CITY OF ANNAPOLIS FINANCIAL ADVISORY COMMISSION
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May 20, 2011

Mayor and City Council of the City of Annapolis
160 Duke of Gloucester Street
Annapolis, Maryland 21401

Re: Report and Recommendations Regarding:
Ordinance No. O-11-11 (Annual Operating Budget: FY 2012)
Resolution No. R-17-11 (Capital Improvement Budget and Program: FY 2012 to FY 2017)
Ordinance No. O-11-11 (Water and Sewer Rates)
Resolution No. R-15-11 (FY 2012 Fees Schedule effective July 1, 2012)
Ordinance No. O-14-11 (Review and Award of Community Grants)

Dear Mayor Cohen and Members of the City Council:

I am writing to you on behalf of the City of Annapolis Financial Advisory Commission. Thank you for referring to us for review and comment Ordinance No. O-11-11 (Annual Operating Budget: FY 2012), Resolution No. R-17-11 (Capital Improvement Budget and Program: FY 2012 to FY 2017), Ordinance No. O-11-11 (Water and Sewer Rates), and Resolution No. R-15-11 (FY 2012 Fees Schedule effective July 1, 2012). The Commission also has reviewed Ordinance No. O-14-11 (Review and Award of Community Grants). The Commission offers the following report and recommendations regarding these five legislative proposals.

Introduction

In February of this year, the Mayor and City Council took bold steps to address the financial dilemma facing the City of Annapolis.

The nationwide economic downturn and subsequent recession reduced tax receipts for many local jurisdictions, including the City of Annapolis. The City faced severe cash flow shortages that led to layoffs, furloughs, and reductions in pay for City employees. In an effort to address the City's cash flow problems, the City Council authorized the Mayor in 2010 to acquire a bank line of credit.

While that line of credit gave immediate relief to the City, mid-term and long-term cash flow projections clearly demonstrated the inability of the City to remain solvent unless significant action was taken to correct structural and systemic financial problems inherent in the budget, appropriation, and tax/fee policies of the City. Of immediate concern was the adoption of a strategy to provide the City with a workable cash flow time horizon for correcting its structural and systemic financial problems, while continuing to meet important operating and capital funding needs.

One of the strategies agreed upon culminated in the City Council approving in February, 2011, Ordinance O-5-11 (Issuance of Bonds), Resolution R-3-11 (Line of Credit), and Charter Amendment CA 1-11 (Public Debt). Ordinance O-5-11 authorized the City to issue bonds in a cumulative amount of up to $38,000,000, of which up to $30,1000,000 would be devoted to restructuring existing debt of the City and up to $7,000,000 would be used to fund critical capital projects of the City.

The result of the bond restructuring established a six year time horizon for the City to realign its financial priorities, and to address structural and systemic deficiencies in its budget, appropriation, and tax/fee policies. The financial solvency of the City will be reasonably assured if the Mayor and City Council diligently approach each budget cycle over the next six years as an opportunity to build a solid financial foundation for the future. Failure to do so will lead to significant consequences equal to or greater than the recently averted prospect of financial insolvency.

In addition to the bond restructuring, Resolution R-03-11 authorized the City to establish two line of credits in the amounts of $5,000,000 each, totaling $10,000,000, to provide short-term operating capital, and Charter Amendment CA-1-11 amended the City Charter to increase from $5,000,000 to $10,000,000 the amount of debt the City may incur on a short-term basis (12 months or less) to pay for obligations of the City.

The City of Annapolis Financial Advisory Commission views its role over the next six years as advising the Mayor and Aldermen on financial and budgetary decisions in an effort to seize upon the opportunity created for the City with the passage of Ordinance O-5-11 (Issuance of Bonds), Resolution R-3-11 (Line of Credit), and Charter Amendment CA 1-11 (Public Debt) in February, 2011.

The Commission's recommendations for the FY 2012 Budget and supporting legislation provides our best judgment on the decisions and actions the Mayor and City Council should undertake in this budget cycle to begin the process of charting a course toward future financial solvency for the City of Annapolis.

