APPENDIX A

THE CITY OF SAN JOSE: DEMOGRAPHIC, ECONOMIC AND FINANCIAL INFORMATION

Table of Contents

Appendix A

THE CITY OF SAN JOSE: DEMOGRAPHIC, ECONOMIC AND FINANCIAL INFORMATION

Introduction to Appendix A

Appendix A is the part of the Official Statement that provides investors with information concerning the City of San José (the "City"). Investors are advised to read the entire Official Statement, including Appendix A, to obtain information essential to making an informed investment decision.

When used in this Appendix A and in any continuing disclosure made by the City, the words or phrases "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project," "forecast," "expect," and "intend," and similar expressions identify "forward looking statements." Such statements are subject to risks and uncertainties that could cause actual results to differ materially from those contemplated in such forward-looking statements. Any forecast is also subject to such risks and uncertainties. Inevitably, some assumptions used to develop the forecasts will not be realized and unanticipated events and circumstances may occur. Therefore, there are likely to be differences between forecasts and actual results, and those differences may be material. This Appendix A speaks only as of its date, and the information and expressions of opinion contained in this Official Statement are subject to change without notice.

Appendix A summarizes portions of the City's Basic Financial Statements for the Fiscal Year Ended June 30, 2010 (included in this Official Statement as Appendix B), the City's Comprehensive Annual Debt Report for the Fiscal Year Ended June 30, 2010, the City's Adopted Budgets for Fiscal Year ("FY") 2009-10 and FY 2010-11, 2009-2010 Annual Report, 2010-2011 Mid-Year Budget Review report, as well as the most recent Actuarial Valuation Reports for the City's Federated City Employees Retirement Plan and the City's Police and Fire Department Retirement Plan. Investors can obtain copies of the Debt Report, the budget and retirement plan documents by writing to the following addresses:

Comprehensive Annual Debt Report	City Budget
Debt Management City of San José - Finance 200 East Santa Clara Street San José, CA 95113-1905	City Manager's Budget Office City of San José 200 East Santa Clara Street San José, CA 95113-1905

Federated City Employees' Retirement System	Police and Fire Department Retirement Plan
Board of Administration Federated City Employees' Retirement System 1737 North First Street, Suite 580 San José, CA 95112	Board of Administration Police and Fire Department Retirement Plan 1737 North First Street, Suite 580 San José, CA 95112

Investors may also contact the Debt Management division of the City's Finance Department for a copy of any other document summarized in Appendix A. The City maintains a website. However, the information presented on the website is not a part of this Appendix A and should not be relied upon in making an investment decision.

General Description

The City is the tenth largest city in the United States and the third largest city in California (the "State"), with a January 1, 2010 population estimated at 1,023,083, according to the California Department of Finance. The territory of the City encompasses approximately 178 square miles. Located at the southern end of the San Francisco Bay, the City is the county seat of the County of Santa Clara (the "County").

Having originated as a Spanish pueblo established in 1777, the City is the oldest city in the State. From a former rich agricultural setting, San José has become the capital of the innovative, high-technology based Silicon Valley - so named for the principal material used in producing semiconductors. During the 1980s and 1990s the City experienced an expansion in manufacturing, service, retail and tourism industries. With the dot-com collapse in the last recession in the early 2000s, Silicon Valley was one of the first and most deeply impacted regions in the nation. This has not been the case in this recession. Until the last quarter of 2008, Silicon Valley was somewhat less impacted than other areas in the state of California and the nation. However, the deep global recession has now enveloped this region as well, as evidenced by increasing job losses, rising unemployment, steep declines in home prices, rising foreclosures, and rising commercial vacancy rates. For additional information regarding the recent economic environment, see "Demographic and Economic Information – *Economic Overview*."

Demographic and Economic Information

Introduction

The information provided in the section entitled "Demographic and Economic Information" has been collected from sources that the City believes to be reliable and is the most current information available from those sources. Because it is difficult to obtain complete and timely regional economic and demographic information, the City's economic condition may not be fully apparent in all of the publicly available regional economic statistics provided herein, but the City has included this information to provide context about the City's finances. For current estimates regarding the City's General Fund revenue sources, see "Budget – *City Budget*" and "Major General Fund Sources of Revenue."

Economic Overview

As stated earlier, the City has experienced a significant economic downturn since the fourth quarter of 2008. This is evidenced in several key economic indicators such as unemployment rates, residential foreclosure rates, office vacancy rates, and median home prices.

In 2008 and 2009, the unemployment rates at the local, State, and national levels significantly increased to some of the highest rates in decades. The unemployment rate in the City remains high at a rate of 11.5% as of December 2010, which reflects improvement from the annual average rate of 12.2% recorded in 2009.

Real estate performance in Santa Clara County improved in 2010 relative to the deep trough in 2008 and 2009, yet the market still remains weak. In the residential real estate market, during the calendar year 2010, San José households received 10,780 foreclosure filings, out of which 1,749 homes were repossessed by banks, down from 16,552 foreclosure filings with 2,455 homes repossessed by banks during the calendar year 2009. The decreased number of foreclosure filings and bank repossessions in

2010 does not necessarily indicate an improvement in the underlying conditions but may be attributable to two factors as follows: 1) the amount of time it takes a home in default to move through the foreclosure process has increased significantly; and 2) longer time is needed for banks to issue a Notice of Default (the first stage of the foreclosure process) to a home in arrears.

The median sales price for single family homes within the City fell 2.4% from $490,000 in December 2009 to $478,000 in December 2010. December 2010 marks the third month in a row that the median sales price has decreased from the same month in the prior year.

In the non-residential real estate market, the vacancy rate for office space in San José increased from 24.2% in the fourth quarter of 2009 to 26.8% during the fourth quarter of 2010.

Population

City residents account for over half of the population of the County, which is the most populous of the San Francisco Bay Area counties. While the period from 1960 to 1980 was characterized by extremely rapid population growth in both the City and County, the last two decades reflect a trend of slower but steady growth. Table 1 shows the population of the City, the County and the State according to the U.S. Census for the years 1960, 1970, 1980, 1990 and 2000 and according to the California Department of Finance for the years 2001 through 2010.

Table 1
City, County and State Population Statistics

	City of San José	Annual % Change	County of Santa Clara	Annual % Change	State of California	Annual % Change
1960	204,196		642,315		15,717,204	
1970	459,913	125.23%	1,064,714	65.76%	19,953,134	26.95%
1980	629,442	36.86	1,295,071	21.64	23,667,902	18.62
1990	782,248	24.28	1,497,577	15.64	29,760,021	25.74
2000	895,131	14.43	1,682,585	12.35	33,873,086	13.82
2001	905,528	1.16	1,701,362	1.12	34,430,970	1.65
2002	915,699	1.12	1,715,295	0.82	35,063,959	1.84
2003	922,905	0.79	1,726,081	0.63	35,652,700	1.68
2004	929,852	0.75	1,738,435	0.72	36,199,342	1.53
2005	941,435	1.25	1,752,696	0.82	36,676,931	1.32
2006	952,897	1.22	1,771,291	1.06	37,087,005	1.12
2007	967,964	1.58	1,797,623	1.49	37,463,609	1.02
2008	985,047	1.76	1,829,977	1.80	37,871,509	1.09
2009	1,006,846	2.21	1,857,516	1.50	38,255,508	1.01
2010	1,023,083	1.61	1,880,876	1.26	38,648,090	1.03

Sources: U.S. Census (1960-2000), California Department of Finance (2001-2010).

Employment

Table 2 sets forth employment figures for the City and the County and unemployment rates for the City, the County, the State and the United States for the five most recent years. The City's unemployment rate has increased from 5.0% in 2006 to 11.5% as of December 2010.

Table 2
Santa Clara County
Estimated Average Annual Employment and Unemployment of Resident Labor Force

Civilian Labor Force *(in thousands)*	**2006**	**2007**	**2008**	**2009**	**2010**[1]
City of San José					
Employed	414	419	429	406	405
Unemployed	22	22	31	56	53
Total[2]	436	441	460	462	458
County of Santa Clara					
Employed	797	807	827	781	780
Unemployed	37	40	53	96	90
Total[2]	834	855	880	878	870
Unemployment Rates					
City	5.0%	5.3%	6.7%	12.2%	11.5%
County	4.5	4.7	6.0	11.0	10.4
State	4.9	5.4	7.2	11.4	12.3
United States	4.6	4.6	5.8	9.3	9.1

(1) Preliminary, not seasonally adjusted; data are for December 2010.
(2) Totals may not add due to independent rounding.
Source: California Employment Development Department, Labor Market Information Division.

The City is the geographic center of Silicon Valley. The high-technology industry component of the City's economy is diversified in research, development, manufacturing, marketing and management. Development of high technology has been supported by the area's proximity to Stanford University, San José State University, Santa Clara University and other institutions of higher education, and such research and development facilities as SRI International (formerly the Stanford Research Institute), the Stanford Linear Accelerator Center (SLAC) and NASA Ames Research Center.

While the County is known worldwide as "Silicon Valley," the silicon-based semiconductor industry is only a part of the industrial picture. Other industries include information systems, solar, computers, peripherals, instruments, software and a wide array of communication electronics.

Table 3 displays the composition of employment in the San José-Sunnyvale-Santa Clara Metropolitan Statistical Area by general category for the most recent three years available.

Table 3
San José-Sunnyvale-Santa Clara Metropolitan Statistical Area
Employment by Category Annual Averages

	2007	Percent of Total	2008	Percent of Total	2009	Percent of Total
Farm	6,700	0.73%	6,100	0.66%	5,700	0.66%
Natural Resources & Mining	300	0.03	300	0.03	200	0.02
Construction	47,200	5.14	44,200	4.80	33,900	3.94
Manufacturing	166,700	18.16	168,000	18.24	155,700	18.08
Wholesale Trade	39,800	4.34	40,600	4.41	35,600	4.13
Retail Trade	86,400	9.41	84,600	9.18	78,900	9.16
Transport Warehousing, Utilities	13,500	1.47	13,300	1.44	12,000	1.39
Information	39,600	4.31	41,700	4.53	41,100	4.77
Financial Activities	37,200	4.05	34,800	3.78	31,700	3.68
Professional & Business Services	178,300	19.42	178,700	19.40	161,900	18.79
Educational & Health Services	103,200	11.24	107,500	11.67	108,100	12.55
Leisure & Hospitality	76,800	8.37	78,200	8.49	74,300	8.63
Other Services	25,100	2.73	25,300	2.75	24,300	2.82
Government	97,200	10.59	97,800	10.62	98,000	11.38
Total(1)	**918,000**		**921,100**		**861,400**	

(1) Totals may not add due to independent rounding.

Source: California Employment Development Department, Labor Market Information Division.

Major Employers

Table 4 shows fifteen selected major employers in San José, ranked by the number of their employees, estimated as of February 2011. Because there is no official source for this information, it has been gathered by the City's Office of Economic Development on an informal basis and the City can provide no assurances as to the accuracy of the information.

Table 4
Selected Major San José Employers
As of February 2011

	Company/Organization	Type of Industry	Approximate Number of Employees
1	Santa Clara County	Government	15,420
2	Cisco Systems	Computer Equipment	11,600
3	IBM Corporation	Computer Equipment	6,750
4	City of San José	Government	5,655[1]
5	San José State University	Education	3,100
6	eBay/Paypal	On-Line Auction	3,000
7	San José Unified School District	Education	2,690
8	Xilinx	Semiconductor	2,440
9	Adobe Systems Inc.	Computer Software	2,000
10	Hitachi	Storage Software	2,000
11	Kaiser Permanente	Health Care	1,920
12	Good Samaritan Health System	Health Care	1,850
13	Cadence Design Systems Inc.	Computer Software	1,800
14	Brocade Communications	Telecommunication/Networking	1,450
15	PricewaterhouseCoopers	Financial Services	1,220

(1) Reflects the City's full-time equivalent authorized employees as of February 28, 2011.

Source: City of San José, Office of Economic Development.

Household Income

Household income, as measured by the U.S. Census Bureau, includes the income of the householder and all other people 15 years and older in the household, whether or not they are related to the householder. The median is based on the income distribution of all households, including those with no income. Table 5 shows the top ten median household incomes by metropolitan statistical area in the United States in 2009. The San José-Sunnyvale-Santa Clara metropolitan area had the second highest median household income in 2009, which was well above the national median.

Table 5
2009 Top Ten Median Household Income
For Statistical Areas with at least 65,000 People

1. Washington-Arlington-Alexandria, DC-VA-MD-WV Metro Area	$85,168
2. San José-Sunnyvale-Santa Clara, CA Metro Area	**84,483**
3. Bridgeport-Stamford-Norwalk, CT Metro Area	79,063
4. San Francisco-Oakland-Fremont, CA Metro Area	73,825
5. Anchorage, AK Metro Area	72,712
6. Lexington Park, MD Metro Area	72,474
7. Oxnard-Thousand Oaks-Ventura, CA Metro Area	71,723
8. Trenton-Ewing, NJ Metro Area	71,650
9. Fairbanks, AK Metro Area	70,610
10. Boston-Cambridge-Quincy, MA-NH Metro Area	69,334
U.S. Median	$50,221

Source: U.S. Census Bureau, 2009 American Community Survey.

Retail Sales

Tables 6a and 6b set forth a history of taxable sales for the City for calendar years 2005 to 2009 reported by the California State Board of Equalization (the "BOE"). A comparison of the total taxable sales in the City between the calendar year 2008 and the calendar year 2009 (the most recent official data available from the BOE) shows a decrease of $1.98 billion, or 16%. However, sales tax revenue only declined 3.5% based on actual receipts in FY 2009-10 due to higher than anticipated collections in the last two quarters of FY 2009-10. For additional information regarding sales tax receipts, see "Major General Fund Revenue Sources – *Sales and Use Taxes*."

The BOE has recently completed a process of converting business codes of sales and use tax permit holders to North American Industry Classification System (NAICS) codes. Taxable sales from calendar year 2005 to 2008, as shown in Table 6a, were reported by BOE using business codes of sales and use tax permit holders. Beginning in 2009, taxable sales are reported using the North American Industry Classification System (NAICS) codes. Table 6b shows taxable sales for the City for calendar year 2009.

Table 6a
City of San José
Taxable Sales
Calendar Year 2005 to 2008
(in thousands)

	2005	2006	2007	2008
Apparel Stores	$ 476,095	$ 514,552	$ 537,902	$ 586,621
General Merchandise Stores	1,273,994	1,332,598	1,425,777	1,361,162
Food Stores	401,720	409,257	427,237	410,915
Eating and Drinking Establishments	1,046,629	1,128,192	1,206,390	1,230,360
Home Furnishings and Appliances	363,119	364,657	360,402	405,072
Building Materials and Farm Implements	853,656	875,354	781,551	699,786
Auto Dealers and Auto Supplies	1,573,954	1,584,002	1,548,373	1,137,915
Service Stations	1,021,176	1,128,236	1,245,967	1,398,999
Other Retail Stores	1,417,102	1,576,089	1,700,093	1,306,125
Retail Stores Total	$ 8,427,445	$ 8,912,937	$ 9,233,692	$ 8,536,956
All Other Outlets	3,279,248	3,357,103	3,542,272	3,860,721
Total All Outlets	$11,706,693	$12,270,040	$12,775,964	$12,403,677

Source: California State Board of Equalization.

Table 6b
City of San José
Taxable Sales
Calendar Year 2009
(in thousands)

	2009
Motor Vehicle and Parts Dealers	$ 993,527
Home Furnishings and Appliance Stores	469,310
Bldg. Matrl. and Garden Equip. and Supplies	567,923
Food and Beverage Stores	442,760
Gasoline Stations	967,330
Clothing and Clothing Accessories Stores	702,930
General Merchandise Stores	1,062,696
Food Services and Drinking Places	1,157,304
Other Retail Group	808,565
Total Retail and Food Services	$ 7,172,346
All Other Outlets	3,252,940
Total All Outlets	$10,425,287

Source: California State Board of Equalization.

Construction Activity

A history of construction valuation and new dwelling units for the most recent five calendar years appears in Table 7 below. More information regarding building permits and fees is set forth below in the section entitled "Major General Fund Revenue Sources – *Licenses, Permits and Miscellaneous Taxes*."

Table 7
City of San José
Construction Valuation and New Dwelling Units
***(in thousands)*[(1)]**

	2006	2007	2008	2009	2010
Valuation:[(1)]					
Residential.........	$ 490,543	$ 348,893	$ 284,103	$ 94,673	$ 419,611
Non-Residential..	409,256	682,705	541,640	289,136	354,230
Total	$ 899,799	$ 1,031,598	$ 825,743	$ 383,809	$ 773,841
New Dwelling Units:					
Single Family.....	611	462	254	75	78
Multi-Family......	2,362	1,708	1,716	232	2,386
Total	2,973	2,170	1,970	307	2,464

(1) Valuation figures are adjusted to 2010 dollars per Bureau of Labor Statistics Consumer Price Index, San José-San Francisco-Oakland.

Source: City of San José, Department of Planning, Building and Code Enforcement as of January 4, 2011.

Education

The residents of the County, for the school year 2009-10, are served by 241 elementary schools; 59 middle schools and junior high schools; 50 high schools; 44 K-12, community, alternative, special education, continuation and juvenile hall schools, 36 charter schools and a number of private schools. The City is served by 15 of the 33 public school districts in the County. These school districts cross municipal boundaries. Principal public school systems serving the City are the San José Unified School District (grades K-12) and the East Side Union High School District. In addition, the City is in close proximity to the County's seven community colleges (within four community college districts: Foothill-DeAnza, Gavilan Joint, San José-Evergreen, and West Valley-Mission). Major universities in the County include Stanford University, Santa Clara University, and San José State University.

Transportation

The San José area is served by a network of freeways providing regional, national and international access. Bayshore Freeway (Highway 101), a major north-south highway between San Francisco and Los Angeles, provides access to air passenger and cargo facilities at Norman Y. Mineta San José International Airport (the "Airport") and San Francisco International Airport. Interstate 880 connects San José with the Oakland International Airport and the Port of Oakland. Interstates 280 and 680 provide access to the peninsula and eastern regions of the San Francisco Bay Area, respectively, and State Route 17 serves to connect San José with the Pacific Coast at Santa Cruz. Additional freeways serving the local area are State Routes 85, 87 and 237. During the past two decades, approximately $1.8 billion has been invested by the State and the County to expand and improve the area freeway system.

The Santa Clara Valley Transportation Authority (the "VTA") provides public transit service throughout Santa Clara County, servicing 326 square miles of urbanized area. Transit services are readily accessible to residents of the City, as most residences and businesses in the City are within a quarter mile of bus or light rail service. According to the VTA Comprehensive Annual Financial Report ("VTA CAFR") for fiscal year ended June 30, 2010, VTA's bus network is comprised of 73 bus routes, over 3,803 bus stops, 799 bus shelters, and 12 park-and-ride bus lots. VTA also partners with Altamont Commuter Express (ACE) and Caltrain to provide commuter rail service, with Santa Cruz Metro to provide regional bus service from Santa Cruz to Downtown San José, and with the Dumbarton Express for bus services between the East Bay to northern Santa Clara County work centers and communities. In addition, VTA offers light rail and ACE Train bus shuttles to various worksites and locations.

In the November 2000 election, the voters of the County approved a 30-year, one-half cent sales tax that commenced collection in 2006 upon the expiration of a previously approved one-half cent sales tax. This sales tax will finance various transit projects, including the Silicon Valley Rapid Transit Project (the "SVRT") which is proposed to extend the Bay Area Rapid Transit ("BART") system to the City. BART is a heavy rail rapid transit system currently serving Alameda, Contra Costa, and San Francisco Counties and the northern portions of San Mateo County.

In November 2008, California voters passed Proposition 1A providing $9 billion in initial funding for a statewide high-speed rail system. The proposed first phase of the line would stretch between San Francisco and Anaheim with stations in San José, Gilroy, Merced, Fresno, Bakersfield, and Los Angeles at an estimated cost of $33 billion. Also, in November 2008, Santa Clara County voters approved a one-eighth of one percent retail sales and use tax as proposed by the VTA to be used by BART to operate, maintain and improve the 16-mile BART extension from Fremont to the County of Santa Clara, with stations in Milpitas, San José, and Santa Clara, connecting with Caltrain from Gilroy to San Francisco, and establishing a People Mover to the Airport. Per the terms of the ballot measure, the tax will be collected only if sufficient State and federal funds are secured to match local construction dollars.

The Airport is located on approximately 1,050 acres of land approximately two miles north of Downtown San José, between the Bayshore Freeway (Highway 101) and Interstate 880. The Airport is a commercial service and general aviation airport and is classified by the Federal Aviation Administration as a "medium hub" (an airport that enplanes at least 0.25% but less than 1.0% of the total number of passenger boardings at all commercial service airports in the United States). The City has invested approximately $1.3 billion in Airport's Terminal Area Improvement Program over the last four years.

Through the second quarter ended December 31, 2010 in FY 2010-11, the Airport served approximately 2.1 million enplaned passengers and accommodated 61,831 operations (takeoffs and landings) compared with 2.1 million enplaned passengers and 69,931 operations for the same period in FY 2009-10. According to traffic statistics published by the Airports Council International-North America ("ACI-NA"), in calendar year 2009, the Airport was the 46th busiest airport in North America in terms of total passengers and the 63rd busiest in terms of total cargo.

In November 2005, the San José City Council approved a comprehensive plan to replace and upgrade the terminal facilities at the Airport. The Terminal Area Improvement Program (the "TAIP") is scheduled to be completed in two phases. The first phase of the TAIP ("Phase 1") includes, but is not limited to, a new Terminal B, upgrades for the existing Terminal A and improvements to the roadway system, and a new consolidated rental car garage. As of March 2011, Phase 1 construction and improvements are largely complete.

The second phase of the TAIP ("Phase 2") includes an expansion of Terminal B and construction of a new South Concourse facility, adding a total of 12 gates. Pursuant to the Airport's lease agreement with its tenant airlines, projects in Phase 2 of the TAIP have been pre-approved, but construction is contingent on meeting certain activity-based benchmarks. Specifically, the Airport must reach 217 scheduled flights on any one day, or must enplane or deplane at least 12.2 million passengers in any given fiscal year in order to begin Phase 2.

San José Municipal Government

The City is governed by the City Council, consisting of a Mayor and ten other council members. The Mayor is elected at large for a four-year term. Council members are elected by district for staggered four-year terms. The Mayor and the council members are limited to two consecutive four-year terms. The City is a charter city, which means the City, through its charter (the "Charter"), may regulate municipal affairs, subject only to restrictions and limitations provided in the Charter. In matters other than municipal affairs or in matters of statewide concern, the City is subject to State law.

The City Council appoints the City Manager who is responsible for the operation of all municipal functions except the offices of City Attorney, City Clerk, City Auditor and Independent Police Auditor. The officials heading these offices are appointed by the City Council and carry out the policies set forth by the City Council.

The City provides a full range of services contemplated by statute or charter, including those functions delegated to cities under State law. These services are organized in five key lines of business - Community and Economic Development, Environmental and Utility Services, Neighborhood Services, Public Safety, Transportation and Aviation Services and Strategic Support. These cross-departmental service areas provide a forum for strategic planning and investment decisions within the context of the Mayor and City Council policy priorities. Plans, policies, and investment decisions are then carried out through departmental core and operational services.

The City Council also acts as the Board of Directors of the Redevelopment Agency of the City of San José (the "Agency"), which is a separate legal entity from the City, established by State law. The Executive Director of the Agency is appointed by and reports directly to the City Council, acting as the Agency Board. The Agency is a component unit of the City and its financial statements are combined into the City's Comprehensive Annual Financial Report. Transfers from the Agency have been a significant source of revenue to the City as discussed in more detail below. See "Major General Fund Revenues Sources – *Revenue from Local Agencies*."

Budget

State Budget

Over the last decade, the State has experienced significant budget challenges and has exercised its authority to divert revenues from property tax, sales and use taxes, gasoline tax, Motor Vehicle License Fees and other revenues payable to the City to address its budget deficits. Additionally, the State has diverted property tax revenues from redevelopment agencies throughout the State, including the Agency, as described below.

During this period, the voters approved Proposition 1A in November 2004 to amend the State Constitution to place constraints on the State's ability to divert certain specified revenues from local agencies to the State. Subsequently, in November 2010, the voters approved Proposition 22 to amend the

State Constitution to further constrain or eliminate the State's ability to redirect revenues from local agencies, including property tax revenues from redevelopment agencies.

Nonetheless, an understanding of the State budget process remains important to understanding the City's financial condition. A brief discussion of the State budget process as well as selected ballot measures and State budget actions over the past decade that had a material impact on the City's finances follows.

State Budget Process. The State's fiscal year begins on July 1 and ends on June 30. The State Constitution requires the Governor to submit a budget for each fiscal year to the Legislature by the immediately preceding January 10 (the "Governor's Budget").

Next, the Legislature considers the Governor's Budget. The Constitution requires the Legislature to pass a budget bill by June 15; however, the Legislature has regularly missed this date. As a result of the passage of Proposition 58, the Balanced Budget Amendment, in March 2004, beginning with FY 2004-05, the Legislature may not pass a budget bill in which State General Fund expenditures exceed estimated State General Fund revenues and fund balances.

Because more than half of the State's General Fund income is derived from the April 15 personal income tax, the Governor submits a "May Revised Budget" by May 14. The Legislature typically waits for the May Revised Budget before making final budget decisions. Once the Budget Bill has been approved by a two-thirds vote of each house of the Legislature, it is sent to the Governor for approval.

March 2004 Ballot Measures. In order to address a projected deficit of approximately $14 billion dollars in FY 2004-05, the State Legislature placed both Propositions 57 and 58 on the statewide ballot at the March 2, 2004 primary election. The voters passed both Propositions 57 and 58, as described below.

- The California Economic Recovery Bond Act ("Proposition 57"), which authorized the State to issue up to $15 billion of economic recovery bonds to finance the negative State General Fund reserve balance as of June 30, 2004 and other State General Fund obligations undertaken prior to June 30, 2004. Proposition 57 also called for local sales and use taxes to be redirected from local governments to the State, including 0.25% that would otherwise be available to the City, to pay debt service on the economic recovery bonds, and for an increase in local governments' share of local property tax by a like amount. As of July 1, 2010, the State had $7.7 billion of economic recovery bonds outstanding. It should be noted that the City continues to record the replacement tax revenues as sales and use tax revenue.

