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Sent to Council:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Nadine Nader

SUBJECT: Early Council Packet

DATE: September 21, 2010

Approved Dana Ah-Tye Date 9/21/10

EARLY DISTRIBUTION COUNCIL PACKET FOR OCTOBER 5, 2010

Please find attached the Early Distribution Council Packet for the October 5, 2010 Council Meeting.

3.x Response to the Santa Clara County Civil Grand Jury Report entitled "Cities Must Rein in Unsustainable Employee Costs."

Recommendation: Approve the response to the 2009-2010 Santa Clara County Civil Grand Jury Report entitled "Cities Must Rein in Unsustainable Employee Costs."
CEQA: Not a Project, File No.PP10-069(a), Staff Reports/Assessments/Annual Reports/ Information Memos. (City Manager's Office)

4.x Actions Related to the RFP for the San José McEnery Convention Center Expansion and Renovation Project.

Recommendation: Adopt a resolution:

(a) Approving the final rankings of the five design-build entities that responded to the RFP for the San José McEnery Convention Center Expansion and Renovation Project; and;

(b) Authorizing the Public Works Director to negotiate a design-build contract for the Project as follows:

(1) Begin negotiating with the highest ranked contractor, Hunt Construction Group;

(2) Begin negotiating with the next highest ranked contractor, Turner Construction, if after having negotiated with Hunt, the Director determines that the City's interests are best served by beginning negotiations with the next highest ranked contractor; and

(3) Begin negotiating with each of the other contractors in order of their ranking as the Director determines is appropriate.

CEQA: Resolution No. 72767 and Addenda thereto. File No. PP08-002. (Public Works)

7.x Actions Related to Fuel Cell System Power Production.

Recommendation: Accept the report on the Request for Proposals for a Power Purchase and Site Lease Agreement for Fuel Cell System Power Production and adopt a resolution authorizing the Director of Finance to execute a Power Purchase Agreement, Site Lease and other necessary documents, with UTS Bio-Energy SJ-1, LLC (UTS) (Encinitas, CA) to purchase fuel cell energy at the Plant for a 20 year term. CEQA: Exempt, File No. PP10-112. (Environmental Services/Finance)

These items will also be included in the Council Agenda Packet with item numbers.

NADINE NADER
Assistant to the City Manager

COUNCIL AGENDA: 10/05/10
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: SEE BELOW

DATE: September 21, 2010

SUBJECT: SANTA CLARA COUNTY CIVIL GRAND JURY REPORT – CITIES MUST REIN IN UNSUSTAINABLE EMPLOYEE COSTS

RECOMMENDATION

It is recommended that the Mayor and City Council approve this response to the 2009-2010 Santa Clara County Civil Grand Jury Report entitled "Cities Must Rein in Unsustainable Employee Costs."

OUTCOME

Approval of this report will satisfy the requirements of Penal Code Section 933(c), which requires the City Council to respond to Civil Grand Jury reports to the presiding judge of the Superior Court.

BACKGROUND

Grand Jury Report

The Santa Clara County Civil Grand Jury provided the City with its final report, including findings and recommendations, entitled "Cities Must Rein in Unsustainable Employee Costs." (Please see Attachment A.) According to the report, the subject of the Grand Jury's inquiry was,

Employee costs are escalating in the cities of Santa Clara County (County), revenues are not keeping pace with these increases and cities are cutting services. How do cities contain these escalating employee costs?

The report contains 13 findings with applicable recommendations. The City has responded to each of those findings and recommendations in accordance with California Penal Code Section

933.05, which states that the responding person or entity shall indicate one of the following with respect to each finding and recommendation:

Finding:

1. The respondent agrees with the finding.

2. The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons thereafter.

Recommendation:

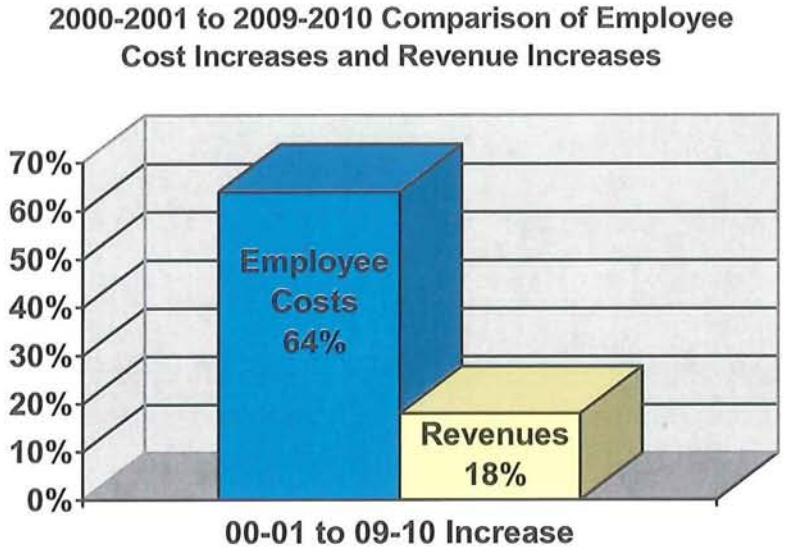
1. The recommendation has been implemented, with a summary regarding the implemented action.

2. The recommendation has not yet been implemented, but will be implemented in the future, with a time frame for implementation.

3. The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a time frame for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This timeframe shall not exceed six months from the date of publication of the grand jury report.

4. The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefor.

The summary of the report indicates that "[t]here is widespread concern that the cost of employee total compensation continues to increase while revenues and services decrease" and that, "[t]he overall costs to cities are not sustainable." The City agrees that the rising personnel costs have outpaced the growth of the City's revenues for the last 9 years. From 2000-2001 to 2009-2010, the average total cost per full-time employee increased by 64%, but the revenues during that same time period only increased by 18%.



It is important to note that the City is not placing the blame for the rising personnel costs on City employees. Because the City is a service organization, most of the City's costs are for employees who provide those essential services.

The primary focus of the Grand Jury's findings and recommendations are options to control personnel costs. The City has either already implemented, is in the process of implementing, or is in the process of reviewing the majority of these recommendations. In summary, the recommendations to the cities in Santa Clara County fall into the following categories as provided in the Grand Jury report:

Long Term Options to Control Employee Costs

- Renegotiate contracts for existing employees with the unions
- Change pension and retiree healthcare benefits for new hires
- Alter personnel policies and workplace practices
- Recommend ballot measures that could mandate changes

Short Term Options to Control Employee Costs

- Ordering furloughs
- Imposing temporary wage freeze
- Enforcing a hiring freeze
- Eliminating vacant positions
- Laying-off staff

With the City's fiscal situation, it is important to ensure that all options to control personnel costs are evaluated.

City's Fiscal Situation

Fiscal Year 2009-2010 was the eighth year in a row that the City has faced a structural budget deficit. The Grand Jury report notes the following major factors contributing to cities' fiscal problems:

- Increased wage and salary costs
- Increased retirement and health care costs
- Reduced property tax revenues
- Reduced sales tax, occupancy tax, and construction tax revenues
- Reduced revenue from the state

The City agrees that the above factors have contributed to the City's fiscal situation. The City has already had to utilize many of the long-term and short-term strategies noted above, in addressing the budget shortfalls. For example, the City has had a voluntary furlough program in place, has instituted hiring freezes, and has eliminated many vacant positions for multiple fiscal years.

In June 2010, the City approved a budget that solved a $118.5 million shortfall for Fiscal Year 2010-2011, which was the highest shortfall the City has had in those eight years of budget deficits. A significant factor in the City's ability to resolve this shortfall was that approximately 1,800 of the City's approximately 5,700 employees took a 10% reduction in total compensation, approximately 50 employees took a 5% reduction in total compensation, and approximately 1100 employees took an a 3.82% total compensation reduction. This was a significant contribution and one that was greatly appreciated and recognized.

Unfortunately, the City is expected to face ongoing structural budget deficits in the next four years (see table below), which is why it is important to evaluate all options, including those recommendations contained in the Grand Jury's report, to control the City's costs.

General Fund Deficits Projected Into Future
($ in Millions)

	2011-2012	2012-2013	2013-2014	2014-2015	Total
Projected Base Shortfall (February 2010 Forecast) [1] [2]	($20.2)	($18.0)	($21.5)	($5.8)	($65.5)
2010-2011 One-Time Solutions	($20.5)				($20.5)
Total Incremental Deficit	**($40.7)**	**($18.0)**	**($21.5)**	**($5.8)**	**($86.0)**

[1] Does not include Development Fee Programs. No cost-of-living salary adjustments assumed.
[2] Does not include unmet/deferred infrastructure and maintenance one-time needs of $446 million ($788 million all funds) and ongoing needs of $43 million ($45 million all funds).

GRAND JURY FINDINGS, RECOMMENDATIONS AND CITY'S RESPONSE

Grand Jury Finding 1

The costs of total compensation for employees have grown substantially in the past decade and now threaten the cities' fiscal stability.

City Response to Finding 1

The City agrees with this finding. As shown below, for the City's sworn employee bargaining units, the San Jose Police Officers' Association ("POA") and the San Jose Fire Fighters Union, from Fiscal Year 2000-2001 to Fiscal Year 2009-2010, the City's average cost per employee for pay and benefits has increased by 77.64%. However, as shown below, during that same time period, the number of full time equivalent positions (FTEs) has only increased by 2.13%. The major factor in the increase in average total cost per FTE was for retirement benefits, which increased by **174.69%**.

Sworn Salary and Benefits[3,4]			
	2000-2001	**2009-2010**	**% Increase**
BASE PAYROLL (includes special/premium pays for all employees)	$153,485,514	$248,621,465	**61.98%**
RETIREMENT BENEFITS	$23,520,821	$64,609,556	**174.69%**
HEALTH/DENTAL BENEFITS	$9,692,922	$22,904,476	**136.30%**
OTHER BENEFITS	$1,778,656	$5,800,686	**226.13%**
GRAND TOTAL	**$188,477,913**	**$341,936,183**	**81.42%**
Average Total Cost Per FTE	**$91,052**	**$161,748**	**77.64%**
TOTAL FTEs	2070.00	2114.00	**2.13%**

[3] Source - Salary and Fringe Benefit Costs by Union Code & Fund for the 2000-2001 Adopted Budget to the 2009-2010 Adopted Budget.

[4] This does not include worker's compensation costs or overtime costs. The figures above are budgeted costs and include the cost of providing paid time off, such as vacation, holidays, personal/executive leave, and sick leave, to the extent that paid leave is taken during the fiscal year. The actual salary and benefit costs of individual employees vary.

Although the costs for our non-sworn employees did not increase as dramatically as the costs for sworn employees, there has also been a significant increase in costs for non-sworn employees. As shown below, from Fiscal Year 2000-2001 to Fiscal Year 2009-2010, the City's average cost per non-sworn employee for pay and benefits has increased by 52.48%. However, as shown below, during that same time period, the number of FTEs has decreased by 8.76%.

Non-Sworn Salary and Benefits [5] [6]			
	2000-2001	**2009-2010**	**% Increase**
BASE PAYROLL (includes special/premium pays for all employees)	$262,524,906	$333,716,243	**27.12%**
RETIREMENT BENEFITS	$39,533,262	$72,862,473	**84.31%**
HEALTH/DENTAL BENEFITS	$20,624,870	$41,293,502	**100.21%**
OTHER BENEFITS	$4,829,656	$7,765,501	**60.79%**
GRAND TOTAL	**$327,512,694**	**$455,637,719**	**39.12%**
Average Total Cost per FTE	**$66,264**	**$101,043**	**52.48%**
TOTAL FTEs	**4942.51**	**4509.36**	**-8.76%**

Grand Jury Recommendation 1

All of the cities in the County need to implement measures that will control employee costs. As a starting point, each city should determine the percentage of savings required from the total compensation package to reach budget stability, and provide choices of wages and benefits in collective bargaining sessions for the unions to choose to achieve that percentage goal.

City Response to Recommendation 1

This recommendation has been implemented. It is important to look at total compensation, as an employee's compensation package is more than just base pay. Total compensation also includes the value of the cost of benefits, including pension and

[5] Source - Salary and Fringe Benefit Costs by Union Code & Fund for the 2000-2001 Adopted Budget to the 2009-2010 Adopted Budget.

[6] This does not include worker's compensation costs or overtime costs. The figures above are budgeted costs and include the cost of providing paid time off, such as vacation, holidays, personal/executive leave, and sick leave, to the extent that paid leave is taken during the fiscal year. The actual salary and benefit costs of individual employees vary.

healthcare. This was the City's approach for the 2009-2010 negotiations with the City's bargaining units. In November 2009, the City Council in open session approved a goal of a 5% total compensation reduction for all City employees. Due to changed circumstances with the City's budget in March 2010 and an increase in the City's structural budget deficit, the City Council changed this goal to a 10% total compensation reduction for all City employees. During negotiations with bargaining units, the City provided many options for achieving that goal through reductions to pay and benefits. As of August 2010, the following was achieved through negotiations using this approach:

Progress of Achieving 10% Total Compensation Reduction[7]

Employee Unit	Total Compensation Reduction			
	5% Ongoing	5% One-Time	Total	FTEs
Unit 99/Unit 82	5%	5%	10%	242
ALP	5%	5%	10%	43
AEA	5%	5%	10%	202
CAMP	5%	5%	10%	360
IBEW	5%	5%	10%	75
AMSP	5%	5%	10%	79
OE#3	5%	5%	10%	772
ABMEI[8]	5%	0%	5%	55
POA	0.67%	3.15%	3.82%	1273
IAFF, Local 230[9]	NA	NA	NA	660
MEF[10]	NA	NA	NA	1958
CEO[11]	NA	NA	NA	191

Grand Jury Finding 2

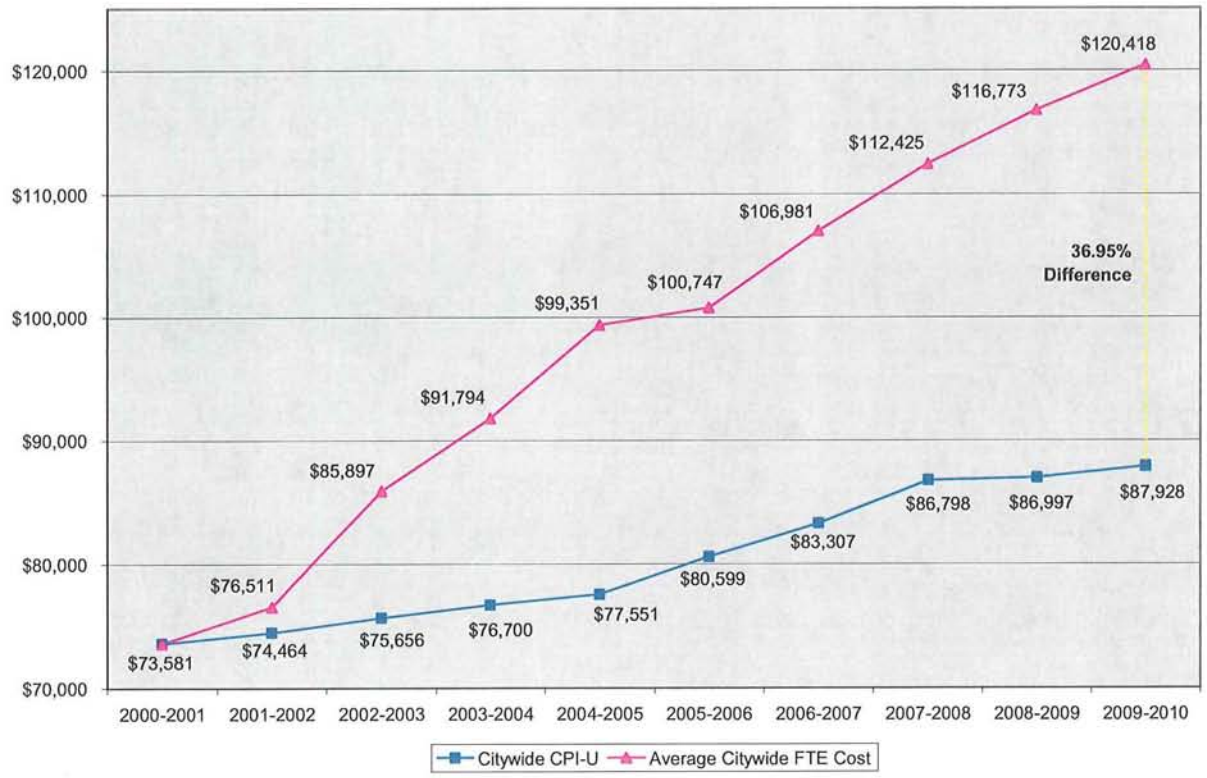
Salary and wage increases do not reflect changes in economic conditions; e.g. even with minimal inflation, yearly COLAs are granted with little bearing on the actual increase in cost of living or market conditions.

[7] Source: Salary and Fringe Benefit Costs by Union Code & Fund for the 2010-2011 Adopted Budget.
[8] Council approved terms of 5% ongoing total compensation reduction in April 2010.
[9] No agreement has been reached with the San Jose Firefighters.
[10] MEF has received a 2% general wage increase per their current contract, which extends through FY 10-11.
[11] CEO will receive a 2% general wage increase per their current contract, which extends through FY 10-11.

City Response to Finding 2

The City agrees with this finding. In past years, general wage increases given in many years exceeded CPI. The chart below shows the average Citywide FTE cost increases versus CPI over the past ten years.[12] This shows that the City's increase in personnel costs have far exceeded the CPI.

Average Citywide FTE Costs versus CPI Changes Over Time



Grand Jury Recommendation 2

Cities should not increase salaries and wages that are not supported by planned revenue increases. Cities should tie COLA increases to clear indicators and retain the ability to adjust or withhold based on current economic data.

City Response to Recommendation 2

This recommendation requires further analysis, which will be done for the upcoming negotiations in the next few months. There are a variety of factors that need to be considered when increasing salary and wages, including CPI, market comparisons, and particularly the City's fiscal situation. In addition, there are downsides to negotiating

[12] Source: Salary and Fringe Benefit Costs from 2000-2001Adopted Budget to the 2009-2010 Adopted Budget and Bureau of Labor Statistics; San Francisco-Oakland-San Jose CPI-U Index.

formulas in contracts that base salary growth on CPI as the City has no control over the CPI and such a formula could require salary increases that do not reflect the City's fiscal situation.

Grand Jury Finding 3

Step increases are arbitrary and do not adequately represent an employee's added value to a city. Combined with COLAs, new employees' wages increase quickly and are not necessarily reflective of improved knowledge and skills.

City Response to Finding 3

The City agrees with this finding. Employees in all but one of the City's non-management bargaining units, are typically eligible for a 5% automatic pay increase just for time spent in the classification until an employee reaches the top step in the position's salary range. When combined with negotiated general wage increases, this could result in an employee receiving a significant pay increase in a year without any consideration given to that employee's performance. For example, in 2010-2011, two City bargaining units had a previously negotiated general wage increase of 2%. Employees represented by those bargaining units who are not at top step, will receive a 7% increase this Fiscal Year, in comparison to approximately 1800 employees who took a 10% total compensation reduction.

