August 13, 2014

Paul Hobby
Chairman, Greater Houston Partnership
1200 Smith, Suite 700
Houston, TX 77002-4400

Dear Paul,

This letter responds to your request for a perspective on the current financial condition of the City of Houston.

Recession and recovery

The Great Recession hit Houston later than other regions. The city had already scaled back on planned spending in 2009—the final year of my administration—when the recession diminished tax revenues late in that year. We had also used surpluses to build general fund cash reserves, which grew from $103 million in fiscal 2003 to $277 million at the outset of fiscal 2009. In response to the recession, the city drew down most of those reserves in fiscal years 2010, 2011, and 2012.

Twice in late 2009 the city finance director and I briefed city council on the future budget implications of a severe recession and collapse of financial markets. Those briefings included a draft budget for FY2011, potential spending cuts if revenues dropped more than anticipated, five year planning forecasts, and recommend reforms "to reduce pressures to increase property tax rates or cut services during recession and beyond." An October 2009 memo distributed before one of those briefings is attached.

In November 2009 we publicly forecasted that revenues would remain depressed through fiscal year 2012, and then rebound. For example, we projected that general revenues and transfers from other funds would support a general fund budget for fiscal 2014 of $1.78 billion. That is the exact amount spent in that fiscal year, which ended weeks ago.

The current administration and city council deserve credit for making hard choices concerning operating budgets during the recession. They cut spending to a level that could be sustained by revenues, lawful transfers, and cash balances. After recovery they have prudently and steadily been restoring cash reserves.

Houston municipal leaders should also be commended for maintaining excellent bond ratings. Total general obligation debt has been stable since the beginning of the downturn. In 2012 voters approved a bond issue authorizing the sale of $410 million in additional general

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obligations bonds, an amount based on the judgment of city officials that Houston could service this debt without an increase in the property tax rate.

Legacy contracts with city employees pre-dating this administration should not be an impediment to balancing current budgets. Contracts with most city employees last only three years or so. Another driver of spending—the level and cost of health benefits—are subject to annual adjustments. Competent managers should be able to accurately forecast the cost of health insurance before each fiscal year.

The city projects an extraordinary increase in general obligation revenue—6.3%—for fiscal 2015. Since the annual escalation of property taxes lags the sharp increase in appraised values, property tax revenues should continue to grow in at least the following two fiscal years.

The charter requirement for voter approval of extraordinary growth in tax revenues should not be a problem so long as city leaders exercise sound foresight. During real estate booms property taxes can rise much faster than the incomes of many residents. The charter requires public officials to justify increases in tax revenues above certain thresholds, just as they must ask for voters to approve the issuance of debt incurred for public improvements.

Pension challenges

In 2001 the state legislature, with the agreement of the city's three pension boards and city officials, enacted changes in pension benefits that increased the present value of future liabilities by more than $2 billion. Those changes in pension benefits cannot be revised without either agreement of the pension boards or a change in state law.

The 2001 increases in pension benefits were negotiated informally by a former GHP executive who was then serving in the city administration and officials in each pension board. The administration and city council's legislative affairs committee then recommended a change in state law incorporating those benefit changes. City Controller Annise Parker, who had served on council in 2001, explained later that the pension board's actuary "estimated that 14 percent of the city's annual payroll would be needed to cover pension obligations. We thought we could afford the more generous pension benefits being discussed in Austin."

City officials relied on erroneous estimates. Consider one particular 2001 change in the pensions for civilian municipal employees. By paying a lump sum amount and agreeing to pay 4 percent of their salary into the pension plan, most city employees were allowed to raise their pensions from 51 percent to 90 percent of their salary in the years before retirement. Yet the amount that employees were required to pay to "buy in" to the higher benefits, plus earnings from investment on that contribution, could never come close to paying for the cost of the higher benefits. That would have been obvious by comparing price and benefits from a wide variety of annuities. The pension board's actuary—along with the pension board members and some other city officials—assumed that relatively few employees would opt for the higher benefits. When most municipal employees did so, pension liabilities soared.

Because of that and other changes in pensions written into state law in 2001, the present value of the liabilities of the municipal pension system jumped from $1.5 billion in 2000 to $3.28 billion in 2003. During those years the portion of the municipal pension liability funded by pension assets dropped from 91 percent to 46 percent. (After two reforms undertaken in 2004 and 2007, it had recovered to 66 percent in the last year of my administration.)

I highlighted the need for pension reform at the very outset of my administration in 2004. Early that year we commissioned reports from independent actuaries, prevailed in an acrimonious public referendum, and obtained the agreement of the police and municipal pension systems for substantial reductions of benefits for new hires and the elimination of some benefits not yet vested for existing municipal employees. (At the time, the firefighters' pension fund had less unfunded liability and firefighters paid a far greater percentage of the annual pension contribution than did other city employees.) These changes reduced the unfunded liability of the municipal plan alone by $820 million.

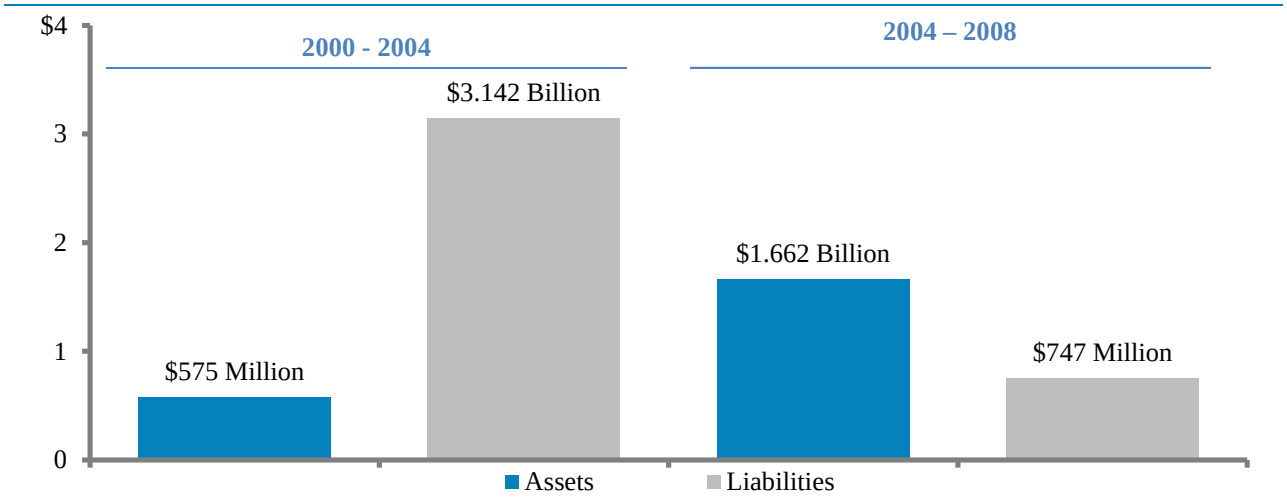
The chart below shows the change in assets and liabilities of the municipal and police pension plans in the years immediately before and after the pension reforms.

Paying Down the Future Pension Liability

($ in millions)

Change in the pension assets and liabilities before and after reforms

GENERAL OBLIGATION DEBT SCHEDULED PRINCIPAL PAYMENTS



Source: Actuarial reports of police and municipal pension systems. The impact of Municipal pension reform was reflected in liabilities as of July 1, 2004 and the police reforms as of July 1, 2005. Accordingly, the second and fourth columns reflect changes before and after those dates.