- The Balanced Budget Amendment ("Proposition 58"), which required the State to adopt and maintain a balanced budget and establish an additional reserve, and restricted future long-term deficit-related borrowing.

Re-allocation of Redevelopment Agency Revenues. In both FY 2004-05 and FY 2005-06, the State directed county auditors to shift the allocation of $250 million in property tax revenue from redevelopment agencies statewide to "educational revenue augmentation funds" ("ERAFs") to support schools. The impact to the Agency in FY 2004-05 was $18,626,954 and in FY 2005-06 was $14,500,614. These payments were made through the Agency's participation in the California Statewide Communities Development Authority (CSCDA) ERAF Loan Program. Although the primary source of repayment is the Agency tax increment or other revenues, if the Agency fails to make a scheduled payment on its ERAF Loan the County Auditor will be directed to transfer the first available ad valorem property tax revenues of the City to make the payment. Payments on the ERAF loan are due semi-annually each March 1 and November 1 in an amount sufficient to pay debt service on the next succeeding August 1 and February 1, respectively. The Agency's annual loan payment is approximately $4.5 million. The final loan payment will be due on March 1, 2016. The Agency has made its required payments to date. See "Major General Fund Revenues Sources – *Revenue from Local Agencies*" for information about moneys transferred by the Agency to the City's General Fund.

FY 2009-10 Budget Act. The FY 2009-10 Budget Act included funding from local government revenues as described below.

The Governor signed the FY 2009-10 Budget Act on February 20, 2009 (the "FY 2009-10 State Budget"). Substantial amendments were made to the FY 2009-10 State Budget on July 28, 2009 to address a projected $24 billion deficit. These amendments include:

- Property Tax Borrowing. The State borrowed 8%, or approximately $1.9 billion, of the amount of property tax revenue apportioned to cities, counties and special districts as permitted under the State Constitution as amended by Proposition 1A (2004). The State is required to repay this amount plus interest by June 30, 2013. The City's portion of the State borrowing was approximately $20.4 million; however, the City participated in the California Statewide Communities Development Authority (CSCDA) Proposition 1A Securitization Program that was established to mitigate the impact of the State borrowing on local governments. Under this program, the City received proceeds of the securitization in the same amounts and on the same schedule as the property taxes that the State borrowed and all costs associated with the program were borne by the State.

- Supplemental ERAF. In July 2009 the State Legislature adopted, and the Governor of the State signed, Assembly Bill No. 26x4 (the "2009 SERAF Legislation"), which mandated that redevelopment agencies in the State make deposits to the Supplemental Educational Revenue Augmentation Fund ("SERAF") that is established in each county treasury throughout the State in the aggregate amount of $1.7 billion for FY 2009-10, which were due prior to May 10, 2010, and $350 million for FY 2010-11.

  The Agency was informed by the State Director of Finance that the total payable by it for FY 2009-10 was $62.2 million and for FY 2010-11 will be $12.8 million. Pursuant to the 2009 SERAF Legislation, redevelopment agencies may use any funds that are legally available and not legally obligated for other uses, including reserve funds, proceeds of land sales, proceeds of bonds or other indebtedness, lease revenues, interest and other earned income. The 2009 SERAF Legislation also allows redevelopment agencies to borrow money from their low and moderate income housing funds to meet their SERAF obligation.

  The Agency met its $62.2 million payment for FY 2009-10 with funds borrowed from the Agency's Low and Moderate Income Housing Fund and from the City. It expects to meet its $12.8 million FY 2010-11 SERAF obligations with funds borrowed from the Agency's Low and Moderate Income Housing Fund. The City and the Agency are currently evaluating options with regards to the FY 2010-11 payment due to the County on May 10, 2011. See "Major General Fund Revenues Sources – *Revenue from Local Agencies*" for a further discussion.

FY 2011-12 Proposed Budget. [TO BE UPDATED PRIOR TO POSTING] On January 10, 2011, Governor Brown submitted his 2011-12 Proposed Budget (the "Proposed Budget") to the Legislature. The Proposed Budget acknowledged a $25.4 billion budget problem, consisting of an $8.2 billion deficit that would remain at the end of FY 2010-11 absent budgetary action, and an estimated $17.2 billion shortfall between revenues and expenditures in FY 2011-12 unless his legislative proposals are implemented. The Governor's Proposed Budget includes a plan to submit to the voters at a special election in June 2011 an extension of the four temporary tax increases adopted in 2009. Additionally, the

Governor proposes to restructure the state-local relationship by shifting funding and responsibility to local government for certain services, resulting in a shift of $5.9 billion in State program costs to counties. The Governor also proposes eliminating redevelopment agencies (See "Major General Fund Revenues Sources – *Revenue from Local Agencies*" for a discussion of this proposal's impact to the City.) The Proposed Budget includes expenditure reductions that touch nearly every area of the State budget. On February 24, 2011, the Department of Finance released proposed legislation to implement the Governor's Proposed Budget. It is currently being debated by the State Legislature.

City Budget

Over the last decade, the City has faced significant budgetary challenges. The City is legally required to have a balanced budget in place before the beginning of each fiscal year and has used a variety of strategies to balance its budget; however, a number of restrictions limit the City's ability to raise revenues. See "Major General Revenue Sources – *City's Financial Condition; Limitation on Sources of Revenues*" for further information.

City Budget Process. In the third quarter of each fiscal year, the City Manager releases the "Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program." Since 1986, the City has used this five-year forecast to assist in projecting revenue levels and expenditures based on certain assumptions and expectations.

Pursuant to the City Charter, the Mayor releases an annual "budget message." This document describes the budget process, the current fiscal situation of the City, the strategy for developing the proposed budget, recommendations on specific budget items and other related issues. The City Council reviews the Mayor's budget message, and a public hearing is held to discuss the budget message prior to its adoption by the City Council.

The City Charter requires that the City Manager release the Proposed Capital Budget and Capital Improvement Program and the Proposed Operating Budget at least thirty days prior to the beginning of each fiscal year, or at such earlier time as the City Council may specify. As currently directed by the City Council, in early May, the City Manager releases the Proposed Operating and Capital Budgets and Proposed Fees and Charges Report. The Proposed Operating Budget contains the complete financial plan for the City for the next fiscal year. It describes, by core service, each department's activities and recommended additions or reductions to those activities. It accounts for all revenue received by the City and accounts for the usage of the revenue. The City Council holds a number of study sessions in mid-May to discuss the proposed operating and capital budgets and holds a series of public hearings on the budget in late May and early June.

In early June, the Mayor releases the final budget modification message. It contains changes to the Proposed Budget recommended by the Mayor after review and discussion of the document during the budget hearings. In mid-June, the City Council adopts the operating and capital budgets for the next fiscal year, along with the implementing appropriation ordinances and funding sources resolutions that appropriate the budgeted amounts to the respective departments.

Current City practice calls for the preparation of Bi-Monthly Financial Reports, which are presented to the City Council Public Safety, Finance, and Strategic Support Committee and subsequently reported to the entire City Council. Additionally, in February each year the City Council holds a study session on the mid-year status of the operating and capital budgets, and takes actions as necessary to maintain a balanced budget. At any public meeting, the City Council may amend or supplement the budget by affirmative vote of at least a majority of the total members of the City Council.

City's 2010-2011 Adopted Budget. The City Council adopted the 2010-2011 Budget on June 17, 2010. This budget closed a projected $118.5 million General Fund deficit – the combined shortfall in the FY 2010-11 base operating budget of $116 million and development fee program services of $2.5 million. A combination of strategies was used to deal with the significant funding shortfall including: 1) service reductions and eliminations; 2) revenue increases, use of reserves, and funding shifts; and 3) cost savings and new service delivery models. The General Fund shortfall was closed by identifying $56.5 million in additional sources, including use of $15.5 million of reserves and FY 2010-11 Beginning Fund Balance to address one-time expenditures, and significantly decreasing expenditures by $62.0 million. Of these solutions, 83% were ongoing solutions and 17% were one-time solutions.

As part of the FY 2010-11 budget balancing strategies, the total employee count was reduced to a level roughly equivalent to the City's FY 1989-90 employee count. In the intervening years, the City population has grown to 1,023,083, representing an increase of approximately 30.8%. Since 2002 when the City's employee count peaked, the net reduction of City positions totals 1,625, which represents a decrease of approximately 21.8%. The 2010-2011 Adopted Budget included a net reduction of 783 positions from the 2009-2010 Adopted Budget. Subsequent to the adoption of the FY 2010-11 budget, 70 police officer positions were restored (see "Budget – *City Budget* – Adjustments to the City's 2010-2011 Adopted Budget" and "Labor Relations" for more information).

During the budget process, the City Council called for all City employees to agree to reductions in total compensation of 10%, with at least 5% of those reductions ongoing. Agreements achieving this objective were negotiated with six of the City's eleven bargaining groups and were approved by the City Council in late June 2010. The cost savings associated with the agreements were used to restore services that were recommended for elimination in the 2010-2011 Proposed Budget, primarily library and community center hours. If these agreements had not been reached, then an additional 107 City positions would have been eliminated as part of the 2010-2011 Adopted Budget. See "Labor Relations" for more information regarding the status of the City's agreements with bargaining/employee groups.

Adjustments to the City's 2010-2011 Adopted Budget. Subsequent to the adoption of the City's 2010-2011 Budget, the City reached an agreement with the Police Officers Association (POA) that reduced the compensation and benefits for members of that bargaining group. Cost savings associated with the agreement were used to restore 70 police officer positions that were eliminated in the 2010-2011 Adopted Budget.

On September 30, 2010, the City Manager transmitted her Annual Report describing the financial status of the City as of the end of FY 2009-10. The Annual Report stated that the General Fund ended the fiscal year with an Available Ending Fund Balance of $141.4 million, an increase of $6.6 million compared to the budgetary estimate of $134.8 million. The report recommended significant adjustments for two of the revenue estimates in the 2010-2011 Adopted General Fund Budget. A decrease to the Property Tax revenue estimate of $4.1 million was recommended to bring the revenue estimate in line with the 2010-2011 Property Tax information provided by the County of Santa Clara Controller-Treasurer. An increase to the Sales Tax estimate of $4.2 million was recommended based on actual 2009-2010 revenue performance. On October 19, 2010, the City Council accepted the City Manager's recommendations for adjusting the 2010-2011 Adopted Budget.

On January 28, 2011, the City Manager transmitted her Mid-Year Budget Review report comparing actual performance through December 31, 2010 with the 2010-2011 Modified Budget as of December 31, 2010 (the "2010-2011 Modified Budget"). The Mid-Year Budget Review report recommended actions to address an estimated $10.0 million General Fund net revenue shortfall and to set aside expenditure savings to establish a 2010-2011 Ending Fund Balance Reserve of $8.5 million to better position the City for the 2011-2012 budget process. A combination of actions was recommended to address the $10.0

million net General Fund revenue shortfall, including use of the City's Economic Uncertainty Reserve ($4.0 million), transfers from other funds and increased revenues ($3.6 million), and expenditure shifts and transfers ($2.4 million). The use of the Economic Uncertainty Reserve provided a significant portion of the balancing strategy, leaving that Reserve with a balance of $5.0 million. On February 8, 2011, the City Council accepted the City Manager's recommendations for adjusting the 2010-2011 Modified Budget. See "Major General Fund Revenue Sources" for more information related to the Annual Report and Mid-Year Budget Review revenue adjustments.

City's 2012-2016 General Fund Forecast. On February 28, 2011, the City Manager transmitted her 2011-2012 City Manager's Budget Request and 2012-2016 Five-Year Forecast (the "Forecast"). The Forecast projected a substantial General Fund Base Budget shortfall of $105.4 million for FY 2011-12 and a $183.7 million cumulative shortfall over the five-year period of the Forecast. The projected FY 2011-12 Base Budget shortfall is attributable to a $20.5 million carry-over from the 2010-2011 Adopted Budget related to the use of one-time solutions; $79.3 million of expenditure changes, the majority of which ($58.4 million) is due to increased retirement contributions; and $5.6 million due to decreased revenue estimates. Alternative "Optimistic" and "Pessimistic" cases have been developed to model the range of financial scenarios possible under varying economic conditions and the projected shortfall for FY 2011-12 ranges from $97.0 million to $109.1 million, as compared to $105.4 million in the Base Case. In FY 2011-12, the City will face its tenth consecutive fiscal year of General Fund budget shortfalls. Over the past nine years, the City has addressed the General Fund budget shortfalls totaling $565.2 million and eliminated approximately 1,600 positions, with staffing now at 1994-1995 levels. Given the magnitude of the FY 2011-12 projected shortfall, fundamental changes to cost and revenue structures will be required to bring the General Fund budget into balance.

For FY 2011-12, General Fund retirement costs total $192.9 million, or 21.4% of the total base expenditure budget. This amount is not final and will be updated based on the Police and Fire Retirement Board's consideration of the actuarial valuation for retiree health care, which is expected to be considered at the April Board Meeting. During the Forecast period, General Fund retirement costs are projected to increase by approximately $112 million from $192.9 million for FY 2011-12 to $304.5 million for FY 2015-16. For additional information on projected retirement contributions, see Table 27d in the "Pension Plans – *Summary of Pension Plans*" section.

It is important to note that this Forecast does not reflect: the impact of unanticipated compensation changes resulting from negotiations or arbitration awards; impacts from the potential future Agency general budget balancing actions or potentially more severe budget impacts associated with the proposed elimination of redevelopment agencies per Governor Brown's budget proposal (see "Budget – *State Budget* – FY 2011-12 Proposed Budget"); additional impacts to the City's contribution to the retirement system from changes in actuarial assumptions and methodologies that may be approved by the Retirement Boards in upcoming years or from pension reform efforts that are currently underway; revenue from the Marijuana Business Tax that is effective March 1, 2011 (see "Major General Fund Revenue Sources – *Licenses, Permits and Miscellaneous Taxes*"); funding for unmet/deferred infrastructure and maintenance needs; and one-time revenue sources or one-time expenditure needs.

The City's General Fund Structural Deficit incorporates both the projected Base Budget shortfall as well as unmet/deferred infrastructure and maintenance needs. When the projected incremental unmet/deferred infrastructure needs of $8.6 million in each fiscal year are added to the projected Base Budget shortfall (excluding one-time infrastructure and maintenance needs of $446 million), the City's General Fund Structural Deficit is projected to total $114.0 million in FY 2011-12 and $226.7 million over the Forecast period. In addition, the projected shortfall only incorporates 5% ongoing compensation reductions agreed to in FY 2010-11, but does not incorporate any one-time compensation reductions.

Table 8 summarizes the updated 2012-2016 Structural Deficit Projection as of February 2011.

Table 8
City of San José
2012-2016 Structural Deficit Projection (February 2011)
(in millions)

	2011-12	2012-13	2013-14	2014-15	2015-16	Total
Projected Base Budget Shortfall (Feb. 2011 Forecast)[1]	($105.4)	($43.1)	($25.1)	($10.0)	($0.1)	($183.7)
Unmet/Deferred Infrastructure & Maintenance Needs[2]	(8.6)	(8.6)	(8.6)	(8.6)	(8.6)	($43.0)
Total Incremental Deficit	**($114.0)**	**($51.7)**	**($33.7)**	**($18.6)**	**($8.7)**	**($226.7)**
Total Cumulative Deficit	**($114.0)**	**($165.7)**	**($199.4)**	**($218.0)**	**($226.7)**	**($226.7)**

(1) Does not assume cost-of-living salary increases; additional impacts associated with the Agency; additional impacts from changes in actuarial assumptions and methodologies that may be approved by the Retirement Boards in future years that could substantially increase the City's required contributions or, conversely, that reduce the City's required contributions as a result of pension reform efforts that are currently underway; revenue from Marijuana Business Tax; unmet/deferred infrastructure and maintenance needs; or one-time revenues/expenses.

(2) Assumes a five-year ramp-up period to reach the annual ongoing funding requirement in the General Fund of $43.1 million identified in May 2010; does not address one-time needs of $446 million in the General Fund ($821 million all funds) based on 2009 estimates.

Source: City of San José 2012-2016 Five-Year Forecast and Revenue Projections.

Table 9 on the following page summarizes the City's FY 2008-09 Actuals, FY 2009-10 Actuals, and the 2010-2011 Modified Budget.

Table 9
City of San José
General Fund Budget Summaries
FY 2008-09, FY 2009-10, FY 2010-11
(in thousands)[1]

	2008-2009 Actuals	2009-2010 Actuals	2010-2011 Modified Budget[2]
SOURCE OF FUNDS			
FUND BALANCE			
Encumbrance Reserve	$ 41,648	$ 25,824	$ 20,635
Carryover	223,651	173,213	141,398
Total Fund Balance	265,299	199,037	162,033
GENERAL REVENUES			
Property Tax[3]	210,844	202,186	194,909
Sales and Use Tax	132,005	127,238	134,679
Transient Occupancy Tax	7,795	6,900	6,684
Franchise Fees	41,067	38,410	42,271
Utility Taxes	85,750	87,651	87,432
Telephone Line Tax[4]	7,870	20,500	20,525
Licenses and Permits	70,388	65,985	68,198
Fines and Forfeitures	13,905	15,998	17,920
Revenue from Use of Money and Property	6,888	3,191	2,667
Revenue from Local Agencies	52,317	48,067	45,682
Revenue from the State Government[3]	13,539	11,749	18,513
Revenue from the State Government-Recovery Act	0	0	404
Revenue from the Federal Government	8,801	5,127	9,313
Revenue from the Federal Government-Recovery Act	0	367	10,955
Departmental Charges	27,276	27,281	29,610
Other Revenue[5]	21,622	27,023	89,866
Total General Revenue	700,067	687,673	779,628
INTERFUND TRANSFERS AND REIMBURSEMENTS			
Overhead Reimbursements	38,635	40,530	34,303
Transfers to the General Fund[4]	48,170	37,504	41,682
Reimbursements for Services	16,648	16,916	17,354
Total Interfund Transfers and Reimbursements	103,453	94,950	93,339
TOTAL SOURCE OF FUNDS	$ 1,068,819	$ 981,660	$ 1,035,000
USE OF FUNDS			
DEPARTMENTAL			
General Government	$ 82,463	$ 76,480	$ 77,043
Public Safety	446,322	442,288	450,721
Capital Maintenance	66,164	60,779	58,927
Community Services	120,286	109,779	107,904
Total Departmental	715,235	689,326	694,595
NON-DEPARTMENTAL			
Citywide[5]	99,671	92,287	205,832
Capital Expenditures	17,007	12,588	8,221
Transfers to Other Funds	37,868	25,425	28,534
Encumbrance Reserve	25,824	20,635	20,635
Earmarked Reserves[6]	0	0	47,874
Contingency Reserve[6]	0	0	29,309
Ending Fund Balance	n/a	n/a	n/a
Total Non-Departmental and Reserves	180,371	150,935	340,405
TOTAL USE OF FUNDS	$ 895,606	$ 840,261	$ 1,035,000

(1) Totals may not add due to independent rounding.
(2) 2010-2011 Modified budget as of 2/15/2011.
(3) Property tax revenue received in-lieu of Motor Vehicle License Fee Revenue is budgeted as Property Tax Revenue, rather than as Revenue from the State.
(4) The Telephone Line Tax was approved by voters on November 4, 2008. On April 1, 2009 the City began collecting the Telephone Line Tax and simultaneously discontinued collection of the Emergency Communications System Support (ECSS) Fee. The ECSS fee was categorized as a transfer to the General Fund. See the "Major General Fund Revenues Sources – *Miscellaneous Revenues* – Telephone Line Tax" and "Major General Fund Revenues Sources – *Interfund Transfers and Reimbursements*."
(5) Other Revenue and Citywide categories include the issuance/repayment of $75 million tax and revenue anticipation notes in FY 2010-11.
(6) Actual application of Earmarked and Contingency Reserve amounts are reflected in the Use of Funds categories to which they were applied. At year end, the unexpended Reserve amounts are rebudgeted to the next fiscal year.

Sources: City of San José 2009-2010 Annual Report, City of San José 2010-2011 Adopted Operating Budget, City of San José 2010-2011 Funding Sources Resolution and Appropriation Ordinance.

Land Annexation

In 2006, the City and the County entered into a settlement agreement that requires, among other things, that the City make good faith efforts to initiate and complete the processing of annexations into the City of existing County pockets that are 150 acres or less by April 15, 2011. Additionally, under the settlement agreement, the City agreed to make good faith efforts to initiate the annexation process for County pockets greater than 150 acres by April 15, 2011.

The City has a program in place to process the annexations of County pockets of 150 acres or less over the course of FY 2006-07 through FY 2010-11, with the smaller pockets processed in advance of the larger ones. Under current State law (which sunsets in 2014), annexations of County pockets that are 150 acres or less do not require an election of the residents. The City has completed the annexations of County pockets of 150 acres or less with the exception of the 103-acre Cambrian No. 36 pocket that is expected to be annexed in June 2011 unless an agreement is reached to allow for the area to be annexed by the City of Campbell.

The City has not yet initiated the annexation process for any County pockets greater than 150 acres in size. The City estimates that there are 8 pockets of this size, totaling approximately 3,500 acres. Under current State law, annexation of County pockets greater than 150 acres may, in some cases, require an election of the residents.

The City projects operations and maintenance expenses of $180,000 in FY 2010-11 related to additional street infrastructure due to annexation of County pockets. In prior years, these costs were incorporated into the City budget as augmentations to the Department of Transportation operating budget; in FY 2010-11, these costs have been absorbed into the Department of Transportation operating budget without augmentation. Other than these additional street infrastructure costs, the City has not budgeted additional funds in the current or prior years to address the incremental operating or capital costs resulting from annexations.

Major General Fund Revenue Sources

Following is a discussion of the City's principal General Fund revenue sources: Sales and Use Taxes; Property Taxes; Licenses, Permits and Miscellaneous Taxes; Utility Taxes; and Revenue from Local Agencies. These major five sources of revenue totaled $531.1 million, representing 77.2% of General Fund revenues in FY 2009-10 and approximately $530.9 million, representing 68.1% of the City's projected General Fund general revenues in the 2010-2011 Modified Budget. It is important to note that for the purpose of this presentation, general revenues, referred to for brevity in the following sections as General Fund revenues, correspond to the items shown under the General Revenues category in Table 9, and do not include Interfund Transfers and Reimbursements, which are discussed separately below. The 2010-2011 Modified Budget represents the 2010-2011 Adopted Budget and any subsequent budget adjustments as approved by City Council through February 15, 2011.

Property Taxes and Assessed Valuations

The assessed valuation of property is established by the County Assessor and reported at 100% of the full cash value as of January 1, except for public utility property, which is assessed by the State Board of Equalization.

The County collects the ad valorem property taxes. Taxes arising from the 1% levy are apportioned among local taxing agencies based on a formula established by State law in 1979. Under this formula, the City receives a base year allocation plus an allocation based on growth in assessed value (consisting of new construction, change of ownership and inflation). Taxes relating to voter-approved indebtedness are allocated to the relevant taxing agency. Beginning in FY 1990-91 (with the adoption of new State legislation), the County deducts the pro-rata cost of collecting property taxes from the City's allocation.

The California Community Redevelopment Law authorizes redevelopment agencies to receive the allocation of tax revenues resulting from increases in assessed valuations of properties within designated project areas. In effect, the other local taxing authorities realize tax revenues from such properties only on base-year valuations that are frozen at the time a redevelopment project area is created. The tax revenues resulting from increases in assessed valuations flow to the redevelopment areas. The City has created redevelopment project areas pursuant to California law. Generally, funds must be spent within the redevelopment areas in which the tax increment revenues were generated, and may only be spent on projects that qualify under California redevelopment law.

Table 10 sets forth a ten-year history of the City's assessed valuation.

Table 10
City of San José
Historical End of Fiscal Year Assessed Value Property
(in thousands)

Fiscal Year	Net Assessed Valuation[1]	Percentage Change
2000-01	$ 57,175,296	(10.59)
2001-02	63,975,252	11.89
2002-03	67,915,616	6.16
2003-04	73,077,977	7.60
2004-05	77,532,649	6.10
2005-06	85,234,836	9.93
2006-07	93,616,483	9.83
2007-08	101,093,290	7.99
2008-09	105,827,554	4.68
2009-10	103,018,120	(2.65)

(1) Valuations as of the end of the fiscal year, and net of exemptions.

Sources: City of San José Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2010.

Under current County policy, the City's allocation of total ad valorem taxes is received in approximately the following cumulative percentages: 40% by mid-December, 50% by the first week of January, 85% by the third week of April, 90% by the end of April and 100% by the end of June.

The County Board of Supervisors approved the implementation of an alternative method of distribution of tax levies and collections of tax sale proceeds (a "Teeter Plan"), as provided for in Section 4701 et seq. of the California Revenue and Taxation Code. Under the County's Teeter Plan, the County apportions secured property taxes on an accrual basis when due (irrespective of actual collections) to its local political subdivisions, including the City, for which the County acts as the tax-levying or tax-collecting agency. The County then receives all future delinquent payments, penalties and interest. The Teeter Plan was effective in the County beginning the fiscal year commencing July 1, 1993.

The Teeter Plan is applicable to all tax levies for which the County acts as the tax-levying or tax-collecting agency, or for which the County treasury is the legal depository of tax collections. As adopted by the County, the Teeter Plan excludes Mello-Roos Community Facilities Districts and special assessment districts that provide for accelerated judicial foreclosure of property for which special taxes or assessments are delinquent.

The Teeter Plan is to remain in effect unless the County Board of Supervisors orders its discontinuance or unless, prior to the commencement of any fiscal year of the County (which commences on July 1), the Board of Supervisors receives a petition for its discontinuance joined in by resolutions adopted by at least two-thirds of the participating revenue districts in the County, in which event the Board of Supervisors is to order discontinuance of the Teeter Plan effective at the commencement of the subsequent fiscal year. The Board of Supervisors may, by resolution adopted no later than July 15 of the fiscal year for which it is to apply, after holding a public hearing on the matter, discontinue the procedures under the Teeter Plan with respect to any political subdivision in the County if the rate of secured property tax delinquency in that political subdivision in any year exceeds 3% of the total of all taxes and assessments levied on the secured rolls for that political subdivision. If the Teeter Plan were discontinued subsequent to its implementation, only those secured property taxes actually collected would be allocated to political subdivisions (including the City) for which the County acts as the tax-levying or tax-collecting agency.

Property Tax receipts collected for the City by the County are set forth in Table 11.

