Report of the Finance Transition Team
January 22, 2018

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Introduction

This report was prepared by the Finance Transition Team for the benefit of Mayor Gavin Buckley. Our goal was to provide Mayor Buckley and City leaders with a clear and concise assessment of the City's current fiscal condition, the strengths and weaknesses of its key financial processes, and future challenges and opportunities.

Report Structure: The sections of our report are listed below. Each section contains our assessment, followed by our recommendations.

Section 1: Assessment of the City's Fiscal Condition and Financial Policies and Processes
Section 2: Budget
Section 3: Procurement
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Section 5: Looking to the Future
Appendix 1: Details to Support our Assessment of the City's Fiscal Condition and Financial Policies and Processes
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Appendix 3: Details to Support our Procurement Assessment

Interviews: The Finance Transition Team interviewed or engaged the following City leaders, commission members, and financial experts retained by the City. We thank them for their time, the documents they provided, and their valuable insight into the inner workings of City government.

- Mayor Gavin Buckley
- Alderperson Sheila Finlayson
- Alderperson Ross Arnett
- Former Alderperson Jared Littman
- Former Alderperson Ian Pfeiffer
- Tom Andrews, City Manager
- Bruce Miller, Director of Finance
- Melissa Leaman, Assistant Director of Finance
- Brian Snyder, Procurement Officer
- Mary O'Brien, Risk Analyst
- Pete Gutwald, Director of Planning and Zoning
- Sally Nash, Chief of Comprehensive Planning
- David Jarrell, Director of Public Works
- Marcia Patrick, Assistant Director of Public Works
- Maria Broadbent, Director of Environmental Policy
- Patricia Hopkins, Human Resources Manager
- David Stokes, Fire Chief
- Dan Horwath, Fleet Maintenance Manager
- Fred Sussman, Chair of the Financial Advisory Commission
- Lee Finney, Member of the Financial Advisory Commission
- Keith Novak, CliftonLarsonAllen, LLP – Audit Engagement Partner
- Joe Mason, Davenport & Co. – Financial Advisor
- Jennifer Diercksen, Davenport & Co. – Financial Advisor

Section 1: Assessment of the City's Fiscal Condition and Financial Policies and Processes

This section presents our assessment of the strengths of and weaknesses in the City's financial condition and financial policies and procedures, followed by our recommendations. Details to support our assessment are found in Appendix 1.

Our assessment is based on financial results as of June 30, 2016 (Fiscal Year 2016) because the Fiscal Year 2017 Comprehensive Annual Financial Report (audited financial statements) has not yet been issued as of January 22, 2018.

Strengths:

- **The City's financial position is strong.** Its tax base is above that for similarly rated cities; its wealth and income levels are above state and national median; and its unemployment rate is below state and national averages. Both the General Fund and the Water and Sewer Funds have adequate cash reserves and fund balances.

- **The City has adopted sound financial policies and conservative management practices designed to ensure financial stability.** These policies establish minimum reserve levels; identify appropriate uses for the expenditure of fund balances; require multi-year comprehensive plans, quarterly budget monitoring, and periodic utility rate studies; and address the goal of increasing the use of pay-go funding for capital improvements.

- **The City has adopted sound debt policies to ensure General Obligation and Utility debt remains affordable.**

- **The City has adopted sound investment policies that provide for consistent, informed decision-making and mitigation of investment risk.** The policies establish investment goals and permit asset mixes that are appropriate for the purposes for which the funds are invested (operating funds, pension funds, and other postemployment benefit (OPEB) funds).

Weaknesses:

- **The City has a weak debt and liability profile.** Its general obligation debt burden is above average, utility debt ratios are high, and the required contributions for pension and other postemployment benefits (OPEB, or retiree health insurance) are an elevated percentage of governmental fund expenditures. Standard and Poor's opined in its June 16, 2017, bond rating summary that "Annapolis' debt and contingent liability profile is very weak."

- **The City routinely fails to contribute the Actuarially Determined Contributions (ADC) to its Police and Fire Retirement Plan and Other Post Employment Benefit (OPEB) Trust for retiree health insurance.**

- **The actuarial assumptions used to determine the ADC are aggressive in the opinion of the Finance Transition Team, and the Deferred Retirement Option Program (DROP) is not cost-neutral.**

- **The Parking and Transportation enterprise funds owe significant amounts to the General Fund** ($5.7 million and $2.1 million, respectively, as of June 30, 2016). **Additionally, the Transportation Fund operates at deficit every year, requiring significant, recurring subsidies from the General Fund** ($7.5 million in FY2016).