It should be noted the City's management bargaining units and unrepresented management employees receive merit increases based on performance. However, merit increases are not guaranteed and are given at the discretion of the City Manager or other Council Appointee. Due to the City's fiscal situation, merit increases have not been authorized in the last two years for management employees.

Grand Jury Recommendation 3

Cities should negotiate step progressions from the current three and a half years to seven years. Employees should not receive COLA increases while in step progression.

City Response to Recommendation 3

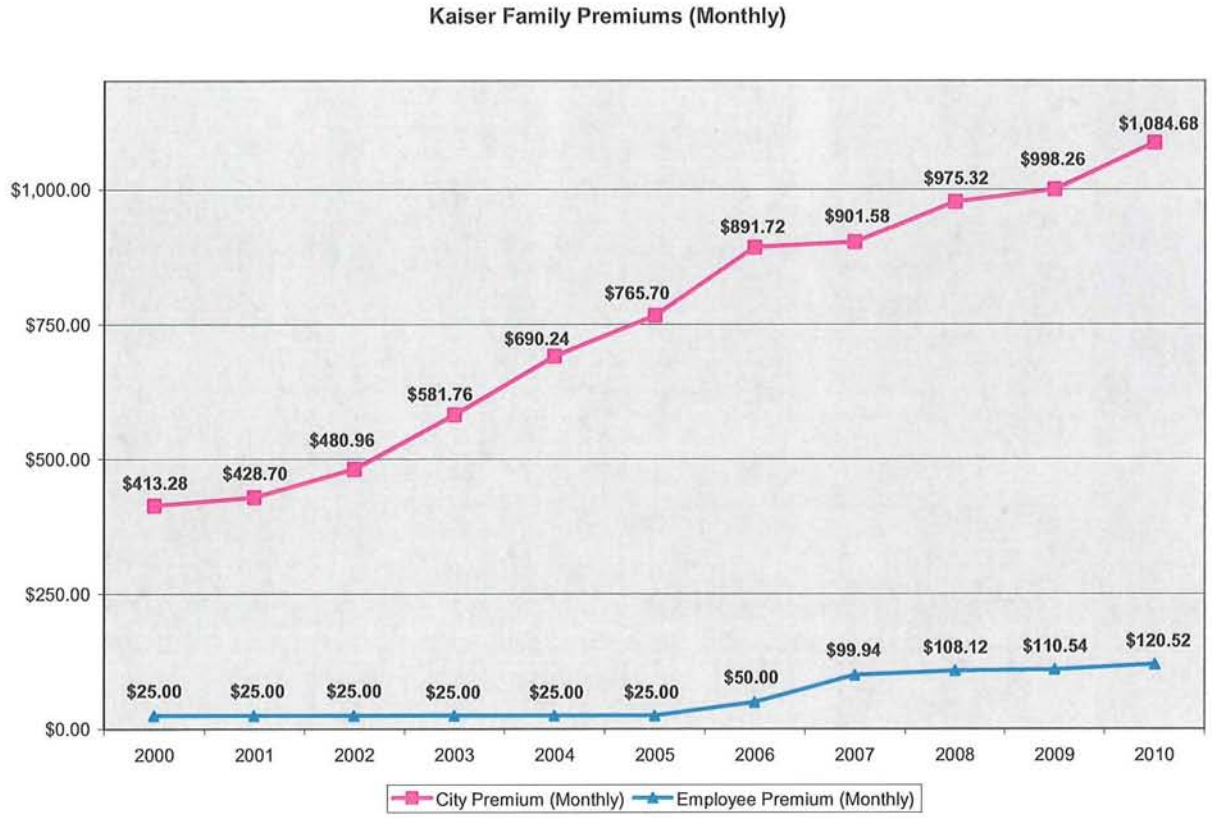
This recommendation has not yet been implemented, but may be implemented in the future. However, there needs to be further analysis on whether or not seven years is the appropriate timeframe. The City has proposed in bargaining for the last few years moving to a system where step increases are given based on performance after an employee receives an "above standard" overall rating on the employee's performance appraisal. The City has also proposed moving the difference in the steps from 5% to 2.5%, which would also assist the City in controlling payroll costs. Unfortunately, this has not yet been achieved with any non-management bargaining unit, but will continue to be the subject of future negotiations.

Grand Jury Finding 4

Medical insurance costs for active employees are growing year after year at rates that exceed most cities' revenue growth, while the employee contribution to medical care is minimal.

City Response to Findings 4

The City agrees with this finding. The following chart shows the increases in medical plan costs for the City versus the increases in active employee costs:



As shown above, for six of the last 11 years, the maximum employee contribution for the Kaiser HMO plan was capped at $25.00 per month and the annual increases in medical costs were completely paid for by the City. However, in the last five years employee contributions towards healthcare have increased to approximately 10% of the cost of Kaiser HMO plan premiums.

Grand Jury Recommendation 4

Cities should negotiate that employees assume some of these increased costs for their medical benefits. To contain medical costs cities should consider the following:

A. *Split monthly premiums between the city and the employee and increase the employee's share, if already cost splitting, and remove any employee caps.*

B. *Establish reasonable co-pays for doctors' visits, prescription drugs, and in-patient and out-patient hospital care.*
C. *Prohibit an employee from being covered by both city-provided medical benefits and as a dependent of another city employee.*
D. *Request cash-in-lieu payments*
E. *Introduce a new lower premium, high-deductible medical plan.*

City Response to Recommendation 4a

This recommendation has been implemented for many of the City's employees. Since 2005, the City has been negotiating with the bargaining units changes to cost sharing and removing caps that had been in place. As a result, most employees have a 90% City/10% Employee cost sharing split with no cap. Employees represented by the San Jose Fire Fighters union continue to have a $150 cap on monthly employee contributions. In 2010 and 2011, there will be approximately 1500 City employees who have moved or will move to an 85% City/15% Employee cost sharing split. The shift to the 85% City/15% Employee cost sharing split will be a subject of the upcoming negotiations with the bargaining units that still have the 90% City/10% Employee cost sharing split.

City Response to Recommendation 4b

This recommendation has been implemented for many of the City's employees. During the last few years, co-pays have also been increased through negotiations with the City's bargaining units. Previously, the City of San Jose had one of the last remaining Kaiser $0 co-pay plans, which was one of the factors of the City's rising healthcare costs. As of 2009, all employees moved to a $10 co-pay plan and in 2010 and 2011, approximately 1500 City employees will move to a $25 co-pay plan. The shift to a $25 co-pay plan will be a subject of the upcoming negotiations with the bargaining units that still have a $10 co-pay plan.

City Response to Recommendation 4c

This recommendation has been implemented for some of the City's employees. In 2010, the City began negotiations to prohibit an employee from being covered by both City-provided medical benefits and as a dependent of another City employee. This prohibition now applies to approximately 1500 City employees and the prohibition will again be the subject of upcoming negotiations with the other bargaining units that are not subject to this prohibition.

City Response to Recommendation 4d

This recommendation has been implemented for some of the City's employees. In 2010, the City also began negotiations to reduce the amount of the cash-in-lieu payments. Previously, the cash-in-lieu payment was tied to medical plan premiums, so as the medical plan premium costs rose for the City, so did the cash-in-lieu payment. In 2010, the City achieved a reduction to the cash-in-lieu payment, as well as a cap on the cash-in-

lieu payment for approximately 1500 City employees. The reduction and cap on the cash-in-lieu payment will again be the subject of upcoming negotiations with the other bargaining units that are not subject to this reduction.

City Response to Recommendation 4e

This recommendation requires further analysis. The Human Resources Department has been evaluating and will continue to evaluate introducing a new lower premium, high-deductible medical plan, which will be done for the upcoming negotiations in the next few months.

Grand Jury Finding 5

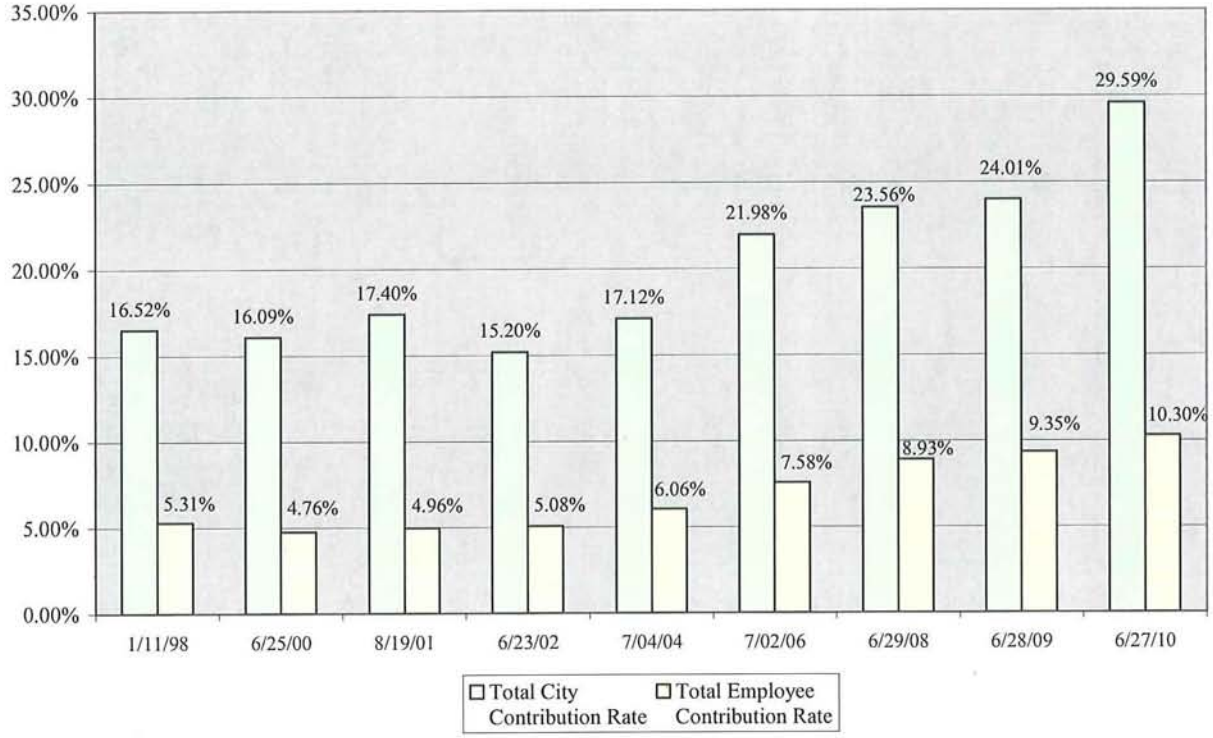
Pension formula changes instituted in the past decade, stock market losses, the aging "baby boomer" work force, and the growing unfunded pension and OPEB liability all contribute to making retiree pension and health care costs the most problematic and unsustainable expense the cities are facing. The city contribution to pension plans and OPEBs far exceeds the employee contribution.

City Response to Finding 5

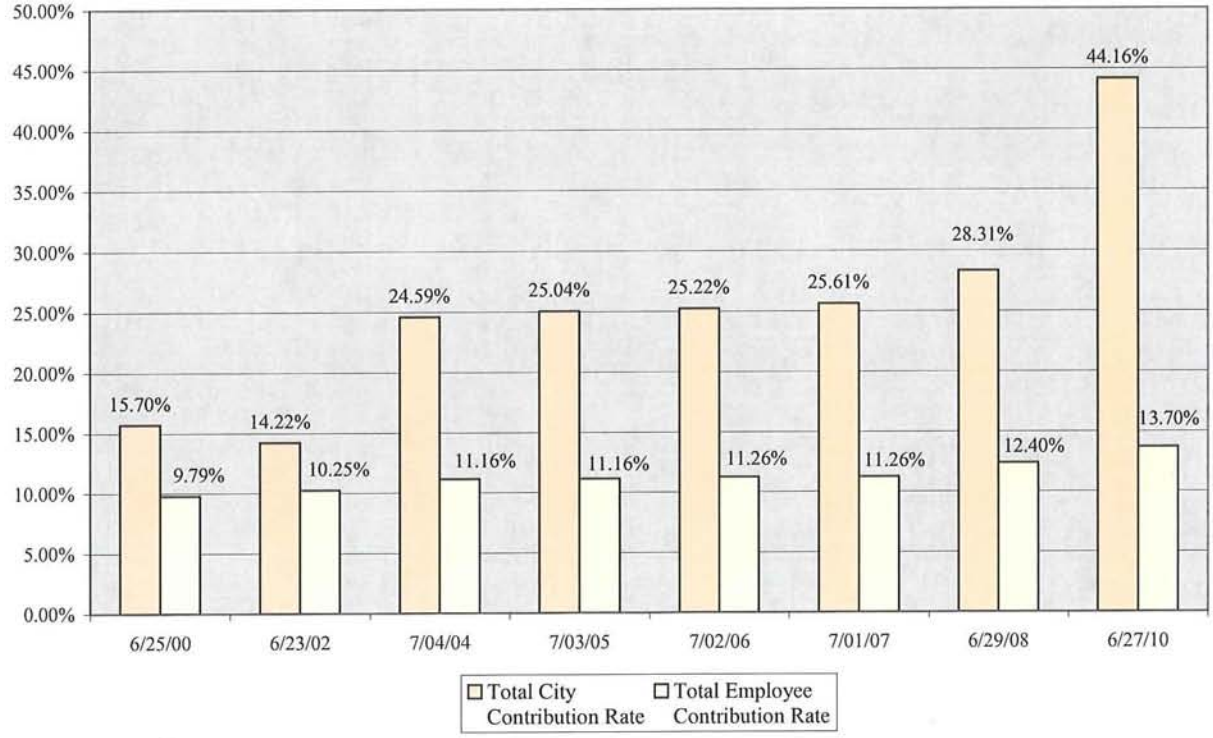
The City agrees with this finding. Below are charts showing the historical City contribution rates, as well as the employee contributions rates.[13][14]

[13] Some bargaining units are contributing more to offset the City's Contribution as part of the 10% Total Compensation Reduction.
[14] Source: Retirement Services Department

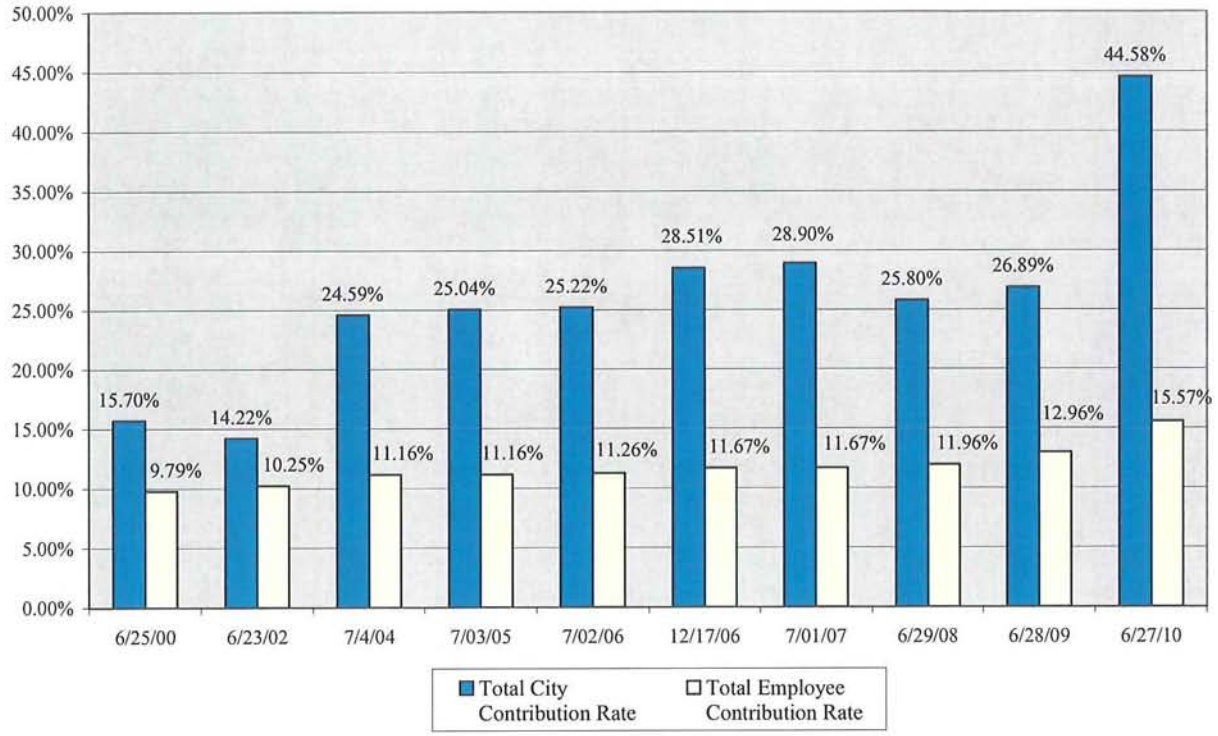
Federated City Employees' Retirement System Contribution Rates



Police & Fire Department Retirement Plan (Fire Contribution Rates)

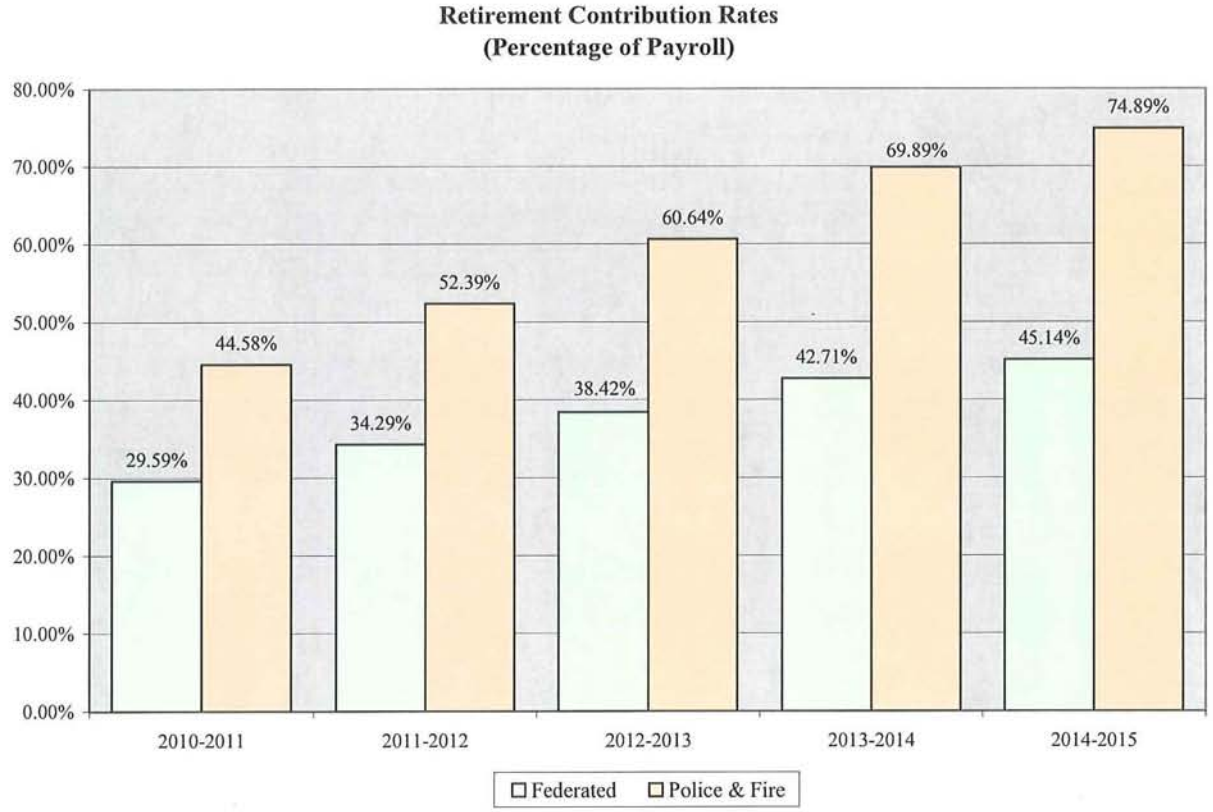


Police & Fire Department Retirement Plan (Police Contribution Rates)



As demonstrated in the charts above, there was a significant increase in contributions from Fiscal Year 2009-2010 to Fiscal Year 2010-2011. This rate increase equates to approximately $25 million in additional costs for retirement, which is the equivalent of approximately 140 public safety positions. Given recent actuarial reports, the City expects contribution rates to rise dramatically in the upcoming years. Below are projected contribution rates as a percentage of payroll for both pension and retiree healthcare are expected to be in the next 5 years. [15]

[15] Does not include Pre-Payment Discount and assumes IAFF, Local 230 will agree to phase in contribution of the employee's share to full pre-fund retiree healthcare.



