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MAYOR SYLVESTER TURNER

TRANSITION COMMITTEE ON COMPREHENSIVE FINANCIAL REFORM

March 24, 2016

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For media inquiries, please contact David Mincberg.

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Resources

The Committee or members of the Committee have met with and learned from a variety of individuals and organizations, some of whom are listed below. All were forthcoming, helpful, and encouraging. **This report is a reflection as to any part solely of the views of the majority of the Committee.**

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Greater Houston Partnership—Marc Watts, Bob Harvey

Arnold Foundation – Denis Calabrese, Dr. Josh McGee

Steven Costello

Jim Noteware

Craig Mason

Bob Lemer

William Fulton, Director, Kinder Institute for Urban Research

Dr. Elena Farah, Adjunct Professor, University of Houston, Research Associate with the Hobby Center for Public Policy

Trey Cash, Managing Director, FirstSouthwest, a Division of Hilltop Securities

The Honorable Chris Brown, City Controller

Carl Medley, Deputy City Controller, City of Houston

The Honorable Dave Martin, City Councilmember, City of Houston

The Honorable Amanda Edwards, City Councilmember, City of Houston

The Honorable Jack Christie, City Councilmember, City of Houston

Donna Edmondson, General Counsel, City of Houston

Judith Ramsey, Chief of the General Litigation Section, City of Houston Kelly Dowe, Director of Finance, City of Houston

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II. EXECUTIVE SUMMARY

Houston faces a difficult financial future. It is no longer news that the City has significant financial problems, and, absent reform, the problems will only worsen. The City faces projected budget deficits in FY 2017 and beyond, resulting from service costs, constrained, unpredictable, and declining revenues, population growth, underfunded pension liabilities, decreasing investment income, infrastructure demands, and spiking debt service.

Comprehensive reform of the City's finances cannot wait. If the City hopes to provide adequate and necessary services to its citizens, maintain and replace critical infrastructure, meet its financial commitments to its bondholders and its employees, and provide the quality-of-life that make a city great, financial reform must remain Mayor Turner's and City Council's first and highest priority.

The areas considered by this Committee and suggestions to be considered by the Mayor are as follows:

<u>Budget Philosophy</u>

- Convert incrementally to a Performance Based Budget system, with a few departments converting each year. The Mayor and Council should establish budget metrics for each department.

<u>Other Revenue Sources</u>

- Increase the sales tax by $0.0025.

- Determine the value of City services provided to each TIRZ, and amend existing MSAs to charge the TIRZ for an appropriate share of the cost of services.

- Review contracts with Local Government Corporations for duplication of services with General Fund Departments and look for opportunities for the self-sustaining LGCs to provide funds back to the City.

- Impose garbage and recycling fees.

- Use drainage fee revenues for other purposes.

- Consider payments in lieu of taxes ("*Pilot*") by certain nonprofits.

- Review the performance of Tax Abatements and 380[1] agreements.

- Review fees to ensure they are at appropriate levels and that they cover costs.

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Cost-Savings Measures

- Take advantage of the current low interest rate environment to achieve debt-service savings on any outstanding debt where savings can be achieved, and particularly to restructure its FY 2017-2018 debt service to flatten the general obligation debt-service spike.
- Evaluate personnel expenses for both classified and civilian employees.[2]
- Review current private contracts for cost effectiveness, whether the contracted services are still needed, and to ensure that appropriate accountability measures are in place for the work performed.
- For federal or state grant-funded programs, ensure that local funds are not being used to supplant expiring grant funds, unless warranted, and that it is taking full advantage of grant opportunities.
- Review and update the Long-Range Financial Management Task Force Report dated February 7, 2012, and follow recommendations where appropriate.
- Consider support of legislative efforts to equalize property values between commercial and residential properties.

Pensions

- Determine supportable contribution levels for its pension liabilities.
- Continue to negotiate Plan changes in good faith to lower Plan costs and ensure future sufficiency at supportable contribution levels.
- Make additional contributions to fund the Plans.
- Consider structural and transparency changes to governance of the Plans.
- Provide independent expert validation of the revised Plans and contribution levels.
- Reach general consensus on pension-reform legislation for the 2017 Texas legislative session.

Revenue Caps

- Modify the existing City Revenue Caps to provide a uniform revenue cap that does not damage Houston’s financial well-being or competitive ability to provide amenities or services, and that takes the population of the entire metropolitan area into account in setting limits.

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- Seek voter approval of Proposition 1 exceptions that will allow additional ad valorem tax revenues sufficient to accelerate payment of unfunded pension liabilities which, together with changed City pension contribution requirements, will secure future Plan sufficiency at an acceptable rate of current budget contributions.

While this report reflects the majority view of the Committee, there are many portions of the report that do not reflect the views of individual Committee members, or, because of other issues, members of the Committee abstained from participation in discussion of matters related to portions of the report. In particular, Sherry Mose, as a trustee for the Houston Municipal Employees Pension System, abstained from much of the discussion of pensions and did not approve that portion of the report. All Committee members, regardless of whether they concurred, abstained, or disagreed with portions of this report, were fully involved in the gathering and sharing of the information upon which this report is based, and in the process voluntarily contributed countless hours to ensure the report's timeliness and comprehensiveness. The views and insights have hopefully resulted in a balanced view of the City's financial challenges.

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III. ISSUE ANALYSIS

A. BUDGET PHILOSOPHY

1. Convert incrementally to a Performance Based Budget system, with a few departments converting each year. The Mayor and Council should establish budget metrics for each department.

Over-arching issues

The private sector has developed various ratios and benchmarks by which management can compare and measure its financial performance primarily to ensure profitability for investors. In contrast, what are the data sets that can effectively measure the overall financial performance of the City especially since its primary mission is to provide an essential set of services to the citizenry rather than a return to investors. In analyzing a governmental organization as colossal as Houston, it would be easy to get buried under the vast amount of facts and figures. Benchmarking against cities of a similar size is useful in gauging the financial health of the City. Moody's has computed key financial figures and ratios for the ten largest U. S. cities. The following data was extrapolated from Moody's findings: [3]

Statistic / Ratio	Median of Top Ten Most Populous U.S. Cities	Houston, TX (#4)
Operating Surplus (Deficit) ($000)	**8,368.5**	**116,914**
Overall Net Debt Outstanding ($000)	**7,403,495**	**9,901,274**
Net Cash % of Operating Revenues	**57.9**	**34.4**
Debt Service as % of Operating Revenues	**12.8**	**15**
Unfunded Long-term debt ($000)	**2,771,305**	**3,153,595**

Moody's figures suggest that Houston's overall financial health is slightly worse than the financial health of its peers. The City carries more debt. The higher debt-service ratio highlights the pressure that annual debt service puts on the City's finances. The rather dismal 34.4% net cash as a percentage of operating revenues means that the City is relying on non-core revenue streams to pay for core services.

Justified or not, many members of the public perceive that the City does not operate effectively or efficiently. Successful enterprises design and operate their business based on a strategic set of goals and objectives–both short-term and long-term. Departments within the enterprises align their budgets to these plans. The Mayor and City Council could set these goals and objectives so that in planning City departments can align their budgets to them. The objectives should be measurable. With clear, measurable goals and objectives, the public could

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have a clearer view of what each department is trying to achieve and how it fits into the programs of the City as a whole. This will also provide a level of transparency into City departments that the public has not otherwise had.

The current budget process does not give elected officials or the public a clear view of how effectively or efficiently each department operates or what outcomes the City is striving to achieve. As recommended by the City Finance Department, department heads could be asked for the rationale for the services they provide and identify, with counsel from the Mayor and City Council, what the core services of the City are. Currently, the reports provided by the majority of City departments state that every service they provide is a core service. The Mayor and City Council could identify the City's strategic goals and objectives and the core services necessary to support those goals and objectives.

Performance Based Budget vs. Incremental Based Budget

The City currently uses an incremental based budget system (IBB), which means that from year to year, the budget is based on slight changes from the preceding period's budgeted or actual results. This is a common approach in businesses where management does not intend to spend a great deal of time formulating budgets, or where it does not perceive any great need to conduct a thorough re-evaluation of the business. This traditional approach to budgeting focuses on incremental changes in detailed categories of expenditures.[4] As one observer noted, *"One of the biggest problems in incremental budgets is the tendency to merely add without looking at whether the additional expense is warranted. When reductions are required, they tend to be made across the board, resulting in losing productivity as well as waste."* [5]

Performance based budgeting (PBB) focuses on results or outcomes rather than just money spent. The basic principle of PBB is accountability, not merely on compliance with law or adherence to previous funding decisions. Performance based budgeting encourages staff and elected officials to reconsider priorities and gives agencies the flexibility to make decisions that are not easily permissible under traditional budgeting systems.[6] By combining the various outcome-expenditure packages, a budget is derived that should result in a specific set of outcomes for the entire business. However, it also takes a considerable amount of time to develop, in comparison to the IBB. PBB is also referred to as zero-based budgeting.

The Mayor has indicated that he wants the City to move from an IBB to a PBB. There are many advantages to PBB:

- Assisting the Mayor and Council with helpful background on the purposes of programs and the results they achieve.
- Reducing governmental waste.
- Reprioritizing government functions.
- Helping explain previous funding decisions.
- Aiding with estimating and justifying the potential consequences of new funding decisions.

