

CITY OF ANNAPOLIS FINANCIAL ADVISORY COMMISSION

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May 6, 2021

BY E-MAIL

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

Re: Financial Advisory Commission Report on Proposed FY 2022 Operating Budget,
FY 2022 Capital Budget and FY 2023-2027 Capital Program,
FY 2022 Fees and FY 2022 Fines

Dear Mayor Buckley and Members of the City Council:

The Financial Advisory Commission's mission is to provide impartial advice and guidance to the Mayor and City Council about the City's financial well-being, financial policies and procedures, and proposed budgets. We also provide input as requested by the Mayor and City Council on other matters impactful to the financial health of the City. We approach our responsibility with the perspective that our elected officials have a fiduciary obligation to ensure accountability for spending public funds by efficiently and economically appropriating only such funds as are necessary to secure the benefits of home rule.

The Mayor and City Council referred to the Commission for our review and advice the Mayor's proposed FY 2022 Operating Budget and Capital Budget, FY 2023-2027 Capital Program, FY 2022 Fees, and FY 2022 Fines. The Financial Advisory Commission has reviewed and discussed these materials with the City's Finance Director and City Manager, and received from the Finance Director and City Manager a well-prepared budget presentation. Finally, the Financial Advisory Commission heard a presentation from the City's consultant, David Hyder of Stantec, regarding the methodology and process for setting appropriate rates for the Water and Sewer, Storm Water and Refuse Collection Enterprise Funds, and received a Debt Capacity Update report from Davenport, the City's financial advisor, regarding the City's debt affordability.

The City Manager, Finance Director, Department Directors and the rest of the Administration's team have done a very creditable job in managing the City's FY 2021 budget expenses in the face of a very challenging COVID-19 pandemic operating environment and accompanying shortfalls in typical anticipated revenues, but aided, in large part by significant infusions of short-term federal ARPA and CARES Act assistance. The job that staff has done should lead to a reasonable year-end fiscal outlook that creates a manageable foundation for FY

2022 budget planning. However, as discussed below, in light of the uncertainty as to how the City, State and the rest of the country will emerge from a COVID-19 pandemic economic slowdown the City will need to remain extremely vigilant in managing expenses and revenues going into what may be an even more challenging FY 2023, and ongoing efforts must continue to reduce or eliminate structural deficits for when federal revenue infusions have ended.

In short, the Financial Advisory Commission generally endorses the Administration's proposed FY 2022 Operating and Capital Budgets, FY 2023-2027 Capital Program, FY 2022 Fines and FY 2022 Fees, subject to the comments below as part of a moderate and responsible fiscal plan for a challenging environment.

The Commission offers the following additional comments, some of which are drawn from the Commission's report to the City Council last year:

1. While the Commission has great confidence in staff's representations that the FY 2022 Operating Budget revenue projections are very conservative and reasonable based upon information now known and reasonably projected about the recovery from the COVID-19 economic downturn, the extent and timing of the recovery and its impact on City revenues is not known and remains fluid. This makes it imperative that:

- (i) the Finance Director continue to monitor and make necessary changes to revenue and cash-flow projections, with corresponding recommendations for Operating Budget revisions, up to the point that the City Council adopts the budget; and
- (ii) the Finance Director, City Manager and the Mayor and City Council begin now to develop a plan for mid-year expenditure reductions if anticipated revenues and cash-flows do not materialize, colloquially a "Plan B." An integral part of this analysis should include early identification of levels of revenue and cash-flow shortfalls that would trigger some or all of the Plan B expenditure reductions.

This recommendation is similar to the Commission's recommendation last year on the FY 2021 budget, was implemented and monitored and was critical to the FAC's recommended oversight.

2. To further provide six months to monitor the Operating Budget revenue trend during FY 2022, the Commission suggests that the Mayor and City Council identify and consider not appropriating funds for expenditures deemed non-essential, and place into the Contingency Fund all or a part of the funds that have been proposed for such expenditures. The Contingency Fund allocations would be available for appropriation for the deferred expenditures later in the fiscal year if fiscal conditions warrant.

3. In the past several years the Commission recommended that, in order to evaluate the future impacts of current budget decisions, future budget presentations should identify significant budgetary recommendations that, if adopted, would result in expenditure impacts beyond the current fiscal year. It does not appear that this recommendation is included in the

proposed FY 2022 Operating Budget although future year financial impacts of proposed capital expenditures are reflected in the 5-year Capital Program. This information becomes particularly important where a significant part of the Operating Budget is funded with grants and less predictable revenue streams generated from fees and other ancillary receipts that may be funding sources for ongoing operating expenses today but may no longer be available at desirable, needed, and appropriate levels to fund such ongoing expenses tomorrow; thereby transferring such funding responsibility to the General Fund. The Commission urges that such information be provided to the Mayor and City Council in the FY 2023 budget presentation.

4. The proposed Operating Budget incorporates appropriate use of fund balances and reserve funds to fund non-recurring expenses, thereby reducing reliance on property taxes for such purposes. Expenditures are being appropriately funded by anticipated revenues and fund balances and reserve funds and, to a lesser but important degree, by federal ARPA funding. However, the Commission cautions again that a close eye must be kept on such fund balances and reserve funds so that they do not fall below required levels and remain available as a backstop in the event of future fiscal emergencies. The City's sound fiscal management for many years has built the reserves and fund balances to healthy levels, but one or two unforeseen events can cause a fiscal calamity that might necessitate drawing heavily from reserve funds and fund balances.

