



CITY COUNCIL AGENDA STATEMENT



February 2, 2021

File ID: 20-0434

TITLE

RESOLUTION OF THE CITY COUNCIL OF THE CITY OF CHULA VISTA APPROVING THE FORM AND AUTHORIZING THE EXECUTION OF AN OFFICIAL STATEMENT AND CONTINUING DISCLOSURE CERTIFICATE RELATING TO THE ISSUANCE OF PENSION OBLIGATION BONDS AND APPROVING ADDITIONAL ACTIONS RELATED THERETO

RECOMMENDED ACTION

Council adopt the resolution.

SUMMARY

City staff, in conjunction with discussions with City Council, has been exploring the use of Pension Obligation Bonds (POBs) to meet several objectives, including: (1) generating cash flow savings to the City through historically low interest rates (currently $\approx 3.55\%$) relative to the CalPERS discount rate assumption (currently 7%); (2) to create a repayment shape for the City's pension liabilities that increases more gradually than currently mandated by CalPERS; (3) enhance budget predictability and long-term fiscal sustainability by creating a smoother repayment shape at a lower level; (4) leverage the projected savings to adequately fund various reserves and (5) to set aside a portion of the future savings into a new Section 115 Trust and Bond Call Fund to mitigate future pension and OPEB cost increases and potentially pay off (redeem) the POBs prior to maturity.

On September 15, 2020, City Council approved the initial legal documents related to a POB and the City and its financing team initiated a validation process in the San Diego County Superior Court. This process has concluded (as of January 11, 2021) and, with the City Council's approval of the attached Resolution approving the Preliminary Official Statement ("POS") and Continuing Disclosure Certificate ("CDC"), the City will have the ability to issue POBs to refinance the City's UAL with CalPERS at historically low interest rates.

ENVIRONMENTAL REVIEW

The Development Services Director has reviewed the proposed activity for compliance with the California Environmental Quality Act (CEQA) State Guidelines and has determined that the activity is not a "Project" as defined under Section 15378 of the California Environmental Quality Act State Guidelines; therefore, pursuant to State Guidelines Section 15060(c)(3) no environmental review is required.

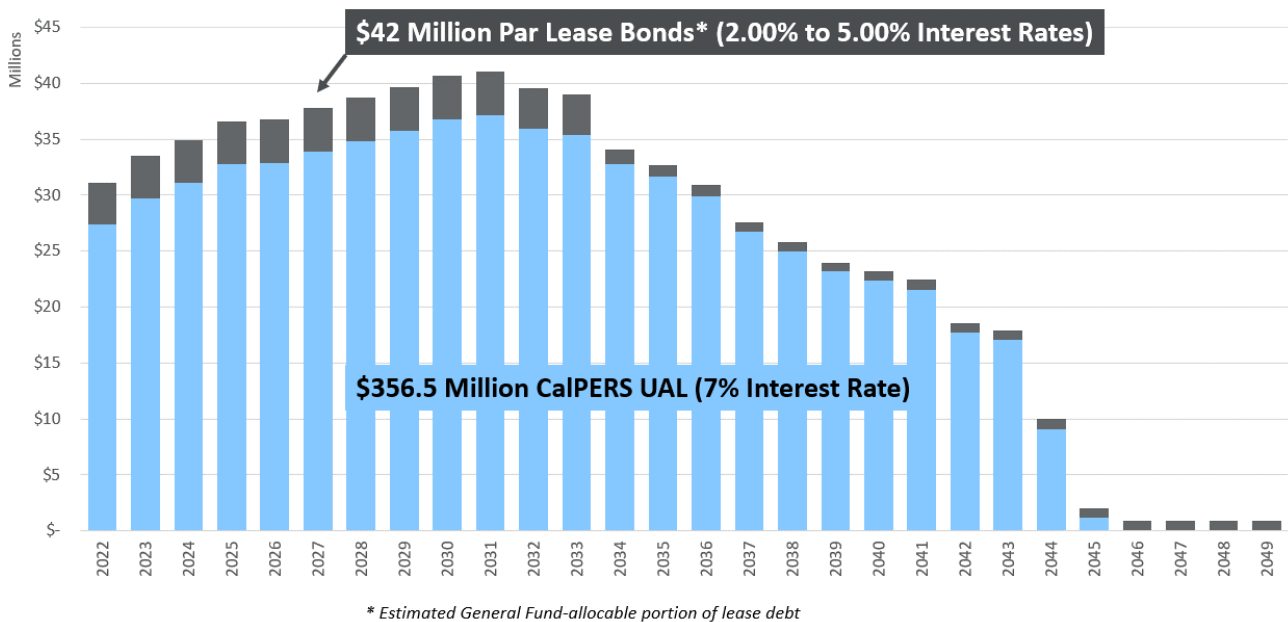
BOARD/COMMISSION/COMMITTEE RECOMMENDATION

