City of San José

Retirement Contributions and the General Fund

&

Rating Agencies' Views on Pension Obligations

Retirement Solutions Working Group

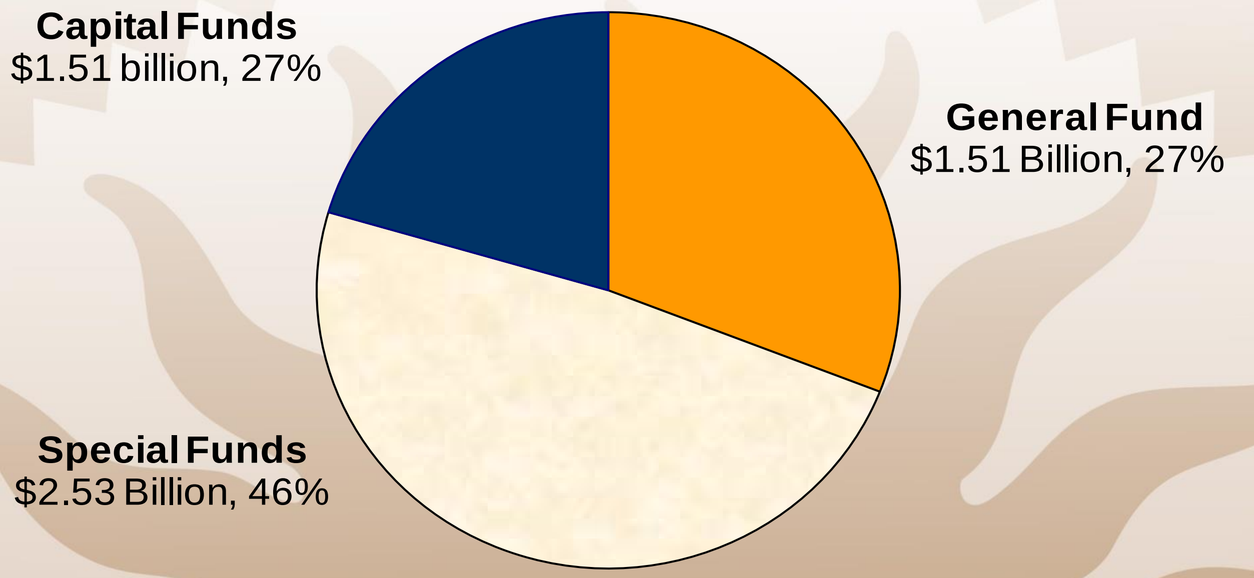
December 9, 2019

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Budget Overview
And
Historical Perspective

City of San José Budget Overview

2019-2020 CITY BUDGET[1]:	**$4.7 billion**
TOTAL NUMBER OF FUNDS:	**120**
TOTAL NUMBER OF POSITIONS (FTE):	**6,647**



[1] An adjustment of $902 million is necessary to arrive at the net $4.7 billion 2019-2020 Adopted City Budget to avoid the double-counting of transfers, loans, and contributions between City funds.

BUDGET OVERVIEW
Special Funds Sample

Airport Funds
Community Development Block Grant Fund
Convention and Cultural Affairs Fund
Housing Funds
Integrated Waste Mgmt Fund (Garbage Collection/Recycling)
Municipal Golf Course Fund
Municipal Water Fund
Parking Fund
San José Clean Energy Fund
Sanitary Sewer Funds
Storm Sewer Funds
Waste Water Treatment Plant Funds
Workforce Investment Act Fund

BUDGET OVERVIEW
Capital Programs

Community and Economic Development
- Developer Assisted Projects

Environmental & Utility Services
- Sanitary Sewer System
- Storm Sewer System
- Water Pollution Control Plant
- Water Utility System

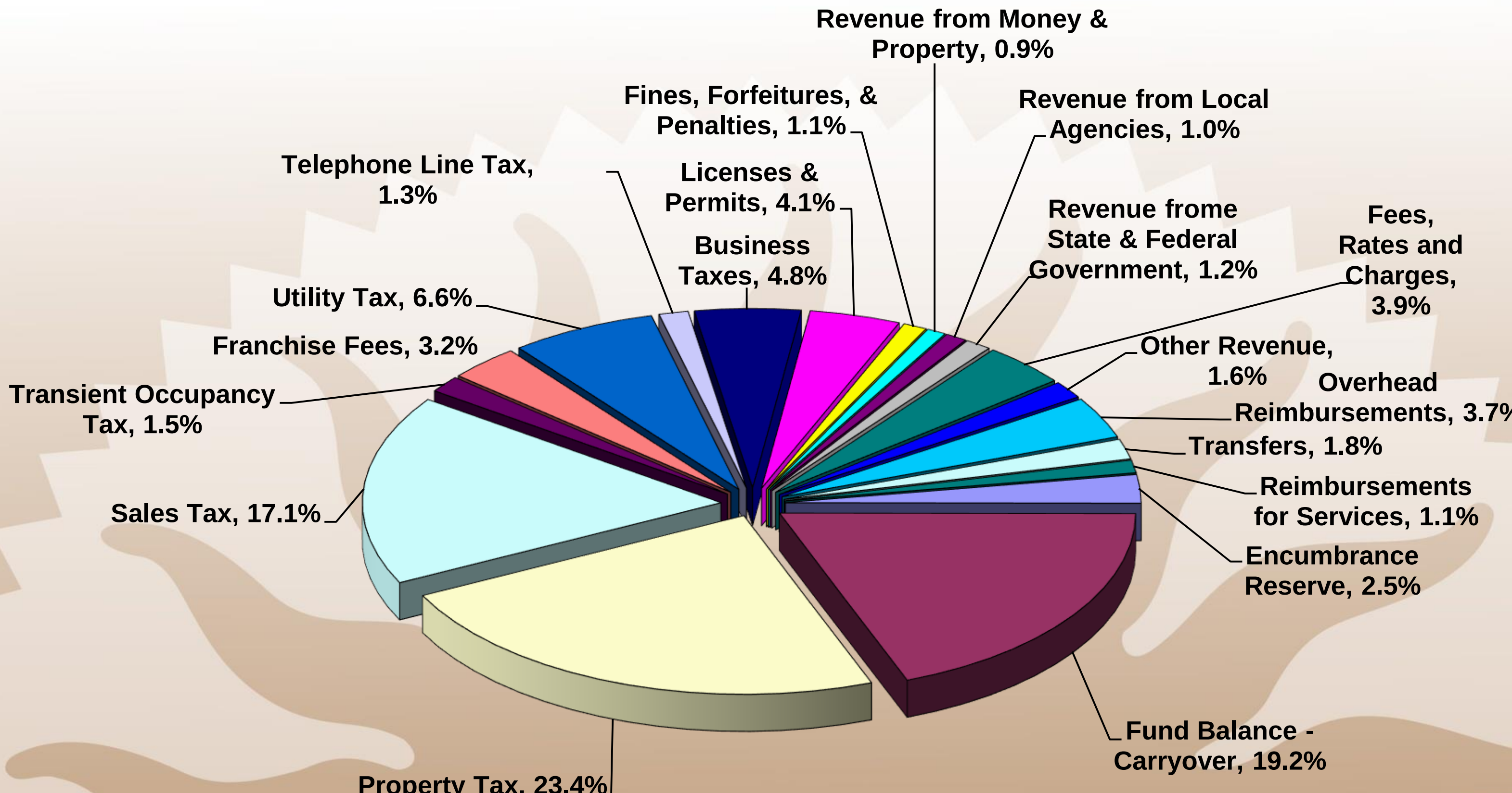
Neighborhood Services
- Library
- Parks & Community Facilities

