LIVERMORE AMADOR VALLEY TRANSIT AUTHORITY

STAFF REPORT

SUBJECT: Pension Liability Assessment

FROM: Tamara Edwards, Director of Finance, Interim Executive Director

DATE: October 17, 2022

Action Requested
This is an information item there will be a presentation by Andrew Flynn from CalMuni Advisors and discussion.

Background
LAVTA has a policy regarding our 115 Trust contributions but not one for our Pension Liabilities as a whole. Staff has been working with CalMuni Advisors in order to develop a policy for the agency. At last month's F&A meeting Andrew presented on the current status of LAVTA Pension Liabilities, and some strategies on funding.

Discussion
At this Committee Meeting Andrew Flynn from CalMuni will work with the committee to help determine what they would like Authority's Pension Liability policy to look like.

Once direction is received from the Committee Andrew will work with staff to develop a policy to be presented to the Board of Directors.

Recommendation
None – information only.

Attachments

1. Draft-UAL Pension Management Policy

UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY

Livermore-Amador Valley Transit Authority

Adopted by the Board of Directors of the Livermore-Amador Valley Transit Authority

Pursuant to Resolution No.

MM DD YYYY

LIVERMORE-AMADOR VALLEY TRANSIT AUTHORITY
UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY

Section 1. Purpose

The purpose of this Unfunded Accrued Liability Pension Management Policy (the "Policy") is to strategically address the existing and any future unfunded accrued liability (the "UAL") associated with the Livermore-Amador Valley Transit Authority's (the "Authority") 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 Authority strives to reduce its UAL and the associated financing costs in the most cost-efficient and fiscally responsible manner possible.

The Authority 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 Authority is well managed and able to meet its obligations in a timely manner.

The Policy is intended to reflect a reasonable and conservative approach to managing the 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 Authority is 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 Authority'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 California Public Employee Retirement System ("CalPERS"). All full-time and certain part-time Authority 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 Authority 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 Authority 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 Authority 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 Authority 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 Authority 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 Authority's Pension Plans wherein it calculates the Authority'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 Authority 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. <u>Funding Level Objective</u>. It is the Authority'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--exceeds the Entry Age Normal Accrued Liability or "EANAL"—as set forth in the most recently published Valuation Report) for each Pension Plan of [90]%, <u>*but never dropping below [85]%*</u> (the "Funding Level Objective").

Funding Level Objective = [85]%

Achieving and maintaining the [85]% Funding Level Objective ensures that the ongoing contributions of the Authority and its employees, and therefore the taxpayer funds, are properly and adequately funding the retirement benefits of retirees and today's workers. This concept is commonly referred to as the intergenerational equity. Falling short of this funded level forces future Board of Directors to pay the costs of the poor planning and execution of today's Pension Plans. 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 Ratio of a Pension Plan above 100% (commonly referred to as "superfunded status"), which means that the Authority and its employees had contributed into the Pension Plan more than was necessary. Thus, while the Authority remains committed to maintaining a 100% funded level, it shall manage the [15]% differential (i.e., the difference between [85]% and 100%) through its own investment process by creating the "Pension Rate Stabilization Fund" discussed herein.

<u>Guidance</u>: To achieve the Funding Level Objective, this Policy provides the following guidance:

1. **<u>*Pre-Pay the Entire Annual UAL Payment by July 31st of each year*</u>.** On or before July 1st of each year, the Authority receives its annual CalPERS UAL invoice. The Authority 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 Authority can concurrently save approximately 3.3% 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) regularly do not earn returns that can offset the interest rate that CalPERS charges on the outstanding UAL balance. 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. CalPERS does not apply any prepayment penalties to ADPs. Therefore, during each budget cycle, the Authority 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. ADPs should not adversely affect the general operations and fiscal soundness of the Authority.

3. ***Capital Financing*.** When considering capital projects, staff regularly reviews and plans for reserving capital to cash fund current and future projects. When considering how to pay for current and future capital 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 funding (and/or such other appropriate funds of the Authority) 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 of Directors would need to approve of the ADPs being paid to CalPERS prior to the financing to ensure that the annal savings generated by implementing the strategy are applied to UAL paydowns.

4. ***Utilize Savings Achieved from Refunding Outstanding Non-Pension Related Debt to Pre-Pay UAL*.** During each budget cycle, staff should review all outstanding long-term non-pension related debt of the Authority 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. 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 Authority.

5. ***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. Staff shall review allocation of labor costs to proprietary and other funds to ensure full reimbursement of the pension cost burden. Staff shall provide, or cause to be provided, consistent and well-documented methodology for pension cost allocation to all funds.

6. ***Pension Obligation Financing*.** The Authority shall consider issuing taxable municipal debt obligations (generically hereafter referred to as "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 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 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 of Directors.