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- Deepening understanding of departmental activities.
- Communicating the return for the investment of tax dollars.
- Re-allocating resources within departments.
- Gaining understanding of program effectiveness instead of focusing on the preservation of existing programs and associated spending levels

There are a number of concerns or weaknesses about the process, including:

- Department personnel and Council may have different ideas regarding what is important about a department's work.
- PBB does not directly address whether the City should be providing a service.
- The size of the City budget, coupled with the number of performance indicators available, can be overwhelming when making crucial funding decisions. The Mayor and Council may become mired in detailed operational information rather than focusing on the larger strategic issues confronting the City.
- PBB is more effective when good performance measures are in place. Until there are measures in place, it is difficult to have confidence that performance information is accurate and valid.
- PBB is perceived to require too much paperwork and time for minimal results.
- PBB does not address alternative service delivery options.
- PBB does not directly address efficiency of services delivered.
- PBB does not provide incentives and disincentives to improve a department's performance.

The initial framework for PBB already exists in the City's Core Services Reports which were prepared by City departments for the past several years. These reports detail the core activities of each City department. The only missing piece is the most crucial and difficult to provide: expected outcome or result. Without a measurable outcome for which the department is responsible, there is no way to truly have PBB. To develop outcome measures for each Core Service will be a daunting task for the departments. Many outcomes already exist within the departments but are not listed in these reports. Other outcomes will need to be developed. The Mayor and Council will have to agree on the desired outcomes they want each department to achieve for the coming fiscal year. This will need to be completed before budgets are presented to the Mayor and Council for approval.

It should be noted that the City has not previously determined whether all the services presented in the Core Service Reports are indeed core services.

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There are numerous articles addressing the pros and cons of PBB vs. IBB. The general conclusion of the research performed to date is that text-book implementation of across-the-system PBB is unwieldy, takes several years, and often does not achieve the desired results of greater transparency and efficiency. PBB has been successful when used to analyze specific service-lines, to reframe budget conversations between staff and elected officials, and to understand exactly what is being given up because of budget cuts.[7]

If the City adopts PBB, the City probably should move towards PBB incrementally. In order to be successful, the Mayor and City Council should agree on a strategic plan for the City, then select for implementation several departments that are critical to achieve the goals of the plan. Department heads and their line staff will then be able to determine the core services and outcomes that support the plan, and can then develop their budgets and provide justification for each service.

B. OTHER REVENUE SOURCES

1. Increase the sales tax by $0.0025.

Currently, the City is at the state legal maximum sales tax rate, but receipts of sales tax revenues can be erratic. Additionally, sales tax revenues are the principal source of City revenue that relieves the burden of City costs on citizens of the City and transfers at least some of the burden to non-residents who benefit from City services. An increase of $0.0025 in sales tax would generate approximately $160 million in revenue. The City could consider asking for legislative approval of a sales tax increase. By increasing the sales tax, the burden of taxation is borne by anyone who makes a purchase in the City, whether the taxpayer is a resident or not. If approved by the legislature, it is likely that any sales tax increase would require voter approval.

2. Determine the value of City services provided to each TIRZ and amend existing MSAs to charge the TIRZ for an appropriate share of the cost of services.

TIRZ generate taxes from property within their zones. The increase in property tax revenue (via increased property valuation) is excluded from the Revenue Caps. TIRZ make ample use of City services, including public safety, streets, roads, sewers, and other services ("*Services*"). There are approximately twelve Municipal Service Agreements ("*MSA*") currently in place and some already contribute to the City budget. Some additional portion could be rebated to the General Fund. The City could develop metrics to determine the value of Services provided to each TIRZ and amend existing MSAs or develop new MSAs to charge TIRZ for an appropriate share of the costs of Services.

3. Review contracts with Local Government Corporations for duplication of services with General Fund Departments and look for opportunities for the self-sustaining LGCs to provide funds back to the City.

The City could review amounts that LGCs draw from the General Fund and determine whether each LGC can be self-sustaining or contributors to the General Fund. The City could also review whether General Fund services are duplicated by other providers.

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4. Impose garbage and recycling fees.

Houston is the only major City in Texas without a garbage or recycling fee. The average garbage/recycling fee for the next-five largest Texas cities by population is $22 per month which, based on active Houston single-family water connections, would generate revenues in excess of $100 million annually.[8] Recently, when a new fee has been imposed, referendum petitions have been presented requiring an election to approve the fee's imposition. If the City ultimately decides to impose a garbage or recycling fee, it should anticipate that a referendum petition may be presented.

5. Use drainage fee revenues for other purposes.

Currently drainage fee revenues are dedicated to infrastructure improvement. The City could consider whether those revenues can and should be used for other purposes.

6. Consider payments in lieu of taxes ("Pilot") by certain nonprofits.

In response to similar situations across the country, hundreds of cities in 28 states have negotiated agreements with nonprofits that own tax-exempt property within their borders for a "payment in lieu of taxes," also known as a PILOT. By entering into a PILOT agreement, the nonprofit organization – typically, but not exclusively, a hospital or university – recognizes that it benefits from municipal services such as fire and police protection and public works. PILOTs help insure that nonprofit beneficiaries of City services pay something towards the cost of providing those services to the nonprofit. Houston could also establish important new sources of revenue by extending fees to exempt properties. Similarly, Public Law 94-565 was adopted in 1976 and updated with 97-258 in 1982 to provide subsidy-type payments to cities and towns that house federal organizations within their boundaries.[9]

7. Review the performance of Tax Abatements and 380 agreements.

Tax abatements and 380 agreements as economic-development incentives are necessary tools to enable Houston to spur economic development. Their use in the City has grown over the years. The policies used to decide when and how to use economic development incentives could be reviewed to ensure that they achieve the desired goals of the Mayor and City Council. Once incentives are awarded, the performance against the contract should be monitored and the businesses held accountable for meeting the terms of the agreements.

8. Review fees to ensure they are at appropriate levels and that they cover costs.

In FY 2015, the City deposited $147.8 Million in "Other Fees" To the General Fund.[10] Fees in this category were mainly comprised of ambulance fees, police-related service fees, and fire protection fees, which brought in $44 million, $36 million, and $18 million, respectively. All "other fees" could be thoroughly reviewed and increased if feasible and appropriate.

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C. COST-SAVING MEASURES

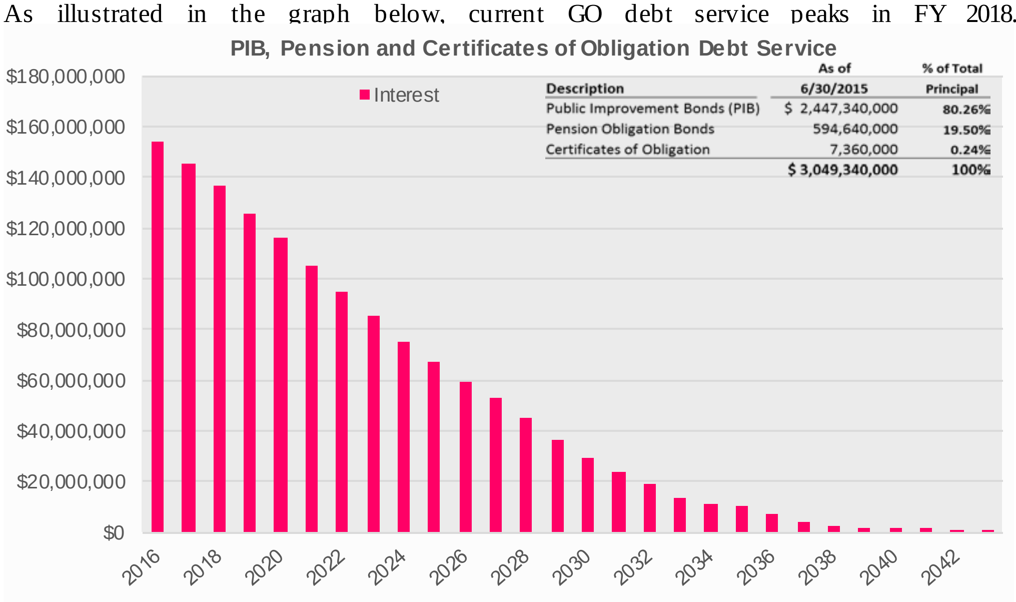
1. Take advantage of the current low interest rate environment to achieve debt-service savings on any outstanding debt where savings can be achieved, and particularly to restructure its FY 2017-2018 debt service to flatten the general obligation debt-service spike.

As of January 31, 2016, the City had $12.3 billion total debt outstanding, but only $3.235 billion of the outstanding debt was general obligation debt ("*GO Debt*") secured by taxes levied on the assessed value of property. The remaining $9.1 billion of City debt is paid from revenues earned from the City's Combined Utility System ("*CUS*"), Airport System, and Convention and Entertainment.[11]

This report focuses on the City's $3.235 billion of GO Debt. For the most part, CUS, Airport, and Convention and Entertainment revenues may not be used to subsidize General Fund expenses. However, the committee encourages the City to continue to evaluate refinancing opportunities for all of its debt obligations.

Background

As illustrated in the graph below, current GO debt service peaks in FY 2018.