Public Safety
- Public Safety

Transportation and Aviation Services
- Airport
- Parking
- Traffic

Strategic Support
- Communications
- Municipal Improvements
- Service Yards

2019-2020 ADOPTED BUDGET
General Fund Funding Sources



TOTAL GENERAL FUND SOURCES: $1,510,135,437

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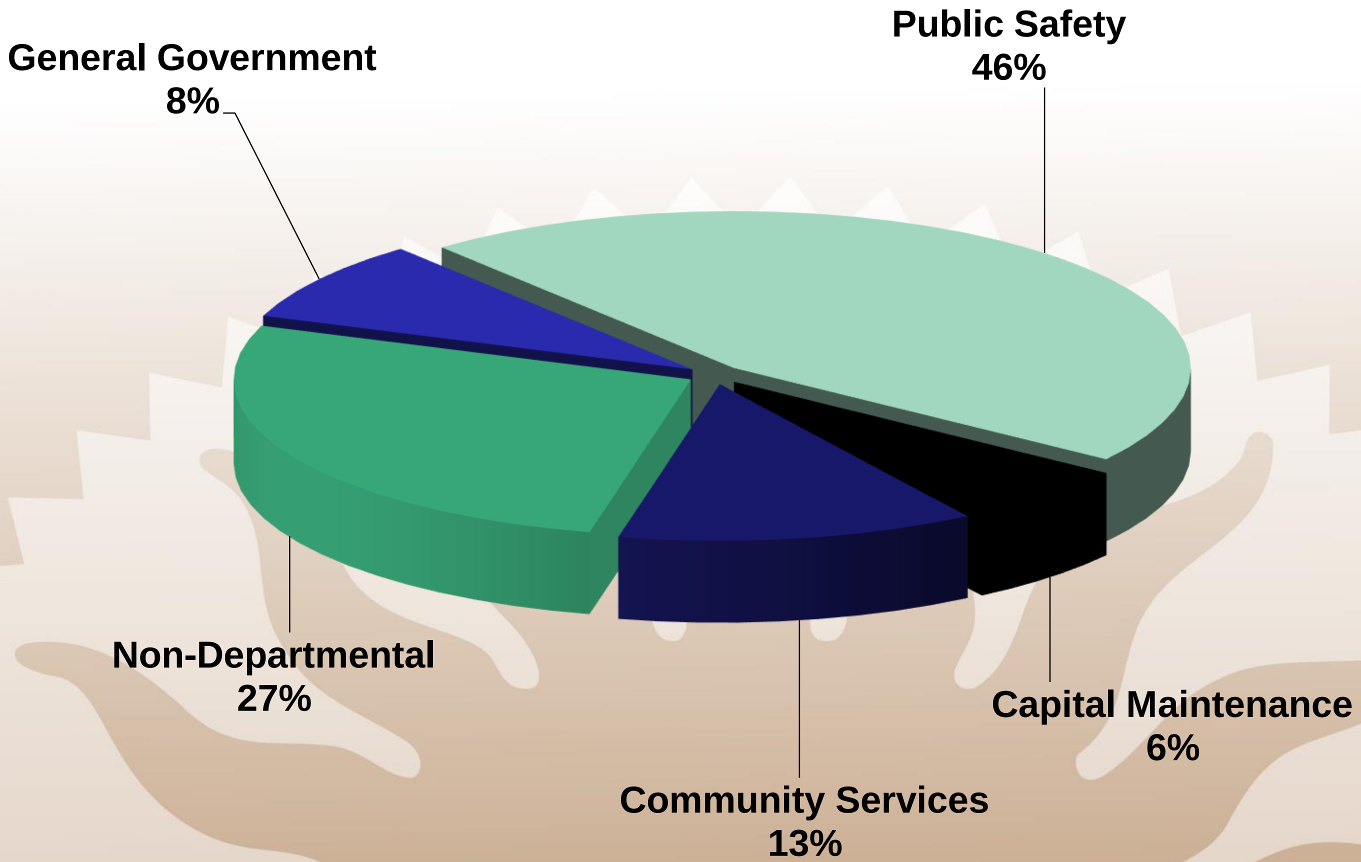
2019-2020 ADOPTED BUDGET
General Fund Uses



