



CALPERS PENSION COSTS UPDATE

INTRODUCTION TO UAL RESTRUCTURING CONCEPT

NHA | ADVISORS
Financial & Policy Strategies.
Delivered.

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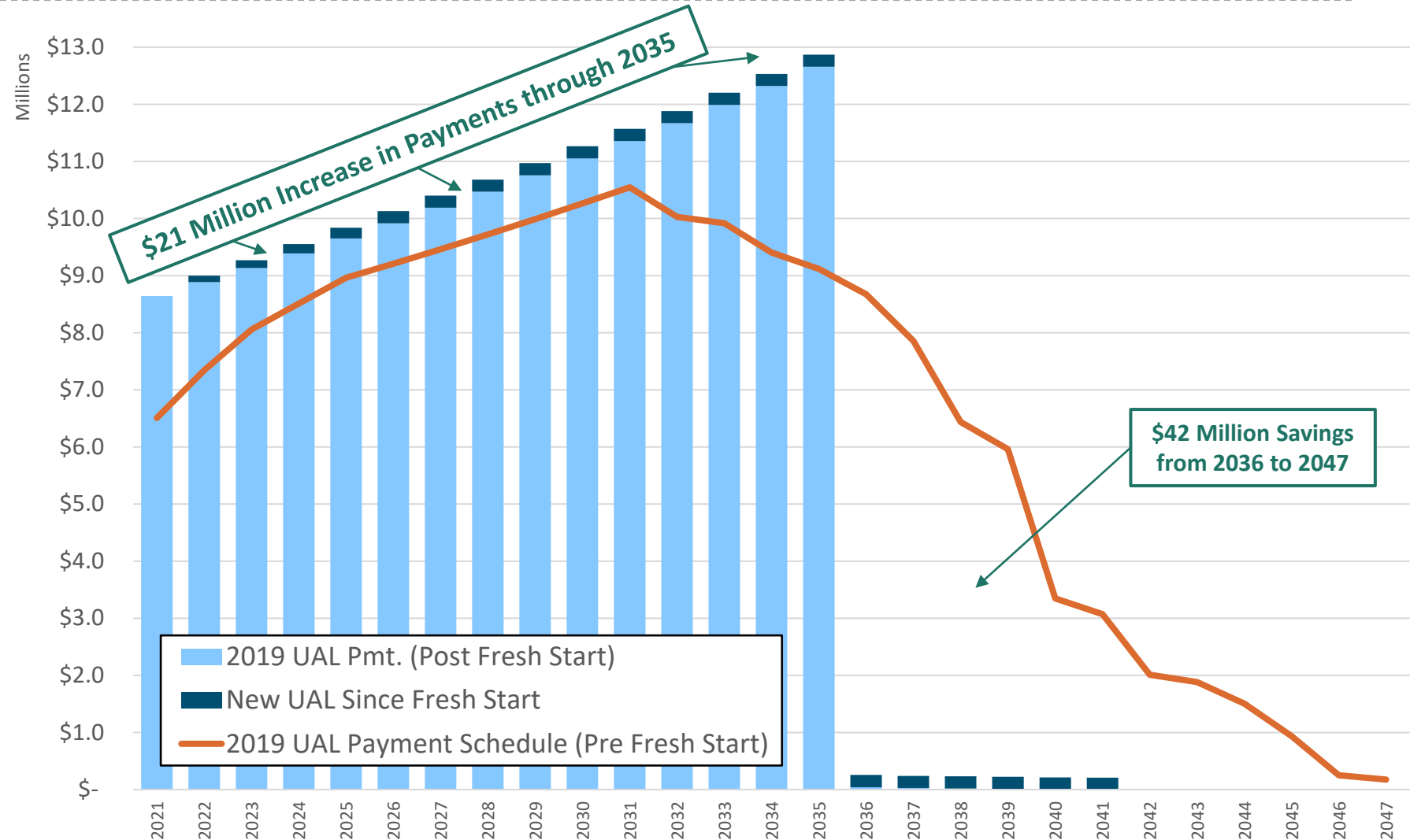
I. EXECUTIVE SUMMARY

Recap: 2019 & 2020 Pension Strategies Presentation

- ▶ In August 2019 and April 2020, the City Council received presentations on historical and projected pension costs and pension cost management strategies from NHA Advisors
- ▶ City of Lompoc has a projected \$96.7M Unfunded Accrued Liability (UAL) projected for 6/30/2021 with CalPERS
 - ▶ Represents a 67% increase (from \$58M) over the past 7 years
 - ▶ Annual UAL payments are rapidly increasing and will continue to increase
 - ▶ 2015: \$2.7M → 2021: \$8.6M → 2031: \$11.6M
- ▶ City implemented a Fresh Start amortization with CalPERS in 2020
 - ▶ Shortens term of UAL debt, but increases payments to City over next 15 years

2020 Fresh Start Implementation

- ▶ City's Fresh Start expected to save \$21M overall
- ▶ \$21M in higher payments over next 15 years
- ▶ \$42M in savings in later years from shortened amortization
- ▶ UAL debt is still amortized at a 7% interest rate



Revisiting the UAL Restructuring Concept

- ▶ This workshop will re-introduce the concept of a UAL restructuring using a pension bond
- ▶ At the time of the 2019 and 2020 workshops, the pension bond market was “untested” and the feasibility of this strategy for Lompoc was unknown
 - ▶ Historically low interest rates and growing comfort level from investors has led to a rapid increase in pension bond activity in the last 12 months for California cities
 - ▶ ≈ 40 cities for over \$4 billion; more than this expected for 2021
- ▶ Restructuring some of the City’s pension debt at a lower interest rate (< 4%) could produce significant savings above and beyond the savings already created by the Fresh Start
 - ▶ >\$50M of savings for next 15 years could be used to address multiple City priorities
 - ▶ **Capital Projects**
 - ▶ **Maintain Services**
 - ▶ **Build Reserve Levels (currently \$1M; target of \$9M)**
 - ▶ **Pensions**
- ▶ Tonight's educational workshop aimed to address potential **benefits and most notably, risks**, of a pension bond and get direction from City Council as to whether concept should be explored further



II. BACKGROUND AND PROJECTED COSTS

CalPERS Pension 101

Retirement Plan Overview

- ▶ City has 2 primary CalPERS plans
 - ▶ Miscellaneous: 882 covered members including 265 active
 - ▶ Safety (Fire & Police): 262 covered members including 68 active
- ▶ Plans include Classic (hired prior to 2013) Plans and PEPRA Plans members
 - ▶ Lower cost/benefit PEPRA plans will be helpful to manage long term pension costs for new employees
 - ▶ However, over 99% of the City's UAL is attributable to Classic (mostly retired/non-active) employees and will not be impacted by the PEPRA reform

MISCELLANEOUS PLANS			SAFETY PLANS		
Benefit Group	# of Actives	Benefit Formula	Benefit Group	# of Actives	Benefit Formula
Miscellaneous	145	2.7% @ 55	Safety	38	3% @ 50
Miscellaneous Tier II	19	2% @ 60	Safety Fire Tier II	3	3% @ 55
PEPRA Miscellaneous	101	2% @ 62	PEPRA Safety Fire	14	2.7% @ 57
			Safety Police Tier II	4	3% @ 55
			PEPRA Safety Police	9	2.7% @ 57
Total	265	-	Total	68	-

CalPERS Pension 101

Payments Made to CalPERS Annually

- ▶ Each year, the City makes two types of payments to PERS:
 - ▶ **Normal Cost (NC)** = Annual cost for current employees
 - ▶ **Unfunded Accrued Liability (UAL):** Actuarial Liability MINUS Actuarial Value of Assets
 - ▶ “How much we currently have vs. how much we need to have in the future when people actually retire”
 - ▶ Shortfall not repaid all at once; amortized over a longer period of time with the City paying down a portion each year (principal and interest)
 - CalPERS currently amortizes this debt at a rate of 7%
 - Various components (layers or bases) of the UAL with amortization periods ranging from 1 to 29 years

Why CalPERS Costs are Trending Higher

**Historical
PERS Returns**
5-Year: 6.3%
10-Year: 8.5%
20-Year: 5.5%
30-Year: 8.0%

Then ...