- **The Self Insurance Fund also has recurring deficits.** The Self Insurance Fund is an internal service fund designed to be self-supporting from internal user charges. However, it had a deficit at the end of each fiscal year 2013 -2016. While the Office of Finance has provided unaudited financial information that shows the deficit has been eliminated in FY2017, recurring revenue for the health insurance portion is not sufficient to cover recurring expenses, and this fund will require monitoring to ensure it remains self-supporting.

- **The City is unnecessarily paying more than required by State law for workers' compensation disability payments and more than necessary to make an employee "whole."**

- **The City vehicle fleet is aging. Maintenance costs are high, and the City has no reserves accumulated for vehicle replacements.**

- **The Capital Budget (FY2018) and Capital Improvement Plan (FY2019 – 2023) rely heavily on bond funding, including bond funding for large vehicle replacements and continuing infrastructure maintenance.** Recurring expenses for vehicle replacements and infrastructure maintenance are more appropriately funded with recurring revenue, not bonds or one-time funding.

- **The City has been unsuccessful in receiving an increase in the payment received from the State to help offset costs the City incurs because the State capital is located here.** The $367,000 payment has not changed since 2006.

- **The City's independent auditors, CliftonLarsonAllen, LLP (CLA), have repeatedly found material weaknesses and significant deficiencies in internal control over financial reporting and federal grants, and in fiscal year 2016, CLA issued a qualified (not "clean") audit opinion on the City's federal transportation grants.** Repeated material weaknesses include limited staffing and turnover in the Office of Finance, lack of review over financial data, management's unfamiliarity with grant compliance requirements, and lack of controls to ensure accurate reporting of federal grant awards.

Recommendations:

<u>Recommendation 1</u>: *The City should work towards improving its weak debt and liability profile.*

- The City's first budget priority should be to fully fund the actuarially determined contribution (ADC) for the Police and Fire Retirement Plan. While the employees' contributions to the pension plan are subject to collective bargaining, the employer's contribution should be funded based on the actuary's recommendation, not collective bargaining.
  - *Suggested timeline: immediate (FY2019 budget)*

- The City should have the pension actuary reevaluate the actuarial assumptions used to determine the ADC, including assumptions on investment returns, pay increases, etc.
  - *Suggested timeline: within one year*

- The City should work with the public safety unions to amend the DROP to make it cost-neutral, as required in the pension plan's provisions.
  - *Suggested timeline: within one year*

- The City should set a target date for when it will fully fund the required contribution to the OPEB Trust and establish a formal plan to increase its annual contributions incrementally to meet the target date. We suggest a target date of no more than 7 years.
  - *Suggested timeline: within one year*

- The City should consider modifying its Debt and Financial Administration Policies to allow unassigned General Fund balance in excess of the 15% target to be used to reduce pension and/or OPEB liabilities. This is an appropriate use of fund balance given the large liabilities in both the Pension and OPEB trust funds attributable to employees' past (not current) service. Increasing the assets accumulated in these funds will also increase the funds' investment returns, thereby providing additional assets to pay the liabilities and reducing future required contributions.

- *Suggested timeline: immediate*

- The City should evaluate how the Parking and Transportation enterprise funds can be restructured to become self-supporting, including setting a target date for the Parking and Transportation Funds to repay the liabilities owed to the General Fund and establishing a repayment plan to meet the target date. If the Parking and Transportation Funds will be unable to repay the liabilities to the General Fund, the liabilities should be written off. While writing off the liabilities will reduce the General Fund balance, it would result in a more transparent picture of the City's financial position.
  - *Suggested timeline: within one year*

- The City should establish an internal service fund for employee health insurance that is separate from the internal service fund for workers' compensation and other insurance liabilities. Separating these insurance activities into separate funds would enhance transparency, allow for more accurate rate setting, and preclude a surplus from one purpose covering a deficit generated by the other purpose.
  - *Suggested timeline: immediate (FY2019 budget)*

