savings achieved by issuing the Pension Obligations should be used to either (i) directly prepay new UAL amortization bases as they arise, (ii) make deposits into the 115 Trust Pension Reserve Fund, (iii) offset operational costs, and/or (iv) fund any other legally permissible activities of the District.

7. <u>Annual Review of the CalPERS Actuarial Valuation Reports and Associated Tasks.</u> The District staff shall review or cause to be reviewed the annual CalPERS actuarial valuation reports once they are made public by CalPERS. The review should focus on identifying the annual changes to each of the Pension Plan's UAL and quantifying the associated cost implications and the corresponding impact on the Funded Ratio. Staff should annually reach out to the District's CalPERS actuary to request a calculation of flat payments (rather than ramp-up payments) for all outstanding and new UAL amortization bases. In making ADPs, the District staff shall determine or cause to be determined the optimal application of the ADPs to the outstanding UAL amortization bases to achieve the Funding Level Objective as well as desired budgetary outcomes.

B. District Contributions

1. Annual Contribution Relative to Payroll. Recognizing the benefit of long-term returns and the need to proactively manage the high long-term costs associated with carrying UAL, the District will proactively contribute funds to the CalPERS Pension Plans and/or the 115 Trust Pension Reserve Fund based on a percentage of each Fiscal Year's forecasted payroll.

   In each Fiscal Year where the Pension Plans total Market Value of Assets combined with the 115 Trust Pension Reserve Fund balance is less than [108]% of the Entry Age Normal Accrued Liability (which summation is hereafter referred to as the "115 Trust Pension Reserve Fund Ceiling"), during the District's normal budget adoption process, beginning with the 2025-26 Fiscal Year budget, the District will consider contributing amounts to either the CalPERS Pension Plans if funded less than 85%, and if not, the Annual Contribution shall be made to the 115 Trust Pension Reserve Fund, in amounts that are between [1]% and [5]% of the forecasted payroll for that Fiscal Year (the "Annual Contribution"), as recommended by the General Manager or Chief Financial Officer and approved by the Board as part of the final Adopted Budget.

2. Other Contributions. If the Funded Ratio falls below 85%, all other discretionary contributions above and beyond the Annual Contributions (the "Other Contributions") made by the District will be allocated to the CalPERS Pension Plans as an ADP. However, if the Funded Ratio surpasses 85% but remains below the 115 Trust Pension Reserve Fund Ceiling, then such Other Contribution will be directed to the 115 Trust Pension Reserve Fund.

C. Establishment and Operation of a 115 Trust Pension Reserve Fund.

1. Establishment of a 115 Trust Pension Reserve Fund. The District has or will have established a 115 Trust Pension Reserve Fund which is managed by a third-party investment manager (the "Investment Manager"). The 115 Trust Pension Reserve Fund may receive funds deposited into it at the discretion of the Board, based on recommendations made by the General Manager or Chief Financial Officer during the annual budget process. Funds in the 115 Trust

Pension Reserve Fund shall only be used for the District's pension benefits costs (i.e., UAL and Normal Costs) associated with the District's Pension Plans in accordance with the goals and objectives set forth in this Policy.

2. Funding the 115 Trust Pension Reserve Fund.

(a) Annual Contributions and Other Contributions. The District will endeavor to make Annual Contributions and Other Contributions in the amounts and manner specified in Section 4B above until such time that the 115 Trust Pension Reserve Fund reaches the 115 Trust Pension Reserve Fund Maximum (as outlined in section 4C3 below).

(b) Sequestered Savings. Upon the issuance of each series of Pension Obligations, for each of the ensuing ten (10) consecutive years (or such other period of years as deemed appropriate by the Board at the time of any subsequent issuances of Pension Obligations) following such issuance, a fixed dollar amount equal to [50%] (or such other percentage as deemed appropriate by the Board at the time of any subsequent issuances of Pension Obligations) of the "Total Sequestered Savings" (as calculated in the manner set forth below) achieved by issuing Pension Obligations (the "Annual Sequestered Savings Savings"), shall be transferred from the operating fund and deposited into the 115 Trust Pension Reserve Fund until such time that the 115 Trust Pension Reserve Fund reaches the 115 Trust Pension Reserve Fund Maximum (as outlined in section 4C3 below), and thereafter all Sequestered Savings will be directed to a "Pension Obligation Prepayment Fund" which will be established and maintained by the District for the purpose of prepaying any outstanding Pension Obligations.

