



TO: Business – Finance Committee  
- Reed Geisreiter  
- Dennis Smith

FROM: Holland MacLaurie, Port Director

DATE: May 16, 2022

SUBJECT: Review Management of the District's Unfunded Accrued Liability for CalPERS Pension Plans

**Recommendation:** *Review and discuss the options for a Pension Liability Management Policy and recommend elements to include in the establishment of such policy for review and adoption by the full Commission.*

## BACKGROUND

As identified in the 2022 Port District Priorities List, the Port Commission is dedicated to exploring pension cost mitigation techniques relating to the District's unfunded accrued liability for its CalPERS pension plans.

California Municipal Advisors (CalMuni Advisors), a financial consultant and municipal advisor to cities and other local government agencies throughout the State of California, has been retained to assist the District in reviewing the funding status of its existing CalPERS pension plans, identifying pension liability management tools, determining preferred pension liability management scenarios (i.e., desired pension plan funding levels), and developing a Pension Liability Management Policy for consideration and approval by the full Commission.

## ANALYSIS

In order to fund its employees' pension benefits, the Port District is required to make recurring contributions (a part of which may come from the employees) to CalPERS. CalPERS then invests the contributions to generate a return to help fund overall pension benefits. The regular required contributions, known as the "normal costs," are calculated as a percent of salaries and represent the annual cost of service accrual for the upcoming fiscal year for active employees.

In the event the actual pension plan experience and investment performance fall short of CalPERS' 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 (UAL) and usually must be covered by the District through a series of UAL payments, which are above and beyond the "normal cost" contributions.

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
- Discount rate reductions

Since pension costs (including the District's unfunded accrued liability) continue to rise, it is important that the Business-Finance Committee review potential options to mitigate future costs via development of a comprehensive Pension Liability Management Policy.

Development of a Pension Liability Management Policy will provide the District with a long-term roadmap to address significant retirement liability. Additionally, it will reduce the District's UAL and ongoing pension costs, increase funding ratios for each pension plan, and ensure vested pension benefits can be paid for future generations.

A sample Pension Liability Management Policy is included as Attachment A for review. The sample policy includes a range of options that are available to address unfunded liabilities and range from incremental items that are reviewed and considered annually, to one-time items that can potentially provide a significant impact. The committee may wish to select some or all of the following mitigation options for incorporation into a draft policy:

- Pre-pay the entire UAL payments by July 31 of each year
- Pre-pay UAL from reserves, one-time revenue, and fund surpluses
- Capital financing
- Utilize savings achieved via refunding outstanding non-pension related debt to pre-pay UAL
- Pension obligation funding

Andrew Flynn of CalMuni Advisors will provide a comprehensive presentation regarding the funding status of the Port District's current pension plans during the committee meeting. He will be available to provide additional information and answer questions.

## **DISCUSSION / DIRECTION**

With the assistance of CalMuni Advisors, the committee may wish to discuss and determine the following items for recommendation to the full Commission:

- Recommend a desired funding level objective for each pension plan (i.e., 90%).
- Recommend mitigation options for incorporation into a draft policy.
- Establish a timeline for presenting a proposed Pension Liability Management Policy to the full Commission.

ATTACHMENTS:     A.     Sample Pension Liability Management Policy

---

**UNFUNDED ACCRUED LIABILITY  
PENSION MANAGEMENT POLICY**

---

**Santa Cruz Port District**



**Adopted by the Board of Directors of the  
Santa Cruz Port District**

**Pursuant to Resolution No.**

**MM DD YYYY**

**SANTA CRUZ PORT DISTRICT**  
**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 Santa Cruz Port 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 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 District 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 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

**SANTA CRUZ PORT DISTRICT**  
**UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY**

**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 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.

*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 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.

*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

**SANTA CRUZ PORT DISTRICT**  
**UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY**

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--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]**%, *but never dropping below [85]%* (the “Funding Level Objective”).

**Funding Level Objective = **[90]**%**

Achieving and maintaining the **[90]**% Funding Level Objective ensures that the ongoing contributions of the District 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 **[90]**% 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 District and its employees had contributed into the Pension Plan more than was necessary. Thus, while the District remains committed to maintaining a 100% funded level, it shall manage the **[10]**% differential (i.e., the difference between **[90]**% and 100%) through its own investment process by creating the “Pension Rate Stabilization Fund” discussed herein.

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

1. **Pre-Pay the Entire Annual UAL Payment by July 31<sup>st</sup> 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 (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 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.

## SANTA CRUZ PORT DISTRICT

### UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY

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

2. **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 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 of Directors would need to approve of the ADPs being paid to CalPERS prior to the financing to ensure that the annual savings generated by implementing the strategy are applied to UAL paydowns.

3. **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 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 from such debt refunding, 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. 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.

5. **Pension Obligation Financing.** The District 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.

**SANTA CRUZ PORT DISTRICT**  
**UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY**

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 District staff shall review or cause to be reviewed the annual CalPERS actuarial valuation reports within 60 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 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. Establishment and Operation of a Pension Rate Stabilization Fund.**

1. **Establishment of a Pension Rate Stabilization Fund.** The District 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 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 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.** At the beginning of each Fiscal Year following the issuance of each series of Pension Obligations, for a total of **[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 District’s general operating funds 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 District for the purpose of prepaying any outstanding Pension Obligations.

**SANTA CRUZ PORT DISTRICT**  
**UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY**

$$\text{Total Sequestered Savings} = \text{UALDS} - \text{DS}$$

$$\text{Annual Sequestered Savings} = 0.5x\left(\frac{\text{UALDS} - \text{DS}}{Y}\right)$$

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 District elected to sequester 50% of the total savings over a 10-year period (Y), which in this example totals \$100,000.

$$\begin{aligned} \text{Annual Seq. Savings} &= 0.5x\left(\frac{8,000,000 - 7,000,000}{10}\right) \\ &= \$50,000 \end{aligned}$$

(b) Sequestered Surplus. Each Fiscal Year during the District’s normal budget adoption process, beginning with the 2022-23 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. Operation of the Pension Rate Stabilization Fund. Sequestered Surplus and Sequestered Savings (and any other amounts contributed by the District) 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, 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 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

## SANTA CRUZ PORT DISTRICT

### UNFUNDED ACCRUED LIABILITY PENSION MANAGEMENT POLICY

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 District’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 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 of Directors and shall be posted on the District’s website. The District’s audited financial statements shall also be posted on the District’s 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.

**D. 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.

**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, and as such, District 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.