Table 11
City of San José
Property Tax Receipts
(in thousands)

Fiscal Year	Property Tax Receipts	Percentage of General Fund Revenues	Percentage Change (Y/Y)
2006-07 Actual[1]	$ 189,683	27.1 %	13.9 %
2007-08 Actual[1]	203,718	28.2	7.4
2008-09 Actual[1]	210,844	30.1	3.5
2009-10 Actual[1][2]	202,186	29.4	(4.1)
2010-11 Modified Budget[1]	194,909	25.0	(3.6)

(1) Includes motor vehicle license fee (MVLF) property tax replacement revenue.
(2) Proceeds from the City's securitization of property revenues that were borrowed by the State in FY 2009-10 are included in the 2009-2010 figures. See "Budget – *State Budget* – FY 2009-10 Budget Act."

Sources: *City of San José 2009-2010 Annual Report, City of San José 2010-2011 Adopted Operating Budget, City of San José 2010-2011 Funding Sources Resolution and Appropriation Ordinance as of 2/15/2011.*

Under California law, property owners are entitled to an assessment based on the lower of the fair market value of their property as of the property tax lien date (January 1) or the assessed value as determined at the time of purchase or construction, and increased by no more than two percent (2%) annually. A reduction of a property's assessed valuation may occur upon the request of the property owner or the County Assessor may unilaterally reduce the assessed valuations of properties in response to declining market values. In the event a property owner's request for a reduction in assessed value is denied, the property owner may file an appeal.

On July 1, 2010, the County Assessor issued its "2010 Assessment Roll" media release documenting taxable FY 2010-11 real and business property values for the City and the Agency. The media release indicated that there was a decrease to the City's assessment roll of 2.3% and a decrease to the Agency's roll of 7.3%. The declines were attributable to a continued drop in real property values, a steep decline in the value of business personal property, and the reduction of assessed real property values by a negative California Consumer Price Index factor, the first since Proposition 13 passed in 1978.

In preparing its budget, the City forecasts property taxes based on each of the specific categories of receipts (secured and unsecured, current and delinquent receipts, supplemental, and State replacement funds). Secured Property Tax receipts are based on the County Assessor's estimate of growth or reduction in assessed valuation, adjusted for estimates in growth, if any, for redevelopment project areas. Estimates of other property tax receipts are primarily based on historical collections. The estimate of Property Tax receipts for FY 2010-11 takes into account the County Assessor's latest projections regarding changes in assessed valuations of property located in the City. Due to constantly changing assessed valuations and the unpredictable nature of payment collections, property tax receipts do not trend proportionately with annually reported assessed values. [PLACEHOLDER FOR ANY PUBLIC STATEMENTS FROM COUNTY ASSESSOR BEFORE PRINTING OF THIS APPENDIX A]

Table 12 presents a list of the ten largest taxpayers for FY 2009-10, based on secured assessed valuations, within the City. A portion of these property owners are located in Agency project areas.

Table 12
City of San José
Ten Largest Local Secured Property Taxpayers
(in thousands)

Name	Assessed Property Valuation	Percentage of Total
Cisco Technology Inc	$ 1,226,712	1.08%
Blackhawk Parent LLC	968,362	0.85
The Irvine Company LLC	647,225	0.57
Legacy Partners	645,974	0.57
Hitachi Global Storage Techs Inc	617,312	0.54
VF Mall LLC	492,108	0.43
Carr NP Properties LLC	386,866	0.34
EBay Inc	357,881	0.31
Sobrato Group	347,806	0.31
Hercules Holding II LLC	342,578	0.30
Total Top 10 secured assessed property valuation, FY 2009-10	$ 6,032,823	5.30%
Total City of San José secured assessed property valuation, FY 2009-10	$ 113,864,934	

Source: California Municipal Statistics, Inc.

Sales and Use Taxes

The sales tax is an excise tax imposed on retailers for the privilege of selling tangible personal property. The use tax is an excise tax imposed on a person for the storage, use or other consumption of tangible personal property purchased from any retailer. The proceeds of sales and use taxes (collectively, "Sales Tax") imposed within the boundaries of the City are distributed by the State to various agencies as shown in Table 13. The total Sales Tax rate for the County of Santa Clara currently is 9.25% and is allocated as follows:

Table 13
City of San José
Sales Tax Rates[(1)]

State – General State – Fiscal Fund	6.00%
State – Fiscal Recovery Fund	0.25
State – Local Revenue Fund	0.50
Local – City of San José	0.75
Local – Santa Clara County	0.25
Public Safety Fund (Proposition 172)	0.50
Sub-Total Statewide Sales and Use Tax	8.25
Santa Clara County Transit District (SCCT)	0.50
Santa Clara County Valley Transportation Authority (SCVT)	0.50
Total	9.25%

(1) The 0.125% increase in sales tax approved by voters in November 2008 to support BART has not yet been implemented. See "Demographic and Economic Information - *Transportation.*"

Source: California State Board of Equalization.

The City's budgeting forecast of Sales Tax receipts is based on State officials' estimates and the forecast of local economists. In addition to the 0.75% Sales Tax to be received by the City in FY 2010-11, the City's budgeting forecast also includes the 0.50% Sales Tax extension under Proposition 172 approved by voters on the November 1993 ballot, property tax in-lieu payments to reimburse the City for reduction in Sales Tax receipts resulting from the passage of Proposition 57, and the redirection of sales tax revenues to pay the State's economic recovery bonds.

Table 14 shows Sales Tax receipts, their respective percentage of General Fund revenues, and year-over-year changes since FY 2006-07.

Table 14
City of San José
Sales Tax Receipts
(in thousands)

Fiscal Year	Sales Tax Receipts[(1)]	Percentage of General Fund Revenues	Percentage Change (Y/Y)
2006-07 Actual	$ 149,962	21.4 %	6.9 %
2007-08 Actual	154,002	21.4	2.7
2008-09 Actual	132,005	18.9	(14.3)
2009-10 Actual	127,238	18.5	(3.6)
2010-11 Modified Budget	134,679	17.3	5.8

(1) Includes property tax in-lieu payments to reimburse the City for reduction in Sales Tax receipts resulting from the passage of Proposition 57 and the redirection of sales tax revenues to pay the State's economic recovery bonds.

Sources: City of San José 2009-2010 Annual Report, City of San José 2010-2011 Adopted Operating Budget, City of San José 2010-2011 Funding Sources Resolution and Appropriation Ordinance as of 2/15/2011.

Utility Taxes

The Utility Tax is charged to all users of a given utility (electricity, gas, water, and telephone) other than the corporation providing the utility (e.g., a utility company's consumption of all utilities used in the production or supply of its service is not taxed). Except as described below with respect to the City's telephone utility user's tax, the consumers of these services pay a tax at the rate of five percent (5%) of the utility charges to the utility company that acts as a collection agent for the City. The utility company collects the tax from consumers on a monthly basis and is required to remit that amount to the City by the 25th of the following month. The tax is not applicable to State, County, or City agencies. Also, per State law, insurance companies and banks are exempted from the tax.

On November 4, 2008, voters approved Measure K, a ballot measure that replaced the existing tax on telephone service with an updated telecommunications user's tax. The updated telecommunication user's tax took effect on April 1, 2009 and reduces the 5.0% tax rate to 4.5%, and applies the tax to all intrastate, interstate and international communications services regardless of technology used to provide such services, such as private communication services, voicemail, paging, and text messaging, and continues to tax existing communication services including landline, wireless, Voice over Internet Protocol (VoIP), and bundled services, where taxable and non-taxable services are bundled together.

In connection with placement of the telecommunications user's tax measure on the November ballot, the City Council directed the Finance Department to continue working with large business partners to determine if the new telecommunications user's tax would create a disproportionate financial impact on large businesses and, if so, to provide a mitigation plan to the Council if the ballot measure were approved by the voters. On February 24, 2009, the City Council approved the Finance Department's proposed mitigation plan, and adopted an ordinance amending the new voter approved telecommunications user's tax to cap the maximum amount of telecommunications user's tax payable by customers that meet certain threshold requirements in order to mitigate any disproportionate financial impact on customers. The ordinance went into effect on April 3, 2009, and expires on December 31, 2012, unless extended by the City Council.

In 2007, the California Court of Appeals held that the City of Los Angeles ("Los Angeles") had violated Proposition 218 in its application of its telephone utility user's tax on wireless telephone calls when Los Angeles changed its taxing methodology without voter approval. See *AB Cellular LA LLC v. City of Los Angeles* (2007) 150 Cal.App.4th 747 ("*AB Cellular*"). Since *AB Cellular* was decided, Los Angeles, like the City, sought and obtained voter approval of a ballot measure which reduced and modernized its telephone utility user's tax in order to address, in part, the issues raised by *AB Cellular*. However, in light of the published *AB Cellular* decision, the City could be subject to potential refund claims in connection with revenues derived from wireless calls under the City's former telephone utility user's tax. Even though the City has a tax refund ordinance which limits the refund period to one year, the courts have not definitively ruled on whether claimants can be limited to a one year refund period or may be able to claim a refund for a three year period (which corresponds to the otherwise applicable statute of limitations).

For FY 2007-08 the revenue derived from wireless calls was approximately $16.8 million. In FY 2008-09 through March 31, 2009, the last date through which the City received tax revenue under its previous structure, tax revenue derived from wireless calls was $14.8 million. See "Significant Litigation, Claims and Proceedings" for more information regarding claims seeking refunds of the City's former telephone utility user's tax.

Table 15 shows Utility Tax receipts, their respective percentage of General Fund revenues, and year-over-year changes since FY 2006-07.

Table 15
City of San José
Utility Tax Receipts
(in thousands)

Fiscal Year	Utility Tax Receipts	Percentage of General Fund Revenues	Percentage Change (Y/Y)
2006-07 Actual	$ 79,129	11.3 %	4.8 %
2007-08 Actual	82,254	11.4	3.9
2008-09 Actual	85,750	12.2	4.2
2009-10 Actual	87,651	12.7	2.2
2010-11 Modified Budget	87,432	11.2	(0.2)

Sources: City of San José 2009-2010 Annual Report, City of San José 2010-2011 Adopted Operating Budget, City of San José 2010-2011 Funding Sources Resolution and Appropriation Ordinance as of 2/15/2011.

Licenses, Permits and Miscellaneous Taxes

This category comprises six major subcategories: business taxes, cardroom taxes, disposal facility taxes, fire permits, building permits and miscellaneous other licenses and permits. Two cardroom clubs exist in the City. The City imposes an annual “base tax” on each cardroom permittee in an annual minimum amount of $150 per year, plus an additional tax in the amount of $18 per employee based on the average number of employees, not to exceed a maximum of $25,000. In addition, if the annual gross revenue of the cardroom exceeds $10,000, the City imposes a tax equal to 13% of the cardroom’s gross revenues. Cardroom tax collections are expected to be approximately $12.7 million in FY 2009-10. In June 2010, San José voters approved a measure to increase the gross receipts tax on cardrooms from 13% to 15%. Additionally, the voters approved: 1) increasing the number of tables allowed in the City from 80 to 98; (2) increasing the number of tables allowed at each cardroom from 40 to 49; (3) removing the limit on the number of permissible card games by permitting any card game allowed under State law consistent with City regulations; and (4) increasing the current $200 betting limit to that allowed under State law which currently specifies no limit. Revenues from the cardroom tax in FY 2010-11 are anticipated to be $13.8 million.

On November 2, 2010, San José voters approved Measure U, which imposed a tax on marijuana businesses in San José at a rate of up to ten percent (10%) of gross receipts from the planting, cultivation, harvesting, transporting, manufacturing, compounding, converting, processing, preparing, storing, packaging, and sales of marijuana and ancillary products in the City. On December 13, 2010, the City Council adopted an ordinance setting the rate of the tax at 7% of gross receipts. Collection of the tax will commence in March 2011. At this time the City has not determined the amount of additional revenue the marijuana tax will generate.

Table 16 shows Licenses, Permits and Miscellaneous Taxes receipts, their respective percentage of General Fund revenues, and year-over-year changes since FY 2006-07.

Table 16
City of San José
Licenses, Permits and Miscellaneous Tax Receipts
(in thousands)

Fiscal Year	Licenses, Permits and Other Tax Receipts	Percentage of General Fund Revenues	Percentage Change (Y/Y)
2006-07 Actual	$ 74,561	10.6 %	(1.7) %
2007-08 Actual	74,059	10.3	(0.7)
2008-09 Actual	70,388	10.1	(5.0)
2009-10 Actual	65,985	9.6	(6.3)
2010-11 Modified Budget	68,198	8.7	3.4

Sources: City of San José 2009-2010 Annual Report, City of San José 2010-2011 Adopted Operating Budget, City of San José 2010-2011 Funding Sources Resolution and Appropriation Ordinance as of 2/15/2011.

Revenue from Local Agencies

As shown on Table 17, 5.9% of General Fund Revenues are derived from transfers from other local public agencies, with the largest portion coming from the Agency. The $45.7 million budgeted for this category in the 2010-2011 Modified Budget includes reimbursements from the Agency ($30.0 million), Central Fire District payments ($5.1 million), paramedic program payments ($1.8 million), and other miscellaneous payments ($8.8 million).

Agency Reimbursements and Obligations to the General Fund. The Agency has various obligations to the General Fund which are subordinate to debt service on its Merged Area Redevelopment Project Tax Allocation Bonds and its variable rate Merged Area Redevelopment Project Revenue Bonds (Subordinate Tax Allocation) (together, "Senior Agency Bonds"). To the extent that tax increment in any year is insufficient to pay debt service on the Senior Agency Bonds, the Agency may not be able to pay the obligations due to the City. Similarly, if for any reason the Agency's payment obligations on the Senior Agency Bonds are accelerated, there may not be sufficient funds to pay the obligations due to the City. The City is aware of three current circumstances beyond the control of the City and Agency that could impact the Agency's ability to continue to make payments to the General Fund: (1) proposed legislation to eliminate redevelopment; (2) declining tax increment revenues; and (3) acceleration of certain obligations relating to the Agency's variable rate Merged Area Redevelopment Project Revenue Bonds (Subordinate Tax Allocation). These conditions are discussed in more detail below. Additionally, other circumstances could arise that could adversely affect the Agency's ability to continue to make payments to the General Fund.

The $30.0 million of reimbursements from the Agency to the General Fund budgeted for FY 2010-11 covers the following expenses:

- $15.0 million in debt service payment on the City of San José Financing Authority Lease Revenue Bonds, Series 2001F (Convention Center Refunding Project) (the "Convention Center Bonds");

- $9.0 million in reimbursement for City staff providing services to Agency projects;

- $4.7 million in payment for eligible City expenditures in redevelopment project areas; and

- $1.3 million in rent payments for Agency use of City Hall facilities.

In addition to the Agency's annual reimbursements discussed above, the Agency has the following outstanding obligations which may impact the City's General Fund if the obligations are not paid in accordance with the instrument creating the obligation:

- SERAF Loan (see "Budget – *State Budget* – FY 2009-10 Budget Act"). Of the $75 million principal amount of the SERAF Loan, $25 million was loaned by the City and the City of San José Financing Authority (the "Authority") to the Agency through the issuance of the Authority's commercial paper notes, which are backed by the City's General Fund, and $10 million was loaned from various City special funds. Interest and fees are anticipated to accrue during the term and are payable with the principal of the SERAF Loan on June 30, 2016; and

- ERAF Loan borrowed by the Agency from the CSCDA (see "Budget – *State Budget* – Re-allocation of Redevelopment Agency Revenues"). The Agency's loan payments are approximately $4.5 million per year through FY 2015-16 and the current outstanding balance is $19 million (principal and interest). In the event that the Agency has insufficient funds to make any of its ERAF Loan payments, the County Auditor is required to deduct the payment from the City's first available ad valorem property taxes.

The Agency has other outstanding obligations to the City that do not impact the City's General Fund and therefore are not discussed herein.

FY 2011-12 State Proposed Budget. [THIS WILL NEED TO BE UPDATED IMMEDIATELY PRIOR TO POSTING TO INCLUDE STATUS OF ANY LEGISLATIVE PROPSALS] On January 10, 2011, the Governor released a proposed budget package (the "Proposed Budget", as previously described in "Budget – *State Budget* – FY 2011-12 Proposed Budget") that, if adopted as proposed, would have direct and immediate impacts on the Agency's ability to make payments to the City. On February 24, 2011, the State Department of Finance released proposed legislation to implement the Proposed Budget, and makes the following redevelopment-related proposals (the "RDA Provisions"), among others:

- The RDA Provisions, if adopted, would prohibit existing agencies from creating new contracts or obligations effective upon enactment of urgency legislation.

- By July 1, 2011, the RDA Provisions, if adopted, would disestablish existing redevelopment agencies and successor local agencies would be required to use the property tax revenues that redevelopment agencies would otherwise have received to retire redevelopment agency debts and contractual obligations in accordance with existing payment schedules.

- For FY 2011-12, the RDA Provisions, if adopted, would divert an estimated $1.7 billion remaining statewide after paying the redevelopment agency debts and contractual obligations to offset State General Fund costs for Medi-Cal and trial courts.

- For fiscal years after FY 2011-12, the RDA Provisions, if adopted, would distribute the money available after payment of redevelopment agency debt and contractual obligations to schools, counties, cities, and non-enterprise special districts for general uses.

- The RDA Provisions, if adopted, would shift amounts in each redevelopment agency's balances reserved for low-moderate income housing to cities or authorities for low and moderate income housing.

The City cannot predict the timing, terms or ultimate implementation of any final legislation implementing the Proposed Budget, including the RDA Provisions or the impact on the Agency of any proposed, interim or final legislative or constitutional changes that may be adopted arising out of the Proposed Budget. The RDA Provisions, as proposed, require the successor agency to make payments on enforceable obligations of the former redevelopment agency, which should include the SERAF Loan, the ERAF Loan and the Reimbursement Agreement for debt service on the Convention Center Bonds.

Declines in Agency's Revenues. Regardless of whether the RDA Provisions of the Proposed Budget are implemented, the City's General Fund is significantly exposed to changes in the Agency's fiscal health. Recent declines in tax increment and diversions of tax increment as part of the recent State budgets have negatively impacted the Agency's ability to continue making the reimbursements and other payments to the City described above. The Agency's proposed revised 2010-2011 Capital and Operating Budgets were released on September 17, 2010 and included a decline of 7.89% in tax increment revenues from FY 2009-10. Despite this decline, the Budget included full appropriation of Agency reimbursement for the Convention Center debt service payments and rent. However, it included reductions to City staff support of approximately $700,000 and payments for eligible City projects of $500,000. The revised 2010-2011 Capital and Operating Budgets were adopted on November 2, 2010 and the City's Budget was adjusted accordingly.

The potential impact on the City's General Fund of current and future declines in tax increment is uncertain at this time. If the Agency defaults under the reimbursement Agreement for the Convention Center Bonds, the City's General Fund will not be reimbursed in the annual debt service amount, currently $15 million. If the Agency does not pay rent for use of City Hall, then other budget adjustments within the General Fund would need to be taken in order to account for the loss of revenue. However, to the extent that the Agency is unable to make transfers to the City to pay for staff costs and capital projects, the City would have the option of eliminating services and projects.

The Agency's ability to repay the SERAF Loan in FY 2015-16 will depend on whether it is able to issue new debt before then. If tax increment does not substantially rebound within the next four years, then it is unlikely that the Agency will be able to issue debt, even if the RDA Provisions discussed above are not implemented. As a consequence, the City's General Fund could be liable for (a) the repayment of the $25 million in Commercial Paper Notes, plus interest and fees, and (b) the $10 million to the special funds with accrued interest.

Additionally, if the Agency's revenues decline to the point where it cannot repay its ERAF Loan, the General Fund could lose up to $4.5 million per year through FY 2015-16 in diverted ad valorem property taxes.

Acceleration of Obligations relating to the Agency's Variable Rate Merged Area Redevelopment Project Revenue Bonds (Subordinate Tax Allocation). The Agency's variable rate Merged Area Redevelopment Project Revenue Bonds (Subordinate Tax Allocation) are currently supported by letters of credit from JPMorgan Chase Bank, National Association ("JP Morgan"). The letters of credit are currently set to expire November 25, 2011. If the Agency is unable to extend the expiration date of the letters of credit or to replace the letters of credit prior to the expiration date, or if the Agency defaults on its obligations to reimburse JP Morgan for amounts drawn on the letters of credit to pay debt service on the variable rate Merged Area Redevelopment Project Revenue Bonds (Subordinate Tax Allocation), JP Morgan could elect to cause the trustee for such bonds to draw on the letters of credit to redeem the bonds in full. In such case, all tax increment in excess of the amounts needed to pay debt service on the Agency's Merged Area Redevelopment Project Tax Allocation Bonds could be required to be paid to JP Morgan until JP Morgan is reimbursed in full, with interest, for such draws. Currently, the outstanding principal amount of variable rate Merged Area Redevelopment Project Revenue Bonds (Subordinate Tax Allocation) is $96.9 million, and it could take the Agency several years to repay JP Morgan if JP Morgan were to direct the bond trustee to draw on the letters of credit to redeem all such bonds.

Table 17 shows Revenue from Local Agencies, their respective percentage of General Fund revenues, and year-over-year changes since FY 2006-07.

Table 17
CITY OF SAN JOSE
REVENUE FROM LOCAL AGENCIES
(in thousands)

Fiscal Year	Revenue from Local Agencies	Percentage of General Fund Revenues	Percentage Change (Y/Y)
2006-07 Actual	$ 45,314	6.5 %	5.3 %
2007-08 Actual	49,127	6.8	8.4
2008-09 Actual	52,317	7.5	6.5
2009-10 Actual	48,067	7.0	(8.1)
2010-11 Modified Budget	45,682	5.9	(5.0)

Sources: *City of San José 2009-2010 Annual Report, City of San José 2010-2011 Adopted Operating Budget, City of San José 2010-2011 Funding Sources Resolution and Appropriation Ordinance as of 2/15/2011.*

Miscellaneous Revenues

The following provides a discussion of the remaining General Fund revenues. Included in this category are Revenue from the State; Telephone Line Tax; Franchise Fees; Departmental Charges (permits, fees for use); Revenue from Use of Money and Property (interest income); Transient Occupancy Tax; Fines, Forfeitures and Penalties; Revenue from the Federal Government; and Other Revenues. In FY 2009-10, these combined sources of revenue total approximately $156.5 million, representing 22.8% of General Fund revenues. In the 2010-2011 Modified Budget, these combined sources total approximately $248.7 million, representing 31.9% of General Fund revenues.

Revenue from the State. Revenue from the State consists of Motor Vehicle License Fees ("MVLF"), Airplane in-lieu taxes and State grants.

The MVLF is a State tax levied annually on the value of motor vehicles registered in the State. Under the State Constitution, MVLF revenues are allocated to cities and counties pursuant to State statute. In FY 2004-05, the MVLF rate was reduced from 2% to 0.65% of the market value of the vehicle. Also commencing in FY 2004-05, by State statute, the State is required to allocate to cities and counties property tax revenues in order to make up the difference in revenues as a result of the MVLF rate reduction from 2% to 0.65%. In FY 2006-07 and thereafter, the replacement property taxes will increase at rates corresponding to the rate of increase, if any, in each jurisdiction's gross assessed property value. Additionally, per the amendments to the State Constitution enacted by the passage of Proposition 1A in November 2004, if the MVLF rate is reduced below 0.65%, then the State must replace the corresponding revenues to cities and counties. The MVLF replacement property tax revenue is reflected in the City's budget as Property Tax Revenue, rather than Revenue from the State.

Revenue from the State in FY 2009-10 was $11.7 million, representing 1.7% of General Fund revenues and a decrease of 13.2% from FY 2008-2009. Revenue from the State in the 2010-2011 Modified Budget is approximately $18.5 million, representing 2.4% of budgeted General Fund revenues and an increase of 57.6% from the FY 2009-10 Actual.

Telephone Line Tax. On November 4, 2008, voters approved Measure J, a ballot measure that replaced the Emergency Communications System Support (ECSS) Fee with a Telephone Line Tax. The City began collecting the Telephone Line Tax and simultaneously discontinued collecting the ECSS fee on April 1, 2009. The Telephone Line Tax is imposed at the rate of $1.57 per telephone line and $11.82 per commercial trunk line. These rates are lower than the comparable ECSS Fee rates of $1.75 per telephone line and $13.13 per commercial trunk line. The Telephone Line Tax is shown as a General Fund revenue line item commencing with the 2009-2010 Budget whereas the ECSS Fee was shown in prior budget documents as a transfer from the ECSS Fee Fund to the General Fund. See "Major General Fund Revenues Sources – *Interfund Transfers and Reimbursements*."

The City collected ECSS revenues of $21.3 million for FY 2006-07 and $23.8 million for FY 2007-08. For FY 2008-09, the City collected ECSS fees of $16.6 million and Telephone Line Tax revenues of $7.9 million, for an aggregate total of $24.5 million. Telephone Line Tax revenues in FY 2009-10 were $20.5 million, representing 3.0% of budgeted General Fund revenues while the 2010-2011 Modified Budget projects the revenues to total approximately $20.5 million, representing 2.6% of budgeted General Fund revenues.

Franchise Fees. Franchise Fees are collected mainly from utility providers for the use of public rights-of-way. Franchise Fees totaled $38.4 million in FY 2009-10, representing 5.6% of General Fund revenues and a decrease of 6.5% from FY 2008-09. The 2010-2011 Modified Budget projects the revenues from Franchise Fees to total approximately $42.3 million, representing 5.4% of budgeted General Fund revenues and an increase of 10.1% from the FY 2009-10 Actual. Franchise Fees include revenues from electricity, gas and water utility services, commercial solid waste, cable television, and City-Generated Towing and nitrogen pipelines. Actual collections are subject to significant fluctuations from the impact of weather conditions and/or rate changes because the largest sources of Franchise Fees are based on utility revenues.

In February 2010, the City and PG&E entered into a settlement agreement to resolve a suit brought by the City for breach of PG&E's franchise agreements, among other claims. The dispute concerned the application of a State statute to the amounts remitted to the City by PG&E for sales of gas and electricity by third party energy service providers to customers in San José ("Surcharges"). In exchange for the City dismissing its case against PG&E, PG&E agreed to pay $6.0 million for the past due Surcharges, to give the City a credit for approximately $1.1 million that the City owed to PG&E for electricity used for the operation of street lights, and to increase the franchise fee rate from 2.0% to 2.3% of PG&E's gross receipts from the sale of gas and electricity in the City through 2021. In May 2010, the California Public Utilities Commission approved the 0.3% rate increase.