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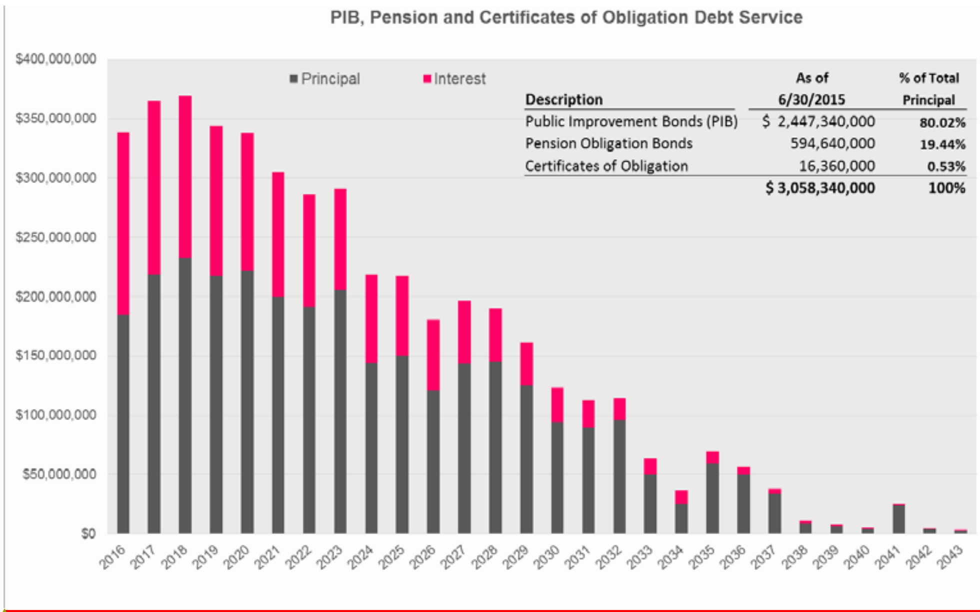
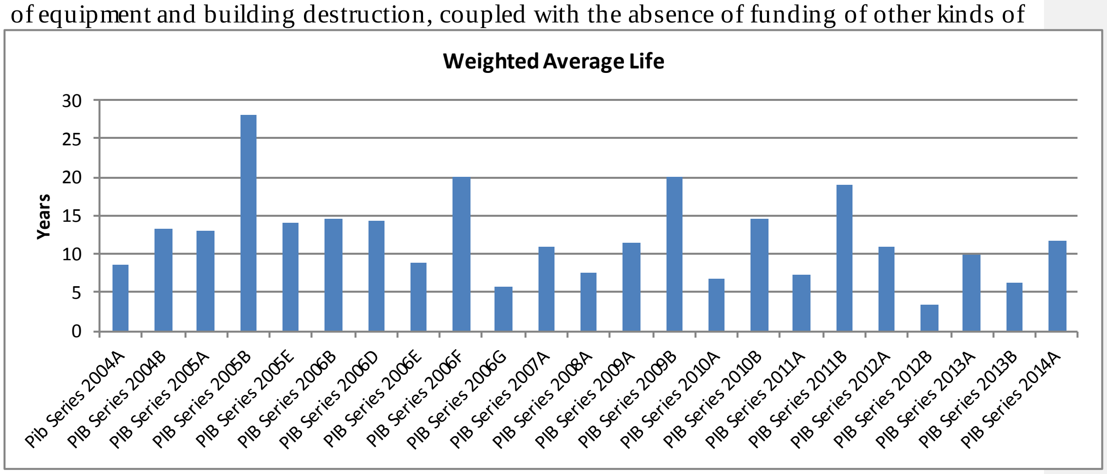


Over the course of many years, several factors discussed below have contributed to the debt profile peaks.

<u>Increased Equipment Funding</u> – The City's recent debt financings funded more equipment purchases and the City's dangerous buildings program, as opposed to long-term assets. Those funded purposes have a shorter amortization under Federal income tax law, which generally requires that the weighted average maturity of tax-exempt bonds not exceed 120% of the weighted average economic life of the asset being financed.[12] Over time, the shorter asset lives of equipment and building destruction, coupled with the absence of funding of other kinds of



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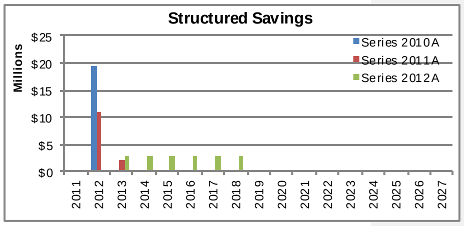
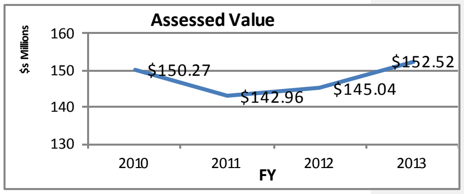
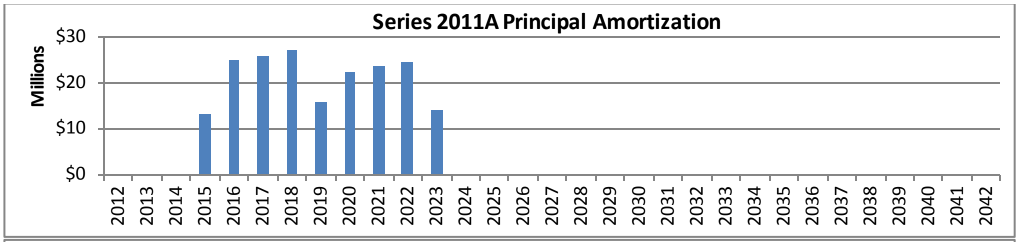
longer-lived assets, has reduced the weighted average life of the City's debt portfolio and concentrated principal amortization in FY 2015 – 2023.

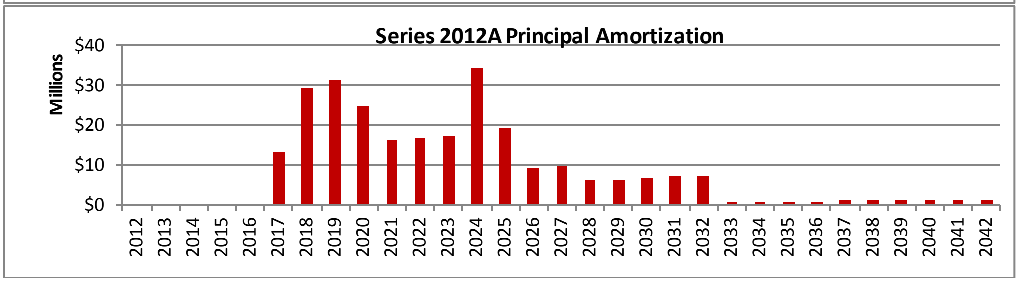
Decrease in Assessed Value - As a result of the 2008-2009 economic recession, the City experienced a 5% decrease in taxable assessed values in FY 2010 to FY 2011. The reduction in assessed value and resulting reduction in property tax revenues caused the City to undertake GO Debt refundings in calendar years 2010, 2011, and 2012 to create cash-flow savings and budget reductions for FY 2012. While the refundings generated positive present value ("PV") savings overall, the economic stress required targeting cash-flow savings in the near term (FY 2012). Consequently, more principal was amortized in later years and the GO Debt spike was not smoothed.



Constrained New Money Amortization – In order to allow the tax base to recover, beginning amortization of the City's Series 2011 and 2012A new money bonds was delayed until 2015 and 2017, respectively. The delayed commencement of principal, combined with the shorter economic life of the financed assets, further compressed amortization between 2015 and 2023.







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Recommendations.

Take Advantage of Additional Refinancing Opportunities

Tax-exempt interest rates remain near historic lows, providing the City with opportunities to refinance portions of its debt at lower interest rates. Since FY 2014, the City has refunded over $3.4 billion of debt obligations to produce net present value savings of over $380 million. We encourage the City to continue to aggressively pursue any refunding or refinancing opportunities for all of its debt obligations.

Take Advantage of Specific GO Debt Refinancing Opportunities – General Obligation

The City could evaluate refunding opportunities related to its GO Debt, with particular focus on the ability to create cash flow and budget savings in the constrained years (FY 2017 and 2018). It should be noted that the City is limited as to which bonds may be refinanced or refunded.