- The City should evaluate the revenue structure of the components of the Self Insurance Fund to ensure recurring revenues are sufficient to cover recurring expenses and maintain appropriate levels of reserves.
  - *Suggested timeline: immediate (FY2019 budget)*

- The City should modify how it pays workers' compensation for temporary total disabilities. When an injured employee making $56,888 or less is on temporary total disability, the City should simply pay the temporary total disability in accordance with State law. If the City wishes to "make whole" an employee who makes more than $56,888, only the amount in excess of the State-ordered amount should be paid via the regular payroll. Structuring the payments in this manner would save both the City and the employee the 7.65% FICA tax on the first $56,888, and the employee would pay income taxes only on the amount in excess of $56,888.
  - *Suggested timeline: immediate*

<u>Recommendation 2</u>: *The City should determine how it is going to address its aging vehicle fleet and fund replacements.*

- The City should evaluate whether it would be more cost-effective to lease vehicles. Given the small geographical area of the city and low annual mileage, the leased vehicles would likely be under warranty during the entire term of the lease. The City would not bear the burden of costly repairs or replacements, and routine maintenance would be less expensive than the high cost of maintaining vehicles that have been retained well beyond the criteria established in the Vehicle Replacement Schedule.
  - *Suggested timeline: within two years*

- The City should evaluate whether it would be cost effective to lease fire apparatus. Leasing fire apparatus would ensure the apparatus was always fairly new with the latest safety and technology features. Given that a new ladder truck costs $1.2 million, which the City would finance with bonds, it may be more cost effective to lease the apparatus.
  - *Suggested timeline: within two years*

- If the City continues to maintain its own fleet, the City should establish Vehicle Operations and Vehicle Replacement Funds (internal service funds). The department to whom the vehicle is assigned should pay an amount into the Vehicle Operations Fund to cover fuel, maintenance, and repairs based on the class of vehicle. Additionally, the department should pay an amount into the Vehicle Replacement Fund sufficient to accumulate enough money to replace the vehicle at the end of its useful life.
  - *Suggested timeline: within two years*

- ➢ The City should evaluate whether there are bona fide, non-compensatory reasons for employees to have take-home vehicles, particularly non-public safety employees. The Planning and Zoning department has 10 employees with take-home vehicles, and the Department of Public Works has 13 (one of which is unmarked). Given that the City is only 7 square miles, it is difficult to justify a bona fide, non-compensatory reason for employees who are not Fire or Police first responders. Unless these employees regularly respond to non-public safety emergencies and unless time is of the essence in their response, it would be less expensive for the employees to park their City vehicles in a City parking garage and commute in their own vehicles.
  - ➢ *Suggested timeline: within one year*

- The Office of Finance needs to evaluate whether it is properly reporting to the IRS the value of employees' personal use of take-home vehicles, including commuting, particularly for (1) those for whom there is no bona fide, non-compensatory reason to commute in a City vehicle; (2) those with unmarked public safety vehicles who are not sworn law enforcement officers; and (3) those who are "control employees" under IRS regulations (anyone whose pay rate is more than $153,800 in 2018).
  - ➢ *Suggested timeline: within calendar year 2018*

<u>Recommendation 3</u>: *The City should work towards funding large vehicle replacements and continuing infrastructure with recurring revenue, not bonds or one-time funding.* Accumulating funds in a Vehicle Replacement Fund as described above would be one way to do this.

- ➢ *Suggested timeline: within two years*

<u>Recommendation 4</u>: *We concur with the 2008 recommendation made by the Annapolis Blue Ribbon Commission on the City of Annapolis Finances that the City work with the State to develop an agreed-upon, objective formula to determine the amounts the State will pay to help offset the costs incurred by the City.*

- We reviewed the letter Mayor Pantelides sent to Governor Hogan in September 2017 asking the State to increase its payment to $1.5 million and identifying approximately $3 million of costs. However, some of the costs identified arguably would be incurred regardless of whether Annapolis was the state capital. An agreed-upon, objective formula would be more likely to ensure the City was reimbursed for costs incurred.
  - ➢ *Suggested timeline: within one year (for FY2020 budget)*