Departmental Charges. Departmental Charges were $27.3 million in FY 2009-10, representing 4.0% of General Fund revenues and no change from FY 2008-09. The 2010-2011 Modified Budget projects revenues from Departmental Charges to total approximately $29.6 million, representing 3.8% of budgeted General Fund revenues and an increase of 8.5% from the FY 2009-10 Actual.

Revenue from Use of Money and Property. Revenue from Use of Money and Property in FY 2009-10 decreased to $3.2 million, representing 0.5% of General Fund revenues and a decrease of 53.7% from FY 2008-09. This decline reflects the impact of lower yields, as well as the application of General Fund reserves to accommodate, in part, the City's budget shortfall. The 2010-2011 Modified Budget projects these revenues to total approximately $2.7 million, representing 0.3% of budgeted General Fund revenues and a decrease of 16.4% from the FY 2009-10 Actual. In this case, the decline is the result of lower yields which were built into the 2010-2011 Modified Budget.

Transient Occupancy Tax. General Fund revenue from the Transient Occupancy Tax in FY 2009-10 was $6.9 million, representing 1.0% of General Fund revenues and a decrease of 11.5% from FY 2008-09. The 2010-2011 Modified Budget projects revenue from Transient Occupancy Tax to total approximately $6.7 million, representing 0.9% of budgeted General Fund revenues and a decrease of 3.1% from the FY 2009-10 Actual.

Fines, Forfeitures and Penalties. Revenues from Fines, Forfeitures and Penalties in FY 2009-10 were approximately $16.0 million, representing 2.3% of General Fund revenues and an increase of 15.1% from FY 2008-09. The 2010-2011 Modified Budget projects revenues from Fines, Forfeitures and Penalties to total approximately $17.9 million, representing 2.3% of budgeted General Fund revenues and an increase of 12.0% from the FY 2009-10 Actual.

Revenue from the Federal Government. Revenue from the Federal Government is in the form of various grants received by the City. Revenue from the Federal Government in FY 2009-10 was $5.1 million, representing 0.7% of General Fund revenues and a decrease of 41.7% from FY 2008-09. The revenue estimates in this category include only those grant proceeds that are obligated to be paid in the fiscal year. The amount of federal grants payable in FY 2010-11 is estimated at $9.3 million.

Revenue from the Federal and State Governments – Recovery Act. This category accounts for the revenue associated with the American Recovery and Reinvestment Act of 2009 that is recorded in the General Fund. Associated expenditure appropriations are also included in the 2009-2010 Budget in the Capital and City-Wide expenditure categories. Currently, no additional grant funds are programmed for FY 2010-11. Grant funding from FY 2009-10 has been rebudgeted in the 2010-2011 Modified Budget.

Other Revenue. Other Revenue in 2009-2010 was $27.0 million, representing 3.9% of General Fund revenues and an increase of 25.0% from FY 2008-09. The 2010-2011 Modified Budget projects these revenues to be approximately $89.9 million, which includes the issuance of $75.0 million in Tax and Revenue Anticipation Notes. Not including this one-time revenue source, Other Revenue represents 1.9% of budgeted General Fund revenues and a decrease of 45.0% from the FY 2009-10 Actual. Major categories of revenue included in Other Revenue are HP Pavilion revenues (parking, arena and suite rentals, and naming rights), investment program reimbursements, the Public, Educational and Governmental Access ("PEG Access") Facilities payment from Comcast, and other miscellaneous revenues.

Interfund Transfers and Reimbursements

This source of revenue to the General Fund was $95.0 million in FY 2009-10. This includes Overhead Reimbursements ($40.5 million), Transfers to the General Fund ($37.5 million) and Reimbursement for Services ($16.9 million). Historically, one of the largest sources of revenue was the transfer from the Emergency Communications System Support (ECSS) Fee Fund. The ECSS Fee became effective on January 1, 2005, and was enacted to fund approximately 80% of the cost of operating, maintaining and upgrading the City's 911 emergency communication system. The ECSS Fee was charged on landline and cellular telephones with a billing address in the City. On November 4, 2008, the voters approved a measure to replace the ECSS Fee with a Telephone Line Tax, which became effective on April 1, 2009. See "Major General Fund Revenues Sources – *Miscellaneous Revenues* – Telephone Line Tax."

Lawsuits challenging similar fees imposed by other jurisdictions including Union City and Santa Cruz County have been brought, alleging, among other theories, that these fees violate Proposition 218. In 2008, the California Court of Appeals for the First District held that Union City's fee violated Proposition 218 in that Union City's fee was a special tax that had not been approved by the voters. See *Bay Area Cellular Telephone Company et al., v. City of Union City* (2008) 162 Cal.App.4th 686 ("*Bay Area Cellular*"). The First District Court of Appeals' decision in *Bay Area Cellular* is in conflict with an earlier but unpublished decision involving Santa Cruz County's fee in which the Sixth District Court of Appeals upheld the imposition of the fee. However, the Sixth District Court of Appeals' unpublished decision may not be cited as authority by other litigants.

The ECSS ordinance, in accordance with State law, provides for a one-year period for filing refund claims. To date, no claims have been filed against the City; the final date for filing was March 31, 2010. In the event that the City's ECSS Fee was challenged and a court determined that it violated Proposition 218 or was otherwise unenforceable, and if claims were filed, the City could be liable for refunds of the ECSS Fees. While the City's ECSS ordinance provides for a one-year refund period, the courts have not definitively ruled on whether claimants can be limited to a one-year refund period or may be able to claim a refund for a three-year period (which corresponds to the otherwise applicable statute of limitations).

The City collected ECSS revenues of $23.8 million for FY 2007-08. For FY 2008-09, the City collected ECSS fees of $16.6 million and Telephone Line Tax revenues of $7.9 million, for an aggregate total of $24.5 million.

City's Financial Condition; Limitation on Sources of Revenues

There are limitations on the ability of the City to increase revenues payable to the General Fund. Legal limitations generally restrict the ability of cities to raise or increase taxes without voter approval and to increase fees in excess of the amount needed to provide the service with respect to which such fees are charged, and increases to property-related fees may be subject to majority protest pursuant to Proposition 218. Additional limitations may also be imposed through legislation or initiatives. Furthermore, existing revenues may be subject to certain risk factors. See "Major General Fund Revenue Sources" for more information.

Financial Operations

Financial Statements

Since FY 2001-02, the City has prepared its audited Basic Financial Statements (referred to as General Purpose Financial Statements in previous years) in accordance with Governmental Accounting Standards Board Statement No. 34 (GASB 34). The Basic Financial Statements provide both government-wide financial statements with a long-term perspective on the City's activities while retaining the more traditional fund-based financial statements that focus on near-term inflows, outflows, and balances of spendable financial resources. The government-wide financial statements report on a full accrual basis and include comprehensive reporting of the City's infrastructure and other fixed assets.

Tables 18 and 19 on the following pages summarize financial information contained in the City's Basic Financial Statements as of June 30 for FY 2005-06 through FY 2009-10. The tables include information solely on the General Fund of the City and the debt service funds that are funded from General Fund revenues.

Table 18
General Fund
Balance Sheet
FY 2005-06 through FY 2009-10

	2005-06	2006-07	2007-08	2008-09	2009-10
ASSETS					
Cash and Pooled Investments	$ 221,735,443	$ 226,712,766	$ 246,586,004	$ 218,535,366	$ 173,830,449
Other Investments	--	--	--	--	--
Receivables:					
Taxes	27,619,359	32,078,847	30,970,055	27,594,883	29,402,612
Accrued Interest	3,392,856	4,860,345	4,947,699	1,295,495	578,113
Grants	2,619,467	6,600,384	4,825,492	3,666,756	2,679,371
Loans	2,141,459	2,391,459	2,141,459	2,391,459	2,391,459
Other	17,295,305	15,816,332	17,085,710	15,496,430	14,749,332
Due from Other Funds	10,598,356	34,744,681	19,165,611	5,688,353	3,026,130
Due from Outside Agency	245,706	1,896,469	2,765,396	3,336,027	3,167,672
Advances to Other Funds	3,634,522	3,607,282	3,337,934	3,332,852	3,957,150
Advances and Deposits	73,761	12,961	12,961	12,961	284,797
Restricted Assets:					
Cash and Pooled Investments	975,019	932,700	1,023,761	722,177	757,540
Other Investments	79,834	85,526	--	--	11,371
Other Assets	--	--	346,736	--	--
TOTAL ASSETS	$ 290,411,087	$ 329,739,752	$ 333,208,818	$ 282,072,759	$ 234,835,996
LIABILITIES AND FUND EQUITY					
LIABILITIES					
Accounts Payable	$ 13,212,020	$ 10,132,718	$ 10,718,772	$ 12,139,373	$ 9,923,313
Accrued Salaries, Wages and Payroll Taxes	18,990,589	20,929,575	25,862,423	34,180,502	35,982,723
Due to Other Funds	44,052	131,338	1,169,051	277,859	1,146
Due to Outside Agency	488,794	301,846	529,138	696,584	875,782
Deferred Revenue	8,634,963	6,946,365	7,483,910	12,096,291	4,432,294
Advance, Deposits, and Reimbursement Credits	7,203	7,203	7,203	7,203	7,203
Advances from Other Funds	604,350	250,000	250,000	500,000	500,000
Other Liabilities	11,459,625	10,443,662	10,055,511	10,982,079	12,226,542
TOTAL LIABILITIES	$ 53,441,596	$ 49,142,707	$ 56,076,008	$ 70,879,891	$ 63,949,003
FUND EQUITY					
Fund Balances:					
Reserved for Encumbrances	$ 26,362,154	$ 28,678,478	$ 41,648,273	$ 25,824,094	$ 20,635,146
Reserved for Non-current Advances and Loans	6,904,595	7,029,928	6,862,851	6,576,280	6,634,000
Unreserved:					
Designated for Contingencies	75,972,562	67,176,372	63,839,981	47,296,128	53,315,711
Designated for Future Projects	68,555,104	91,849,562	69,029,254	50,453,640	34,292,251
Undesignated	59,175,076	85,862,705	95,752,451	81,042,726	56,009,885
TOTAL FUND EQUITY	$ 236,969,491	$ 280,597,045	$ 277,132,810	$ 211,192,868	$ 170,886,993
TOTAL LIABILITIES AND FUND EQUITY	$ 290,411,087	$ 329,739,752	$ 333,208,818	$ 282,072,759	$ 234,835,996

Source: City of San José Comprehensive Annual Financial Reports, FY 2005-06 through FY 2009-10.

Table 19
General Fund
Statement of Revenues, Expenditures and Changes in Fund Balance
FY 2005-06 through FY 2009-10

	2005-06	2006-07	2007-08	2008-09	2009-10
REVENUES					
Taxes:					
Property Taxes	$ 168,523,127	$ 191,825,613	$ 203,718,290	$ 210,843,575	$ 202,186,036
Sales Taxes	140,327,107	149,962,080	154,001,942	132,005,205	127,237,778
Utility Taxes	75,488,559	79,129,154	82,254,430	93,619,124	108,150,882
State of California in-lieu Tax[(1)]	5,817,221	5,910,847	9,244,157	8,838,369	7,168,871
Franchise Taxes	36,759,857	40,415,138	41,063,799	41,067,393	38,410,068
Miscellaneous Taxes	7,688,090	8,600,000	9,560,000	7,795,177	6,900,000
Total Taxes	434,603,961	475,842,832	499,842,618	494,168,843	490,053,635
Licenses, Permits, and Fines	90,351,138	88,611,157	89,655,944	84,274,251	81,983,013
Intergovernmental	12,231,773	20,487,739	12,762,108	16,365,749	12,822,916
Charges for Current Services	27,847,331	29,624,325	30,533,402	28,139,927	28,055,147
Interest and Investment income	9,697,772	18,454,100	27,146,043	7,541,406	1,514,213
Other Revenues	27,817,324	41,264,785	34,467,568	32,605,741	34,852,861
TOTAL REVENUES	$ 602,549,299	$ 674,284,938	$ 694,407,683	$ 663,095,917	$ 649,281,785
EXPENDITURES					
Current:					
General Government	$ 78,504,837	$ 86,047,864	$ 86,907,472	$ 98,536,305	$ 76,717,521
Public Safety	341,794,392	368,839,637	416,255,089	419,043,439	427,020,434
Capital Maintenance	37,666,933	43,303,338	50,678,104	53,439,861	46,160,853
Community Services	124,057,227	129,063,357	141,877,817	138,991,586	126,815,406
Sanitation	1,735,317	1,832,698	1,896,091	2,620,646	1,671,593
Capital Outlay	27,288,306	3,921,801	1,468,606	5,233,310	3,940,205
Debt Service[(2)]:					
Principal	--	--	--	953,000	1,008,000
Interest	--	--	--	630,021	146,196
TOTAL EXPENDITURES	$ 611,047,012	$ 633,008,695	$ 699,083,179	$ 719,448,168	$ 683,480,208
Excess (Deficiency) of Revenues over Expenditures	$ (8,497,713)	$ 41,276,243	$ (4,675,496)	$ (56,352,251)	$ (34,198,423)
OTHER FINANCING SOURCES (USES)					
Transfers In	$ 43,814,163	$ 38,072,779	$ 39,192,371	$ 32,809,381	$ 22,661,774
Loan Proceeds	25,093,930	--	373,930	--	--
Transfers Out	(15,472,302)	(35,721,468)	(38,355,040)	(42,397,072)	(28,769,226)
TOTAL OTHER FINANCING SOURCES (USES)	$ 53,435,791	$ 2,351,311	$ 1,211,261	$ (9,587,691)	$ (6,107,452)
Excess (Deficiency) of Revenues and Other Sources over Expenditures and Other Uses	$ 44,938,078	$ 43,627,554	$ (3,464,235)	$ (65,939,942)	$ (40,305,875)
Fund Balance - July 1	192,031,413	236,969,491	280,597,045	277,132,810	211,192,868
Residual Equity Transfer	--	--	--	--	--
Fund Balance - June 30	$ 236,969,491	$ 280,597,045	$ 277,132,810	$ 211,192,868	$ 170,886,993

(1) Includes MVLF in-lieu.
(2) Excludes debt service funds of the Redevelopment Agency and other debt service funds.

Source: City of San José Comprehensive Annual Financial Reports, FY 2005-06 through FY 2009-10.

Financial and Accounting Information

The accounts of the City are organized on the basis of funds, each of which is considered a separate accounting entity. The fund financial statements provide information about the City's funds, including fiduciary funds. The emphasis of fund financial statements is on major governmental and enterprise funds, each displayed in a separate column. All remaining governmental and enterprise funds are separately aggregated and reported as non-major funds. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures (or expenses) as appropriate. Government resources are allocated and accounted for in individual funds based on the purposes for which they are to be spent and the means by which spending activities are controlled. Separate statements for each fund category – governmental, proprietary and fiduciary – are presented.

All governmental funds are accounted for using the modified accrual basis of accounting. Their revenues are recognized when they become measurable and available. Taxpayer-assessed income, gross receipts and other taxes are considered "measurable" when in the hands of intermediary collecting governments and are recognized as revenue at that time. Anticipated refunds of such taxes are recorded as liabilities and reductions of revenue when they are measurable and their validity seems certain. Expenditures are recognized when a liability is incurred. Exceptions to this general rule include: (1) accumulated unpaid vacation, sick pay, and other employee amounts which are not accrued; and (2) principal and interest on general long-term debt which is recognized when due. All proprietary funds are accounted for using the accrual basis of accounting. Their income is recognized when it is earned and expenses are recognized when they are incurred.

Insurance and Self-Insurance Programs

The City reassesses its insurance coverage annually. Therefore, the City makes no representations that these insurance coverages will be maintained in the future.

The City self insures for liability (other than for the Airport and the Water Pollution Control Plant), personal injury, and workers' compensation. The City currently maintains an all-risk property insurance policy with coverage for City and Redevelopment Agency property, including coverage for boiler and machinery exposures. This policy also provides coverage for loss due to business interruption or flood. The City generally does not carry earthquake insurance. A summary of the City's all-risk property insurance is provided in Table 20.

Table 20
City of San José
Summary of Citywide Property Insurance Coverage
(For Policy period October 1, 2010 – October 1, 2011)

	Limit Per Occurrence	Deductible Per Occurrence
Property, including Business Interruption(1)	$ 1 billion	$ 100,000
Flood		
Flood Zones A and V	$ 25 million(1)	$ 500,000(2)
Flood Zone B	$ 50 million(1)	$ 100,000(2)
All Other Flood Zones	$ 100 million(1)	$ 100,000(2)

(1) Annual Aggregate
(2) Deductible applies per location affected

Source: City of San José, Human Resources Department - Risk Management.

The City has airport liability policies covering the Airport, which provide a $200 million each occurrence combined single limit for bodily injury and property damage, with a $25 million each occurrence limit for personal injury, currently subject to a per occurrence deductible of $250,000 and in the aggregate. The City also maintains an automobile liability policy covering vehicles associated with the Airport and Water Pollution Control Plant operations. The limit of liability is $1 million for each occurrence for liability, and the City is self-insured for physical damage.

Workers' Compensation and Third Party Liability Claims. As noted above, the City is self-insured and self-administered for workers' compensation with claims paid on a "pay as you go" basis. The City budgets for workers' compensation payouts based on prior year payout history. Over the five-year period of FY 2005-06 through FY 2009-10, the City experienced workers' compensation payouts ranging from $15.1 million to $17.5 million, with the payout from the General Fund averaging approximately 89% of the total. The City is also self-insured for third party liability claims other than those involving the Airport and the Water Pollution Control Plant, as described above. All third party liability claims are handled by the City Attorney's Office. There is an emergency reserve fund of $10 million in the General Fund for both liability and workers' compensation claims.

Unemployment Insurance. The City self-insures to the limits required by State statute. The City budgets for each year's anticipated unemployment insurance claims. By policy, the City also funds a reserve of the same amount in each fiscal year.

Airport Coverages for Phase 1 of the Airport Development Program

Airport Owner-Controlled Insurance Program – North Concourse Project. On March 31, 2004, the City bound certain liability insurance coverages for the major components of the North Concourse project through an owner-controlled insurance program from American International Group ("AIG"), now Chartis. An owner-controlled insurance program ("OCIP") is a single insurance program that provides insurance coverage for construction job site risks of the project owner, general contractors, and all subcontractors associated with construction at the designated project site. The specific coverages, limits, and deductibles are summarized in Table 21 below.

Table 21
City of San José
Summary of Airport Owner-Controlled Insurance Program – North Concourse Project

Coverages	Limit	Deductible Per Occurrence
General Liability	$2 million per occurrence $4 million aggregate	$ 250,000
Workers' Compensation	Statutory	$ 250,000
Employers' Liability	$2 million per accident	$ 250,000
Excess Liability	$150 million	

Source: City of San José.

The City was required to establish a claims loss reserve for the North Concourse Project in the aggregate principal amount of $3.6 million with an additional $300,000 available in a cash working fund. The claims loss reserve funds the deductible amount of up to $250,000 per occurrence, to a maximum loss exposure to the City of $3.9 million.

The North Concourse Project has been completed and the policies expired December 31, 2008. AIU refunded to City $2.5 million of the loss fund in June 2010. AIU will continue to hold the remaining funds in the loss reserve fund until such time as the exposure to risk of claims ceases or the City opts to cash out the remaining funds in exchange for accepting responsibility for potential future claims.

Airport Owner-Controlled Insurance Program – Terminal Area Improvement Program. On March 15, 2007, the City bound certain liability insurance coverages for the major components of the Terminal Area Improvement Program through another OCIP (the "TAIP OCIP") procured through Chartis (formerly known as AIG). The terms of the TAIP OCIP require the City to fund a claims loss reserve with Chartis in the amount of $8.9 million which Chartis has permitted the City to fund incrementally. The claims loss reserve had a balance of $5.9 million as of June 30, 2010**.** The specific coverages, limits, and deductibles are summarized in Table 22.

The City is obligated to maintain the TAIP OCIP through the term of its design-build contract with Hensel Phelps for the design and construction of the TAIP. The term of the TAIP OCIP is currently set to expire on March 31, 2011. The City's final acceptance of the TAIP is presently scheduled for the end of March 2011. The City has the option to either extend the OCIP or to require Hensel Phelps to provide the required coverages through the date of City's final acceptance of the TAIP, pursuant to the terms of the design-build contract.

Table 22
City of San José
Summary of Airport Owner-Controlled Insurance Program – Terminal Area Improvement Program

Coverages	Limit	Deductible Per Occurrence
General Liability	$2 million per occurrence $4 million aggregate	$ 250,000
Workers' Compensation	Statutory	$ 250,000
Employers' Liability	$1 million per accident	$ 250,000
Excess Liability	$200 million	

Source: City of San José.

<u>*Builders' Risk and Owner's and Contractor's Protective Professional Indemnity, Including Contractor's Pollution Liability Policies.*</u>

On July 23, 2007, the City bound the builders' risk coverage for the TAIP through December 31, 2010 (construction is currently scheduled for final completion by March 31, 2011). The original limit on the coverage was $488,210,574 and the budgeted construction cost for Terminal Area Improvement projects is $600,717,460.

Following substantial completion, the buildings included within the TAIP will be added to the City's property insurance coverage. All of the TAIP projects are estimated to be substantially completed on or before March 31, 2011.

Hensel Phelps, under its design-build agreement with the City for the TAIP, has provided a contractor's protective professional liability insurance ("CPPI") policy specific to its design work on the Terminal Area Improvement Program. The CPPI affords vicarious liability coverage for the City and the contractor's pollution liability policy names the City as an additional insured. The limit on the coverage is $5.0 million.

Significant Litigation, Claims and Proceedings

The City is involved in a variety of pending actions. Additionally, there are a number of claims filed against the City. The pending or threatened litigation and other proceedings, described below, is the most significant in terms of potential risk of loss, using a threshold of $10 million.

Significant Litigation

Litigation Related to Watson Park. The City has been sued by fifteen family members alleging damages totaling $19.4 million (the "Plaintiffs"). The Plaintiffs currently or previously have resided at, or have visited, a home in San José that is located adjacent to the City-owned Watson Park. Watson Park, which was formerly a landfill site, has been closed to the public since 2005, due to the discovery of hazardous materials in the park. The City has undertaken hazardous remediation work at Watson Park and at the homes that are located adjacent to Watson Park, including the home involving the Plaintiffs. The Plaintiffs allege that each has suffered injuries as a result of contamination at the subject home. Since the lawsuit was filed, eleven of the fifteen plaintiffs have dismissed their cases against the City. The City is unable to predict the outcome of this litigation or whether any of the plaintiffs who have filed dismissals will attempt to file another case against the City.

The City has entered into a settlement agreement with the owners of the other properties located adjacent to Watson Park at which the City performed remediation work.

Water Company Litigation. A private water company in San José sued both the City and the Agency claiming that they have illegally used their respective authority to deny permits, licenses and other authorizations to the water company and its potential customers, in an effort to cause property owners and developers to use the City's Municipal Water System instead of the private water company in two areas of the City. The water company alleged that the City and/or the Agency inversely condemned the water company's property, interfered with its contracts and business opportunities, and violated various provisions of the State Water Code. In 2008 the water company agreed to dismiss its case without prejudice while the parties attempt to settle the matter. If a settlement is not reached by the end of 2011, the water company can re-file the lawsuit, or as has occurred the past three years, the parties can extend their agreement. Discovery concerning the water company's alleged damages was not completed before the case was dismissed. If the effort to reach a settlement fails, and the water company re-files its case and ultimately prevails, the City and the Agency are unable to predict the nature or amount of the damages that can be proven.

Significant Outstanding Obligations

In November 2006, the City entered into a settlement agreement with the County of Santa Clara (the "County") to resolve litigation brought by the County and neighboring cities related to the sufficiency of an Environmental Impact Report for an update to the City's North San José Development Policy. As part of the settlement agreement, the City agreed, among other things, to pay to the County an amount up to $11 million no later than June 30, 2010 in order for the County to construct road improvements in the North San José area. The City has not made its payment to date and the County has not taken any action to enforce payment. The County and the City are in negotiations to reduce and/or delay the payment of this obligation. Under the settlement agreement, matters related to the enforcement or interpretation of the settlement agreement are to be submitted to a judge selected by the Presiding Judge of the Superior

Court of Santa Clara County. The City cannot predict the outcome of these negotiations or whether the matter will be submitted to the Santa County Superior Court for resolution.

Other Significant Proceedings

FAA Audit of Use of Airport Revenue. The FAA commenced an audit of the City's use of Airport revenue in the spring of 2010. Federal law requires all airport owners that receive Federal assistance, such as the City, to use airport revenues for the capital or operating costs of the Airport. As a general rule, any use of airport revenues by an airport owner for costs that cannot properly be considered airport capital or operating costs is deemed to be improper revenue diversion. On June 2, 2010, auditors from the FAA provided the City with a draft audit finding improper use of Airport revenues by the City in three areas of expenditure as described below.

The City provided its response to the draft findings in June 2010 and awaited the FAA's response. In March 2011, the FAA notified the City that the FAA was prepared to issue its final audit consistent with the draft findings, but would give the City the opportunity to comment on the final draft of the audit findings prior to issuance The FAA has not provided the City with a timeframe for its issuance of a final audit. In the event that the FAA issues a final audit finding improper use of Airport revenue by the City, the City will have an opportunity for an administrative hearing to contest any such determination through the administrative procedures set forth in 14 CFR Part 16.