	As of 6/30/2015	May be Refunded for Savings	% of Total
Tax-Exempt Debt Eligible for a Current Refunding	$34,465,000	Yes	1.13%
Tax-Exempt Debt Eligible for an Advance Refunding (Callable) [1]	1,180,985,000	Yes	38.66%
Tax-Exempt Debt Eligible for TAXABLE Advance Refunding [2]	825,890,000	Yes/More costly	27.04%
Taxable Pension Obligations (Make Whole Call) [3]	594,640,000	No	19.47%
Taxable Build America Bonds (BABs) - 10-Year Par Call	268,225,000	Yes	8.78%
Other Taxable Debt Subject to Make Whole Call [3, 4]	97,075,000	No	3.18%
Other Taxable Debt - Non-Callable [5]	53,060,000	No	1.75%
	$3,058,340,000		**100.00%**

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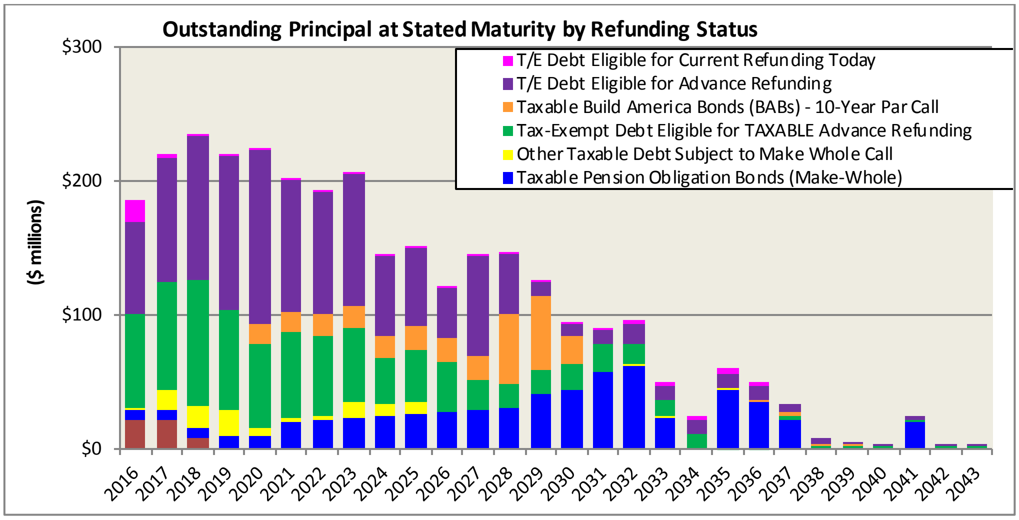
The graph below illustrates in dark purple the amount of principal in each year that may be advance refunded prior to the call date. These are the refunding candidates the City could evaluate for refunding opportunities.



Creating meaningful savings in light of its projected budget shortfalls in FY 2017 and 2018 requires more than just refinancing to take advantage of lower interest rates. In order to create real cash flow savings, the City would need to refund and delay principal repayment. For example, executing a refunding for savings only, i.e., no principal restructuring except where savings result, produces only $3.8 million and $4 million of cash flow savings in FY 2017 and 2018, respectively.

Adopt a Holistic View of Current and Projected Debt.

The portion of the adopted 2016-2020 Non-Enterprise Fund Capital Improvement Program ("*CIP*") funded from debt proceeds totals $550.8 million, with amounts allocated to Police and Fire, General Government, Library, Heath, Solid Waste Management, Bayou Greenways, Parks and Recreation, Homeless and Housing, Information Technology, and Fleet. It is unrealistic for the City to expect that it can fund CIP costs without future GO Debt, and if the City evaluates restructuring opportunities to provide budget relief, it should also consider the projected debt financing of its future CIP costs.

The graph below illustrates debt service related to projected future CIP debt service in blue. As the graph demonstrates, debt service declines after FY 2018 but then increases again in FY 2023.

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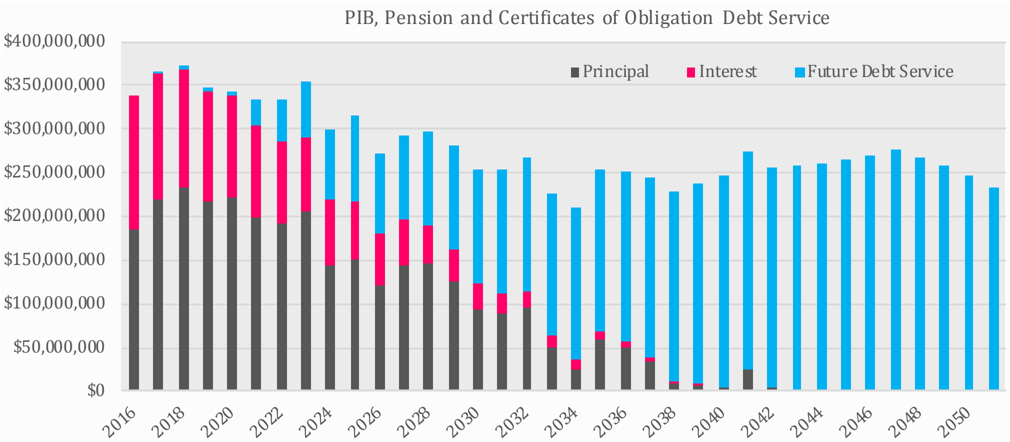

The City can structure debt service to minimize future spikes. In hindsight, the City's past practice of scooping out current debt service and delaying its payment may create future budgetary pressure when the financial strength and health of the City's economy is unknown. A fiscally responsible refunding that structures savings in critical years (FY 2017 - 2018) while minimizing any material increase in future debt service is recommended. No such refunding should limit or constrain the City's future financial flexibility, and principal with later call dates that may not be refunded as efficiently today should be delayed for future refundings, especially for any principal maturing in 2023, which is the City's next projected spike year.

Match Debt Amortization with Useful Life. Financial management best practices recommend amortizing debt based on the estimated useful life of the asset, and federal income tax law generally limits the weighted average maturity of bonds to no greater than 120 percent of the reasonably expected useful life of an asset. The City's recently adopted Financial Policies provide that "any capital project financed through the issuance of bonds shall be financed for a period not to exceed the average expected life of the assets." Especially with respect to equipment financing, the City could relieve budget pressures in a manner consistent with best practices by maximizing the years over which the debt is amortized to minimize future spikes in debt service.

2. Evaluate personnel expenses for both classified and civilian employees.

When discussing expense reductions that relate to personnel cost, the City may take into account multiple factors, including the potential negative effects on morale and the City's ability to hire and retain competent staff. Personnel costs represent approximately 63% of General Fund expenditures. The remaining 37% of General Fund expenditures is comprised of other services and charges (19%), debt service (15%), and energy/fuel expense 3%.

Personnel costs divide into two categories: Classified personnel—police and fire personnel—which represent 47% of General Fund expenditures, and Civilian personnel—all other employees—which represent 16% of General Fund expenditures. There are already in

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place at the City various ordinances, rules, policies, and procedures for changes affecting the City's workforce, and many positions may otherwise be governed by various types of employment agreements or contracts. Thorough analysis would need to be done to understand the effect of each of the following options, but possible reductions could include:

- Careful evaluation of overtime in expenses in classified and civilian positions. In the FY '16 budget, total overtime expense is $38.2M; the classified personnel expense was $33.7M and civilian personnel is $4.5M.
- Providing incentives for eligible employees to retire.
- Eliminating or freezing hiring for all vacant positions.[13]
- Eliminating or freezing consultant contracts.
- Reviewing all enterprise funds for similarity or duplication of services with General Fund positions and eliminating duplicate positions.
- Developing incentive plans for employees to identify waste.
- Eliminating non-core functions.

The City could conduct an organizational structure evaluation to determine if and where there are duplicate functions between departments that, if consolidated, would achieve cost savings. While efficiency in core programs should be a goal of the City, imposing furloughs or layoffs merely to meet budget demands should be considered only as in extraordinary financial circumstances.

3. Review current private contracts for cost effectiveness, whether the contracted services are still needed, and to ensure that appropriate accountability measures are in place for the work performed.

Privatized contract services may from time to time be economical for the City, but they may also carry significant hidden costs to be carefully evaluated. The transparency of providing services, auditing and oversight costs, the lack of continuity when contracts are changed, and the difficulty of controlling privatized expenses are all hidden costs that may not be apparent in initial bid prices.

4. For federal or state grant programs, ensure that local funds are not being used to supplant expiring grant funds, unless warranted, and that the City is taking full advantage of both private and public grant opportunities.

The City could review grant programs to determine if local funds are replacing expiring grant funds, and if so whether the grant programs could be discontinued. This review should also examine whether or not the City is taking full advantage of both private and public grant opportunities.

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5. Review and update the Long-Range Financial Management Task Force Report dated February 7, 2012, and follow recommendations where appropriate.

The City invested substantial effort into a Long-Range Financial Management Task Force Report that includes a comprehensive list of various cost reduction recommendations as well as opportunities to partner with other government entities such as Harris County to provide services jointly. The primary opportunities for City/County partnerships are with the libraries and the health department.[14] The City could review and, to the extent necessary, update the Report and implement appropriate recommendations.

6. Consider support of legislative efforts to equalize property values between commercial and residential properties.

It was suggested to the Committee that there is inequity in the manner by which the Harris County Appraisal District (HCAD) values commercial property versus residential property, which, together with successful court challenges by commercial owners, has resulted in residential property owners bearing a greater burden from ad valorem taxes. The State Legislature is responsible for the laws governing appraisal districts. The City could evaluate the effects of any such inequality on its revenues and consider supporting legislative changes to provide better equity for residential property owners.

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D. PENSIONS

1. Determine supportable contribution levels for its pension liabilities.

The City of Houston contributes to three separate pension programs for its employees (the "*Plans*"): Houston Firefighters' Relief and Retirement Fund ("*HFRRF*"), Houston Municipal Employees Pension System ("*HMEPS*"), and Houston Police Officer's Pension System ("*HPOPS*").[15] Together with employee contributions and investment earnings, in order to fund the Plans, City contributions must be sufficient to fund its current pension contributions, make up for past unfunded obligations, and make up for investment earnings which did not meet Plan investment-earning targets. However, not only must the City budgets be sufficient for pension payments, they should also be at a level from year to year that allows the City to fund core services, maintain and replace its infrastructure, and preserve sufficient reserves.