The municipal pension system agreed to additional changes that reduced pension liabilities in 2007, and the city agreed to increase its pension contributions in each of the

following three fiscal years. Houston's pension reforms were recognized as a model for other governments. http://www.economics21.org/commentary/high-cost-hidden-pension-promises.

State law gives pension boards controlled by beneficiaries the ability to veto any change in pension benefits. In order to secure the municipal and police pension boards' agreement to benefit reductions, the city committed to a predictable annual schedule of higher contributions to pension fund assets. We bit the bullet rather than kicking the can down the road.

The city's general fund pension contribution averaged $88 million in the three fiscal years before my administration. In order to fund higher contributions required by the 2004 and 2007 reforms, the city council overwhelming approved use of combination of tax revenue and debt so as to avoid cuts in essential services. We phased out the debt-funded component as city revenues rose. In order to retire pension liabilities set by state law, the city contributed general funds revenues of $166 million plus debt proceeds of $20 million by the last full fiscal year in my administration. That higher level of contributions reduced the amount that otherwise would be owed to cover future liabilities. (For perspective, in fiscal 2013 the city's general fund contributed $168 million.)

In addition, in 2004 the city reduced unfunded pension liabilities by contributing a second lien note on the convention center hotel, and wisely later refinanced that note—at the recommendation of the city controller and finance director—at a lower interest rate. The total amount of debt used to retire outstanding, vested pension liabilities was limited to a level that could be sustained without raising the property tax rate earmarked for debt service. That required a reduction in planned capital spending.

Every dollar of debt reduced the city's future pension obligations by far more than the principal and interest on that debt. Debt proceeds were invested in securities that have appreciated. (For the ten years ending in July 1, 2013, the municipal employees' system averaged a 9.5% return, and returns will be higher through July 1, 2014.) In addition, of course, the aggressive schedule of pension contributions—in part funded with debt—was a quid pro quo for obtaining large reductions in pension benefits.

Members of city council and the city controller provided invaluable help in support of pension reforms, including the reduction of benefits and higher levels of contributions required to obtain those pension changes and reduce unfunded pension liabilities. As the *Houston Chronicle* noted at the time: "few taxpayers would argue with [the] choice of bond funding over tax increases or cuts in fire and police staffing." Certainly no elected officials at the time advocated those alternatives.

A blue ribbon commission of business leaders reviewed and endorsed the 2004 pension reforms, which also included institutional changes such as the creation of a council pension committee and recruitment of an independent Chief Pension Officer with decades of private sector actuarial and benefit experience. Craig Mason, who has served well in that position since 2005, is a respected national authority on pensions and benefits with decades of private sector experience as a benefit consultant and actuary.

The 2004 and 2007 reforms set police and municipal pension benefits at a level sufficient for the city's annual contribution to cover the additional liability accrued as pensions vested each year. (Actuaries call that balance of pension accruals and contributions a "normal" rate.)

State elected officials have refused to allow future benefits—those not yet earned—even for new hires. As is the case with private employers, cities should be able to adjust the level and mix of future compensation (salaries plus benefits) in a manner required to provide adequate staffing and attract and retain talented employees. State officials should allow them to do so. This can be done while retaining appropriate regulatory oversight designed to prevent "raids" on pension assets and to monitor the fiduciary duty of board members responsible for pension investments.

The GHP should join Mayor Parker in seeking any appropriate legislative changes.

When my administration sought to develop a defined contribution alternative for municipal employees, the lawyers for the municipal pension fund—Baker Botts—noted that state law required agreement by the pension board. Yet even if state law allowed the city to prospectively substitute defined contributions for defined benefits, that would not solve the problem of unfunded liabilities arising from benefits vested under the 2001 pension law.

Just like any other employer, the city would be obligated to fund the present value of all liabilities in excess of pension assets if it ever converted from defined benefits to defined contributions. That one-time cost would be enormous. The city would either have to either temporarily double property tax rates or incur debt at a level requiring a smaller rise in property taxes for a longer period of time. If the city laid of thousands of police, firefighters, and civilian employees in order to make a one-time termination payment to the defined benefit plans, it would increase the present value of liabilities by accelerating the date when many employees received their first pension payment. Then the city would require substantial additional costs in order to replace an experienced workforce.

City leadership in this and the prior administration has not swept the issue of pension liabilities under the rug. It is also worth noting that Houston—unlike some big cities--does not have massive unfunded liabilities for public safety. The firefighters plan should be well over 90 percent funded after accounting for the plans excellent investment performance during the last year. The percentage of payroll contributed by the city to the firefighters' plan in the most recent fiscal years has been in line with the city's contributions in 2006-2008. In 2011 the city agreed to a back-end-loaded schedule of contributions to the police plan each year through 2023.

Citizens should remember that firefighters and police do *not* receive Social Security pensions. While many employers assert they have defined contribution rather than defined benefit plans, virtually of their employees in addition receive defined social security benefits earned through a contribution of 12.4 percent of payroll.

"Incentives" that shift the tax burden from some taxpayers to others

As originally developed in Houston and other cities, a TIRZ was an incentive used to encourage a developer to invest in construction on a particular site in a distressed area. Various taxing jurisdictions froze property taxes paid into the general fund based on a property value at a particular date and allowed all tax revenues from higher future valuation for some period of time to be reinvested for certain limited and defined purposes within the zone. In essence, for a limited time real estate owners in a TIRZ paid a smaller share of taxes on their appraised values into the city's general fund, which finances public safety, parks, libraries, and everything else.

Before 2004 these zones grew to cover a significant portion of the city's tax base. The tax increment dedicated to them has grown at a faster rate than property tax revenues available to the city as a whole. In Houston and other cities TIRZ have experienced "mission creep." As part of a council briefing on this issue in 2009, we provided the attached chart showing TIRZ revenue growth through fiscal 2011.

Consider, for example, the downtown TIRZ, in which the general fund tax revenues were capped in 1995 at level based on a property tax valuation of $216 million, an amount now less than the market actual value of some individual buildings. Next year, with a booming market, appraised values within the zone could rise to $1.7 billion. No wonder the downtown TIRZ can offer incentives to apartment developers that encourage people to relocate from other parts of the city.

We created no new TIRZs during my administration. (On rare occasions we adjusted boundaries to help finance community-wide improvements such as the Dynamo stadium and Buffalo Bayou improvements.) Since 2010, however, TIRZs have grown from 19,397 acres five years ago to 35,976 acres today. That expansion-- which includes a doubling of the downtown TIRZ--includes three new zones, one of which was created for the participation of Harris County.

Many fair-minded people do not share my concern about the ultimate impact of TIRZ on the city's tax base. I served with an outstanding group of citizens on city council and we were unable to form a consensus on how best to limit these zones to their original duration. Though no reasonable person can believe that much or all of the appreciation of property values in the large zones resulted from tax incentives rather than market forces, the TIRZs have in fact facilitated concentrations of public investments in defined areas and have helped fund affordable housing. Many are staffed by outstanding professionals supervised by dedicated boards.

Regardless of one's overall perspective on TIRZs, no one can deny that they are a long term "off-balance sheet" dedication of city revenues, with an economic impact similar to public improvement debt. Last year, just 6 of the 24 TIRZs proposed to fund capital improvements totaling $239 million for fiscal 2014-2018. (In contrast, the total planned capital improvements for city libraries and the fire and police departments for those years total $185 million.) The proliferation of jurisdictions that direct capital improvement also undermines the ideal of greater regional planning.

With Houston experiencing the strongest real estate development boom in the United States, now is a good time for reviewing the need for tax incentives for commercial

development. It would be a particularly, slippery slope if the city ever departed from its longstanding opposition to developers' requests for rebates on sales taxes paid by retail owners or tenants within their development. That would be unfair to competitors.