Ordinance No. O-11-11 (Annual Operating Budget: FY 2012)

The Commission reviewed and considered the following materials and presentations in addition to the Ordinance text:

- Proforma Budget dated March 14, 2011, as revised;
- Fiscal Year 2012 Budget Analysis: Sources and Uses of Additional Revenue – All Funds;
- Projected Cash Flows dated February 3, 2011;
- Sales Ratios, Real Estate Sales Summary, City of Annapolis after Reassessment, Department of Finance January 1, 2012 for tax year beginning July 1, 2012, plus a verbal presentation by Joseph Glorioso, Supervisor of Assessments for Anne Arundel County, State of Maryland, Department of Assessments and Taxation;
- Draft FY 2012 Budget Report of Finance Committee of the Annapolis City Council dated May 9, 2011;
- City of Annapolis Fire & Police Retirement System Actuarial Valuation dated January 20, 2011 by Fiona Liston, FSA from Cheiron;
- City of Annapolis Other Postemployment Benefits June 30, 2009 OPEB Actuarial Valuation dated January 20, 2011 by Margaret Tempkin, FSA from Cheiron; and
- Verbal reports provided by The Finance Director, Bruce Miller, and/or the City Manager, Mike Mallinoff, at meetings of the Commission on March 10, 2011, April 14, 2011, April 26, 2011, May 3, 2011, May 12, 2011, and May 19, 2011.

The Commission did not attempt to replicate the City Council Finance Committee's extensive review of all departmental budget submissions and instead focused on the overall fiscal climate impacting the viability of the proposed FY 2012 Operating Budget and potential areas of concern. The Commission's work was greatly enhanced by the cooperation of City staff, especially the Finance Director and his staff who provided timely answers to the Commission's many requests for information. This was particularly important this year as the methodology of the proposed Budget is significantly different than the methodology used previously so that it was impossible for Commission members to independently observe which changes from FY 2011 line items are due to the methodology changes and which are due to changes in actual amounts reported or proposed.

The Mayor's stated goals for the proposed Budget are: preserving existing service levels without layoffs or raising the property tax rate, making Enterprise Funds self-sufficient, rebuilding fund balances and starting to address unfunded liabilities. The feasibility of these goals was considered in the context of the City's fiscal climate including projected revenues, liabilities, and cash flow status, all of which are interrelated. There now appear to be reasons for concern in each of these areas.

Projected Revenues:

On April 14, 2011, Joseph Glorioso, Supervisor of Assessments for Anne Arundel County, provided information to the Commission regarding the assessments that will be published by January, 2012, and that will serve as the basis for real property taxation for the period from July 1, 2012, through June 30, 2015. Real property values in the County are expected to drop by 20% while real property values in Annapolis are likely to decline by 7.5% to 15%. After application of Homestead Tax Credits the change in the taxable base at a 7.5% decline in property assessed value is -5%, a 10% decline in assessed value is -7.3%, and a 15% decline in assessed value is -12.1% change in the taxable base. Mr. Glorioso suggested that at least a 10% decline in real property assessments is a reasonable expectation. This translates to a loss of 7.3% in property tax revenue – approximately $2.5 million – or, an increase in the tax rate from the current $.53 per $100 of assessed value to $.572per $100 of assessed value. This is consistent with Mr. Glorioso's estimate that the 10% decline in real estate assessments would require a 4 cent increase in the City's property tax rate to raise the same amount of revenue. If the assessed value drops by 15%, Mr. Glorioso's conservative estimate, the loss in property tax revenue will be 12.1% - approximately $3.76 million, requiring an increase in the property tax rate to $.603 per $100 of assessed value to raise the same amount of revenue.

