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TO:
Honorable Mayor and Members of the City Council

THROUGH:
Bruce Moe, City Manager

FROM:
Steve S. Charelian, Finance Director
Julie Bondarchuk, Acting Controller
Libby Bretthauer, Senior Financial Analyst

SUBJECT:
Consideration of Pension Obligation Bonds Financing Structure Options and Pension Policy (Finance Director Charelian).
APPROVE

RECOMMENDATION:
Staff recommends that the City Council approve Pension Obligation Bond (POB) Financing Structure Option #2, with 100% UAL Funding and all plans maturing in 2043, and approve the Unfunded Pension Liability Policy.

FISCAL IMPLICATIONS:
As of June 30, 2019, the most current actuarial valuation available from CalPERS, the City's Unfunded Accrued Liabilities (UAL) for all citywide employees and retirees is approximately $91.5 million. Approximately 69% of the UAL is related to sworn Police and Fire Department ("Public Safety") employees, and 31% is related to non-safety ("Miscellaneous") employees.

The City's required annual UAL payments to CalPERS were projected to range from approximately $6.7 million in fiscal year (FY) 2021-2022, up to approximately $10.0 million in the peak year of FY 2031-2032. To prevent these variable rising costs from impacting future balanced budgets and essential service levels, staff explored various long-term options to reduce the UAL that would: (1) preserve the City's fiscal integrity; (2) take advantage of current historically low interest rates; and (3) create fixed costs with level-debt payments.

The issuance of Pension Obligation Bonds (POBs) will achieve these goals for the City. When the concept was first introduced last November, a present value savings of $31.8 million was estimated based on interest rates at the time. Since then, interest rates have continued to drop to the City's benefit. At current rates, POBs could potentially save the City over $33.8 million (present value) in pension costs over the next 25 years.

Savings generated by the issuance of POBs may be deposited to the City's Pension Rate Stabilization Trust Fund to achieve better returns on our investments. Beginning in FY 2017-2018, the City has been transferring $250,000 from the General Fund to the Pension Rate Stabilization Trust Fund. The annual $250,000 transfer may come to an end with the adoption of the new pension policy. The current balance of the Trust Fund is about $1.76 million, including principal of $1.5 million and accumulated interest. These funds are available to fund any pension-related payments to CalPERS at the City Council's discretion.

The projected budgetary savings over the next ten years ranges from $1.1 million to $4.4 million annually. The estimated savings would be as follows: approximately 60% of the savings will be used to offset future UAL costs and approximately 40% of the savings will be used for future capital improvements, infrastructure needs and/or debt service

Fiscal implications of the POB financing structure options and allocation of savings are discussed throughout the body of this report.

BACKGROUND:

On October 6, 2020, the City Council considered the issuance of POBs for long-term CalPERS pension liabilities, and an Unfunded Pension Liability Policy (Pension Policy). To allow additional time for questions, City Council requested staff bring back the item to the October 20, 2020 meeting. After additional discussion and questions, City Council continued this item to the November 4, 2020, City Council meeting.

The City Council approved the recommendation in regards to the issuance of POBs at the November 4, 2020, meeting and directed staff to initiate the process. On December 15, 2020, the City Council adopted Resolution No. 20-0149 authorizing the issuance and sale of pension obligation bonds. Judicial validation proceedings are in progress and expected to be finalized in March. Once finalized, the pricing and sale of the bonds will commence.

The Finance Subcommittee discussed the following options during its February 19, 2021, meeting and recommended that all options be presented to the City Council for further discussion and consideration.

DISCUSSION:

With City Council's authorization to commence with the issuance of POBs, the City's municipal advisor, KNN Public Finance, began conducting scenario analysis to help determine the most beneficial terms for the bond issuance.

PENSION OBLIGATION BONDS FINANCING STRUCTURE OPTIONS

The two most beneficial options and the "Base Case" scenario for comparison are discussed below and attached to this report.

Option 1: "Base Case" POB Structure - 100% UAL Funding, Maturity of 2045 for Public Safety, and Maturity of 2043 for Miscellaneous, all level debt service.