The clustering of bond maturities

The city's finance director has highlighted the challenge resulting from a clustering of debt maturities later in this decade. That is a serious issue.

Why has Houston incurred public improvement debt?

For decades the City of Houston—like most businesses—has used debt to finance long-lived improvements that have promoted the growth and quality of life. Every administration has used this authority in order to fairly spread the tax burden of long-lived capital improvements such as police and fire stations, parks, and libraries over the useful lives of those assets.

How should principal payments be scheduled?

Debt with a shorter maturity typically has a lower interest rate and debt with a longer maturity gives the borrower greater flexibility in dealing with the risks of future emergencies, economic downturns, or rising interest rates. Responsible public officials balance those interests, which usually results in the issuance of bonds with maturities spread in some manner over the useful life of improvements. In recognition of the risks of excessively short maturities, the city has a long-standing policy of limiting the percentage of debt financed with commercial paper.

Any public or private organization can operate more efficiently with a stable and predictable level of principal payments or amortization in a sinking fund. In my administration annual general fund debt service remained between 12 to 13 percent of general fund outlays.

The city's capacity to service debt with a stable property tax rate will generally grow alongside the growth in the property tax base. As the debt rating agencies recognize, a city with good growth prospects can prudently increase debt service as the tax base grows. So, for example, the annual debt service during my administration grew from $178 million to $251 million, while the property tax base grew from $112 billion to $195 billion.

The city uses a designated portion of property tax revenues to pay principal and interest on general obligation bonds. Revenues otherwise available for operations and maintenance would drop if principal payments spiked in a handful of years. Operational efficiency and continuity of services would suffer if the city had to lay off employees and defer maintenance because of a spike in scheduled principal payments and then later replaced that workforce and caught up on maintenance after principal payments returned to normal.

How were principal payments scheduled at the beginning of this administration?

After the recession hit city revenues in 2009, we reduced by $240 million the amount of outstanding short-term commercial paper for public improvements and substituted long term

public improvement debt. We took care not to load principal payments at the beginning of new administration, which would have the challenge of dealing with the continuing consequences of recession.

As shown in an attached exhibit, in early 2010—even after the 2009 adjustment to give a new administration more breathing room-- future annual principal payments still remained fairly stable. When the new administration took office in 2010, the next 10 annual principal reductions in public improvement bonds averaged $142 million, with a high of $160 million in 2018. Annual planned debt service for all outstanding general obligation debt was also stable through 2018, and then steadily declined.

The cash balance in the general obligation debt service account in 2010 was a record $181 million, far more than the standard required set-aside. A portion of the excess was drawn down in the following fiscal years.

What accounts for the sharp rise in principal payments due in 2017-2018?

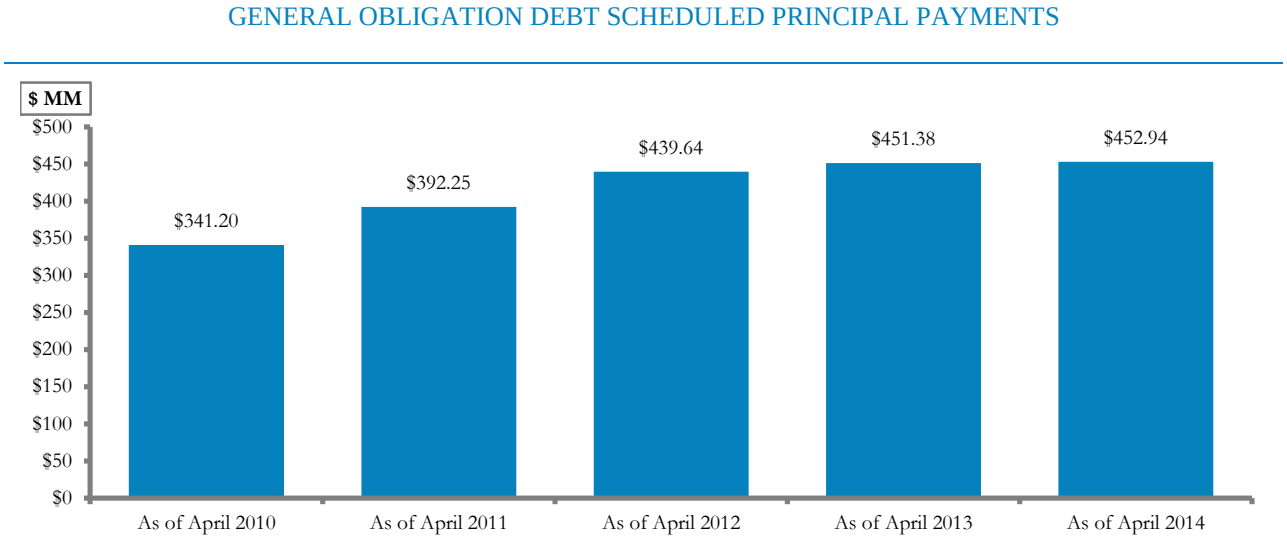
The city now has only slightly more public obligation debt than it did in early 2010. In short, new debt has been incurred for capital improvements at the same pace as existing debt was paid off. That makes sense, because appraised property values have only exceeded 2009 levels in the last two years. The budget for fiscal 2015 shows that the city intends to sharply accelerate capital spending in the next two fiscal years.

Since 2010 the city has clustered principal payments disproportionately in relatively few fiscal years beginning in fiscal 2017. In fiscal 2012, 2013, and 2014 the city made principal payments on public improvement debt at an average annual rate of $131 million, about $3 million more annually than had been planned at the end of the prior administration. In recent years, however, the city has scheduled principal payments that rise sharply to an annual average of $208 million in fiscal 2017-2019, an average $55 million higher than had been on the books in 2010.

The following charts show when the city began to cluster debt maturities in fiscal years 2017-2018. Each column shows the principal payments for fiscal 2017-2018 according to the terms of debt outstanding as of April each year.

Peak Principal Payments on General Obligation Debt – FY 2017-2018

($ in millions)



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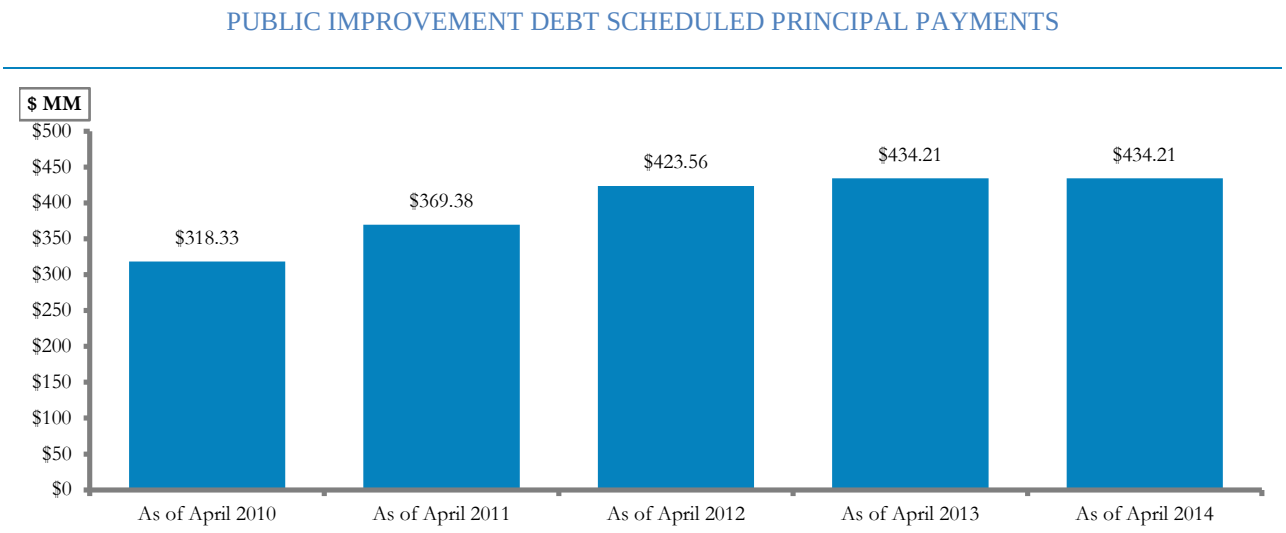
The next chart shows that this sharp rise in principal payments on debt during two years occurred because of manner in which the city, since 2010, has scheduled the principal payments on public improvement debt.