In 2000, as a basis for Plan changes, the City contribution to HFRRF was estimated to increase from the statutory minimum, 13.7% of firefighters' payroll, to 15.2%. In 2001, when the Texas legislature changed HFRRF benefits, the actuarially determined contribution required to fund projected benefits increased significantly beyond the projected 15.2%. By 2002, the City's contribution to HFRRF was 22.3% of firefighters' payroll, and it was recognized that the accrued unfunded liability was a substantial $163 million.[16] By June 30, 2015, the City's net HFRRF unfunded pension liability had increased to $577,690,000,[17] and the contribution as a percentage of member payroll for the fiscal year had increased to 33.2%.[18] Because the City pension contributions to HFRRF are mandated by state statute and may not be reduced by agreement,[19] the HFRRF pension is well-funded, at 86.6% as of July 1, 2013.[20] It appears that the problem with the HFRRF contribution is not that the Plan is underfunded, but that the contribution rate required to maintain funding, when taken with other City budget demands, is higher than optimum.

As a percentage of salary, HMEPS (at 26.1%) and HPOPS (at 34.5%)[21] contribution rates are less than the 31.1% contribution rate for HFRRF. However, because of the City's historic underfunding of its portion of the contributions, as of June 30, 2015, HMEPS was estimated to be funded at 51.6%, with a net pension liability of $2.308 billion, and HPOPS was estimated to be funded at 61.6%,[22] with a net pension liability of $2.688 billion.[23] Fire, police, and civilian employees have continually supported their share of the pension contributions, so the sources of underfunding are the extent to which investments have not achieved targeted returns and, most importantly, the City's contribution shortfalls.[24] Moreover, HMEPS[25] and HPOPS have more than once renegotiated pension benefits by agreement to lower the City's pension payment obligation by reducing benefits.[26]

The City's fire, police, and civilian employees are the City's most valuable and constant contributors to our quality of life, our health, and our safety, and they deserve to be compensated with salaries and benefits, including pension benefits, at not less than market levels for their services. The pension benefits should provide a secure and dignified retirement for City employees. However, City pension contributions increased over a 15-year period from less than 15% of salary to 23.2% and 28.7% of payroll for HMEPS and HPOPS for FY 2015, and together with the increased demands for services from increased population in the SMSA,[27] capped revenues,[28] and spiking debt service, have strained municipal finances. To address those strains,

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the burden of pension reform should not be placed solely on changes to the Plans: the City could also begin to accelerate repayments of the amounts effectively borrowed from the Plans by its historic underfunding of its pension obligations.

For planning, negotiation with the Plans, the job and financial security of current and future employees and the stability of Houston's finances and services, the City could establish a supportable target rate of pension contributions and increase its funding and negotiate Plan changes towards that target rate. This report does not suggest a target rate but only suggests that the City establish what, over time, will be a supportable rate of contributions. Establishing a supportable future contribution rate would help the City fairly and consistently negotiate with the Plans and employee unions to compensate employees with market salaries and benefits, and at the same time develop public support and trust.

2. Continue to negotiate Plan changes in good faith to lower plan costs and to ensure future Plan sufficiency at supportable contribution levels.

There are a remarkable number of parties affected by the condition of the three Plans: the Mayor, the Controller, City Council, the three pension boards, the three employee unions, retirees, current and future employees, and Houston's legislative delegation. Not least among the affected parties are Houston's home- and business-owners, whose property values could be significantly damaged by a City financial crisis if the City fails to reach an appropriate resolution, and the residents and non-residents who depend on City services. Nothing would hurt Houston more, or go further to create a City divided by economic condition, than the loss of basic services because of unresolvable financial obligations.

Additional City contributions could stabilize the Plans, and the Mayor could consider an authorizing election for increased tax revenues as an exception to the Revenue Caps under the City Charter.[29] The next date a Revenue Cap exception election could be held is November 8, 2016.[30] If contemplating a Revenue Cap exception election in November 2016, timely completing negotiations could prepare public support to call an election in August 2016. With Plan changes, there is likely to be business and community support for increased funding levels, but any change in the Revenue Caps, whether in 2016 or 2017, will probably need demonstrable City efforts towards financial reform, including budgeting and Plan changes. If the Revenue Cap exception was approved before the legislative session, it could affirm to the legislature the public support for the City's and the Plan's negotiations.

It is not appropriate for this Committee to recommend specific changes to the Plans: those are matters to be negotiated by the Mayor and Plans during their continued negotiations, not considered in a vacuum.[31] Several items could be considered by the Mayor and the Plans in Plan negotiations. They could consider conversion of all or parts of a Plan to defined contribution Plans, the elimination or adjustment of Cost of Living Adjustments ("COLA"), the freezing, elimination, or alteration, where applicable, of the Deferred Retirement Option Plan ("DROP"), changes to retirement ages or eligibility, changes in the bases for establishing benefits, and changes in survivor benefits. There are also Plan changes—restoring contributory plans for new employees in HMEPS or changing retirement eligibility dates in HPOPS, for instance—which could benefit employees and could also be considered. The largest savings

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might be achieved by changes to the HFRRF. The City has already obtained at least one fairly detailed recent study of options and the probable effects of a laundry list of possible changes.[32]

In negotiating Plan changes, it might be helpful to the Mayor to know that there is resentment caused by plan disparity, particularly between the HFRRF on the one hand and HPOPS and HMEPS on the other, that there could be issues that arise not only from the negotiation of particular changes to individual Plans but also from what is perceived as the current funding and benefit disparity among Plans.

3. Make additional contributions to fund the Plans.

The City has significantly underfunded its pension obligations, particularly to HMEPS. Additionally, Plan investment underperformance could increase the City's Plan liability. To protect the City's financial health and the security of benefits, the City could accelerate payments to make up its underfunding. There are three choices for funding its unfunded liability: the City can increase revenues to pay the costs, it can decrease its operating and maintenance costs and divert the savings to fund pension costs, or it can issue pension bonds. While decreasing operating and maintenance costs might be everyone's preferred course, that course may be exhausted to meet the currently projected $145 to $160 million budget deficit for FY 2017. Clearly, significant steps towards greater operating and administrative efficiency are advisable for many reasons, but it is unlikely that operating and administrative efficiencies in and of themselves will be sufficient to reduce the estimated $5.6 billion unfunded pension liability, even over time, and decreasing needed facility maintenance to fund pension liabilities seems an uneconomical choice

The Committee does not suggest pension bonds. While there is nothing theoretically wrong with pension obligation bonds—particularly if earnings exceed interest costs—the bonds must be repaid, and with current budget problems, issuance of pension obligation bonds only increases the debt service contributing to Revenue Cap pressures.[33] Moreover, replacing unfunded liabilities owed to the Plans with fixed liabilities held by investors would allow the City less flexibility with adjusting future budgets to adapt to economic downturns or unexpected operating needs.

The City could consider a specific exception to the Revenue Caps which authorizes additional tax revenues clearly tied to accelerating repayment of its unfunded liability, and contingent on the approval by the legislature of pension changes agreed upon with the Plans.

4. Consider structural and transparency changes to the governance of the Plans.

Governance of the current Plans is established by statutes.[34] There are significant tensions built into the governance structures and they are often the target of critics.[35] The City, for instance, is ultimately responsible for funding much of the Plan costs but has limited representation on the Plan boards and is unable to challenge Plan determinations concerning contributions. For HFRRF, the City has no authority to reach meet and confer agreements with the Plan board that could change the Plan. Pension benefits are determined not by negotiation between the employee unions and the City as part of an overall compensation package but by the

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Plan boards or the Legislature, divorcing the intertwined questions of current compensation levels and future pension benefits.

There are important roles for each of the State of Texas, the City, the Plan boards, and the employee unions to play in pension governance. Additional Plan funding requires support of citizens and the business community. To receive public approval of additional Plan funding, pension governance could be better cast to reflect the strengths of each and serve the needs of the Plans and the City.

Investments. No component of pension governance has received more recent criticism than Plan investment returns.[36] Historic investment returns for the Plans appear to have been excellent,[37] but the current investment environment is very difficult. If investment returns are less than the returns assumed in calculating the City's pension liabilities—whether due to disappointing performance or because investment return assumptions are too high—then the City's unfunded liability to the Plans will increase. While the City appoints members to the Plan boards, allowing the City investment staff to periodically review and comment on Plan investments could provide transparency and increase public confidence without fundamentally altering investment governance.

State Control. The current legislation establishing plan terms for HFRRF undermines public support of HFRRF. HFRRF could have the ability to confer with the City for Plan changes. The State, however, through its Pension Review Board, could enforce City contribution levels in accordance with an actuarially-sound funding plan, review City challenges to Plan adjustments, and recommend meet and confer changes to the Plans when appropriate.

5. Provide independent expert validation of the revised Plans and contribution levels.

No one benefits from bad or limited information about the Plans. Retirees and employees need to know that the assumptions, funding levels, and investments protect their future security. The Plans depend on information when selecting investment advisors and establishing contribution levels. The City should be able to test Plan information to maintain public confidence in Plan administration.

More importantly, during the period of negotiation of any Plan revisions, independent validation could provide to City Council and the public sufficiently certain information to quantify the value of potential Plan changes, whether permanent or temporary. Each potential change to a Plan results in some financial outcome, and to avoid prior errors in valuation of those outcomes, the City could engage its own pension experts, including particularly actuarial experts, to advise it as to the effects of pension negotiation and to confirm the outcome of negotiations.[38]

Additionally, both the Plans and the City could look to independent, trustworthy sources of information for plan ideas, and for information from other jurisdictions.[39]

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6. Reach general consensus on pension-reform legislation for the 2017 Texas legislative session.