Not applicable

DISCUSSION

Over the last 5 years, the City of Chula Vista’s (the “City”) unfunded actuarial accrued liability (“UAL”) for its CalPERS Miscellaneous and Safety Plans has grown from \$234.4 million to about \$356.5 million (6/30/2021 projected valuation). The UAL represents the shortfall/gap between what is needed to pay retiree benefits versus how much in current assets the City actually has in its accounts with CalPERS. Annual payments made to CalPERS to amortize the UAL have grown rapidly: from \$11.2M in FY 2016 to \$24.7M in FY 2021 and projected to grow to \$32.8M by FY 2025 and \$37.1M by FY 2031. The \$356.5 million UAL is not required to be repaid all at once but is amortized over a longer period (different components are amortized over different time periods, with most between 3 and 29 years) at an interest rate of 7.0%. Pension cost increases are the largest financial challenge facing most cities throughout the state and are primarily due to factors outside of the cities’ control, namely assumption changes made by CalPERS and below average investment returns.

The chart below provides a current snapshot of the City’s projected payments to amortize its \$356.5 million UAL. In order to get a better sense of overall General Fund liabilities, the portion of lease revenue bond debt service that is paid by the General Fund is also included (grey color bars). Using current CalPERS estimates, annual UAL and debt service costs are projected to escalate rapidly from \$31.1 million to \$41.1 million, before dropping off in FY 2032 and then fully amortizing by FY 2045 for the UAL and FY 2049 for the lease bonds.



* Estimated General Fund-allocable portion of lease debt

The City is considering issuing POBs to pay off its UAL to achieve several objectives:

Objectives of Chula Vista’s Proposed POB Financing

- **Fiscal Sustainability Tool:** Ability to “re-shape” the City’s overall pension repayment in a way that creates enhanced long-term fiscal sustainability, budgetary predictability, and enhanced resiliency to future economic shocks.
- **Near-Term Budgetary Savings:** By modifying the current near term “peak” in scheduled payments into a more predictable structure, near term cash flow savings are created. Based on current assumptions, it is expected that the City can realize over \$180 million in savings over the next 15 years which can be utilized to fund future pension shortfalls.

- **Interest Rate Savings “Arbitrage”:** City can borrow at rates much lower (currently ≈3.55% assuming City’s current “AA” credit rating) than those being charged by CalPERS on the UAL debt (7%).
- **Increase Funding Ratio:** Current ratios range from 67.1% (Miscellaneous) to 69.6% (Safety); these would be increased closer to 100%.
- **Maintain Same Maturity (Payment Term):** The City intends to maintain the same maturity as its current UAL, which is FY 2044/45.
- **Leverage Savings through Improved Policies:** On November 3, the City adopted a revised Reserve Policy that details how projected savings will flow to various City reserves, including the Operating Reserve, Economic Contingency Reserve (“ECR”), Catastrophic Emergency Reserve (“CER”), Pension Funding Reserve, OPEB Reserve and a POB Bond Call Fund.