<u>Recommendation 5</u>: *To ensure timely and accurate financial reporting and grant compliance, the City Manager and Director of Finance should evaluate and address the causes of the material weaknesses and significant deficiencies repeatedly noted by the outside auditors, including turnover, staffing levels, and expertise, both within the Office of Finance and in other departments, particularly those that administer grants and process receipts, such as Transportation, Recreation and Parks, and the Harbormaster's Office.*

- ➢ *Suggested timeline: within one year*

<u>Recommendation 6</u>: *Although not directly linked to an identified weakness, we believe the effectiveness of the risk management division would be enhanced if the Risk Analyst position reported directly to the City Manager. Previously the Risk Analyst position reported to the Fire Chief before being moved under the Office of Finance. However, risk management is a citywide function that affects all departments. It is not a function of the Fire Department, the Finance Department, or any other individual department.*

- ➢ *Suggested timeline: within one year (for FY2020 budget)*

Section 2: Budget

Adopting the budget is arguably the most important legislative act of the Mayor and City Council. The budget serves as an expression of public policy and the tool by which the elected officials' priorities are executed.

This section presents our assessment of the budget documents and processes, followed by our recommendations. Details to support our assessment are found in Appendix 2.

Assessment:

- ***The City lacks codified controls on spending.*** The City Charter and City Code do not include provisions designed to ensure departments do not overspend the legally adopted budget.

- ***Neither the operating nor capital budgets are specific enough to serve as an effective tool for the Mayor and City Council to set policy and communicate priorities.***

- ***There is a lack of consistency in budget reporting detail.*** The proposed operating budget published on the City's website includes details by fund, department, and line item expenditure category, but the final budget published on the website does not include the same level of detail.

- ***Budget amendments adopted by the City Council are not disclosed in published budget documents.*** Failure to disclose amendments to the budget makes it difficult for the public to determine how the City Council modified the Mayor's proposed budget.

- ***The City budget is prepared using extensive and complex Excel spreadsheets that are time-consuming to prepare and subject to data entry errors.*** Management does not make effective use of budget reporting module of MUNIS, the City's financial ERP software.

Recommendations:

<u>Recommendation 1</u>: *The City Charter and/or City Code should be amended to:*

- Explicitly state that it is a violation of City law for departments or managers to spend or contract to spend more than the legally adopted budget appropriations.
- Require the Director of Finance to certify the availability of funds and sufficient appropriations for any contract to spend money.
- Ensure multi-year contracts contain clauses that make future expenditures contingent upon the City Council's appropriation of funds in future years.
- Require the CIP to identify the scope of each capital project and prohibit the expenditure of funds for purposes other than those that fall within the identified scope.
  - *Suggested timeline: immediate*

<u>Recommendation 2</u>: *The proposed and final capital budget and CIP should identify:*

- How each project is linked to the Comprehensive Plan.
- The scope of each project.
- The timing and funding sources for each project for each year.
- The current status of the project and amounts spent and encumbered to date.
- Any costs that will be incurred beyond the last year of the CIP.
  - *Suggested timeline: immediate (FY2019 budget)*

Recommendation 3: *Both the proposed and final operating budget should include sufficient detail to allow for meaningful analysis by the Mayor, the City Council, and the public.*

- At a minimum, the proposed budget should include for both revenues and expenditures the upcoming year's request, the current year's projections, and actual amounts for one year preceding the current year. Ideally the proposed budget would disclose the actual amounts for the three years preceding the current year.
- The final budget should include the line item level of detail currently included only in the proposed budget for both revenues and expenditures.
- Amendments to the budget should be published along with the proposed and final budgets.
  - ➢ *Suggested timeline: immediate (FY2019 budget)*

Recommendation 4: *City management should monitor budget to actual expenditures throughout the year and seek additional appropriations when necessary.* It should be rare, not routine, for departments to exceed their legally adopted budget appropriations.

- ➢ *Suggested timeline: immediate*

Recommendation 5: *Rather than rely on extensive and complex spreadsheets that are subject to data entry error, the Office of Finance should compile the budget using the MUNIS budget module.*

- ➢ *Suggested timeline: within one year*

Section 3: Procurement

Procurement is one of the most basic functions of government. Because procurement policies have a profound impact on the cost of implementing government programs, codified, efficient, and transparent procurement policies and procedures are essential to ensuring fair and impartial procurements.