Liabilities:

The present value of the City's financial liabilities is approximately $155 million. The components are $84 million in bond debt, $7 million short-term line of credit debt, $19 million in unfunded actuarial liability for the Police and Fire Pension, and $45 million in unfunded actuarial liability for Other Post Employment Benefits (OPEB) for all City employees. The most recent actuarial valuation on the Police and Fire Pension shows the fund as 89% funded and recommended that the City contribute 42%, or approximately $8 million, of police and fire payroll to adequately fund the ongoing pension liability. However, the proposed Budget includes only $250,000 for this purpose. There is no fund established for OPEB and the City

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has been paying these obligations on a pay-as-you-go basis, expected to be $1.36 million this year. The Proposed Budget includes only $200,000 to begin a fund for this obligation.

The City recently refinanced $35 million of outstanding bond debt that was expected to provide a period of five to six years of reduced debt service payments during which the City should regain a more secure fiscal picture. It is also expected that the City will need to issue additional bonds in the foreseeable future to fund new capital improvements. Interest rates may go up and it is imperative that the City recover its standing with the bond rating agencies. Specifically, the City needs to be removed from the current negative watch status assigned by Moody's in order to secure the best possible interest terms for any future bonds. A drop in the funding level of the Police and Fire Pension to below 80% would be likely to have a negative effect on Moody's rating of the City.

Cash Flow Status:

It was recently reported to the Commission by City staff that although departments have operated within the 2011 budget, the fund balance of $2 million originally projected for the end of FY 2011 has been absorbed by some major insurance payouts. The City had previously underfunded all the self-funded insurance accounts, including workers compensation. In addition, the required Park Place TIF payments were not included in the 2010 and 2011 budgets. As the anticipated revenue from fee increases will not materialize until the second quarter of FY 2012, the City will likely be out of money by July, 2011. The Finance Director now estimates that an additional $4 million in short term borrowing will be needed and that such short-term borrowing needs will continue until December, 2011 / January, 2012, when new revenues should become available. The $10 million line of credit authorized by the City Council in February, 2011 still has $3 million available. The Administration will likely be seeking City Council approval to pursue tax anticipation notes to cover the City's short-term cash flow needs until tax payments are received in October, 2011.

Discussion:

It is very likely that the City's revenues will decline dramatically for the three year period starting in July 2012 – probably in an amount of $2.5 to $3.76 million. This is lost revenue that will continue for at least three years which makes this a "structural" revenue loss that suggests a "structural" expenditure adjustment that must come from ongoing expenditures which are primarily personnel costs. Making such an adjustment in FY 2012 should make absorbing the impact of the loss in FY 2013 less difficult.

The depletion of all of the City's cash reserves in FY 2010 has created multiple fiscal problems for the City - the need to refinance bond debt to reduce debt service cost, an inability to pay for unanticipated costs such as the excessive medical and workers compensation insurance claims in the current fiscal year, vendors not being paid on time, normal maintenance being deferred, the inability to adequately fund outstanding liabilities leading to the growth of those liabilities, the use of lines of credit to manage day to day cash flow needs in much the same way that individuals with no savings rely on high interest payday loans to manage from paycheck to paycheck. It is imperative that the City restore its fund balance as required by R-21-10 with a target floor of 10% and ceiling of 15%. The cumulative impact of the $2 million non-budgeted TIF payments and the excess insurance disbursements, approximating $4 million in FY 2011 diminishes the City's ability to add to cash and rainy day reserves projected in the proposed Budget. This becomes a structural loss if no other measures are taken to make up the $4 million.

As with offsetting revenue loss, the only realistic place to reduce structural expenditures is in salaries and benefits. However, even significant and instant staff reductions will not do anything to solve the immediate cash flow problem but should move the City toward building necessary reserves and start regular contributions to unfunded liabilities. In addition, the City should consider an increase in the budgeted amount of the Finance Department Reserve to anticipate unbudgeted expenses that are very likely to occur during the course of the fiscal year. Such an additional Finance Reserve would help avoid the use of short-term borrowing as a way to manage operations.

Neglecting to build reserves back up or adequately fund the City's pension and OPEB obligations will leave the City in the unsustainable situation of being vulnerable to recurring financial "train wrecks". The City Council must look at the City's calamitous fiscal situation over the past few years and make difficult decisions now. The Council must anticipate and plan for the worst, rather than anticipate that the City's revenue picture and overall fiscal condition will not be as bad as some forecast for the future.

