Scotts Valley City Council
In-Person and Remote Access
Date: December 7, 2022
Time: 6:00 PM

**CONTACT INFORMATION**

City of Scotts Valley
1 Civic Center Drive
Scotts Valley, CA 95066
(831) 440-5600

**MEETING LOCATION**

City Council Chambers
1 Civic Center Drive
Scotts Valley, CA 95066
OR
Zoom Video Conference
https://us02web.zoom.us/j/84827813528

**POSTING**

The agenda was posted
at City Hall, SV Senior Center, SV Public Works Building, and on the Internet
at www.scottsvalley.org.

**ADDITIONAL INFORMATION**

Staff report for Regular Agenda Item 1
AGENDA ITEM 1
DATE: 12-07-2022

City of Scotts Valley
CITY COUNCIL STAFF REPORT

DATE: December 7, 2022
TO: Honorable Mayor and City Council
FROM: Mali LaGoe, City Manager
SUBJECT: CalPERS Pension Funding Policy Approval and Section 115 Trust Next Steps

SUMMARY OF ISSUE

CalPERS Unfunded Accrued Liability:
The City of Scotts Valley (the “City”), like most cities in California, has an unfunded accrued liability (“UAL”) associated with its CalPERS pension plans. A UAL occurs when current pension plan assets are not projected to be sufficient to pay total pension costs in future years. As of June 30, 2021 (the most recent CalPERS valuation), the City’s UAL was $15.9 million. CalPERS, however, has reported an investment return of -7.5% for FY 2021-22 (recently revised from -6.1%), which is projected to increase the City’s UAL to approximately $23.6 million. CalPERS charges the City a 6.80% interest rate on this liability. The -7.5% investment returns will lead to an increase in the City’s annual UAL payment, beginning in FY 2024-25 and ramping up until a peak payment in FY 2031-32. The annual UAL payment has been, and will continue to be, a significant impact to the City’s budget.

Historical Efforts:
The City has previously taken proactive steps in an effort to control pension costs. In 2012, the City issued $4.46 million of Pension Obligation Bonds (“POBs”), which reduced the interest rate on a portion of the UAL (as it existed in 2012) from the CalPERS discount rate of 7.50% to the bond interest rate of 4.31%. With pension costs increasing dramatically, however, staff believe more action is prudent.

At the August 17, 2022, City Council meeting, the City’s Municipal Advisor, NHA Advisors (“NHA”), delivered a comprehensive presentation that focused on the City’s various CalPERS Plans, historical costs trends, and various cost management strategies that can be considered. These cost management strategies included the following:

1) Prepaying the Annual UAL Cost
2) Negotiating Cost Sharing with Employees (if applicable)
3) Implementing a CalPERS Fresh Start Amortization
AGENDA ITEM 1  
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4) Utilizing Cash Reserves to Pay Extra (Section 115 Trust or CalPERS Additional Discretionary Payment (“ADP”))

5) Restructuring UAL using debt

Following NHA’s presentation, the City Council adopted a resolution establishing a temporary project specific CalPERS Pension Cost Management Committee (the “Committee”) to continue the pension cost management discussions in more depth with NHA and City staff, and to work on a formal pension funding policy. Council Members Dilles and Timm were named to the Committee.

City’s CalPERS Pension Cost Management Committee:
The Committee and City staff met with NHA three times over the course of mid-September to early November.

In the first meeting, NHA and the Committee had an in-depth discussion of the pension cost management strategies presented at the August City Council meeting, and the Committee decided that it favored setting up a Section 115 Trust as the primary initial pension cost management strategy given the benefit of budgetary flexibility and increased investment earnings.

In the second meeting, NHA prepared a dynamic cash flow model that allowed the Committee to analyze various Section 115 Trust funding scenarios by modifying different inputs (e.g., initial deposit, annual contributions, annual investment return). As a result, the Committee decided that an initial Section 115 Trust deposit between $1.5 million and $2.5 million in FY 2022-23 would be feasible and effective.

After the meetings, NHA also shared with the Committee various pension funding policies from other agencies, as a template for what the City’s pension funding policy could look like. After thorough review of these policies by City staff and Committee members, a draft policy was prepared prior to the third meeting that incorporated everyone’s input.

In the third meeting, NHA and the Committee analyzed Section 115 Trust funding scenarios in the context of the City’s 10-year financial forecast, reviewed the draft pension funding policy, and then finalized the proposed pension funding policy based on additional edits and input from the Committee.

The pension funding policy presented to City Council for adoption today, as well as the recommendation to pursue the next steps of evaluating and selecting a Section 115 Trust provider, are products of these three Committee meetings.

