CITY OF ANNAPOLIS FINANCIAL ADVISORY COMMISSION
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May 23, 2014

BY E-MAIL AND HAND DELIVERY
Mayor and City Council of the City of Annapolis
160 Duke of Gloucester Street
Annapolis, Maryland 21401

Re: Recommendations Regarding:
Ordinance No. O-8-14 (Annual Operating Budget: FY 2015)
Ordinance No. O-9-14 (Capital Improvement Budget FY 2015)
Resolution No. R-12-14 (Capital Improvement Program: FY 2015 to FY 2020)
Resolution No. R-10-14 (FY 2015 Fees Schedule)

Dear Mayor Pantelides and Members of the City Council:

I am writing to you on behalf of the City of Annapolis Financial Advisory Commission ("Commission" or "FAC"). With the assistance of the City's Finance Director, we have reviewed Ordinance No. O-8-14 (Annual Operating Budget: FY 2015), Ordinance No. O-9-14 (Capital Improvement Budget FY 2015), Resolution No. R-12-14 (Capital Improvement Program), and Resolution No. R-10-14 (FY 2015 Fees Schedule). Collectively, these ordinances and resolutions reflect the City's fiscal plan for the upcoming year. The Commission offers the following observations and recommendations.

The Commission is pleased that on May 7, 2014, Fitch Ratings affirmed the City's ratings on general obligation bonds at 'AA+' and improved the City's rating outlook to Stable from Negative. Fitch's outlook is now consistent with the most recent outlooks from Moody's and Standard and Poor. Fitch's action reflects Fitch's growing confidence that City officials have worked diligently over the past year to address the challenges of unfunded liabilities and other structural fiscal issues that resulted in the City's financial crisis that began approximately four years ago and presented challenges to the City's long-term financial stability. The City must continue to be vigilant in order to minimize the likelihood that a severe financial crisis will recur, and to ensure that the City remains on a path towards long-term fiscal sustainability.

This year's budget process has been particularly challenging as a result of increased fixed expenses in an environment of flat revenues and limited revenue options. These increased expenses, many of which were anticipated, include (i) funding salary and retirement fund contributions negotiated last year as part of the Interest Based Bargaining negotiations, (ii) increases in costs of employee health insurance and other general insurances, (iii) increased debt service payment obligations resulting from recent bond issuances and refinancing, and (iv) an increase in workers compensation costs. The challenges may become greater in years to come as fixed costs continue to escalate through normal increases in costs of goods and services, without any enhancement to services provided to the public, and even if the size of government is reduced.

Operating Budget

For this upcoming fiscal year the Commission encourages the Mayor and City Council to adopt a balanced budget that uses a combination of (i) limited staffing cuts through positions elimination and attrition, (ii) increases in selected fees and charges, (iii) enhancement of selected estimated revenues based upon new information received since the revenue estimates initially were generated, and (iv) modest real and personal property tax rate increases. While the Commission would not always encourage property tax rate increases, a modest increase is appropriate this year because the other tools available to close the budget gap are not likely to do so without making dramatic decreases to City programs and services that have not yet been well thought out.

The Commission recommends that the Mayor and City Council reject efforts to close the budget gap through use of employee furloughs because furloughs are a short-term remedy, do not address funding of structural budget challenges and will place a significant burden on managing delivery of service. The Commission also urges that elimination or reduction of proposed modest additions to fund balance not be used to close the budget gap. As a matter of prudent fiscal policy the City has been diligent in attempting to maintain a healthy general fund fund balance but has not yet achieved its goal of $30,000,000 exclusive of debt.

The Commission further recommends that the City make a concerted effort to fund some capital projects with PayGo funding as part of the operating budget rather than through the issuance of new debt. Every dollar borrowed for capital projects must be repaid over many years along with interest. While paying the costs of capital projects as part of the operating budget will result in a short-term increase in costs, it will reduce the amount of debt service that the taxpayers will have to fund in future years.

The issue of PayGo funding becomes even more important in light of the City's deferred maintenance backlog for buildings and infrastructure that potentially is a fiscal time bomb greater than the retirement plan and OPEB funding issues that the City recently addressed. The Commission strongly recommends that the City undertake a comprehensive study to evaluate and quantify the fiscal implications of the deferred maintenance backlog and the amount of PayGo funding required to eliminate or substantially reduce future accruals.

The Commission recommends that during the six months after completion of this year's budget process, the Mayor, City Council and staff should engage in a deliberative process to study existing program and service levels and reach consensus as to what, if any, programs and service levels can and should be reduced to establish a baseline for development of the FY 2016 budget. It appears to the Commission that the City cannot continue to provide programs and services at current levels without experiencing routine increases in costs in coming years or finding new revenue sources, a challenge that has proven illusory because of the severe hamstrings that State law imposes on the ability of cities and towns to raise revenues.

The Commission has observed during its deliberations the various proposals have been made for staffing reductions which do not include full consideration of the implications of those reductions on City services and programs, nor full consideration of what programs and services City taxpayers <u>are willing to pay for</u>. The City must plan in a rational and deliberate way for a reduction in program and service levels to a fiscally sustainable level. This may involve organizational and cultural changes from the way that the City has conducted business such as lesser services and changes in service delivery models or increased taxes. The City government should be prepared to embrace those necessary changes.

As part of this review, the City, with the use of independent consultants, should examine the service models for the delivery of services to determine whether there are better and more cost-efficient ways to provide services than have been utilized in the past. As an example, the service model for delivery of fire suppression and emergency medical services should be examined in light of the fact that the ratio of emergency medical service to fire suppression calls has shifted dramatically over the years.

As a further part of this review the City should establish policies and benchmarks for general fund subsidies for public transportation, recreational facilities, the Market House and the City Dock operations, based on desirability and general availability of these services as public goods and recouping the balance of direct and indirect costs at the point of sale (*e.g.*, the national norm for public transportation is to recoup 35% of total costs from the ridership).

Fees and Charges

The City's annual fees resolution is a selective modification of fees and charges that the City passes along to the public for the use of City programs and services. The Commission previously has recommended that the City undertake a comprehensive review of all of its fees and charges to determine whether the fees and charges reasonably and fairly recoup all direct and indirect costs of providing the programs and services. Because of limited revenue sources available to the City it is more imperative than ever that the City recover these costs from the users of services and programs rather than leaving this burden upon the taxpayers as a whole. The Commission strongly recommends that the City engage an independent consultant to work with the City to undertake this study before the next budget season begins.

Capital Budget and Program

Last year the Commission noted that great strides have been made in the formulation and presentation of the Capital Budget and Program but urged staff to continue to refine project rating criteria to ensure that projects are fully evaluated and funded on their relative merits. The Commission reiterates this recommendation again this year. After this year's budget process is completed, the City should review the capital project rating matrix to determine the continuing propriety of all ratings categories and the relative weightings of those categories to determine whether the categories and weightings remain relevant and appropriate.

As noted earlier in this letter, the City should undertake a study to comprehensively evaluate the City's infrastructure and building maintenance backlog and develop a Capital Infrastructure Program to establish priorities and a timetable to address the maintenance backlog and determine the fiscal impact that addressing the backlog will have on future City budgets.

The Commission stands ready to answer any questions you may have, provide greater detail on our recommendations, and/or offer further guidance as you may request.

Sincerely,

Frederick C. Sussman, Chair

cc: Commission Members (By e-mail)
Bruce Miller, Finance Director (By e-mail)
Hilary Raftovich, Boards and Commissions Coordinator (By e-Mail)
Jessica Cowles, Legislative and Policy Analyst (By e-mail)