RESOLUTION NO. 2021-10

A RESOLUTION OF THE BOARD OF DIRECTORS OF THE SAN BENITO COUNTY WATER DISTRICT ADOPTING AN UNFUNDED ACCRUED LIABILITY MANAGEMENT POLICY

WHEREAS, the Board of Directors (the "Board") of the San Benito County Water District (the "District") is obligated by the Public Employees' Retirement Law, commencing with Section 20000 of the Government Code of the State of California, as amended (the "Retirement Law"), to make payments to the California Public Employees' Retirement System ("CalPERS") relating to pension benefits accruing to current and former District employees who are CalPERS members, including retired employees (the "CalPERS Obligations"); and

WHEREAS, the District currently has an unfunded accrued liability (the "UAL") in respect of the CalPERS Obligations; and

WHEREAS, the CalPERS Obligations, including the UAL, and all other aspects of the pension plan arrangements between CalPERS and the District, is evidenced by a contract or contracts with CalPERS with respect to public safety employees and miscellaneous employees of the District, as heretofore and hereafter amended from time to time (collectively, the "Pension Plans"); and

WHEREAS, the District is in the process of issuing municipal obligations that will generate proceeds to pay off a certain portion of the District's current estimated UAL owed to CalPERS; and

WHEREAS, CalPERS provides the District with new actuarial valuations on an annual basis that calculates the District's total pension liability as of the new valuation date; and

WHEREAS, on an annualize basis, it is possible that the District will incur new UAL costs if the District's funded assets are not equivalent to the actuarially determined liability amounts; and

WHEREAS, the District desires to establish a framework for funding new UAL costs that may arise in the future with the objective of funding the Pension Plans at certain targeted levels of the total accrued liability, whenever possible; and

WHEREAS, to facilitate payment of future UAL costs in a timely manner and to reduce the risk that future UAL costs pose to the District's financial position, the District desires to adopt the Unfunded Accrued Liability Management Policy, attached hereto (the "UAL Management Policy"); and

NOW, THEREFORE BE IT RESOLVED AND ORDERED BY THE BOARD OF DIRECTORS OF THE SAN BENITO COUNTY WATER DISTRICT THAT:

Section 1. **Recitals and Findings**. The Board hereby specifically finds and declares that all of the facts set forth in the Recitals of this Resolution are true and correct.

Section 2. **Adoption of UAL Management Policy**. The Board hereby finds and declares that the UAL Management Policy, attached as Exhibit "A" hereto, is hereby approved and adopted as the official San Benito County Water District Unfunded Accrued Liability Management Policy to be effective April 28, 2021.

Section 3. **Authorized Official Actions.** The District Manager, Assistant Manager, Secretary and all other officers of the District are hereby authorized and directed, jointly and severally, to do any and all things to effectuate the purposes of this Resolution and to implement and administer the UAL Management Policy.

Section 4. **Effective Date.** This Resolution shall take effect from and after the date of its passage and adoption.

PASSED AND ADOPTED by the Board of Directors of the San Benito County Water District at a meeting thereof on the 28th day of April 2021, by the following vote:

AYES: Williams, Tonascia, Flores, Shelton and Tobias

NOES: None

ABSENT: None

ABSTAIN: None

<u>*/s/Doug Williams*</u>
Doug Williams
President

ATTEST:

<u>*/s/Sara Singleton*</u>
Sara Singleton
Assistant Manager/Board Secretary

<u>EXHIBIT A</u>

UNFUNDED ACCRUED LIABILITY MANAGEMENT POLICY

San Benito County Water District

Adopted by the Board of Directors of the San Benito County Water District

Pursuant to Resolution No. 2021-10

April 28, 2021

Section 1. Purpose

The purpose of this Unfunded Accrued Liability Management Policy (the "Policy") is to strategically address the unfunded accrued liability (the "UAL") associated with the San Benito County 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, maintaining 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, identify policy goals, and to demonstrate a commitment to long-term financial planning. Adherence to this Policy signals to rating agencies and capital markets that the District is well managed and able to meet its obligations in a timely manner.

The Policy is intended to reflect a reasonable, conservative approach with each generation of taxpayers financing, to the greatest extent possible, the cost of pension benefits accruing under 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

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 over the active service life of benefitting employees. 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.

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 Normal 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.

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 present rate of 7%. 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.