Peak Principal Payments on Public Improvement Debt – FY 2017-2018

($ in millions)



Source: Same as above

Since 2010 the city has clustered slightly more than a third of debt incurred for capital projects such as streets, police and fire stations, parks, libraries, and the like in 2017-2020, the first four fiscal years in a new administration. A swing in annual principal payments for public improvement debt—from $145 million in fiscal 2014 to $222 million in 2018—can play havoc with the operating budget.

The city continued to face a financial challenge in fiscal 2012, even though the local economy had largely recovered. So it deferred $20 million in principal payments due that year. By then cash reserves remaining from the prior administration had been exhausted. That deferral seems reasonable if it was necessary to avoid a temporary curtailment of essential services. That decision, however, did not require a clustering of debt at the beginning of the next administration.

At the beginning of 2010 the contractual general obligation debt service—the principal and interest due on all debt secured by property taxes–was $276 million for fiscal 2018. Today that amount has increased by $79 million, a spike that exceeds the entire annual budgets for many city departments.

This pattern of debt maturities does not conform to the estimated useful lives of debt-financed capital improvements. The useful life of a third of the city's last $2 billion in debt-financed capital improvements does not end in 2017-2020. If so, the city has a scandalous problem with structural engineering.

Interest rate "savings" do not justify such a clustering of debt. Obviously any private or public entity can show a short-term "savings" by shortening the average maturity of loans. But any temporary savings needs to be weighed against the increase in operational and financial risks. Suppose my administration could have reduced its annual interest expense by shortening

debt maturities and clustering those maturities in 2010-2012, immediately after a new administration took office. That would have created havoc at the beginning of the Parker administration.

A clustering of relative short maturities magnifies the risk of having to refinance at higher interest rates. That is why many well-run businesses have extended maturities in order to minimize the impact of higher interest rates. As you know from your service on the regional Federal Reserve Board, the Federal Reserve has clearly stated its intention to taper off support for the extraordinarily low interest rates experienced in the last several years. The risks of rising rates are well-known. Homeowners understand that a five-year mortgage will have a lower interest rate than would a longer maturity, but the shorter maturity exposes them to potentially higher interest rates if they must refinance at the end of the five year term. Sophisticated finance professionals look beyond the simplistic "present value of debt service" formula when scheduling debt maturities.

The city's well-known charter limitations on annual revenue increases should also discourage the clustering of maturities on debt. Bond covenants require that the property tax rates earmarked for debt service be sufficient to service annual debt obligations. As a result, if principal payments spike in some year, the revenues available for operations and maintenance may plummet.

It is alarming that the city's finance director is unaware of who and when decisions were made to cluster debt maturities later in this decade. He was recently cited in the *Houston Chronicle* as stating that "past mayors put off principal payments for future leaders to pay, creating a debt bubble that now is coming due. General obligation debt payments will jump from $297 million this fiscal year to $355 million by fiscal 2018, before falling." As shown by the above charts, those debt maturities were clustered in the last several years. Former mayors did not do that.

No former mayor has any political incentive to cluster debt maturities after the 2013 election or after the end of the current administration.

Any concern about the level of debt does not justify a clustering of maturities. If the city's finance director believes that too much debt has been incurred for long-lived public improvements, then he ought to recommend a deferral of the massive planned increases in two large categories of capital expenditures in the next two years, as shown in an attachment.

Fair-minded citizens can debate how much tax revenue should be devoted to support of debt for financing long-lived improvements and how much should be used for ongoing operations and cash-financed investments. They can also embrace different priorities for public improvements financed with debt secured for property taxes. (For example, my administration used debt more extensively for street improvements while the current administration relies more heavily on debt to fund trails along the bayous. Mayor Parker and I both supported the bond issues reflecting these priorities during both of our administrations.) Any difference of opinions regarding those issues does not justify either the clustering of debt maturities or attempts to shift responsibility for a spike in debt that was planned during the last several years.

Conclusion

On balance, city leaders managed Houston's operating budget and total indebtedness well in the aftermath of the Great Recession. Houston dealt with the challenge of pensions earlier and more effectively than most big cities, but state officials should allow city leaders to manage future pension benefits in a manner that is affordable for the long run and allows city management to weigh the balance between retirement benefits and other forms of compensation. If the city seeks assistance as a result of debt maturities now clustered in the next five years, perhaps it—like the city administration in 2001—would welcome volunteer advice from private sector executives recruited by the Greater Houston Partnership.

In light of its booming economy and property tax values, with good financial management the city ought to be able to continue its long term record of sound financial management while in the future providing essential services such as street repair that are critical to future growth.

Sincerely,

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CITY OF HOUSTON

Office of the Mayor

Interoffice

Correspondence

To: City Council Members
City Controller

cc: Anthony Hall
Michelle Mitchell
Marty Stein
Michael Moore

From: Mayor Bill White

Date: October 12, 2009

Subject: Critical Issues for City of Houston General Fund Budget in FY2011 and Beyond

Many of you are campaigning for re-election or election to other offices. It has been my privilege to work with a remarkable group of elected public servants. Those following this Administration will have choices to make. Tomorrow, October 13, I will present a FY2011 "planning budget" or projection. The purpose of this memo is to highlight important budget issues for our future.

In my State of the City Address I said that Houston would suffer from the global economic crisis, and its effects would become more apparent throughout the year. The global downturn and its effect on consumer and investor psychology will likely depress our economy and associated revenues through 2010 and perhaps through June 2011, the end of the City's next fiscal year. Of course, we remain confident that Houston will emerge stronger and more competitive than ever in the next five years.

Like many families and businesses, the City of Houston has made hard choices in the FY2010 budget. Some of those hard choices will need to be made in FY2011. <u>These decisions cannot be fully planned in advance, both because we do not have a crystal ball and the right balance should be</u>

left in the capable hands of a new Mayor and Administration. I offer these observations to those committing to managing the City in a business-like, fiscally responsible fashion over the long run. Our city can stand in sharp contrast to those in California, where the inability to control public costs is likely to result in a cycle of higher taxes, deep cuts in public services, and private employment losses as jobs move out.

This memo provides several observations concerning basic changes in City practices and the City's long-term financial structure which will reduce pressures to increase property tax rates or cut services during recession and beyond. We have initiated reforms in each of these areas, which set the groundwork for future actions. Each of these budget areas will require diligence before and throughout each fiscal year, and especially during those years in which the nation is in recession.

None of these are "glamorous" issues. There will be vested interests fighting each change. But I believe Houston is worth it.

Pension Contributions

We have undertaken two reforms in the municipal pension system and one in the police pension system. Those changes have made those systems more secure for employees and affordable for

taxpayers. However, the recent downturn in the value of investments for all defined benefit plans, public and private, throughout the nation, can pose challenges for the future.