7. **Annual Review of the CalPERS Actuarial Valuation Reports and Associated Tasks.** The Authority 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 changes to each of the Pension Plans UAL, and quantifying the associated cost implications and the corresponding impact on the Funded Ratio. Staff should annually reach out to the Authority'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 Authority 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.

8. **ADPs Shared Between All Benefiting Authority Funds.** Whenever an ADP is made, the Authority will endeavor to ensure that all benefitting funds (the "Benefiting Funds") contribute their fair share in accordance with the Authority's allocation method of charging off its pension costs for each Authority fund.

B. Establishment and Operation of a Pension Rate Stabilization Fund.

1. ***Establishment of a Pension Rate Stabilization Fund*.** The Authority shall establish a Pension Rate Stabilization Fund, either self-managed or a Section 115 trust fund managed by a third-party investment manager (the "Investment Manager"). The Pension Rate Stabilization Fund will receive Sequestered Savings (defined below) and Sequestered Surplus (defined below) as well as any other funds deposited into it at the discretion of the Board of Directors, based on recommendations made by the Authority staff during the annual budget process. Funds in the Pension Rate Stabilization Fund should only be used to manage the Authority's pension benefits costs to maintain each of the Pension Plans at the Funding Level Objective in accordance with the goals and objectives set forth in this Policy.

2. ***Funding the Pension Rate Stabilization Fund*.**

(a) *Sequestered Savings*. Upon the issuance of each series of Pension Obligations, for each of the next [ten (10)] consecutive years (or such other period of years as deemed appropriate by the Board of Directors 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 of Directors 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 Benefiting Funds (as established in section A8 above) and deposited into the Pension Rate Stabilization Fund until such time that the Pension Rate Stabilization Fund reaches the Pension Rate Stabilization Fund Maximum (as outlined in section B3 below), and thereafter all Sequestered Savings will be directed to a “Pension Obligation Prepayment Fund” which will be established and maintained by the Authority for the purpose of prepaying any outstanding Pension Obligations.

$$Total\ Sequestered\ Savings\ = UALDS - DS$$

$$Annual\ Sequestered\ Savings\ = SSP\ x(\frac{UALDS - DS}{Y})$$

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 in 2022 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 Authority elected to sequester 50% of the total savings over a 10-year period (Y), which in this example results in an Annual Sequestered Savings of $50,000.

$$Annual\ Seq.Savings\ = 0.5x(\frac{8{,}000{,}000 - 7{,}000{,}000}{10})$$

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

(b) <u>*Sequestered Surplus*</u>. Each Fiscal Year during the Authority’s normal budget adoption process, beginning with the 202_-2_ Fiscal year budget, and for each of the following 9 years, a percent between 0% and 10% of any available surplus from the prior Fiscal Year (the “Sequestered Surplus”) shall be set aside, transferred and deposited into the Pension Rate Stabilization Fund.

3. ***<u>Operation of the Pension Rate Stabilization Fund</u>***. Sequestered Surplus and Sequestered Savings (and any other amounts contributed by the Authority) shall be deposited in the Pension Rate Stabilization Fund and used solely for the purpose of making ADP’s (and Normal Cost payments during a Fiscal Hardship, and/or to the extent the amount therein exceeds the Pension Rate Stabilization Fund Maximum, as described below) to CalPERS for the purpose of achieving and maintaining Funding Level Objective.

With the goal of achieving and maintaining the Funding Level Objective, each year during the budget cycle, Authority 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 Pension Rate Stabilization 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 Pension Rate Stabilization Fund, staff shall assess whether to fully amortize any new UAL amortization bases in order to reduce the long-term interest costs associated with the "ramping" procedures used by CalPERS.

Moneys in the Pension Rate Stabilization Fund shall not be used for 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 Entry Age Normal Accrued Liability (as set forth in the most recently published Valuation Report) by 110% (the "Pension Rate Stabilization Fund Maximum"). To the extent monies in the Pension Rate Stabilization Fund on June 31st exceed the Pension Rate Stabilization 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 110% may be used to offset the Authority's Normal Cost payment made to CalPERS in such Fiscal Year, and any Sequestered Savings will be directed to the Bond Call Fund.

4. ***Fiscal Hardship*.** In the event of a Fiscal Hardship (as defined below), transfers of Sequestered Savings may be abated and/or the Pension Rate Stabilization Fund may be utilized for either normal or UAL costs until the Fiscal Hardship is no longer in effect.

   "Fiscal Hardship" means an economic hardship, or other unanticipated fiscal emergency, that has been declared by resolution of the Board of Directors.

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

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

E. 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 to consider changes in the Authority's financial position and Pension Plan funded status over time. As such, Authority staff will review the policy for implementation of new best practices and will provide to Board of Directors for adoption on an as needed basis, not to exceed 5 years.