

***Minority Report
City of Houston
Long-Range Financial
Management Task Force***

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SUBMITTED BY:
Terry Bratton
Barbara Chelette
Todd Clark
Celeste Fatheree
Melvin Hughes
Ralph Marsh

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Long-Range Financial Management Task Force

Executive Summary

We are six members of the City of Houston's Long-Range Financial Management Task Force (Task Force), representing nearly 40,000 City employees, retirees and beneficiaries. We commend the creation of the Task Force as a much-needed first step in moving the City toward a long-term fiscal balance that can help Houston remain one of the fastest-growing cities in North America.

We have decided to issue this Minority Report not because we disagree with the goals of the Task Force – we fully support them – but because we believe too much of the Task Force's efforts were spent on short-term solutions that fail to address core financial issues.

We believe the City, and the Task Force, should focus on finding innovative and effective ways to take advantage of such truly major developments as the astonishing growth rate of our region, historically low interest rates and significant cost-control mechanisms in national healthcare legislation.

Each of us came to work on this effort in good faith and put our best effort toward achieving the Task Force's goals. However, we are deeply concerned that many Task Force members argued for "more control" of the pensions by the City as a solution to the fiscal problems. The emphasis on pensions is misplaced, as is illustrated in the chart on page 5, which shows pension costs within the context of the City general fund budget.

Over the course of the Task Force meetings, it became clear to us that "pension governance" was a superficial issue. The important problem is City governance, specifically the decision-making that is routinely done with little or no long-term planning. The most obvious symptom of this is the overall City

debt load, which now amounts to \$13.1 billion. In recent years, the City has aggressively rolled this debt forward (see chart on page 3). We are not pointing fingers; rather we are trying to honestly identify the core problems.

In the spirit of finding the best solutions for the City, we offer the following recommendations and comments:

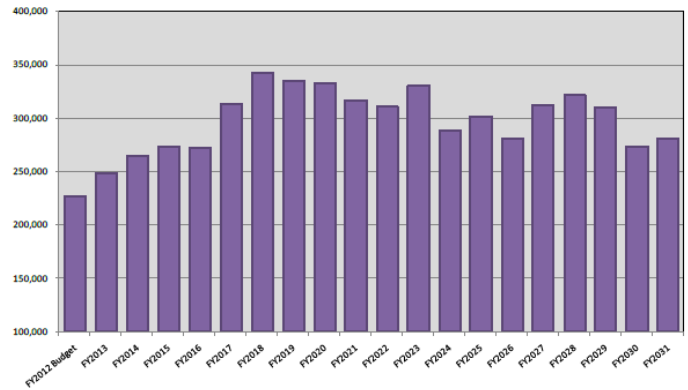
- Restructuring Debt: In the past, administrations have refinanced current obligations to address debt service matters. This method of addressing long-term debt should be further reviewed given the opportunities to refinance the debt at historically low levels.
- City Structural Challenges: The City must thoroughly analyze whether Enterprise Funds, TIRZs and Management Districts provide a real financial benefit to City taxpayers.
- Drainage Fee Structure: The City has implemented a drainage fee that is expected to raise billions of dollars in funding. Employees may be funded through this fee, freeing up General Fund dollars. The City should clearly report this so that the savings to the General Fund are transparent and communicated to the public.
- Economic Growth: The City's long-term approach should include economic growth strategies – recognizing that providing effective and efficient services to the citizens of Houston is essential in this effort.

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- Public-private combinations: While these strategies may be worth considering in some cases, studies show that privatization does not deliver the savings for taxpayers promised by its proponents. Instead, public accountability is lost. Proposals to privatize EMS, for example, are highly questionable. Even setting aside the substantial legal challenges in curtailing emergency medical services, it would be detrimental to the citizens of Houston (one out of ten of whom call upon EMS at some point). Houston's EMS is recognized worldwide as a leader in injury care, and Houston was identified by Fortune Magazine as one the safest cities in the U.S. to have a medical emergency.

