CalPERS

Investment Committee
Agenda Item 6a

June 13, 2016

Item Name: Assembly Bill 2348 (Levine): CalPERS Investments in California Infrastructure Projects

As Amended April 28, 2016

Program: Legislation

Item Type: Action

Recommendation
Adopt a **Neutral** position on AB 2348 as it encourages critical infrastructure investments in California, without placing an investment mandate on the California Public Employees' Retirement System (CalPERS) Board of Administration (Board), or requiring the Board to take any action detrimental to the Fund.

Executive Summary
AB 2348 authorizes the Department of Finance (DOF) to identify infrastructure projects in California for which it will guarantee a rate of return for investments made by CalPERS, subject to the availability of special fund moneys deposited into a newly-established Reinvesting in California Special Fund.

The Board's Legislative and Policy Engagement Guidelines related to Investment Sustainability suggests support for proposals that foster a healthy and diverse California economy with strong companies, solid infrastructure for commerce, robust business development, and fair labor practices and employment.

While the goals of the bill's author appear to compliment CalPERS' various initiatives that support economic growth in California without attempting to impose an investment mandate on the Fund, the risks and rewards associated with CalPERS' participation cannot be assessed until the Department of Finance has identified potential infrastructure projects and specified the terms and conditions of its financial guarantees. It is at that time the Investment Office and Legal Office staff and consultants could assess whether CalPERS participation in the program, as implemented, aligns with the Board's Infrastructure Policy and other Investment Policies, as well as its fiduciary duty to plan participants and employers.

Strategic Plan
This item supports CalPERS' 2012-2017 Strategic Plan Goal C to engage in state and national policy development to enhance the long-term sustainability and effectiveness of our programs.

Investment Beliefs
This item supports CalPERS Investment Belief 3, that CalPERS investment decisions may reflect wider stakeholder views, provided they are consistent with its fiduciary duty to members and beneficiaries.

Background

Existing Law
Article XVI, Section 17 of the California Constitution provides the governing boards of public pension funds sole and exclusive authority over investment decisions and administration of their respective retirement systems. It also directs state and local pension systems to diversify their investments so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. Last, it requires the governing boards to administer their systems so as assure prompt delivery of benefits and specifies the board's duty to participants and beneficiaries takes precedence over any other duty.

Current law authorizes, but does not require, the governing boards of CalPERS, the California State Teachers' Retirement System (CalSTRS), and 1937 Act County Retirement Systems, subject to and consistent with their fiduciary duties and standards for prudent investment to prioritize investment in an in-state infrastructure project over a comparable out-of-state project. This includes, but is not limited to, investments in telecommunications, power, transportation, ports, petrochemical, and utilities.

An important consideration for CalPERS is that, under Internal Revenue Code Section 503, a Section 401(a) trust such as CalPERS can lose its tax-exempt status if it has engaged in a prohibited transaction. CalPERS must carefully evaluate whether there could be such a prohibited transaction whenever it engages in a transaction with the State of California or a CalPERS contracting local agency and CalPERS either lends, guarantees, pays compensation to, or purchases or sells securities to or from the state or a local agency. California infrastructure investments could implicate such issues.

The CalPERS Infrastructure Program
The CalPERS Infrastructure Program is part of its Real Assets portfolio. The role of the Program is to provide stable and predictable cash yield, diversification of equity risk and inflation protection. The Program primarily targets long-term, stable, defensive investments within the energy, power, transportation, water, waste, and telecommunications sectors. The Program is focused on investment opportunities in the United States and in certain developed Organization for Economic Co-operation and Development regions, such as Australia, Canada, United Kingdom, and selected countries in Continental Europe.

The target allocation of the Program is 2.0 percent of the Total Fund. The Net Asset Value is approximately $2.3 billion. Performance of the Program has been strong, delivering returns of 11.0 percent, 15.0 percent, and 19.1 percent for the 1-, 3- and 5-year periods, respectively.

CalPERS California Infrastructure Initiative
On September 12, 2011, the Board's Investment Committee earmarked up to $800 million for investment in California infrastructure over a three-year time period. The primary goal of this initiative was to make investments in essential infrastructure assets that meet the risk-return objectives of CalPERS Infrastructure Program, while also potentially benefiting local economic development and essential community services across the state. The Investment Committee instructed staff to develop a plan for outreach to state and local governments to explore the role

CalPERS and other pension systems can play in facilitating infrastructure investment in California.