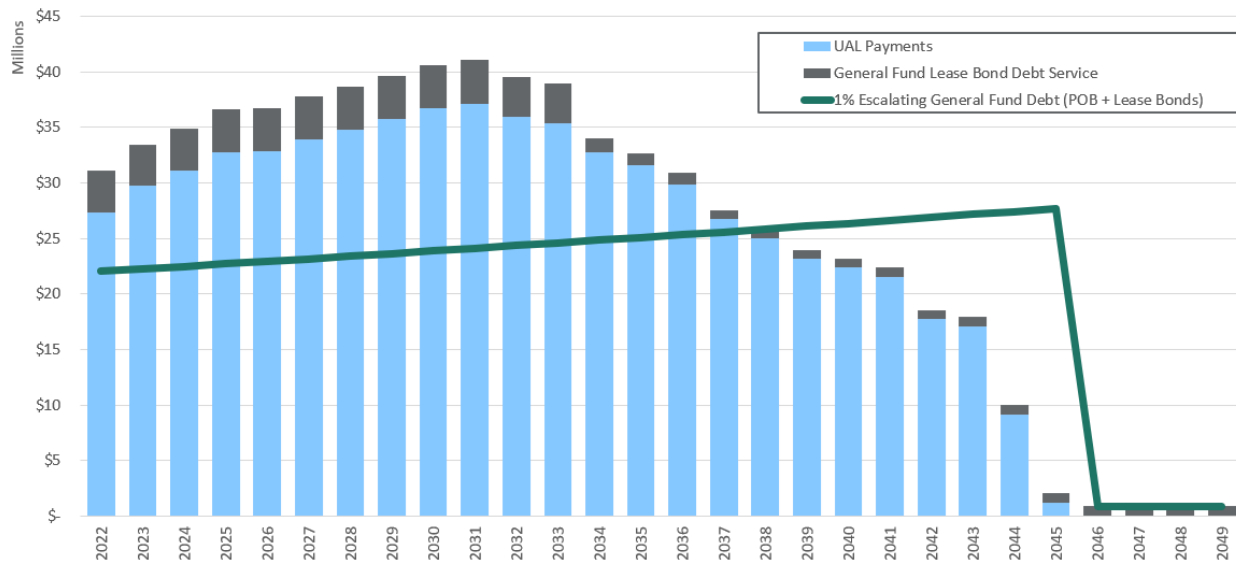
Numerous cities (Riverside, Pomona, Torrance, Gardena, Ukiah, Placentia, West Covina, El Monte, Ontario, Carson, Inglewood, Montebello, Pasadena, Glendora, Larkspur, Monrovia, Hawthorne, La Verne and several others) throughout California have recently refinanced their UAL to restructure the payment pattern and increase the funding of their pension plans. El Cajon is also expected to sell their POBs in early 2021 and National City is currently undertaking a validation process. Interest rates set on these recent financings ranged from about 2.75% to 4.25%, with rates dictated by market conditions at the time of pricing, credit rating of the issuer, and length of term of the bonds.

While the City’s legal team has been managing the court validation process, the City and its financing team have evaluated a range of structuring options (various maturities and repayment shapes), undergone a credit rating process with S&P (meeting on January 11th with results expected by January 19th), engaged its actuary to conduct stress testing analysis, and drafted a comprehensive disclosure document for potential investors known as the Preliminary Official Statement. Staff has also undertaken an RFP process to hire a firm that can manage the City’s new Section 115 Trusts for Pension/OPEB liabilities.

Tonight’s approval of the resolution, POS and CDC is the last City Council approval required in the financing process. The City will then have the authorization to issue POBs if staff and its financing team feel that market conditions are advantageous at the time of pricing (currently scheduled for February 2nd or 3rd).