- ▶ PERS investment returns were robust (10%+)
 - ▶ Retirement plans were “Super-Funded” through the 1990s
 - ▶ Earnings on funds were more than adequate to cover retirement costs
- ▶ Super-funded Status induced widespread retirement benefits enhancements

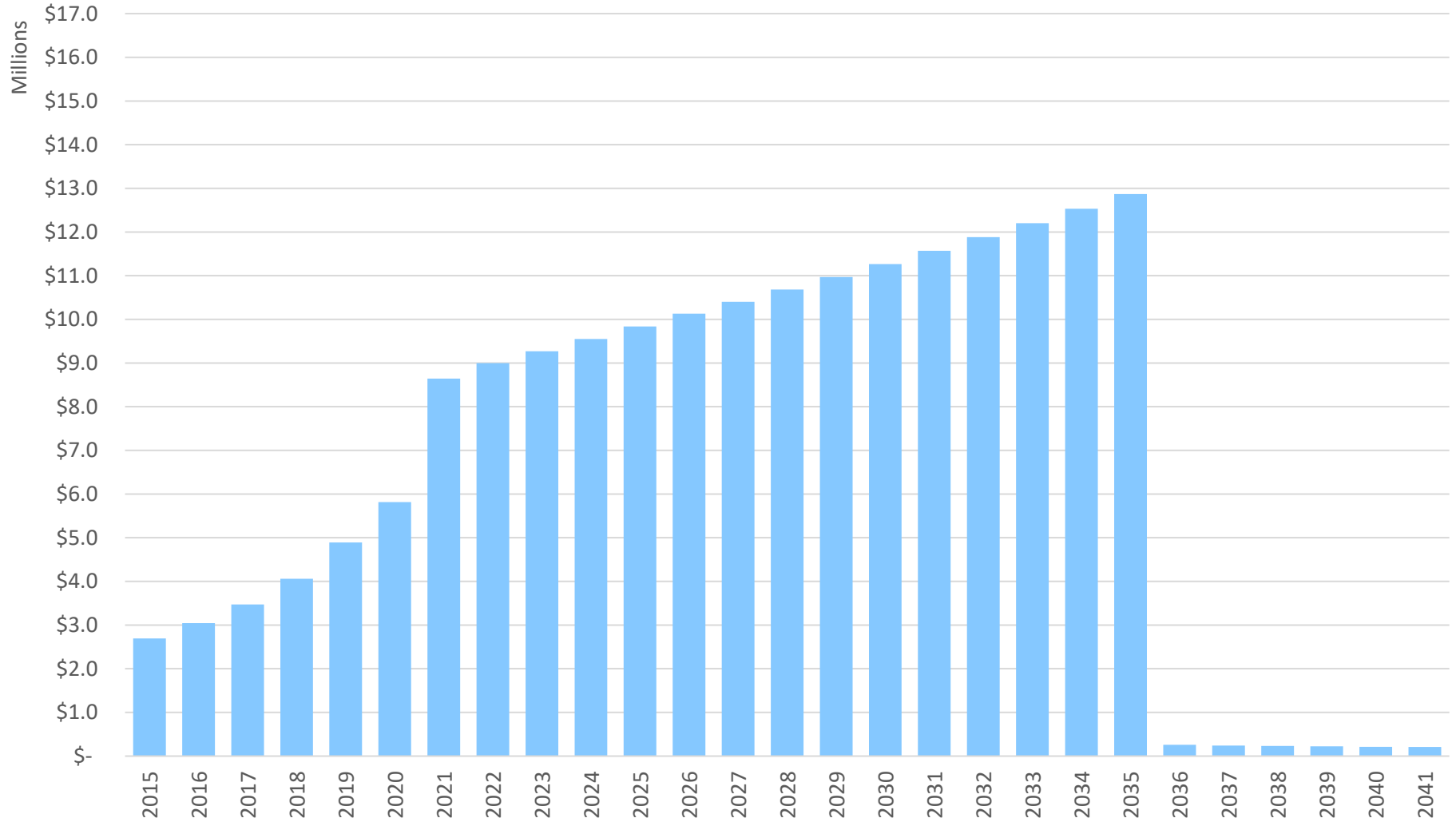
Now ...

- ▶ Sluggish investment growth (<6%)
- ▶ Assumptions are changing
 - ▶ Expected returns: 8.25% → 7.75% in 2003; 7.75% → 7.50% in 2013 → 7.00% by 2020
 - ▶ Mortality rates (people living longer)
 - ▶ Actuarial Valuation → Market Valuation
- ▶ Shorter (20 year) UAL amortization periods
- ▶ Unfunded liabilities are rapidly growing
 - ▶ City’s Miscellaneous Plan UAL has grown from \$34.6M to \$61.6M over last 7 years
 - ▶ City’s Safety Plan UAL has grown from \$19.5M to \$35.1M over last 7 years

