City of Santa Ana
20 Civic Center Plaza, Santa Ana, CA 92701
Staff Report
August 17, 2021

TOPIC: Resolution of the City of Santa Ana Authorizing the Issuance and Refinancing of the City's Pension Obligations (Unfunded Actuarial Liability) with the California Public Employees Retirement System (CalPERS)

AGENDA TITLE:
Resolution of the City Council of the City of Santa Ana, California Approving the Form of a Preliminary Official Statement and Continuing Disclosure Certificate in Connection with the Issuance of Bonds to Refund Certain Pension Obligations of the City and Approving Additional Actions Related Thereto

RECOMMENDED ACTION
Adopt a Resolution (Exhibit 1) Approving the Preliminary Official Statement (Exhibit 2) and the Continuing Disclosure Certificate (Exhibit 2-Appendix E) in connection with the City of Santa Ana Pension Obligation Bonds, Series 2021A ("the Bonds") to refinance of the City's pension obligations to CalPERS.

EXECUTIVE SUMMARY
The recommendation is the City Council's final action to approve the sale of up to $513 million of pension debt refinancing bonds. The financing team is on track to price and close the bonds early September 2021. Based on many months of careful analysis, we consider the recommended refinancing structure to be the best balance of maximizing savings and minimizing risk. The proposed refinancing strategy follows.

- The latest estimate of the True Interest Cost (TIC) is approximately 2.9% for the bonds. However, rates could change between the latest information on August 10 and the scheduled pricing date of August 25. As of the latest valuation report, CalPERS charges 7% on the pension debt.
- Structure debt payments to avoid an increase from the current year budget of $54.3 million for future annual pension debt payments. The current CalPERS amortization schedule indicates annual payments would increase to $79.2 million over the next five years without a refinancing.
- Schedule repayment of the bonds no later than the current CalPERS amortization scheduled payoff in 2046.
- Structure a decrease in future annual pension debt payments to coincide with the decrease of the Measure X rate in 2029.

Bond rates have recently began to increase, and the bond financing team expects rates will continue to increase slowly in the coming months. Therefore, staff recommends closing the bond issuance in September. Small rate increases can increase future bond payments dramatically.

The CalPERS Board will make decisions about the discount rate and investment strategy in November. If the CalPERS Board decreases its assumed investment rate of return, which is the discount rate, the City's pension debt will increase. This is a feasible scenario considering CalPERS recently earned 21.3% on its investments for FY20-21, which decreased the pension debt from an estimated $762.4 million at June 30, 2022 to an estimated $601.1 million at June 30, 2022. A reduction of the discount rate could return the pension debt balance to something near the higher amount.

Part of the overall savings strategy includes requesting a "Fresh Start" shorter amortization period for the remaining pension debt with CalPERS. A CalPERS policy requires an additional cash payment on the pension debt in order to request the Fresh Start. Staff recommends the City request the Fresh Start after the CalPERS Board makes its November decisions regarding discount rate and investment strategy. To make the additional cash payment to CalPERS, staff recommends holding up to $40.0 million of the current year spending authorization in the City's Section 115 Trust account, for use when requesting the Fresh Start after November. In turn, the City would use bond proceeds for the remaining FY21-22 required payment to CalPERS. This strategy allows the financing team to request the most advantageous Fresh Start and maximize savings once we have all the facts from upcoming CalPERS Board decisions.

DISCUSSION

Background

The City contracts with CalPERS to administer its employee pension plans. Each year, the City receives an actuarial valuation report from CalPERS identifying the total accrued liability and the market value of assets. When the liability exceeds assets, the City has a net pension debt. CalPERS amortizes the pension debt and requires annual payments from the City. The pension debt accrues 7% interest annually (recently reduced to 6.8% as discussed below). The recommendation would allow the City to refinance the debt, potentially at a rate less than 3%, and reduce the City's costs. The following table summarizes the project timeline.

April 21, 2020	City Council directed staff to proceed with a feasibility analysis to refinance the pension debt.
July 7, 2020	City Council approved the financial advisor contract with Urban Futures, Inc. (UFI), including preparation of the analysis.
February 2, 2021	City Council received a comprehensive report, including the feasibility analysis, recommendations and a proposed Unfunded Employee

	Pension Liability Cost Reduction Policy. City Council directed staff to proceed and approved the proposed Policy.
February 16, 2021	City Council approved the bond counsel contract with Stradling Yocca Carlson & Rauth (Stradling).
March 16, 2021	City Council approved a Resolution authorizing issuance of the Bonds.
May 18, 2021	City Council approved selection of the bond underwriting team.
August 17, 2021	City Council final action to approve the sale of pension debt refinancing bonds.
September 8, 2021	Expected closing date for the bonds.

