NHA | ADVISORS

4040 Civic Center Drive, Suite 200
San Rafael, CA 94903

Office: 415.785.2025
www.NHAadvisors.com

MEMORANDUM

Date: July 14, 2022

To: Shasa Curl, Interim City Manager, City of Richmond
Anil Comelo, Interim Deputy City Manager, City of Richmond
Anita Luck, Deputy City Attorney, City of Richmond
Delmy Cuellar, Director of Finance

From: Mark Northcross, Mike Meyer and Roy Kim

RE: Attachment 1 – July 7, 2022 Memo from NHA Advisors on 2022 Refunding Bonds.docx

Addressing the Imminent Risks Facing the City: Over the past several months, the City's financing team has worked diligently to develop a simple, easy-to-administer fixed rate refunding bond which will finance the RBC termination payment and accomplish the Council's direction of removing swaps and reducing interest rate risk within the City's debt profile. To re-iterate some of the challenges that this fixed rate refunding addresses, a summary of the current situation related to the 2005 POBs is below:

- The 2005 B-2 POBs will convert from accretion mode to current interest mode on 8/1/23, at which time the Bonds will become variable rate Index Bonds
- LIBOR will expire 6/30/23; Pursuant to the Adjustable Interest Rate (LIBOR) Act (S. 3779) passed by Congress this spring, the reference index mode will change from LIBOR to SOFR
- The Accreted Value of the B-2s at Conversion will be $128 million, which is $86 million greater than the initial principal amount of $41 million
- The City faces a ~$20mm Automatic Termination payment to RBC on 8/1/23

Bartel Report and Preliminary NHA Findings. The City's 2005 pension obligation bond ("2005 POB") refinancing team has reviewed the Bartel report projecting pension tax override ("PTO")-eligible expenses through FY 2042. Below is a short summary of the findings that the finance team believes should be considered by staff and City Council in determining the final bond term/structure for the proposed refinancing of the 2005 POBs, which will include amortizing the Automatic Termination cost of the 2016 RBC swap.

Based on current assumptions for CalPERS costs (Normal Costs and UAL) and 2% growth in assessed valuation for the City:

1) The portion of pension expenses (CalPERS UAL/Normal Cost and POB debt) that are legally eligible to be paid by the PTO ("PTO-eligible expenses"[1]) are currently anticipated to exceed projected PTO revenues through FY 2034 by about $28 million per year on average. This means that the

[1] PTO Eligible expenses are pension related costs that correlate to benefit levels in place for employees before 1978. These costs are summarized in the presentation and Bartel PTO Report.

General Fund will need to deliver significant supplemental funding for CalPERS expenses for the next 12 fiscal years; approximately $15 to $20 million in FY 2023, growing rapidly to over $30 million by the end of the decade. This is separate from the roughly $11 million (annually on average through FY 2034) in total non-PTO eligible pension expenses[2] that will need to be covered by the City/General Fund over this period as well. Overall, the City (primarily General Fund) is projected to need to pay about $25 million in pension expenses from non-PTO revenues in FY 2023, which will grow to $48 million by FY 2031 – an increase of $23 million.

2) By FY 2045, all City CalPERS expenses are projected to be PTO-eligible, due to a combination of the CalPERS mandated UAL amortization schedule (on the City's estimated $380+ million UAL) and an increasing portion of active employees in PEPRA Plans rather than Classic Plans.

3) By FY 2042, projected PTO revenues are anticipated to exceed projected PTO-eligible expenses.

Based on these assumptions, and as detailed further in the accompanying presentation, the City's overall PTO revenues vs. overall pension expense (UAL + Normal Cost + POBs) profile may not be optimal from a fiscal sustainability and budget predictability standpoint. In the near term, the City is scheduled to pay significantly more than is covered by the PTO (given that eligible expenses are much higher than the PTO revenue) but has significant projected capacity beyond FY 2042 to cover additional payments using PTO revenue (without any increase to the 0.14% levy). Without paying off any of the current $380+ million UAL with CalPERS, one tool that the City can use to better re-align pension costs to match PTO revenues is a term extension and restructuring for the 2005 POBs.

NHA's preliminary analysis shows that a term extension for the 2005 POBs between 2044 and 2052 can result in significant benefit to the General Fund, especially over the next 12 years (over $80 million of reduction in pension expenses through FY 2034). This is done through the re-alignment of pension expenses to better match PTO revenues. Said another way, currently frontloaded pension costs can be shifted to later years by extending the term of the debt, reducing the burden on the General Fund and allowing more of the City's total projected pension costs to be paid for by PTO revenues.