This section presents our assessment of procurement documents and processes, followed by our recommendations. Details to support our assessment are found in Appendix 3.

Assessment:

- ***The City Code contains no provisions governing procurement or the disposition of surplus property.*** When goods and services are purchased with taxpayer, not private, funds, regulations are necessary to ensure procurements and dispositions of public property are conducted in a fair and impartial manner using methods applied consistently and with transparency.

- ***City procurement is governed by a 5-page "Procurement Policy and Procedure Statement," a document that does not have the force of law.*** This document denotes different methods for soliciting goods, services, or construction based on different dollar thresholds. However, the language in the document is somewhat cryptic, incomplete, and not comprehensive.

- ***In 2014, the City hired NIGP Consulting to review, analyze, and make recommendations concerning the City's procurement practices.*** The resulting "City of Annapolis Procurement Function Review and Recommendations" (issued in April 2014) contains a helpful synopsis of all the City's procurement policies and practices, including suggestions for improving the policies and procedures and identification of redundant or overlapping policies that should be reorganized, combined, or eliminated.

Recommendations:

__Recommendation 1:__ The City should adopt purchasing regulations by ordinance that establish permitted procurement method.

- The 5-page "Procurement Policy and Procedure Statement" and the 2014 "City of Annapolis Procurement Function Review and Recommendations" together would serve as a good starting point for City management to draft procurement and purchasing regulations.
- Procurement regulations should include language defining each permitted procurement method and identifying when each method may be or is required to be use. The regulations should address:
  - Competitive bids and requests for proposals; sole source procurements: emergency procurements: purchases by procurement card (p-card): cooperative purchases: specialized professional services: bridge contracts: and public entity contracts.
  - Contract disputes and solicitation protests; termination for cause; liquidated damages; compliance with federal laws such as FLSA standards and Equal Opportunity regulations; assignment of contracts; subcontracting; modification of contracts; and termination for convenience.
- The regulations should ensure the dollar amount for solicitations of construction contracts, performance bonds, labor and material bonds, and retainage comport with the Maryland "Little Miller Act."
- The regulations should include language that governs solicitations for leases of City-owned property, such as the Market House.

- The regulations should include language that ensures any contract beyond one year is subject to and contingent upon the appropriation of funds in future periods.
  - *Suggested timeline: within one year*

Recommendation 2: *The City should adopt regulations via ordinance that govern the disposition of surplus property, including specifications for when solicitations are required, when independent appraisals are required, what public notice is required, and who is required to approve the dispositions (the Administration or the City Council) and at what amounts.*

- *Suggested timeline: within one year*

Section 4: Infrastructure

It is hard to overestimate the importance of infrastructure – concrete, steel, pipes, roads, bridges, power lines – to our local, state, and national communities. Additionally, in cities like Annapolis, natural infrastructure and cultural infrastructure, such as historic structures, are also critically important to local economies and quality of life. Consequently, the financing systems and processes that support the development and maintenance of these infrastructure assets are critically important.

Though there are many infrastructure systems that are essential to the City of Annapolis, we assessed the financing processes around four that we believe are critically important to the City at this time: transportation, drinking water, wastewater, and stormwater. While other needs and concerns associated with other infrastructure systems, such as city-owned structures, energy, cyber/data, and historic structures, are important, we feel these four represent the most significant financing responsibility of the City, as well as the most significant future concerns.

This section sets forth our assessment of these four infrastructure systems, followed by our recommendations.

Transportation: Transportation infrastructure in Annapolis has three essential elements: road maintenance, parking, and bus transit.

- Road maintenance: The City of Annapolis is fully developed and essentially built out. Consequently, major new road projects that expand capacity are unlikely to be necessary in the foreseeable future, and the focus of the City's expenditures for roads primarily will be for road resurfacing and reconstruction. Currently the city budgets $2 million annually for road projects, including resurfacing and reconstruction. According to the Director of Public Works, this level of funding is insufficient for the city to maintain its desired maintenance schedule. Additionally, this level of funding currently is supported through debt financing, while best practices would fund recurring road maintenance with pay-go funding.