Debt Validation

State law allows the City to refinance existing debt without voter approval. The City was required to obtain a validation of the existing debt from the Orange County Superior Court. The City received a validation for $711 million of debt on June 25, 2021 and the 30-day appeal period for the validation ended on July 25. With the validation, the City can refinance up to $711 million of debt through one or more debt issuances. There is no expiration on the validation. However, the validation does not allow the City to refinance new pension debt incurred in the future.

Credit Rating

A better credit rating leads to better financing interest rates. Standard & Poor's issued a credit rating of AA for the proposed bond sale, noting the following factors.

- Adequate economy in the City of Santa Ana.
- Very strong management, with strong financial policies and practices.
- Strong budgetary performance.
- Very strong budget flexibility and liquidity.
- Weak debt and contingent liability profile, primarily due to the large pension debt.
- Strong institutional framework.

Documents for City Council Consideration

- **Preliminary Official Statement (Exhibit 2) -** This is the City's document used by the Underwriters to market the bonds for purchase. This document must contain all facts significant or material to the Bonds and the City (with certain permitted exceptions to complete with the final Official Statement), and must not omit any such material facts.
- **Continuing Disclosure Certificate (Exhibit 2 – Appendix E) -** This document outlines the City's requirements to provide certain annual reports to investors and notices of certain enumerated events in order to allow the Underwriters to comply with federal securities laws.

On March 16, 2021, the City Council approved a resolution authorizing the issuance of Bonds and approving both the Trust and Bond Purchase Agreements. Prior to the closing of bonds, the City will finalize the previously authorized agreements to include the final pricing of the debt issuance.

<u>Fresh Start Amortization</u>
After applying the bond proceeds to the existing pension debt, staff will request a "Fresh Start" amortization for the remaining pension debt to CalPERS. The fresh start will reduce the amortization period for the remaining debt, contributing to the overall savings. The City will repay the remaining debt to CalPERS faster to save additional interest.

A CalPERS policy requires an additional cash payment to reduce the debt when requesting a Fresh Start. Staff recommends holding $40 million of the current year spending authorization to fund this additional cash payment and request a Fresh Start, after the CalPERS Board selects a discount rate and investment strategy in November.

<u>Comparison of Other Cities Recent Pension Debt Refinancing Activity</u>
The following table compares the estimated City refinancing compared with other agencies that have recently refinanced pension debt.

Sale Date	City	Amount ($M)	S&P Rating	All-In TIC
8/25/21[1]	Santa Ana [1]	Up to $513[1]	AA	2.9%[1]
8/3/21	Whittier	$133.90	AA	2.59%
7/14/21	Covina	$62.80	AA	2.64%
7/1/21	Redondo Beach	$226.18	AA	2.82%
5/26/21	El Segundo	$144.14	AA+	2.59%
4/28/21	Manhattan Beach	$91.28	AAA	2.75%
3/17/21	Huntington Beach	$363.65	AA+	2.94%
3/3/21	Orange	$286.49	AA	2.75%
2/11/21	Chula Vista	$350.03	AA	2.53%
2/9/21	Downey	$113.59	AA	2.63%
2/2/21	Monterey Park	$106.34	AA	2.67%
1/13/21	El Cajon	$147.21	AA	2.87%
11/10/20	Gardena	$101.49	AA-	3.33%
10/29/20	Placentia	$52.95	BBB+	4.25%
10/27/20	Arcadia	$90.00	AAA	2.70%

[1]Estimate

<u>Risk of Refinancing Pension Debt</u>
There is a risk associated with refinancing pension debt. CalPERS assumes it will earn 7% interest on its investments. If CalPERS consistently earns more than the assumption over the life of the debt, the City will pay more with the refinancing. The CalPERS investment rates of return follow.

Investment & Pension Funding Facts at a Glance for Fiscal Year 2019-20

Investments (PERF*)

Total Fund Market Value & Fund Returns by Fiscal Year**
(for FY end 6/30)

	(in billions)	(%)
2020	$392.5	4.7%
2019	$372.6	6.7%
2018	$354.0	8.6%
2017	$326.4	11.2%
2016	$302.0	0.6%
2015	$301.9	2.4%
2014	$300.3	18.4%
2013	$257.9	13.2%
2012	$233.4	0.1%
2011	$237.5	21.7%

* *Public Employees' Retirement Fund (PERF)*
** *Time-weighted rate of return net of investment expenses*

Annualized Investment Returns*
(for FY end 6/30)

1 year	4.7%
3 years	6.6%
5 years	6.3%
10 years	8.5%
20 years	5.5%
30 years	8.0%

* *Time-weighted rate of return net of investment expenses*

Source: CalPERS website

On April 27, 2021, CalPERS CEO Marcie Frost indicated that CalPERS expects to earn an average of 5.6% over the next 10 years (interview with Amanda White on top1000funds.com). CalPERS recently announced its preliminary rate of return for FY20-21 was 21.3%, which is significantly higher than the 7.0% assumption and the expectation stated by Ms. Frost in April. CalPERS has a policy to reduce the discount rate, which is also the assumed investment rate of return, after high-return years. The 21.3% return results in a discount rate decrease from 7.0% to 6.8% effective with the June 30, 2021 actuarial valuation, likely available in August 2022, affecting the FY23-24 contribution rates.