Grand Jury Recommendation 5a

Cities should:

1. *Renegotiate and make provisions for increasing the employees' contribution for current pension plans*
2. *Renegotiate to stop paying the employees' contribution amount to pension plans*
3. *Renegotiate to implement a contribution amount for employees to OPEB; this contribution should provide for a reasonable split of costs between a city and the employee for retiree medical and dental benefits.*

City Response to Recommendation 5a-1

This recommendation has been implemented for some of the City's employees. As noted above, as part of the agreements with some bargaining units for the total compensation reduction, some bargaining units agreed to make additional retirement contributions, thereby offsetting the City's contribution obligation. In addition, the City's focus in 2010-2011 will be retirement reform and there are a variety of things occurring in order to negotiate these changes. The City has developed a stakeholder process to begin at the end of September 2010, in order for stakeholders to have input on the goals for retirement reform. In addition, the stakeholder process will provide an opportunity for education on why retirement reform is necessary.

City Response to Recommendation 5a-2

This recommendation will not be implemented because it is not warranted because it is not applicable to the City. Unlike certain PERS agencies which pay a portion of the employees' contribution amount to pension plans, the City is not in PERS and does not pick up any of the employee's portion.

City Response to Recommendation 5a-3

This recommendation has been implemented. For the City, eligible employees can receive a lifetime benefit for retiree health and dental. The cost sharing for retiree medical benefits is already 50% City/50% Employee. However, the amount contributed was only a portion of what needed to be contributed in order to fully pre-fund the benefit. In 2009, the City and all of the bargaining units, except for the San Jose Fire Fighters, began ramping up to fully pre-funding the Annual Required Contribution (ARC) for retiree medical benefits.

Grand Jury Recommendation 5b

Cities should thoroughly investigate reverting to prior pension formulas that were less costly.

City Response to Recommendation 5b

This recommendation requires further analysis. The City's focus in 2010-2011 will be retirement reform and there are a variety of things occurring prior to beginning negotiating these changes, including a ballot measure in November to allow the City Council to adopt an ordinance to exclude future City officers and employees from any existing retirement plans or benefits and to establish retirement plans for future employees that do not provide for the current minimum requirements in the City Charter. The City has developed a stakeholder process to begin at the end of September 2010, in order for stakeholders to have input on the goals for retirement reform. In addition, the stakeholder process will provide an opportunity for education on why retirement reform is necessary.

Grand Jury Recommendation 5c

To provide a meaningful, long-term solution, the cities should negotiate agreements to:

1. *Institute a two-tier system for pension and retiree health care for new hires.*
2. *Increase the retirement age from 50 or 55 to 60 or 65.*
3. *Calculate pensions on the last three to five years of salary.*
4. *Replace current post-employment health care plans with health savings plans.*

City Response to Recommendations 5c-1

This recommendation requires further analysis. The City's focus in 2010-2011 will be retirement reform and there are a variety of things occurring in order to negotiate these changes. The City has developed a stakeholder process to begin at the end of September 2010, in order for stakeholders to have input on the goals for retirement reform. In addition, the stakeholder process will provide an opportunity for education on why retirement reform is necessary.

City Response to Recommendations 5c-2 and 5c-3

These recommendations require further analysis. The City's focus in 2010-2011 will be retirement reform and there are a variety of things occurring in order to negotiate these changes, including a ballot measure in November 2010 to allow the City Council to adopt an ordinance to exclude future City officers and employees from any existing retirement plans or benefits and to establish retirement plans for future employees that do not provide for the current minimum requirements in the City Charter to eliminate the minimum benefits section of the City Charter. The City has also developed a stakeholder process to begin at the end of September 2010, in order for stakeholders to have input on the goals for retirement reform. In addition, the stakeholder process will provide an opportunity for education on why retirement reform is necessary.

It is not specified in the recommendation as to whether or not these changes are recommended for current employees or new hires. There are legal issues, however, related to the City's ability to make modifications to retirement benefits for retirees and current employees. As part of retirement reform, the City will be discussing with the bargaining units changes to retirement benefits. This will include potential changes to pension formulas for new hires, as well as increasing retirement age, the calculation of the pension benefit and options regarding retiree healthcare benefits.

City Response to Recommendations 5c-4

This recommendation requires further analysis in order to determine the cost benefit of instituting a health savings plan. This will be evaluated during the upcoming retirement reform process and discussions.

Grand Jury Finding 6

Public sector employees are granted a generous number of holidays, personal days, vacation days and sick leave annually. Rules and limits on accrual vary by city and union, but vacation days and sick leave can be accumulated and converted to cash or calculated into the pension benefit within those limits.

City Response to Finding 6

The City agrees with this finding. Previously, City employees were able to accrue an unlimited amount of vacation that would be paid out upon leaving City employment. The City has since negotiated a vacation accrual cap, which limits the amount of vacation an employee can accrue to two times an employee's annual accrual rate. It should be noted that accumulated vacation and sick leave are not part of the calculation of determining an employee's pension benefit.

There has been significant focus on the City's sick leave payout benefits. In comparison to other public sector agencies, the City's sick leave payout formulas are very generous. In the case of employees represented by the POA and the San Jose Fire Fighters union, those employees are eligible to receive a payout of 100% of their sick leave hours, with no limit. In Fiscal Year 2009-2010, the City spent $14 million on sick leave payout alone.

Sick Leave Payouts
(Fiscal Year 2007-2008 to 2009-2010)

FY 07-08		FY 08-09		FY 09-10	
High	Total	High	Total	High	Total
$227,351	$6.96 Million	$251,870	$11.73 Million	$256,969	$14.61 Million

Grand Jury Recommendation 6a

Cities should renegotiate with the bargaining units to 1) reduce vacation time; 2) reduce the number of holidays and/or personal days; 3) cap sick leave and eliminate the practice of converting accumulated sick leave to cash or adding into their years of service for inclusion in their retirement benefit.

City Response to Recommendation 6a

This recommendation requires further analysis. The City has already made changes to vacation in order to limit the City's liability when it comes to vacation payout. The City will also be evaluating reductions in all leave benefits as a cost containment measure and in order to limit time away from work so as to maintain City services.

In regards to sick leave payout, this has been a topic of negotiations this year and in past years, but unfortunately changes have only been achieved with one bargaining unit. The sick leave payout benefit will again be a topic of negotiations in 2011.

Grand Jury Recommendation 6b

Cities should negotiate to substitute paid days off for unpaid days instead of imposing furloughs. For example, reduce paid holidays to major holidays only, consistent with the private industry; and convert minor holidays to unpaid. Therefore, the public is not impacted by fewer services cause by furloughs, and the city saves the employee cost.

City Response to Recommendation 6b

This recommendation requires further analysis. The City has utilized voluntary furloughs for many years as a cost savings measure and has also had a limited use of mandatory furloughs. The City is mindful that furloughs are also a service level reduction and could in some cases, increase the City's costs or liabilities. When furloughs have been instituted recently, the City has been cautious to ensure that the retirement system is kept whole through retirement contributions still being made on the unpaid time since employees can earn a full year of pension credit. This ensured that an unfunded liability was not created through the use of furloughs.

The concept of substituting paid days off for unpaid days was evaluated during the 2009-2010 negotiations and would have been considered had furloughs been more a focus of the discussions. Through the City's evaluation of this concept, various issues were raised, including the impact it would have to exempt employees. This recommendation would need to be evaluated further.

Grand Jury Finding 7

Cities traditionally determine their compensation packages by surveying the wages and benefits of other public sector employees in the same geographic area. There is a major resistance to comparing themselves or mirroring trends with the private sector. This has allowed wages and benefits to become artificially high and out of sync with market trends.

City Response to Finding 7

The City disagrees partially with this finding. Trends in employee compensation in the private sector are important to consider when determining City employee pay and benefits. However, determining the value of some benefits that vary drastically from those found in the private sector can make comparisons difficult. Where such comparisons are possible, they should be considered, along with several other factors, when deciding what the appropriate compensation package for City employees.

Grand Jury Recommendation 7a

Cities should research competitive hiring practices and alter the approach to determine fair wages and benefits for each city by using public and private sector data.

City Response to Recommendation 7a

This recommendation requires further analysis. The City has in some cases compared specific classifications to the private sector. This would not be able to be done in all circumstances as some job duties/classifications do not exist in the private sector.

Grand Jury Recommendation 7b

Cities should renegotiate salaries and wages using valid market comparisons and not only the current wage index. Cities should utilize more market-oriented compensation practices so that salaries can adjust as competition for labor changes. Cities should reduce entry-level compensation for positions for which there are many qualified applicants.

City Response to Recommendation 7b

This recommendation has not been implemented, but may be implemented in the future. Reducing entry-level compensation for positions for which there are many qualified applicants was also a recommendation that came out of the City Manager's Structural Deficit Task Force. This will be subject to negotiations with the bargaining units.

Grand Jury Finding 8

All cities perform certain core functions to run smoothly and provide services to their residents. To reduce employee costs and streamline operations, the cities are in various stages of contracting services to private industry or partnering with other cities, special districts or the County to deliver services.

City Response to Finding 8

The City agrees with this finding. With the City's current budget situation, all options should be evaluated in order to continue providing services. This includes evaluating contracting services to private industries and partnering with other cities, special districts or the County to deliver services.

Grand Jury Recommendation 8a

Cities should explore outsourcing some functions and services to private industry. Cities should discuss the prospect with cities that are successfully doing this to determine best practices and areas for success. Cities should develop contracts with measurable objectives, performance goals, and timelines.

City Response to Recommendation 8a

This recommendation has been implemented and will continue to be pursued. For Fiscal Year 2010-2011, as part of resolving the City's $118.5 million deficit, the City Council made the difficult decision to contract out various services in order to continue providing

those services at a lower and more sustainable cost. These options will continue to be evaluated this year for Fiscal Year 2011-2012.

Grand Jury Recommendation 8b

Cities should create partnerships with other cities, special districts and/or the County for services, such as payroll, human resources, animal control, police and fire. Cities should investigate sharing the cost of new information technology systems.

City Response to Recommendation 8b

This recommendation has been implemented. The City of San Jose is currently participating in a City/County Workgroup to evaluate the sharing of municipal services.

Grand Jury Finding 9

Cities can gain operational efficiencies and effectiveness with lower employee costs by making sure they are staffed with the correct numbers of people in the appropriate job classification in all departments and work groups.

City Response to Finding 9

The City agrees with this finding. Again, with the City's fiscal situation and facing a $118.5 million deficit for Fiscal Year 2010-2011, it was important that all avenues be considered, including operational efficiencies.

Grand Jury Recommendation 9

Cities should analyze the functions performed by all job classifications and make adjustments in the work force. Consolidate functions within the same group or a similar group. Reassign appropriate work to lower paid job classifications. Eliminate unnecessary functions.

City Response to Recommendation 9

This recommendation has been implemented. The City has always strived to be an efficient and an effectively staffed organization. Changes to staffing receive careful review and consideration and are included in the budget process. Further, as vacancies in staffing arise, careful consideration of the vacant position is completed before refilling the position and any changes to the job classification are pursued. In July of 2010, almost 800 filled and vacant positions were eliminated resulting in approximately 200 layoffs. Reductions occurred in all departments and at all levels of the organization. This significant organizational staffing reduction has necessitated the consolidation of duties, elimination of unnecessary work, and regular pursuit of efficiencies in an effort to maintain quality services to the public. Layoffs and substantive job changes are subject to impact bargaining pursuant to collective bargaining laws.

Grand Jury Finding 10

The San Jose City Auditor identified 88 positions currently being performed by public safety employees that can be performed by civilian employees at lower costs. The safety employees could be moved to positions that require their expertise and training. The auditor estimated this could be accomplished in less than 90 days and save approximately $5 million annually.

City Response to Findings 10

The City agrees with this finding and the City Council approved the City Auditor's report that contained this recommendation. The amount of savings generated would be determined by the number of sworn positions being eliminated and replaced with civilian positions. If the City maintains the same number of sworn positions while creating additional civilian positions, this would result in additional cost to the City. Civilianization is subject to labor negotiations with affected bargaining units, please see response to Recommendation 10 below.

Grand Jury Recommendation 10

San Jose should negotiate this suggested transfer with the San Jose Police Officers' Association and set realistic timeframes to move these safety positions to civilian positions.

City Response to Recommendation 10

This recommendation has not yet been implemented, but will be implemented in the future. The City of San Jose and the San Jose Police Officers' Association (POA) currently have an agreement that extends through June 30, 2011. The City will commence negotiations with the POA in January 2011 and will discuss the issue of civilianization of certain positions.

Grand Jury Finding 11

In many cities, the contract negotiation process is completed by placing the negotiated collective bargaining agreements on the consent calendar for approval, which is acted on quickly at the start of council meetings by a single motion and vote of the council.

City Response to Finding 11

The City agrees with this finding.

Grand Jury Recommendation 11

Cities should consider holding well-publicized public hearings about the cities' goals of negotiations before negotiations begin, and again at the end of negotiations to report to citizens clearly what changes have been made in contracts.

City Response to Recommendation 11

This recommendation has been implemented. As part of the City's Sunshine Reform Measures to enhance open government, the City adopted reforms specific to these recommendations. Since 2008, prior to negotiations beginning, the City presents in open session an annual summary of the upcoming labor negotiations. This provides the public an opportunity for input on labor negotiations prior to commencing negotiations with the bargaining units.

Also as part of the City's Sunshine Reform Measures, unless the requirement is waived, Council memos regarding labor negotiations must be released fourteen days in advance of the Council meeting. This provides an opportunity for the public to review and provide input. Labor negotiation agenda items are not placed on the consent calendar, allowing for public discussion and comment.

Grand Jury Finding 12

Current contracts were negotiated in good faith by representatives of the cities and the bargaining units; they were approved by the city councils. Promises made to employees were made by elected officials, past and present. Responsibility for formulating and approving solutions to restore the cities' financial stability resides squarely with our elected officials. The economic downturn has placed additional pressure on the situation.

City Response to Finding 12

The City agrees with this finding.

Grand Jury Recommendation 12a

City council members and mayors should become better informed about the fiscal realities in their cities, long-term costs and commitments, and be cognizant of potential issues in labor agreements.

City Response to Recommendation 12a

This recommendation has been implemented. City Administration informs the City Council of the fiscal situations, long-term costs and commitments and other issues in labor agreements through open and closed session, stakeholder process and other educational task forces. As mentioned above, City Administration brings forward in open session to the City Council, prior to the negotiations beginning an Annual Summary of Labor Negotiations. This provides information to the City Council and members of the public regarding labor issues.

As part of the annual budget process, the Administration submits a Preliminary One-Year General Fund Forecast to the City Council in November, a Five-Year General Fund Forecast in February, and the annual Proposed Budget document in May and discusses

budgetary issues with the City Council at special meetings in November, February, May, and June. As part of monitoring budgeted revenues and expenditures, every two months, the Administration submits a financial status report to the Public Safety Finance & Strategic Support Committee outlining the year-to-date performance of the General Fund and selected special funds as well as informing the City Council about economic trends impacting the City's budgetary situation. Finally, in accordance with the City Charter, in October, the Administration presents to the City Council the Annual Report which summarizes the fiscal performance of the General Fund and selected special and capital funds of the previous fiscal year.

Grand Jury Recommendation 12b

City councils and mayors should direct city administrators to (re)negotiate collective bargaining agreements that reverse the escalation of employee costs through concessions, cost sharing, and a second tier for new employees.

City Response to Recommendation 12b

This recommendation has been implemented in part. This was the direction to City Administration for 2009-2010 negotiations. For 2009-2010, the City negotiators were directed to achieve a 10% total compensation reduction. This was achieved with many of the City's bargaining units through pay decreases, health plan changes and additional retirement contributions. A second tier for retirement benefits for new hires will be a subject of negotiations in 2011.

Grand Jury Recommendation 12c

City councils and mayors should meet with the bargaining units to clearly outline the cities' financial health and show how employee costs are impacting the budget.

City Response to Recommendation 12c

This recommendation has been implemented. The City Manager is responsible for negotiations with the bargaining units and has delegated this authority to the Office of Employee Relations. During negotiations and through the budget process, the bargaining units are informed of the City's financial situation and the impact of employee costs. Bargaining units are provided with the budget documents containing this information.

Although the Mayor and City Council cannot negotiate directly with the bargaining units, there are many learning opportunities for the bargaining units regarding the budget, including budget study sessions. In addition, the City Manager holds regular meetings with the bargaining units and some of those meeting are dedicated solely to budget updates.

In addition, the City has an unprecedented amount of information available to the public on its Labor Relations Website, http://www.sanjoseca.gov/employeerelations/labor.asp,

including total compensation information, negotiations updates, correspondence between the City and the bargaining units and proposals exchanged during negotiations.

Grand Jury Recommendation 12d

City councils and mayors should inform citizens of their plans for controlling unsustainable employee costs and remove politics from the equation.

City Response to Recommendation 12d

This recommendation has been implemented. For the 2009-2010 negotiations, the City negotiators were directed to achieve a 10% total compensation reduction for Fiscal Year 2010-2011. This was achieved with many of the City's bargaining units through pay decreases, health plan changes and additional retirement contributions. This occurred in open session and gave the public an opportunity for input into the process.

In addition, the City has an unprecedented amount of information available to the public on its Labor Relations Website, including total compensation information, negotiations updates, correspondence between the City and the bargaining units and proposals exchanged during negotiations.