In the long run there should be a limit – such as 15-20% of payroll – for the public contribution to pension plans. Excessive growth is the percentage of compensation paid to support retired employees, which at some point comes dollar-for-dollar at the expense of the level of active duty employment and the City's ability to provide services. Benefit levels for years of service not vested, vesting schedules, and incentives for retirement should be adjusted to reflect that goal.

Depending on market conditions in the next several years, there may need to be increases in the employee contributions to pension funds. For a number of years in the Firefighters Pension System there was an appropriate contribution ratio of $1 for employees for $2 funded by taxpayers. A substantial contribution by employees to their own pension system in relation to the taxpayer contribution will best align the interests of all involved concerning the appropriate level of pension benefits. If employees value this benefit, and its security, then they should share in any change in costs created by higher benefit levels, longer life expectancies of employees, or the market performance of the pension assets. Of course, employees should be given a choice to contribute more or less. Those who choose to do so should have their benefits not already vested adjusted accordingly.

Any of these changes will require either agreement by the particular system or changes in state law.

Again, the urgency of these changes will depend in part on the length of the recession. That affects both the value investments of the pension systems and the ability of the City to make higher contributions without laying off employees.

Healthcare Benefits

The operating costs of the City cannot increase on an annual basis over extended periods of time faster than City revenues, without cutbacks in needed services and related employment. Moreover, we know there are some substantial sources of City revenue, notably franchise fees, which will not increase as fast as inflation and growth, and certainly not as fast as the cost of City services. By charter amendment we will limit the annual growth in property tax.

For several years before this Administration there were double-digit increases in the cost of health benefits. We have brought that down. But we need to bring that down further to be more in line with the City's revenue growth.

The fundamental causes for premium increases in health benefits include factors outside the control of local government. Examples of this include upward pressure on premiums to offset the cost of

unreimbursed care, the consequences of unhealthy lifestyles, and the rising cost of treatment of chronic conditions for a retiree population which is – thank goodness – living longer. These upward pressures on cost are not unique to Houston or any City. Federal legislation may have some impact on those costs. But in the meantime we must act to consider all actions needed to contain the growth of those increases to the average historical growth in City revenues.

One logical place to start would be to continue reducing the amount of the subsidy by taxpayers and current employees for the annual increase in health care costs for able-bodied City retirees who are not yet eligible for Medicare. Another reform would be to increase the percentage contribution based on some years-of-service schedule.

TIRZs

Tax Increment Reinvestment Zones have played constructive roles in economic development, targeted infrastructure improvements, neighborhood revitalization, and the funding of affordable housing within the city limits. Where other jurisdictions participate they can also be a means of pooling resources of several local jurisdictions. However, the effect of capping the contribution to the general fund from property taxes for substantial portions of the City has been to reduce the overall financial contribution by parts of the City to public safety, garbage collection, citywide infrastructure, health benefits, pensions, and other citywide costs.

About ten percent of the property tax base of the City is now within the TIRZs. Almost two-thirds of that value is now within the "increment," the difference between the baseline and the current valuation. These increments are growing at a more rapid rate than the City tax base as a whole, because they include several of our largest employment centers (e.g., Downtown and Uptown).

Since public safety has been both the largest and fastest growing portion of the City budget, inevitably there will be upward pressure on everybody's tax rate or artificially low limits on public safety investments resulting from a "cap" on the amount paid by TIRZs to common public safety expenses. Citywide, overall two-thirds of each dollar of O&M property taxes collected is spent on public safety. Within the TIRZs increments the portion of property tax increment used for public safety – "municipal services" changes – is a small single-digit percentage. We have made some strides to require some contributions to public safety from TIRZs constituting the bulk of the TIRZs tax increment. We have proposed stepping up these contributions in the FY11 budget scenario presented today. But more basic long-term reforms need to be made.

I strongly warn against the creation of any new TIRZ in which the City participates until this fundamental problem is addressed.

Employee Pay Increases

For FY2011, we have assumed little or no growth in city revenues from the current year. If, however, city revenues actually decline in FY2011 (July 1, 2010 – June 30, 2011) – which we do not expect – then any employee pay increases would be "paid" by the loss of jobs by other city employees. This is just a matter of math. For FY2010 and FY2011, employee pay increases at a faster rate than our revenues. We have built up cash balances expressly for the purpose of "paying for" certain employee increases. However, these cash balances were not intended to cover all pay increases for all employees for all time. If the recession is more severe than anticipated, any employee pay increase comes almost dollar-for-dollar at the expense of jobs, health benefits, and pension contributions or a combination of all three. Of all the actions described in this memo – pensions, health benefits, and TIRZs – I believe reconsideration of contracted employee pay should be the last considered, because it bears most directly on our ability to recruit and retain employees. This alternative should be considered only if there are no concrete signs of recovery by the end of this fiscal year, next June.

A Note on Budget Process

It is critically important that the new Administration undertake budget planning throughout each fiscal year, and adjustments be made promptly in response to any changes in revenue projections. Also, Departments must live within their budgets, except as authorized in advance by the Mayor. These basic disciplines were instituted at the beginning of this Administration and have served us well.

Also, our new Mayor and City Council should recognize that 12-24 months ahead it should not be a "crisis" to project a "gap" of 2-4% of the overall general fund budget with "business as usual." After all, there will always be more need for services than funds available. Departments with a keen sense of mission will ask for more. At the beginning of this Administration the gap six months in advance was about ten percent of the General Fund budget. At the beginning of each of the following fiscal years, we project a 2-4% gap, 12 to 24 months out, and then worked to reduce it throughout the year.