Projected Savings from POB and Benefit of Pension Funding Policy: Based on current interest rates, and future CalPERS returns of 7%, the City’s proposed POB issuance will generate \$116.5 million of total savings, or \$112.1 million on a present value (“PV”) basis (31.5% of the refunded UAL amount). Over the next 15 years, the period where the City is facing the largest cash flow pressure from pension costs, average annual savings is expected to be \$12.5 million. The charts below and to the right have been included to better illustrate the potential benefit of the POB.

Metrics	1% Escalating General Fund Debt (24-Year)
UAL Funded (\$)	\$356,520,092
UAL Payoff at Closing (w/ Discount)	\$347,843,885
UAL Funded (%)	100%
Funded Ratio	100%
Final Maturity	24 Years (2045)
Average Life	15.8 Years
POB All-In Interest Rate	3.55%
PV Savings (% Refunded UAL)	31.46%
PV Savings (\$)	\$112,160,445
Cumulative Savings thru Maturity	\$116,509,473
Avg. Annual Savings Through 2036	\$12,508,023
Cash Flow Savings Through 2036	\$187,620,344



Over the past several months, the City and its Municipal Advisor (NHA Advisors) have explored several different structuring options, including 15-, 20-, 24- and 30-year maturities, as well as level debt service vs. escalating payments. Ultimately, the City is proposing to maintain the same 24 maturity and create an overall smooth general fund debt (inclusive of its LRBs) repayment shape that grows at 1% per year. While shorter maturities provide a slightly lower interest rate, savings over the next 15 years would be substantially less and the resiliency for the City to handle future downturns and/or more UAL would be greatly reduced given the higher POB payments required in the early years. Conversely, the 30-year maturity that was analyzed did provide enhanced resiliency, but the increase in interest rate, extension of maturity and reduction in overall savings did not meet all the City’s objectives. **The 24-year maturity provides an optimal balance of short/long term savings as well as improved resiliency to absorb future economic shocks.**

Reinvestment Risk: Ultimately, actual savings from the restructuring will be dependent on two factors: (1) actual interest rates at the time of pricing and (2) future CalPERS returns, which is an unknown at the time of bond issuance. To the extent that CalPERS earns lower than 7.0% over the next 24 years, the estimated savings shown above will be less. If CalPERS earns higher than 7.0%, then the estimated savings shown in the table will be higher. *The rule of thumb for evaluating the benefit of the proposed refunding is that the City will be better off (i.e. the UAL refunding will produce positive savings) if CalPERS earns more than the interest rate on the Bonds (currently estimated at 3.55%).* While past performance does not guarantee future results, CalPERS’ historical 30-year returns are 8.0%, 5.5% for the last 20 years on average, 8.5% for last 10 years and 6.3% for the last 5 years.

To assess and address reinvestment risk, the City engaged its actuary to conduct stress testing analysis to calculate actual savings from the POB if CalPERS has below average investment performance in the future. Two core simulations conducted included a long-term underperformance scenario, where CalPERS only earns 6% instead of 7%, and a more dire situation where there is another “2008-like Recession” stock market crash immediately following the issuance of the POBs (similar returns to 2008 – 2012 before returning to 7% assumption in year 6). As expected, savings from the POB under these situations would be lower than if CalPERS earns 7%, however, the **City would still be significantly better off under either of these situations having issued the POB than if it did not.** PV savings would be reduced to about \$83 million