The Base Case POB structure mimics the amortization schedule of the City's current UAL payback terms with CalPERS, with the Police and Fire plans maturing in 2045, and the Miscellaneous plan maturing in 2043. Over the next ten years, potential annual budgetary savings would range from $1.3 million to $4.6 million.

With this structure, the overall true interest cost (TIC) of the POBs would be 2.91% and the present value savings is estimated at $33.8 million over the term of the bonds.

Option 2: 100% UAL Funding, Maturity of 2043 for Public Safety and Miscellaneous, all level debt service.

Option 2 reduces the amortization schedule for the Police and Fire plans to align with the schedule for Miscellaneous employees. Over the next ten years, potential annual budgetary savings would range from $1.1 million to $4.4 million.

All plans would be fully amortized in 2043, which increases the City's initial payments but saves in overall interest costs (2.86%). With this financing structure, the present value savings is estimated at $34.5 million over the term of the bonds.

Option 3: 100% UAL Funding, Maturity of 2041 for Public Safety and Miscellaneous, all level debt service.

Option 3 reduces the amortization schedule for both Public Safety and Miscellaneous plans to twenty years. Over the next ten years, potential annual budgetary savings would range from $0.8 million to $4.0 million.

All plans would be fully amortized in 2041, which further increases the City's initial payments but saves even more in overall interest costs (2.75%). With this financing structure, the present value savings is estimated at $35.7 million over the term of the bonds.

Staff recommends Option 2, with all plans maturing in 2043, to take advantage of lower overall interest costs and higher budgetary savings over the near term. Although shortening the terms to 20 years would generate additional long-term savings, having lower debt service payments over the next few years will provide the City greater flexibility during this period of economic recovery after the COVID-19 Pandemic.

This recommendation also takes into account the maturity of the City's Certificates of Participation for Marine Avenue Sports Fields in Fiscal Year 2032-2033, which will free up nearly $500,000 in General Fund dollars that could be allocated to other debt service payments or ongoing operations.

UNFUNDED PENSION LIABILITY POLICY

If the City Council selects "Option 2" above, the projected budgetary savings over the next ten years ranges from $1.1 million to $4.4 million annually. The attached Unfunded Pension Liability Policy aims to memorialize how the City plans to utilize this projected budgetary savings.

Staff recommends using an allocation as follows: approximately 60% of the savings will be used to offset future UAL costs and approximately 40% of the savings will be used for future capital improvements, infrastructure needs and/or debt service. In addition to the proposed Fire Station No. 2 Certificates of Participation, the City has other major capital projects in need of financing, including: Joslyn Center, the Senior & Scout House, Downtown Sidewalk Expansion, Historical Documents Repository, Begg Pool/Aquatics Center, etc.

Each year during the Budget process, a recommendation for the precise savings allocation for the next fiscal year will be determined based on CalPERS' latest year-end investment return. For example, if CalPERS' fiscal year-end investment return is below its benchmark, the City Council may choose to allocate a higher portion of savings to fund future UAL costs. Alternatively, if CalPERS' fiscal year-end investment return is higher than its benchmark, then the City Council may choose to allocate more of the budgetary savings to fund capital improvements and/or pay down debt service ahead of schedule.

CONCLUSION:
Staff recommends the City Council approve "Option 2" for the POB Financing Structure, with all plans maturing in 2043, and approval of the attached Unfunded Pension Liability Policy.

PUBLIC OUTREACH:
The Finance Subcommittee discussed the following options during its February 19, 2021, meeting and recommended that all options be presented to the City Council for further discussion and consideration.

ENVIRONMENTAL REVIEW:
The City has reviewed the proposed activity for compliance with the California Environmental Quality Act (CEQA) and has determined that there is no possibility that the activity may have a significant effect on the environment; therefore, pursuant to Section 15061(b)(3) of the State CEQA Guidelines the activity is not subject to CEQA. Thus, no environmental review is necessary.

LEGAL REVIEW:
Bond Counsel has reviewed this report and determined that no additional legal analysis is necessary.

ATTACHMENTS:
1. Option 1: "Base Case" POB Structure
2. Option 2: POB Structure with Maturity of 2043 for Public Safety and Miscellaneous
3. Option 3: POB Structure with Maturity of 2041 for Public Safety and Miscellaneous
4. Unfunded Pension Liability Policy