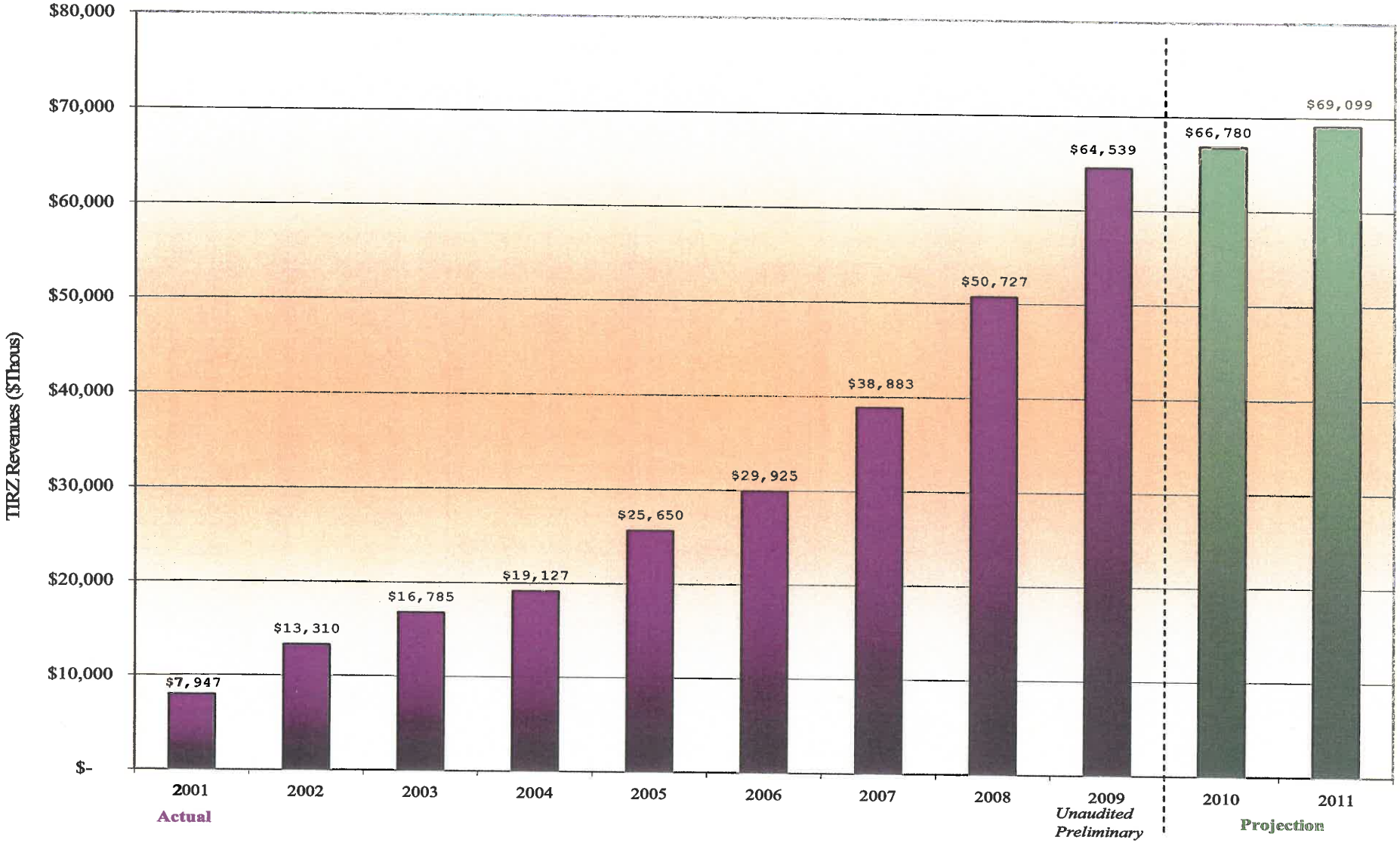
My message to our future leadership is simple: you must make choices, each month and each quarter, to chip away at any gap. Avoiding $100,000 here or there does add up. The gap can become a problem if every month senior leadership does not look for improved efficiency, grants, private funding, asset sales, etc.

Schedule of Funding Progress

Date (1)	Actuarial Value of Assets (AVA) (2)	Actuarial Accrued Liability (AAL) (3)	Unfunded Actuarial Accrued Liability (UAAL) (3) - (2) (4)	Funded Ratio (2)/(3) (5)	Annual Payroll (6)	UAAL as % of Payroll (4)/(6) (7)
July 1, 1992	$ 608,524	$ 765,299	$ 156,775	79.5%	$ 314,686	49.8%
July 1, 1993	660,637	840,321	179,684	78.6%	340,249	52.8%
July 1, 1994	713,696	886,699	173,003	80.5%	366,561	47.2%
July 1, 1995	770,189	963,712	193,523	79.9%	378,511	51.1%
July 1, 1996	857,332	1,042,459	185,127	82.2%	367,610	50.4%
July 1, 1998	1,095,617	1,240,141	144,524	88.3%	397,698	36.3%
July 1, 1999	1,222,240	1,339,933	117,693	91.2%	407,733	28.9%
July 1, 2000	1,376,020	1,509,373	133,353	91.2%	432,604	30.8%
July 1, 2001	1,490,179	1,955,806	465,627	76.2%	418,234	111.3%
July 1, 2002	1,519,717	2,515,189	995,472	60.4%	399,794	249.0%
July 1, 2003	1,510,264	3,278,251	1,767,987	46.1%	390,314	453.0%
July 1, 2004	1,501,235	2,633,817	1,132,582	57.0%	366,190	309.3%
July 1, 2005	1,777,656	2,725,272	947,616	65.2%	404,565	234.2%
July 1, 2006	1,867,293	2,894,295	1,027,002	64.5%	422,496	243.1%
July 1, 2007	2,193,745	3,128,713	934,968	70.1%	448,925	208.3%
July 1, 2008	2,310,384	3,296,370	985,986	70.1%	483,815	203.8%
July 1, 2009	2,284,442	3,451,410	1,166,968	66.2%	539,023	216.5%

Note: Dollar amounts in $000

TIRZ Revenues FY2001- FY2011



TAX INCREMENT REINVESTMENT ZONES

The City of Houston accomplishes a portion of its Capital Improvement Program through a financing mechanism called a Tax Increment Reinvestment Zone, or "TIRZ". Each of the City's twenty-two TIRZ share common characteristics:

- Each zone is created by action of City Council pursuant to a project and financing plan approved by City Council.
- Each zone has defined geographical boundaries.
- At the time each zone is created, the property taxes due to the City based on the current property valuation within the zone is "frozen", and for the life of the zone, any incremental property tax revenue resulting from revaluation of property is dedicated to public improvements within the zone.
- Each TIRZ has a Board of Directors that is responsible for its activities.
- Each TIRZ has a termination date incorporated into the ordinance that created it.

TIRZ's are reinvestment zones created by the City that use tax increment revenue generated by increased value in the zone to promote development and redevelopment in that zone. As development occurs in each zone, the taxes generated by the increase in value attributable to those improvements, or "tax increment", are captured in separate funds set up for each TIRZ. These funds are then used to pay for approved project costs. For a majority of these TIRZ's, the City has created a companion redevelopment authority (RDA) to implement the project and financing plan.

The TIRZ budgets are being reviewed by the Council Committee for Regulation, Development and Neighborhood Protection. The Finance Department coordinates the preparation and presentation of the budgets to City Council. These budgets are approved separately from the City's budget.

TIRZ/Authority	Created	Termination	Size (acres)
#1 / St. George Place RDA	12/12/1990	12/31/2031	121.57
#2 / Midtown RDA	12/14/1994	12/31/2024	756.42
#3 / Main St./Market Sq. RDA	12/13/1995	12/31/2025	335.39
#4 / Village Enclaves RDA	09/25/1996	12/31/2016	1,189.86
#5 / Memorial Heights RDA	12/18/1996	12/31/2016	915.73
#6 / Eastside RDA	01/15/1997	12/31/2027	769.98
#7 / OST/Almeda Corridors RDA	05/07/1997	12/31/2028	1,728.91
#8 / Gulfgate RDA	12/10/1997	12/31/2027	296.18
#9 / South Post Oak RDA	12/17/1997	12/31/2022	262.70
#10 Lake Houston TIRZ	12/17/1997	12/31/2027	1,934.81
#11 / Greater Greenspoint RDA	08/26/1998	12/31/2028	3,396.75
#12 / City Park RDA	12/02/1998	12/31/2028	91.71
#13 / Old Sixth Ward RDA	12/22/1998	12/31/2028	151.18
#14 / Fourth Ward RDA	06/09/1999	12/31/2029	157.67
#15 / East Downtown RDA	07/04/1999	12/31/2029	387.02
#16 / Uptown RDA	07/07/1999	12/31/2029	1,045.87
#17 / Memorial City RDA	07/21/1999	12/31/2029	944.11
#18 / Fifth Ward RDA	07/21/1999	12/31/2029	498.97
#19 / Upper Kirby RDA	07/21/1999	12/31/2014	838.78
#20 / Southwest Houston RDA	12/15/1999	12/31/2029	3,167.41
#21 / Hardy Place TIRZ	12/17/2003	12/31/2033	326.10
#22 / Leland Woods RDA	12/23/2003	12/31/2033	80.33

TAX INCREMENT REINVESTMENT ZONES

The City of Houston accomplishes a portion of its Capital Improvement Plan through a financing mechanism called a Tax Increment Reinvestment Zone (TIRZ). Each of the City's twenty-five TIRZs share common characteristics:

- Each zone is created by action of City Council pursuant to a project and financing plan approved by City Council.
- Each zone has defined geographical boundaries.
- At the time each zone is created, the property taxes due to the City based on the current property valuation within the zone is "frozen", and for the life of the zone, any incremental property tax revenue resulting from revaluation of property is dedicated to public improvements within the zone.
- Each TIRZ has a Board of Directors that is responsible for its activities.
- Each TIRZ has a termination date incorporated into the ordinance that created it.