20 Year Debt Payment Schedule (\$ in thousands)



Source: Task Force Presentation 9/6/11

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Background

In June 2011, the Houston City Council passed an amendment to the annual budget ordinance that created a Long-Range Financial Management Task Force. The Mayor was required to appoint, within 60 days, the members of the Task Force. The amendment mandated that the Task Force membership include at least two members of the City Council, a representative of the Mayor, a representative of the City Controller, representatives from each of the three pension systems, representatives from each of the three employee unions and five members of the community. Ultimately, three members of the City Council were appointed to the Task Force bringing the total membership to sixteen. The Task Force is advisory only.

While the City Council lacked the authority to mandate participation in the Task Force by representatives of the unions and pension funds, these groups desired, as in the past, to work with the City Council in a cooperative manner in the endeavor. The unions and pension funds represent nearly 40,000 City employees, retirees and beneficiaries.

Furthermore, the amendment creating the Task Force had three requirements: First, that the final report be submitted to the Mayor followed by a meeting of a “Committee of the Whole” no later than January 31, 2012. Also that the final report must include a recommendation on whether continued existence of the Task Force, in its current or altered form, would be beneficial. Finally, the Task Force shall maintain as privileged and confidential any work product or draft document used to compose its final report. By ordinance, the City Council subsequently changed the January 31, 2012 deadline to February 6, 2012. Further, despite the requirement that the Task Force keep draft

documents confidential, one key document was in fact widely made public. This caused confusion for the public, and panic among many City employees, retirees and beneficiaries who read in the news media that their pensions might soon be eliminated.

We have decided to issue this Minority Report not because we disagree with the goals of the Task Force – we fully support them – but because we believe too much of the Task Force’s efforts were spent on short-term solutions that fail to address core issues. Of the 229 original Task Force suggestions, 58 of them (25%) were pension oriented, even though pension expense represents only 9% of the 2012 General Fund budget, and even less when compared to the entire City budget.

We commend the creation of the Task Force as a much-needed first step in moving the City toward a long-term fiscal balance. By focusing on real solutions and addressing core issues through meaningful and lawful action, we can help Houston remain a vibrant and affordable place to live and continue as one of the fastest growing cities in North America.

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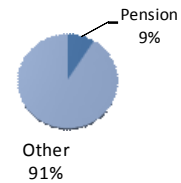
Recommendations on Pension Issues:

Because pensions dominated so much of the Task Force’s time, we find it necessary to point out some misconceptions about pension reform matters.

Many people are not aware that the Houston pension systems have already implemented a significant number of reforms to maintain strong and sustainable plans. Several of these reforms have received nationwide recognition for their success and have shown the way for other state and local plans to adopt modifications to strengthen their finances. In addition, we want to note that changes to pension plans can only be made through the statutory Meet and Confer process or by the Texas Legislature. In regards to some suggestions offered regarding pensions, we provide the following comments and recommendations:

- **Pension Governance.** Some suggestions stated that the City needs to have “more control” over pensions. These proposals are misguided. The underlying problem, indeed the source of current imbalances, is that the City is able and eager to take on long-term obligations without first determining how to fund them, resulting in the current debt load of \$13.1 billion. Just as the debt burden has not been forced upon the City, pension obligations have also received City approval each step of the way. The chart below (“Cost Breakdown”) helps place the pension “burden” within the context of the overall City budget.

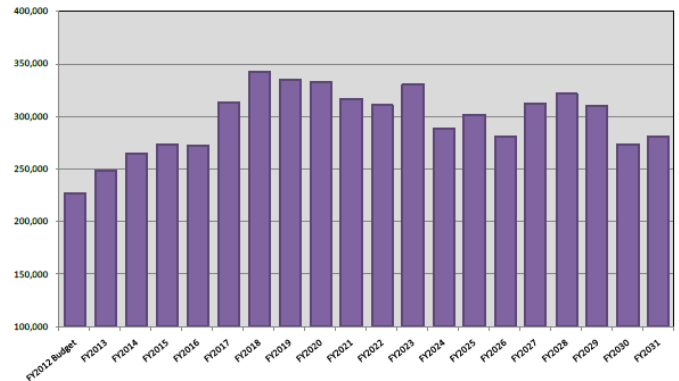
FY 2012 City General Fund Budget - Cost Breakdown



Source: Task Force Presentation 9/6/11

Also, the “20 Year Debt Payment Schedule” chart demonstrates how the City has been aggressively rolling its debt forward, such that nearly \$2 billion comes due between FY2012-FY2018.