After the refinancing is complete, the City's debt to the CalPERS pension system could continue to grow if the plan does not meet assumptions going forward. For example, salary increases in excess of the assumption drove a $20 million increase of the unfunded liability in FY19-20. The CalPERS wage growth assumption is 2.75%, yet the City granted salary increases of 4% to the Police Officers Association and the Police Management Association, and 3.5% increases to all other bargaining groups.

<u>Stress Test Analysis</u>
The financing team has run many different scenarios to gain an understanding of the best refinancing structure to minimize risk for the City and maximize savings. In each stress test scenario, with future CalPERS investment returns ranging from annual 4.5% gains to an immediate 20% loss, there is an expected net present value benefit from the refinancing.

Compliance with City Council Policy

On February 2, 2021, the City Council adopted the Unfunded Employee Pension Liability Cost Reduction Policy. The proposed refinancing is compliant with the City Council policy. Specifically, staff will direct CalPERS to apply the bond proceeds to the layers of unfunded liability (loss bases) with the longest amortization periods to maximize overall savings. In addition, the Policy requires the City to consider issuing pension obligation bonds only if the following criteria exist.

Policy Criteria	Compliance
The City Council must conduct a public meeting to consider the results of an analysis quantifying the risk probability of the City paying more over the life of the bonds.	Public meeting conducted on February 2, 2021 including review of the comprehensive analysis.
To maximize potential savings, the bond interest rate must be at least 30% less than the plan's current discount rate.	The estimate bond rate is approximately 2.9%, which is 57% less than the new 6.8% discount rate effective June 30, 2021.
To ensure the City benefits from the possible scenario of actual plan results exceeding CalPERS assumptions shortly after issuing debt, the bonds must not exceed 90% of the unfunded liability.	The CalPERS estimate of the unfunded liability as of September 2021 is $570 million, factoring in the recent investment returns and the corresponding reduction of the discount rate to 6.8%. The bond issue will not exceed $513 million (90% of the estimated $570 million unfunded liability).
The bond structure must not extend the life of the debt.	The current CalPERS amortization includes payments through 2046. Bond debt service payments will end no later than 2046.
The City must not use bond proceeds to pay the normal cost of the pension plan.	Staff will direct CalPERS to apply bond proceeds only to the unfunded liability. The current year budget includes full funding for the City's normal cost contributions.

Next Steps

Staff will report final actual results to the City Council at least twice, as follows.

- Bond issue results with the September 21, 2021 agenda.
- Fresh Start results and an updated 10-Year Outlook for the General Fund with the Midyear Report scheduled for February 15, 2022.

FISCAL IMPACT

The FY21-22 budget includes an appropriation of $54.3 million (approximately $47.0 million in the General Fund and $7.3 million in other restricted funds) to make payments on its unfunded liability. Staff expects to close the bonds in September 2021 and make the first interest payment in February 2022. Due to the timing of the bond sale and the first bond payment, and the staff recommendation to hold up to $40 million in the City's Section 115 Trust account until after the CalPERS Board makes its November decisions, staff expects to use bond proceeds for the remainder of the current year required payment.

Staff proposes the following revised spending plan for FY21-22 to remain within the current appropriation.

City Appropriation:			**Bond Proceeds:**	
July and August Monthly Payments to CalPERS for the FY21-22 unfunded liability obligation	$9.4 million		Costs of Issuance (up to amount)	$1.3 million
First Bond Payment in February 2022 (up to amount)	$4.9 million		Remainder of the FY21-22 unfunded liability obligation (up to amount)	$46.8 million
Hold in Section 115 Trust Account, for subsequent payment to CalPERS after November Board decisions	$40 million		Payment on the estimated $570 million unfunded liability (up to amount)	$464.9 million
Total FY21-22 Appropriation	$54.3 million		Bond Proceeds (up to amount)	$513 million

With the Midyear report, staff expects to propose a housekeeping adjustment to shift the current year spending authorization between different accounts to accommodate the first bond payment, with no increase to the overall FY21-22 appropriation.

EXHIBIT(S)

1. Resolution Approving the Preliminary Official Statement and the Continuing Disclosure Certificate
2. Preliminary Official Statement & Continuing Disclosure Certificate (Appendix E)

Submitted By: Kathryn Downs, Executive Director Finance and Management Services
Approved By: Kristine Ridge, City Manager