  Parking: Parking infrastructure creates a particular challenge the new administration. Specifically, the Hillman Garage is rapidly reaching the end of its useful life and will need to be replaced or relocated. While some might suggest issuing revenue bonds to pay for a new garage, the revenue bonds would have to be repaid from parking revenues, and parking revenue is already insufficient to cover operating and maintenance costs without any debt burden.

  Transportation: The Transportation Fund never has been and never will be self-sustaining. It borrows or receives approximately $10 million from the General Fund every year. Without restructuring, there is little that can be done to improve the bus transportation network.

Drinking water and wastewater: The City's drinking water and wastewater programs are operated using traditional enterprise funds where the operations, maintenance, and capital improvements directly associated with the utilities are covered by customer charges. As detailed in Appendix 1, the water and wastewater utility cash position is strong, and utility rates are affordable. However, utility debt is high and anticipated to grow in the future. Because the capacity of the water and sewer systems are sufficient for the long-term, the City's focus will be on maintaining and repairing existing infrastructure, which should be substantially funded with pay-go, not debt. The City will have to exercise fiscal discipline to control spending and ensure utility rates are sufficient to cover operating costs, pay-go funding, and debt service.

Stormwater and watershed improvements: Stormwater has created a significant financing challenge for the City. Like the Transportation and Parking Funds, the City's Stormwater Fund is also an enterprise fund, but it does not, in fact, function that way. The City collects approximately $875,000 through its existing stormwater fee. These fees are sufficient to support salaries, operations and maintenance, but insufficient to fund stormwater and watershed improvement projects. The FY2017 CIP includes $1 million for stormwater and watershed improvement projects, funded with general obligation bonds. This level of funding will need to extend well into the future to finance the estimated $25 million cost of implementing the 19 watershed improvement projects that are necessary to achieve permit compliance by 2025.

Recommendations:

Recommendation 1: *The City needs to move towards self-sufficient and balanced enterprise funds for its transportation, parking, and stormwater/green infrastructure programs.* We recognize the difficulties associated with financing enterprise fund programs. Ensuring consistent services via enterprise funds that are self-supporting and stable often requires increasing rates and fees, which is rarely popular. This is especially true for (1) bus transportation, a service that is popular with those members of the community who cannot afford or are unable to provide their own transportation, and (2) stormwater management, the benefits of which are generally poorly understood. However, generating consistent and long-term revenue flows is essential for financing infrastructure into the future.

- *Suggested timeline: within four years*

Recommendation 2: *The City should endeavor to lower its utility debt profile.* While the water and wastewater funds have cash and liquidity, the utility debt profile is weak. City management has advised us that the City plans to begin funding 40% of water and sewer capital projects with pay-go beginning in FY2019, pending the results of a utility rate study. This is an important step to ensuring future capital improvements do not overwhelm the system's debt profile.

- *Suggested timeline: immediate (FY2019 budget) for funding 40% of CIP with pay-go; within 4 years for overall improvement in utility debt profile.*

Section 5: Looking to the Future

Finally, we address some key financing issues that will impact the City well into the future. We recognize that primary focus of any mayoral administration is the current well-being of the City's citizens, businesses, and voters. However, every mayor has an obligation to the future, especially in regard to how infrastructure and critical services and resources will be financed in the years to come. To that end, we provide a look at issues we feel this administration should embrace for the betterment of both the community today and future generations.

The impacts of climate change on infrastructure and City financing systems: Coastal urban communities like Annapolis face dual financing challenges: maintaining and expanding critical city services and infrastructure while preparing for and mitigating the impact and risk associated with climate change, including sea level rise, major and catastrophic storm events, and changing temperatures. By addressing these two financing challenges collectively, holistically, and with a long-term vision in mind, coastal communities will be better positioned to thrive economically, socially, culturally, and environmentally into the future.