It is never easy to get legislation passed in Texas. For Plan reform to succeed, it will require legislative action. For good reasons, our fire, municipal, and police employees have built a great deal of good will among members of the legislature. If agreement can be reached on pension changes, the City and the Plans have the best chance of legislation passage if they could complete preparation of a legislative package by December 2016 and obtain a broad consensus of support from the Houston legislative delegation before the session begins.

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E. REVENUE CAPS

1. Modify the existing City Revenue Caps to provide a uniform revenue cap that does not damage Houston's financial well-being or competitive ability to provide amenities or services, and that takes the population of the entire metropolitan area into account in setting limits.

On March 16, 2016, Moody's Investors Service downgraded the City's Aa2 general obligation debt rating to Aa3, and retained the City's negative outlook signaling additional downgrades. The rationale for the release stated that it reflected the City's "weakening economic and financial performance driven by prolonged decreases in oil prices," and also reflected the City's "high fixed costs, large unfunded pension liabilities (among the highest in the nation), as well as property tax caps."[40] In particular, Moody's noted four items that could lead to an upgrade of the City's rating, including removal of the revenue cap to allow the City "flexibility to capture growth in assessed values."[41] Moody's also noted three items that would make the City's rating go down, the first being the City's "[f]ailure to address projected deficits through revenue flexibility, reduced spending or a combination thereof, leading to a reduction in reserves."[42]

Moody's clearly identifies the strain that the Revenue Caps place on City finances by limiting revenue flexibility, and the report highlights the cost of the Revenue Caps to the City and its taxpayers. The City has held four elections, three Charter amendments and one exception election, limiting its revenue increases from year to year, and the Revenue Caps so adopted have not served the City well. Because of the Revenue Caps, the City is paying increased interest costs for its infrastructure debt. The Revenue Caps cost us money.

The imposition of the Revenue Caps has not only contributed to the factors that put the City's credit rating at continued risk, they have also spawned costly and on-going litigation, are confusing as to their application, put the City at a competitive disadvantage with its neighbors, and fail to recognize the real service area of the City. Many members of the Committee felt that the Revenue Caps should be eliminated entirely, and that City accountability should be tied to identification and focus on core services as demonstrated in the budget process.

Description of the Revenue Caps

The original Revenue Caps were voted in 2004 and are commonly referred to as Proposition 1 and Proposition 2. Proposition 1 was placed on the ballot by the then-Mayor and City Council, and absent voter approval, it restricted new ad valorem tax revenues to an amount not exceeding the lesser of (i) the City's actual tax revenues in the preceding fiscal year plus 4.5%, or (ii) the cumulative combined rates of inflation and the City's population growth using base-year taxes collected during the fiscal year ending June 30, 2005.[43] In any year for which voters approve an increase in total ad valorem tax revenues above the limit, the ad valorem tax revenues for future fiscal years are to be measured against the first base year in which the increase is authorized.[44]

Unless an increase is approved by voters, Proposition 1 also limits water and sewer service revenues to an amount not greater than the combined rates of inflation and population growth in the City, excluding rate increases required by contract or by bond covenants.[45]

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Proposition 2 has a broader effect than that of Proposition 1 and provides that absent approval of 60% of voters in a regular election, the City's Combined Revenues[46] for any fiscal year may not increase over the Combined Revenues for the preceding fiscal year by more than the combined rate of inflation and population growth for the past 12 months.[47] The City included language in Proposition 1 that provided that whichever proposition passed with the greater number of votes would be effective. Proposition 1 had the higher vote total, and the City has consistently argued that Proposition 2 had no effect.[48] The effectiveness of Proposition 2 has been and is currently being litigated.

Whatever the final outcome of Proposition 2 litigation, the City subsequently passed another revenue limitation which effectively removed the enterprise funds—notably the combined utility system and the airport system—from operation of Propositions 1 and 2, except that the water and sewer rates collected for the combined utility system are subject to the inflation and population growth limits of Proposition 1.[49]

Why the Revenue Caps Matter

For fiscal year 2016, the General Fund comprises approximately 51% of the funds expended under the City's budget.[50] From the General Fund, the City pays for its police, fire fighters, emergency services, municipal courts, parks, neighborhood protection, planning, building and safety inspections, street and drainage improvements and repairs, General Fund debt service, libraries, solid waste disposal, and administrative costs. The current property tax rate of $.601120 per $100 assessed value provides 49% of the General Fund revenues, with another 30% paid from sales tax revenues.[51]

For a host of reasons discussed below, the Revenue Caps were not well-conceived when adopted. Even if revenues were relatively stable from year-to-year, the Revenue Caps are inflexible, leave the City in an artificially weak market position vis-à-vis neighboring cities and Harris County, cause reliance on artificial exceptions to the Revenue Caps, and adopt revenue limitations that ignore the real service area of the City.

What's Wrong with the Revenue Caps?

<u>The Revenue Caps are based on the population of the City, not the population served by the City.</u> In 2014, Harris County estimated its current population as 4.4 million residents, estimating growth since 1990 of 56.20%, with 75% of the growth in unincorporated areas of the County.[52] As of the 2010 census, the population of Houston was estimated to be 2,099,451. The Revenue Caps assume that the population using City services and supporting City costs are the same, but it seems likely that a large part of the more than 2.3 million additional residents in surrounding Harris County (and other counties) work in Houston, shop in Houston, eat in Houston restaurants, drive on Houston streets, and otherwise increase the need for Houston services.[53]

<u>The Revenue Caps assume that base line expenditures were sufficient.</u> The Revenues Caps assume that in 2004, City expenditures for services, maintenance, improvements, and other costs were adequate, but given the current state of City infrastructure and pension deficits, expenditures were not adequate in 2004 and have not been adequate since.[54] The City must provide budget methods and demonstrate to the public that it is making administrative changes to

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identify and provide core services efficiently, but it must also pay for the cost of core services and infrastructure.

The Revenue Caps place the City at a competitive disadvantage by ignoring new value. There are three ways that ad valorem tax revenues can increase.

First, the City Council can vote to raise the tax rate. In the City, the tax rate has remained flat or declined from a high in the years 1995-2004 of $.665 per $100 assessed valuation to the current tax rate, $0.601120 per $100 assessed valuation. Ignoring exemptions, if valuations had otherwise remained stable from 2004 to 2016, the decrease from an ad valorem tax of $.665 per $100 valuation to $0.601120 per $100 valuation would have saved the owner of a house with an assessed value of $210,000[55] a total of $134.148 in taxes annually.

Second, revenues can increase by appreciation of the taxable values of current property. As noted, the savings for the $210,000 property owner with stable values were very small, but the real cost to taxpayers is the product of the tax rate and the appreciated value of their property, which, if the tax rate remains the same, is a tax increase because of the valuation increase. In 2004, the taxable value of property in the City of Houston was estimated to be $105,881,225,000, producing current tax revenues of $645,536,000. By 2015, the total appraised value used to set the 2015 tax rate was $187,823,028,000, for a roughly 82% increase, resulting in tax revenues of $1,074,070,000.[56] But the increase includes both appreciated values and new values.

For an owner of a $210,000 median priced home, the increase in value for the period from 2004 to 2015 was probably considerably less than 82%, and HAR estimated the median sales price for a single family home in Harris County in July 2014 to be $136,500.[57] That owner's tax costs would have increased from $907 for 2004 (assuming a value of $136,500) to $1,262 for 2015 (assuming a value of $210,000). It can be argued that the cost of the tax increase would have been reasonable given the appreciation of market value for the period, but the gain in market value is unrealized until the owner sells the home, and the increased ad valorem tax is particularly stressful to those on fixed income or in low-income households. Without giving effect to any exemptions of value, while house values increased 53% from 2004 to 2010, ad valorem taxes derived from those values increased by 39%.

The third way tax revenues increase is through assessment of taxes against new construction, increased inventory and equipment, and improvements. Because Houston's Revenue Caps—which aren't applicable to other jurisdictions—only allow increases for population and inflation, the Revenue Caps limit the City's ability to collect tax revenues produced by new taxable value, and under the Revenue Caps additions of new property values may result in reductions of City revenues. In 2015, the City decreased its tax revenues by approximately $19,930,000 because of the Revenue Caps and projects decreases in 2016 of $99,864,000. For its 2015 tax rates, the City estimated that the increase resulting from new property values was $5,140,645,071. Harris County was not required to include its new value in calculating the limits on its tax increases, nor was Sugar Land, The Woodlands Township, or Friendswood.[58] Those entities are in direct competition with the City for residents and businesses, and they can improve both services and amenities because of the revenues from that growth. For 2015, based on the addition of $5 billion in new value, the City could not exclude the $32,441,583 in associated new property tax revenues from operation of the Revenue Caps.

There is also no reason to think that those values are accompanied by proportionate population growth. A new office building or a new restaurant isn't necessarily populated by City residents, but the City provides services for increased workers or diners whether they live in Friendswood or West University or Houston, and those services are not provided for where Revenue Caps are based on population increases within the Houston city limits.

The Revenue Caps do not take into account extraordinary costs outside of disasters. Houston has infrastructure that is not maintained, Houston has rising pension costs, Houston suffers flooding, Houston is subject to regulatory costs that may require extraordinary expenditures. Other than by election, the City has no mechanism to ensure that extraordinary costs are covered.[59]

The Revenue Caps have encouraged the use of TIRZ. TIRZ tax revenues are not limited by the Revenue Caps, and the exclusion has consequently encouraged the City to use TIRZ to provide amenities and infrastructure where the City otherwise cannot.