CalPERS Projected UAL Repayment Schedule

\$96.7M Current UAL

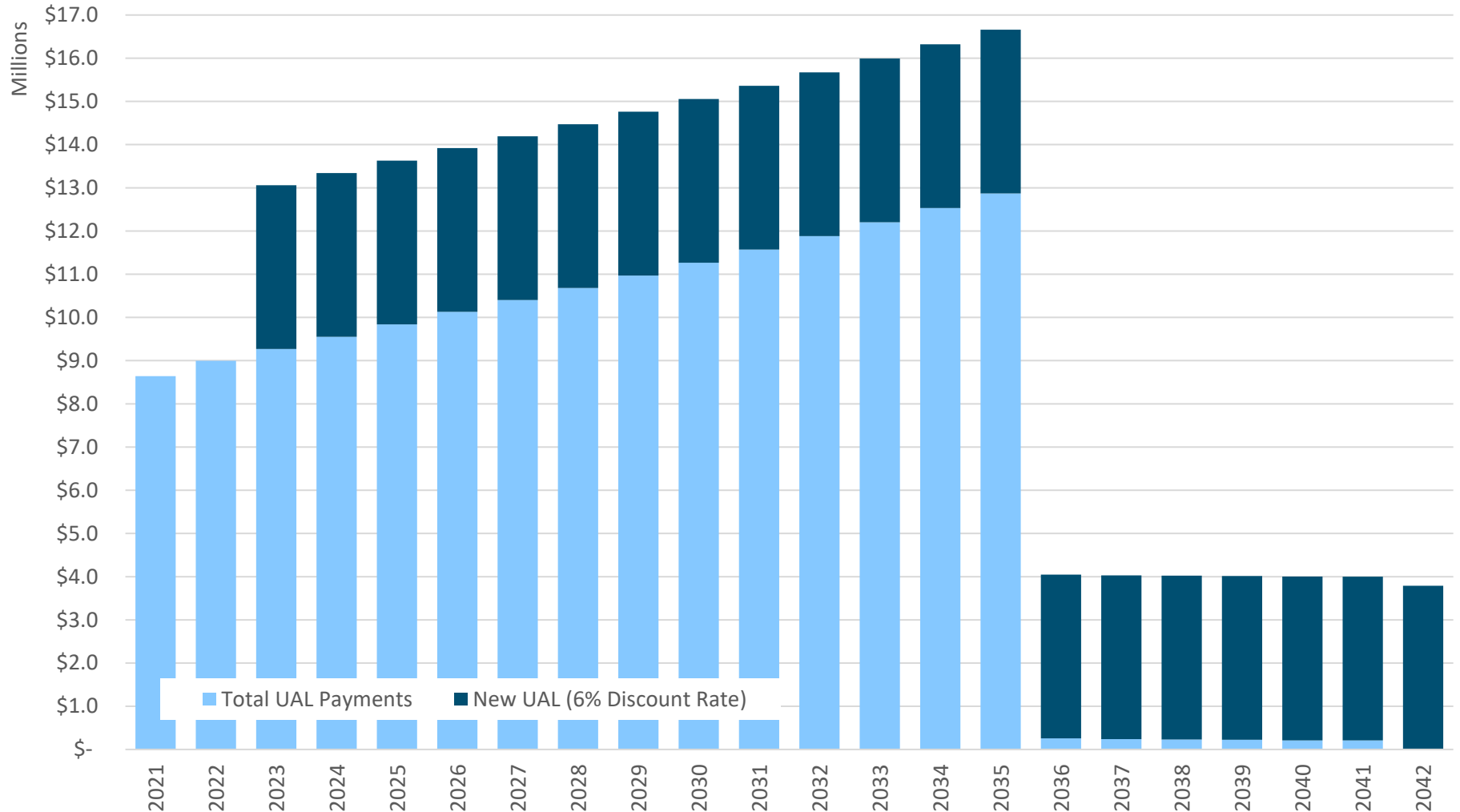
- ▶ City's UAL payment was \$2.7M in 2015
 - ▶ \$8.6M for FY 2021
 - ▶ \$11.6M for FY 2031
- ▶ Assumes CalPERS earns 7% and no assumption changes



UAL Repayment Schedule IF CalPERS Reduces Discount Rate to 6.0%

\$96.7M Current UAL + \$41.5M New UAL

- ▶ City's UAL would increase by about \$41.5M to \$138M total
- ▶ Annual payments would increase by \$3.8M per year from current projections





III. UAL RESTRUCTURING CONCEPT




























Restructuring UAL Debt – Conceptual Overview

- ▶ Borrow money to pay off all or a portion of UAL with CalPERS
 - ▶ Pension Obligation Bond (POB) is typically utilized
 - ▶ Unsecured debt (no collateral required)
 - ▶ “Court Validation” process is required to confirm UAL is a “debt” that can be refinanced (3-to-5-month process)
 - ▶ Validation provides foundation to issue POBs now or anytime in the future if approved by City Council (doesn’t lock City into a transaction)
- ▶ Interest rate paid on a POB significantly lower than the 7% CalPERS charges
 - ▶ Current market is 2.75% to 3.75% depending on length of term and credit rating
- ▶ Restructuring the annual payments into a smoother, predictable schedule is core objective
- ▶ Key risk / consideration: re-investment and market timing risk

Partial List of Recent UAL Restructuring Bonds

Record Low Taxable Interest Rates Have Resulted in Increased Issuance

- ▶ Interest rates have ranged from 2.54% to 4.25% for recent POBs
 - ▶ Dependent on credit rating, market conditions, security/ structure, term of debt, method of sale
- ▶ Given low rates and reduced risks to reward calculation, more public agencies are evaluating the UAL restructuring strategy
- ▶ Most recent 2021 transactions (Chula Vista, Orange, Downey, Monterey Park, El Cajon) obtained rates between 2.54% and 2.84%

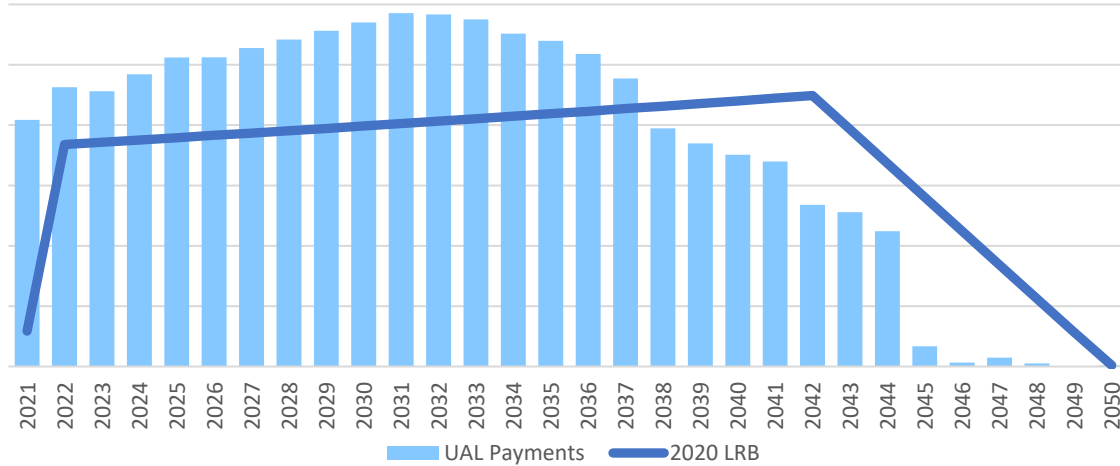
 Orange (2021) \$286,485,000 AA	 Chula Vista (2021) \$350,025,000 AA	 Downey (2021) \$113,580,000 AA	 Monterey Park* (2021) \$106,335,000 AA	 El Cajon (2021) \$147,210,000 AA	 Ukiah (2020) \$49,875,000 A+	 Coachella (2020) \$17,590,000 AA-	 Gardena (2020) \$100,590,000 AA-	 Arcadia (2020) \$90,000,000 AAA
 Placentia (2020) \$52,950,000 BBB+	 Torrance (2020) \$349,515,000 AA	 Novato Sanitary District (2020) \$6,467,000 Private Placement	 Azusa (2020) \$70,075,000 AA-	 Pomona (2020) \$219,890,000 AA-	 West Covina (2020) \$204,095,000 A+	 Grass Valley (2020) \$18,311,000 Private Placement	 North County Fire Protection District (2020) \$20,305,000 AA-	 Kingsport Police Protection CSD (2020) \$4,544,000 Private Placement
 Carson (2020) \$108,020,000 AA-	 El Monte* (2020) \$118,725,000 A+ (Ins.)	 Riverside (2020) \$432,165,000 AA	 Inglewood* (2020) \$101,620,000 AA- (Ins.)	 Montebello* (2020) \$153,425,000 A+ (Ins.)	 Ontario (2020) \$236,585,000 AA	 Larkspur (2020) \$18,295,000 AAA	 Riverside County (2020) \$719,995,000 AA	 Pasadena (2020) \$131,805,000 AAA