TOTAL GENERAL FUND USES: $1,510,135,437

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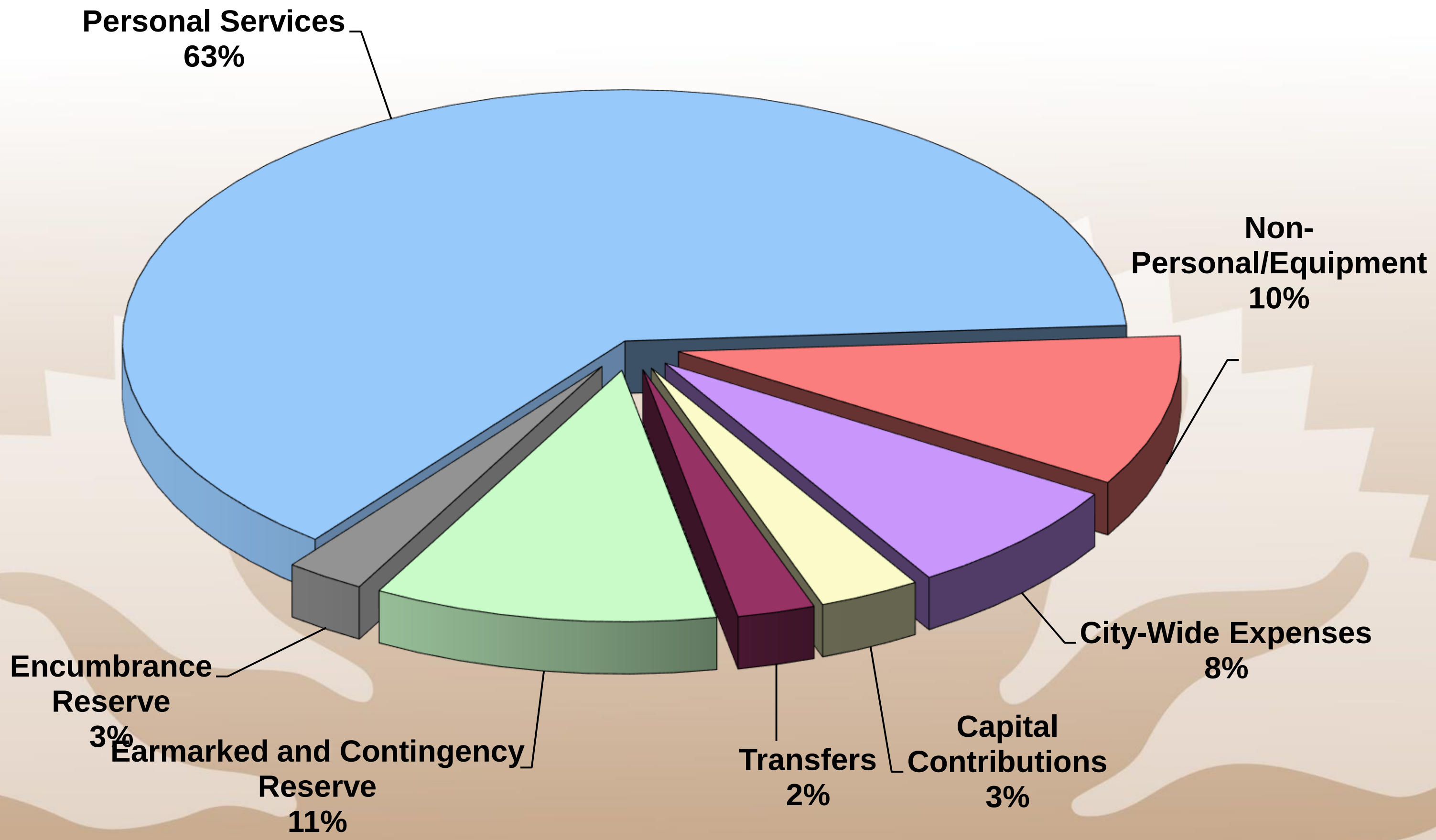
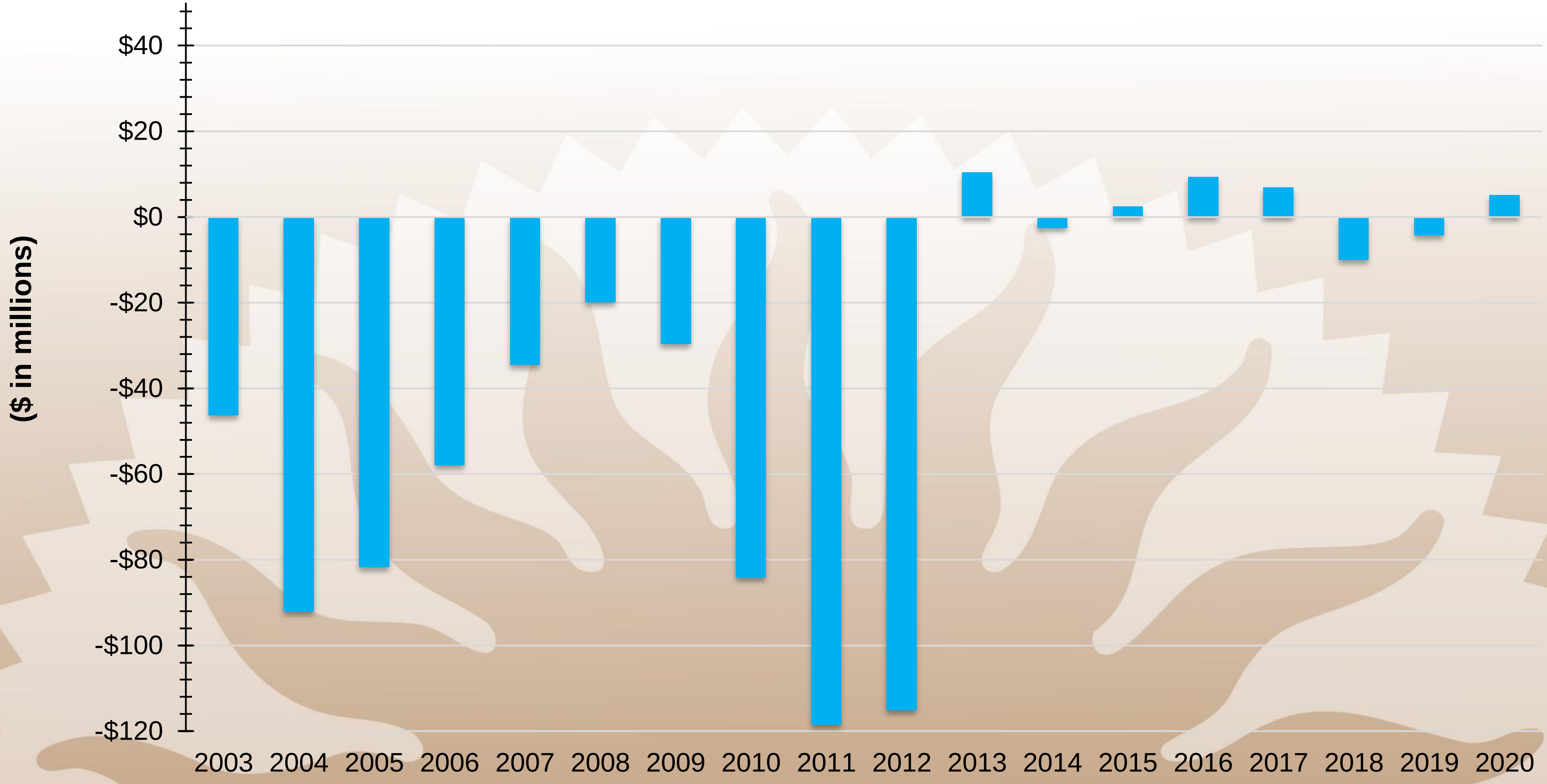
2019-2020 ADOPTED BUDGET
General Fund Uses by Category