Recommendations

The City could adopt new Charter provisions in 2017 that repeal the existing Revenue Caps and enact provisions that are reasonably related to the costs of service and needs of the citizens. Particularly, the City could consider the following measures:

- Measure increases in revenues allowed by population to the population of the SMSA.
- Exclude the value of new improvements from the Revenue Cap.
- Allow valuation increases consistent with the provisions of the Texas Tax Code, effectively limiting increases for M&O to the lesser of 8% annually, rather than 4.5%, so that the City is consistent with the limits placed on competing jurisdictions.
- Provide that instead of elections, 60% of City Council may approve any increases above limits.
- Because they have already been voted, exclude taxes for voted debt service from the Revenue Cap.
- Provide for water and sewer increases relating to extraordinary regulatory or enforcement measures, or extraordinary improvement needs protecting public health and safety.
- To the extent that new construction values have been captured for TIRZ revenues, as TIRZ sunset exclude those captured values from City revenue limits.

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2. Seek voter approval of Proposition 1 exceptions that will allow additional ad valorem tax revenues sufficient to accelerate payment of unfunded pension liabilities which, together with changed City pension contribution requirements, will secure future Plan sufficiency at an acceptable rate of current budget contributions.

If the City considers an election to approve an exception to the Revenue Caps to fund the City's unfunded pension liabilities, the election will not pass without public and business support.[60] To build public and the business community support, City and the Plans could show three things:

- That the City has identified its core services.
- That the City can demonstrate that it has undertaken efficiency measures that will control municipal costs and concentrate on providing core services.
- That there have been changes to the Plans, both to reduce the costs of the Plans in the future and to improve the governance structure of the Plans.

The City could consider an exception to the Revenue Caps for paying the unfunded liability which is pursuant to a quantifiable formula, projects accelerated payment of the unfunded liability, is used solely for that purpose, and that terminates when the City's targeted Plan contributions can be reasonably paid as a part of current budget payments.

[1] A 380 agreement allows a municipality to provide direct assistance to businesses for economic development, and may include direct payments, loans, assistance by city personnel, and city services. Tex. Local Gov't Code Ann ch. 380 (Vernon 2005 & Vernon Supp. 2015).
[2] A substantial portion of non-classified personnel costs are covered by either the airport or combined utility system enterprise funds. Because other committees are considering the airport and combined utility systems, our report is focused on the General Fund.
[3] © 2015 Moody's Corporation, Moody's Investors Service, Inc.., as of June 30, 2014.
[4] Stephen Bragg, *What is Incremental Budgeting,* Accountingtools.com *(* Jan. 17, 2013*)*
[5] Jay K. Aier, *Mayor's New Budget Approach Can Transform City Government*, Houston Chronicle *(*Feb. 10, 2016).
[6] National Conference of State Legislatures, *Performance Based Budgeting: Fact Sheet*
[7] Government Finance Officers Association, *Zero-Base Budgeting: Modern Experiences and Current Perspectives* (2011).
[8] Mayor Turner has noted that a garbage and recycling fee would particularly affect lower-income customers and customers on fixed incomes.

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San Antonio	20.93	251.16
Dallas	21.31	255.72
Austin	35.00	420.00
Fort Worth	18.00	216.00
El Paso	17.00	204.00
Average of annual fee		285.72

[9] Webb, Candace, *What is in Lieu of Taxes*, Houston Chronicle (http://smallbusiness.chron.com/lieu-taxes-23021.html).
[10] City of Houston Working Trial Balance (2015).
[11] City of Houston, Texas, *Monthly Financial Report* (Jan. 2016).
[12] Treas. Reg. § 1.148-1(c)(4)(i)(B).
[13] Interoffice memo dated February 29, 2016, Mayor Turner is now requiring a new process, Staffing Efficiency Assessment, for filling vacant positions.
[14] As Budget Woes Linger, Departments Must Consider New Models, Firefighter Nation, August 2, 2012; 4 big-impact fire-service changes to expect, Fire Rescue, April 8, 2015.
[15] We have not discussed other post-employment benefits (OPEB), though the liability for such benefits is listed in the 2015 CAFR as $1.5 billion. It is our understanding that for the City, OPEB consists primarily of medical benefits for retirees. Under Texas law, OPEB benefits are apparently not fixed liabilities, and the benefits may be changed. Tex. Local Gov't Code Ann. ch. 175 (Vernon Supp. 2015). The City should be aware of the level of OPEB liabilities and future payments and their value to current and future retirees.
[16] *City of Houston v. Towers Watson & Co.*, No. 4:14-CV-02213 (S.D. Tex. Sep. 23, 2015), Opinion & Order.
[17] *City of Houston, Texas*, 2015 *Comprehensive Annual Financial Report* 15 (2016). It is worth noting that the net pension liability reflected in the CAFR is a snapshot value as of the end of the fiscal year, based, among other variables, on the estimated market values of the Plan investments as of that date. Those values will increase or decrease as of any given date and are at best an indicator of magnitude. To provide greater certainty in estimates of pension liabilities and to account for fluctuations in values, actuaries would establish pension liabilities based on averages over broader periods of time and then recalculate those liabilities frequently.
[18] City of Houston Finance Department.
[19] "The municipality shall make contributions to the fund once every two weeks in an amount equal to the product of the contribution rate certified by the [HFRRF] board and the aggregate salaries paid to members of the fund during the period for which the contribution is made. The board shall certify the municipality's contribution rate for each year or portion of a year based on the results of actuarial valuations made at least every three years. The municipality's contribution rate shall be composed of the normal cost plus the level percentage of salary payment required to amortize the unfunded actuarial liability over a constant period of 30 years computed on the basis of an acceptable actuarial reserve funding method approved by the board. Notwithstanding any other provision of this article, the contributions by the municipality, when added to any contributions with respect to a qualified governmental excess benefit arrangement maintained in accordance with Section 14(c) of this article, may not be less than twice the amount paid into the fund by contributions of the members." Tex. Rev. Civ. Stat. Ann. Art. 6243e.2, § 13(e) (Vernon 2010).
[20] HFRRF 2015 *Comprehensive Annual Financial Report* 17 (2015). HFRRF Board of Trustees established the value as of July 1, 2013, based on the plans most recent actuarial valuation, adjusted for actual rates of return through that date. Based on that valuation, the Plan established the City's contribution at 33.2% of salary beginning July 1, 2014.
[21] *Presentation by Marc Watts, Chair, Municipal Finance Task Force, Greater Houston Partnership* at 7 (Jan. 13, 2016).
[22] City of Houston Finance Department.
[23] The City's unfunded pension liability is discussed at length, but it should be noted that under the current meet and confer agreements with HMEPS and HPOPS, over time the City will fund its unfunded liability, or (for HPOPS), lower the unfunded liability to no less than 80% of the funding requirement. Under the HMEPS agreement, the City was required to contribute $98.5 million in FY 2012 (assumed to be 19.36% of member payroll), and then increase its contribution each year thereafter by the greater of 2% of payroll or $10 million until the fiscal year after the City's contribution reaches the amount required for sufficiency based on a 30-year amortization as determined by

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the HMEPS actuary. *Agreement between the Houston Municipal Employees Pension System and the City of Houston* § 3, at 2-4. For HPOPS, the City contribution in 2012 was established at $83 million, with no shortfall to exceed $17 million, and increase by $10 million until an actuary determines that the ratio of the actuarial value of HPOPS' assets divided by the HPOPS' actuarial accrued liability equals 100%. At that time, annual City contributions will be the greater of an amount equal to 16% of plan member pay and the actuarially determined contribution (formerly known as the actuarially required contribution).

[24] For 2015, actual fire employee contributions to the HFRRF were $117,710,000, HMEPS employee contributions were $161,200,000, and HPOPS employee contributions were $151,400,000.

[25] HMEPS renegotiated benefits in 2005 and again in 2008. In 2013, the City's contribution to the HMEPS plan was just under $112 million, or about 2.67 % of the total City budget.

[26] HMEPS and HPOPS most recently entered into meet and confer agreements in 2011. *Amended and Restated Meet and Confer Agreement between the Houston Municipal Employees Pension System and the City of Houston* (July 1, 2011); *2011 Agreement Between the Houston Police Officers' Pension System and the City of Houston* (June 30, 2011).

[27] Standard Metropolitan Statistical Area. The Houston SMSA includes Harris, Brazoria, Fort Bend, Liberty and Montgomery Counties. From April 1, 1990 to April 1, 2000, the population of the Harris County SMSA increased from 3,731,131 to 4,669,571, for a 25.2% increase. https://www.census.gov/population/www/cen2000/briefs/phc-t3/tables/tab03.txt . By 2010, the population estimate for the Houston-The Woodlands-Sugar Land MSA was 5,920,416, for another 21.1% increase. https://www.dshs.state.tx.us/chs/popdat/st2010.shtm

[28] The City's revenue caps (the "*Revenue Caps*") are discussed at length in Part III. E.