* Secured by pension tax override

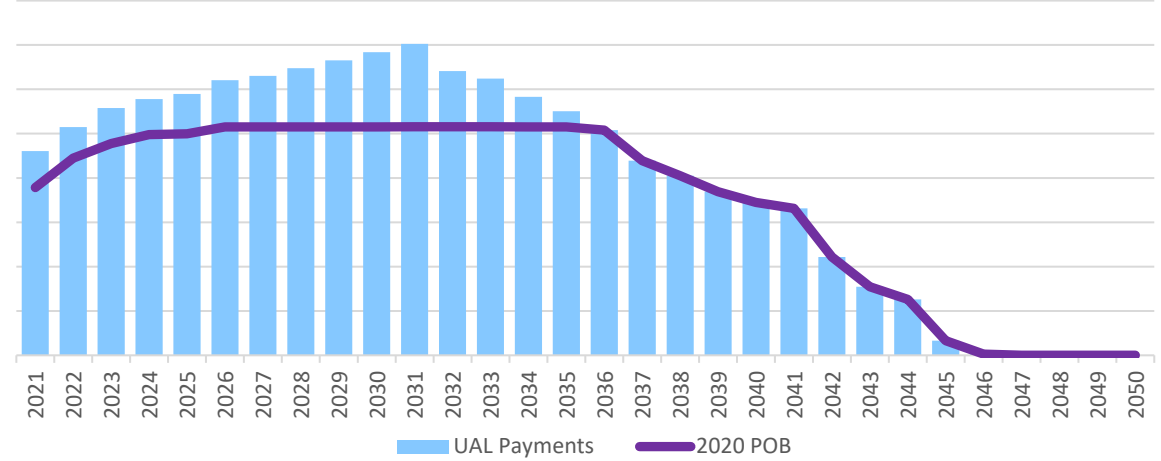
Restructuring for Smoothing is a Common Strategy

No Once Size Fits All: Term and Shape of Repayment Unique to Each Issuer

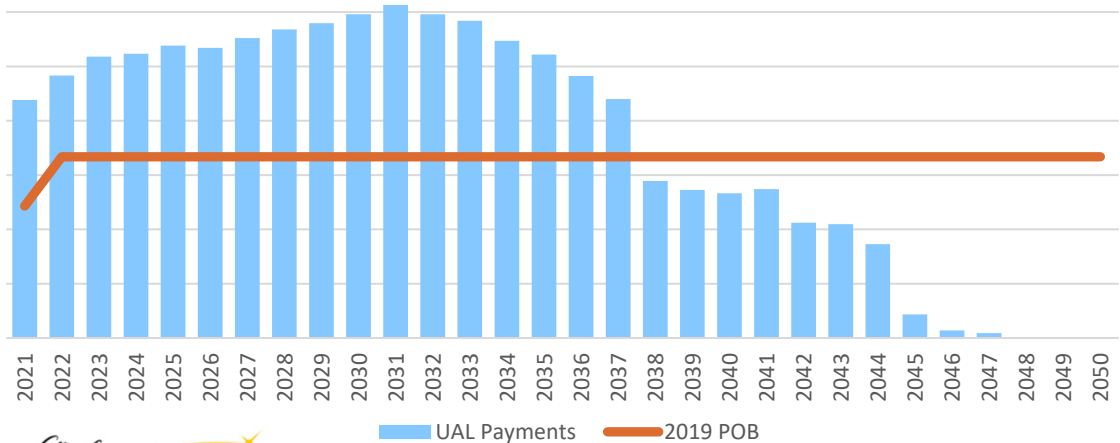
Ukiah: Upfront Relief + 1% Escalating + Linear Decline to 2050



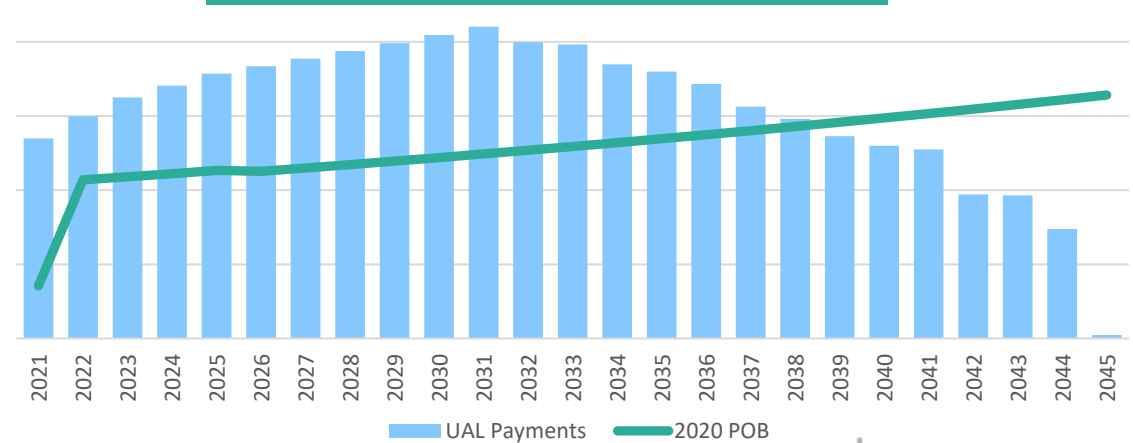
Riverside: Targeted Early Savings + "Chop the Peak" + No Dissavings