5. The Commission has encouraged and supported the use of pay-go to fund capital projects where feasible to reduce reliance on the issuance of debt for such purposes, and, philosophically continues to do so. There has been a gradual expense "creep" going on in the capital budget. The City's percentage of bond debt has gone from 8% to approximately 10% of budgeted expenses over the past few years, and is currently projected to reach 11%, with a 12% cap. Although a prioritization process exists in determining what capital projects to undertake, along with using more PayGo and anticipatory financial note obligations, that process and those policies have not yielded the intended results of stabilizing the percentage of bond debt to budgeted expenses. Because of the continued uncertainty of revenue and cash-flow influx during FY 2022 due to the pandemic-related economic downturn and the unsettled recovery timeline toward pre-pandemic economic performance levels, the Commission recommends that reliance on pay-go to fund proposed projects be curtailed in FY 2022. This may mean that such projects be deferred, reduced in scope, or funded from other revenue sources. Although the Commission has urged a careful monitoring of the City's debt capability and reduced reliance upon debt to fund capital projects, extremely low public finance interest rates may make it desirable at this time for the City to consider some debt issuance, in lieu of pay-go, to fund capital projects that will have a measurable impact on the public safety and health of the city's residents and businesses, as well as a long-term useful life.

6. Because such a large portion of the City's Operating Budget (currently approximately 70% for the General Fund) is driven by personnel-related costs, the Commission historically has urged restraint in adding to the City's personnel costs, and continues to do so. The growth in City expenditures attributable in large part to rising personnel-related costs continues to outpace the growth of revenues. Personnel costs also have a direct impact on the

City's cash-flows. Even though the City is a service industry and heavily relies upon personnel to provide services, the continued growth of expenses, including personnel and pension-related expenses, in excess of the growth of revenues and the associated impact on cash-flows will not be sustainable in the medium to long term. We note that the successful management of the FY 2021 budget resulted from City Departments maintaining significant numbers of open vacancies; a practice that is not likely continue for an extended period of time. If the City is able to maintain reasonable service levels with such vacancies remaining unfilled, then the interesting question is posed as to whether such positions are needed at all and can be eliminated. The City may be facing some difficult choices to control personnel costs, including eliminating, reducing or modifying City service and program delivery across the board. If not that, then the City may be facing the prospect of increasing taxes and fees to bring personnel costs into line with revenues and cash-flows. The City should begin now the process of evaluating the feasibility of such actions. As part of this evaluation the City must examine the levels of the City's contributions to employee pensions and/or consider transitioning to retirement programs based on defined contributions from the City and away from programs which guarantee a defined benefit. The upcoming negotiations with the City employee collective bargaining units provide an opportunity for the City to do so. As a possible means of reducing public safety expenses, the City also should explore the practicality and financial feasibility of joint City and County sharing of certain public safety functions.

7. As the City needs to take steps to control expenditures, the City also must continue to explore new or supplementary non-grant revenue streams. As the capital city of Maryland, Annapolis enjoys a special relationship with the State, provides numerous services to and in support of State government operations, and is the home to many tax-exempt State-owned properties. In FY 2021 the State provided an enhanced payment in lieu of taxes to the City and financial support through capital project funding. The Financial Advisory Commission encourages the City to calculate the costs borne by the City that are expected to be offset by an annual payment in lieu of taxes from the State, and the "lost revenue" from exempt property in Annapolis owned by the State, and to use such information in future PILOT negotiations with the State.

8. The City's Transportation system has never been self-sustaining, and, as a public transit system, is not likely to be self-sustaining. Because the Transportation Fund is not self-sustaining it requires annual subsidies from the City's General Fund. In order to reduce and stabilize reliance on support from the General Fund the City should continue to explore ways to enhance Transportation system revenues and reduce its operational expenses. As part of this evaluation the City should explore whether any reasonable, cost effective, opportunities exist for the City to operate its Transportation system more efficiently and as part of a regional approach to providing public transportation.

There is still work to be done. We should not lull ourselves into believing this past year's management of expenses in an unusually challenging time, with the assistance of federal funding, offers a reason to reduce our vigilance on these other important budgetary matters. A reasonable

argument can be made that the FY 2022 budget has not really begun to address these issues in any material way.

In conclusion, the Commission would like to acknowledge the work and responsiveness of Finance Director Jodee Dickinson, City Manager David Jarrell and other City staff. These individuals and their teams were instrumental in helping to bring forward a fiscally responsible financial program for FY 2022. The Financial Advisory Commission has confidence in their future leadership to keep the City on solid financial footing. The entire budget process thus far has been extraordinary considering the significant challenges and uncertainties presented by the COVID-19 pandemic.

The Financial Advisory Commission pledges our continued support to work collaboratively with the Mayor and City Council to chart a fiscally responsible and financially sustainable course for the future welfare of our City.

Sincerely,

Frederick C. Sussman

Frederick C. Sussman, Chair

cc: David Jarrell, City Manager (By e-mail)
Jodee Dickinson, Finance Director (By e-mail)
Regina C. Watkins-Eldridge, City Clerk (By e-mail)
Jacqueline Lee, Legislative and Policy Analyst
Financial Advisory Commission Members (By e-mail)