TOTAL GENERAL FUND USES $1,510,135,437

CITY BUDGET – HISTORICAL PERSPECTIVE
Decade of General Fund Shortfalls Solved



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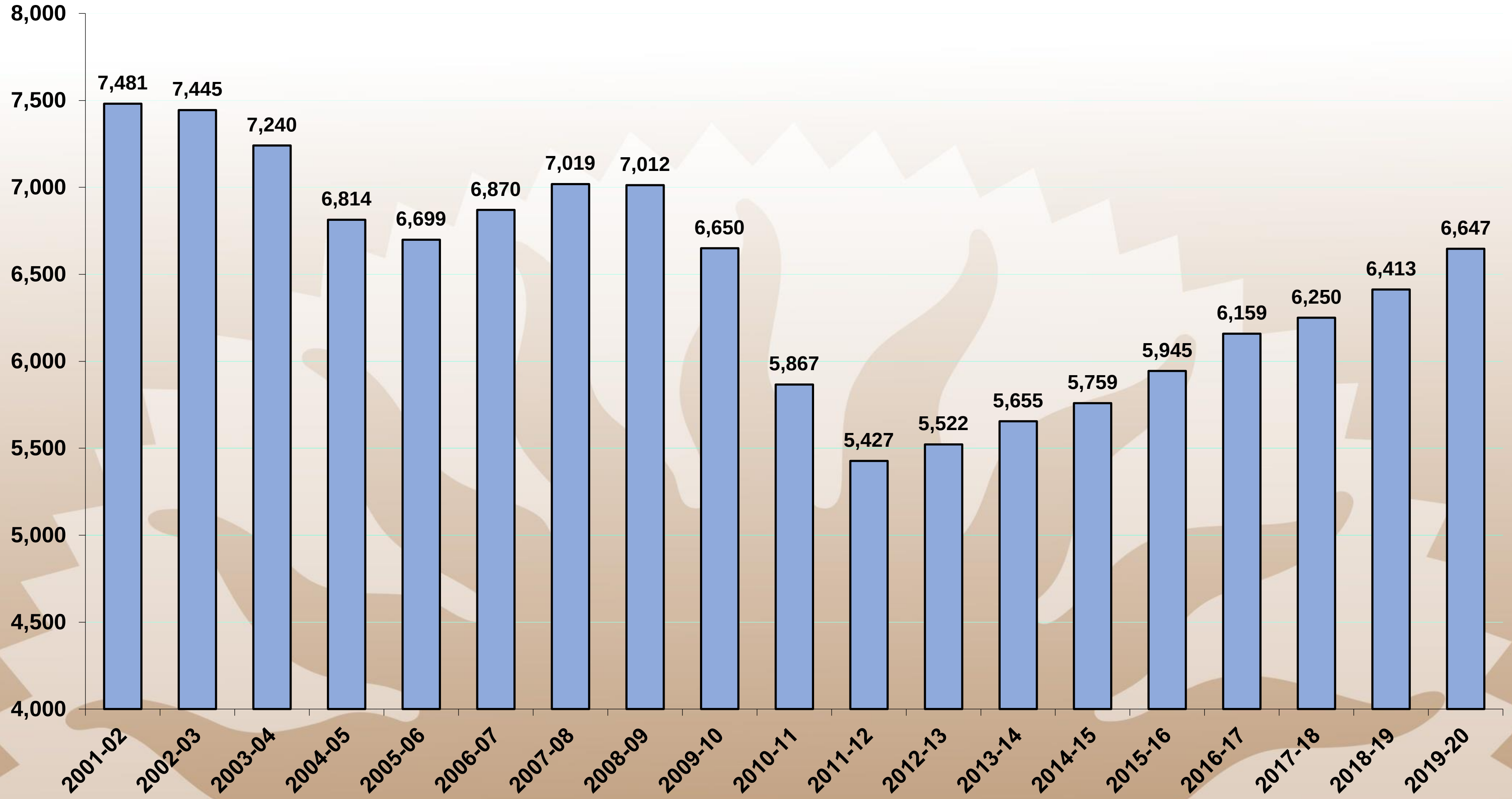
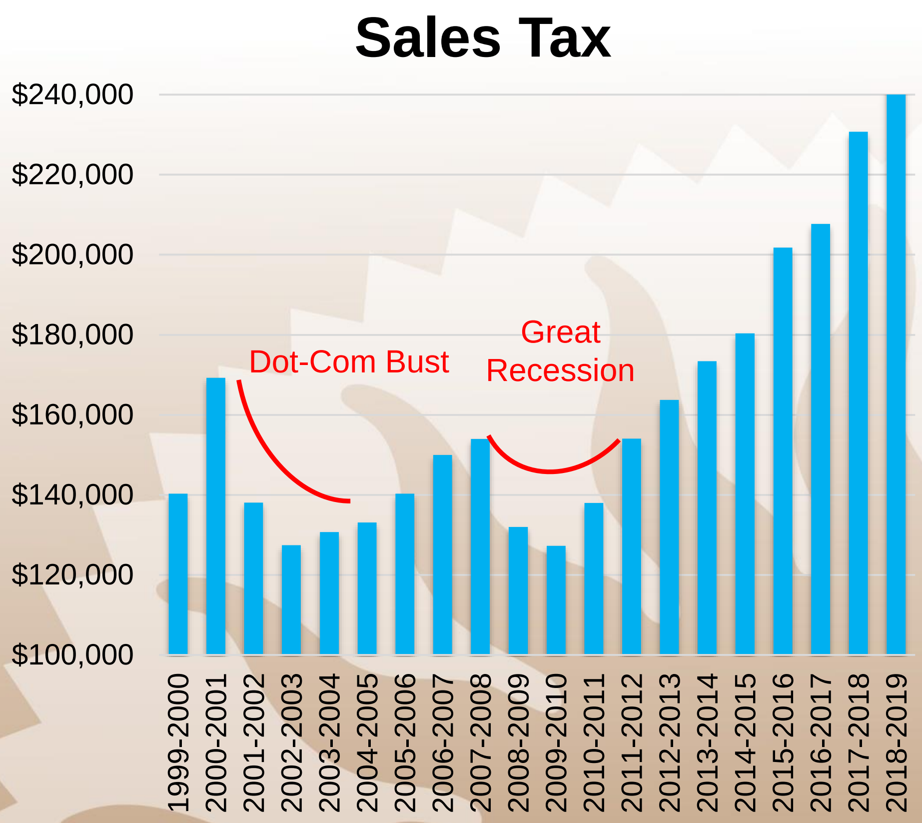
CITY BUDGET – HISTORICAL PERSPECTIVE
Budgeted Positions Well Below Peak in 2001-2002