In January, as part of the budget development, the Mayor's Office in conjunction with the Administration holds a Neighborhood Association/Youth Commission Budget Priority Setting session to set the context for the budget for the upcoming fiscal year. During the budget process, the Mayor's Office and respective City Council District offices hold budget meetings in each of the ten City Council Districts. Then, after the release of the City Manager's Proposed Budget document, there are multiple public hearings in May and June to allow members of the public to provide input into the budget process and recommendations. As part of the 2011-2012 Budget, the City Council will discuss the drivers for the anticipated 2011-2012 budget shortfall and potential solutions for the shortfall at a November Budget Study Session. Additionally, the various City Council and Public Safety Finance and Strategic Support Committee meetings are open to the public and streamed via the City's website. All budget documents are posted on the City's website at www.sanjoseca.gov and the City's Adopted Budget documents are available in the City's libraries.

Grand Jury Finding 13

Binding arbitration is not open to the public and results in an adversarial process between the city and employee groups. Binding arbitration limits the ability of city leaders to craft solutions that work for the city's budget. The process has resulted in wage and benefit decisions that have been great than the growth in basic revenue sources.

City Response to Finding 13

The City agrees with this finding.

Grand Jury Recommendation 13a

San Jose City Council should make binding arbitration open to the public.

City Response to Recommendation 13a

Binding arbitration under City Charter Section 1111 has not historically been open to the public. Through the City's arbitration panel representative, the City requested that the 2006-2007 interest arbitration with the San Jose Firefighters, IAFF, Local 230 be open to the public. The Union's arbitration panel representative opposed the City's request and requested that the proceedings be closed to the public. The Chair of the Board of Arbitrators, having the final deciding vote, also opposed having the proceedings open to the public and did not grant the City's request. Therefore, the arbitration proceedings were closed. Binding arbitration provides for a third party, often times not even a resident of the City of San Jose, to make financial decisions that can have serious impacts on the City's fiscal situation.

On August 3, 2010, the City Council approved putting a measure on the ballot for the November 2010 election to amend City Charter Section 1111 relating to interest arbitration. This ballot measure includes a provision that would require arbitration hearings to be open to the public and documents submitted designated public records, unless provided otherwise by law.

Grand Jury Recommendation 13b

San Jose City Council should prepare a ballot measure asking voters to repeal Section 1111 of the City Charter that addresses binding arbitration.

City Response to Recommendations 13b

On August 3, 2010, the City Council approved putting a measure on the ballot for the November 2010 election to amend Charter Section 1111. The measure changes the arbitration procedures for Police and Fire arbitrations and changes the factors considered by the Board of Arbitrators in making an award. In particular, the primary factors to be considered by the Board are the City's financial condition and its ability to pay for compensation (defined to include wages and benefits) from ongoing revenues without reducing services.

PUBLIC OUTREACH/INTEREST

By the very nature of the Grand Jury's report and its release, public outreach requirements have been met. Additionally, upon approval of this memorandum by Council, the City Attorney will submit the memorandum to the presiding judge of the Superior Court, as required under Penal Code Section 933(c).

COORDINATION

This memorandum was coordinated with the Human Resources Department, the City Manager's Budget Office and the City Attorney's Office.

CEQA

Not a project, File No.PP10-069 (b) Personnel Related Decisions.

Debra Figone
City Manager

For additional information on this report, contact Alex Gurza, Director of Employee Relations, at 535-8150.

Attachment: 2009-2010 Santa Clara County Civil Grand Jury Report: Cities Must Rein in Unsustainable Employee Costs

CITIES MUST REIN IN UNSUSTAINABLE EMPLOYEE COSTS

Issue

Employee costs are escalating in the cities of Santa Clara County (County), revenues are not keeping pace with these increases and cities are cutting services. How do cities contain these escalating employee costs?

Summary

In this report, the 2009-2010 Santa Clara County Civil Grand Jury (Grand Jury) takes a broad look at employee costs in the County's fifteen cities and recommends solutions to control costs so that cities over time can achieve fiscal and organizational stability and eliminate budget deficits.

There is widespread concern that the cost of employee total compensation continues to increase while revenues and services decrease. Wages and salaries climb, even as the economy struggles. Pension and health care benefits have risen substantially since 2000. Vacation, holiday and sick leave policies are overly generous and exceed those of private industry. The overall costs to cities are not sustainable. Cities need to negotiate, approve and implement considerable cost containment measures so that employee financial obligations do not continue to escalate.

Cities should expand the comparison of salaries and benefits beyond other nearby cities to include the private sector. Options for additional cost savings include: outsourcing some activities to private industry; consolidating services with other cities or the County; optimizing job functions; and introducing lower cost pension and health care plans for new employees.

It is important for the cities to solicit community input so that taxpayer money is spent prudently and fairly, while maintaining the obligations of local government to its citizens, and ensuring that services and infrastructure improvements are not neglected.

Background

During the last decade, cities significantly increased the total compensation that employees receive, but city leaders did not adequately forecast and plan, nor allocate enough money to pay for these long-term obligations. In order to attract qualified workers during the dot-com boom, the cities, flush with revenue, increased wages and benefits, especially pension benefits, with unrealistic expectations that the economy and

the stock market would continue to expand. These increases are largely guaranteed by union collective bargaining agreements. Binding arbitration in public safety has compounded the situation in the City of San Jose.

Two recessions later, most cities are experiencing chronic budget deficits. The economic downturn that started in December 2007 is exacerbating the cities' poor financial health. The following major factors are contributing to the cities' problems:

- Increased wage and salary costs
- Increased retirement and health care costs
- Reduced property tax revenues
- Reduced sales tax, occupancy tax, and construction tax revenues
- Reduced revenue from the state

In order to balance budgets, cities are dipping into "rainy day" funds and reserve funds, shifting funds, and reassigning redevelopment money. Many of the cities are facing looming general fund deficits ranging from $3 million to more than $100 million. Overall, the cities are taking a multi-pronged approach in tackling these projected deficits by generating new revenue, reducing operating expenses, and curbing employee compensation costs.

The opportunity for generating revenue is primarily limited to increasing taxes and fees, or in some cities, selling surplus property. Voter approval of a ballot measure is necessary to increase taxes and few cities are considering this option. To achieve cost recovery for all programs, cities have raised or are raising fees—business license fees, parking lot and meter fees, parks and recreation fees, building fees, sewer connection fees, etc.

Cities are reducing operating expenses by streamlining operations, implementing technology improvements, delaying infrastructure projects, cutting support to nonprofits, and reducing or eliminating services. Service reductions are across all departments, such as code enforcement, arson investigation, customer service, tree trimming, landscape maintenance, graffiti abatement, canine units, street repairs, fleet services, and hours of operation in parks, libraries and community centers.

Long-term, cities have few options to control employee costs. Among these are:

- Renegotiate contracts for existing employees with the unions.
- Change pension and retiree health benefits for new hires.
- Alter personnel policies and workplace practices.
- Recommend ballot measures that could mandate changes.

Short-term, cities can control employee costs by:

- Ordering furloughs
- Imposing temporary wage freezes
- Enforcing a hiring freeze
- Eliminating vacant positions
- Laying-off staff

Methodology

The Grand Jury took the following actions:

Reviewed the 2008-2009 San Mateo County Civil Grand Jury report "Reversing the Upward Trajectory of Employee Costs in the Cities of San Mateo County".

Requested from each city in the County:

- 2009-2010 City Budget
- Latest Certified Annual Financial Report
- Any amended agreements or Memoranda of Understanding (MOUs) of union contracts that were negotiated, imposed and/or implemented in 2009

Surveyed the cities for information on number of employees, employee benefits, employee salary/wages, total revenues, retirement formulas, and contributions to pension plans and other post-employment benefits (OPEB). (Survey Forms; Appendix A-C)

Interviewed the city manager or finance/budget director in each city and gathered information on the city's financial health, deficits, labor negotiation practices, strategies to balance the budget, and specific actions to increase revenue and reduce employee costs.

Interviewed the president of Santa Clara County/Cities Managers' Association and the former president of the Santa Clara County Cities Association (comprised of elected officials) and discussed pension reform and how the cities can work together on issues of mutual concern.

Interviewed the president of the San Jose Police Officers' Association and talked about the contract negotiation process and the role of labor in a city's financial health.

Discussion

Without deliberate, collaborative action, employee wages and benefits will continue to increase substantially year-over-year. The percentage of general fund money spent on employee costs is escalating. During Grand Jury interviews, most of the city managers and finance directors indicated that their current percentages are unsustainable and additional increases would lead to drastic changes to city services. San Jose Mayor Chuck Reed in his State of the City Address on Feb.18, 2010 stated that employee costs shot up 64% in the last nine years while revenues climbed just 18%.

Table 1: Comparison of Overall Employee Costs in Selected Full-Service Cities[1] (With Police and Fire Departments) as Percentage of General Fund.

	Gilroy	Los Gatos	Milpitas	Mountain View	Sunnyvale	Santa Clara	**Average**
2000-2001	61%	61%	73%	71%	64%	76%	**67.6%**
2009-2010	72%	79%	83%	78%	77%	77%	**77.6%**

[1] These cities provided data for both fiscal years.

As this table shows, controlling employee costs is imperative for the ongoing financial health of our cities. For all cities, the Grand Jury investigated the main components of total compensation, work force practices, labor negotiations, and public involvement.

TOTAL COMPENSATION

The cities' median total compensation cost per full-time equivalent (FTE) for:

- Regular employees (non-safety) increased 37% from an average median of $71,379 in fiscal year 2000-2001 to an average median of $113,704 for fiscal year 2009-2010.
- Safety employees (police and fire) increased 41% from an average median of $102,646 to $173,714.

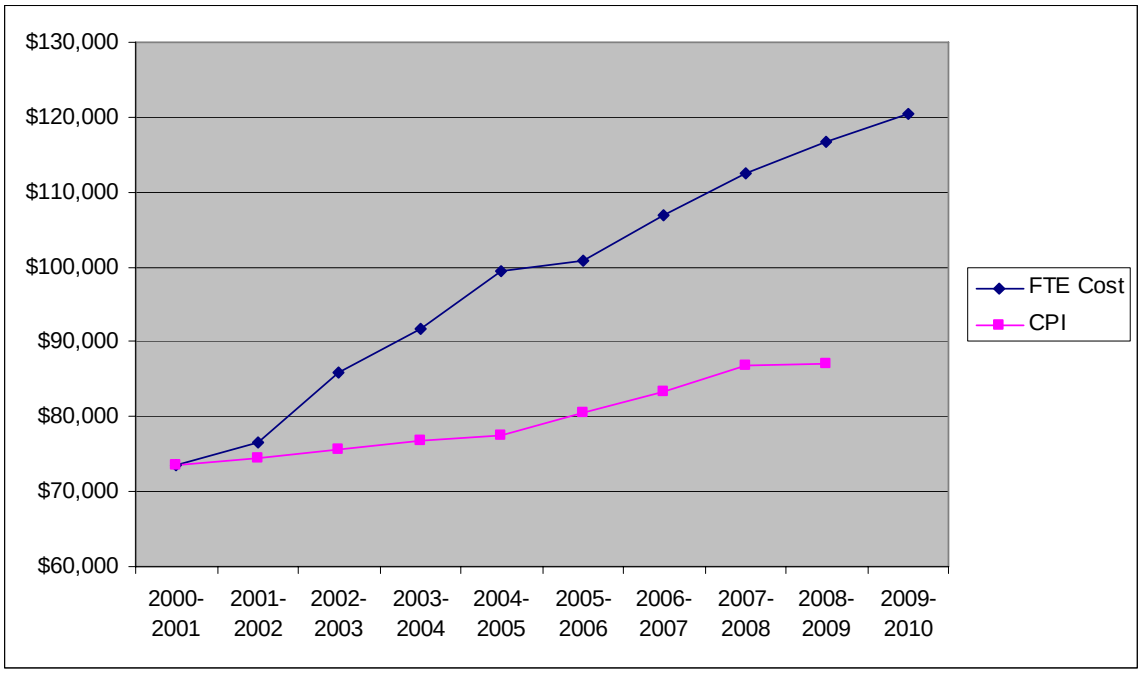
Table 2: Changes in Median Total Compensation, includes Wages and Benefits

	Regular (Non-Safety)		**Police and/or Fire (Safety)**	
	2000 - 2001	**2009 - 2010**	**2000 - 2001**	**2009 - 2010**
City				
Campbell	$63,784	$106,476	$100,412	$172,422
Cupertino	$85,481	$132,982	Contract/district	Contract/district
Gilroy	$54,078	$ 85,940	$97,273	$156,231
Los Altos	$59,000	$ 97,000	$74,000	$131,000
Los Altos Hills	N/A	$118,842	Contract/district	Contract/district
Los Gatos	$72,460	$110,243	$119,940	$183,725
Milpitas	$77,072	$121,924	$113,117	$191,855
Monte Sereno	$66,946	$128,992	Contract/district	Contract/district
Morgan Hill	N/A	$104,545	N/A	$160,890
Mountain View	$79,033	$123,754	$106,654	$190,591
Palo Alto	$75,814	$113,841	$89,059	$146,061
San Jose	$66,264	$101,043	$101,928	$162,604
Santa Clara	$82,836	$120,792	$109,350	$178,950
Saratoga	$66,314	$114,783	Contract/district	Contract/district
Sunnyvale	$78,847	$124,403	$114,722	$236,524

Note: Contract/district means that services are provided via a contract with the County or via a special district.

The cumulative increase in the total compensation is the result of increases to base payroll, health/dental benefits, retirement benefits, and other benefits. The rate of increase in total compensation for city employees has been higher than growth in the local economy, and employee costs are escalating at a higher rate than the growth in the cities' general fund revenues. For the 10 years from 2000-2009, the Consumer Price Index for the Bay Area increased by a total of 26.8%, or an average of 2.7% a year.

Graph 1: Average San Jose FTE Costs versus CPI Changes over Time



1. Salary/Wages

At present, the cities utilize a traditional public sector salary schedule with five 5% salary steps for most job classifications. Step increases occur automatically unless action is taken to withhold the 5% increase based on poor performance. The typical time it takes an employee to reach the top step of the salary range is three and a half years.

During the time employees are moving from the first to the top step, they also receive any general salary increases negotiated by bargaining units. After they reach the top step, they continue to receive annual negotiated cost-of-living adjustment (COLA) increases. In the three years starting July 1, 2008, and ending June 30, 2011, the COLA increase in typical contracts is scheduled to rise by 6% to 9.5%. In this scenario, an employee in step progression could receive a salary increase of 26% to 29.5% in those three years. During Grand Jury interviews, city managers indicated that automatic step increases cause undue hardship on the cities' finances.

2. Health Benefits

Employees in each city receive a generous contribution from the city toward numerous health care benefits: medical insurance, vision insurance, dental insurance, employee assistance programs, and cash-in-lieu of medical coverage. Medical expenses continue to rise, and the cities have been pressured into identifying new strategies to minimize the impact of rising medical insurance costs. Medical insurance expenses are increasing at rates that exceed public employers' revenue growth.

Table 3: Cities' Monthly Contributions to Health Care Benefits

	2000 - 2001		2009 - 2010	
	Individual	Family	Individual	Family
Campbell	$295	$493	$668	$1,224
Cupertino	$634	$634	$792	$869
Gilroy	Average was $453		Average was $1024	
Los Altos	$569	$569	$550	$1400
Los Altos Hills	$228	$594	$592	$1540
Los Gatos	$262	$586	$629	$1,442
Milpitas	$318	$621	$760	$1,622
Monte Sereno	$490	$800	$600	$1300
Morgan Hill	$475	$475	$600	$1260
Mountain View	$303	$739	$777	$1,824
Palo Alto	$296	NA	NA	NA
San Jose	$289	$545	$540	$1,139
Santa Clara	Average was $498		$720	$720
Saratoga	$201	$523	$611	$1,609
Sunnyvale	Average was $534		$635	$1666

In the table above, the monthly premiums increased significantly from 2000 to the present. To reduce costs while preserving essential medical benefits, the cities have implemented or are considering various cost-sharing initiatives. Among these are:

- Cost sharing of monthly premiums; some cities set a certain dollar amount that employees contribute, others set a percent, e.g. San Jose has a 90/10% split (employee share is 10)
- Co-pays for doctor visits, hospital stays and prescription drugs; co-pays currently are relatively low, usually $5.00
- High deductible plans
- Health savings plans for new employees

3. Retirement Pension Benefits

Defined-Benefit Plan

Employees in a defined-benefit retirement system are guaranteed a specific, annual pension at retirement. The annual benefit is distributed in monthly payments. Monthly benefits are calculated using a formula based on the employees' years of service and the salary they received at the time of retirement. In addition, after retirement, retirees are eligible for cost-of-living increases. Most pension plans also provide benefits for disability and death, and in some cases, provide benefits to survivors or beneficiaries.

In the cities of Santa Clara County, similar to most public sector organizations, full-time and many part-time employees are enrolled in a defined-benefit retirement system.

a. CalPERS

California Public Employees' Retirement System (CalPERS) is the defined-benefit plan in which employees in the majority of the cities of the County are enrolled. The cities and employees make contributions for retirement benefits to CalPERS. CalPERS invests, manages, and distributes money to employees when they retire. Cities are required to increase their contributions when the costs of benefits increase and/or when investment returns decline.

Examples of How the CalPERS Formula Works for Regular Employees

Each city chooses among legislatively-approved formulas that determine the amount of lifelong pensions. The most common formula for regular employees is 2.7% at age 55. To apply this formula: 1) take 2.7% of the employee's last year's salary; and 2) multiply it by the number of years of service to determine the amount received upon retiring at 55.

- Regular city employees with 30 years of service will receive 81% of their last year's salary for life.
- Regular city employees with 20 years of service will receive 54% of their last year's salary for life.
- Regular retirees will receive an annual COLA of up to 2% a year.

Examples of How the CalPERS Formula Works for Safety Employees

The typical formula for safety employees is 3% at age 50. Upon retirement, an employee will annually receive 3% of their last year's salary, multiplied by the number of years of service.

- Safety employees with 30 years will receive 90% of their last year's salary.
- Safety employees with 20 years will receive 60% of their last year's salary.
- Safety retirees will receive an annual COLA of up to 2% a year.

b. San Jose Pension Plan

San Jose does not participate in CalPERS, but instead has two retirement plans: the Police and Fire Department Retirement Plan and the Federated City Employees' Retirement System. Both the City and its employees make contributions for retirement benefits. The formulas used to calculate pensions for San Jose employees are similar to those used for CalPERS.

- Regular employee formula: 2.5% at 55; maximum base benefit of 75% of final average salary
- Police formula: 2.5% for first 20 years; 4% starting at 21st year; maximum base benefit of 90% of final average salary
- Fire formula: 2.5% for first 20 years; 3% starting 21st year; maximum base benefit of 90% of final average salary
- All retirees receive annual COLA increases of 3%.

Calculating Pension Benefits

Employee pensions are based on general formulas that are agreed on between the City and the labor unions. A typical pension formula takes into account salary, number of years served, age eligibility for retirement, and a percentage rate of an employee's recent salary level. Table 4 provides some examples.