The distinctiveness of resilience as the focal point of local financing and economic investment is more than semantic. Resilience focuses investment on increasing a city's overall ability to support a vibrant, healthy society and economy under a wide range of circumstances. By contrast, adaptation focuses resources on mitigating specific risk factors. Though mitigating specific risk factors associated with climate change is essential – especially in coastal communities like Annapolis – planning and financing efforts are often executed without a clear connection to the overall economic, environmental, and social performance of a community as a functioning urban unit or system. In effect, this describes the distinction between resilience and adaptation.[1]

Resilience focuses on the reliability, sustainability, and efficiency of performance. From an urban property and infrastructure development perspective, resilience is the reliability of an investment in a city to generate returns and revenue streams under a wider range of circumstances. Resilience, therefore, creates a clearer linkage with the area or infrastructure system's overall investment attractiveness and potential. Rather than just being a risk-reduction cost, resilience investments aim to create an urban area's development potential.[2]

Though the challenges facing Annapolis are real, the City is facing an equally significant opportunity to transform resilience and infrastructure financing costs into very real investment opportunities. By addressing these financing challenges collectively, the City will be positioned to incentivize investment in critical infrastructure projects while simultaneously transforming climate change adaptation efforts into a comprehensive resilience-based, economic development process designed to support economic growth and development into the future. Transforming the City's infrastructure financing responsibilities into investment opportunities will require establishing key enabling conditions and processes that are common to virtually all economic development and infrastructure financing systems.

We address four conditions that we believe are essential for advancing resilient infrastructure financing systems: Leadership; Planning Expertise; Regulatory Consistency; and Financing Institutions, Processes, and Expertise. Below we provide a brief description of each condition and an assessment of how well the City is developing and establishing these critical processes.

Enabling Condition 1: Leadership: Effective leadership at both the regional and local level is essential to attract and deploy investment in resilience efforts. Specifically, advancing resilience priorities, including embedding those priorities into the economic fabric of the community, will require establishing community leaders that are charged with moving resilience initiatives forward. The need for enabling this type of resilience-based leadership was

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[1] ICLEI, 2011, Financing the Resilient City: A demand driven approach to development, disaster risk reduction and climate adaptation - An ICLEI White Paper, ICLEI Global Report.
[2] ICLEI.

identified years ago by the Rockefeller Foundation; this, in turn, influenced the establishment of the Resilient 100 Cities program, which has supported the establishment of resilience leaders in cities across the country.

Assessment and recommendations: This is a unique moment in time for this administration. Mayor Buckley brings an energy and commitment to addressing the impacts of climate that will serve the City well moving forward. In addition, he does not need to start at the beginning; rather, this administration has an opportunity to build on the foundation of the work that was done over the past four years. The Pantelides administration had a very effective resilience program, specifically in regard to addressing the threats to the City's many historic structures. Through the Department of Planning and Zoning, the City was also able to implement effective community outreach efforts, thereby educating the citizens of Annapolis on the threats related to climate change. It is necessary now to expand on those efforts to build a truly comprehensive resilience effort. Our recommendations include:

- ***Making resilience in general and resilience infrastructure financing specifically top-level City priorities over the coming years.*** The mayor and all of the City's top leaders must embrace this issue and work cohesively to execute a comprehensive infrastructure financing program. This issue must resonate at the top levels of leadership.

- ***Embracing an integrated resilience infrastructure and financing approach.*** The potential impacts of climate change in Annapolis are well-documented. However, ensuring a resilient community into the future will require addressing multiple economic, cultural, social, and environmental issues. Though addressing physical threats to the City are necessary, they are not sufficient. A holistic approach to community development will be essential.

- ***Redouble efforts to reach all residents of the City.*** What is certain about climate change is that it will impact everyone; however, the most vulnerable – economically, socially, and geographically – will be impacted most severely. Working towards resilience is a unique opportunity to engage the entire community and to advance a broad set of community goals equitably. In other words, the City needs to move well beyond addressing the impacts on some communities and types of property owners to engaging the entire community.

Enabling Condition 2: Planning Expertise: Resilience cuts across departments and processes that are often isolated from one another in local governments, including hazard mitigation, emergency management, long-range land use planning, zoning and code enforcement, economic development, public works, public budgeting, and capital improvement planning. Effective planning both within and between these areas is important for a locality to identify and pursue resilience priorities, bundle projects for investment, and ensure that projects are implemented in a coordinated, effective way.