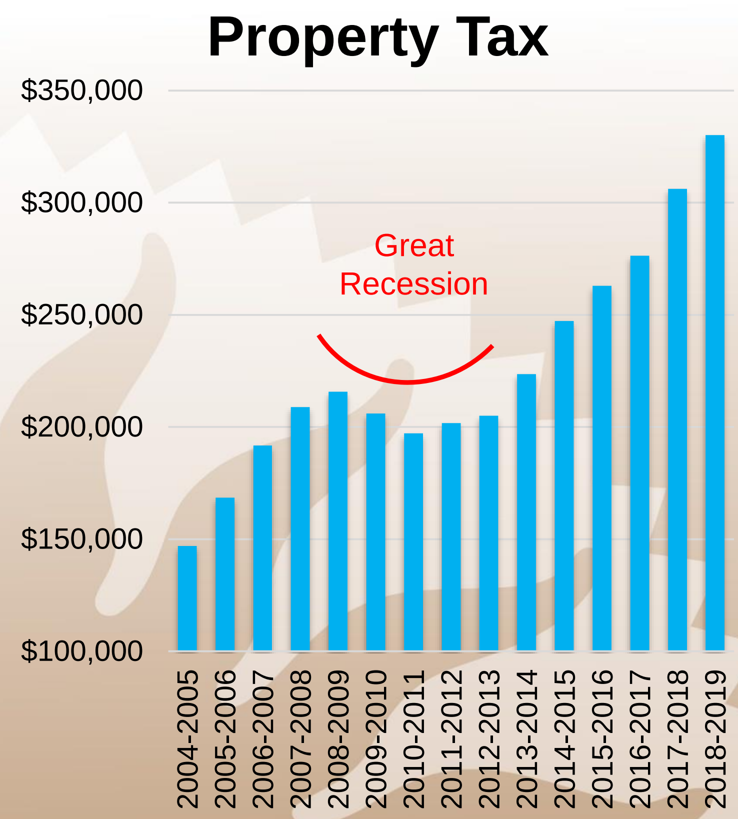


CITY BUDGET – HISTORICAL PERSPECTIVE
Economically Sensitive General Fund Revenues

$ in thousands
(All figures not adjusted for inflation)



For 2015-2016, amount excludes one-time "Triple Flip" wind down monies; Local Sales Tax implemented October 2016



Graph begins in 2004-2005 due to a change in the calculation formula of property tax

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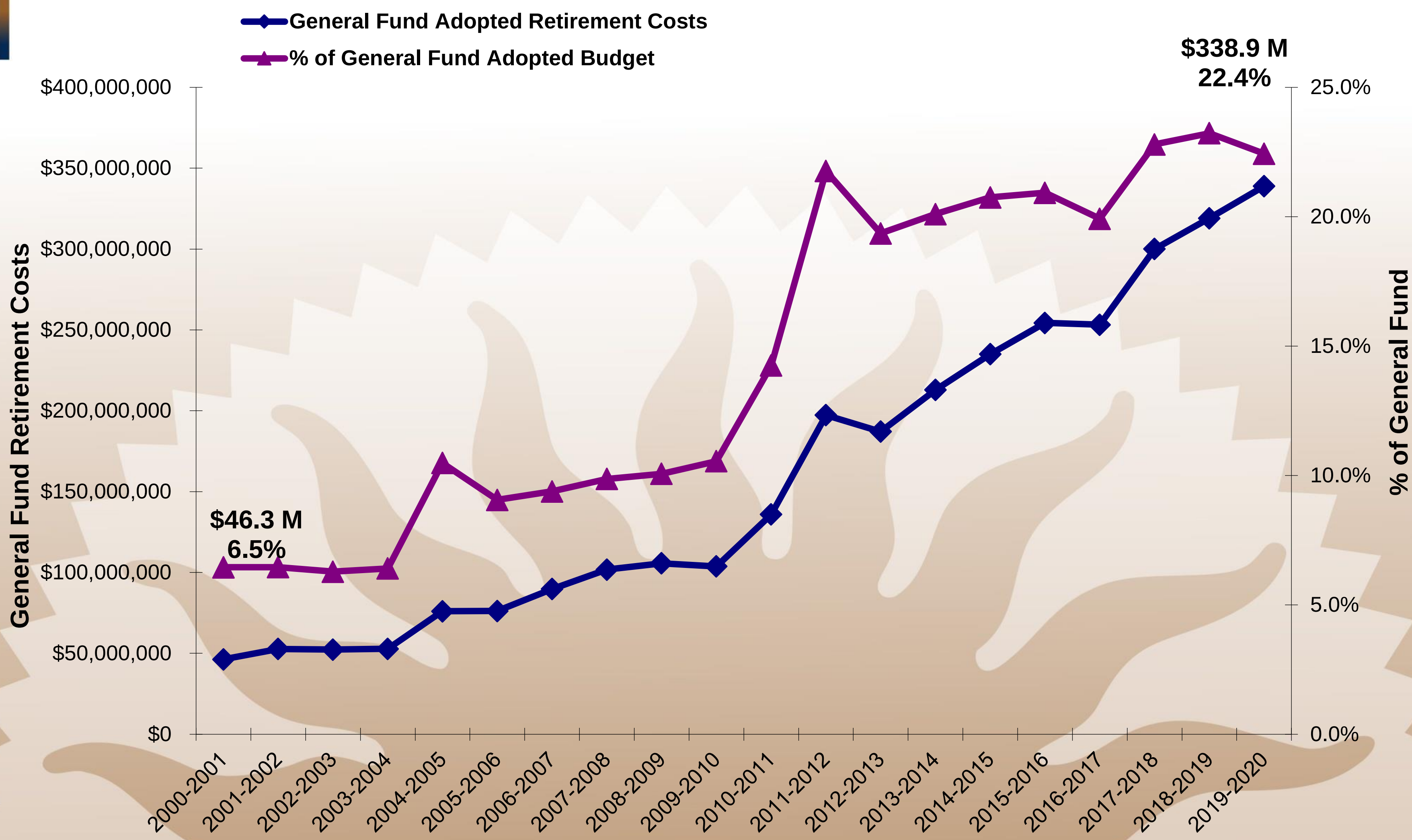
CITY BUDGET – HISTORICAL PERSPECTIVE
Escalating Retirement Costs (General Fund)