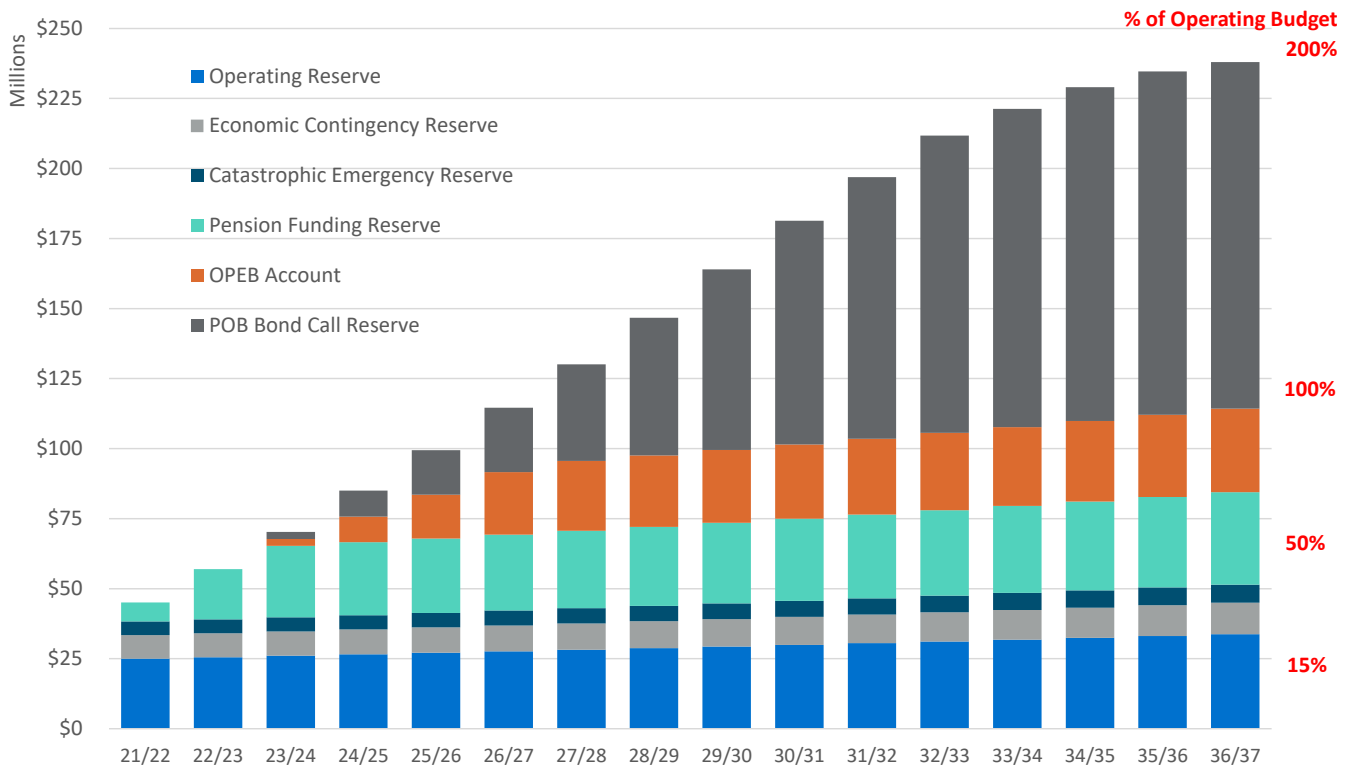
under the 6% long term return scenario (24% of refunded UAL), and to \$47 million (13% of refunded UAL) under the 2008 stock market crash scenario.

Market Timing Within FY 2020/2021: With the stock market near all-time highs and CalPERS year to date returns likely above their target, a common question is how the issuance of pension obligation bonds will impact the City's actuarial return this fiscal year (2021). Rather than credited in real time for when the funds are sent to CalPERS, the funds will get credited with CalPERS returns only at the end of the fiscal year, using the final year end returns %, and credited in a pro-rata manner for the amount of time the funds were with CalPERS during the year. Thus, it is beneficial to have additional money with CalPERS during a year of above average returns, while it may be disadvantageous to have funds on deposit during a year of very poor returns (< 3.5%). While it is impossible to predict where investment returns will trend from now until June 30, 2021, based on current CalPERS returns estimates for FY 2020/21, the City projects to benefit from having additional funds on deposit this fiscal year, with the potential benefit possibly offsetting the new UAL that is already scheduled to be added from the below average 4.7% returns in FY 2019/20. While this is a nuanced component of the analysis, and should not impact the longer-term, strategic restructuring goals, it is something the team is monitoring.