The Outreach Effort consisted of CalPERS sponsorship of four Infrastructure Roundtables between March and May 2012, as well as other industry networking and information sharing initiatives. While the roundtable discussions did note there is a vast unmet need for investment in California infrastructure, a couple of key findings were also noted:

- There are numerous challenges to pension system investment in California infrastructure, including the availability of lower cost, tax-exempt financing, a lack of projects which are suitable for public pension funds and other institutional investors, the absence of necessary statutory authorities in some cases and complex regulatory processes.
- Concerns were expressed related to potential conflicts of interest and reputational risk for CalPERS, or any state pension system, as a potential direct shareholder of a public infrastructure asset in California. For example, certain investment-related decisions may result in outcomes that are unpopular, such as decisions to raise tolls on toll roads.

Analysis

<u>Specifically, AB 2348 would:</u>

- Allow the DOF to evaluate and identify infrastructure projects in the state for which the Department will guarantee a rate of return on investment in that project by CalPERS.
- Create the Reinvesting in California Special Fund within the State Treasury, which shall be continuously appropriated and shall be used to pay the rate of return guaranteed by the DOF.
- Limit the rate of return guaranteed by the DOF subject to the availability of moneys in the Reinvesting in California Special Fund.
- Prohibit General Fund moneys from being deposited into the Reinvesting in California Special Fund, and expressing the intent of the legislature to identify and deposit special fund moneys into the fund.

1. <u>Author's Intent</u>
   Assembly Member Levine has stated that California has a large infrastructure funding gap that is growing every day. He cites a study by the reform group California Forward, which estimates that the state will need to spend $835 billion over the next decade to meet its water, transportation, and K-12 infrastructure needs. He states that only one third of one tenth of one percent of CalPERS holdings are in California Infrastructure, and if CalPERS were to increase its investment in California-based infrastructure projects to just one tenth of one percent, this would produce an additional 2,600 California jobs.

2. <u>Implementation by the DOF</u>
   A key component of this bill is the involvement of the DOF in identifying appropriate California infrastructure projects and guaranteeing a rate of return if CalPERS were to invest in those projects. DOF opposes AB 2348, noting that the bill lacks sufficient detail on what criteria it would use to evaluate infrastructure projects for investment or how the state would "guarantee" a rate of return for any CalPERS investment, and that the state faces unknown financial risks in doing so. In addition, it says CalPERS already has the mechanisms and resources in place to identify and evaluate infrastructure investment projects, and that a mechanism for guaranteeing a rate of return for an investment in California infrastructure already exists in the form of state general obligation bonds or State Public Works Board lease revenue bonds.

3. Additional Considerations
   AB 2348 does not appear to mandate or specify that CalPERS would engage in a transaction between it and the State of California or a contracting agency relative to an infrastructure investment. Instead, it appears that the DOF would only guarantee CalPERS' return on the investment through some unspecified mechanism. Without additional background information or language being added to AB 2348, it is difficult to determine whether and to what extent Section 503(b) or other prohibited transaction rules may or may not come into play. Additional review regarding the prohibited transaction rules on a case by case basis would be necessary to the extent that CalPERS determines that a transaction with the state or a CalPERS contracting local agency under the bill would otherwise be a prudent investment.

Budget and Fiscal Impacts

The bill as drafted imposes no investment mandate on CalPERS, as the DOF's decision whether to set a guaranteed rate of return for California infrastructure projects is optional and CalPERS is under no compulsion to invest in any project based on the guaranteed rate of return. Therefore, AB 2348 should not impose any additional budgetary or fiscal costs upon the Fund.

Benefits and Risks

Benefits:

- Potentially overcomes certain obstacles to infrastructure investment identified by the CalPERS Infrastructure Investment Roundtables

Risks:

- May create situations for CalPERS engagement in prohibited transactions.
- May encourage external parties in future efforts to direct portfolio activities.

Attachments

Attachment 1 – AB 2348 (Levine) As Amended April 28, 2016
Attachment 2 – Legislative History
Attachment 3 – Support and Opposition

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Mary Anne Ashley, Chief
Legislative Affairs Division

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Wylie Tollette
Chief Operating Investment Officer