CITY BUDGET – HISTORICAL PERSPECTIVE
Strategies Used to Address General Fund Shortfalls

Strategy #1 **Cost Savings**

Strategy #2 **Revenues**

Strategy #3 **Service Reductions/Eliminations**

CITY BUDGET – HISTORICAL PERSPECTIVE
#1: Cost Savings Strategies

- Wage freezes
- 10% total compensation reductions and rollback of 2010-2011 wage increases for certain bargaining units ($40 million)
- Pension reform, including Supplemental Retiree Benefit Reserve (SRBR) elimination, retiree healthcare changes (lowest cost plan), and new Tier 2 retirement plans ($25 million)
- Outsourced City services at lower cost
- Consolidated City operations and services
- Implemented new technology in libraries to reduce staffing needs
- Civilianized police and fire functions to lower costs
- Developed public-private partnerships for parks maintenance

CITY BUDGET – HISTORICAL PERSPECTIVE
#2: Revenue Strategies

- **Voter-Approved Ballot Measures**
  - Nov. 2008 – replaced Emergency Communication System Support Fee with Telephone Line Tax ($20.5 million – not new revenue)
  - Nov. 2008 – reduced/broadened the Telephone Utility Tax ($30.8 million–not new revenue)
  - June 2010 – $3 million by increasing Cardroom Business Tax rate and increasing number of cardroom tables allowed
  - Nov. 2010 – $2.5 million by establishing Marijuana Business Tax; $1.5 million from increase to tax rate to max. allowable in 2013
  - June 2016 - $40 million Local Sales Tax (effective October 2016)
  - Nov. 2016 - $12.0 million by modernizing the Business Tax
- **Adjusted Fees and Charges**
  - Fees and Charges adjusted to maintain or achieve cost recovery
- **Used One-Time Revenue Sources**
  - Exhausted City's Economic Uncertainty Reserve – $15.8 million in 2001-2002 spent down to zero as of 2011-2012
  - Made maximum allowable transfers from other funds (e.g., Construction Excise Tax Fund)
  - Used revenue from legal settlements and property sales

CITY BUDGET – HISTORICAL PERSPECTIVE
#3: Service Reductions/Eliminations

Significant service reductions in both public safety and non-public safety areas

- Reduced police field patrol, special operations (metro, downtown, VCET, curfew, canine, horse mounted units) and investigative services in all areas
- Reduced police school liaison, PAB lobby hours/staff, police pre-processing center, training, performance analysis and research
- Reduced fire apparatus staffing and fire companies
- Reduced community centers (down from 56 at peak in 2007-2008 to 12 in 2013-2014); 39 sites in re-use program
- Reduced neighborhood and regional parks maintenance and park ranger staffing
- Reduced/eliminated recreational services and special events support
- Reduced/eliminated services to seniors, persons with disabilities, and youth
- Reduced code enforcement staffing
- Reduced strong neighborhoods initiative
- Reduced long-range planning services
- Less resources for pavement maintenance (special funds, grants)
- Reduced traffic maintenance program (e.g., traffic signals, streetlights, roadway striping)
- Eliminated funding for sidewalk repairs and street tree services (property owners responsible)
- Reduced street landscape services
- Reduced transportation operations services (e.g., traffic calming, neighborhood traffic studies)

Retirement Impacts on Budget Development

Annual Budget Development Process

Sept - Jan	Develop Base Budget
Nov/Dec	Preliminary General Fund Budget Planning
January	Community Budget Meeting and Outreach
February	Five-Year General Fund Forecast Released
March	Mayor’s March Budget Message Released/Public Hearing
April/May	Proposed Operating/Capital Budgets, Fees & Charges Released
May	Budget Study Sessions/Public Hearings; Community Budget Meetings; Manager Budget Addenda and Council Budget Documents Released
June	Mayor’s June Budget Message Released/Public Hearing; City Council Final Adoption of Budget

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Incorporating Retirement Costs into the Budget

- Preliminary Valuation Results from the actuary for each of the Retirement Plans in November/December

- Final Retirement Contributions Factored into Five-Year Forecast (issued at the end of February)

- Use Actuarial Reports for Federated and Police and Fire Retirement Systems with Adjustments for Budgeted Personal Services, and UAL Funding Calculation