New Pension Funding Policy: On November 3, 2020, the City Council approved a new Pension Funding Policy and amended its current Reserve Policy. The new policy puts into place the framework for allocating future surplus and savings from the POB to prudently fund the City's critical reserves. This includes the City's main Operating Reserve, Economic Contingency Reserve (ECR), Catastrophic Emergency Reserve (CER), Section 115 Trust for OPEB and Pension Liabilities, and a POB Bond Call fund that can be used to pay down the POBs early (prior to their maturity).

Based on a more conservative projection of 6% CalPERS returns (as opposed to 7%), the chart below depicts the City's ability to fund, and grow these accounts over the next 15 years by leveraging the potential savings from the POB. While the City's Operating Reserve is currently fully funded at \$25 million (meeting the target of 15% of operating expenses) and the ECR is now fully funded at \$8.3 million, the CER is expected to be funded in the next few years, while the OPEB and Pension Funding Reserves (both in a Section 115 Trust) are expected to be fully funded between FY 2024 and FY 2028. The POB Bond Call Reserve is expected to grow to over \$110 million by around FY 2035, which could be used to eliminate over 60% of the outstanding POB debt in 15 years. Based on a more optimistic assumption (7% investment returns), the City may be able to fully pay off the POBs in the next 15 to 20 years using funds in the Pension Reserve Fund and POB Bond Call Funds. Additionally, after 10 years, the City will also have the opportunity/flexibility to refinance the POBs (or a combination of paying off with cash and refinancing) at a lower interest rate depending on market conditions at that time.

LEVERAGING POB SAVINGS TO BOLSTER CURRENT AND NEW RESERVES (ESTIMATED PROJECTION)



RESOLUTION

Adoption of the attached Resolution will result in the approval of the POS and CDC. The POS is the primary prospectus and disclosure document that will be used to solicit investor interest during the sale of the POBs. The document summarizes the key legal covenants of the transactions and provides a factual description of the City’s creditworthiness to repay the debt, including a discussion on the City management team, operations, financial and economic trends and various risk factors. The CDC is required to ensure that the City will, on an annual basis, make public certain financial and economic updates so that investors can keep track of any material changes in the City’s creditworthiness. The City already makes annual Continuing Disclosure filings for its other General Fund-backed debt obligations and this filing will be similar in nature.

CONCLUSION

Staff recommends the City Council approve this resolution so that the City can take advantage of historically low interest rates to refinance its UAL with CalPERS and create a new repayment shape that is more conducive to enhanced future fiscal sustainability, resiliency and improved reserve levels.

DECISION-MAKER CONFLICT

Staff has reviewed the decision contemplated by this action and has determined that it is not site-specific and consequently, the real property holdings of the City Council members do not create a disqualifying real property-related financial conflict of interest under the Political Reform Act (Cal. Gov’t Code §87100, et seq.).

Staff is not independently aware, and has not been informed by any City Council member, of any other fact that may constitute a basis for a decision-maker conflict of interest in this matter.

CURRENT-YEAR FISCAL IMPACT

None. Savings from the 2021 POB will begin in FY 2022, and all costs will be financed through the bond issuance. There will be no impact for FY 2021.

ONGOING FISCAL IMPACT

The projected benefit to the City from the 2021 POB issuance is expected to be \$116 million, or \$112 million on a present value basis. These savings estimates assume that CalPERS earn 7% in the future. Savings will be higher if CalPERS earns more than 7% and lower if it earns less than 7%. This savings will be utilized to fund the new reserve funds mentioned, mitigating future fiscal impacts from anticipated CalPERS pension investment return shortfalls.

ATTACHMENTS

1. Preliminary Official Statement (Includes CDC)

Staff Contact: David Bilby, Finance Department