TIRZs are reinvestment zones created by the City that use tax increment revenue generated by increased value in the zone to promote development and redevelopment in that zone. As development occurs in each zone, the taxes generated by the increase in value attributable to those improvements, or "tax increment", are captured in separate funds set up for each TIRZ. These funds are then used to pay for approved project costs. For a majority of these TIRZs, the City has created a companion redevelopment authority (RDA) to implement the project and financing plan.

The Mayor's Office of Economic Development/TIRZ coordinates the preparation and presentation of the budgets to City Council. These budgets are approved separately from the City's budget.

TIRZ/Authority	Created	Termination	Size (acres)
#1 / St. George Place RDA	12/12/1990	12/31/2031	121.57
#2 / Midtown RDA	12/14/1994	12/31/2033	764.52
#3 / Main St./Market Sq. RDA	12/13/1995	12/31/2043	653.61
#4 / Village Enclaves RDA	09/25/1996	12/31/2016	1,189.86
#5 / Memorial Heights RDA	12/18/1996	12/31/2029	1,410.36
#6 / Eastside RDA	01/15/1997	12/31/2027	769.98
#7 / OST/Almeda Corridors RDA	05/07/1997	12/31/2028	1,728.91
#8 / Gulfgate RDA	12/10/1997	12/31/2027	296.18
#9 / South Post Oak RDA	12/17/1997	12/31/2022	262.70
#10 / Lake Houston RDA	12/17/1997	12/31/2027	3,234.23
#11 / Greater Greenspoint RDA	08/26/1998	12/31/2028	3,396.75
#12 / City Park RDA	12/02/1998	12/31/2028	91.71
#13 / Old Sixth Ward RDA	12/22/1998	12/31/2028	249.84
#14 / Fourth Ward RDA	06/09/1999	12/31/2029	157.67
#15 / East Downtown RDA	07/07/1999	12/31/2040	387.02
#16 / Uptown RDA	07/07/1999	12/31/2029	1,045.87
#17 / Memorial City RDA	07/21/1999	12/31/2029	971.98
#18 / Fifth Ward RDA	07/21/1999	12/31/2029	498.97
#19 / Upper Kirby RDA	07/21/1999	12/31/2029	838.78
#20 / Southwest Houston RDA	12/15/1999	12/31/2029	3,167.41
#21 / Hardy Place RDA	12/17/2003	12/31/2033	326.10
#22 / Leland Woods RDA	12/23/2003	12/31/2033	80.33
#23 / Harrisburg TIRZ	10/25/2011	12/31/2040	1,600.00
#24 / Greater Houston TIRZ	12/18/2012	12/31/2042	7,109.00
#25 / Hiram Clarke/Fort Bend TIRZ	08/13/2013	12/31/2042	5,633.00

Scheduled Principal Payments on All General Obligation Debt

Due in Fiscal Year	As of April 2010*	As of April 2011	As of April 2012	As of April 2013	As of April 2014
2011	140,405,000				
2012	136,870,000	148,435,000			
2013	136,710,000	137,450,000	138,875,000		
2014	140,520,000	141,060,000	142,915,000	147,625,000	
2015	151,465,000	166,785,000	178,960,000	181,395,000	182,178,751
2016	156,160,000	172,130,000	185,655,000	184,910,000	185,693,751
2017	168,490,000	193,475,000	216,840,000	219,035,000	219,818,751
2018	172,705,000	198,770,000	222,800,000	232,340,000	233,123,751
2019	150,545,000	177,800,000	193,210,000	202,670,000	203,453,751
2020	167,480,000	182,310,000	195,565,000	204,800,000	205,586,751
2021	152,545,000	167,630,000	172,350,000	181,895,000	182,678,751
2022	148,370,000	163,890,000	168,800,000	172,130,000	172,913,751
2023	161,015,000	177,095,000	182,205,000	185,650,000	186,433,751
2024	112,595,000	129,200,000	134,440,000	136,530,000	137,313,751
2025	117,705,000	134,860,000	140,210,000	142,400,000	142,400,000
2026	85,755,000	103,505,000	109,085,000	112,585,000	112,585,000
2027	107,185,000	125,645,000	131,505,000	135,175,000	135,175,000
2028	107,025,000	126,225,000	132,385,000	136,240,000	136,240,000
2029	84,770,000	104,735,000	111,205,000	115,255,000	115,255,000
2030	52,280,000	73,045,000	79,840,000	84,090,000	84,090,000
2031	66,850,000	66,850,000	73,985,000	78,445,000	78,445,000
2032	73,260,000	73,260,000	80,750,000	84,205,000	84,205,000
2033	35,155,000	35,155,000	36,075,000	37,950,000	37,950,000
2034	10,080,000	10,080,000	11,040,000	12,980,000	12,980,000
2035	57,655,000	57,655,000	58,650,000	59,290,000	59,290,000
2036	46,520,000	46,520,000	47,555,000	49,690,000	49,690,000
2037	30,690,000	30,690,000	31,765,000	34,010,000	34,010,000
2038	5,115,000	5,115,000	6,235,000	8,590,000	8,590,000
2039	2,405,000	2,405,000	3,570,000	6,045,000	6,045,000
2040			1,210,000	3,810,000	3,810,000
2041			21,510,000	24,240,000	24,240,000
2042				4,175,000	4,175,000
2043				3,005,000	3,005,000
Total	**2,978,325,000**	**3,151,775,000**	**3,209,190,000**	**3,181,160,000**	**3,041,375,510**

Source: *http://www.houstontx.gov/budget/10budadopt/XIV_GOD.pdf,*
http://www.houstontx.gov/budget/11budadopt/XIV_GOD.pdf,
http://www.houstontx.gov/budget/12budadopt/XIV_GOD.pdf,
http://www.houstontx.gov/budget/13budadopt/XIV_GOD.pdf,
http://www.houstontx.gov/budget/14budadopt/XIV_GOD.pdf
http://www.houstontx.gov/budget/15budprop/XIV_GOD.pdf

* *Sum calculation of Tax Bonds Principal + Pension Obligations Principal + Tax Certificates Principal*

Scheduled Principal Payments on Public Improvement Debt

(a Category in General Obligation Debt)