<u>Recommendations:</u>

The Commission supports and endorses adoption of the Proposed FY 2012 Operating Budget with the following revisions:

- The proposed Budget be reduced by the anticipated $2.5 to $3.76 million revenue shortfall for FY 2013 – FY 2015 by raising the tax rate to cover 50% of the budget reduction and reducing ongoing salary and benefit costs to cover the other 50% reduction. The proposed Budget be modified to include a one-time adjustment of $4 million to accommodate the one-time loss of $4 million in FY 2011 by allocating all unallocated revenue such as the $450,000 set aside for the potential exchange of furlough days in contract negotiations to reserves (fund balance).

- The budgeted Finance Department Reserve of $250,000 be increased to $ 1 million.

- Vacant positions identified to be funded in the proposed Budget at approximately $700,000 should not be funded and a strict hiring freeze should be adopted. In lieu of funding vacant positions a personnel contingency fund of $250,000 could be established to accommodate urgent and necessary hiring needs as they arise and as such need is demonstrated and justified.

The Commission recommends that following adoption of the FY 2012 Budget the Administration and the City Council engage in a comprehensive strategic planning process to:

- Review City services to establish priorities to meet the core needs of the City and its residents and identify activities that can be eliminated.

- Look for further ways to streamline operating costs based on productivity analyses.

- Complete corporate governance development.

- Enhance risk management to control insurance and workers compensation costs.

- Explore opportunities for contracting out City services where feasible.

- Develop a liabilities budget separate from the operating budget to include a specific and ongoing plan for dealing with unfunded liabilities and managing debt service costs.

- Explore opportunities for increasing revenues in predictable streams.

The Commission also recommends the City Council authorize tax anticipation notes as needed to maintain the City's financial viability until projected property tax revenue is received.

Resolution No. R-17-11 (Capital Improvement Budget and Program: FY 2012 to FY 2017)

Resolution No. R-17-11 proposes to adopt the City's Capital Budget for FY 2012 and the Capital Program for FY 2013-FY 2017. The Commission was impressed with the thoroughness of the new format for the Capital Budget and Program, and related Capital Planning and budget Policy attached as Exhibit A to the Capital Improvement Budget and Program. The new format provides significant organization and transparency to the capital improvement planning process. The Policy, in particular, establishes a rational framework and sound criteria for budget and program development and the allocation of the City's limited capital improvement funding resources.

The Commission supports and endorses the enactment of Resolution No. R-17-11 subject to the following:

1. Project No. 531, "Capital Grants to Annapolis non-profit organizations", reflects the final payments of multi-year funding commitments that the City made to support three projects by non-profit organizations. These are not City capital improvements. Therefore, the Commission recommends that these commitments be removed from the Capital Budget and moved to the Operating Budget to be included in the "Grants and Other Not-for-Profit Donations" line item.

Ordinance No. O-11-11 (Water and Sewer Rates)

Ordinance No. O-11-11 proposes to make substantial increases in water and sewer usage rates for all usage over the minimum rates established for water consumption up to 5,000 gallons per quarter. This Ordinance also would give the Mayor or City Manager authority, in each fiscal year, effective for the fiscal year beginning July 1, 2011, to increase these rates up to an amount equal to the lesser of 5% or the Community Fuel (energy) Index.

The proposed water and sewer rate increases are intended to address increased costs of operations since the last rate adjustments many years ago, to begin the payback of loans made by the General Fund to the Water and Sewer Funds, and to make the Water and Sewer Enterprise Funds solvent and in good fiscal condition within the next six years. The payback of such loans made will reimburse the General Fund for the subsidies that the General Fund has made to the Water and Sewer Fund over the years.

The current and proposed rate structure treats all classes of users the same, taking into consideration only amounts of consumption. The Commission is concerned that under the proposed rate structure larger users, which tend to be commercial users, will shoulder a disproportionate burden of the operational costs of the water and sewer systems. The Commission was advised that the City is undertaking review of a new rate structure that takes into account types of users in addition to amounts of consumption. The Commission endorses this effort.