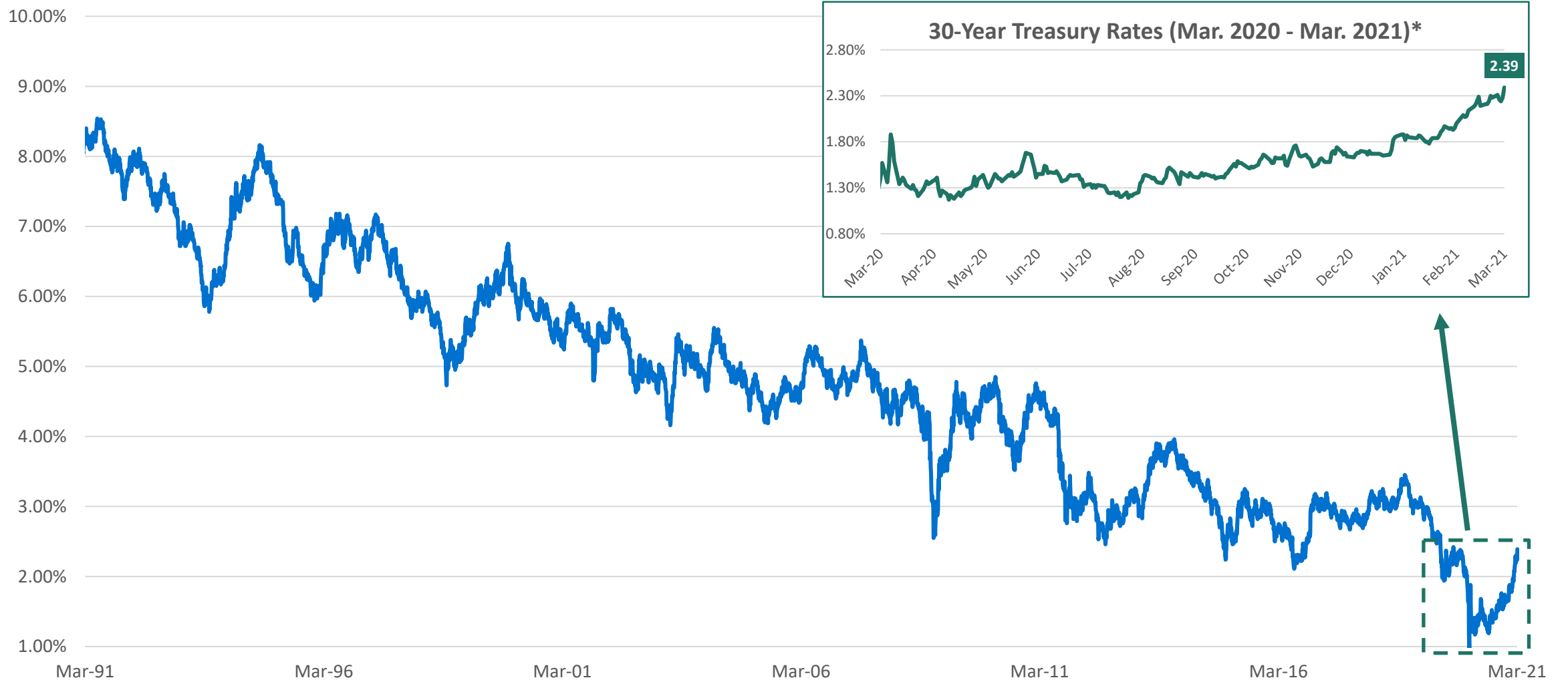
Hawthorne: Upfront Relief + 30 Year Level



West Covina: Upfront Relief + 25-Year @ 2% Escalating



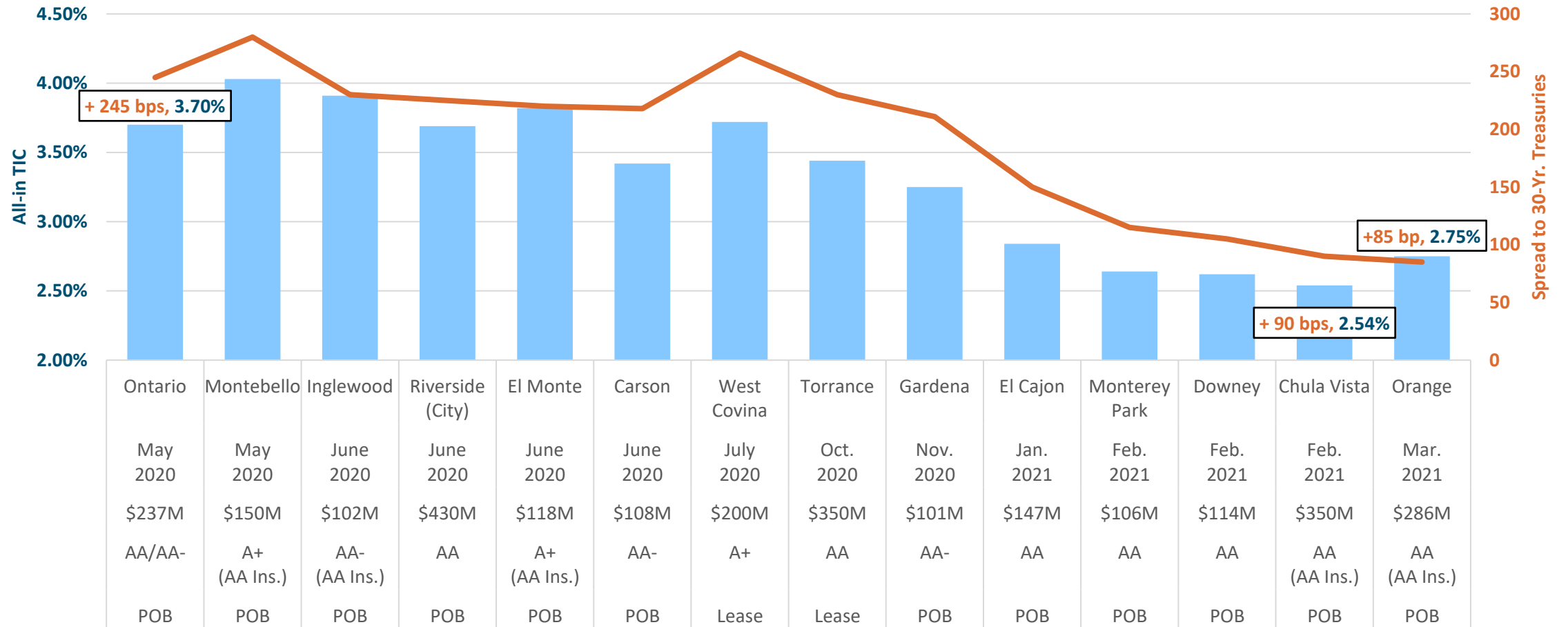
Taxable Interest Rate Trends (30-Year Treasury Rates)