One downside for the City's consideration is that the term extension options add significantly to the overall interest costs on the debt – between $60 million (2044 term) and $130 million (2052 term) – vs. keeping the same 2034 term. It should be noted that if there is PTO revenue which would otherwise be unused in a future year, after 2032 (when a standard 10-year call provision would be active on the 2022 POBs), some of the 2022 POBs could be called (paid off early) with no penalty, thereby saving on future interest costs.

The policy decision of a term extension, and added interest costs, should be seriously considered by the City, however the projected General Fund benefits (through re-alignment of General Fund-paid pension costs to PTO-paid pension costs) currently appear to outweigh the cost of the extra interest. As shown on slide 10 of the presentation, the present value benefit (already factoring in the added interest costs) is projected between $11 million (2044 term) and $26 million (2052 term). Most importantly, over $80 million of reduced General Fund expenses through FY 2034 are projected, which may be a critical period of financial challenge for the City due to rising pension expenses.

[2] Non-PTO eligible pension expenses include the portion of UAL, Normal Cost and Debt Service attributable to post 1978 benefit levels and the swap termination payment. These costs cannot legally be paid from PTO revenue.

Even with the extension, the City will face an escalating and challenging repayment shape for overall pension expenses, though a term extension and reduction of $80 million of projected General Fund expenses through FY 2034 can make this burden more manageable and may reduce the need for the City to make large budget cuts and/or raise revenue through new taxes.

Since the structure/bond term will also drive the credit rating strategy, which will include communicating to S&P Global Ratings how the City intends to address this overall $500 million pension challenge, it is important for the financing team to receive direction from City staff and the Council on this extension concept, and preferred bond term, in the next couple of weeks.

While there is no right answer, NHA believes that a term extension should be strongly considered, given that the potential cash flow benefits of the term extension project to outweigh the added interest costs and may provide enhanced financial stability to City's General Fund. The preliminary recommendation on the bond term is currently 2044. While the cash flow benefit through FY 2034 is lower than the 2052 term option ($84 million vs. $103 million), the added interest cost is over $70 million less than the 2052 option.

Pending further confirmation based on analysis of monthly CalPERS related cash flows through FY 2024, NHA's preliminary analysis indicates over $7 million per year (on average through 2035; $2 million in FY 2023, $7 million FY 2024, growing to over $10 million by FY 2031) in net cash flow benefit to the City, and primarily to the General Fund. This means that the City could spend $7 million per year less on PTO-eligible expenses than it does currently. This $7 million number is preliminary and subject to further revision pending a more detailed cash flow analysis with the City's Finance Department.

Next Steps.

1) An educational presentation will be made to City Council on July 19th

2) Council action approving the final bond structure and all legal documents for the 2005 POB refinancing would take place on July 26th.

3) Credit rating discussion with S&P and bond sale take place in the month of August.

4) Bond Closing and Swap Termination to take place in early September.

NHA Advisors, LLC is registered as a Municipal Advisor with the SEC and Municipal Securities Rulemaking Board ("MSRB"). As such, NHA Advisors, LLC has a Fiduciary duty to the public agency and must provide both a Duty of Care and a Duty of Loyalty that entails the following.

Duty of Care

a) exercise due care in performing its municipal advisory activities;
b) possess the degree of knowledge and expertise needed to provide the public agency with informed advice;
c) make a reasonable inquiry as to the facts that are relevant to the public agency's determination as to whether to proceed with a course of action or that form the basis for any advice provided to the public agency; and
d) undertake a reasonable investigation to determine that NHA Advisors, LLC is not forming any recommendation on materially inaccurate or incomplete information; NHA Advisors, LLC must have a reasonable basis for:
    i. any advice provided to or on behalf of the public agency;
    ii. any representations made in a certificate that it signs that will be reasonably foreseeably relied upon by the public agency, any other party involved in the municipal securities transaction or municipal financial product, or investors in the public agency securities; and
    iii. any information provided to the public agency or other parties involved in the municipal securities transaction in connection with the preparation of an official statement.

Duty of Loyalty

NHA Advisors, LLC must deal honestly and with the utmost good faith with the public agency and act in the public agency's best interests without regard to the financial or other interests of NHA Advisors, LLC. NHA Advisors, LLC will eliminate or provide full and fair disclosure (included herein) to Issuer about each material conflict of interest (as applicable). NHA Advisors, LLC will not engage in municipal advisory activities with the public agency as a municipal entity, if it cannot manage or mitigate its conflicts in a manner that will permit it to act in the public agency's best interests.