- Data Needed for Five-Year Period

2020-2024 General Fund Forecast

2020-2024 General Fund Forecast
Incremental General Fund Shortfalls

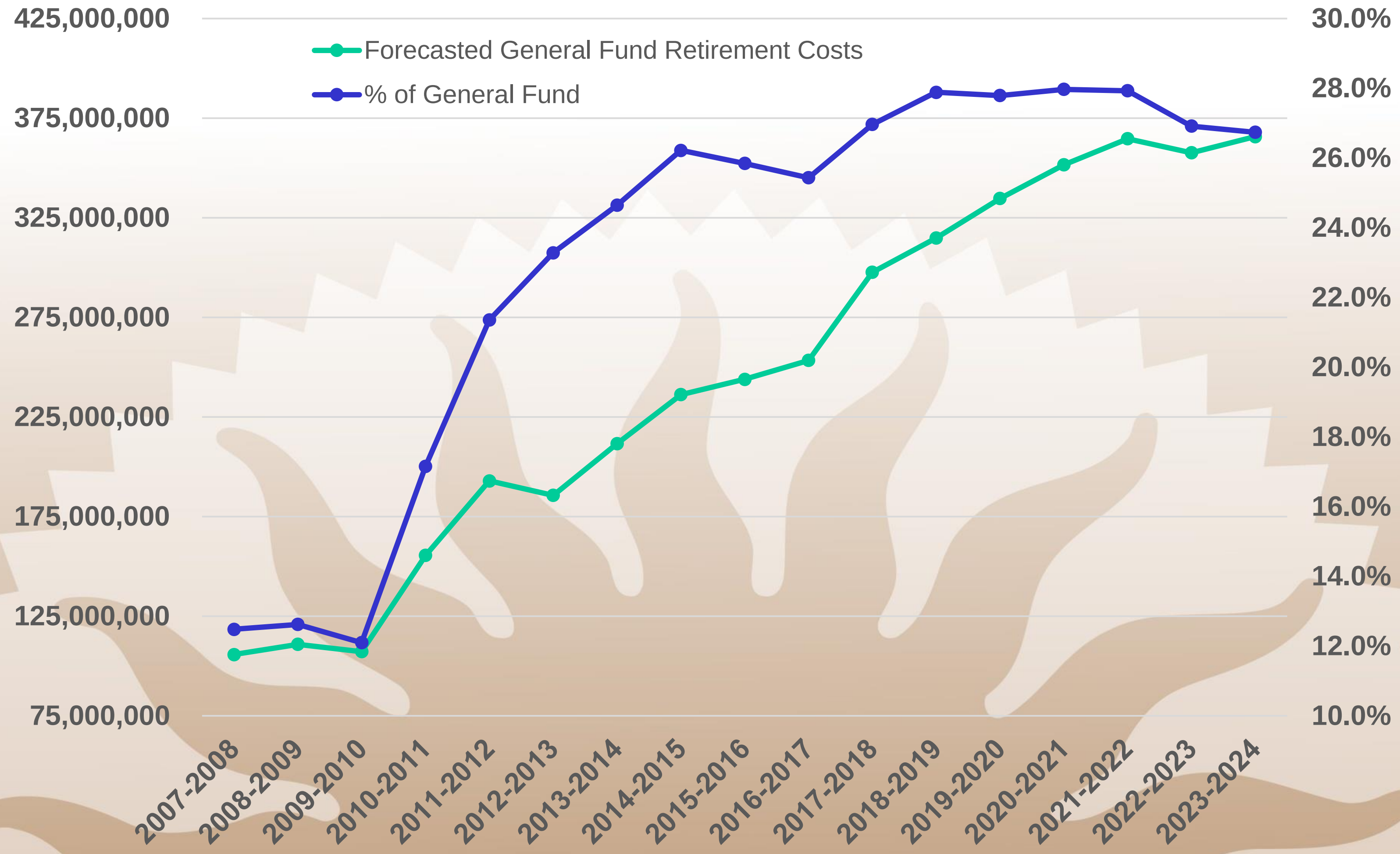
	2019-2020	2020-2021	2021-2022	2022-2023	2023-2024
Incremental Shortfalls	$5.1 M*	($10.9 M)*	($13.7 M)	$11.4 M	($1.7 M)
% of Annual Budget	(0.4%)	(0.9%)	(1.0%)	(0.9%)	0.1%

**These figures were revised from the $3.5 million surplus and $15.6 million deficit in 2019-2020 and 2020-2021, respectively, as presented in the February 2019 Forecast. The figure for 2019-2020 was revised as a result of continued analysis of projected revenues and expenditures; the 2020-2021 figure was revised downward to account for the $4.7 million of unallocated ongoing surplus in 2019-2020.

Does not include:

- Costs associated with services funded on a one-time basis in 2018-2019
- Costs associated with unmet/deferred infrastructure and maintenance needs
- One-time revenues/expenses

Forecasted General Fund Retirement Costs Historical and as Forecasted through FY 2024



2020-2024 General Fund Forecast

($ in Millions)

Retirement Plans	2020-2021	2021-2022	2022-2023	2023-2024
Federated Retirement Plan				
Tier 1 Pension (Normal Cost)	$15.9	$14.4	$13.1	$11.8
Tier 2 Pension	$9.3	$10.5	$11.5	$12.7
Unfunded Actuarial Liability	$81.3	$85.4	$88.0	$90.9
Retiree Health Care	$12.2	$12.4	$12.6	$12.6
Total Federated Contributions	**$118.7**	**$122.7**	**$125.2**	**$128.0**
Police and Fire Retirement Plans				
Tier 1 Pension (Normal Cost)	$56.0	$52.6	$48.9	$45.3
Tier 2 Pension	$12.8	$15.9	$19.2	$22.5
Unfunded Actuarial Liability	$137.8	$145.5	$135.1	$139.5
Retiree Health Care	$25.4	$27.0	$28.3	$29.5
Total Police and Fire Contributions	**$232.0**	**$241.0**	**$231.5**	**$236.8**
Other Retirement Contributions	**$0.8**	**$0.9**	**$0.9**	**$0.9**
Total General Fund	**$351.5**	**$364.6**	**$357.6**	**$365.7**
Total All Funds	**$448.0**	**$464.3**	**$459.4**	**$469.7**

CITY OF SAN JOSE
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Rating Agencies' Views on Pension Obligations

City of San Jose Credit Ratings

- City of San Jose has several credits that are rated by Moody's Investors Service, Standard & Poor's and Fitch Ratings
- Ratings include City's General Obligation Bond which is considered by some as the "report card" rating for the City – Aa1/AA+/AA+
- Other credits include Airport, Sewer Revenue, Lease Revenue, Tax Allocation Bonds

Moody's Rating Process and Views On Pensions

- Uses a Scorecard as a tool in providing a composite score of local government's credit profile – not viewed as a calculator

EXHIBIT 1

Scorecard Factors and Weights

Local Governments

Broad Scorecard Factors	Factor Weighting	Sub-factors	Sub-factor Weighting
Economy/Tax Base	30%	Tax Base Size (full value)	10%
		Full Value Per Capita	10%
		Wealth (median family income)	10%
Finances	30%	Fund Balance (% of revenues)	10%
		Fund Balance Trend (5-year change)	5%
		Cash Balance (% of revenues)	10%
		Cash Balance Trend (5-year change)	5%
Management	20%	Institutional Framework	10%
		Operating History	10%
Debt/Pensions	20%	Debt to Full Value	5%
		Debt to Revenue	5%
		Moody's-adjusted Net Pension Liability (3-year average) to Full Value	5%
		Moody's-adjusted Net Pension Liability (3-year average) to Revenue	5%

Source: Moody's US Local Government General Obligation Debt, September 27, 2019, page 3

Moody's Rating Process and Views On Pensions

- Why Moody's views debt/pensions as important components of long-term financial obligations facing local government
  - Measures of financial leverage of community
  - See pension liabilities as similar to debt, but not identical
  - Because of disparities in way local governments measure and report pension liabilities, use internal standardization process to adjust liability
  - Pension scores are used as a starting point for an analysis of the pension position and its impact on operations.
    - Analysis considers the funded status, future contributions, and overall liability in the context of the local government's long-term resources.
    - Analysis is not driven solely by the ANPL number.