Table 4: Examples of Lifetime Retirement Pensions
(Does Not Include Health Care Benefits or Annual COLAs)

Employee and Formula	Example Salary*	No. Years Worked and Age	Percentage of Final or Highest Year Salary	Annual Retirement Pension
Regular employee 2.5%@55	$74,005 (1)	30 years, age 55	75%	$55,504
Regular employee 2.0%@55	$76,956 (2)	30 years, age 55	60%	$46,174
Safety employee 3%@50	$114,004 (3)	25 years, age 50	75%	$85,503
Safety employee 3%@55	$103,093 (4)	25 years, age 55	75%	$77,320
Safety employee 2.5% plus (police get 4% after 20 years)	$116,210 (5)	25 years, age 50	70%	$81,347
Safety employee 2.5% plus (fire get 3% after 20 years)	$120,206 (6)	25 years, age 50	65%	$78,134

*Depending on the city, employee retirement pension is based on final or highest years' salary.

(1) This example salary is the median 2010 salary for regular employees in San Jose
(2) This example salary is the median 2010 salary for regular employees in Saratoga
(3) This example salary is the median 2010 salary for police officers in Los Gatos
(4) This example salary is the median 2010 salary for firefighters in Gilroy
(5) This example salary is the median 2010 salary for police officers in San Jose
(6) This example salary is the median 2010 salary for firefighters in San Jose

The cities use retirement formulas that vary somewhat from one city to another. The table below shows the retirement formulas used by the cities for the 2009 - 2010 fiscal year. In the past decade, these pension formulas have been modified substantially. Most cities increased their formulas from 2% at age 55 to the current 2.7% at age 55 for regular employees, and changed their formulas for safety employees to the more generous 3% at age 50. The cities also vary on the base salary on which retirement benefits are calculated. The highest or final year of salary is now most commonly used as the base salary; earlier, more cities calculated employee pension amounts based on an average of the last three years' salary.

Table 5: Retirement Formulas for Cities

City	Retirement Formula – Percentage Gained for Each Year Worked & Age Needed to Retire		Pension Based on Last Year's Salary or the Average of Three Years
	Safety	**Regular**	**All Employees**
Campbell	3% @50	2.5% @55	3 Year Average(Regular) Highest Year (Police)
Cupertino	None; contracted out	2.7% @55	Final Year
Gilroy	3% @50 (Police) 3% @ 55 (Fire)	2.5% @55	Highest Year
Los Altos	3% @50	2.7% @55	Final Year
Los Altos Hills	None; contracted out	2% @55	3 Year Average
Los Gatos	3% @50	2.5% @55	Highest Year
Milpitas	3% @50	2.7% @55	Highest Year
Monte Sereno	None; contracted out	2% @55	Highest Year
Morgan Hill	3% @50	2.5% @55	Highest Year
Mountain View	3% @50	2.7% @55	Highest Year
Palo Alto	3% @50	2.7% @55	Final Year
San Jose	2.5% 1st 20 yrs;3% starting 21st yr (Fire) 2.5% 1st 20 yrs; 4% starting 21st yr (Police)	2.5% @55	Final Year; 75% maximum regular; 90% maximum safety
Saratoga	None; contracted out	2% @55	Highest Year
Santa Clara	3% @50	2.75% @55	Final Year
Sunnyvale	3% @50	2.7% @55	Highest Year

In Grand Jury interviews, some city managers reported that these formula changes are causing a systemic problem for their cities. The changes in the formulas provide for a generous but costly increase to the monthly benefits. Estimates project that annual pension benefits will increase approximately 25% to 50% from the previous formulas.

4. Other Post-Employment Benefits (OPEB)

Most of the cities in the County provide OPEBs in addition to pension benefits to their retirees. OPEBs typically include health, dental, vision, or prescription drug care to eligible retirees, their families, and in some cases, their beneficiaries. However, benefits vary widely from no additional contributions after retirement, to full retiree and dependent coverage for life, after a vesting period. These benefits are tax free.

Retiree health insurance premiums have been escalating. The increased number of baby boomers reaching retirement age and employees retiring at a younger age are affecting this cost.

Cities are required by the federal Governmental Accounting Standards Board (GASB) to calculate their long-term retiree health obligations by June 2010, depending upon the annual amount of city revenue. Therefore, complete information is not yet available. However, the magnitude of the obligations reported to the Grand Jury for the next several years shows a dramatic increase in projected yearly expenditures and future liabilities.

Funding Pensions and OPEBs

To cover pension obligations city employees pay fixed rates into CalPERS, while the rate the cities pay is adjusted every three years. Rates are determined by the performance of CalPERS investments and the anticipated pension obligations for each city. The payment is made as a percentage of employee salaries.

Similarly, in San Jose, city employees contribute a fixed rate as a percentage of salary into the applicable pension plan. The City's contributions are established by its retirement boards and are based on many factors, including the cost-sharing arrangement with the employees and the level of benefits provided. Rates can increase if there is a decline in the assets of the retirement fund, which has occurred recently with the steep decline in the stock market.

The cities are responsible for the mounting unfunded pension liability. Unfunded pension liability is an estimate of the cost of future retirement payments for which the city does not have funds already set aside. This is one of the reasons that the cities' contribution rates are notably higher than employees' contribution rates, as set forth in the table below.

Table 6: Employer Contributions as a Percentage of Salary to Pension Plans and OPEB

	Employer Contribution as a Percentage of Salary to Pension Plan			Employer Contribution as a Percentage of Salary to OPEB		
City	**Police**	**Fire**	**Regular Employees**	**Police**	**Fire**	**Regular Employees**
Campbell	35.2%	None[2]	10.7%	5.0%	None[2]	4.0%
Cupertino	None[2]	None[2]	21.56%[1]	None[2]	None[2]	13.9%
Gilroy	35.25%[1]	35.25%[1]	12.64%	0.02%	0.02%	0.02%
Los Altos	28.99%[1]	None[2]	22.69%[1]	CALPERS Minimum Health Benefits		
Los Altos Hills	None[2]	None[2]	21.69%[1]	None[2]	None[2]	14.2%
Los Gatos	33.84%	None[2]	14.58%	2.21%	None[2]	5.19%
Milpitas	21.68%	21.68%	14.58%	7.9%	7.9%	7.9%
Monte Sereno	None[2]	None[2]	19.66%[1]	N/A	None[2]	None[2]
Morgan Hill	28.05%	None[2]	19.69[1]	0.00%	None[2]	0.00%
Mountain View	25.56%	25.56%	15.59%	7.34%	7.34%	7.34%
Palo Alto	33.7%[1]	33.7%[1]	23.55%[1]	9.9% (08/09)	9.9% (08/09)	9.9% (08/09)
San Jose	21.61%	24.12%	18.31%	5.28%	4.19%	5.7%
Santa Clara	26.12%	26.12%	17.02%	2.29%	2.24%	2.31%
Saratoga	None[2]	None[2]	18.65%[1]	None[2]	None[2]	N/A
Sunnyvale	41.09%[1]	41.09%[1]	22.25%[1]	8.0%	8.0%	8.0%

Source: Data from Fiscal Year 2009-2010, except as otherwise noted

Notes:

1 Includes percentage of employee contribution that the city pays

2 Service provided by County or special district

Employee Contributions to Pensions and OPEB

Employee contribution rates as a percentage of salaries are as follows:

- Regular employees: 8% to CalPERS when the formula is 2.7% at 55, and 7% if the formula is less
- Safety employees: 9% to CalPERS when the formula is 3% at 50, and 8% if the formula is less
- San Jose Regular employees: 4.28% to The Federated City Employees' Retirement System
- San Jose Police employees: 8.18%, Fire employees 8.62% to Police and Fire Department Retirement Plan
- Cupertino Regular employees: 2.4% for OPEB
- San Jose Regular employees: 5.7% for OPEB
- San Jose Police employees 5.28%, Fire employees 4.19% for OPEB
- Employees in the other cities contribute nothing for OPEB

Nine of the 15 cities – Cupertino, Gilroy, Los Altos, Los Altos Hills, Monte Sereno, Morgan Hill, Palo Alto, Saratoga, and Sunnyvale – pay all or a portion of the employees' pension contributions. For example, Gilroy pays 100% of safety employees' contributions; Morgan Hills pays 100% of regular employees' contributions. This means those employees do not make any contributions to their own pensions.

Social Security Contributions

Of the 15 cities, only Monte Sereno and Santa Clara contribute to Social Security for regular employees. Such participation requires both the city and the employee to contribute 6.2% of the employee's salary to the Social Security system. The employees of most cities will not be able to receive Social Security unless they have worked and contributed for 40 quarters at another employer.

Pension Reform; Two-Tier System

The pension benefit is the most expensive benefit provided to employees and has significant cost implications, which is why cities must ensure that the costs of pension benefits are sustainable in the long term. During Grand Jury interviews, many city managers and finance directors stated that pension costs are skyrocketing and diverting limited resources from community services. For example, in Mountain View, CalPERS costs have increased over the past decade from $2.8 million to $7.7 million. San Jose will contribute approximately $138 million into its two retirement plans for 2009 - 2010; more than double that of just 10 years ago. Pension costs are increasing due to benefit enhancements and losses in investment returns.

City managers recognize the challenge they are facing and are working together through the Santa Clara County/Cities Managers' Association to investigate ways to reduce pension costs. Since pension benefits are considered vested, there are limitations on what can be changed. Recently the city managers of Santa Clara County and San Mateo County agreed on a joint policy statement that recommends that all cities adopt a two-tier pension system. (Appendix D) In the two-tier system, cities would implement a reduced level of retirement benefits for all new employees in all agencies in the region. This solution would take detailed planning and communication to implement. The Santa Clara County Cities Association has asked the city managers to present the proposal to their respective city councils and start preliminary discussions with the unions.

Among other cities statewide, San Carlos and Brisbane have already initiated a lower, second tier for new hires. Palo Alto is in the process of implementing a second tier for new Service Employees International Union workers. Sunnyvale completed a preliminary analysis of a second tier and estimated it could save approximately $45 million over 20 years. The goal of two-tier system would be to provide a competitive pension at a more sustainable long-term cost by increasing the age of retirement and lowering the retirement payout.

Other suggested options to reduce pension costs are 1) convert to defined contribution plans for new hires, which are common in private industry and 2) eliminate "double dipping", which occurs when a public employee retires and subsequently enrolls in a new public retirement fund while continuing to collect from the earlier one.

Retiree Health Care Reform

Retiree health care costs continue to increase and cites are facing significant unfunded liability for their retirees' health care benefits. San Jose is working on a plan that provides for the costs of retirees' medical benefits to be split 50/50 by the city and the employees, which over time would reduce the city's unfunded liability.

Other cities are looking at modified health care plans for their new employees. In some of these plans, the obligations of the city end when the employee retires. One example is establishing a health savings account for each employee hired after a certain date; the city contributes to the account each month, which after vesting the employee can take into retirement. Health savings plans are tax sheltered and the employee can contribute to them.

5. Days Off

Employees receive paid time off for holidays, vacations, personal leave days and sick days; the number of days granted each employee vary by city and by union.

The number of vacation days increase based on length of employment with an allotted number of hours or days granted each year. In some cities vacation days can be accumulated year after year and converted to cash at termination or retirement, or added to the number of years of service and calculated into the retirement benefit. Other cities have imposed limits on accrual time, and require cash out at that time.

Employees receive approximately 12 days of sick leave each year. Disability insurance is available for extended sick leaves. Depending on union affiliation, employees are eligible to receive accrued sick leave as a cash payment or added into their number of years of service and calculated into their retirement benefit. Some are eligible to receive up to 100% of their sick leave paid out at retirement, with no cap on the number of hours. Other employees are eligible to receive up to 75% of their sick leave paid out to a maximum of 1200 hours at retirement.

Although payouts of accrued sick leave are common in government agencies, these benefits are not common in the private sector and could be reduced and capped to save costs.

Table 7: Days Off Per Year by City

City	Vacation Days [1]	Holidays	Floating or Personal Days	Total Possible Days Off (retainable) [2]	Sick Leave
Campbell	11 to 21	10	5	24 to 38	12
Cupertino	10 to 22	12	3 (FLSA exempt)	22 to 44	12
Gilroy	10 to 20	9	4.5	20 to 40	12
Los Altos	10 to 20	10	2 (5 for mgmt.)	N/A	12
Los Altos Hills	12 to 20	12	12 (FLSA exempt)	30	12
Los Gatos	10 to 25	10 to 12	3 (6 for mgmt.)	40	12
Milpitas	11 to 31	12	1	Note 4	12
Monte Sereno	10 to 20	12	0	25	12
Morgan Hill	10 to 20	11.5	2	20 to 40	12
Mountain View	12 to 25	11[3]	2	30 to 60	12
Palo Alto	10 to 25	12	0	30 to 75	12
San Jose	10 to 25	14	3 (some classifications)	20 to 50	12
Santa Clara	10 to 24 (fire 36)	13 to 14	3	50 (fire 84)	12
Saratoga	22 to 32	13	0	75	0
Sunnyvale	11 to 26	11	2.5 – 3.5	62 (safety 50)	0

Notes:

1 Number of days varies by length of service.

2 In most cities vacation and sick leave days above the allowed retainable number can be cashed out annually; the retainable amounts can be cashed out at retirement or resignation.

3 Mountain View fire and police receive 5.55 days in lieu of holidays; San Jose fire and police receive 5.6 days in lieu of holidays.

4 Employees may annually cash out up to 50% of their balance of sick days and 80 hours of vacation; the rest is retainable.

In the past year, a few cities have imposed furlough days; although this reduces costs, it also impacts services provided to the community. Some cities are considering substituting certain paid days off for unpaid days, instead of imposing furloughs to reduce the impact on services.

WORK FORCE PRACTICES

1. Determining Wage and Benefits Packages

The Grand Jury learned from interviews that most cities set their compensation packages by surveying the wages paid to public employees in a handful of like cities in the general area, rather than wages for the employment market at large. In union negotiations, cities will often negotiate to a place on the comparable wage index rather than negotiating what they think are reasonable salaries by job classification. If the wages in a salary range increase due to negotiations, all negotiated salaries increase.

Limiting comparisons to other cities in the same geographic area results in “a follow the leader” or “keeping up with the Jones” mentality in the cities, rather than real market-based compensation. Neither cities nor the labor unions appear to see a value in comparing private and public sector wages and benefits, or in tracking compensation trends in general. Recently, the Bureau of Labor Statistics reported that high-tech wages in the Bay Area (54% were in Santa Clara County) dropped 12% in the past nine years following the collapse of the dot-com bubble. During this time period, wages in city government increased substantially.

Private industry has wrestled with the same benefit issues as the public sector, and has been quicker to implement solutions that have reduced or contained employer-paid costs, especially pension and health care costs. A report published by the Employee Benefit Research Institute (EBRI) noted that, “State and local governments have sharply higher costs for health and retirement benefits than private-sector employers, since their workers participate in these benefits at far higher rates and public-sector workers are far more likely to have defined benefit retirement benefits than are private-sector workers.” The EBRI stated that government employers’ overall total compensation costs were 51.4% higher than private-sector employers’ costs; the costs were 42.6% higher for wages and salaries and 72.8% higher for benefits.

2. Consolidating Services with Other Cities or the County

All cities provide core services for their residents and perform operational activities to keep the city running properly. With 15 cities performing similar functions, there are opportunities to reduce duplication, decrease costs and improve efficiency by sharing or consolidating services among cities or the County.

Currently, four cities obtain police services from the County Office of the Sheriff; others utilize the County’s fire services or have special fire districts. Several cities have consolidated their animal control functions. The Grand Jury learned through interviews that these arrangements are successful and provide a sizeable cost savings. Additional merging of services, such as trash collecting, library functions, payroll activities, and parks and recreation work, could be pursued to reduce employee costs while providing effective and efficient services to the community.

3. Outsourcing to Private Industry

Outsourcing to private industry is another avenue for cities to pursue to decrease employee costs while maintaining services. Through interviews, the Grand Jury learned that Saratoga and Monte Sereno utilize this service delivery model extensively. Saratoga identifies itself as a "contract city." Several cities have limited contracts with private firms and other cities are beginning to examine the option.

Functions currently being contracted out include landscaping, street sweeping, tree trimming, recreation services, road surfacing, janitorial services, fleet maintenance, trash collection, and traffic engineering. Santa Clara has outsourced the bulk of its information technology functions.

Outsourcing services traditionally performed by employees requires proper planning, effective communication, reliable cost comparisons, and performance-based contracts. And for many cities, it means negotiating with and working with their unions to accomplish this transition.

4. Optimizing Staff

Organizationally, the cities should ensure that their staffing models are efficient, effective and are operating at the optimum level to decrease employee costs. It is important to analyze the functions performed by all job classifications and make adjustments in the work force. As appropriate, cities should reassign functions to lower paid job titles, consolidate functions with similar jobs in the same or similar work group, and trim unnecessary functions.

In 2009, Sunnyvale retained a consulting group to conduct an optimal staffing study of seven departments. Many of the staffing and operational improvements recommended by the group have been adopted and other changes will be implemented in the future.

The Office of the City Auditor in San Jose recently completed a study that identified 88 positions being performed by public safety employees that could be performed by civilian employees at a lower cost. These positions are in Administration, Investigations, Technical Services, and the Office of the Police Chief. Some examples of the positions that could be switched to civilians are: Public Information Officer, Police Artist, Watch Bulletin Police Officer and Main Lobby Police Officers. The estimated annual savings would be $5,077,500.

LABOR NEGOTIATIONS

1. Collective Bargaining Agreements

In the cities, with the exception of Los Altos Hills and Monte Sereno, the majority of the work force is represented by labor unions and operates under collective bargaining agreements. Salaries, health care benefits, retirement pension plans, other post-employment benefits plans, and workplace rules are negotiated by the unions on behalf of their members.

Each city negotiates with from three to 11 unions. For instance, Los Gatos has three unions; San Jose has 11 bargaining units, representing approximately 96% of the work force. The cities and each bargaining unit negotiate legally-binding contracts, which are known as either a Memorandum of Agreement (MOA) or a Memorandum of Understanding (MOU), and they are effective for a designated period of time, usually two or three years.

Pursuant to the Meyers-Milias-Brown Act (MMBA), the cities have a right to insist that contract negotiations take place at the bargaining table between the designated representatives of each city and the designated representatives of the various bargaining unit employees. Both the cities and the unions have an obligation under applicable law to negotiate in good faith. It is the goal of both parties to reach a negotiated collective bargaining agreement.

2. Mediation and Arbitration

Under the MMBA, if negotiations do not result in a tentative agreement, impasse procedures allow either party to invoke mediation. If there is still no agreement after impasse procedures are exhausted, the MMBA states that the public agency may implement its last, best and final offer. Additionally, after mediation the bargaining units have the right to strike, except for police officers or firefighters who do not have the right to strike.

For San Jose police and firefighters, if parties fail to reach agreement after mediation, City Charter Section 1111, approved by voters in 1980, allows the parties to submit the dispute to binding arbitration. A three-member panel comprised of a city representative, a union representative, and a neutral arbitrator selected by the city representative and the union representative, decides each issue by majority vote. The arbitration is not open to the public.

3. Negotiating Team

Each city delegates the authority to negotiate labor contracts on behalf of the city to the city manager or the city manager's designee. The city manager generally delegates the lead negotiating responsibility to one of these job titles: assistant city manager, human resources director, employee relations director, or administrative services director. Other key members of the city negotiating team may include the city attorney or an outside labor attorney, the department head or a high-level manager of the applicable work group, the finance director, and occasionally an outside consultant.