Benefits of a Section 115 Trust:
As discussed in the August presentation, setting aside funds in a Section 115 Trust should, over time, allow the City to earn more on its reserves than it normally would if those funds were left in the General Fund (which are highly restricted in investment options). Especially in today’s inflationary environment, even the more conservative/moderate Section 115 Trust portfolio options are yielding significantly more...
Other benefits include:

- Ability to “smooth out” higher UAL payments in the future by withdrawing funds from the Section 115 Trust to supplement payments from the General Fund (see chart below)

![Projected UAL Payments Chart]

- Investment diversification from CalPERS (CalPERS manages $57.6 million of the City’s pension assets, as of the 6/30/2021 CalPERS actuarial valuation)
- Increased budgetary flexibility
- Ability to prefund OPEB within the same Section 115 Trust at a later date
- Potential for positive rating agency and investor consideration

**Pension Funding Policy:**
The City’s pension funding policy will be a policy of the City to ensure that promised pension benefits are funded. The pension funding policy lays out the following guidelines:

1. The City will pay at least the minimum required employer contribution to CalPERS each year
2. The City will prepay its annual UAL payment each July to achieve budgetary savings
3. The City will have a target funded ratio of 85% for its pension plans
4. The City will establish and maintain a Section 115 Trust dedicated to pensions
5. The City will consider ADPs within the context of its annual evaluation of reserve levels, budgetary requirements, funded ratio, and other metrics
6. The City will only consider POBs as a cost management strategy under very strict guidelines and after thorough due diligence and risk assessment
7. The City will review this policy periodically to determine if changes are necessary

**Next Steps for the Section 115 Trust:**
The next step in the process of establishing a Section 115 Trust is evaluating and selecting the provider. The provider will be responsible for setting up the Section 115 Trust and being the central point of contact for the City. The provider often partners with an investment manager, who will be responsible for investing the City’s Section 115 Trust assets based on the City’s preference. It is expected that evaluating and selecting the provider may take a month or more. After the provider is selected, the next steps would include working with the provider’s associated investment manager to determine an optimal investment portfolio for the City’s Section 115 Trust assets (based on the City’s risk tolerance and expected time horizon for withdrawals from the Section 115 Trust), and then adopting the Section 115 Trust at a later City Council meeting. This entire process can be completed in 30 – 90 days.

**FISCAL IMPACT**
There is no fiscal impact associated with this item.

**STAFF RECOMMENDATION**
It is recommended that the City Council take the following 3 actions:

1. Approve the Draft City of Scotts Valley Pension Funding Policy.
3. Authorize the City Manager and CalPERS Pension Cost Management Committee to evaluate and select a provider responsible for setting up the Section 115 Trust.

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RESOLUTION NO. 2017.1

RESOLUTION OF THE CITY COUNCIL OF THE CITY OF SCOTTS VALLEY CONTINUING A TEMPORARY PROJECT SPECIFIC CALPERS PENSION COST MANAGEMENT COMMITTEE

WHEREAS, the City Council may establish project specific Council subcommittees to address an explicit purpose or need; and

WHEREAS, project specific Council subcommittees are of a limited duration and should be active for no more than one year; and

WHEREAS, on August 17, 2022 the City Council adopted Resolution 2017, establishing a Project Specific CalPERS Pension Cost Management Committee effective August 17, 2022 through December 31, 2022; and

WHEREAS, the CalPERS Pension Cost Management Committee is comprised of Councilmember Timm and Councilmember Dilles; and

WHEREAS, the purpose of the CalPERS Pension Cost Management Committee is to engage the City’s financial advisor, NHA Advisors and City staff to develop a CalPERS Unfunded Pension Liability Cost Management Plan for City Council consideration and action; and

WHEREAS, the CalPERS Pension Cost Management Committee has begun its work but needs additional time to complete the work; and

WHEREAS, the City Council desires to extend the CalPERS Pension Cost Management Committee through June 30, 2023, to complete its work.

NOW, THEREFORE, BE IT RESOLVED AND ORDERED that the City Council of the City of Scotts Valley hereby extends the Temporary Project Specific CalPERS Pension Cost Management Committee through June 30, 2023 and extends the appointment of Councilmembers Dilles and Timm until that time.

The above and foregoing resolution was duly and regularly adopted by the City Council of the City of Scotts Valley at a regular meeting held on the 7th day of December, 2022 by the following vote:

AYES: __________________________
NOES: _________________________
ABSENT: _______________________
ABSTAIN: ______________________

Approved: _______________________
Donna Lind, Mayor

Attest: _________________________
Cathie Simonovich, City Clerk
City of Scotts Valley
Pension Funding Policy

Policy:
It is the policy of the City to fulfill its obligation to maintain fiscally responsible management practices and to ensure that promised pension benefits are funded. To that end, the City will meet its pension funding obligations as follows:

1. **Actuarially Determined Contributions**: Each fiscal year, the City will contribute to CalPERS the amount determined by CalPERS actuaries to be the minimum required employer contribution for that year. The minimum contribution consists of two components, normal cost and unfunded accrued liability ("UAL"). The normal cost is expressed as a rate that is applied to pensionable payroll costs and reflects the cost of pension benefits earned by employees in the current fiscal year. The UAL payment is a flat dollar amount that represents a portion of the cost of past benefits earned by employees, but for which, because of deviations in actual experience and changes in assumptions about investment performance, the normal cost rates established for those prior years have been determined to be insufficient to provide the promised retirement benefit. The CalPERS actuaries recalculate the total UAL each year and an updated multi-year amortization schedule is provided to show the projected annual minimum payments.