Moody’s Views on San Jose

- City’s General Obligation – Aa1, with stable outlook
- Last confirmed June 21, 2019
- Rating commentary, *“… has a large and diverse tax base poised for continued healthy growth, and city residents’ have solid wealth indicators. … benefits from a robust economy with a low unemployment rate and tech companies continue to make large investments in office space and retail developments. …* ***sound financial position that is expected to remain healthy, which is largely due to management’s adopted fiscal policies and conservative budgetary practices. Pension and OPEB costs will remain high and continue to be budgetary pressures*** *(emphasis added)***.** *… expect the city’s revenue base to remain very strong and that management will to continue to implement the necessary strategies to fund these expenditures, while preserving the city’s healthy financial position.”*
- Moody's three-year adjusted net pension liability (ANPL) for the city, under methodology for adjusting reported pension data, equaled $6.8 billion or elevated at 4.1 times operating revenues and equates to a Baa-rating score on their scorecard. Moody's makes certain adjustments to improve comparability of reported pension liabilities and to improve comparability with other rated entities.

S&P's Rating Process and Views On Pensions

- Criteria assign ratings based on the assessment and scoring of seven key factors:
  1. Institutional framework
  2. Economy
  3. Management
  4. Budgetary flexibility
  5. Budgetary performance
  6. Liquidity
  7. Debt and contingent liabilities
- Analytic focus when assessing the pension and OPEB burden:
  - Required annual pension payment plus annual OPEB payment as a percentage of total governmental funds expenditures;
  - Actuarial funded ratio(s) of the pension plan(s) and if the ratio(s) are less than 80%, further review;
  - Contributions actually made to all pension plans;
  - OPEB costs exceed 5% of total governmental funds expenditures and limited flexibility to change or amend these benefits.

S&P's Rating Process and Views On Pensions

Guidelines For Typical U.S. Public Finance Pension And OPEB Plans	
Actuarial assumption or method	**S&P Global Ratings guideline as of Oct. 7, 2019**
Funding Goal	100%
Discount Rate	6.50%
Actual Contribution	Minimum funding progress
Amortization Methods	
Period	Closed
Length	≤ 20 years
Basis	Level-dollar or minimal payment acceleration
Payroll Growth Assumption	< 1% + long-term inflation
Longevity	Generational Improvements
Long-Term Medical Cost Trend	5%

Source: Standard & Poor's -** Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings* ***– October 7, 2019, page 3

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S&P's Rating Process and Views On Pensions

"Assumptions as well as funding methods underpin the trajectory of pension and OPEB costs, informing our assessment of obligor credit risk. We believe the most sustainable pension and OPEB plans prioritize long term savings and stability over short-term budgetary relief by using conservative assumptions and methods and proactively addressing liabilities."

S&P's Views on San Jose

- City's General Obligation and Issuer Credit Rating – AA+, with stable outlook
- Last confirmed June 18, 2019
- Rating reflects, *"… very favorable economic conditions as the technology sector has led the way during the nation's long-running economic expansion, which has supported local employment growth and surging real estate values. …* ***a significant portion of this revenue growth … offset by rising nondiscretionary expenditures--specifically for pension and other postemployment benefits--and very large liabilities remain in these areas (emphasis added)****. … believe that the city's overall credit profile will remain very strong going forward, based on our view that the city's very strong management policies and practices are well embedded within the organization and the city continues to hold very strong reserve balances despite modest drawdowns in recent years."*

S&P's Views on San Jose Pension Liabilities

- **S&P opinions on pension liabilities** - *"In our opinion, the City has a very large pension liability … and low funded ratios … with no plan to address the liability other than annual required contributions. The low funded ratios are driven in part by the lower-than-average assumed earnings rates of 6.75% for each plan; … still view the pension liability as very large even if the assumed earnings rate was in line with the statewide average and the funded ratios were correspondingly better. The city also has large other postemployment benefit liabilities … and low funded ratios."*

Fitch's Rating Process and Views On Pensions

- **Four Key Drivers Assessed:**
  1. Revenue framework
  2. Expenditure framework
  3. Long-term liability burden
  4. Operating performance
- Considers combined debt and net pension liability metric to be of primary importance in the assessment of a government's long-term liability burden.
- Believes that debt and net pension liabilities are effectively equivalent obligations.
- Evaluating an issuer's net pension liability – considers not only the current liability but also the expected trajectory.
- Relatively high exposure to riskier, more volatile investment classes may suggest additional risk that can negatively affect the liability assessment.

Fitch’s Views on San Jose

- City’s General Obligation and Issuer Default Rating – AA+, with stable outlook
- Last confirmed June 13, 2019
- Rating reflects, *“… strong economy and concomitant revenue growth, adequate expenditure flexibility, moderate liability burden and consistently strong reserves relative to its revenue volatility and budget flexibility. Concerns about the city's relatively high carrying costs for debt service and pension liabilities are partially offset by management's focus on fiscal balance, including a multiyear forecast with a recession scenario, and demonstrated flexibility of other spending categories.”*

Pension Obligations are a Driver in the Rating Process

- All three rating agencies have metrics and analytical tools to measure local agencies' pension and OPEB obligation exposure
- Impacts the City's rating, and City's strong management and budget policies have demonstrated dedication to manage large pension obligations and offset lower metrics related to pension liabilities
- Budgetary tools available to cover increasing pension costs are often on the expenditure side of the balancing equation

Pension Obligations are a Driver in the Rating Process

- As single employer plans – San Jose reports pension information in Comprehensive Annual Financial Report
- Access to public bond market requires extensive disclosure of City's pension obligations in offering documents
- City issued $502.02 million in General Obligation Bonds in July 2019 and undertook updating of "Appendix B – The City of San Jose Retirement Plans"
- Copy of Official Statement can be found on the Municipal Securities Rulemaking Board, Electronic Municipal Market Access (EMMA)

https://emma.msrb.org/ER1253338-ES1010358-ES1411721.pdf

Questions and Answers