Due in Fiscal Year	As of April 2010	As of April 2011	As of April 2012	As of April 2013	As of April 2014
2011	137,155,000				
2012	130,620,000	113,715,000			
2013	125,615,000	126,355,000	128,435,000		
2014	131,285,000	131,825,000	134,360,000	139,070,000	
2015	141,665,000	156,985,000	169,870,000	172,305,000	172,305,000
2016	145,740,000	161,710,000	172,975,000	177,645,000	177,645,000
2017	157,410,000	182,395,000	209,070,000	211,265,000	211,265,000
2018	160,920,000	186,985,000	214,485,000	222,945,000	222,945,000
2019	138,010,000	165,265,000	184,315,000	192,640,000	192,640,000
2020	154,140,000	168,970,000	186,045,000	194,085,000	194,085,000
2021	128,395,000	143,480,000	152,205,000	160,495,000	160,495,000
2022	122,725,000	138,245,000	147,360,000	149,375,000	149,375,000
2023	134,815,000	150,895,000	159,400,000	161,465,000	161,465,000
2024	84,765,000	101,370,000	110,135,000	112,265,000	112,265,000
2025	88,140,000	105,295,000	114,390,000	116,580,000	116,580,000
2026	54,345,000	72,095,000	81,610,000	85,110,000	85,110,000
2027	73,820,000	92,280,000	102,270,000	105,940,000	105,940,000
2028	75,925,000	95,125,000	101,285,000	105,140,000	105,140,000
2029	43,345,000	63,310,000	69,780,000	73,830,000	73,830,000
2030	8,285,000	29,050,000	35,845,000	40,095,000	40,095,000
2031	8,715,000	8,715,000	15,850,000	20,310,000	20,310,000
2032	11,610,000	11,610,000	19,100,000	22,555,000	22,555,000
2033	12,190,000	12,190,000	13,110,000	14,985,000	14,985,000
2034	10,080,000	10,080,000	11,040,000	12,980,000	12,980,000
2035	13,310,000	13,310,000	14,305,000	14,945,000	14,945,000
2036	11,120,000	11,120,000	12,155,000	14,290,000	14,290,000
2037	8,265,000	8,265,000	9,340,000	11,585,000	11,585,000
2038	5,115,000	5,115,000	6,235,000	8,590,000	8,590,000
2039	2,405,000	2,405,000	3,570,000	6,045,000	6,045,000
2040			1,210,000	3,810,000	3,810,000
2041			1,260,000	3,990,000	3,990,000
2042				4,175,000	4,175,000
2043				3,005,000	3,005,000
Total	**2,319,930,000**	**2,468,160,000**	**2,581,010,000**	**2,561,515,000**	**2,422,445,000**

Source: *http://www.houstontx.gov/budget/10budadopt/XIV_GOD.pdf,*
http://www.houstontx.gov/budget/11budadopt/XIV_GOD.pdf,
http://www.houstontx.gov/budget/12budadopt/XIV_GOD.pdf,
http://www.houstontx.gov/budget/13budadopt/XIV_GOD.pdf,
http://www.houstontx.gov/budget/14budadopt/XIV_GOD.pdf
http://www.houstontx.gov/budget/15budprop/XIV_GOD.pdf

CAPITAL IMPROVEMENT PLAN SUMMARY

In November 1983, the City Council established a five-year capital improvement planning process for physical improvements to public facilities and infrastructure. By resolution, it became City policy to engage in a continuous five-year capital improvement planning process that includes annual review, revision, and adoption of a five-year Capital Improvement Plan (CIP). The five-year CIP is revised annually to include new projects, reflect changes in priorities, and extend the plan an additional year. The first year of the plan is the current Capital Budget, and it is revised throughout the year as needs dictate or when changes are made to existing approved capital projects.

The CIP provides a schedule for capital project implementation and anticipated project allocations. Details on capital projects for public improvement programs which include Fire, General Government, Library, Parks, Police, Health, Solid Waste Management, Storm Sewer, Streets and Traffic Control, and Housing projects are included as well as enterprise capital programs which are Airport, Wastewater, and Water.

Presented below is a summary of the planned appropriations for the FY2013-17 CIP:

	($thousands)					
	2013	2014	2015	2016	2017	Total
Enterprise Programs						
Aviation	218,943	206,336	111,450	295,002	152,019	**983,750**
Storm Drainage	60,459	73,220	54,007	74,966	72,580	**335,232**
Street & Traffic	158,089	127,037	148,621	91,211	96,552	**621,510**
Wastewater	249,100	185,000	185,000	185,000	185,000	**989,100**
Water	245,000	197,545	220,000	224,000	205,627	**1,092,172**
Sub Total:	**931,591**	**789,138**	**719,078**	**870,179**	**711,778**	**4,021,764**
Public Improvement Programs						
Equipment and Other	5,503	9,504	6,009	6,005	6,004	**33,025**
Fire	15,662	12,725	10,225	5,325	10,700	**54,637**
Fleet	30,606	26,347	27,591	30,359	29,155	**144,058**
Gen. Gov't.	5,970	2,125	2,275	2,250	3,100	**15,720**
Health	1,580	3,980	5,850	5,840	3,200	**20,450**
Housing	2,700	3,000	3,000	3,000	3,100	**14,800**
Information Technology	69,803	21,485	13,185	15,385	15,260	**135,118**
Library	10,923	7,100	2,601	8,528	7,852	**37,004**
Parks	24,851	13,512	11,200	8,725	9,800	**68,088**
Police	10,982	18,050	28,275	12,645	17,600	**87,552**
Solid Waste	4,168	935	3,995	4,300	1,585	**14,983**
Sub Total:	**182,748**	**118,763**	**114,206**	**102,362**	**107,356**	**625,435**
Grand Total:	**1,114,339**	**907,901**	**833,284**	**972,541**	**819,134**	**4,647,199**

The FY2013 Capital Improvement Plan calls for the appropriation of $1.1 billion in FY2013. Of the total appropriations planned, $932 million is from Enterprise Programs with user-fee supported funds and the remaining $183 million addresses a full range of capital facility and infrastructure improvements that uses, among other funding sources, the issuance of tax-supported Public Improvement Bonds (PIBs). The citizens of Houston approved a Bond Election for $625 million in November 2006 and $410 million in November 2012.

FISCAL YEAR 2015-2019 PROPOSED CAPITAL IMPROVEMENT PLAN

All Funding Sources

Fiscal Year Planned Appropriations ($ Thousands)

	2015	2016	2017	2018	2019	2015- 2019
Public Improvement Programs						
Fire	18,431	24,145	5,866	5,950	8,013	62,405
General Government	4,362	6,622	14,343	46,939	3,510	75,777
Homeless & Housing	36,712	41,218	13,300	13,300	13,300	117,830
Library	12,591	10,257	10,106	14,697	1,679	49,330
Parks and Recreation	72,850	91,904	69,137	47,373	26,466	307,730
Police	61,942	54,051	16,107	1,755	1,689	135,544
Public Health	7,458	15,438	15,942	7,689	1,167	47,694
Solid Waste Management	13,173	2,506	7,533	1,306	243	24,762
Subtotal	**227,519**	**246,141**	**152,334**	**139,009**	**56,067**	**821,070**
Enterprise Programs						
Aviation Facilities	270,871	220,481	306,336	131,400	281,628	1,210,716
Storm Drainage System	81,198	96,229	74,061	81,746	96,007	429,241
Street & Traffic Control	167,944	133,362	159,945	140,262	129,098	730,611
Waste Water	181,887	185,787	167,782	188,435	268,227	992,118
Water	339,643	385,697	924,266	611,609	435,316	2,696,531
Subtotal	**1,041,543**	**1,021,556**	**1,632,390**	**1,153,452**	**1,210,276**	**6,059,217**
Citywide Programs						
Technology	23,270	5,866	7,503	3,442	3,124	43,205
Fleet	46,922	34,137	35,531	36,101	36,770	189,461
Subtotal	**70,192**	**40,003**	**43,034**	**39,543**	**39,894**	**232,666**
Component Units	**271,696**	**257,048**	**170,835**	**113,863**	**38,441**	**851,883**
Overlap Between Component Units and Public Improvement Programs	(16,216)	(58,955)	(35,506)	(20,158)	(17,440)	(148,276)
Grand Total	**1,594,734**	**1,505,793**	**1,963,087**	**1,425,709**	**1,327,238**	**7,816,561**

Revised