20 year Debt Payment Schedule (\$ in thousands)



Source: Task Force Presentation 9/6/11

Since the City willingly took on these obligations (often in the form of express contracts) over recent decades with little or no long-term planning, we simply do not understand how “more City control” of pensions could seriously be considered as a credible solution.

It must be understood that any changes to benefits or contribution levels have always been agreed upon by both parties. Statutory changes in the pension plans are subject to state agency oversight and independent actuarial review. Therefore, all parties are a part of the process and

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changes cannot be initiated without agreement of all the groups.

Above all, it is important to remember that pensions are set up as trusts with strict oversight and controls to prevent governments from raiding pension funds to pay for other projects. This has happened in the past, which is why public plans are now separate systems with independent governance, while still including City appointees.

While an enormous amount of Task Force time was spent discussing pension governance, very little was spent exploring City governance. We support proposals to address the City governance issue, which is at the heart of the City's "structural" financial imbalances. We recommend that the City focus on this key underlying issue.

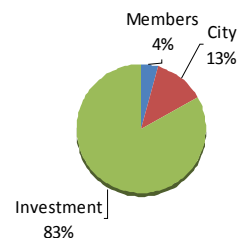
- **Funding of Pensions:** Several suggestions would require the City to fund the pension systems at actuarially required contribution levels. We agree.
- **The Risk Equation:** Some have asserted that the City "bears the risk" of any market underperformance relative to the 8.5% assumed rates of return. But ordinarily, over two-thirds of the systems' funding comes from returns on their investments, which are all professionally managed and have excellent track records. Also, in all three systems, employees contribute their own money to help fund their benefits. The risk equation is further balanced by each system's plan designs, which have been modified to address their unique funding circumstances. Finally, pension funds exist for the benefit of multiple generations of workers and therefore must focus on the long term – and over the long

term the City's pension funds have matched or exceeded their target returns of 8.5%.

Additionally, we believe that the debate over the appropriateness of the 8.5% rate has been confused. Sometimes, the debate concerns what percent should be used for accounting purposes. Using a different rate for reporting and accounting purposes is just that – simply a matter of reporting. It would result in a different expression of the same data, but would not necessarily be better or more useful information.

Some Task Force debate suggested that a rate lower than 8.5% be used in calculating City contribution levels. Each of the pension systems periodically analyzes the appropriateness of an 8.5% return assumption, and they have found that the rate is reasonable but always subject to continued review. However, using a lower rate to calculate City contribution levels would result in higher required contributions by the City at a time when the City is arguing that the current contribution requirements are overly burdensome. Our recommendation is to first meet contribution goals based on the current rates before attempting to achieve more ambitious levels.

Sources of Funds for Houston Pensions FY 2011



Sources: FY2011 CAFR's from City's Municipal, Police and Fire Pension Systems

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- Defined Benefit Plans. Several of the suggestions advocated changing from the current Defined Benefit (DB) approach to 401(k)-style defined contribution (DC) accounts for City employees. In fact, we already have that type of program at the City, which is the 457 plan. The 457 plan is a great way to save more for retirement and health care expenses, but it is not a replacement for the DB plan, which is the bedrock upon which City employees have built a secure and hard-earned retirement. In comparing DB plans with DC plans, DC plans are not necessarily cheaper. They are only cheaper if benefits are drastically cut. On an apples-to-apples comparison, DB plans are a cheaper, safer and more efficient way to provide for retirement. Although pensions represent a higher portion of total compensation for state and local workers, recent studies show that this in large part offsets the fact that salaries (and the virtual nonexistence of bonuses) tend to be lower¹. Furthermore, sponsors of DB plans in the past have often found that closing their plans and converting to DC plans results in substantial increases in costs. We recommend that DB plans be maintained as a critical element of the task of attracting and retaining qualified employees in the long term. Of course, we should always look for ways to increase their efficiency and effectiveness.