Pension Bond Interest Rates have recently Trended Down

Pension Bond Rates Have Dropped Over 1.00% in Last 12 Months

Selected California UAL Restructuring Transactions



Preliminary UAL Restructuring Options for Lompoc

Three Basic Options for Presentation Purposes

OPTION 1

14 Year – 1%
Escalating Payments

OPTION 2

20 Year – 1%
Escalating Payments

OPTION 3

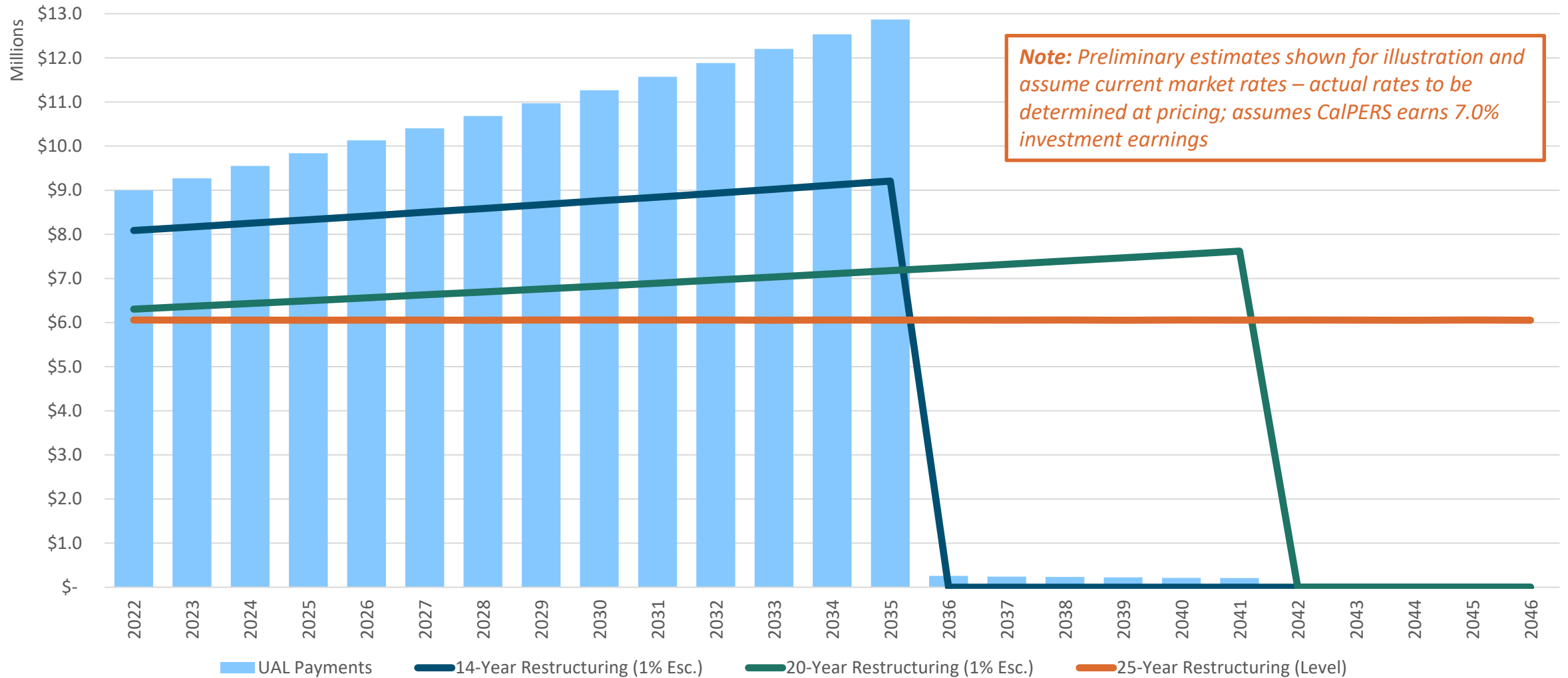
25 Year – Level
Payments

Assumptions

- ▶ 100% UAL Paid Off
- ▶ Interest Rates from Recent “AA” Chula Vista POB + 1.20%
- ▶ POB issued in June 2021 with savings beginning in FY 2022
- ▶ Bonds are “callable” (City has ability to pay off/refinance the POBs early if desired)

100% UAL funding and 3 basic bond options assumed for presentation simplicity. If City moved forward with evaluating concept further, dozens of options could be assessed (different sizes, maturities, repayment shapes, etc.)

Preliminary UAL Restructuring Options



Preliminary UAL Restructuring: Savings Analysis

▶ Moving from Left to Right:

- ▶ Average life of debt and interest rate increases
- ▶ Cumulative savings decreases
- ▶ Savings over next 14 years during “peak” period increases

▶ Savings are in addition to those created by Fresh Start program

Metrics	14-Year Restructuring (1% Esc.)	20-Year Restructuring (1% Esc.)	25-Year Restructuring (Level)
UAL Funded (\$)	\$96,704,053	\$96,704,053	\$96,704,053
UAL Funded (%)	100%	100%	100%
Funded Ratio	100%	100%	100%
Maturity	14 Years	20 Years	25 Years
Average Life	8.1 Years	12.0 Years	14.7 Years
All-In Interest Rate	3.05%	3.59%	3.79%
Present Value Savings (%)	25.77%	20.84%	19.06%
Present Value Savings (\$)	\$24,916,459	\$20,151,272	\$18,434,205
Cumulative Savings	\$32,652,985	\$14,710,206	\$2,138,322
Savings (2022-2035)	\$31,279,760	\$57,927,838	\$67,381,472
Average Savings (2022-2035)	\$2,234,269	\$4,137,703	\$4,812,962

Preliminary Options -Takeaways

- ▶ 3 preliminary options presented for simplicity; many options are available to evaluate (shapes, maturities, sizes, etc.) if more comprehensive evaluation process is initiated
- ▶ Present Value savings for options ranges from \$18.4 million - \$24.9 million
 - ▶ Assumes CalPERS earns 7.00%; if CalPERS earns less, savings are reduced
- ▶ **\$31M to \$67M over next 14 years** can help build reserves, fund capital, maintain service/staffing levels and address pension challenge
- ▶ Tradeoffs between shorter and longer maturities
 - ▶ Shorter: More cumulative savings, but less over next 14 years and **less resiliency to handle future economic shocks**, including CalPERS' underperformance
 - ▶ Longer: Less Cumulative savings, but more in the next 14 years & **increased long-term resiliency**


Pension Bonds - Benefits and Risks

Primary Benefits

- Fiscal Sustainability Tool: Ability to “re-shape” the City’s pension debt payments
- Near-Term Budgetary Savings can be used for other priorities
- Interest Rate Savings “Arbitrage”: City can borrow at rates much lower (currently $\approx 3.0\% - 4.0\%$) than what CalPERS charges on UAL debt (7%)
- Increase Funding Ratio
- Flexibility to Modify Maturity