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. If the investment performance during that fiscal year was different from the discount rate used by CalPERS, 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 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 impact in the near term, increases the overall UAL repayment costs for the District. Since the UAL balances accrue interest at the rate that is equal to the CalPERS discount rate (presently 7%), 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. UAL Funding Objective of 95 Percent or Greater. It is the District's policy to strive to achieve and maintain a UAL funded level for each Pension Plan of at least 95%, but never dropping below 85%. Achieving and maintaining the 95% funded level ensures that the ongoing contributions of the District and its employees – and therefore the taxpayer funds – are properly funding the retirement benefits of today's workers. This concept is commonly referred to as the intergenerational equity. Falling short of this funded level forces future taxpayers to pay the costs of the poor planning and execution of today's Pension Plans. The reason for the funded level goal of 95% rather than 100% is to allow some cushion for the possibility that good investment returns in a given year might push the funded level of a Pension Plan above 100% (commonly referred to as "superfunded status"), which means that the District and its employees had contributed into the Pension Plan more than was necessary. Thus, while the District remains committed to the 100% funded level, it shall manage the 5% differential through its own investment process by creating the "Pension Rate Stabilization Fund" discussed below. Therefore, any UAL below the 95% funded level should be paid down as soon as possible.

Guidance: To achieve this Funding Objective, this Policy provides the following guidance:

1. ***Pre-Pay the Entire Annual UAL Payment by July 31st of each year*.** On or before July 1st of each year, the District receives its annual CalPERS UAL invoice. The District has two payments options. The invoice can be paid in equal monthly increments or 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 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 (often invested in LAIF) rarely earn returns that can offset the interest rate that CalPERS charges on the outstanding UAL balance (presently 7%). Supplemental contributions into the Pension Plans 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 budgetary constraints and the prudence of maintaining adequate reserves, but balancing the fiscal soundness of eliminating the high-interest (presently, 7%)

UAL debt. ADPs should not adversely affect the general operations and fiscal soundness of the District.

Additionally, reserve policies should take into consideration the possibility of financing capital improvement projects and major equipment purchases with low tax-exempt interest rate debt and weigh it against the interest costs related to having outstanding UAL.

3. ***Utilize Savings Achieved from Refunding Outstanding Debt to Pre-Pay UAL*.** During each budget cycle, the District staff should review all outstanding long-term debt of the District to determine whether a refunding of such debt might result in net present value savings of greater than 3%, and if so, consider a structure and strategy that frontloads the savings, which can then be used to pay down the UAL.

4. ***Sources of Revenue*.** 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 (i.e., enterprise funds), 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. The District staff shall provide, or cause to be provided, consistent and well-documented methodology for pension cost allocation to all funds.

5. ***Pension Obligation Financing*.** The District shall consider issuing taxable municipal debt obligations (generically hereafter referred to as "Pension Obligations") to refund the UAL, in part or in whole, if such bond obligations are expected to produce minimum cash flow savings of at least 5%, taking into account all debt service and costs of issuance associated with such bond obligations, in comparison to CalPERS' respective UAL amortization schedule and the then-current discount rate. Pension Obligations shall not utilize derivatives / swaps and should be structured with reasonable and flexible call provisions. 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 Pension Rate Stabilization Fund, (iii) offset General Fund operational costs, and/or (iv) fund any other legally permissible activities of the District.

   During each budget cycle, a recommendation for the actual savings allocation should be partially determined based upon CalPERS' latest actuarial valuation report and most recent fiscal year investment returns. If the investment returns are below the discount rate, the District should allocate a higher portion of savings to fund future UAL costs (either making an ADP towards the newest bases first and/or making a deposit into the Pension Rate Stabilization Fund). Alternatively, if the investment returns are higher than the discount rate, then the District may allocate more of the savings to offset General Fund operational costs or to other uses.

6. **Pension Rate Stabilization Fund.** The District staff shall research and bring to Board for consideration the possibility of establishing a Pension Rate Stabilization Fund, either self-managed or a Section 115 trust fund managed by a third-party investment manager. The Pension Rate Stabilization Fund will have funds deposited into it at the discretion of the Board, based

on recommendations made by the District staff during the annual budget process. Funds in the Pension Rate Stabilization Fund should only be used to manage the District's pension benefits costs in accordance with the goals and objectives set forth in this Policy.

7. **Annual Review of the CalPERS Actuarial Valuation Reports and Associated Tasks.** The District staff shall review or cause to be reviewed the annual CalPERS actuarial valuation reports within 30 days of their release by CalPERS, which usually takes place during the month of August. The review should focus on identifying the annual increases to the UAL and quantifying their cost implications. The District 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 desired budgetary outcomes.

B. Transparency and Reporting. 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. The District's audited financial statements shall 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.

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

D. Review of Policy. 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 and constant update to consider changes in the District's financial position and Pension Plan funded status over time. As such, the Board will review this Policy at least every five years.