The negotiating team members do not belong to unions, and they do not operate under a financial incentive. But as employees of the city, their compensation is proportional with union employees; when salaries and benefits increase for union members, they are generally awarded similar increases. In some cities, members of negotiating teams have worked for the cities for a number of years, and many have come "up through the ranks" and have strong connections to the union employees. Some of the city managers told the Grand Jury that this can be problematic, as these negotiators may experience peer pressure and concede to the unions. For this reason, among others, a few cities are considering adding outside consultants to their teams.

4. Role of the City Manager

Prior to labor negotiations, the city manager provides to the mayor and city council a detailed fiscal analysis of current and projected economic conditions, and the current and projected budget. The city manager also meets with the mayor and council in closed session to recommend the city's position on contract renewal, itemize issues, and receive direction about the intended outcome of negotiations. In upcoming negotiations, it is anticipated that cities will ask for concessions for both current wages and current and future benefits. Prior to negotiations, some of the city managers conduct informal meetings with union leadership, as well as the rank and file members, to provide data on the city's financial health and employee costs.

The city manager is integral to negotiations and is responsible for setting strategy, direction, and parameters for the negotiating team. The city manager is closely engaged with the team prior to negotiations to determine the areas the city would like to negotiate and those it would not like to negotiate. The MMBA, however, defines and controls the areas that are subject to negotiation. Throughout negotiations, the city manager is briefed regularly on progress and issues. The negotiating team will consider the union proposals during the length of the negotiations, and discuss and counter the proposals within the confines of the council's guidance.

5. Role of the City Council and Mayor

The mayor and council are responsible for setting policy direction and guidelines for labor negotiations, overseeing the city manager, and approving labor contracts. The mayor is the public spokesperson.

Although the mayor and council are supposed to represent the best interests of the city and ultimately the taxpayers during negotiations, it is difficult to separate politics from bargaining sessions. If the council approves a package that is favorable to labor, some council members could benefit if they keep or earn union support. Throughout the County, many city councils are dominated by labor-endorsed candidates, and unions play an active role in elections. Unions often support their candidates' campaigns with endorsements and contributions. They print and distribute literature, manage phone banks, make personal appearances at campaign events, and canvass neighborhoods. Conversely, unions will sometimes negatively campaign against a candidate they oppose.

During its investigation, the Grand Jury learned that labor representatives sometimes go directly to council members while negotiations are occurring to solicit their support for various proposals. For this reason, the Santa Clara City Council and the city manager developed and approved "Employer Notification Principles" for the negotiating team and the council to observe during negotiations. These principles govern the commitment, responsibility and behavior of the city manager and the council and have improved the city's negotiations. These principles discourage council and labor discussions during the negotiation process. San Jose has a similar policy that sets guidelines for the council to ensure labor negotiations are conducted in good faith and to avoid actions that would circumvent the city's designated bargaining team.

PUBLIC INVOLVEMENT

In the past year, many articles have appeared in newspapers and other publications about the dire fiscal straits of our cities. The public is becoming aware of the growing cost of employee obligations. Until recently most residents were relatively uninformed about long-term financial costs and how they came about.

During Grand Jury interviews, four of the cities indicated that they did not hold public discussions before the start of their last contract negotiations; other cities stated that they did encourage public comment in regard to the salaries or benefits being negotiated, but that these sessions did not garner a lot of public attention. Some of the city managers acknowledged that the taxpayer is often unaware of the long-term financial impact of negotiations, especially concerning pensions.

The negotiated MOAs and MOUs are either on a council's consent calendar for approval or appear as a separate agenda item. In either case, there is seldom lengthy discussion around this approval. Approved contracts are posted to a city's web site.

Many city leaders are currently engaged in a variety of activities to better inform the public about the cities' financial health and to solicit input. These activities include publishing quarterly newsletters, posting reports on city web sites, conducting budget sessions, sending out surveys, and creating task forces.

Ballot Measures

Escalating public employee costs are a problem occurring throughout California. In some cities and counties, recent ballot initiatives have given citizens an opportunity to vote on retirement and health care benefits.

Orange County, San Francisco, and San Diego voters passed ballot measures as follows:

- In November 2008, Orange County voters decided that future retirement increases must be voter approved.
- In June 2008, San Francisco approved two measures increasing pension benefits for existing employees, but limiting the future costs of retiree health care benefits:
    - New employees will contribute 2% of salary and the employing agency will contribute 1% to a new retiree health care fund.
    - New employees must work ten years to receive half of their health care costs upon retirement and 20 years for full coverage; previously employees were 100% vested after five years.
- In November 2006, San Diego required voter approval of any increase in retiree benefits.

Conclusion

In the past decade, reasonable, intelligent people – city and labor representatives – negotiated generous employee wage and benefit packages through collective bargaining agreements under which the cities are currently operating. As these expire, both groups must recognize the financial impact of these agreements, coupled with the economic downturn, and negotiate contracts that will:

- Assist the cities in returning to fiscal health.
- Preserve the services the taxpayers deserve and expect.
- Provide competitive and affordable compensation for employees.

For many years, there was a common belief that public sector employees earned lower wages than the private sector, but this was balanced by more generous public benefits. Current data shows wages have increased in the cities and are at least on par with private sector jobs, while benefits in the cities have escalated dramatically, thus increasing total compensation to a point that it is out of sync with private industry and is unsustainable for the cities. Unfortunately the taxpayers, who come from both public and private sectors, are funding this inequity.

The cities' leadership must look beyond political barriers and focus on total compensation and on workplace practices to contain escalating employee costs. All parties – city administrators and labor unions – need to negotiate in good faith to implement lasting, vigorous, sustainable change for our cities.

Findings and Recommendations

Finding 1

The costs of total compensation for employees have grown substantially in the past decade and now threaten the cities' fiscal stability.

Recommendation 1

All of the cities in the County need to implement measures that will control employee costs. As a starting point, each city should determine the percentage of savings required from the total compensation package to reach budget stability, and provide choices of wages and benefits in collective bargaining sessions for the unions to choose to achieve that percentage goal.

Finding 2

Salary and wage increases do not reflect changes in economic conditions; e.g. even with minimal inflation, yearly COLAs are granted with little bearing on the actual increase in cost of living or market conditions.

Recommendation 2

Cities should not increase salaries and wages that are not supported by planned revenue increases. Cities should tie COLA increases to clear indicators and retain the ability to adjust or withhold based on current economic data.

Finding 3

Step increases are arbitrary and do not adequately represent an employee's added value to a city. Combined with COLAs, new employees' wages increase quickly and are not necessarily reflective of improved knowledge and skills.

Recommendation 3

Cities should negotiate step progressions from the current three and a half years to seven years. Employees should not receive COLA increases while in step progression.

Finding 4

Medical insurance costs for active employees are growing year after year at rates that exceed most cities' revenue growth, while the employee contribution to medical care is minimal.

Recommendation 4

Cities should negotiate that employees assume some of these increased costs for their medical benefits. To contain medical costs cities should consider the following:

A. Split monthly premiums between the city and the employee and increase the employee's share, if already cost splitting, and remove any employee caps.
B. Establish reasonable co-pays for doctors' visits, prescription drugs, and in-patient and out-patient hospital care.
C. Prohibit an employee from being covered by both city-provided medical benefits and as a dependent of another city employee.
D. Reduce cash-in-lieu payments.
E. Introduce a new lower premium, high-deductible medical plan.

Finding 5

Pension formula changes instituted in the past decade, stock market losses, the aging "baby boomer" work force, and the growing unfunded pension and OPEB liability all contribute to making retiree pension and health care costs the most problematic and unsustainable expense the cities are facing. The city contribution to pension plans and OPEBs far exceeds the employee contribution.

Recommendation 5a

Cities should:

1) Renegotiate and make provisions for increasing the employees' contribution for current pension plans.
2) Renegotiate to stop paying the employees' contribution amount to pension plans.
3) Renegotiate to implement a contribution amount for employees to OPEB; this contribution should provide for a reasonable split of costs between a city and the employee for retiree medical and dental benefits.

Recommendation 5b

Cities should thoroughly investigate reverting to prior pension formulas that were less costly.

Recommendation 5c

To provide a meaningful, long-term solution, the cities should negotiate agreements to:

1) Institute a two-tier system for pension and retiree health care for new hires.
2) Increase the retirement age from 50 or 55 to 60 or 65.
3) Calculate pensions on the last three to five years of salary.
4) Replace current post-employment health care plans with health savings plans.

Finding 6

Public sector employees are granted a generous number of holidays, personal days, vacation days and sick leave annually. Rules and limits on accrual vary by city and union, but vacation days and sick leave can be accumulated and converted to cash or calculated into the pension benefit within those limits.

Recommendation 6a

Cities should renegotiate with the bargaining units to 1) reduce vacation time; 2) reduce the number of holidays and/or personal days; 3) cap sick leave and eliminate the practice of converting accumulated sick leave to cash or adding into their years of service for inclusion in their retirement benefit.

Recommendation 6b

Cities should negotiate to substitute paid days off for unpaid days instead of imposing furloughs. For example, reduce paid holidays to major holidays only, consistent with private industry; and convert minor holidays to unpaid. Therefore, the public is not impacted by fewer services caused by furloughs, and the city saves the employee cost.

Finding 7

Cities traditionally determine their compensation packages by surveying the wages and benefits of other public sector employees in the same geographic area. There is major resistance to comparing themselves or mirroring trends with the private sector. This has allowed wages and benefits to become artificially high and out of sync with market trends.

Recommendation 7a

Cities should research competitive hiring practices and alter the approach to determine fair wages and benefits for each city by using public and private sector data.

Recommendation 7b

Cities should renegotiate salaries and wages using valid market comparisons and not only the current wage index. Cities should utilize more market-oriented compensation practices so that salaries can adjust as competition for labor changes. Cities should reduce entry-level compensation for positions for which there are many qualified applicants.

Finding 8

All cities perform certain core functions to run smoothly and provide services to their residents. To reduce employee costs and streamline operations, the cities are in various stages of contracting services to private industry or partnering with other cities, special districts or the County to deliver services.

Recommendation 8a

Cities should explore outsourcing some functions and services to private industry. Cities should discuss the prospect with cities that are successfully doing this to determine best practices and areas for success. Cities should develop contracts with measurable objectives, performance goals, and timelines.

Recommendation 8b

Cities should create partnerships with other cities, special districts and/or the County for services, such as payroll, human resources, animal control, police and fire. Cities should investigate sharing the cost of new information technology systems.

Finding 9

Cities can gain operational efficiencies and effectiveness with lower employee costs by making sure they are staffed with the correct numbers of people in the appropriate job classification in all departments and work groups.

Recommendation 9

Cities should analyze the functions performed by all job classifications and make adjustments in the work force. Consolidate functions within the same group or a similar group. Reassign appropriate work to lower paid job classifications. Eliminate unnecessary functions.

Finding 10

The San Jose City Auditor identified 88 positions currently being performed by public safety employees that can be performed by civilian employees at lower costs. The safety employees could be moved to positions that require their expertise and training. The auditor estimated this could be accomplished in less than 90 days and save approximately $5 million annually.

Recommendation 10

San Jose should negotiate this suggested transfer with the San Jose Police Officers' Association and set realistic timeframes to move these safety positions to civilian positions.

Finding 11

In many cities, the contract negotiation process is completed by placing the negotiated collective bargaining agreements on the consent calendar for approval, which is acted on quickly at the start of council meetings by a single motion and vote of the council.

Recommendation 11

Cities should consider holding well-publicized public hearings about the cities' goals of negotiations before negotiations begin, and again at the end of negotiations to report to citizens clearly what changes have been made in contracts.

Finding 12

Current contracts were negotiated in good faith by representatives of the cities and the bargaining units; they were approved by the city councils. Promises made to employees were made by elected officials, past and present. Responsibility for formulating and approving solutions to restore the cities' financial stability resides squarely with our elected officials. The economic downturn has placed additional pressure on the situation.

Recommendation 12a

City council members and mayors should become better informed about the fiscal realities in their cities, long-term costs and commitments, and be cognizant of potential issues in labor agreements.

Recommendation 12b

City councils and mayors should direct city administrators to (re)negotiate collective bargaining agreements that reverse the escalation of employee costs through concessions, cost sharing, and a second tier for new employees.

Recommendation 12c

City councils and mayors should meet with the bargaining units to clearly outline the cities' financial health and show how employee costs are impacting the budget.

Recommendation 12d

City councils and mayors should inform citizens of their plans for controlling unsustainable employee costs and remove politics from the equation.

Finding 13

Binding arbitration is not open to the public and results in an adversarial process between the city and employee groups. Binding arbitration limits the ability of city leaders to craft solutions that work for the city's budget. The process has resulted in wage and benefit decisions that have been greater than the growth in basic revenue sources.

Recommendation 13a

San Jose City Council should make binding arbitration open to the public.

Recommendation 13b

San Jose City Council should prepare a ballot measure asking voters to repeal Section 1111 of the City Charter that addresses binding arbitration.

Appendix A

Retirement Information Form Sent to Cities

City: _____

	Union Name	Union Name	Union Name	Union Name	Union Name	Union Name
Current Pension Plan (formula)						
Future Pension Plan based on MOU						
Year Future Plan is effective						
Current COLA						
Future COLA based on MOU						
Current Pension calculated based on final year salary, 3 year average, or other						
Future Pension calculated based on final year salary, 3 year average, or other						

Appendix B

City Contribution Form Sent to Cities

City: _____

A	B	C	D	E	F	G	H
	City Contribution to Pension as % of pay	Employee Contribution to Pension as % of pay	% of Employee's Pension Contribution paid by City*	City Contribution to OPEB as % of pay	Employee Contribution to OPEB as % of pay	Current Amount of Pension that is Funded	Current Amount of Pension that is Unfunded
Non-Public Safety Employees							
2009							
2010							
2011							
2012							
2013							
2014							
Police							
2009							
2010							
2011							
2012							
2013							
2014							
Fire							
2009							
2010							
2011							
2012							
2013							
2014							

Question: Does City/Employee contribute to Social Security? Yes/No _____

*Does the city pay a portion of the employee's required share of retirement contribution? If so what is that percent? _____

Appendix C

City Information Form Sent to Cities

City of _____

CITY INFORMATION

1. What is the population of your city based on the 2000 census? _____
2. What is the estimated current population? _____

3. How many total FTE's (Full Time Equivalents) did your city have in 2000/01? _____
4. How many total FTE's does your city have now (2009/10)? _____

5. How many FTE were in the Police department in 2000/01.? _____ Now _____
6. How many FTE were in the Fire department in 2000/01? _____ Now _____

7. What was your Total Revenue in fiscal year 2000/01 _____
8. What is your Total Budgeted Revenue for 2009/10? _____

9. What per cent of the General Fund were employee costs with benefits in 2000/01? _____
10. What per cent are employee costs of the 2009/10 budget? _____
Employee costs include payroll, retirement benefits, health/dental benefits and other benefits.

11. How much did the city contribute to non-safety Retirements benefits in 2000/01? _____
How much did the city contribute to Police/Fire in 2000/01? _____

12. What is the non-safety Retirement cost for 2009/10? _____
What is the Police/Fire Retirement cost for 2009/10? _____

13. How much did the City pay for Health/Dental Benefits in 2000/01? _____
14. What is the 2009/10 City cost for Health/Dental Benefits? _____

15. What was the average monthly premium the City paid for employee Health/Dental Care in 2000?
Individual _____ Family _____
16. What are the current average premiums for Health/Dental Care?
Individual _____ Family _____

17. What was the median salary for non-safety employees without benefits in 2000? _____
With benefits _____
18. 2009/2010 median salary without benefits _____ With benefits _____

19. What was the median salary for police employees without benefits in 2000/01? _____
With benefits _____
20. Current median salary without benefits _____ With benefits _____

21. What was the median salary for fire employees without benefits in 2000? _____
With benefits _____
22. Current median salary without benefits _____ With benefits _____

Appendix C - continued

City Information – continued

23. What is the average number of years for your non-safety employees? _____
What is the average number of years for police? _____
What is the average number of years for fire employees? _____

24. How many vacation days, floating days, holidays, personnel leave days and sick days are employees entitled to annually?

25. What are the vacation and sick leave accrual and buy out policies?

26. Did you impose any furlough days this year? **Y N** If yes, which work groups? How many people are affected? How often?

27. Prior to entering into each of your current agreements with organized labor, did your city Council, as part of regular business, encourage public comment in regard to the salaries or benefits being negotiated? **Y N**

28. Are the MOU's resulting from contract negotiations typically on the consent calendar when coming to the City Council for approval? **Y N**

Appendix D

Santa Clara County/Cities Managers' Association Policy Statement on Retirement Benefits

Santa Clara County/Cities Managers' Association

San Mateo County City Managers Association

Policy Statement on Local Government Retirement Benefits

Background

For more than 70 years, the State of California and local governments have offered a "defined benefit" retirement plan to employees. This system provides a guaranteed annual pension based upon retirement age, salary, and years of service. Most, but not all, municipalities in California are part of the Public Employees' Retirement System (PERS).

Over the years, local government retirement costs have risen and fallen based on two key factors: investment returns and the level of benefit payments provided to employees. In the late 1990's the California legislature enacted significant benefit enhancements for public employees in the PERS system that were optional for participating local governments. At that time, some retirement plans were deemed to be "super funded" and many local governments adopted benefit enhancement plans. For example, most public safety personnel are on the "3% @ 50" plan, which provides a pension benefit of up to 90% of salary after 30 years of service as early as age 50.

When the retirement system suffered serious investment losses in the early part of this decade, these losses, combined with newly approved benefit enhancements, caused dramatic increases in employer contribution rates. Cities in our two counties have seen the percentage of their General Fund budget dedicated to PERS costs increase while their retirement liability funding had decreased from over the past decade. For example, in Mountain View, General Fund PERS costs have gone from $2.8 million in FY00 to $7.7 million in FY10; in San Bruno, it has gone from $240,000 to $4 million. Daly City's percent of the General Fund budget spent on retirement benefits has increased from 4.3% to 10.4% between FY00 and FY10; in Belmont, it has gone from .5% to 11.4%. And Campbell has seen its public safety retirement system fall from 122% funded to 70% funded over ten years.

In the past five years, a number of proposals have been introduced to reform or dramatically revise the public pension system in California. In 2004, a task force of the League of California Cities began an extensive study of the defined benefit system and proposed reforms. In 2005, the League board of directors accepted a report on pension reform from the task force as an initial assessment and for consideration in the ongoing debate of this issue. The report included a number of "general principles" and specific reform recommendations. To date, no concrete action has been taken by the legislature.

Recently, the city managers of San Diego County have prepared a white paper on this issue calling for a new and lower second tier retirement benefit for new hires. Other manager groups across the state have begun a similar dialogue in recognition that the costs of the current system are not sustainable. Additionally, Governor Schwarzenegger has proposed returning pension formulas to 1999 levels for new hires – a move he says will save the state $74 billion through 2040. The City of Sunnyvale has done a preliminary analysis of a lower tier and has estimated it could save a total of $44 million over 20 years. The cities of San Carlos and Brisbane have already initiated a lower, second tier for new hires (among other cities statewide).