Primary Risk: *Reinvestment & Market Timing Risk*

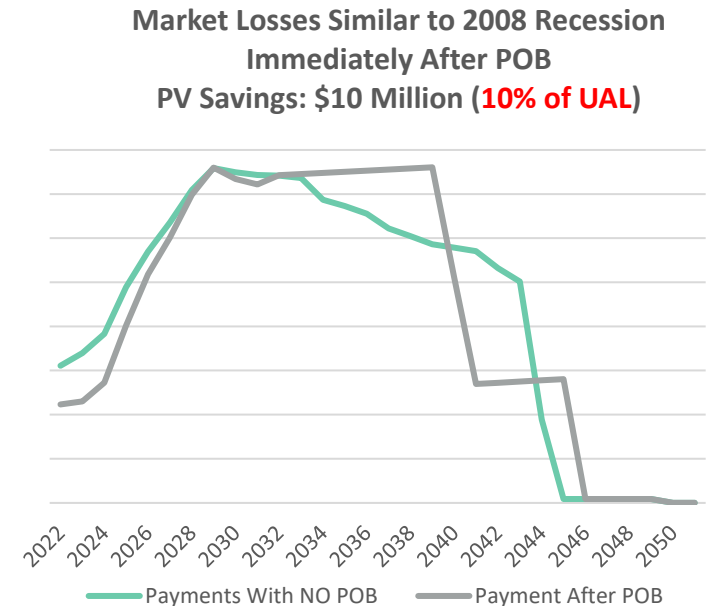
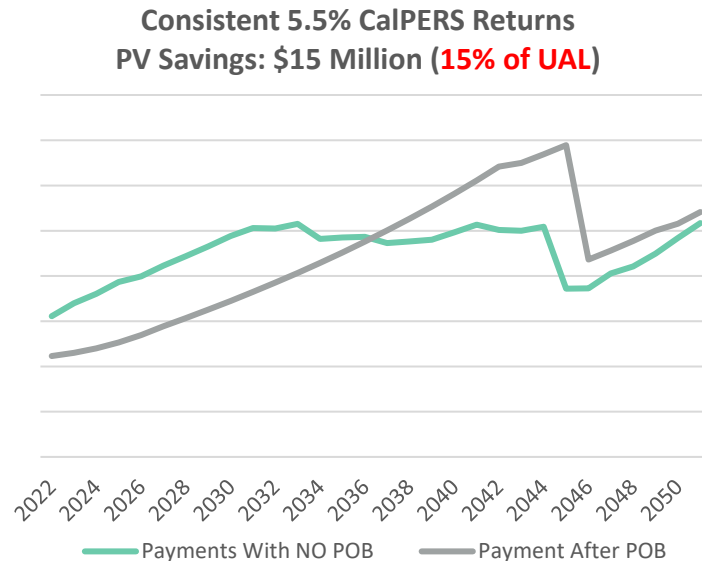
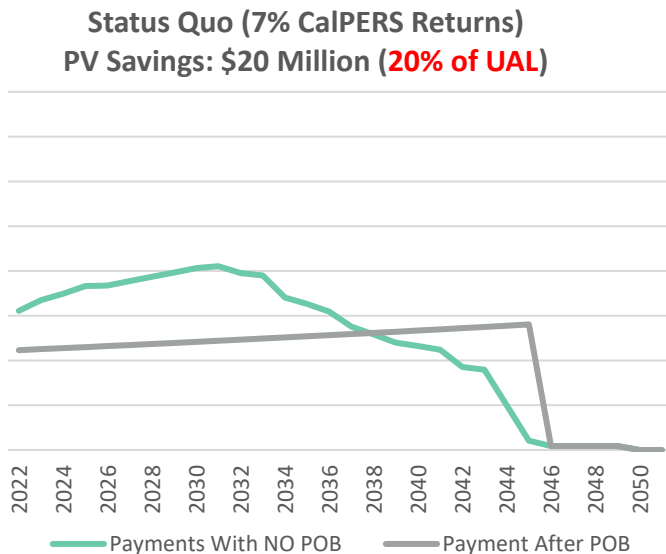
- Savings is ultimately dependent on future CalPERS returns, which are unknown at time of issuance (primary concern of GFOA)
- Present value savings occur if PERS earns greater returns than pension bond interest rate
- Near-term losses exacerbate this risk given large lump sum deposit into the market



*These risks should be quantified through a **stress testing process** to better understand the impacts of potential poor investment performance by CalPERS*

Stress Testing – What Does This Mean?

- ▶ Will City be better off with a UAL restructuring?
 - ▶ For example: What if CalPERS only earns 5.5% instead of 7%? What if we have another 2008 Recession?
 - ▶ City, advisor and actuarial experts could analyze any downside scenario to help quantify risks
- ▶ The financial impacts of these “what-if” scenarios should be analyzed so City makes decisions with “eyes wide open” and in its best interests



Government Finance Officers Association (GFOA)

GFOA's 2015 POBs Critique and How Current POBs Differ

Invested pension bond proceeds might earn less than the borrowing costs

- Yes. Instead of CalPERS's expected earnings rate of 7.0%, lower actual returns could occur. The chances of long-term returns being below current < 3.5% borrowing costs are low, but they do exist. A "stress testing" process is often helpful to better quantify this risk (i.e., analysis based on CalPERS earning poor returns in future)

"Pension bonds are complex instruments that carry considerable risk...and may include swaps or derivatives..."

- No. Current pension bond issuances are fixed rate bonds that typically do not include swaps or derivatives.

"Issuing taxable debt to fund the pension liability increases the jurisdiction's bonded debt burden and potentially uses up debt capacity..."

- No. Pension bonds replace all or a portion of an agency's payments to PERS with debt service on the bond. It is converting one liability for another on the balance sheet at a lower interest rate. A lease bond will reduce asset capacity for future issuances.

Pension bonds are "typically issued without call options" making it more difficult to refund bonds if interest rates fall or a different debt service structure is desired in the future.

- No. Nearly all recent pension bonds are issued with an optional redemption feature, allowing agencies to refinance or accelerate repayment upon them in the future.

"Pension bonds are frequently structured in a manner that defers the principal payments..."

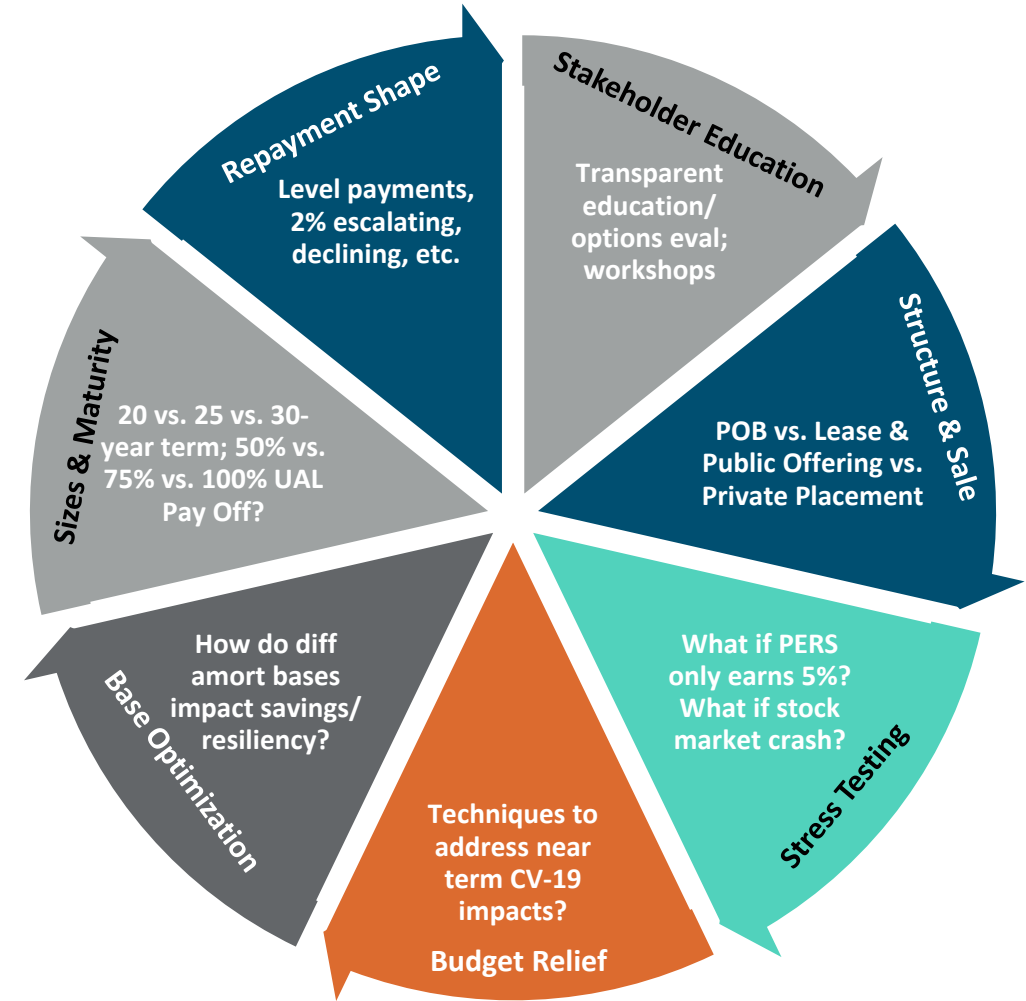
- Not Always. Most of the recent pension bonds amortize principal immediately. Shortening, lengthening, or maintaining the same term of payments is at the discretion of each agency.