2. **Annual UAL Prepayment**: CalPERS offers the option to make monthly payments on the UAL or prepay the entire annual UAL amount at a discounted level by the end of July. Assuming the City’s current reserves meet their respective reserve policies, at that point the City will prepay its annual UAL payment each July to achieve budgetary savings.

3. **Funded Ratio Goal**: The City’s goal is to achieve and maintain a funded ratio, for each of its pension plans, of 85%. A funded ratio of 100% signifies that the City’s assets held with CalPERS, in addition to assets held in other pension accounts, match its accrued liabilities for pension. If the City has assets in a Section 115 Trust, these assets should be included in the City’s funded ratio calculation.

4. **Section 115 Pension Trust**: The City will establish and maintain a pension stabilization fund in the form of a Section 115 Pension Trust ("Trust"). Assets in the Trust may be used only for pension related costs and at the direction of the City Council. The City’s objective with the Trust is to accumulate assets to fund its CalPERS pension costs, as well as mitigate the budget impact of costs associated with future UAL. The City will strive to meet the following guidelines:
   - **Initial Deposit**: It is recommended that $2,000,000 be used to initially fund the Trust in FY 2022-23.
   - **Investment Portfolio Selection**: City staff will work with its advisory team, including the Trust’s investment advisor, to select investment portfolios based on the City’s risk tolerance and projected withdrawal schedule from the Trust.
   - **Ongoing Deposits**: In any fiscal year, the City may make annual contributions to the Trust in an amount up to 50% of surplus remaining after all other City reserve policies have been met. An updated description of the City’s reserve policies can be found in the City’s most recent annual budget.
• **Enterprise Funds:** A portion of the City’s pension costs within its CalPERS Miscellaneous Plan are attributable to employees within the City’s Enterprise Funds. Therefore, the City will ensure that any deposits to the Trust and withdrawals from the Trust are made in consideration of this fact to ensure equitable cost/benefit between City funds and CalPERS Plans. In years when Enterprise Funds have met their minimum reserve policy goals, such Enterprise Funds can contribute a portion of remaining surplus to the Trust. The City will strive to ensure that any withdrawals from the Trust benefit the Enterprise Funds equitably.

• **Use of Trust Funds:** The funds in the Trust may be used for any of the following purposes at the City’s discretion: (1) City’s annual UAL payment to CalPERS, (2) City’s annual normal cost payment to CalPERS, (3) reimbursement to the City for CalPERS pension costs, and (4) Additional Discretionary Payments to CalPERS.

• **Funding Goals:** As stated above, the City is targeting a funded ratio of 85% for each of its pension plans. When measuring its funded ratio, the City should incorporate assets in the Trust, in addition to the assets under management by CalPERS. The City may consider foregoing contributions to the Trust if its funded ratio is determined to be too high, or if the current assets on deposit in the Trust are projected to be sufficient to cover budgetary fluctuations in the future.

5. **Additional Discretionary Payments:** CalPERS allows member agencies to make Additional Discretionary Payments (“ADPs”) at any time and in any amount, which would serve to reduce the City’s UAL and future required contributions. Once the City’s Trust is established, the City has the option to make ADPs to CalPERS using the assets held in the Trust, if desired. The City will consider ADPs within the context of its annual evaluation of reserve levels, budgetary requirements, funded ratio, and other timing considerations unique to CalPERS’ investment performance. ADPs may prove to be advantageous in the future once Trust levels are funded to sufficient thresholds to stabilize budgetary volatility.

6. **Pension Obligation Bonds:** Pension Obligation Bonds (“POBs”) are a tool that can be used to provide an ADP to CalPERS upon the determination that the cost to borrow the funds for the payment is less than continuing to make the projected prescribed UAL payments at the current discount rate. If the City considers issuing POBs, the following guidelines will apply:

   • Expert advice and analysis by actuaries and municipal advisors will be utilized to quantify the risk of CalPERS investment underperformance (including discount rate reductions, stock market crashes, or sustained investment underperformance) and the threshold at which the City would be worse off issuing POBs versus not.

   • Significant education and evaluation will occur at the City staff and Council level given the complexity of POBs.

   • The interest rate on the POBs shall be at least 2.5% less than the current CalPERS discount rate.

   • The final maturity date on the POBs will be no greater than the final projected payment date of the UAL at the time the POBs are issued.

   • The POBs structure will contain an early call provision.

   • The POBs shall not finance normal cost and shall only be used to refinance UAL.
• The POBs should provide significant demonstrated cash flow savings.

• The City shall budget and transfer at least 25% of projected cash flow savings to the Trust to mitigate against future UAL likely to occur. Any cash flow savings not transferred to the Trust shall be transferred to the City’s other reserves.

7. **Review of Funding Policy:** The City will review this policy periodically to determine if changes to this policy are necessary to ensure progress is being made towards funding the City’s CalPERS pension costs and mitigating the impact of the costs associated with future UAL.