Discussion

While the debate is ongoing, no clear consensus has been achieved on addressing the high cost of pension benefits and no action appears imminent. The city managers of Santa Clara and San Mateo counties believe it is important to take a proactive stance on this issue which has long-term implications for the fiscal stability of our cities. This issue is even more important now, given the tremendous losses suffered in the stock market in the past year. At fiscal year end in June 2009, PERS annual returns were down 23.4% from the previous year. This is on top of losses of 5.1% in Fiscal 2008. PERS assumes a 7.75% gain annually to maintain its pension obligations, but clearly there is no guarantee this rate can be achieved. Based on this year's negative returns, employer rates are expected to jump significantly as of July 1, 2011.

Therefore, as a matter of public policy, we endorse the following principles for a revised pension system.

Guiding Principles

- Our residents deserve fiscal policies that preserve local government's ability to meet community needs, while attracting competent and motivated employees to public service.

- Providing adequate retirement benefits is an important part of attracting and retaining public employees; this continues to be an issue as, demographically, there are fewer young people to enter the public sector.

- Current retirement benefit formulas are not fiscally sustainable. The costs are escalating beyond our ability to fund them and diverting limited resources from direct service delivery to our communities. In addition, current pension benefits exceed what private sector employees receive and what is reasonably needed to attract public employees.

- Ideally, this situation would be addressed at a statewide level and there would be consistent standards for all. We cannot, however, afford to wait for a statewide solution. Therefore, the cities of Santa Clara and San Mateo counties support

implementation of a reduced and sustainable level of retirement benefits for all new employees of agencies in the region.

- Each city has different histories, perspectives, and fiscal conditions; a "one size fits all" approach may not be realistic, but all cities in the region compete for the same employees and therefore should move in the same direction to a lower-cost benefit.
- Each city has the legal duty to meet and confer in good faith with its recognized bargaining unit representatives concerning changes to existing terms and conditions of employment.
- Every city is committed to moving toward a two tier system for all new contracts.
- Any new system or tier should be fair to employees, sustainable for taxpayers and employers, and based on objective actuarial data.

Action Steps

The city manager associations of Santa Clara County and San Mateo County support the statements in this document and their members pledge to work with their elected officials and labor groups to implement its principles. We further pledge to work with other city managers across the state and the League of California Cities to advocate for changes consistent with this document.

Dave Anderson, SCCCMA

Connie Jackson, SMCCMA

Adopted July, 2009

3

This report was **PASSED** and **ADOPTED** with a concurrence of at least 12 grand jurors on this 13th day of May, 2010.

Angie M. Cardoza
Foreperson

Judy B. Shaw
Foreperson pro tem

Mary Nassau
Secretary

COUNCIL AGENDA: 10-05-10
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Katy Allen

SUBJECT: SEE BELOW

DATE: 09-16-10

Approved

Date 9/17/10

COUNCIL DISTRICT: Citywide

SUBJECT: APPROVE RANKINGS AND AUTHORIZATION TO NEGOTIATE THE DESIGN BUILD CONTRACT FOR THE SAN JOSE MCENERY CONVENTION CENTER EXPANSION AND RENOVATION PROJECT

RECOMMENDATION

Adoption of a resolution by the City Council:

(a) Approving the final rankings of the five (5) design-build entities that responded to the RFP for the San José McEnery Convention Center Expansion and Renovation Project; and;

(b) Authorizing the Public Works Director to negotiate a design-build contract for the Project as follows:

1. Begin negotiating with the highest ranked contractor, Hunt Construction Group;

2. Begin negotiating with the next highest ranked contractor, Turner Construction, if after having negotiated with Hunt, the Director determines that the City's interests are best served by beginning negotiations with the next highest ranked contractor; and

3. Begin negotiating with each of the other contractors in order of their ranking as the Director determines is appropriate.

OUTCOME

Council approval of the final ranking and authorization to the Director of Public Works to negotiate with the design-build entities as described in this memorandum will allow the development of a design-build contract for the San José McEnery Convention Center.

EXECUTIVE SUMMARY

Five high-quality entities were prequalified to submit proposals for the Convention Center Expansion and Renovation Project. All five prequalified firms responded to the RFP and were evaluated by the criteria approved by Council on June 22, 2010. A selection panel comprised of diverse stakeholders evaluated the proposals and the following is the outcome of the ranking based on the aggregate of the panelist's scores.

Proposer	Ranking
Hunt / Populous	1
Turner / HNTB	2
Hensel Phelps / Fentress	3
Clark / TVS	4
Gilbane / URS	5

Upon Council approval of the final ranking, staff will enter into contract negotiations with Hunt Construction Group. This contract will specify the schedule, cost and scope of the improvement program. In the event that the Director of Public Works determines that the City and Hunt Construction Group are not making adequate progress on the negotiations of the contract, staff recommends that Council authorize the Director of Public Works to commence negotiations with the next ranked proposers in the order of their ranking.

The current schedule provides for staff to return to Council in December 2010, for approval of the contract and make a finding that the Design-Build procurement process will save money or result in faster project completion than if the City used a procurement process involving its normal competitive bidding procedures.

BACKGROUND

On June 22, 2010, Council approved preliminary findings that using design-build would save time over a traditional design-bid-build project and authorized advertisement of the RFP. Based on that action, staff has developed a more specific schedule to move through the RFP process. As of today, each milestone has been met and the procurement process is on schedule.

The following is a recap of the schedule:

- June 22 — Approval of the RFP and Advertisement
- September 1 — Due Date for RFP
- September 1 to 10 — Evaluation of Proposals and Interviews
- October 5 — Council Authorization to Negotiate
- October and November — Contract Negotiations
- December 14 — Council Award of Contract

Council's action is the second of three actions mandated under the Design-Build Ordinance. The final remaining mandate is scheduled for December 14 when Council will be asked to make a finding that the design-build construction process will save money or result in faster project completion than if the City used a procurement process involving its normal competitive bidding procedures.

In response to direction from the Council/Redevelopment Agency Board, staff developed an integrated City/Redevelopment Agency team to develop the solicitation documents necessary to acquire the services of a design-build contractor. The documents developed were as follows:

REQUEST FOR PREQUALIFICATIONS:

All design-build entities were prequalified through a rigorous process designed to limit proposals to only the qualified firms who met the following criteria:

- A project team of contractor and designer that have worked on a comparable project
- Completion of a design-build project within the last five years.
- Completion of a public building construction project over $75 million.
- Completion of a convention center project (or equivalent) over 250,000 square feet.
- A bonding capacity of at least $120 million.
- An excellent safety record.

Eight design-build entities submitted requests for prequalification and five were determined to be prequalified.

REQUEST FOR PROPOSALS:

The next step was to evaluate the detailed proposals of how the design-build entities would approach the project. In general, the RFP follows standard City of San José format and requirements. The design-build process and the corresponding RFP being utilized to solicit proposals allow the use of qualification-based selection criteria rather than best value or lowest cost. The RFP describes the selection process that will be used, the information required of proposers, a description of the program, and the necessary forms for submitting a proposal. Proposers submitted information relative to their experience and qualifications as well as other goals the City has relative to small and local contracts, labor peace, and local subcontracting.

The selection criteria approved by Council on June 22, 2010 is summarized as follows:

- Project Specific Approach (20%)
- Delivery of Quality Projects on Time and within Budget (20%)
- Experience (20%)
- Strategy for Stakeholder Participation (10%)
- Strategy for Local Subcontracting (10%)
- Adherence to and Commitment to City's Organizational Goals, Policies, and Codes (5%)

- Labor Peace Plan (5%)
- Small and Local Business Preference (10%)

ANALYSIS

Proposals were received by the City on September 1, 2010, and were evaluated by the selection panel with a ranking for each proposal as before mentioned, and the proposers were invited to present their proposals. The panel consisted of the following individuals representing diverse backgrounds and experience relevant to the Convention Center Project:

Name	Represents	Position
Katy Allen	City of San José	Director of Public Works
Cindy Chavez	South Bay Labor Council	Executive Director
Bill Ekern	San José Redevelopment Agency	Director of Project Management
Dan Fenton	Team San José	CEO
Randy Knox	Adobe / Chamber of Commerce	Senior Director
Paul Krutko	City of San José	Chief Development Officer
Bill Kuenhle	Freeman Companies	General Manager
Bill Sherry	City of San José	Director of Aviation

Upon completion of the interviews held on September 8 and 9, the panel deliberated and ranked the proposals in accordance with the scoring criteria with the following result:

Proposer	Ranking
Hunt / Populous	1
Turner / HNTB	2
Hensel Phelps / Fentress	3
Clark / TVS	4
Gilbane / URS	5

Hunt Construction Group teamed with Populous Architects was overwhelmingly ranked first among the panel members. While all firms were well qualified, the Hunt team distinguished itself from other proposers in the areas of Project Specific Approach, Quality Projects on Time and Within Budget, and Experience. In addition, Hunt brought a highly experienced team to the project. Their team consists of a Project Executive and Project Manager who have worked extensively on convention centers in Phoenix and San Francisco. In addition, they worked on the HP Pavilion and AT&T Park.

Hunt and Populous together have teamed on over $1.1 billion of work in the past five years. Most recently they completed a state-of-the-art convention center in Phoenix. They have also worked together to deliver almost six million square feet of LEED Certified buildings. The design and construction teams have worked together individually and together on previous projects.

Convention Centers successfully designed and constructed by Hunt and Populous include:

- Phoenix Convention Center
- McCormick Place, Chicago
- Connecticut Convention Center, Hartford
- DeVos Place, Grand Rapids, Michigan
- Orange County Convention Center, Orlando
- Moscone West expansion
- Salt Palace Convention Center, Salt Lake City
- Dallas Convention Center
- Duke Energy Center, Cincinnati
- Indiana Convention Center, Indianapolis
- Anaheim Convention Center
- Iowa Events Center, Des Moines

The Turner and HNTB team was ranked second by the panel and also has extensive experience in the design and construction of convention centers. Several of the successful projects completed by the Turner team are listed below:

- San Diego Convention Center Renovation and Expansion
- Las Vegas Convention Center Renovation and Expansion
- Palm Springs Convention Center
- Kansas City Convention & Entertainment Center
- Albany Convention Center
- Boston Convention and Exhibition Center

The Design-Build Ordinance and the RFP allow proposers an opportunity to object to this recommendation. The Director of Public Works has notified all proposers in writing of this recommendation by providing them a copy of this memorandum. Pursuant to the procedure described in the RFP, any proposer may submit to the Director of Public Works a written statement setting forth any objections to this recommendation on or before five working days following the date of the notice to the proposers. Should any objections to this recommendation be submitted to the Director of Public Works prior to September 24, 2010, a supplemental staff report will be prepared describing our findings for the Council's consideration.

Compliance with Local Preference Ordinance

The City's Local Preference Ordinance for professional service contracts where price is not the determinative factor allows proposers to receive a five point credit if they are local. Local business enterprises that also qualify as small business enterprises are given an additional credit equal to five points. The Local Preference Ordinance applies to the RFP, because the Convention Center Design-Build Project includes professional design services.

All of the proposers qualified for the local business preference. None of the proposers qualified as small. Consequently, five points were added to the scores of the local proposers. In this case, the five points did not change the outcome of the evaluation process.

PROCESS INTEGRITY

Representatives from Public Works, Redevelopment Agency, and City Attorney's Office worked to develop a process that was fair and transparent. The RFP was prepared in conformance with the Design Build Ordinance. In addition, the RFP process followed integrity guidelines set forth by the Finance Department. All participants in the preparing, reviewing, and scoring of the RFP have signed conflict of interest statements.

The City employed a single point of contact strategy to ensure communication was consistent with all potential proposers. In addition, a web-based procurement tool (Bid Sync) was employed to answer questions and provide clarifications. Prospective proposers were also afforded the opportunity to review and comment on the draft RFP prior to advertisement.

CONTRACT NEGOTIATIONS

The basis for the design-build contract is the exemplar agreement that was included in the RFP. Staff will negotiate the price for the design of the Convention Center using Basis of Design documents circulated with the RFP. In December, Council will consider approval of the $120 million project based on the negotiated terms and a not-to-exceed agreement. It is likely to include fixed or lump sum price for profit and overhead. After contract approval, staff and the design-build entity will engage in an on-going design effort with design documents to be delivered at 30 percent, 60 percent and possibly 100 percent completion. The City will have the option at each design submittal to accept and negotiate a lump sum cost or a guaranteed maximum price (GMP) to be proposed by the design-build entity for completion of design and construction of each project element.

Included in this contract will be performance bonds, payment bonds, warranty bonds and project insurance as deemed required or mandated by Municipal Code. If the City and contractor cannot reach agreement on price for any project component at any stage, the City can complete the remaining portion of the design for that project component and publicly bid and manage the project. Contract terms are subject to negotiation so it is possible the final contract is different from what is described in this report.

Contract provisions setting out the schedule for design development and sequencing of projects will also be negotiated during this period, and information regarding these contract provisions will be presented to Council in the memorandum for the contract approval in December.

PROGRAM VALIDATION

The contractor, designer, and City will jointly perform a construction program validation during the negotiations period. The results of the validation will provide clarity to how much each

element of the program will cost. The goal will be to validate the cost of the expansion, central utility plant replacement, building maintenance system, and fire alarm upgrades. Once these costs are validated we can then determine the scope of the cosmetic enhancements to the existing building. The results of this exercise will be presented to the Council prior to award of the construction project.

EVALUATION AND FOLLOW-UP

A design-build construction contract will be presented to Council for approval in December.

PUBLIC OUTREACH/INTEREST

- ☐ Criterion 1: Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**
- ☐ Criterion 2: Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ Criterion 3: Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

While this action does not meet the $1 million threshold under Criterion 1, this memorandum will be posted on the City's website for the October 5, 2010 Council agenda. If approved by the City Council, staff will begin negotiations with the design-build entity and work to validate the program within the $120 million budget.

COORDINATION

This staff report has been prepared in coordination with the City Attorney's Office, the Redevelopment Agency, and the Finance Department.

COST SUMMARY/IMPLICATIONS

Ranking and Authority to Negotiate of the project does not commit the City to fund or construct. The award of the project is contingent upon development of a financing plan suitable to deliver the construction program.

CEQA

CEQA: Resolution No. 72767 and Addenda thereto. File No. PP08-002.

/s/

KATY ALLEN
Director, Public Works Department

For questions please contact HARRY FREITAS, DEPUTY DIRECTOR, PUBLIC WORKS DEPARTMENT, at 408-535-8300.

COUNCIL AGENDA: 10-5-10
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott Johnson
John Stufflebean

SUBJECT: SEE BELOW

DATE: 09-16-10

Approved

Date 9/17/10

COUNCIL DISTRICT: City-Wide

SUBJECT: REPORT ON REQUEST FOR PROPOSALS FOR A POWER PURCHASE AGREEMENT TO FINANCE, ENGINEER, INSTALL, COMMISSION, AND MAINTAIN A TURNKEY BIO-GAS FUEL CELL CO-GENERATION SYSTEM AT THE SAN JOSE/SANTA CLARA WATER POLLUTION CONTROL PLANT (PLANT).

RECOMMENDATION

It is recommended that the City Council accept the report on the Request for Proposals for a Power Purchase and Site Lease Agreement for Fuel Cell System Power Production and adopt a resolution authorizing the Director of Finance to execute a Power Purchase Agreement, Site Lease and other necessary documents, with UTS Bio-Energy SJ-1, LLC (UTS) (Encinitas, CA) to purchase fuel cell energy at the Plant for a 20 year term.

OUTCOME

Execution of the Power Purchase Agreement (PPA) with UTS will result in a fuel cell system with the capacity of generating 1.4 megawatts (MW) of electrical power at the Plant providing clean, renewable and reliable power at a reasonable cost. The system will advance the Plant's energy self sufficiency goal and also advance the City's Green Vision renewable energy goal of receiving 100% of electrical power from clean renewable sources.

EXECUTIVE SUMMARY

The Plant relies on self generation of power to provide reliable supply of electricity to run its critical equipment. The generation systems are 30 to 53 years old and are in need of replacement. City staff has pursued an option of obtaining this equipment through a 20 year PPA using newer, renewable fuel cell technology that uses the Plant's digester gas. Under the

PPA, UTS will design, build, own, operate and maintain a 1.4 MW fuel cell, and the Plant will purchase all power generated by the fuel cell at the agreed upon price. In addition, the Plant will construct the concrete pad the fuel cell will be installed on and the interconnection between the Plant and fuel cell (water, gas, electrical). The Plant's capital investment is estimated at $2,000,000. City staff looked at other more traditional generation systems such as Internal Combustion (IC) engine generators and concluded that fuel cell has slightly higher cost but significant environmental benefits. This recommendation accomplishes several of the Plants and City's goals:

- Reliable power generation of aging engine generators
- Low up front capital investment
- Advances the goal of Plant energy self sufficiency by 2022
- Comparable but slightly higher power costs to other more traditional generation systems
- Additional energy source of hot water as a by-product of the system
- Regulatory compliance by elimination of air permit requirements for this system
- Environmental stewardship through lower green house gas emissions

The planned completion date of the project is January 20, 2012.

BACKGROUND

The electrical generation and distribution system is the lifeline of Plant operation, without which, the plant would not function. As with much of the infrastructure at the Plant, the engine generators are 30 - 53 years old and are at a high-risk of failure. Of the eight originally installed engine generators at the plant, representing an installed capacity of 13 mega-watts (MW), two generators equaling 2.5 MW have been retired due to age, and three of the remaining six generators with a combined capacity of 3.4 MW need replacement due to lack of reliability, high maintenance costs, and difficulty in obtaining spare parts.

The Plant uses an average of 7.6 MW of electricity for its daily operations, with peak loads reaching 11 MW on occasion. On average, 5.2 MW is produced on-site using engine generators fueled by a blend of natural gas purchased from PG&E, landfill gas purchased from Newby Island Landfill, and digester gas produced on-site as part of the waste water treatment process. The remaining 2.4 MW of electricity is purchased from PG&E. Although current Plant generation capacity is 10.5 MW, generation frequently falls short of demand due to the unavailability of generators down for maintenance and other operability factors. Even though the plant can purchase all of its electricity needs from PG&E, the ability to generate electricity in-house is critical for reliable plant operations in the event of a PG&E power failure caused by an earthquake, bird strike, or other blackout. Lack of reliable in-house electrical generation during PG&E power failures can have disastrous consequences with significant damage to critical equipment and facilities, and potential discharge of untreated sewage into the bay.

The Plant needs to maintain a minimum of 8 MW of very reliable on-site generation to meet current critical power demands. This minimum power requirement is expected to increase over next 20 years as the Plant is modernized through implementation of the Plant Master Plan. The need to replace aging engine generators is critical.

Along with the need to replace aging generators, is the need for increased efficiency and environmental sustainability. Concerns over climate change and environmental responsibility have prompted the City of San Jose, and the State of California to establish policies and programs aimed at addressing these issues. In addition to the City's adopted Green Vision goals and Strategic Energy Plan, other key policies include:

- The City signing the Urban Environmental Accords (November 2005)
- The City signing the U.S. Conference of Mayor's Climate Protection Agreement with a goal of reducing greenhouse gas emission by 80% of 1990 levels (March 2007)
- The State of California, through the California Public Utility Commission (CPUC) started the Self Generation Incentive Program (SGIP) which offers substantial rebates towards the implementation of renewable self-generation technologies, such as Photovoltaic Cells (solar), fuel cells, and wind turbines.