"Rating agencies may not view the proposed issuance of Pension bonds as credit positive..."

- Not true if pension bond is prudently structured to increase payment affordability, financial flexibility and resiliency as part of a policy driven reserves and pension funding strategy.

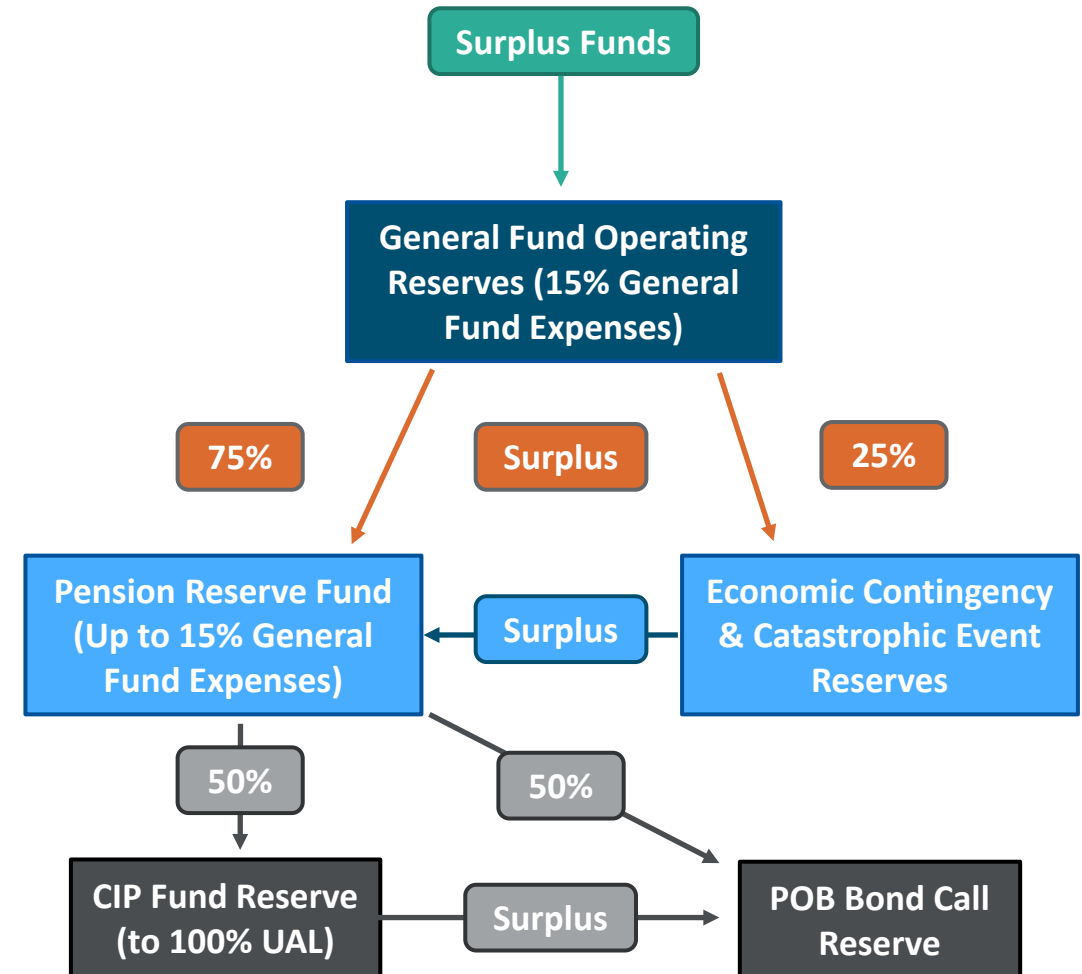
Components of a Thoughtful Evaluation Process

- ▶ Proper Stakeholder education
 - ▶ Full exploration of options
 - ▶ Shapes, sizes, durations
 - ▶ Tailor to City's financial objectives, risk tolerance and other constraints
- ▶ **Stress testing process to quantify risks**
- ▶ Structuring techniques to optimize savings / resiliency to future PERS volatility
- ▶ Market timing of investing proceeds
- ▶ Restructuring strategy and use of future savings should be governed by a **Pension Funding Policy (see next page for example)**



Recommendation: Pension Funding Policy (Illustrative Purposes)

- ▶ Integrated into a comprehensive reserve policy
 - ▶ Provides direction and prioritization to use surplus funds for “filling up” City reserves and other important accounts
- ▶ Detailed projections that account for positive POB cash flow benefits under different CalPERS performance assumptions can be a very strong planning tool
 - ▶ Also, a “credit positive” by rating agencies
- ▶ Beyond economic contingency reserves, surpluses may also be targeted towards funding Section 115 Trusts for additional future smoothing, if needed, of pension or OPEB costs
- ▶ Finally, funding an early redemption account of POBs, as well as other priority capital project funds may be considered



UAL Restructuring Process

Hypothetical Timetable if Strategy Pursued Further

March 2021

Educational Workshop
Q&A with City Council and Stakeholders

• *Workshops and Q&A can continue for as long during the process as is needed. Since Court Validation can take 3-5 months, there should be ample time for a full evaluation by Council and community stakeholders.*

April 2021

Engage Bond Counsel
Council approval of basic legal documents
Validation Proceedings initiated in Santa Barbara County Court

• **Does not lock City into issuing bonds; starts legal process required to preserve future flexibility**

April 2021 – July 2021

Continued workshops and meetings to evaluate concept
Engage Underwriter
Legal documents and Preliminary Official Statement (POS) drafted
Stress testing analysis & restructuring options refined
Credit rating process

Aug./Sept. 2021

Validation proceedings completed (CV-19 may delay process)
Council approval of POS and preferred option, IF ANY
Sell and close bonds and pay off portion of UAL with CalPERS

- ▶ **Multiple City Council approvals would be required before any bonds can legally be issued**
- ▶ **Evaluation process could continue during 3-5 month validation process**



IV. CONCLUSION AND NEXT STEPS

Conclusion and Potential Next Steps

- ▶ The City has taken proactive step to address \$97 million pension liability through recent Fresh Start implementation
 - ▶ Shortening term of debt will bring significant savings in the future
 - ▶ However, current repayment shape/level does not: (1) allow for resiliency to absorb UAL increases in future from poor CalPERS performance and/or assumption changes and (2) allow City to address other core priorities, such as funding capital and building reserves
- ▶ A UAL restructuring may provide City with opportunity to (1) more effectively leverage new sales tax revenue for various City priorities; (2) generate savings above and beyond what was created through Fresh Start and (3) enhance the City's resiliency and ability to absorb future economic "shocks" and/or additional UAL
- ▶ Whether a UAL restructuring is executed or not, a Pension Funding Policy should be adopted
- ▶ **Provide direction to staff to further evaluate UAL Restructuring or not and whether to initiate validation process to give City future flexibility**
 - ▶ **If validation process is recommended, legal counsel could be engaged, and documents prepared for City Council meeting approval in April 2021**