The improper uses of airport revenues alleged by the FAA are described below:

> *Airport Lease Obligation.* The City purchased approximately 75 acres of real property located near the southwest corner of the Airport from the FMC Corporation between 2005 and 2006, as a strategic effort to promote economic development opportunities and to preserve the future viability of the Airport. The City acquired the property in two phases. The initial phase, consisting of the acquisition of 52 acres of the property (referred to as the "Airport West Property") was completed in February 2005. The City completed the second phase, consisting of the acquisition of the remaining 23 acres of the property, in May 2006. The City intended to use the remaining 23 acres of the property for non-Airport economic development purposes.
>
> The purchase of the Airport West Property was financed with lease revenue bonds issued by the City of San José Financing Authority (the "Authority"). Upon acquisition, the City leased the Airport West Property from the Authority and used a portion of the Property for construction laydown needs (including material storage and construction employee parking) to support the Terminal Area Improvement Program. The City agreed to make lease payments for the Airport West Property from Airport operating revenues available in the Maintenance and Operation Fund. At the time of the acquisition, the City contemplated other potential Airport uses for the Airport West Property, such as rental car storage, public or employee parking, flight kitchen operations, airport/airline warehouses and compatible non-aviation leaseholds. The City subsequently determined not to use the Airport West Property for these other potential Airport uses, and the City's use of the Property for construction laydown needs ceased with the completion of the Terminal Area Improvement Program on June 30, 2010. The City ceased using Airport operating revenues to make Airport West Property lease payments as of July 2, 2010.
>
> In its June 2, 2010, draft audit finding, the FAA determined that the City could use Airport operating revenues to pay rent only for those portions of the Airport West property that the City actually used for its Airport construction laydown needs and that the use of Airport operating revenues to pay rent for the remainder of the Airport West Property not actually used

by the City for Airport purposes violated federal law regarding use of airport revenue. Consequently, the FAA auditors recommended that the City recalculate the rent paid from Airport operating revenues based upon actual Airport use, set the rent at fair market value, and return the remainder to the Airport enterprise fund, with interest. The City paid approximately $2.2 million from Airport operating revenues and approximately $10.0 million from the issuance of Airport Commercial Paper supported by general Airport revenues as rent for the Airport West Property from its acquisition through June 30, 2010.

The City believes that it has viable defenses to the FAA audit determination with regard to Airport West lease payments. Acquisition of property for Airport purposes (whether by purchase or lease) necessarily requires planning and development prior to the commencement of actual Airport uses, and the use of Airport operating revenues to pay rent on property acquired for planned future Airport uses does not constitute improper use of Airport operating revenues under federal law. There is no basis under applicable federal law for the distinction made by the FAA auditors between rent payments for actual as opposed to planned airport uses.

Guadalupe Gardens. In early 2002, the City Council approved a Master Plan for Guadalupe Gardens, consisting of approximately 120 acres of mostly vacant, City-owned property located south of the Airport, much of which falls within an FAA-established safety zone. The City acquired the Guadalupe Gardens properties using FAA grants for airport approach protection and noise compatibility, and the FAA grant agreements consequently required FAA approval of any planned City use of the properties acquired with grant proceeds. By letter dated August 9, 2002, addressed to the City's Director of Aviation, the FAA San Francisco Airport District Office ("ADO") approved the City's Master Plan for reuse of Guadalupe Gardens for runway and approach protection, and the City finalized the Master Plan in reliance upon the FAA approval.

Citing provisions of federal law that require recipients of FAA grants for acquisition of land for noise compatibility purposes to dispose of any such acquired land when no longer needed by the airport owner for noise compatibility purposes, the FAA auditors determined that the FAA ADO erred in its 2002 approval of the Guadalupe Gardens Master Plan and that the City is obligated to prepare an inventory of the Guadalupe Gardens to identify those parcels that were acquired by the City with noise compatibility grant proceeds. This inventory would then be used to prepare for FAA review and approval a disposition plan for those parcels no longer needed by the City for noise compatibility. Proceeds of the sale of the parcels proportionate to the FAA grant share of the original purchase price would be required to be used for other approve noise compatibility projects at the airport or returned to the FAA.

The City believes that it has viable defenses to the FAA audit determination with regard to Guadalupe Gardens. The FAA ADO's 2002 approval of the Guadalupe Gardens Master Plan constituted an official FAA approval of the City's reuse of the parcels acquired with proceeds from FAA noise compatibility grants, and the approval expressly provides that the entire Guadalupe Gardens is necessary for the continuing aeronautical purpose of runway and approach protection. Having received official FAA approval of its reuse of the parcels, the City is under no obligation to take any further action to secure further FAA approval of its continuing use of the Guadalupe Gardens.

Cost Allocations. The FAA auditors reviewed the City's allocation of its costs to the Airport department for services provided by the City to the Airport in FY 2010-11. The City uses both direct and indirect methodologies to allocate costs to the Airport. The FAA auditors found the direct cost allocations to be acceptable.

The FAA contends that the City's indirect methodology does not correlate to the cost of services actually provided by the City to the Airport. Consequently, the auditors have recommended that the City re-allocate its costs charged to the Airport for fiscal years 2005 through 2010 using an allocation methodology that reflects services actually provided to the Airport and repay any overcharges to the Airport enterprise fund, with interest. The amount of costs allocated by the City to the Airport using the indirect methodology for fiscal years 2005 through 2010 was estimated to be $41 million.

The City believes that its cost allocation methodologies reflect the cost of City services actually provided to the Airport and that the methodologies used by the City are consistent with applicable federal cost allocation guidance.

Significant Tax Refund Claims

Before Measure K was approved by the voters, the City imposed a Telephone utility user's tax ("UUT") on every person in the City using intrastate telephone communication services. The City's former Telephone UUT is described above in "Major General Fund Revenue Sources – *Utility Taxes*." The City stopped collection of the former Telephone UUT on March 31, 2009.

The City's former Telephone UUT, like the telephone utility tax imposed by many other jurisdictions, linked imposition of the tax to the Federal Excise Tax ("FET") and was written before the introduction of new communications technologies and changes to federal law. Utility user's taxes imposed by other California cities that contain language similar to that in the City's former Telephone UUT have been the subject of legal controversy. The City's current Telephone UUT removed outdated language that was the subject of lawsuits in other jurisdictions. However, if the City's former Telephone UUT were challenged, the outdated language could subject the City to significant tax refund claims. On May 25, 2006, the U.S. Treasury Department issued Notice 2006-50 in which it announced it was conceding the legal dispute over whether it should be applying the FET to long distance and bundled telephone communication services, where the charges for the services are based on time only and not time and distance. Consequently, effective August 1, 2006, the IRS no longer applies the FET to long distance and bundled services. A bundled service is local and long distance service provided under a single plan that does not separately state the charges for local telephone service.

On June 27, 2006, in response to Notice 2006-50, the City Council adopted an urgency ordinance which went into effect the same day reaffirming its intent to continue its long-standing practice of applying its Telephone UUT in a manner consistent with the IRS' interpretation of the FET prior to the issuance of Notice 2006-50. The City Council subsequently adopted an identical regular ordinance which became effective on September 8, 2006. The ordinances clarified that the City was not changing its application of its Telephone UUT based on the IRS' decision to discontinue taxing long distance and bundled services in order to resolve legal disputes with telephone customers. Rather, the City would continue to tax intrastate local, long distance, and bundled services based on the IRS's interpretation of the FET prior to May 25, 2006. In light of the *AB Cellular* decision discussed above in "Major General Fund Revenue Sources – *Utility Taxes*," there is a risk that if the City's application of its former Telephone UUT was challenged, a court could rule that the actions the City took in June 2006 violate Proposition 218.

Following the Council's actions in June 2006 with respect to the ordinances, on July 24, 2006, the City's Director of Finance gave notice to approximately 200 telecommunication carriers doing business in the City that the City would continue to apply its Telephone UUT to intrastate telephone communication services consistent with the IRS' interpretation of the FET prior to May 25, 2006. One carrier objected to the July 24 notice, but continued to collect and remit the former Telephone UUT to the City, without waiving its rights to seek refunds and other appropriate relief.

On January 29, 2007, the U.S. Treasury Department issued Notice 2007-11, which states that Notice 2006-50 does not affect the ability of state or local governments to impose or collect telecommunication taxes under their respective statutes of government. However, the City is unable to determine at this time what impact, if any, Notice 2007-11 might have on future requests for refunds in connection with revenues derived from the City's former Telephone UUT.

Prior to the IRS' issuance of Notice 2006-50, two telephone customers filed claims with the City seeking refunds of the City's Telephone UUT. Collectively, the two customers seek refunds in the amount of approximately $2.7 million, claiming among other things, that the City's former Telephone UUT was erroneously applied to package or bundled plans where the charges are exempt under the FET and, accordingly, under the City's former Telephone UUT. On June 2, 2008, the City received a third claim from a telephone customer, seeking a refund of the City's former Telephone UUT in an unspecified amount for what appears to be a one year period between May 2007 and May 2008 on the grounds that it was being charged a tax on communication services which were not subject to the FET and, therefore, not subject to the City's former Telephone UUT. In addition, the telephone customer claimed that the City's post IRS Revenue Notice 2006-50 modification of its former Telephone UUT is unenforceable because it violates Proposition 218. On June 1, 2009, the City received another claim from the same telephone customer seeking an additional refund of the City's former Telephone UUT in an unspecified amount for what appears to be a one year period between May 2008 and May 2009 on the grounds set forth above.

To date, the City has not taken action on these claims and the claimants have not pursued litigation against the City. However, lawsuits have been filed challenging the authority of other California cities to impose taxes on package or bundled plans where the charges are exempt under the FET, including lawsuits filed against the City of Los Angeles, the County of Los Angeles, and the City of Long Beach. In light of Federal Court decisions regarding the exemption of bundled telephone service plans from the FET and the litigation described herein, the City may be presented with additional requests for refunds in connection with its former Telephone UUT.

On November 19, 2010, the City received a refund claim from AT&T Mobility, seeking a refund of Telephone UUT from 2005-2010, in the amount of approximately $3.3 million. Based upon the refund claim submitted, it appears that AT&T Mobility and its affiliates (collectively, "AT&T") have been sued in a number of cases in which the plaintiffs (AT&T customers) allege that AT&T applied taxes for certain data services which included internet access in violation of the Internet Tax Freedom Act ("ITFA"). These cases have been consolidated in a class action overseen by a federal district court in Illinois. AT&T and the attorneys representing the class have negotiated a settlement agreement. Under the proposed settlement, AT&T has agreed, among other things, to pursue refunds on behalf of the class from various taxing authorities and then pay the refunded amounts to the class. [As of the date of this Official Statement, the court has not approved the proposed settlement.]

[The City has sent AT&T a notice of insufficiency related to its claim, but has otherwise not taken any action on it. The City cannot predict whether AT&T will pursue litigation against the City to obtain a refund or the outcome of any such litigation.]

Even though the City has a tax refund ordinance which limits the refund period to one year, and the refund period expired, the courts have not definitively ruled on whether claimants can be limited to a one year refund period or may be able to claim a refund for a three year period (which corresponds to the otherwise applicable statute of limitations).

The City's revenue from the former Telephone UUT (including revenues from landline and wireless calls) for FY 2007-08 and FY 2008-09 (through March 31, 2009) was approximately $45.8 million. At this time, the City is unable to separately estimate the Telephone UUT revenues derived from long-distance and bundled services from local service or from data services. Further, the City is unable to estimate the amount of Telephone UUT revenues that may be subject to refund based on the claim that the telephone service provided was not subject to the FET under the former Telephone UUT.

Labor Relations

Overview

The City has eleven recognized employee bargaining units. The representation and agreement dates are shown in Table 23. All bargaining units have current agreements with the exception of the International Association of Firefighters, Local 230 ("Local 230") and the Association of Building, Mechanical and Electrical Inspectors (ABMEI). All of the City's remaining bargaining units have agreements expiring in FY 2010-11, with the exception of the Confidential Employees' Organization ("CEO") whose agreement expires September 17, 2011. In addition to its represented employees, the City has 209 unrepresented employees as of February 28, 2011.

Table 23
City of San José
Summary of Labor Agreements

	Agreement Expiration Date	Full-Time Equivalent Employment(1)
Assoc. of Building, Mechanical and Electrical Inspectors (ABMEI)	12/10/2009	50
Association of Maintenance Supervisory Personnel (AMSP)................	06/30/2011	79
Association of Engineers and Architects (AEA)(2)	06/30/2011	200
Association of Legal Professionals (ALP) ……………………………..	06/30/2011	38
Operating Engineers, Local #3 (OE#3)	06/30/2011	759
International Brotherhood of Electrical Workers (IBEW)	06/30/2011	74
City Association of Management Personnel (CAMP)	06/30/2011	344
San José Police Officers' Association (POA)	06/30/2011	1220
International Association of Firefighters (IAFF, Local 230) …………..	06/30/2009	647
Municipal Employees Federation (MEF)	06/30/2011	1844
Confidential Employees' Organization (CEO)	09/17/2011	191
Total...		5,446

(1) Full Time Equivalents (FTE's) are the combined total number of budgeted full-time positions. For example, one full-time position equals one FTE. Similarly, two half-time positions equal one FTE. The FTE numbers presented are as of February 28, 2011.
(2) The City has two separate agreements with AEA; the first agreement is related to employees of Unit 41 and Unit 42 and the second agreement is related to employees in Unit 43. Both agreements expire on June 30, 2011.

Source: City of San José, Office of Employee Relations, City Manager's Budget Office.

Under California law, sworn police and fire employees are not permitted to strike. The City Charter provides that police and fire bargaining units have the right to binding interest arbitration of labor disputes once either the City or the applicable bargaining unit declares that the negotiations are at impasse. AEA, CEO, IBEW, MEF, and OE#3 have "no strike" clauses during the terms of their respective agreements.

<u>*Labor Costs and Staffing Reductions*</u>

During the period from FY 2000-01 through FY 2009-10, the City's total compensation costs have increased significantly. The term "total compensation costs" refers to the City's cost of pay and benefits, including base pay, retirement contributions, health insurance and other benefits. The chart below shows the increase in budgeted costs of total compensation of the City's full-time employees ("FTEs") from FY 2000-01 through FY 2009-10 for all of the City's funds. Although the number of FTEs decreased during this period, the City's average total compensation cost per FTE has increased approximately 63.65% from $73,581 per FTE in FY 2000-01 to $120,418 in FY 2009-10.

Table 24
City of San José
Citywide Salary and Benefits[(1)]

	FY 2000-01	FY 2009-10	Difference
Base Payroll	$416,010,420	$582,337,708	39.98%
Retirement Benefits	**$63,054,083**	**$137,472,029**	**118.02%**
Federated Retirement	$39,409,193	$72,534,127	84.05%
Police/Fire Retirement	$23,644,890	$64,937,902	174.64%
Health/Dental Benefits[(2)]	**$30,317,792**	**$64,197,978**	**111.75%**
Health	$24,856,910	$57,160,932	129.96%
Dental	$5,460,882	$7,037,046	28.86%
Other Benefits (Unemployment & Other Miscellaneous Benefits)	**$6,608,312**	**$13,566,187**	**105.29%**
Total (All Benefits)	**$99,980,187**	**$215,236,194**	**115.28%**
Grand Total	**$515,990,607**	**$797,573,902**	**54.57%**
Average Total Cost Per FTE	**$73,581**	**$120,418**	**63.65%**

(1) Does not include worker's compensation cost or overtime. 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.
(2) Health/Dental Benefits are the costs budgeted for the health and dental benefits provided to FTEs.

Source: City of San José Salary and Fringe Benefit Costs by Bargaining Unit & Fund for 2000-2001 through 2009-2010 Adopted Budget

In November 2009, the City Council considered the City's projected budget deficit for FY 2010-11 and gave direction that the City's ongoing total compensation costs of City employees must be reduced by 5.0%. Subsequently in March 2010, in response to a projected increase in the budget deficit for FY 2010-11, the City Council directed that total compensation costs be reduced by 10.0%. The City Council further directed that half of the reduction be an ongoing reduction and the remaining half be compensation savings for FY 2010-11.

As discussed above in "Budget – *City Budget* – City's 2010-2011 Adopted Budget", the City reached agreement with six bargaining units, each for a one-year term, that resulted in a 10% reduction in total compensation for FY 2010-11 for these bargaining units with 5.0% considered to be ongoing. As each of these agreements expires, any further ongoing concessions will be subject to negotiation in future agreements. Additionally, the City Council approved a compensation package for 237 unrepresented employees for FY 2010-11 that includes a 10% reduction in total compensation for FY 2010-11 with 5.0% considered to be ongoing. Also, as discussed above in "Budget – *City Budget* – Adjustments to the City's 2010-2011 Adopted Budget", subsequent to the adoption of the City's FY 2010-11 budget, the City and the POA entered into an agreement for FY 2010-11 that avoided layoffs of 70 police officers. The reduction in total compensation agreed to by the POA was approximately 3.82%.

The City was unable to reach agreement with CEO, MEF and ABMEI to reduce their total compensation. In the case of CEO and MEF, their agreements are in effect through FY 2010-11 and their members received a 2.0% wage increase in FY 2010-11. The agreement with ABMEI had expired prior to the City Council's directive to achieve a 10.0% reduction in total compensation. After ABMEI and the City were unable to reach an agreement, the City Council imposed the terms of its Last, Best and Final Offer on ABMEI that resulted in a 5.0% ongoing reduction in total compensation for FY 2010-11. The implementation of the City's Last, Best and Final Offer on ABMEI does not result in a memorandum of agreement between the City and ABMEI.

With the restoration of the 70 police officer positions, the 2010-2011 Budget reduced the total number of positions by 713 city-wide. 185 FTEs and 21 part-time employees were laid off.

Status of Current Negotiations

The City is in negotiations with all of the other bargaining units in 2011. On November 18, 2010, the City Council gave direction to the City Manager regarding the negotiations with the bargaining units for the FY 2011-12 agreements as follows: (1) continue, on an ongoing basis, the 10% total compensation reduction for those bargaining units that had agreed to the reduction in FY 2010-11; (2) roll back any general wage increases received in FY 2010-11 and reduce total compensation by 10% on an ongoing basis; (3) include healthcare cost containment in cost sharing, co-pays, health and dental in-lieu and dual coverage as had been previously recommended by the City's Auditor.

In addition, the City Council has directed the City Manager to negotiate reforms with respect to pension and retiree healthcare benefits, payments of accrued sick leave to employees upon retirement, disability leave supplement, supplemental retiree benefit reserve**,** and compensation structure. See **"**Pension Plan – *Pension Plan Reform Initiatives* **–** Second Tier Retirement Benefit for New Employees.**"**

[On March 3, 2011, the City and Local 230 reached a tentative agreement in their negotiations of a new agreement. The agreement requires ratification by union members and is anticipated to be considered by the City Council on March 8, 2011. Key components of the agreement include (1) a 10% total compensation reduction, (2) healthcare cost containment in cost sharing, co-pays, health and dental in-lieu and dual coverage, and (3) five-year phase in of retiree healthcare funding commencing on June 26, 2011. Under the tentative agreement, the City will establish a qualified trust by July 2, 2011 for the retiree healthcare funding.] [To be updated following March 8, 2011.]

Pension Plans

General

All regular full-time City employees participate in one of two public employee retirement plans established pursuant to the City Charter: the Federated City Employees' Retirement System (the "Federated Plan") and the Police and Fire Department Retirement Plan (the "Police and Fire Plan" and together with the Federated Plan, the "Pension Plans"). Both Pension Plans are structured as tax qualified defined benefit plans in which retirement benefits are based upon salary and length of service. Both Pension Plans pay fixed cost-of-living increases and all or a portion of health and dental insurance premiums for retirees who qualify.

Each Pension Plan is administered by its own Board of Administration, and day-to-day operations are carried out by the City's Director of the Department of Retirement Services and by the Director's staff. Participation by covered employees in the Pension Plans is mandatory; employees contribute a percentage of their salaries to the applicable Pension Plan, and currently the City provides funding through contributions equal to a percentage of its full-time employee covered payroll. The total contribution rates for the City and employees are based upon actuarial calculations that take into consideration a number of assumptions, including assumed investment earnings on the valuation assets of the Pension Plans that are used to pay benefits. However, the Boards for both Pension Plans recently expressed support for implementing a fixed dollar contribution "floor" each year as determined by the respective Pension Plan's actuary as an alternative to the current percent of payroll method, so that future required contributions will be whichever method yields the higher contribution amount.

The information presented hereafter regarding retirement benefits and postretirement healthcare and dental benefits for the Pension Plans excludes assets, liabilities and costs associated with the Supplemental Retiree Benefit Reserves (SRBRs) for the Pension Plans which are separately described below.

The following terms will be used in this section:

Actuarial Accrued Liability (AAL): That portion of the present value of future benefits not provided for by future normal costs. The AAL can be thought of as the value of benefits already earned (under the Pension Plan's funding method) in exchange for employees' past service.

Actuarial Value of Assets: In order to reduce the impact of market fluctuations on City contribution rates, market returns above/below the assumed net rates of return are recognized over a five-year period, beginning with the year the returns are first measured. The actuarial value of assets is determined by the Pension Plan's respective actuary and incorporates a smoothing methodology.

Annual Required Contribution (ARC): The City's actuarially determined contributions to the Pension Plans have two components, the "normal cost" and the amortized amount of the unfunded actuarial accrued liability ("UAAL"). The amortization of the UAAL represents the current year's portion of the unfunded actuarial accrued liability costs (i.e., the UAAL) attributable to past years' employment that is charged to the City.

Market Value of Assets: The market value of assets is the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion. The market value of assets is adjusted for accruals at the end of each fiscal year and is reported in the CAFR of each Pension Plan.

Normal Cost: Normal cost is the portion of the contribution the City will be expected to fund that covers the present value of benefits that are attributable to current service by covered employees under the funding method adopted by each Board. The covered employees also contribute a portion of the normal cost. Currently, the Pension Plans use the entry age normal cost method to calculate the annual normal cost rates of contribution.

Smoothing: When measuring assets for determining the UAAL, many pension plans, including each of the Pension Plans, "smooth" gains and losses to reduce the volatility of contribution rates. Specific smoothing methodologies for the respective plans are discussed below in *Actuarial Valuations* - Smoothing Methodology.

Unfunded Actuarial Accrued Liability: The UAAL is the excess of the AAL over the actuarial value of assets. The UAAL is an estimate based on a series of assumptions, and that calculation utilizes the demographic data of the Pension Plan's membership. The UAAL typically results from investment losses and gains and changes in actuarial assumptions, benefit improvements and other experiences that differ from those anticipated by the actuarial assumptions. The purpose of the UAAL calculation is to determine, as of the date of the calculation, the sufficiency of the assets in the Pension Plan for funding, the accrued costs attributable to currently active, vested terminated (i.e., the deferred members) and retired employees. The funding sufficiency is typically expressed as the ratio of the actuarial valuation of assets to the actuarial accrued liabilities. If the actuarially calculated funding level of a plan is less than 100%, the plan has a UAAL.

Recent Governance Changes to Boards of Administration

In August 2010, the City Council adopted ordinances to implement governance changes for the Board of Administration for each Pension Plan to provide for the following: (1) the majority of each Board be members of the public; (2) minimum qualifications for the public members, including education and expertise related to pension plan administration; (3) geographical requirements for the public members; (4) revising the process for removal of Board members and defining the causes for removal, including provisions for removal due to actual, potential or the appearance of a conflict of interest. The membership changes to both Boards eliminate the seats designated for City Council members, and the Civil Service Commission member seat and City's Administration seat on the Police and Fire Board.

The governance change to the Police and Fire Board increased the size of the Board from seven to nine members and changed the composition to: (1) five public members; (2) one current Fire Department employee and one current Police Department member who are members of the Police and Fire Plan; and (3) one retired Fire Department and one retired Police Department employee who are members of the Police and Fire Plan. The governance changes to the Federated Board maintained the Board's size of seven members but changed the composition to: (1) four public members; (2) two current City employees who work in different City departments and who are members of the Federated Plan; and (3) one retired member of the Federated Plan.

All seven (7) Federated Board seats are filled. [As of the date of this Official Statement, eight (8) of the nine (9) Police and Fire Board seats are filled, with the appointment by the City Council of the final public member to occur after the Police and Fire Board conducts interviews of candidates.]

Recent Tax Filings by Boards of Administration

On January 28, 2011, applications were filed with the Internal Revenue Service (IRS) pursuant to the direction of both Boards of Administration, for a tax compliance statement and favorable determination letter under the streamlined procedures of the Voluntary Correction Program ("VCP") pursuant to Revenue Procedure 2008-50. Tax qualified governmental plan are not required to file these applications, but receipt of a tax compliance statement provides assurance that the plan submitted for review to the IRS is tax compliant as of the date of the review. In addition, receipt of a favorable determination letter under the VCP provides assurance that the IRS will not pursue sanctions under Internal Revenue Code Section 401(a), 403(b) or 408(p) on account of any plan failures identified in the VCP filing,. The Pension Plans' VCP filings sought relief for failure to timely adopt certain Plan amendments, including requirements related to compliance with IRC Section 401(h) and Treasury Regulation 1.401-14, which relate to the provisions of medical and dental benefits to retirees and survivors. On February 15, 2011, the City Council adopted an ordinance containing amendments to the Municipal Code as recommended by outside tax counsel for submission to the IRS. Both Pension Plans' tax applications are currently pending with the IRS and there is no estimated date for commencement of IRS review or decision.

Summary of Pension Plans

A summary of Pension Plan characteristics and actuarial results as of the most recently completed valuation is presented in Table 25. The UAAL and funded ratio calculations provided in the table exclude health, dental and Supplemental Retiree Benefit Reserves assets and benefits for both Pension Plans. As described in Table 26a, over the past nine years, both Pension Plans have experienced steady and significant increases in UAAL, primarily attributable to changes in actuarial assumptions, unfavorable demographic experience and unfavorable investment returns (some of which have not yet been recognized under the Pension Plans' "smoothing" methodology).

In order to achieve and maintain the appropriate funding status of the Pension Plans, the Pension Plans' actuaries analyze the respective assets and liabilities of the Pension Plans to determine what level of required annual contributions are needed. The actuarial process can employ various funding methodologies to determine annual contribution levels and currently both Plan's actuaries employ the Entry Age Normal funding method. Under this method, there are two components to the total required annual contribution: the normal cost, and the unfunded actuarial accrued liability contribution.

Normal costs for both Pension Plans, as governed by the City Charter and the San José Municipal Code, are shared by the City and the active employee members of the Pension Plans with a contribution ratio of 8/11 for the City and 3/11 for the employee. Historically, the City has been responsible for funding the cost of amortizing the majority of the UAAL and other miscellaneous costs of the Pension Plans. In 2010, some employee bargaining groups agreed to pay a portion of the cost of amortizing the UAAL in addition to the employee contribution for the normal costs. See *Funding Status and Contribution Rates –* Federated Plan Contribution Rates; – Police and Fire Contribution Rates.

The annual contribution costs for the health and dental benefits provided to retirees by both Pension Plans are allocated to both the City and the active employee members. For the Federated Plan, the annual contributions for health costs are shared 50/50 and the dental costs are shared in a ratio of 8/11 for the City and 3/11 for the employee. For the Police and Fire Plan, the annual contribution for health costs is shared 50/50 and the annual contributions for dental costs are shared in a ratio of 75/100 for the City and 25/100 for the employee. The City is in the process of phasing in payment of the annual required contributions for the retiree health and dental benefits provided by both Pension Plans as calculated pursuant to Governmental Accounting Board Statements 43 and 45. For more information on the City's funding of health and dental costs of retirees, see *Other Postemployment Benefits*.