Aging engine generators and the need to move toward increased efficiency and environmental sustainability led staff to evaluate options for replacement of the generators, which would meet the Plant's goals and at the same time take advantage of the rebate incentives offered by the CPUC. Staff has evaluated the cost benefits and applicability associated with these renewable technologies and identified fuel cell electrical generation as a cost effective technology that would yield the greatest resource and environmental benefit to the Plant.

Fuel cells convert natural gas or biogas to electricity electrochemically like a battery. But unlike a battery which eventually goes dead as the chemicals in the battery are depleted, the fuel cell is continuously fed new chemicals so it can produce electricity for up to 5 years before the cell needs to be rebuilt. Fuel cells require very clean fuel to prevent early failure so the biogas from the Plant must first be cleaned and conditioned through a gas cleaning system to remove most of the contaminants. The gas is then delivered to the fuel cell along with oxygen where the gas is converted to electricity, hot water and a residual gas stream of mainly carbon dioxide. The heat from the fuel cell is recovered and used in Plant operations.

Fuel cells have one of the highest financial incentives because they use renewable biogas as fuel. They are highly efficient, and have very low air emissions compared to more traditional generation systems like Internal Combustion (IC) engines or turbine generators. Fuel cells generate approximately 20% less greenhouse gases compared to internal combustion engines and near zero air pollutant emissions. As a result, fuel cells do not require an air permit to operate.

Based on the recent successes with the City's Solar PPA process, City staff looked at a PPA as a way to procure a fuel cell instead of funding and constructing one through the capital program. The PPA option uses a private entity to fund, own and operate the fuel cell. The private entity

can take advantage of the Investment Tax Credit (ITC) program funded by the American Recovery and Reinvestment Act (ARRA). The ITC program allows private companies who build own and operate fuel cells (as well as solar and wind power systems) to take a 30% tax credit or grant on their net capital expenditures. This is in addition to the rebate offered through the SGIP. Government agencies are ineligible for the tax credit because they do not pay taxes. The PPA allows the project developer to capture the SGIP incentive along with the ITC, making the project viable with significantly less upfront City funding.

In order to capture the SGIP rebate incentive, City Staff submitted an application for reservation of the rebate for the installation of up to a 2.8 MW fuel cell and received a conditional reservation letter dated July 20, 2010 from PG&E for a maximum rebate amount of $7.4 million. For a 1.4 MW fuel cell, the rebate amount is $5.4 million. The remaining two important milestones of the conditional reservation are:

- Execution of a contract of the Power Purchase Agreement by March 17, 2011
- Submit proof of installation and operation of fuel cell by January 20, 2012

ANALYSIS

On June 29, 2010, the City released a Power Purchase & Site Lease Agreement for Fuel Cell Power Production Request for Proposal (RFP) for the Plant on the City e-procurement system. Under the provisions of the RFP, the Fuel cell provider will fund the construction of the gas cleaning system, fuel cell, hot water transfer system, and electricity monitoring/distribution system as well as operate and maintain the fuel cell a for period of 20 years. The Plant will pay for the construction of the interconnections between the fuel cell and the existing plant utilities (water, gas, electric) including the concrete pad the fuel cell will be installed on. The City's capital investment is estimated at $2,000,000.

Forty-nine companies viewed the RFP, sixteen companies downloaded the RFP, and the following two companies/teams submitted technical proposals by the July 28, 2010 deadline:

- Chevron Energy Solutions/UTC Bio Energy (San José, CA)
- UTS Bio-Energy (Encinitas, CA)

In accordance with the evaluation process set forth in the RFP, a three person evaluation team from within the Environmental Services Department evaluated the written proposals on August 16, 2010. Proposals were evaluated against the following criteria: Experience (30%), Technical Competency of Key Staff (30%), Overall System Efficiency (30%) and Local/Small Business Preference (10%). The final scores and rankings are summarized in the table below:

Team Name	Experience (30 pts)	Technical Competency of Key Staff (30 pts)	Overall System Efficiency (30 pts)	Local/ Small (10 pts)	Total (100 pts)	Rank
UTS Bio-Energy	25	25	30	0	80	1
UTC/Chevron	22	30	8	5*	65	2

*UTC/ Chevron qualified for the City's Local Business Enterprise preference as they have an office with at least one employee located in San Jose

The evaluation team determined that the proposal submitted by UTC/Chevron shows a lower combined heat and power output than the existing system in the plant and so did not meet the City's goal for conversion of biogas to electricity and hot water. The evaluation criteria established in the RFP required that, with the exception of the local and small business preference, Proposers must score at least 50% of the total available points for each category. Because the UTC/Chevron proposal did not meet this requirement in the Overall System Efficiency category, their proposal was dropped from further consideration.

UTS submitted their Best and Final Offer (BAFO) on August 31, 2010 with a price of 11.5 cents/kWh and an annual escalation of 3.25 percent. The quoted price of 11.5 cents/kWh did not include renewable energy credits which UTS valued at 0.5 cent/kWh. If the City allows UTS to keep the renewable energy credits (RECs), the power purchase price is 11 cents/kWh. City staff is recommending that UTS keep the RECs and accept the starting price of 11 cents/kWh.

This Agreement is subject to the City's Prevailing Wage Policy and the Office of Equality Assurance will ensure compliance.

Given the age and declining reliability of the Plant's older engine generators, additional or replacement capacity must be secured. Therefore, the primary motivation in this proposed PPA is to secure clean, on-site generation of electricity at the best price with the least capital investment, in order to have backup power in the event of a PG&E power failure or other loss of electricity. The starting price of 11 cents/kWh is consistent with the Plant's current PG&E annual average billing rate of 10.8 cents/kWh. The escalator of 3.25% per year is also within the range of expected PG&E rate increases (3-6%) over the term of the agreement.

To secure the additional generator capacity, City staff considered a traditional generation system like IC engines as well as the fuel cell. For the IC engine generator, staff would not recommend a PPA approach since the Plant has skilled employees familiar with IC engine operation and maintenance. For the fuel cell, staff is recommending a PPA in order to qualify for the ITC credit, reduce City risk to a new technology, and to secure a firm that has the skills and abilities to operate and maintain the system. The table below compares the cost of a similar size (1.4 MW) IC engine generator without a PPA, with the fuel cell PPA, and concluded that the fuel cell

PPA will cost slightly more per year ($85K) even with the current high SGIP incentives and ITC tax credit. (see table below), However, the fuel cell comes with significant environmental advantages over the IC engine generator such as lower GHG emissions, no air permit requirements, greater regulatory certainty, improved efficiency, and a very reliable base load generator.

Cost Comparison Fuel Cell vs. IC Engine

	1.4MW Fuel Cell PPA	1.4MW IC Engine – non-PPA
Capital Cost	$12,100,000	$8,760,000
Rebate & Incentives	$6,810,000	
Net Capital Cost	$5,290,000	$8,760,000
Capital Cost/Year (@5% interest rate)	$424,483	$702,925
O&M Cost (3% escalation rate)	$943,002	$578,695
Total Cost/Year	$1,367,485	$1,281,620

In terms of added benefits, with the acquisition of a new base load generator, the Plant will be able to reduce PG&E peak demand charges during the high-demand hours of the summer months by about $108K/yr. In addition, to this the fuel cell will produce free hot water which has an economic value to the Plant. The Plant currently captures waste heat from its engine generators and uses it to heat digesters and thereby reduced the need to run natural gas fired boilers. With the addition of the fuel cell, the Plant will have this additional energy source (electricity and hot water) that will benefit current and future planned operations.

When all the costs and benefits are taken into consideration, the fuel cell will cost the plant more than purchasing the same amount of power from PG&E (around $250K/yr) if PG&E rate increases average 3.25% over the life of the fuel cell. If actual PG&E rate increases are lower or higher than 3.25%, the relative cost of energy from the fuel cell may be greater or the project could result in a savings. However, although cost is important, the main purpose of procuring new onsite generation is not to beat PG&E prices, but to secure reliable power for emergencies at the reasonable cost. By committing to the initial capital investment of $2,000,000 to build the interconnections, and entering into the full-service PPA, the Plant is able to acquire a new, but developed technology with minimal risk and be positioned in the long-term to develop an environmentally friendly and diverse generation portfolio.

Key Business Terms

Agreement Term: The Power Purchase Agreement will be for a term of 20 years that will begin upon completion of construction of the fuel cell facilities and generation of electrical power. The initial price per kilowatt hour will be eleven cents that will escalate as described below.

System Construction: The City will pay for the construction of the interconnections between the fuel cell and existing plant utilities including gas, water, and electric. The City will also construct the concrete pad that the fuel cell will be installed on per the design of the fuel cell manufacturer. These costs are estimated at $2,000,000.

UTS will construct, at its expense, the fuel cell system including the gas cleaning system and power conditioning equipment. UTS will provide a performance and payment bond. The PPA requires UTS to pay the prescribed prevailing wage rates. The City is not obligated to make any payment until power becomes available from the completed system. At the end of the term, UTS must remove the Fuel Cell System from the site and return the Plant premises to its original state if the PPA is terminated at any point in time even if the project is terminated before completion. UTS is also obligated to indemnify the City against any claims arising out of its construction activities at the site. The estimated time to install and commission the system is approximately twelve months after notice to proceed.

System Ownership: UTS will own, operate and maintain the system throughout the term of the Agreement. As part of the Agreement, UTS is requesting that any entity holding a leasehold interest in the property where the system is installed acknowledge UTS's ownership interest and right to give security interests in the system to other providers of financing.

Payment Terms: Under the PPA, the City must pay for all the energy that the fuel cell system produces at the agreed upon price. If the system is down for maintenance and not producing electricity the City does not pay. The initial price for the first year of the PPA is set at $0.11/kWh and UTS keeps the energy credits. The annual escalation will be 3.25% per year for the first 10 years of the PPA. At the start of the second 10 year period, the actual average core-CPI (consumer price index minus food and energy) for the first 10 year period will be compared to the 3.25% escalator. If the average core-CPI is higher than 3.25%, the escalation rate will be increased to match the average core-CPI with a maximum of escalation rate of 4% for the second 10 year period. The contract pricing contemplates full benefit from the SGIP grant of $5.4M offered by PG&E and an ITC offered by the IRS, which is based on 30% of UTS's net capital costs invested in the project.

Fuel Cell Energy, the manufacturer of the fuel cell, is engaged with the CPUC to get recognized as a California supplier from PG&E. If this happens, an additional $1M in SGIP rebate could be obtained. The PPA provides that if this occurs, the kilowatt hour charge will be adjusted to reflect a split of this additional revenue between UTS and the City.

The PPA also provides that UTS will adjust the rate down by 10% on the power generated from the fuel cell, for power produced in excess of 90% (10,585,000 kWh) of the system capacity.

Disruption: UTS will not be penalized for electrical power disruptions from the fuel cell if it is down for maintenance or other technical reason. If there are problems with the supply or quality of the digester gas from the Plant, the Plant will pay for the natural gas to keep the fuel cell running. UTS and the City will split the natural gas cost for the first 48 hours, in case of failure of the gas cleaning system after which time UTS will pay for all the natural gas until the gas cleaning system is back on line.

Ongoing Funding: Payment obligations for the first year of operation will be encumbered against the Plant's general utility charges appropriations and will be encumbered on an annual basis throughout the twenty year term of the PPA.

City's Buyout Rights: This PPA is being financed by UTS partially through the Federal ITC program. Because of restrictions on the use of these tax credits, the City may not exercise the right to purchase the system until the 91st day following the anniversary date of the 5th year of commercial operation. The buyout price is equal to the greater of the fair market value of the system as determined at that time or the buyout schedule as set forth in a schedule attached to the PPA. If the City exercises its buyout right, then the City would need to provide for the operation and maintenance of the System, including replacement fuel cells from the manufacturer.

Site Lease: The fuel cell needs to tie into the Plant's electrical distribution system, so it will be located on approximately 5,000 square feet of Plant property next to a main power substation. This property will be leased to and controlled by UTS as the fuel cell owner/operator for $10 for the 20 year lease term.

Property Tax: The system will be owned and operated by a non-governmental entity and therefore, is subject to property taxes. These taxes have been factored in by UTS into their price of 11 cents/kWh.

Other terms and conditions: The PPA contains a mutual indemnification provision and standard insurance and construction bonding requirements.

Fuel Cell and PPA Advantages:

Minimizes Future Costs: The fuel cell PPA minimizes future energy costs as best possible by locking in a reasonable fixed escalator of 3.25% over the 20 year term. Future increases in energy prices (both gas and electric) are uncertain, but market indicators point to higher than average increases over the next 20 years in the range of 4 – 6% with higher increases in the early years, as PG&E renews its infrastructure and increases it renewable energy generation portfolio to include more solar, wind and other capital intensive technologies. In PG&Es recent rate increase request to the CPUC for years 2011-2013, PG&E asked for a 19.7%, 4.1,% and 4.9% rate increase respectively. It is unlikely that PG&E will get the requested increases, but they are

likely to receive something in the middle. According to the federal report published for the Solar America Initiative, the electricity price escalation is estimated at 4.25% per year over a 20 year period.

Environmental Benefits: The fuel cell will provide the Plant with 1.4 MW toward its goal of achieving energy self-sufficiency by the year 2022. Fuel cells are recognized as having one of the lowest environmental impacts compared to other traditional generation technologies such as IC engine or turbine generators. They have lower green house gas emissions (16 tons/day vs. 19 tons/day), virtually no regulated emissions (3 lb/d vs. 30 lb/d), and are highly efficient. The reduced GHG are equivalent to taking 192 medium sized cars off the road or planting 26,000 trees.

Emissions Compliance: Fuel Cell power production is exempt from Bay Area Air Quality Management District (BAAQMD) permitting. Therefore, there is no permit fee or emission testing requirements. The fuel cell provides insurance against changing emissions standards and regulatory uncertainty that frequently impacts engine driven generators.

Reliable Generator Capacity: The fuel cell will provide a stable base load of 1.4 MW of power to the Plant. Fuel cells are also less vulnerable to down time and outages compared to traditional engine generators. The fuel cell will also offset an equivalent 1.4 MW of power purchased from PG&E. This stable base load is expected to reduce monthly peak demand (highest 15 minute electrical demand from PG&E) charges by approximately $108,000 per year.

At a minimum, the Plant needs to maintain a reliable emergency generation capacity of 8 MW. The current aging generators need to be modernized and replaced with newer, high efficiency generators. The fuel cell PPA begins that process by providing a reliable, high efficiency generation system that will remain available as long as the plant has any fuel gas (Digester gas or Natural Gas) available. This will help provide critical power for the plant to restart minimum required loads in the event of PG&E power failure.

Higher Efficiency Generation: The fuel cell being used in this project has an efficiency rating of 45% in terms of converting methane gas to electricity. The Plant's current engine generators have an efficiency of 33%. This 12% higher efficiency is one of the key contributors in achieving a 20% energy saving goal for the plant by year 2012.

Hot water: The fuel cell will produce approximately 0.6 MW equivalent of hot water to be recovered and reused in Plant operations at no additional cost to the City.

Reduced Risk: Using a PPA approach, the City only pays for the power produced thus reducing the City's risk of investing in a young and still growing power technology. The City's initial capital investment is limited to providing the mounting pad and interconnection facilities.

Reduced Workload on City: UTS will own, operate and maintain the fuel cell for the duration of the contract period unless the City chooses to exercise its buyout option. This reduces the City's

obligation and responsibility for hiring employees or third party contractors with knowledge in fuel cell technology and from ensuring that the system runs reliably and efficiently. Under the PPA, UTS is required to ensure that the fuel cell is up and running 90% of the time or greater and with 90% or greater rated efficiency.

SGIP Rebate Timeline: The current completion date per the SGIP Conditional Acceptance letter is January 20, 2012. The SGIP recognizes a longer execution time for government entities and has a provision for an extension of the completion date by a maximum of 180 days. If Council approves moving forward with this project, City staff will submit a letter to PG&E to request extension for the completion date, if needed, in accordance with the program guidelines, two months before the said date as per PG&E requirement.

POLICY ALTERNATIVES

Alternative # 1: Purchase and install new engine-generator
Pros: City staff is very familiar with this technology.
Cons: This technology is less clean, less efficient, has greater regulatory uncertainty, and not lower cost.
Reason for not recommending: City staff has opted to use a cleaner, more efficient technology that has a similar cost. City staff also wants a technology that will maximize the amount of rebate that we can get from the SGIP, but still be cost-effective. City staff is more familiar with the engine generator technology, but tighter emission regulations and compliance are expected to increase the O&M costs in the long run. Learning to deal with a new technology will give City staff additional knowledge and experience.

Alternative # 2: Reject bid and drop project
Pros: Money already allocated for engine-generator replacement could be used for other reliability projects.
Cons: Need to purchase more electricity as self-generation capacity reduces with aging engine generators. City will also lose the opportunity for a $5,400,000 rebate.
Reason for not recommending: Cost to purchase electricity is forecast to be significantly higher than that from self-generation and the City will lose the opportunity for a clean and efficient technology for electrical generation utilizing the rebate incentive. According to the federal report published for the Solar America Initiative, the electricity price escalation is estimated at 4.25% per year over a 20 year period.

PUBLIC OUTREACH/INTEREST

☑ **Criteria 1:** Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**

☐ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

☐ **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This requirement meets criteria 1 above and will be posted on the City's website for the October 5, 2010 Council agenda.

COORDINATION

This project and memorandum have been coordinated with the Finance Department, Planning Building and Code Enforcement, Office of Equality Assurance, Risk Management, Budget Office, and the City Attorney's Office. The City coordinated with PG&E and submitted an application for rebate through the SGIP and the City has received a conditional reservation letter. This item is scheduled to be heard at the September 23, 2010 Treatment Plant Advisory Committee (TPAC) meeting.

FISCAL/POLICY ALIGNMENT

This project is consistent with the Council approved Budget Strategy, Economic Recovery section, in that it will help to stimulate construction spending in our local economy. This project is in line with the City's Resolution Endorsing the U.S. Mayors Climate Protection Agreement. The fuel cell is a more efficient electric generation technology and will produce less greenhouse gasses compared to other technologies at the same amount electric energy produced.

COST SUMMARY/IMPLICATIONS

As described in the Analysis section, entering into this contract will cause the Treatment Plant to incur both capital and operating costs in the future. The capital costs are currently estimated at $2,000,000. The actual costs will be determined once the construction contract has been put out to bid. The Department will return to the City Council for approval of the construction contract

at a later date. Funding for the construction costs is available in 2010-2011 in the San José/Santa Clara Treatment Plant Capital Fund ($1.3 million in the Fuel Cell appropriation, and approximately $700,000 in the Plant Electrical Reliability appropriation).

The proposed operating and maintenance costs of this project have been reviewed and will result in the need to purchase additional landfill or natural gas. The impact is estimated at $250K/yr to the San Jose-Santa Clara Treatment Plant Operating Fund. This funding will be requested through the budget process once the capital project has been completed.

CEQA:

Exempt, File No. PP10-112

/s/
SCOTT P. JOHNSON
Director of Finance

/s/
JOHN STUFFLEBEAN
Director, Environmental Services

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