$$\text{Annual Sequestered Savings} = \text{SSP} \times \left(\frac{\text{UALDS - DS}}{\text{Y}} \right)$$

SSP = Sequestered Savings Percentage
UALDS = Scheduled UAL debt service being paid off by the Pension Obligations
DS = Total principal amount of Debt Service on the Pension Obligations
Y = Number of years to pay back Sequestered Savings

Example of Annual Sequestered Savings Calculation

A $5M Pension Obligation was issued for the purpose of prepaying UAL. The total UAL debt service (UALDS) paid off with the Pension Obligation was $8,000,000 and the total debt service (DS) on the Pension Obligation is $7,000,000. The District elected to sequester 50% of the total savings over a 10-year period (Y), which in this example results in Annual Sequestered Savings of $50,000.

$$\text{Annual Sequestered Savings} = 0.5\text{x}\left(\frac{8{,}000{,}000 - 7{,}000{,}000}{10}\right)$$

$$= \$50{,}000$$

3. <u>Operation of the 115 Trust Pension Reserve Fund.</u> All Annual Contributions and Other Contributions that have been directed to the 115 Trust Pension Reserve Fund, along with all applicable Sequestered Savings, shall be used solely for the purpose of making ADP's (and Normal Cost payments during a Fiscal Hardship, as defined below) to CalPERS for the purpose of achieving and maintaining the Funding Level Objective.

   With the goal of achieving and maintaining the Funding Level Objective, each year during the budget cycle, District staff shall calculate, or cause to be calculated, the upcoming Fiscal Year's estimated Funded Ratio by taking into account the most recent Valuation Report's statement of Funded Ratio and adjusting for the estimated UAL amortization base that will be either added or subtracted due to the prior Fiscal Year's investment result of either exceeding or falling short of the then current Discount Rate for that Fiscal Year (the "Estimated Funded Ratio"). If the Estimated Funded Ratio is estimated to be less than the Funding Level Objective, to the extent funds are available in the 115 Trust Pension Reserve Fund, the appropriate member of staff shall either make, or shall direct the Investment Manger to make, an ADP to CalPERS in the amount necessary to bring the Funded Ratio back up to the Funding Level Objective. Additionally, if sufficient funds are available in the 115 Trust Pension Reserve Fund, staff shall assess whether to fully amortize any new UAL amortization bases to reduce the long-term interest costs associated with the "ramping" procedures used by CalPERS.

Except in the case of a Fiscal Hardship, as defined below, moneys in the 115 Trust Pension Reserve Fund shall not be used to pay Normal Costs until such time as the amount therein, when combined with the Market Value of Assets (as set forth in the most recently published Valuation Report) exceeds the 115 Trust Pension Reserve Fund Maximum. To the extent monies in the 115 Trust Pension Reserve Fund on June 30th exceed the 115 Trust Pension Reserve Fund Maximum (after consideration has been given to the amounts therein required to be paid to CalPERS for the ensuing Fiscal Year to maintain the Estimated Funded Ratio at or above the Funding Level Objective), any accrued surplus over [108]% may be used to offset the District's Normal Cost payment made to CalPERS in such Fiscal Year, and any applicable Sequestered Savings will be directed to the Pension Obligation Prepayment Fund.

4. <u>Fiscal Hardship.</u> "Fiscal Hardship" means an economic hardship, or other unanticipated fiscal emergency, that has been declared by resolution of the Board.

D. <u>Transparency and Reporting.</u> Funding of the Pension Plans should be transparent to all stakeholders, including plan participants, annuitants, the Board, and District residents. To achieve this Policy objective, copies of the annual actuarial valuation reports for each Pension Plan shall be made available to the Board, and shall be posted on the District's website. The District's audited financial statements shall also be posted on the District's website because they include, among other things, information on the District's current and future annual Pension Plan contributions as well as the funded status of each Pension Plan.

E. <u>Annual Budget to Contain Policy Directed Information.</u> The District's annual operating budget shall consider the items specified in this Policy for inclusion in each such annual budget.

F. <u>Review of Policy.</u> Funding a defined benefit pension plan requires a long-term horizon planning approach. This Policy is intended to provide general objectives and guidelines, which will require periodic review to consider changes in the District's financial position and Pension Plan funded status over time. As such, the District staff will review this Policy for implementation of new best practices and will provide such proposed changes to the Board for adoption on an as needed basis, not to exceed 5 years.