The actuaries for the Federated Plan have concluded as of June 30, 2010 that employer contribution rates are expected to increase for the next few years as the balance of the market value investment losses are recognized under the asset smoothing method and as the actuarially assumed net rate of return is decreased to 7.75%. In addition, actuaries for the Police and Fire Plan have concluded as of June 30, 2010 that contribution requirements are expected to increase over the next few years as a result of deferred investment losses under the actuarial value of assets smoothing process, to the extent those losses are not offset by future investment gains. In addition to the plan assessments provided by the Pension Plan's respective actuaries, on September 29, 2010, the City Auditor published the audit report as discussed below in *Pension Plan Reform Initiatives* – City Auditor's Pension Report.

Table 25
City of San José
Summary of Pension Plan Characteristics and Actuarial Results[1]
As of June 30, 2010

	Federated Plan	Police and Fire Plan
Membership		
Active	3,818	2,021
Deferred[2]	732	79
Retired + Beneficiaries	3,111	1,810
Total	7,661	3,910
Covered Payroll	$ 300,811,165	$ 251,058,473
Calculation of Unfunded Actuarial Accrued Liability (UAAL)[3]		
Actuarial Accrued Liability	$ 2,510,358,000	$ 3,230,456,034
Actuarial Value of Assets	1,729,414,000	2,576,704,563
UAAL	$ 780,944,000	$ 653,751,471
Actuarial Funded Ratio[3]	68.9%	79.8%
Employer Cost (% of covered payroll)		
Retirement Benefits[4]	28.34%	50.44%[6] [7]
Health and Dental Benefits[5]	7.16	TBD[6]
Total	35.50%	55.88%
Employee Cost (% of covered payroll)		
Retirement Benefits[4]	4.68%	10.57%[6]
Health and Dental Benefits[5]	6.51	TBD[6]
Total	11.19%	15.57%

(1) The contribution rates are the result of actuarial valuation reports and do not reflect contribution shifts associated with various bargaining groups and contribution prefunding described in the *Funding Status and Contribution Rates for Retirement Benefits* for both Pension Plans.

(2) Deferred refers to vested terminated employees.

(3) UAAL and Funded Ratio calculations exclude health, dental, and Supplemental Retiree Benefit Reserves assets and liabilities for both Pension Plans.

(4) For the Police and Fire Plan, the rates for the employer and Employee as shown are a blend of the different rates calculated for Police officer Employees and Fire department Employees. Retirement contribution rates for the Federated Plan reflect the second year of a three-year phase-in of economic assumptions changes applicable for the June 30, 2010 actuarial valuation.

(5) The Federated and Police and Fire contribution rates for health and dental benefits only provide partial funding of the liabilities for these benefits. See "*Other Postemployment Benefits* – Contribution Rates for Phase-In of ARC for Federated Plan*"* and – "Contribution Rates for Phase-In of ARC for Police Members of the Police and Fire Plan*"* for a discussion of increased contribution rates for health and dental benefits starting July 1, 2009 for Police Employees..

(6) Represents payroll based weighted average of Board adopted separate rates for Police Employees and Fire Employees. Police and Fire Health and Dental Benefits rates are pending receipt and approval of valuations from the actuary for the Police and Fire Plan.

(7) Will be offset by 0.49% on account of a transfer of $1.3 million from the Supplemental Retiree Benefit Reserve to the valuation assets which was applied to reduce the City's required contributions, but only for FY 2011-12.

Sources: *Report of the Actuarial Valuation of Federated City Employees' Retirement System as of June 30, 2010, dated December 3, 2010 and City of San José Police and Fire Department Retirement Plan Actuarial Valuation Report as of June 30, 2010, dated December 22, 2010. Report of the Actuarial Valuation of Federated City Employees' Retiree Healthcare Plan as of June 30, 2010, dated January 7, 2011 and City of San José Police and Fire Department Retire Medical and Dental Actuarial Valuation Report as of June 30, 2010, dated March 1, 2010.*

Table 26a below shows the historical dollar amount of the UAAL for both Pension Plans as of the last six valuation dates, calculated using the actuarial (smoothed) value of assets.

Table 26a
City of San José
Historical Retirement Plan UAAL and Funded Ratio

	Federated Plan		Police/Fire Plan	
Fiscal Year	**UAAL**	**Funded Ratio**	**UAAL**	**Funded Ratio**
6/30/2001	$ 12,189,000	99%	$ (221,080,000)	115%
6/30/2003	30,972,000	98%	(3,087,000)	100%
6/30/2005	326,916,000	81%	44,342,000	98%
6/30/2007	338,092,000	83%	6,596,000	100%
6/30/2009	729,567,000	71%	393,913,000	87%
6/30/2010	780,944,000	69%	653,751,000	80%

Source: City of San José, Retirement Services Department.

Table 26b below shows the historical dollar amount of the unfunded liability and the funded ratio for both Pension Plans as of the last six valuation dates, calculated using the market value of assets.

Table 26b
City of San José Historical Retirement Plan
Market Value of Assets Unfunded Liability and Market Value Funded Ratio

	Federated Plan		Police/Fire Plan	
Fiscal Year	**Unfunded Liability**	**Funded Ratio**	**Unfunded Liability**	**Funded Ratio**
6/30/2001	$ (41,256,000)	103.8%	$ (170,577,000)	111.4%
6/30/2003	176,958,000	86.5%	191,103,000	89.5%
6/30/2005	293,366,000	82.9%	(17,110,000)	100.8%
6/30/2007	213,136,000	89.1%	(282,257,000)	111.9%
6/30/2009	1,149,303,000	53.8%	994,350,000	66.4%
6/30/2010	997,556,000	60.3%	999,749,000	69.1%

Source: City of San José, Retirement Services Department.

As shown in Table 26c below, the Pension Plans' actuaries initiated Health and Dental actuarial studies for both Pension Plans in 2006.

Table 26c
City of San José
Historical Health and Dental Plan UAAL and Funded Ratio

	Federated Health and Dental Plan		Police/Fire Health and Dental Plan	
Fiscal Year	**UAAL**	**Funded Ratio**	**UAAL**	**Funded Ratio**
6/30/2006	$ 621,651,000	12%	$ 812,836,000	5%
6/30/2007	520,148,000	16%	620,834,000	7%
6/30/2009	520,148,000	11%	705,987,000	7%
6/30/2010	520,148,000	12%	Not available	

(1) Police and Fire Health and Dental Benefits rates are pending receipt and approval of valuations from the actuary for the Police and Fire Plan

Source: City of San José, Retirement Services Department.

As shown in Tables 27a, 27b and 27c, the City's contribution to the ARC has recently been an increasing percentage of the City's covered payroll. The employee contribution is also growing.

Table 27a
City of San José
Retirement and Health and Dental Contributions (%)
Federated Plan

Fiscal Year	Employer Cost (% of covered payroll)	Employee Cost (% of covered payroll)
1999-00	16.52	5.31
2000-01	16.09	4.76
2001-02	17.40	4.96
2002-03	15.20	5.08
2003-04	15.20	5.08
2004-05	17.12	6.06
2005-06	17.12	6.06
2006-07	21.98	7.58
2007-08	21.98	7.58
2008-09	23.56	8.93
2009-10	24.01	9.35
2010-11	29.59	10.30
2011-12	35.50	11.19

Source: City of San José, Retirement Services Department.

Table 27b
City of San José
Retirement and Health and Dental Contributions (%)
Police and Fire Plan

Fiscal Year	Employer Cost (% of covered payroll)		Employee Cost (% of covered payroll)	
1999-00	20.11[(1)]		10.22[(1)]	
2000-01	15.70		9.79	
2001-02	15.70		9.79	
2002-03	14.22		10.25	
2003-04	14.22		10.25	
2004-05	24.59		11.16	
2005-06	25.04		11.16	
2006-07	28.51[(2)]	25.22[(3)]	11.67[(2)]	11.26[(3)]
2007-08	28.90	25.61	11.67	11.26
2008-09	25.80	28.31	11.96	12.40
2009-10	26.89	28.31	12.96	12.40
2010-11	45.03	44.61	15.57	13.70
2011-12[(4)]	TBD	TBD	TBD	TBD

(1) Combined rate for Police and Fire Employees
(2) Rate for Police Employees
(3) Rate for Fire Employees
(4) Police and Fire Health and Dental Benefits rates are pending receipt and approval of valuations from the actuary for the Police and Fire Plan.

Source: City of San José, Retirement Services Department.

Table 27c
City of San José Employer
Retirement and Health and Dental Contributions ($)

Fiscal Year	Federated Plan	Police/Fire Plan	Total
2006-07	$ 61,732,000	$ 55,707,000	$ 117,439,000
2007-08	66,518,000	66,990,000	133,508,000
2008-09	73,388,000	62,991,000	136,379,000
2009-10	71,593,000	63,599,000	135,192,000
2010-11	66,986,000	89,144,000	156,130,000
2011-12	TBD	TBD	TBD

Source: City of San José, Retirement Services Department.

In addition to the increases in contribution rates illustrated in Tables 27a through 27c, it is projected that annual dollar contributions to the Pension Plans will continue to increase through FY 2015-16. The total anticipated City contribution levels incorporated in the City's Budget Office Five Year Forecast for the General Fund are based on actuarial projections provided by the Department of Retirement Services. The actuarial projections include estimates of the additional costs due to deferred asset losses under the Pension Plans' actuarial asset smoothing processes and the additional future costs associated with the five-year phase in of contributions to the Retiree Health and Dental Plans. Table 27d below represents anticipated contribution levels, derived from the total projected estimates of contribution costs, for the

General Fund as reported by the City's Budget Office in their Five Year Forecast. As depicted in the table below, during the Forecast period, General Fund retirement and health and dental costs are projected to increase to $303.9 for FY 2015-16, representing an increase of 58% from FY 2011-12. For FY 2015-16, projected retirement and health and dental costs would represent 28% of the total base expenditure budget compared to 21% for FY 2011-12. These contribution rates assume the current staffing level of the Forecast; however, in order to close the shortfall in FY 2011-12, it will be necessary to reduce staffing levels and therefore, it will be necessary to increase contribution rates for the remaining positions to generate the fixed contributions. It should be noted that the contribution amounts in Table 27d reflect the "floor" methodology. As discussed above, the City Council has not taken action to amend the Municipal Code in order to implement the "floor" methodology. See *Funding Status and Contribution Rates –* Federated Plan Contribution Rates; – Police and Fire Contribution Rates.

Table 27d
City of San José Employer
Projected Employer Retirement and Health and Dental Contributions[1]
(in millions)

Fiscal Year	Federated Plan	Police/Fire Plan
2012-13	$65,100,000	$170,500,000
2013-14	78,100,000	194,400,000
2014-15	84,700,000	209,900,000
2015-16	87,300,000	216,500,000

(1) Does not include retirement costs associated with part-time benefited employees and the Mayor and Council who do not participate in the City's Pension Plans.

Source: City of San José 2012-2016 Five-Year Forecast and Revenue Projections.

<u>*Service Retirement Formulas*</u>

The service retirement formulas for both the Police and Fire Plan and the Federated Plan are described below.

<u>Federated Plan.</u> An employee may retire at age 55 with five or more years of service or at any age with 30 years of service. The calculation of the retirement annuity is Final Average Salary (defined below) multiplied by 2.5% per year of service (maximum benefit is 75% of Final Average Salary). For Federated Plan members who retire on or after July 1, 2001, Final Average Salary is the average annual compensation earnable for the highest 12 consecutive months, not to exceed 108% of the second highest 12 consecutive months. For Federated Plan members who retired prior to July 1, 2001, Final Average Salary is the highest compensation earnable during any three consecutive years of service.

<u>Police and Fire Plan</u>. An employee who reaches normal retirement age of 55 with 20 years of service; an employee of age 50 with 25 years of service; an employee of any age with 30 years of service; or an employee of age 70 with no service requirement is entitled to a monthly retirement allowance. For employees who retired prior to February 2, 1996, the allowance is equal to Final Average Salary (defined below) multiplied by 2.5%, multiplied by years of service up to 30 years (maximum benefit is 75% of Final Average Salary.) The allowance formula has been modified three (3) times since 1996. The current monthly allowance for members with less than 20 years of service is Final Average Salary multiplied by 2.5% for each year of service. Effective July 1, 2006, the current monthly allowance for police members of the Plan with 20 or more years of service is equal to Final Average Salary multiplied by 2.5% for the first 20 years of service, plus 4% of Final Average Salary for each year of service thereafter (maximum benefit is 90% of Final Average Salary). For fire members of the Plan with 20 or more years of service,

the current monthly allowance (effective July 1, 2008) is equal to Final Average Salary multiplied by 3% for each year of service (subject to a maximum of 90% of Final Average Salary). Final Average Salary is defined as the highest 12 consecutive months of compensation, not to exceed 108% of compensation paid to the employee during the 12 months immediately preceding the last 12 months of service. The Police and Fire Board has proposed a minor amendment to return this definition to its wording in 1992, when the 108% limit only applied to that part of the pension that is based on compensation earned during the last year of service. Final Average Salary excludes overtime pay and expense allowances.

Actuarial Valuations

Prior to FY 2010-11 actuarial valuations for the retirement benefits of both Pension Plans were prepared on a biennial basis. Commencing with the June 30, 2009 actuarial valuations, the valuations for the retirement and health and dental benefits of both Pension Plans will be prepared on an annual basis, and, in each actuarial valuation for each of the Pension Plans, the corresponding actuary recommends contribution rates for the fiscal year beginning after the completion of that actuarial valuation. When approved by the respective boards of administration of the Pension Plans, these become the City's and the employees' legally required contribution rates for the fiscal year beginning one year after the valuation date. For example, the recommended contributions contained in each of the actuarial reports for the Pension Plans as of June 30, 2010 apply to contributions by the City and the employees for the fiscal year beginning July 1, 2011.

Actuarially Assumed Investment Rates of Return. The net rate of return that is assumed by each Pension Plan's actuary represents the rate of return on the applicable Pension Plan's investments that together with current assets and future contributions would generate sufficient funds to pay benefits. The Board for each Pension Plan has approved reducing the net investment rate of return for purposes of the respective Pension Plan's actuarial valuations. For the June 30, 2009 actuarial valuation, the Federated Board adopted a phase-in of the actuarially assumed net investment rate of return from 8.25% to 7.75%. For the June 30, 2010 actuarial valuation, the Police and Fire Board approved reducing the actuarially assumed net investment rate of return from 8% to 7.75% with no phase-in period. In addition, the actuary for each respective Pension Plan has recommended that the actuarial assumed net investment rate of return for each respective Pension Plan should be lowered to 7.50%. These recommendations are anticipated to be scheduled for discussion by the respective Boards the later half of FY 2010-11.

For the June 30, 2009 actuarial valuation the Federated Plan valuation report and the ARC were prepared in accordance with the standards of the Governmental Accounting Standards Board (GASB) using an actuarially assumed net investment rate of return of 7.75%. In conjunction with that change, the Federated Plan's actuary provided a contribution schedule for the 2010-11 fiscal year which implemented a five year phase-in of the dollar impact of the change from 8.25% to 7.75% (not an incremental reduction in the Plan's assumed net investment rate of return). The City fully paid the contribution amount for FY 2010-11 as presented in the contribution schedule prepared by the Federated Plan's actuary and approved by the Federated Board.

It is the City's policy to pay the ARC for its Pension Plans but due to these changes in actuarial methodology the amount of the City's payment to the Federated Plan for FY 2010-11 was less than the GASB ARC as presented in the actuarial valuation report for the Federated Plan dated as of June 30, 2009. In order to address this situation, in February 2010, the Federated Board directed that the phase in to a 7.75% assumed net investment rate of return be implemented as an incremental change in the assumed net investment rate of return as opposed to the dollar impact methodology previously utilized. Additionally, the Federated Board adopted a faster phase-in of the actuarially assumed net investment rate of return resulting in full implementation of the 7.75% actuarially assumed net investment rate of return for the valuation to be dated as of June 30, 2011. As a result of the actions taken by the Federated Board, the actuarially assumed net investment rate of return for the June 30, 2010 valuation was 7.95%.

In addition to the net rate of return necessary to provide sufficient funding for benefits, the investment and administrative cost associated with maintenance of the Federated Pension Plan and the SRBR benefits is estimated to be 0.90% and the investment and administrative cost associated with maintenance of the Police and Fire Pension Plan and SRBR benefits is estimated to be 0.75%. Consequently, the Retirement Services Department has estimated that the investment portfolio for the Federated Plan and the Police and Fire Plan need to earn the gross rate of 8.85% and 8.50%, respectively, in order to pay investment manager fees, administrative expenses and benefits not reserved for, such as the Supplemental Retiree Benefit Reserve transfers. In general, if the Pension Plans do not earn the gross rates of return, then the UAAL for each Plan would increase as a result.. The investment portfolio must earn the gross rates in order to have the net rate available for benefit payments, i.e. in order to break even.

Potential investment returns and the subsequent risk associated with those returns are partially a function of the underlying assets of the respective Plans. Each Pension Plan Board, as part of its fiduciary responsibilities, adopts asset allocation targets commensurate with the plans diversification goals and risk tolerance. For further information on plan assets and allocation refer to the Federated City Employees' Retirement System CAFR for the year ended June 30, 2010 and the Police and Fire Department Retirement Plan CAFR for the year ended June 30, 2010. In addition to the Plan CAFRs the investment policies of both Pension Plans provide additional information on allowable asset classes and constraints.

During the past two years, the Boards for both Pension Plans have received projections from their respective investment consultants for the expected net rates of return over a 20 year period based on the respective approved asset allocations. In January 2010, the investment consultant for the Federated Plan, provided its projection of the expected net rate of return of 7.00%. In August 2009, the investment consultant for the Police and Fire Plan provided its projection of the expected net rate of return of 6.7%.

In addition, as shown in Table 28 below, in November 2010, the Department of Retirement Services provided the Boards for both Pension Plans, the staff's projections for expected net rates of return for a 30 year period that was based on the approved asset allocations for each of the Pension Plans. As shown in Table 28, the expected net rates of return projected by the Retirement Services Department staff are significantly below the net actuarially assumed investment rates of return and the gross investment rate of return that Retirement Department staff has estimated to be required in order to pay the benefits that have not been reserved for and the expenses of the Pension Plans. If the projections of net investment rates of returns made by the Retirement Department staff and the Pension Plans' investment consultants were to come to fruition, then the UAAL for both Plans would increase due to the disparity between actual investment results and actuarially assumed investment rates of return.

Table 28
City of San José
Assumed and Projected Investment Rates of Return

	Actuarially Assumed Investment Rate of Return (Net)	Investment Rate of Return (Gross) [5]	Forward Looking Expected Rate of Return (Net)
Federated Plan	7.95%[1]	8.85%	6.70%[3]
Police and Fire Plan	7.75%[2]	8.50%	6.75%[4]

(1) Report of the Actuarial Valuation of Federated City Employees' Retirement System as of June 30, 2010, dated December 3, 2010 and City of San José Police and Fire Department Retirement Plan Actuarial Valuation Report as of June 30, 2010, dated December 22, 2010.
(2) City of San José Police and Fire Department Retirement Plan Actuarial Valuation Report as of June 30, 2010, dated December 22, 2010
(3) 30 year projection based on Department of Retirement Services Department staff memo dated November 4, 2010 using the approved asset allocation.
(4) 30 year projection based on Department of Retirement Services Department staff memo dated November 23, 2010 using the approved asset allocation.
(5) The Investment Rate of Return is equal to the Actuarially Assumed Investment Rate of Return added to the investment and administrative cost associated with maintenance of the Federated Pension Plan and the SRBR benefits estimated to be 0.90% and the investment and administrative cost associated with maintenance of the Police and Fire Pension Plan and SRBR benefits estimated to be 0.75%.

Source: City of San José, Retirement Services Department.

"Smoothing" Methodology. When measuring assets for determining the UAAL, many pension plans, including each of the Pension Plans, "smooth" gains and losses to reduce the volatility of contribution rates. If in the one-year period prior to the annual actuarial valuation the actual net investment return on the Pension Plan's market value of assets is lower or higher than the actuarial assumed net rate of return (7.95% for the Federated Plan and 7.75% for the Police and Fire Plan as of June 30, 2010), then 20% of the shortfall or excess is recognized each year when determining the recommended contribution rates for that actuarial valuation. This results in the smoothing or spreading of that shortfall or excess over a five-year period. The impact of this will result in "smoothed" assets which are lower or higher than the market value of assets depending upon whether the remaining amount to be smoothed is either a net gain or a net loss.

For the Police and Fire Plan, past practice has been to limit the smoothed assets to be no greater than 120% and no less than 80% of the market value of assets. The market value range from 80% to 120% is referred to as a "market value corridor" and is currently only applied to the Police and Fire Plan. Under this practice, any investment gains or losses that would cause the smoothed assets to fall outside of this 80-120% market value corridor would be recognized immediately rather than be smoothed over the next five years. As of February 4, 2010, the Police and Fire Board increased the market value corridor to 70-130% only for the June 30, 2009 valuation in order to recognize the market rebound that had occurred as of the date of the Board action and to continue its policy of minimizing volatility of contribution rates.

As of June 30, 2010, as a consequence of smoothing, there were approximately $244.9 million in deferred losses yet to be realized for the Federated Pension Plan. The Federated Health and Dental Plan valuation uses the market value of assets and there is no smoothing of asset gains and losses. Similarly for the Police and Fire Plan, there were approximately $353.8 million in deferred losses ($346.0 million pension benefits plus $7.8 million health and dental benefits). It is anticipated that future actuarial valuations will incorporate investment portfolio performance and both gains and losses will be "smoothed" as described above. If the $244.9 million in deferred asset losses for the Federated Plan were to be recognized immediately and amortized, it would result in an increase in annual required contributions of $18.6 million for FY 2011-12. If the $346.0 million in deferred asset losses for the Police and Fire Plan were to be recognized immediately and amortized, it would result in an increase in annual required contributions of $28.5 million for FY 2011-12.

Amortization Method and Period. Various plans use different amortization periods for paying off (or “amortizing”) a UAAL. Prior to June 30, 2009, the Federated Plan used a 30-year open or rolling amortization period which meant that in each actuarial valuation, the entire UAAL is reamortized over a new 30-year period following each valuation period. Subsequent to June 30, 2009, the UAAL for the Federated Plan as of June 30, 2009 will be amortized over a 30-year closed period. Changes in the UAAL in future years will be amortized over a 20-year closed period, with a separate amortization schedule set up for each change in UAAL in each year for both pension and health and dental benefits.

With respect to all unfunded liabilities attributable to periods on or before June 30, 2003, the Police and Fire Plan uses a closed amortization period which ends on June 30, 2017. With respect to all unfunded liabilities attributable to periods after June 30, 2003, the Police and Fire Plan amortizes such unfunded liabilities through a layered amortization method in which unfunded liabilities experienced between annual valuation dates are amortized over a period ending 16 years following each applicable valuation date. The contribution to the UAAL as of the end of a given year (as reflected in an actuarial valuation report) is amortized as a level percentage of payroll.

Actuarial Methods and Assumptions. Investors are cautioned that, in considering the amount of the UAAL, the funded ratio, and the calculations of normal cost as reported by the Pension Plans and the resulting amounts of required contributions by the City, this is “forward looking” information. Such “forward looking” information reflects the judgment of the Board of Administration of the respective Pension Plans and their actuaries as to the amount of assets which the Pension Plan will be required to accumulate to fund future benefits over the lives of the currently active employees, vested terminated employees, existing retired employees, and their beneficiaries. These judgments are based upon a variety of assumptions, one or more of which may prove to be inaccurate or that may change with the future experience of the Pension Plans. The actuarial methods and assumptions could be changed by the Boards of the respective Pension Plans at anytime. Such changes could cause the City’s obligations to the Pension Plans to be higher or lower in any particular year. The more significant actuarial methods and assumptions used in the calculations of employer and employee contributions for the retirement benefits of each Pension Plan are summarized in Table 29.

Table 29
City of San José
Summary of Key Actuarial Methods and Assumptions

	Federated Plan (June 30, 2010)	Police and Fire Plan (June 30, 2010)
Actuarial Methods		
Actuarial Cost Method	Entry Age Normal Cost Method	Entry Age Normal Cost Method
Amortization Method	Level Percentage of Payroll	Level Percentage of Payroll
Amortization Period	30/20 layered closed	Varies[(1)]
Asset Valuation Method	5-year Smoothed Market (without corridor)	5-year Smoothed Market (with an 80%-120% corridor, adjusted to 70%-130% only for the June 30, 2009 valuation)
Actuarial Assumptions		
Investment Annual Net Rate of Return[(2)]	7.95%	7.75%
Annual Fixed Cost-of-Living Adjustments for Retirees	3.0%	3.0%
Salary Increases	Salary increase rates are based on years of service as described in the Federated Experience Study as follows: The base annual rate of salary increase is comprised of a 3.90% inflation rate. This is added to a rate increase for merit/longevity for the first 5 years of service ranging from 5.75% to 0.25% at the 5th year of service.	Salary increase rates are based on years of service as described in the Police and Fire Experience Study as follows: The base annual rate of salary increase is comprised of a 3.50% inflation rate plus 0.75% for wage inflation for a total rate of 4.25%. This is added to a rate increase for merit/promotion set at 5.50% for the first five years of service; 2.50% for years 6 and 7; and 1.75% for year 8 and beyond.
Active Service, Withdrawal, Death, Disability Retirement	Based on June 30, 2009 Experience Study.	Based on the June 30, 2009 Experience Analysis.
Postretirement Mortality (non-disabled retirees)	1994 Group Annuity Mortality Table (sex distinct), set back three years for males and one year for females.	RP-2000 combined healthy mortality table for males with no collar adjustment, projected for 10 years, set back four years. RP-2000 combined healthy mortality table for females with no collar adjustment, projected for 10 years, with no age set-back.

(1) With respect to all unfunded liabilities attributable to periods on or before June 30, 2003, the Police and Fire Plan uses an amortization period which ends on June 30, 2017. With respect to all unfunded liabilities attributable to periods after June 30, 2003, the Police and Fire Plan amortizes such unfunded liabilities through a layered amortization method in which unfunded liabilities experienced between annual valuation dates are amortized over a period ending 16 years following each applicable valuation date.