- Transparency: There is nothing secretive about how pension benefits (including DROP) are calculated. The City has all

payroll and employment data concerning its employees (that's where the pension funds obtain employment information in the first place). The idea that DROP accounts represent some sort of mystery is not correct. Actuaries typically assume that all participants enter DROP as soon as eligible, and that any variations from this assumption are immaterial. The Comprehensive Annual Financial Reports for the pension funds contain substantial aggregate information on DROP participation and funding. We recommend that work continually be done to improve information flow between the pensions and the City, but also that all legally required privacy and confidentiality conditions be absolutely respected.

¹ "Comparing Compensation: State-Local Versus Private Sector Workers," The Center for Retirement Research at Boston College.

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Other Recommendations:

We believe the City, and the Task Force, should focus on finding innovative and effective ways to take advantage of such truly major developments as the astonishing growth rate of our region, historically low interest rates and significant cost control mechanisms in national healthcare legislation. For example, the City should thoroughly explore the following:

- Restructuring Debt: In the past, administrations have refinanced current obligations to address debt service matters. This method of addressing long-term debt should be further reviewed given the opportunities to refinance the debt at historically low levels.
- City Structural Challenges: The City must thoroughly analyze whether Enterprise Funds, TIRZs and Management Districts provide a real financial benefit to City taxpayers.
- Drainage Fee Structure: The City has implemented a drainage fee that is expected to raise billions of dollars in funding. These funds cannot be used for debt service but to actually assist in solving the long-term drainage issues. The City should report how many employees will be funded through this fee, freeing up General Fund dollars.
- Economic Growth: The City's long-term approach should include economic growth strategies – recognizing that providing effective and efficient services to the citizens is essential in this effort.
- Public-private combinations: While these strategies may be worth considering in some cases, we recommend that such ideas be considered with great caution. Studies show that privatization does not deliver the savings for taxpayers promised by its proponents. As public services are shifted to the private sector, public accountability is lost and contractors take advantage of the system to profit at the expense of the public. Proposals to privatize EMS, for example, are highly questionable. Even setting aside the substantial legal challenges in implementing privatization, it would be detrimental to the citizens of Houston (one out of ten of whom call upon EMS at some point). Houston's EMS is recognized worldwide as a leader in injury care, and Houston was identified by Fortune Magazine as one the safest cities in the U.S. to have a medical emergency.

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Conclusion

Some facts have become clear to the members who comprise the minority members of the Task Force:

First, over the years, the City of Houston has continued to grow. Rated as a global city, Houston's economy has a broad industrial base in energy, manufacturing, aeronautics, and transportation. It also leads in the health care and oilfield equipment sectors. Only New York City headquarters more Fortune 500 companies than Houston. The Port of Houston ranks first in the United States in international waterborne tonnage handled and second in total cargo tonnage handled. Houston's population grew 7.5% over the past decade and it remains a vibrant, affordable City that provides its citizens with employment opportunities and a high quality of life.

Second, the City's elected leaders have all too frequently made fiscal decisions that focused on the short term. Consequently, there has been a lack of institutional accountability, which has resulted in costly obligations being passed from one administration to the next. Sadly, City employees are repeatedly asked to make sacrifices as the elected officials struggle to reconcile their current thinking with these prior decisions.

Lastly, as did our colleagues in the majority, we came in good faith to work hard and reach a consensus. However, we believe we have a responsibility to those we represent to outline separately and distinctly our suggested opportunities for the City's elected representatives' consideration.

We look forward to contributing to efforts in the future that focus on the core fiscal problems facing the City.

Respectfully submitted,

Terry Bratton
Barbara Chelette
Todd Clark
Celeste Fatheree
Melvin Hughes
Ralph Marsh