The Commission supports and endorses the enactment of Ordinance No. O-11-11, subject to the following. The Commission understands the desire by the Administration to have a built-in mechanism to increase water and sewer rates in the future annually up to a predetermined maximum amount to meet increases in operational costs. From a business perspective this makes sense. It also avoids the situation in which the City now finds itself, having to make substantial increases in rates to meet substantial increases in operational costs because rates have not been increased to keep up with operational costs in many years. However, the Commission believes and recommends:

1. That the authority to increase rates annually be vested in either the Mayor or City Manager, but not both.

2. The authority to provide an annual rate increase start with the fiscal year beginning July 1, 2012, not July 1, 2011, as proposed. If the increases in rates proposed by Ordinance No. O-11-11 is enacted there should be no need to increase rates again for at least one full fiscal year.

Resolution No. R-15-11 (FY 2012 Fees Schedule effective July 1, 2012)

Resolution No. R-15-11 revises certain fees charged by the City for services rendered or made available to users. The commission believes that a fundamental premise of sound fiscal management is that fees charged for services rendered should, to the greatest extent practicable, reflect the direct and indirect costs incurred by the City in providing the service. Among the proposed revisions are increases in fees charged for residential trash collection and transportation on City buses. These fee increases, in particular, are necessary (i) to offset the heavy subsidy of bus ridership by the City's General Fund, and (ii) provide additional revenues to the allow the Solid Waste Fund to begin to repay loans made to it from the General Fund.

The Commission supports and endorses the enactment of Resolution No. R-15-11 as proposed subject to the following:

1. The City should promptly explore the feasibility and cost benefits of having trash collection services provided by private contractors. Other jurisdictions, including Anne Arundel County, have residential trash collected by private contractors at significantly lower rates than the City charges to its users. As has been recommended by others, this should entail the issuance of a request for proposals to contractors and the City to provide this service. However, as the City undertakes this analysis, any proposed rate to be collected by the City for service provided by a private contractor should include not only the contractor's cost, but also the City's cost for administering the contract and a factor to repay over a several year period prior loans by the General Fund to the Solid Waste Fund.

2. The Commission has been advised that many of the other fees that are listed in the fee schedule have not been increased in many years. The City should make an aggressive effort to evaluate all other City fees that were not revised by Resolution R-15-11 to determine whether those fees accurately reflect the City's costs of providing the respective services. If this evaluation determines that various fees no longer reflect the cost of providing the service, the City should give strong consideration to increasing those fees.

Ordinance No. O-14-11 (Review and Award of Community Grants)

The Commission recognizes that there are competing public policy considerations as to whether the City's taxpayers should subsidize non-profit organizations through a system of grants. Section 6.16.060 of the City Code currently contains detailed standards and criteria for the submittal and review of grant applications. Ordinance No. O-14-11 proposes to eliminate these codified standards and criteria and, instead, provide for the submittal, review and evaluation of grant requests pursuant to "Community Grants Application Requirements/Guidelines" established by the Administration. Because the City Council ultimately will have to decide which, if any grant requests, to fund each year, the process and criteria for submitting and evaluating grant requests should be established by the City Council.

The Commission recommends that Ordinance No. O-14-11 not be enacted. Alternatively, Ordinance No. O-14-11 should be amended to require the "Community Grants Application Requirements/Guidelines" to be approved by the City Council by Resolution.

Conclusion

This year's budget cycle presents a critical opportunity for the Mayor and City Council to continue efforts to place the City on sound financial footing for years to come. This will involve making difficult, and potentially politically unpopular, fiscal decisions. This is the essence of leadership. The Financial Advisory Commission strongly urges the Mayor and City Council to meet the challenge laid out for it in a responsible way.

Sincerely,

Frederick C. Sussman, Chair

cc: Commission Members (By e-mail)
Michael Mallinoff, City Manager (By e-mail)
Bruce Miller, Finance Director (By e-mail)
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