(2) The Retirement Services Department has clarified that, for both Pension Plans, the assumed net rate of return is a net rate of return and does not take into account the amounts necessary to fund the administrative, operating expenses, investment management fees or costs associated with the respective SRBR for each Pension Plan.

Sources: Report of the Actuarial Valuation of Federated City Employees' Retirement System as of June 30, 2010, dated December 3, 2010; and City of San José Police and Fire Department Retirement Plan Actuarial Valuation Report as of June 30, 2010, dated December 22, 2010.

Funding Status and Contribution Rates

A description of the current funding status of the retirement benefits provided by both Pension Plans is summarized below. As set forth above, the funded ratio for each Pension Plan does not take into account the assets and liabilities related to health and dental benefits or the SRBR for such Pension Plan. The Schedules of the Funding Progress for both Pension Plans are set forth in the Required Supplementary Information Section of the City's Basic Financial Statements for the Fiscal Year Ended June 30, 2010. However, it is important to note that the Funding Progress schedules referred to in the City's Basic Financial Statements for the Fiscal Year Ended June 30, 2010, attached as Appendix B to this Official Statement, reflect actuarial data as of June 30, 2009. The most recent actuarial valuations for the Federated Plan and the Police and Fire Plan, both as of June 30, 2010, represent the current data available for the Funding Progress for both Pension Plans.

The Federated Plan Retirement Benefits. The most recent actuarial valuation of the Federated Plan, as of June 30, 2010, was performed by Cheiron (the "Federated Plan Actuary") and summarized by the Federated Plan Actuary in its report dated December 3, 2010, entitled: "Federated City Employees Retirement System June 30, 2010 Actuarial Valuation" ("2010 Federated Actuarial Report"). In the 2010 Federated Actuarial Report, the Federated Plan Actuary concluded that the funded ratio for the actuarial value of assets for the Federated Plan as of June 30, 2010, was 68.9%, down from 70.7% as of June 30, 2009. The net return on the market value of assets for the period from July 1, 2009 to June 30, 2010 was better-than-expected. However, on an actuarial asset value basis, the smoothing in of the less-than-expected returns for the period from July 1, 2007 to June 30, 2009 was the primary reason for the decrease in the funded ratio. Since 1993, the funded ratio has ranged from the current low of 68.9% as of June 30, 2010, to a high of 98.9% as of June 30, 2001. As of June 30, 2009, the Federated Plan had a UAAL of approximately $780.9 million as compared to a UAAL of $729.6 million in the Actuarial Report completed as of June 30, 2009. As of June 30, 2010, the Federated Plan had an actuarial value of assets, exclusive of assets in the health and dental reserve and the SRBR reserve, equal to $1,729.4 million and actuarial accrued liabilities of $2,510.4 million. For the period ending June 30, 2010, the funded ratio based on the market value of assets was 60.3%, up from 53.8% as of June 30, 2009. The Federated Plan has deferred losses of $244.9 million (16.2% of market value of assets) as of June 30, 2010. If deferred losses aren't offset by future investment gains or other favorable experience, the recognition of the $244.9 million in deferred market losses is expected to have a significant impact on the Plan's future funded ratio and contribution rate requirements.

Federated Experience Study. On November 3, 2009, Gabriel, Roeder, Smith & Company (GRS), the previous actuary for the Federated Plan delivered its Report of an Experience Investigation (the "Federated Experience Study") and reported findings and recommendations from its investigation of the experience of the Federated Plan during the period from July 1, 2003 through June 30, 2009. Based on this investigation, GRS recommended several changes to the actuarial assumptions used to prepare the retirement valuation. The current assumptions were approved by the Board of the Federated Plan and implemented in the 2009 Federated Actuarial Report. The actuarial assumption changes approved by the Board included phasing in the impact on contribution rates of the following over a five year period: a reduction in the investment net rate of return assumption from 8.25%, net of expenses, to 7.75%, net of expenses; a reduction in the underlying inflation assumption from 4.0% to 3.67%; a reduction in the payroll growth assumption from 4.00% to 3.83%; and a reduction in the ultimate salary increase assumption from 4.25% to 4.08%. The impact of these economic assumption changes was to increase the actuarial accrued liability by $141.5 million. The Board also approved immediate implementation of demographic assumption changes to include a longer life expectancy for post-retirement mortality calculations. The impact of these changes was to increase the actuarial accrued liability by $87.3 million. The Federated Plan Actuary is scheduled to complete an updated Experience Study as of June 30, 2011. As part of Board's methodology change to phase in the actuarially assumed net rate of return to 7.75%

over a revised three-year period (discussed in the Summary of Pension Plans section), the Federated Plan Actuary revised the payroll growth assumption from 3.83% to 3.90% and the ultimate salary increase assumption from 4.08% to 4.15% for the June 30, 2010 actuarial valuation only.

Federated Plan Contribution Rates. Table 30 below summarizes the contribution rates for both the City and the employee members of the Federated Plan for both retirement benefits and health and dental care benefits, as recommended in the Federated Actuarial Report dated as of June 30, 2009, and adopted by the Federated Board for FY 2010-2011. Table 30 also summarizes the contribution rates, adopted by the Federated Retirement Board for FY 2011-12, based on the 2010 Federated Actuarial Report, and the Board's revised decision to adopt a revised three-year phase in period (ending with the June 30, 2011 actuarial valuation) for the change in actuarially assumed net rate of return to 7.75%. The retirement contribution rates shown reflect the second year of the revised phase in policy.

After the 2010-2011 retirement contribution rates were approved by the Federated Board, several of the City's bargaining units agreed to make additional employee contributions in order to reduce the City's required contributions toward the Federated Plan's UAAL. In June 2010, the City reached agreements with AEA, CAMP, OE#3, AMSP and IBEW to have employees covered under these agreements make additional one-time retirement contributions, equal to 10.83% of pensionable compensation, effective June 27, 2010 through June 25, 2011. These bargaining units also agreed to make a portion of these additional contributions, ranging from 7.30% to 7.75% of pensionable compensation, continue on an on-going basis. These additional employee contributions are being made on a pre-tax basis pursuant to IRS Code Section 414(h)(2) and are subject to withdrawal, return and redeposit in the same manner as any other employee pension contributions. However, as the AEA, CAMP, OE#3, AMSP and IBEW collective bargaining agreements will expire on June 30, 2011, the on-going contributions will be subject to renegotiation. It is unknown at this time whether further additional contributions to the UAAL will be agreed to by employees.

The required contributions rates determined by the Federated Plan Actuary anticipate that the City will make contributions on a bi-weekly basis throughout the fiscal year. The City has elected since FY 2008-09 to "prefund" all or part of its total annual required contributions to the Plan at the beginning of each fiscal year and the Federated Plan's Actuary applies an interest discount to the required contributions to account for the fact that contributions are made at the beginning of the year instead of throughout the year. The "prefunded" annual contributions are made on the basis of estimated bi-weekly pay for the fiscal year and are trued up at the end of the fiscal year based on actual bi-weekly payroll. It is anticipated that the City will elect to prefund its total annual required contributions for FY 2011-12.

In early 2011, the Federated Board took action to address unexpected shortfalls in contributions that may result when payroll does not grow at the rate assumed by the actuaries. The Board adopted a resolution recommending that the City Council amend the Municipal Code to set the ARC to be the greater of the dollar amount reported in the actuarial valuation ("the floor") and the dollar amount determined by applying the percent of payroll reported in the actuarial valuation to the actual payroll for the fiscal year. Council has yet to take action but if adopted by the Council, the floor would be established as a normal cost contribution of $40,639,000 and a UAAL contribution of $49,636,000 for a total floor contribution of $90,275,000. [As of the date of this Official Statement, the Council has not taken action on the Board's recommendation.]

Table 30
City of San José
Federated City Employees' Retirement Plan
Contribution Rates[(1)]
(As Percentage of Covered Payroll)

	June 30, 2009	June 30, 2010
Employer Cost[(2)]		
Retirement		
Normal Cost Rate	12.35%	12.76%
Rate of Contribution to UAAL	10.83	15.58
Total Retirement	23.18%	28.34%
Health and Dental[(3)]	6.41	7.16
	29.59%	35.50%
Employee Cost[(2)]		
Retirement	4.54%	4.68%
Health and Dental[(3)]	5.76	6.51
	10.30%	11.19%
Total Cost	39.89%	46.69%

(1) The contribution rates are the result of actuarial valuation reports but do not reflect subsequent contribution shifts associated with various bargaining groups and contribution prefunding described above in *Funding Status and Contribution Rates*.
(2) Represents a percentage of covered payroll. The total covered payroll for employees covered by the Federated Plan as of June 30, 2009 was $323,020,387 and as of June 30, 2010, was $300,811,165.
(3) The contribution rates for health and dental benefits only provide partial funding of the liabilities for these benefits. See "*Other Postemployment Benefits* – Contribution Rates for Phase-In of ARC for Federated Plan" and – "Contribution Rate for Phase-In of ARC for Police Members of the Police and Fire Plan" for a discussion of increased contribution rates for health and dental benefits as of FY 2009-10.

Sources: Reports of the Actuarial Valuation of the San José Federated City Employee's Retirement System as of June 30, 2009, dated March 1, 2010 and June 30, 2010, dated December 3, 2010. Report of the Actuarial Valuation of the City of San Jose Federated Retiree Healthcare Plan as of June 30, 2009, dated March 8, 2010 and the Report of the Actuarial Valuation of Federated City Employees' Retiree Healthcare Plan as of June 30, 2010, dated January 7, 2011 .

Police and Fire Department Retirement Plan. The most recent actuarial valuation of the Police and Fire Plan, as of June 30, 2010, was performed by The Segal Company (the "Police and Fire Plan Actuary" or "Segal") and summarized by the Police and Fire Plan Actuary in its report dated December 22, 2010 (the "2010 Police and Fire Report"). In the 2010 Police and Fire Report, the Police and Fire Plan Actuary concluded that the funded ratio of the Police and Fire Plan as of June 30, 2010, was 79.8%, down from 86.7% as of June 30, 2009. Over the last ten years, the funded ratio has ranged from the current low of 79.8% as of June 30, 2010, to a high of 114.8% as of June 30, 2001, taking into account all benefit improvements that have occurred over this time period. As of June 30, 2010, the Police and Fire Plan had a UAAL of approximately $653.8 million as compared to the UAAL of approximately $393.9 million in the Actuarial Report completed as of June 30, 2009. This decrease in the funded ratio, and increase in UAAL, are primarily attributable to changes in actuarial assumptions and unfavorable investment returns during the two year period ended June 30, 2009. As of June 30, 2010, the Police and Fire Plan had an actuarial value of pension assets equal to approximately $2.577 billion, not including the Police and Fire SRBR, and actuarial accrued liabilities of approximately $3.230 billion. As of June 30, 2010, the Police and Fire Plan had a total unrecognized investment loss of approximately $353.8 million ($346.0 million pension benefits plus $7.8 million health and dental benefits) for both pension and health and dental benefits. For the period ending June 30, 2010, the funded ratio based on the market value of assets was

69.1% for the Pension Plan, up from 66.4% as of June 30, 2009. The Police and Fire Plan Actuary noted that deferred losses represent 15% of the market value of assets as of June 30, 2010. If deferred losses aren't offset by future investment gains or other favorable experience, the recognition of the $353.8 million in deferred market losses is expected to have a significant impact on the Police and Fire Plan's future funded percentage and contribution rate requirements.

Police and Fire Experience Study. On October 26, 2009, the Police and Fire Plan Actuary issued its Actuarial Experience Study (the "Police and Fire Actuarial Experience Study") for the period July 1, 2005 through June 30, 2009. The study utilized census data prepared for the four-year period ending June 30, 2009. Based on this investigation, the Police and Fire Plan Actuary recommended several changes to the actuarial assumptions used to prepare the retirement valuation. The actuarial recommended demographic (non-economic) assumption changes were approved by the Police and Fire Board on February 4, 2010. Approved changes included establishing a higher retirement rate for Police, higher disability rates for Fire, and an increase of one year for life expectancy for mortality rates, among other changes. Combined, the assumption changes accounted for an increase in the actuarial accrued liability of $145.4 million as of June 30, 2009. In addition to increases in the actuarial accrued liability from assumption changes, losses associated with actuarial experience included a net loss from investments of $138.4 million, a loss of $106.5 million for differences in actual experience, and a loss of $7.0 million for data corrections. Recent experience over the last few experience study periods has indicated that demographic assumptions should have been more conservative in many areas, which has resulted in additional unfunded actuarial liabilities and plan costs as the experience has emerged. Effective with the June 30, 2010 actuarial valuation, the Board, based on a recommendation from the Retirement Department staff and with concurrence from the actuary, changed the assumed investment net rate of return assumption from 8.00% to 7.75%. The Police and Fire Plan Actuary is scheduled to complete an updated Experience Study as of June 30, 2011.

Police and Fire Contribution Rates. The contribution rates for both the City and the members of the Police and Fire Plan for both retirement and health and dental benefits, are summarized below in Table 31. In August 2010, the City reached agreement with the POA to require Police members of the Police and Fire Plan to make additional retirement contributions of 5.25% of pensionable compensation, effective June 27, 2010 through June 25, 2011. These additional employee contributions are in addition to the employee retirement contribution rates approved by the Police and Fire Board. The additional employee contributions will be applied to reduce the City's required contributions toward the Plan's UAAL. These additional employee contributions are made on a pre-tax basis pursuant to IRS Code Section 414(h)(2) and are subject to withdrawal, return and redeposit in the same manner as any other employee contribution. It is unknown at this time whether further additional contributions to the UAAL will be agreed to by employees.

The Police and Fire Plan Actuary has determined that the additional 5.25% employee contributions will offset an equivalent 5.21% City required contribution rate, due to the estimated portion of the additional employee contributions which will be paid as refunds of employee contributions upon employee termination.

The required contributions rates determined by the Police and Fire Plan's Actuary anticipate that the City will make contributions on a bi-weekly basis throughout the fiscal year. The City has elected since FY 2008-09 to "prefund" all or part of its total annual required contributions to the Plan at the beginning of each fiscal year and the Plan's Actuary applies a discount to the required contributions to account for the fact that contributions are made at the beginning of the year instead of throughout the year. The "prefunded" annual contributions are made on the basis of estimated bi-weekly pay for the fiscal year and are trued up at the end of the fiscal year based on actual bi-weekly payroll. It is anticipated that the City will elect to prefund its total annual required contributions for FY 2011-12.

In early 2011, the Police and Fire Board addressed unexpected shortfalls in contributions that may result when payroll does not grow at the rate assumed by the actuaries. The Board expressed support that the City Council amend the Municipal Code to set the ARC to be the greater of the dollar amount reported in the actuarial valuation ("the floor") and the dollar amount determined by applying the percent of payroll reported in the actuarial valuation to the actual payroll for the fiscal year. Council has yet to take action but if adopted by the Council, the floor would be established as a normal cost contribution of $70,303,098 and a UAAL contribution of $56,318,587 for a total floor contribution of $126,621,685. [As of the date of this Official Statement the Council has not taken action on the Board's recommendation.]

Table 31
City of San José
Police and Fire Department Retirement Plan Contribution Rates
(As Percentage of Covered Payroll)

	June 30, 2009(1)(2)	**June 30, 2010**
Employer Cost(4)		
Retirement		
Normal Cost Rate	26.24%	28.00%
Rate of Contribution to UAAL	13.21	22.44
Total Retirement(3)	39.45%(5)	50.44%(6)
Health and Dental(6)	5.44	**TBD**(7)(8)
Total City	44.89%	**TBD %**(7)(8)
Employee Cost(4)		
Retirement(3)	9.91%	10.57%
Health and Dental(7)	5.00	**TBD**(7)(8)
Total Employee	14.91%	**TBD%**(7)(8)
Total Cost	59.80%	**TBD%**(7)(8)

(1) Contribution rates were calculated based on the actuarial assumptions used to prepare the Police and Fire Report as of June 30, 2009.

(2) The contribution rates are the result of actuarial valuation reports but do not reflect the subsequent contribution shift agreed to by the POA for police officer Employees and contribution prefunding described above in *Funding Status and Contribution Rates* for the Police and Fire Plan.

(3) For the Police and Fire Plan, the rates for the employer and Employee as shown are a blend of the different rates calculated for police officer Employees and fire department Employees.

(4) Represents a percentage of payroll. Total covered payroll was $255,222,552 as of June 30, 2009 and $251,058,473 as of June 30, 2010.

(5) Was offset by 0.45% on account of a transfer of $1.2 million from the SRBR to the valuation assets which is applied to reduce the City's required contributions, but only for FY 2010-11.

(6) Will be offset by 0.49% on account of a transfer of $1.3 million from the SRBR to the valuation assets which is applied to reduce the City's required contributions, but only for FY 2011-12.

(7) The contribution rates for health and dental benefits only provide partial funding of the liabilities for these benefits. See "*Other Postemployment Benefits* – Contribution Rates for Phase-In of ARC for Federated Plan" and – "Contribution Rate for Phase-In of ARC for Police Members of the Police and Fire Plan" for a discussion of increased contribution rates for health and dental benefits as of FY 2009-10.

(8) Police and Fire Health and Dental Benefits rates are pending receipt and approval of valuations from the actuary for the Police and Fire Plan.

Source: City of San José Police and Fire Department Retirement Plan Actuarial Valuation Reports as of June 30, 2009, dated February 23, 2010 and as of June 30, 2010, dated December 22, 2010.

Supplemental Retiree Benefit Reserves

Both Pension Plans include a Supplemental Retiree Benefit Reserve ("SRBR"). The purpose of each SRBR is to establish a reserve to provide a lump sum supplemental payment to the pension plan's retirees no more frequently than annually. The terms of each SRBR are described below.

Federated SRBR. Within the assets of the Federated Plan, there is a Supplemental Retiree Benefit Reserve (the "Federated SRBR"). As of June 30, 2010, $28.331 million were on deposit in the Federated SRBR. After the end of each fiscal year, an amount equal to the investment earnings attributable to the SRBR balance is transferred to the SRBR, using the lesser of the actuarially assumed net rate or the actual rate of return earned by the retirement fund; then the Board of Administration of the Federated Plan determines the amount of excess earnings, if any (i.e., earnings of the retirement fund after accounting for any investment losses recognized during the year and any administrative costs, and after crediting interest and income to the various accounts and reserves). To the extent there are excess earnings, 90% of the excess earnings are transferred to the Plan's General Reserve, and 10% of the excess earnings are transferred to the Federated SRBR. At the end of each fiscal year, to the extent that the amount on deposit in the Federated SRBR satisfies certain thresholds, the Federated Plan pays each retiree a lump-sum payment as a supplemental benefit. For the fiscal year ended June 30, 2010, the total amount of interest credited to the SRBR was $8.545 million and $1.595 million was available for distribution during FY 2010-11. SRBR transfer amounts, if any, are determined after the fiscal year end and except for fiscal year 2010-11 distribution amounts, if any, are made to retirees in the following fiscal year. For fiscal year 2010-11, the City Council adopted a resolution suspending distribution of SRBR payments to retirees.

Police and Fire SRBR. Within the assets of the Police and Fire Plan, there is a Supplemental Retiree Benefit Reserve (the "Police and Fire SRBR"). As of June 30, 2010, $33.3 million was on deposit in the Police and Fire SRBR. The Police and Fire SRBR was originally funded through a one-time transfer from the valuation assets of the Police and Fire Plan calculated as of the end of the fiscal year ending June 30, 1999, in the amount of $19,110,300. After that transfer, the Police and Fire SRBR is funded from certain earnings (calculated on a smoothed actuarial basis as described previously) of the Police and Fire Plan, as follows. After the end of each fiscal year, an amount equal to the investment earnings attributable to the SRBR balance is transferred to the SRBR; then the Board of Administration for the Police and Fire Plan determines the amount of excess earnings, if any (i.e. earnings of the retirement fund after accounting for any investment gains and losses recognized during the year and any administrative costs, and after crediting interest to other accounts and reserves at the Board adopted actuarially assumed net rate of return). Ninety percent of excess earnings are allocated and included as valuation assets, and the remaining 10% are transferred to the Police and Fire SRBR. At the end of each calendar year, from the earnings credited to the Police and Fire SRBR, the Police and Fire Plan pays each retiree and each person receiving survivor benefits, a lump-sum payment as a supplemental benefit. For the fiscal year ended June 30, 2010, the total amount of interest transferred to the Police and Fire SRBR was $1.0 million. The SRBR excess earning transfer amount, if any, is determined after the fiscal year end and except for fiscal year 2010-11, distribution amounts, if any are made to retirees in the following fiscal year. In late 2010, the City Council adopted Ordinance No. 28848, suspending distribution of SRBR payments to retirees for the remainder of the fiscal year.

If City contributions are increased due to poor investment returns, 10% of the City's increased contributions for the first 12 months after the increase in rates is transferred (certain restrictions apply to the maximum amount transferable) from the SRBR to the valuation assets and is applied to reduce the City's required contributions. As of June 30, 2009, $1.2 million was transferred from the SRBR to the valuation assets and applied to reduce the City's required contributions for FY 2010-11 only, on account of this provision. As of June 30, 2010, $1.3 million was transferred from the SRBR to the valuation assets and applied to reduce the City's required contributions for FY 2011-12 only, on account of this provision.

Other Postemployment Benefits

Overview. In April 2004, the Governmental Accounting Standards Board ("GASB") issued Statement No. 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans. Statement No. 43 establishes uniform financial reporting standards for postemployment healthcare and other nonpension benefits ("OPEB") plans. The approach followed in Statement No. 43 is generally consistent with the approach adopted for defined benefit pension plans with modifications to reflect differences between pension plans and OPEB plans. Statement No. 43 became effective for the City's OPEB Plans for the fiscal year ending June 30, 2007.

Additionally, in June 2004, GASB issued Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, which addresses how state and local governments should account for and report their costs and obligations related to OPEB. Statement No. 45 generally requires that employers account for and report the annual cost of OPEB and the outstanding obligations and commitments related to OPEB in essentially the same manner as they currently do for pensions. Statement No. 45's provisions may be applied prospectively and do not require governments to fund their OPEB plans. An employer may establish its net OPEB liability at zero as of the beginning of the initial year of implementation; however, the unfunded actuarial accrued liability is required to be amortized over future periods. Statement No. 45 also establishes disclosure requirements for information about the plans in which an employer participates, the funding policy followed, the actuarial valuation process and assumptions, and, for certain employers, the extent to which the plan has been funded over time. Statement No. 45 became effective for the City's fiscal year ending June 30, 2008.

Both Pension Plans provide eligible retirees with both health and dental benefits ("Health and Dental Benefits"). For health benefits, the Pension Plans pay that portion of the premium that is equivalent to the premium for the lowest-priced medical plan with which the City contracts for medical benefits for City employees; if the retiree elects a medical plan that is not the lowest-priced plan, the eligible retiree or survivor pays the difference between the portion paid by the applicable Pension Plan and that charged by the medical care provider. In the case of dental benefits, both Pension Plans pay the entire premium.

An implicit subsidy for Health and Dental Benefits exists because the medical experience for retirees under age 65 are pooled with the experience for active employees thereby resulting in a lowering of the premium paid for retirees under age 65. While the liabilities for the implicit subsidy have been included in the GASB 43 and 45 disclosure calculations, they have not been included in the phase-in contribution rate calculations for Police but have been included in the phase-in contribution rate calculations for Federated.

For the Federated Plan, per the San José Municipal Code, the City and the active employee members of the Federated Plan share the cost of health benefits at a ratio of 50/50, and, with respect to the dental benefits, they share that cost at a ratio of 8/3. For the Police and Fire Plan, per the San José Municipal Code, the City and the active employee members of the Police and Fire Plan share the cost of health benefits at a ratio of 50/50 and, for dental benefits, they share that cost at a ratio of 75/25.

Funding Policy. Until the City entered into agreements with various bargaining groups as described below, contributions for the Health and Dental Benefits for both the City and the participating employees of both Pension Plans were based upon an actuarially determined percentage of employees' base salary sufficient to provide adequate assets to pay benefits when due, over the next 10 years for the Police and Fire Plan, and over the next 15 years for the Federated Plan.

Increased contribution rates for Health and Dental benefits for some, but not all of, the members of both Pension Plans that became effective in FY 2009-10, are discussed below in Contribution Rates for Phase-

In of ARC for the Federated Plan and Contribution Rates for Phase-In of ARC for POA Members of the Police and Fire Plan. The contribution rates for the Fire members of the Police and Fire Plan continue to be calculated per the methodology discussed above. However, the City and Local 230's tentative agreement includes a five-year phase-in of full funding of the ARC as of June 26, 2011. See "Labor Relations – *Status of Current Negotiations*."

Postemployment Healthcare Plan Valuations. The City's Federated Plan engaged the Federated Plan Actuary to perform an actuarial valuation, as of June 30, 2010, of the Federated Retiree Health and Dental Care Plan. The actuarial accrued liability as of June 30, 2010 is $926.4 million with $108.0 million in assets resulting in a UAAL of $818.4 million, with a plan funded ratio of 11.7%. The ARC calculated in accordance with GASB, and based on a 6.71% actuarially assumed net rate of return is $47.6 million.

The City's Police and Fire Plan engaged its actuary to perform an actuarial valuation, as of June 30, 2009, of its Health and Dental Benefits. The actuarial accrued liability as of June 30, 2009 is $761.6 million with $55.6 million in assets resulting in a UAAL of $706.0 million, with a funded ratio of 7.30%. The ARC calculated in accordance with GASB, and based on a 6.7% actuarially assumed net rate of return is $48.8 million. [Note: to be updated when the health and dental valuation dated June 30, 2010 become available.]

Actuarial assumptions used for the postemployment healthcare plan valuations are generally the same as are used for the pension plan valuations, but also include assumptions with respect to future healthcare utilization and inflation. Actuarial methods are generally the same, except for the use of a 30-year open (non-decreasing) amortization period for the Police and Fire Health and Dental Benefits Plan ARC calculation and a 28 year declining amortization period for the City and employee contributions for Police members.

The City implemented GASB 45 in fiscal year 2008 and elected to report a zero net OPEB obligation at the beginning of the transition year for both Pension Plans. As reported in the City's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2010, the net OPEB obligation for the Federated Plan was $62.6 million and the net OPEB obligation for the Police and Fire Plan was $107.1 million.