[29] A November 8 election must be ordered by the City Council by August 22, 2016. Tex. Elec. Code Ann. § 3.005(c) (Vernon Supp. 2015). An election to change the Charter cannot be held until November 2017, but an election to increase revenues above the Revenue Cap limitations would not be an election to change the Charter and would be authorized by the terms of the current Revenue Cap limitations. See Tex. Const. art. XI, § 5(a).

[30] HFRRF does not have authority to alter its plan by agreement, but nothing would prevent HFRRF and the City from negotiating and proposing to the 2017 legislature mutually agreed upon legislation to modify Plan terms.

[31] Under their statutory authorization, HMEPS and HPOPS are authorized to negotiate pension terms by meet and confer agreements. Tex. Rev. Civ. Stat. Ann. art. 6243g-4, § 27 (Vernon 2010) (authorizing HPOPS to enter written agreements with the City concerning the plan); *Id.* art. 6243h, § 3(n) (authorizing HMEPS to enter written agreements with the City).

[32] *Report of Retirement Horizons Incorporated,* Jan. 17, 2014.

[33] The Revenue Caps, often referred to as Propostions 1, 2, G, and H, are a series of City Charter amendments and exceptions aimed at limiting increases in City revenues from year to year. The Revenue Caps and their effect are discussed extensively under **III. E. REVENUE CAPS** *infra.*

[34] Tex. Rev. Civ. Stat. Ann. Art. 6243e.2, § 13(e) (Vernon 2010) (HFRRF authorizing statutes); *Id.* art. 6243g-4, § 27 (Vernon 2010) (HPOPS authorizing statutes); *Id.* art. 6243h, § 3(n) (HMEPS authorizing statutes).

[35] During the 2015 legislative session, critics of the governance structures of the Plans proposed legislation dramatically changing how the Plans would be governed:

> Except as provided by Sections 66 and 67, Article XVI, Texas Constitution, and notwithstanding any other law, a municipality that is the sponsoring authority of a public retirement system that was created under a state statute, but is not a part of a statewide retirement system, may adopt by ordinance or resolution, as applicable, provisions that supplement or supersede the operative provisions of the public retirement system's statute, including any provision relating to the benefits, participation and eligibility requirements, funding source or amount, and administration of the system.

H.B. 2608, 84th Tex. Leg., Reg. Sess., § 1 (by Murphy). A companion bill, S.B. 1994, was introduced in the Senate by Senator Paul Bettencourt.

[36] *See, e.g.,* Kuriloff, Aaron, *Houston's Conundrum: Closing its Pension-Funding Gap,* The Wall Street Journal (Nov. 15, 2015) (quoting Marc Watts).

[37] As of June 30, 2015, gross investment performance for HMEPS, for example, was reported as 3.4%, 10.7%, and 10.9% for the past one-, three-, and five-year periods. *HMEPS 2015 Comprehensive Annual Financial Report* at 17.

[38] *See City of Houston v. Towers Watson & Co.*, No. 4:14-CV-02213 (S.D. Tex. Sep. 23, 2015).

[39] Rice University's Kinder Institute has offered to help with this role.

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[40] Moody's Investors Service Credit Opinion, *Moody's downgrades Houston's (TX) GOLT to Aa3; maintains negative outlook* (March 16, 2016).

[41] The other three items were a stabilized economy, a sustainable plan to manage pension obligations and fully fund pension contributions, and strong operating performance with a trend of surpluses to boost reserves and liquidity. *Id*.

[42] The other items were "[f]urther economic deterioration beyond current projections" and "lack of sustainable plan to address growing pension liability." *Id.*

[43] Houston, Tex., Charter art. III, § 1(a). The initial inflation rate was the United States Consumer Price Index for All Urban Consumers (also known as the CPI-U) for the Houston-Galveston-Brazoria, Texas Metropolitan Area (1982-1984=100), as published by the Bureau of Labor Statistics, U.S. Department of Labor, though successor indexes are provided for. *Id.* The Charter expressly provides that the increases do not apply to expenditures required because of the declaration for the City of an emergency or disaster. *Id.*

[44] *Id.*

[45] Houston, Tex., Charter art. IX, § 20.

[46] "Combined Revenues" are defined as the combined revenues of the City's General Fund, Enterprise Funds and Special Revenue Funds, excluding (1) grant monies and other revenues received from other governmental entities; and (2) intra-City revenues. Houston, Tex., Charter art. VI, § 7, subsec. 6.

[47] Houston, Tex., Charter art. VI, § 7, subsec. 2.

[48] Prop. 1 garnered more votes, with 280,596 favorable votes, or 64% of the total, as opposed to 242,697 favorable votes for Prop. 2, or 56% of the total. *Robinson v. Parker*, 353 S.W.3d 753, 754 (Tex. 2011). In the first litigation, the City argued that Proposition 2 was not effective, both because of the "poison pill" provision of Proposition 1, and Charter provisions that provide that if Charter amendments conflict, the amendment receiving the greater number of votes is effective. Houston, Tex., Charter art. VII-b, § 8 (providing that if two or more proposed resolutions approved at the same election are inconsistent, the ordinance receiving the higher number of votes prevails). The "poison pill" provided:

> If another proposition for a Charter amendment relating to limitations on increases in City revenues is approved at the same election at which this proposition is also approved, and if this proposition receives the higher number of favorable votes, then this proposition shall prevail and the other shall not become effective.

Robinson, 353 S.W.3d at 754, n. 1. The Texas Supreme Court found that it had no jurisdiction to hear the original proceeding, because no evidence was submitted that the limits of Proposition 2 had ever been exceeded, and that the matter was therefore not ripe for adjudication. Plaintiffs in the original lawsuit have since refiled.

[49] Houston, Tex., Charter art. IX, § 21.

[50] City of Houston Finance Department, *Financial Management Budget Overview* at 19 (Dec. 16-18, 2015).

[51] *Id.* at 28. Sales tax revenues are volatile, with revenues tied to employment and consumer confidence. It was suggested to the Committee that the City review its fee structure for costs that could go directly against users, but fees provide less than 12% of General Fund revenues. The Committee determined that only a garbage fee could make a substantial financial contribution to the City, and the Mayor has rejected imposition of a garbage fee. Mike Morris, Houston Chronicle, *Turner Torpedoes Garbage Fee Idea* (Feb. 24, 2016).

[52] Harris County Budget Management, *Population Study* (Jan. 2015).

[53] It is difficult to compare the cost of services among cities. Cities don't do the same things, and how things are accounted for can be very different. It is easier to compare the City over time, and it is interesting to look at the City of Houston's General Fund costs over the past 15 years. In 2001, the City's projected General Fund budget projected revenues of $1,346,341,000, with a City population of 1,953,631, for revenues of $689 per citizen. The SMSA had a population in 2000 of 4,669,571, for revenues of $288 per person served. The City budget for 2015 projected revenues of 2,410,693,000, for a City population of 2,239,558, for projected revenues of $1076 per citizen and an increase of $387 per person over the 15 years. For the SMSA, however, the population increased to 6,622,047, for revenues of $364 per person served and an increase over 15 years of $75 per person. ***The numbers are not adjusted for inflation.*** City of Houston, Texas, Official Statement for Public Improvement Refunding Bonds, Series 2000 at 27 (Nov. 29, 2000) (2001 budget projections); United States Census, *Profile of General Demographic Characteristics: 2000* (http://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk) (2000 Houston population); U. S. Census Bureau, *Ranking Tables for Metropolitan Areas: 1990 and 2000* (Apr. 2, 2001) (2000 SMSA population); City of Houston, Texas, *Official Statement for Public Improvement Refunding Bonds, Series 2014A* at 37 (July 22, 2014) (2015 budget projections); Texas Department of State Health Services, *Texas*

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Population, 2015 (Projections) (2015) (2015 SMSA population); U. S. Census Bureau, *Quick Facts, Houston City, Texas* (http://www.census.gov/quickfacts/table/PST045215/4835000).

[54] It has been argued that the best measure of the size of City government is as a comparison of expenditures for a city against local gross domestic product over time. For the General Fund for the period from 2002 to 2012, HMEPS estimated that General Fund expenditures shrank from $0.53 per $100 of SMSA GDP to $0.37. *Government Shrinks as Economy Grows*, HMEPS Pension Press at 4 (Sep. 2015).

[55] As of December 2014, the Houston Association of Realtors estimated the median price of a single family house sold in Harris County at just over $209,000. Harris County Appraisal District, *2015 Market Trends Report* At 2 (Feb. 10, 2015).

[56] City of Houston, *Report of 2015 Appraisal Roll Information and Anticipated Excess Collections* (Sep. 1, 2015).

[57] Houston Association of Realtors, *MLS Press Release* (Aug. 17, 2005)

[58] New value is expressly excluded from limits imposed by state law on tax increases. Tex. Tax Code Ann ch. 26 (Vernon 2015).

[59] The cost of the past two municipal elections in Houston were about $2.2 million, with $700,000 for the general election and $1.5 million for the runoff. The cost for an election on a measure not held during a general election would presumably be consistent. Because of the cycle of tax levy and collection, receipt of voted revenues could be delayed for as long as two years after approval at an election. The 60% voter requirement of Proposition 2 seems particularly odd, since the Charter itself can be amended by a majority vote.

[60] Proposition 2 actually requires 60% voter approval for any exception to its terms, but that 60% approval requirement seems in direct contradiction to the terms of Proposition 1 that allow for an increase in tax revenues upon voter approval. The inconsistency should be handled through legislative validation of a successful election.