Phase-In Funding of the ARC for Both Healthcare Plans. In 2007 and 2008, the City engaged in a process to determine whether to implement a policy to fully pre-fund the ARC as calculated under GASB 45 for each of the Healthcare Plans. In connection with this process, the City retained outside counsel to provide advice regarding the legal restrictions on making changes to the Health and Dental Benefits of both retirees and active employees. In a March 2008 memorandum to City employees and retirees, the City Manager announced that because the Health and Dental Benefits can be considered a "vested" benefit, at such time the City Administration would not be recommending a change in these benefits as specified in the Municipal Code.

Agreements Related to Federated Plan's Health and Dental Benefits. In April, 2009, the City reached agreements with ABMEI, AEA, AMSP, CAMP, IBEW, MEF, and CEO to phase in full pre-funding of the ARC over a five year period. The pre-funding specified in these terms of these agreements is also being applied to unrepresented employees. These agreements provide that the initial unfunded retiree healthcare liability will be fully amortized over a thirty year period so that it will be paid by June 30, 2039. From time to time, the Federated Plan's Actuary will update the contributions required to fully pre-fund the ARC by such date. In December 2010, the Board, acting upon advice from its actuary, adopted a 20 year closed amortization period for changes in unfunded actuarial liabilities which develop on or after June 30, 2010.

The agreements also provide that the five year phase-in of the ARC will not have an incremental increase of more than 0.75% of pensionable pay in each fiscal year for the employee contributions and the City cash contribution rate will not have an incremental increase of more than 0.75% of pensionable pay in each fiscal year. Notwithstanding these limitations on incremental increases, the agreements further provide that by the end of the five year phase-in the City and the members "shall be contributing the full Annual Required Contribution in the ratio currently provided" in the relevant sections of the San José Municipal Code.

Agreement Related to Police and Fire Plan's Health and Dental Benefits. In February 2009, the City reached an agreement with the POA to fully pre-fund the ARC with respect to the police members over a five year period, subject to the limitations described below. The agreement provides that the initial unfunded retiree healthcare liability will be fully amortized over a thirty year closed (decreasing) period starting July 1, 2009 so that it will be paid by June 30, 2039. From time to time, the Police and Fire Plan's actuary will update the contributions required to fully pre-fund the liabilities for retiree healthcare.

The agreement with the POA provides that the five year phase-in of the annual required contributions for police members in the Police and Fire Plan will not have an incremental increase of more than 1.25% of pensionable pay in each fiscal year for the employee contributions and City cash contribution will not have an incremental increase of more than 1.35% of pensionable pay in each fiscal year. If at any time the plan member cash contribution rate exceeds 10% of pensionable pay or the City cash contribution rate exceeds 11% of pensionable pay (excluding implicit subsidy as discussed below), the City and the POA will meet and confer on how to address any retiree healthcare contributions above 10% of pensionable pay for plan members or 11% of pensionable pay for the City. Such discussions will include alternatives to reduce retiree healthcare costs. These limitations may preclude full pre-funding of the ARC within the five year period.

Contribution Rates for Phase-In of ARC for Federated Plan. On March 11, 2010, the Federated Plan's Board adopted a policy that the contribution rates for the City and the members of the Federated Plan will be phased in to meet full pre-funding of the ARC. The approved contribution rates, expressed as a percentage of payroll, are 6.51% for the employees and 7.16% for the City for FY 2011-12.

Contribution Rates for Phase-In of ARC for Police Members of the Police and Fire Plan. On May 6, 2010, the Police and Fire Board approved new contribution rates for the City and the Police and Fire members of the Police and Fire Plan. These rates are effective for FY 2010-11. Contribution rates for FY 2011-12 are not yet available but are anticipated to be submitted to the Board for approval in April 2011. Contribution rates for subsequent fiscal years will require approval by the Police and Fire Board. [Note: to be updated when the health and dental valuation dated June 30, 2010 become available.]

The approved contribution rates for Police employees, expressed as a percentage of payroll, are 5.76% for the employees and 6.26% for the City. The contribution rates were based on the 2009 valuation of the Police and Fire Plan's Health and Dental Benefits prepared by Segal.

The approved contribution rates for Fire employees, expressed as a percentage of payroll, are 3.61% for the employees and 3.92% for the City. The contribution rates were based on the 2009 valuation of the Police and Fire Plan's Health and Dental Benefits prepared by Segal.

Potential Tax Limitation on Phase In Funding of ARC for Health and Dental Benefits. On February 10, 2011, the Federated Board received a report from the Federated Plan Actuary, indicating that projected contributions to the Plan's medical and dental benefits account were projected to exceed the subordination limits set forth in Internal Revenue Code Section 401(h) during the fiscal year ending June 31, 2012. The Federated Plan Actuary further advised that once the limit is reached, future 401(h) contributions would be limited to one-third of the pension normal cost contributions. Although, a subordination limit calculation for the Police and Fire Plan for fiscal year 2011-12 is still pending it is anticipated that a similar concern will arise soon. In order to assure that the ramp up to full funding of the ARC can continue, the City is actively pursuing establishment of an IRC 115 trust as an alternative medical and dental benefits funding vehicle.

Section 401(h) of the Internal Revenue Code permits a pension plan to provide retiree health care benefits under certain conditions, one of which is that the medical benefits are subordinate to the pension benefits. In order to be considered subordinate, Treasury regulations require that the aggregate contributions for medical benefits not exceed 25% of the total contributions, including pension contributions (other than UAAL contributions) and medical benefit contributions. Violation of the 25% rule could potentially void the plan's tax qualified status.

Pension Plan Reform Initiatives

City Auditor's Pension Report. The City's Charter establishes the office and responsibilities of the City Auditor. The City Auditor is an appointee of the City Council whose responsibilities under the City's Charter include the conducting of City Council-assigned performance audits to determine whether (1) City resources are being used in an economical, effective, and efficient manner; (2) established objectives are being met; and (3) desired results are being achieved.

As noted above, on September 29, 2010, the City Auditor released a report entitled: "Pension Sustainability: Rising Pension Costs Threaten the City's Ability to Maintain Service Levels – Alternatives for a Sustainable Future" (the "Pension Report"). The City Auditor presented the Pension Report to the full City Council on October 26, 2010, and the Council accepted the Report in its entirety.

The Pension Report outlines its objectives as "to assess the long-term sustainability of the City's pension benefits and the potential impact of increase in pension costs on City operations, and provide background on pension reform alternatives." The Pension Report's focus is on the pensions paid by Pension Plans, rather than the retiree health and dental benefits provided by the Pension Plans. The City Auditor in the Pension Report made a number of recommendations to the City Council and the City Administration as generally discussed below.

The Pension Report provides background information regarding both Pension Plans, including the history of pension benefit increases, the significant growth of the UAAL for both Pension Plans since 1991 in terms of both the dollar amount and percentage of the unfunded liability and the costs associated with various benefits provided by the respective Plans. In this connection, the Pension Report recommends that the City Council explore prohibiting:

1. Pension benefit enhancements without voter approval.
2. Retroactive pension benefit enhancements that create unfunded liabilities.

Further, as a significant portion of the UAAL for both Pension Plans as of June 30, 2009 is attributable to actuarial assumptions not holding true, the City Auditor recommends that the City Council amend the Municipal Code to require an actuarial audit of the Pension Plans' valuations every five years if the actuary retained by the Police and Fire Board or Federated Board, as applicable, has not changed during the five year time period. See *Funding Status and Contribution Rates* above.

The Pension Report describes fiscal sustainability as "… whether the City can maintain current service levels without compromising service levels for future generations and whether the City can meet future obligations." In this regard, the Pension Report notes that current salary and benefit costs for City employees, including the pension and retiree health and dental costs comprise approximately two-thirds of the City's General Fund. Citing to the City Manager's Five Year General Fund Forecast for fiscal years 2010 through 2015, the Pension Report notes that the City's annual contributions to fund both pension and retiree health and dental costs are projected to total 25% of total General Fund expenditures by FY 2014-15. Since the Pension Report's release date, the City Manager has issued the Five Year General Fund Forecast for fiscal years 2011 through 2016, which increased this projection of annual contributions to 28%. See "Budget – *City Budget* – City's 2012-2016 General Fund Forecast."

As the City Manager's Office projected deficits in the City's General Fund in each fiscal year through FY 2014-15, the Pension Report observes the following:

> To close projected budget deficits, the City Council will need to make decisions about cutting services, laying off employees, and negotiating with bargaining units including retirement reform. Continuing this trend of layoffs or reducing pay or benefits may make it difficult for the City to retain and attract a quality workforce in the future. Moreover, years of successive budget reductions are cutting City services to the core.

The Pension Report also briefly outlines five additional recommendations for the City's Administration to pursue as cost-containment strategies, either alone or in combination.

1. Additional cost sharing between City and employees.
2. Eliminating the SRBR in both Pension Plans or at least prohibiting transfers in and distributions from the SRBRs when the Pension Plans are underfunded.
3. Negotiating with employee bargaining groups for changes to the Pension Plans for existing employees.
4. Establishing a second tier pension benefit for new employees.
5. Considering whether to join the California Public Employees Retirement System in order to reduce administrative costs.

As a number of the above recommendations involve changes to the Pension Plans for the City's current employees, the Pension Report recognizes that there are legal constraints on the City's ability to make changes.

Furthermore, the Pension Report recommends that the City Manager should propose an annual ongoing budget for actuarial services in order to obtain independent expert advice on pension risks and liabilities. The City Auditor notes that this recommendation is made in order to assist the City's Office of Employee Relations in negotiations with bargaining groups regarding pension benefits.

The Pension Report makes the observation that "…there is the risk that even if the previous recommendations are implemented, pension costs may still be unsustainable." The Pension Report does not quantify the potential risk or address at what level pension costs would be unsustainable. In this regard, the Pension Report recommends that the City Council should receive annual updates related to the Pension Plans and that communication with the Pension Plans' members regarding the performance of the Plans and financial health should be improved. Specifically, the Pension Report recommends that Retirement Services Department should:

1. Ensure that each Councilmember receive both Pension Plans' Comprehensive Annual Financial Report.

2. Provide an annual report to the City Council that includes updates on the financial status of the Pension Plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios. This would be a supplement to the City Manager's Budget Office's Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program.
3. Prepare an annual summary report containing current and historical financial and actuarial information to be distributed to the Pension Plans' members and posted on the Retirement Services Department website.

Consistent with the City's practices related to the City Auditor's issuance of audit reports, the Pension Report includes a response from the City's Administration. The City Administration's response notes that there will be retirement reform efforts undertaken in FY 2010-11. These include: (1) the reconvening of a prior task force comprised of residents, employees and other interest groups to consider issues related to retirement reform; and (2) negotiations with City employee bargaining groups related to retirement reform.

The City cannot predict whether any of the recommendations addressed in the Pension Report will be implemented or, the effect that implementation of any of the recommendations may have on the City's pension costs.

<u>Charter Amendment Related to Pensions.</u> The City Council placed Measure W on the November 2, 2010 ballot to amend the pension provisions in the City Charter to (1) allow the City Council, by ordinance, to exclude officers and employees hired on or after the ordinance's effective date from any retirement plans or benefits then in existence and to establish a retirement plan or plans for such officers and employees that do not meet current minimum requirements set forth in the Charter for City retirement plans, and (2) require in the Charter that any new or different retirement plan be actuarially sound. Measure W required majority approval and passed with 71% of the electorate voting in favor of passage.

<u>Second Tier Retirement Benefit for New Employees.</u> The City Council at its November 18, 2010 *Organizational and Budget Planning* special City Council meeting approved staff recommendations for direction in labor negotiations. That direction included analyzing options for a Second Tier retirement program for new employees and returning to the City Council with recommendations. On January 25, 2011, the Administration presented their recommendations for implementing a Second Tier retirement program in a memorandum entitled: "Recommendations for Labor Negotiations Direction on Second Tier Retirement Benefits for New Employees" (the "Memorandum"). The Memorandum outlined historic costs associated with the Plans and summary of benefit provisions and eligibility among other items.

The City Council approved the Memorandum, and directed staff to explore issues related to the proposed benefits under a second tier retirement plan. The City Council accepted the staff recommendation that the normal cost to the City and employees not exceed 12.4% of pensionable pay. In addition, the Council directed that second tier retirement plan proposals provide benefits greater than those provided by Social Security and to seek further direction from the City Council as necessary. The City cannot predict whether any of the recommendations addressed in the Memorandum will be implemented or, the effect that implementation of any of the recommendations may have on the City's pension costs.

Investment Policy and Practices of the City

The City and its related entities are required to invest all funds under the Director of Finance's control in accordance with principles of sound treasury management and in accordance with the provisions of the

California Government Code, the Charter, the City Municipal Code and the City Investment Policy (the "Policy"). The Policy was originally adopted by the City Council on April 2, 1985 (Resolution No. 58200) and is reviewed annually by the City Council. The Investment Policy was recertified in December 2009 by The Association of Public Treasurers of the United States and Canada ("Association") that the revised policy is a professionally accepted policy based on the standards developed by the Association. This certification is applied for every two years.

On September 28, 2010 Council approved various updates to the Investment Policy. All changes are consistent with the California Government Code.

The primary objectives of the Policy, in their order of priority, are to (1) provide for the safe preservation of principal, (2) ensure that there is sufficient liquidity for operating needs, and (3) attain the maximum yield possible as long as investment practices are consistent with the first two stated objectives.

Current Investment Portfolio

As of January 31, 2011, the book value of the City's pooled investment fund was $976,015,145 while the market value was $978,171,178. The composition of this fund, including the weighted average days to maturity and yield, is provided in Table 32. The General Fund portion of the pool was approximately 15.23% as of January 31, 2011.

With respect to potential loss of principal on any of the City's investments, the Policy limits the composition of the holdings within the Investment Portfolio. Those limitations include the ability to hold medium-term notes within the criteria enumerated in the Policy. The City's holdings as of January 31, 2011 included $29,919,250 medium term notes. These notes were purchased under the FDIC's Temporary Loan Guarantee Program which offers "full faith and credit of the US Government", and meets the criteria in the Policy. The Finance Department's investment staff continues to focus investment decisions in accordance with the Policy's primary investment objectives as described above in "Investment Policy and Practices of the City".

Table 32
City of San José
Pooled Investment Fund – General Pool Investments[4]
As of January 31, 2011

	Book Value	Percent of Portfolio	Market Value	Weighted Average Days to Maturity	Weighted Average Yield
U.S. Treasury Bills and Notes...	$ 0	0.0%	$ 0	0	0.000%
Federal Agency Securities[1]......	728,902,194	74.7	730,369,404	196	0.500
Medium Term Notes (corp.)	29,919,250	3.1	30,550,000	283	2.859
Bankers Acceptance	0	0.0	0	0	0.000
Commercial Paper....................	107,641,701	11.0	107,699,774	77	0.283
Repurchase Agreements	0	0.0	0	0	0.000
Neg. Certificate of Deposit	0	0.0	0	0	0.000
Money Market Mutual Fund.....	9,552,000	1.0	9,552,000	1	0.058
State of California LAIF[2]........	100,000,000	10.2	100,000,000	1	0.540
Total[3]......................................	$ 976,015,145	100.0%	$ 978,171,178	163	0.548%

(1) Composed only of Federal Home Loan Bank (FHLB), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), and Federal Farm Credit Bank (FFCB) securities.
(2) Estimated based upon City's participation in the Local Agency Investment Fund (LAIF). Weighted average yield for LAIF is based upon the most recently reported quarterly earnings rate.
(3) Totals may not add due to independent rounding.
(4) Excludes funds invested in separate, segregated accounts as part of City held invested funds; excludes bond proceeds held by fiscal agents/trustees.

Source: City of San José, Finance Department.

Debt Management Policy

The City Council adopted a Debt Management Policy for the City on May 21, 2002 (Resolution #70977). The policy allocates responsibility for debt management activities to the Finance Department, describes the purposes for which debt may be issued, and establishes overall parameters for issuing and administering the City's debt.

Bonded and Other Indebtedness

The City may issue general obligation bonds for the acquisition and improvement of real property subject to the approval of the voters voting on the bond proposition. In accordance with all relevant provisions of law, the City is obligated to levy ad valorem taxes upon all property within the City subject to taxation by the City, without limitation of rate or amount (except with respect to certain personal property that is taxed at limited rates), for the payment of all outstanding general obligation bonds and the interest thereon. The City is obligated to direct the County of Santa Clara to collect such ad valorem taxes in such amounts and at such times as is necessary to ensure the timely payment of debt service on the general obligation bonds (See "Major General Fund Revenue Sources – *Property Taxes and Assessed Valuations*" herein). As of June 30, 2010, the City has issued $589,590,000 in general obligation bonds; of that amount, $499,970,000 was outstanding. The City anticipates that it will issue $9,230,000 in the summer of 2011, at which point, its general obligation bond authorization will be exhausted. Table 33 below summarizes the various voter authorizations for general obligation bonds.

Table 33
City of San José
General Obligation Bonds
As of June 30, 2010

Date of Election	Projects	Amount Authorized	Amount Issued	Amount Authorized but Unissued
11/07/2000	San José Neighborhood Libraries Bonds	$ 211,790,000	$ 205,885,000	$ 5,905,000
11/07/2000	San José Neighborhood Parks and Recreation Bonds	228,030,000	228,030,000	0
03/05/2002	San José 911, Fire, Police and Paramedic Neighborhood Security Act	159,000,000	155,675,000	3,325,000
Total		$ 598,820,000	$ 589,590,000	$ 9,230,000

Source: City of San José, Finance Department

The City has the authority to issue tax and revenue anticipation notes ("TRANs") that are to be repaid within the same fiscal year for cash management purposes without first obtaining voter approval. On July 2, 2010, the City issued its 2010 TRAN in an amount not to exceed $75,000,000 to facilitate the prefunding of employer retirement contributions. Security for repayment of the 2010 TRAN is a pledge of the City's 2010-2011 secured property tax revenues received on and after April 1, 2011 plus all other legally available General Fund revenues of the City, if required. During FY 2010-11, the City has borrowed $75,000,000 under the 2010 TRAN. The 2010 TRAN was fully repaid on January 31, 2011.

The City has authority to enter into long-term lease obligations without first obtaining voter approval. The City has entered into various lease arrangements under which the City must make annual payments to occupy public buildings or use equipment necessary for City operations. Securities have been issued which certificate these lease arrangements.

As of June 30, 2010, the City had approximately $844.4 million in non-voter approved bonded or certificated lease obligations outstanding. Table 34 on the following page summarizes the bonded and certificated General Fund lease obligations payable out of the revenues and general funds of the City as of June 30, 2010. The City has never failed to pay principal of or interest on any debt or any lease obligation when due.

Table 34
City of San José
Bonded and Certificated General Fund Lease Obligations
As of June 30, 2010

Issuer/Issue	Issue Date	Project	Amount Issued	Amount Outstanding	Final Maturity
City of San José Financing Authority					
Lease Revenue Bonds, Series 1993B[(1)]	04/13/93	Community Facilities	$ 18,044,854	$ 2,243,039	11/15/12
Lease Revenue Bonds, Series 1997B	07/29/97	Child Care Facilities, Fire Apparatus, Library Land Refinancing	9,805,000	1,165,000	08/01/12
Lease Revenue Bonds, Series 2001F	07/26/01	Convention Center Refunding Project	186,150,000	145,895,000	09/01/22
Lease Revenue Bonds, Series 2002B	11/14/02	Civic Center	292,425,000	291,820,000	06/01/37
Lease Revenue Bonds, Series 2003A	09/18/03	Central Service Yard Refunding	22,625,000	17,465,000	10/15/23
Taxable and Tax-Exempt Lease Revenue Commercial Paper Notes[(2)]	01/13/04	Multiple Projects	116,000,000	53,530,000	N/A
Lease Revenue Bonds, Series 2006A	06/01/06	Civic Center Refunding	57,440,000	57,440,000	06/01/39
Lease Revenue Bonds, Series 2007A	06/28/07	Recreational Facilities Refunding	36,555,000	33,435,000	08/15/30
Lease Revenue Bonds, Series 2008A[(3)]	08/14/08	Civic Center Refunding Project	60,310,000	56,920,000	06/01/39
Lease Revenue Bonds, Series 2008B[(3)]	07/10/08	Civic Center Garage Refunding Project	36,580,000	35,280,000	06/01/39
Lease Revenue Bonds, Series 2008C[(3)]	06/26/08	Hayes Mansion Refunding Project	10,915,000	10,915,000	06/01/27
Taxable Lease Revenue Bonds, Series 2008D[(3)]	06/26/08	Hayes Mansion Refunding Project	47,390,000	45,080,000	06/01/25
Taxable Lease Revenue Bonds, Series 2008E[(3)]	07/03/08	Ice Centre Refunding Project	28,070,000	26,025,000	06/01/25
Taxable Lease Revenue Bonds, Series 2008F[(3)]	06/11/08	Land Acquisition Refunding Project	67,195,000	67,195,000	06/01/34
			$ 1,008,114,854	$ 844,408,039	

(1) Includes Capital Appreciation Bonds at an accreted value as of June 30, 2010.
(2) Value presented as "Amount Issued" is the authorized amount.
(3) Variable rate bonds.

Source: City of San José, Finance Department.

In addition, the City and its departments have issued bonds or entered into installment purchase contracts secured by and payable out of loans and installment sale contracts, in order to provide conduit financing for single and multi-family housing, industrial development, and 501(c)(3) non-profit corporations. Such bonds and certificates of participation are not secured by any City general funds or revenues.

Overlapping Bonded Debt

Contained within the City are overlapping local agencies providing public services. These local agencies have outstanding bonds issued in the form of general obligation, lease revenue, and special assessment bonds. A statement of the overlapping debt of the City, prepared by California Municipal Statistics, Inc., as of June 30, 2010, is shown in Table 35. The City makes no representations as to the completeness or accuracy of such statement.

Table 35
City of San José
Statement of Direct and Overlapping Debt

Direct and Overlapping Tax and Assessment Debt:	**% Applicable**	**Debt 6/30/10**
Santa Clara County	38.181%	$ 133,633,500
Santa Clara Valley Water District Zone W-1	46.114	419,637
Foothill-De Anza Community College District	4.576	21,931,820
Gavilan Joint Community College District	7.789	5,805,531
San José-Evergreen Community College District	86.997	209,227,835
West Valley Community College District	27.965	60,144,239
Milpitas Unified School District	0.0002	97
Morgan Hill Unified School District	18.876	12,339,060
San José Unified School District	97.772	510,191,881
Santa Clara Unified School District	4.085	10,910,422
Campbell Union High School District	61.253	83,546,029
East Side Union High School District	94.537	534,963,754
Fremont Union High School District	9.829	19,895,370
Los Gatos-Saratoga Joint Union High School District	0.644	379,413
Alum Rock Union School District	74.053	59,809,148
Berryessa Union School District	93.933	38,942,772
Cambrian School District	67.610	12,960,799
Campbell Union School District	48.926	48,056,754
Cupertino Union School District	16.476	20,968,167
Evergreen School District	99.446	121,154,264
Evergreen School District Community Facilities District No. 92-1	100.000	3,940,000
Franklin-McKinley School District	98.428	57,705,707
Los Gatos Union School District	1.440	1,230,408
Luther Burbank School District	20.956	1,859,585
Moreland School District	76.059	55,729,853
Mount Pleasant School District	87.545	7,380,036
Oak Grove School District	99.548	92,654,224
Orchard School District	100.000	46,038,315
Union School District	72.041	54,122,685
City of San José	**100.000**	**499,970,000**
City of San José Community Facilities Districts	100.000	34,180,000
City of San José Special Assessment Bonds	100.000	26,725,114
Santa Clara Valley Water District Benefit Assessment District	38.181	58,203,116
Total Direct and Overlapping Tax and Assessment Debt		$ 2,845,019,535

Table 35 (Cont'd.)
City of San José
Statement of Direct and Overlapping Debt

	% Applicable	Debt 6/30/10
Direct and Overlapping General Fund Debt:		
Santa Clara County General Fund Obligations	38.181%	$ 315,019,977
Santa Clara County Pension Obligations	38.181	148,159,393
Santa Clara County Board of Education Certificates of Participation	38.181	5,184,980
Foothill-De Anza Community College District Certificates of Participation	4.576	1,073,072
San José-Evergreen Community College District Benefit Obligations	86.997	40,692,847
West Valley-Mission Community College District General Fund Obligations	27.965	15,693,958
Morgan Hill Unified School District Certificates of Participation	18.876	2,557,698
San José Unified School District Certificates of Participation	97.772	109,783,018
Santa Clara Unified School District Certificates of Participation	4.085	530,230
East Side Union High School District Benefit Obligations	94.537	30,076,947
Los Gatos-Saratoga Joint Union High School District Certificates of Participation	0.644	65,720
Alum Rock Union School District Certificates of Participation	74.053	2,221,590
Franklin-McKinley School District Certificates of Participation	98.428	5,497,204
Luther Burbank School District General Fund Obligations	20.956	451,059
City of San José General Fund Obligations	**100.000**	**789,448,126**
Santa Clara County Vector Control District Certificates of Participation	38.181	1,513,877
Midpeninsula Regional Open Space Park District General Fund Obligations	0.016	18,206
Total Gross Direct and Overlapping General Fund Debt		$ 1,467,987,905
Less: San José Convention Center Lease Revenue Bonds (100% self-supporting from tax increment revenues)[1]		145,895,000
Total Net Direct and Overlapping General Fund Debt		$ 1,322,092,905
Gross Combined Total Debt[2]		$ 4,313,007,440
Net Combined Total Debt		$ 4,167,112,440
Ratios to 2009-10 Assessed Valuation:		
Direct Debt ($499,970,000)	**0.41%**	
Total Direct and Overlapping Tax and Assessment Debt	2.33%	
Ratios to Adjusted Assessed Valuation:		
Gross Combined Direct Debt ($1,289,418,126)	**1.25%**	
Net Combined Direct Debt ($1,143,523,126)	**1.11%**	
Gross Combined Total Debt	4.18%	
Net Combined Total Debt	4.04%	
State School Building Aid Repayable as of 6/30/10:		$ 0

[1] Supported from surplus tax increment revenues pursuant to a Reimbursement Agreement between the City and the Redevelopment Agency.
[2] Excludes tax and revenue anticipation notes, enterprise revenue, mortgage revenue and tax allocation bonds and non-bonded capital lease obligations. Qualified Zone Academy Bonds are included based on principal due at maturity.

Source: California Municipal Statistics, Inc.