Assessment and recommendations: Annapolis has a very skilled planning department and team, and though the recent loss of the Director of Historic Preservation resulted in a loss of institutional knowledge, the department appears to be well-positioned to make appropriate adjustments. Moving forward, we recommend the following actions and next steps:

- ***The City must develop a comprehensive resilience implementation plan and strategy.*** We recognize that there are many different planning processes that the City is required to implement at any given time. Each of these plans and processes provides value to the City's resilience efforts. For example, planning officials will soon embark on the development of an updated Comprehensive Plan, and that plan will go a long way towards defining how the City envisions addressing climate change in the future. However, the Comprehensive Plan, while necessary for achieving resilience, is not sufficient. A detailed resilience plan will identify the specific projects that are necessary for achieving the vision in the comprehensive plan. It will detail the anticipated timing of those projects and the processes for implementation. In addition, a resilience plan must identify the anticipated financing processes that will be necessary for ensuring implementation happens on schedule.

- ***The resilience plan must include a thorough assessment of the City's assets.*** Very importantly, the plan must address the unique assets within the community that can be leveraged to ensure success. The resources necessary to incentivize investment and create a more resilient community exist in many cases within the community itself and are, therefore, assets to attract capital, financing, and economic development, and investment. These assets can be physical, such as natural resources and man-made infrastructure; cultural, often in the form of unique institutions or in the form of a particularly skilled labor force; and/or they can be an established industry that is uniquely appropriate for a particular region, such as tourism in Annapolis. What is important is that these assets are directly embedded in the financing process, specifically as mechanisms for incentivizing investment.

Enabling Condition 3: Regulatory Consistency: Regulations are an important component of the resilience financing and economic development process. Regulatory consistency is especially important for those activities or events that have the potential for common impact across the region. For example, consistency in building codes is important for reducing relative development costs region-wide. Development costs can increase when developers and businesses are required to navigate varying permitting requirements from community to community. Because of the necessary regional approach to achieving resilience, regulatory effectiveness will also require regional coordination and, at times, implementation.

Assessment and recommendations: It was beyond the scope of this effort to do a comprehensive assessment of regulatory programs that are not directly tied to financing processes. That said, we would like to point out that the City's financing processes and systems will directly impact the nature of its regulatory programs. For the City to appropriately address the physical threats from climate change, its regulations must work to incentivize the most innovative and aggressive actions across all areas of development.

Enabling Condition 4: Financing Institutions, Processes, and Expertise: The challenges of financing large-scale infrastructure efforts are clear, especially in small coastal cities like Annapolis. Specifically, the potential scale of achieving community infrastructure implementation goals can appear overwhelming at times. In addition, the scale will be exacerbated by the comprehensiveness and breadth of the infrastructure needs. As a result of the complexity of the financing challenge, it is essential that the City leverage and, if necessary, develop innovative and scalable resilience financing institutions that include three essential processes and characteristics:

- The capacity to establish, allocate, and invest revenue;
- The capacity to innovatively incentivize private sector engagement and investment in resilience infrastructure; and
- The authority and flexibility to leverage and invest fiscal resources.

Recommendations:

With these four conditions in mind, we make the following recommendations:

<u>Recommendation #1</u>: *The City's resilience financing effort must enable more effective engagement and participation with the private sector.* Our assessment of the City's existing fiscal condition makes clear aggressively addressing future infrastructure financing needs will stretch the financing system beyond its capacity. Consequently, the scale of the problem and the magnitude of the potential opportunity will require innovative and substantive changes in how the City partners with the community. Contrary to popular belief, the world is awash in capital, especially capital looking to invest in infrastructure projects. What is missing are innovative programs and processes that enable private capital to realize a return on investment while at the same time providing a public good to the community in the most efficient manner. Making these connections will require several foundational elements, each of which was addressed in our assessment of the City's finances:

- Innovative procurement systems that enable City leaders to pay for desired outputs and performance in ways that incentivize innovation and efficiency within the private sector;
- Stable, sufficient revenue streams, especially those associated with enterprise programs;
- Innovative risk management processes through long-term partnerships with developers and capital managers in the private sector.

- *Suggested timeline: immediately and ongoing*

Recommendation #2: *Create a resilience director position.* Directly connected to Condition 1, it is essential that the City create a resilience director position that reports directly to the City Manager and work directly with the Mayor and City Council. Again, the anticipated scale of the problem and, just as importantly, the anticipated scale of the opportunity will require a dedicated financing and implementation approach that cannot be achieved within any single agency. A resilience director with the authority to help lead the City through a resilience infrastructure financing process will be essential in the long-term.

- *Suggested timeline: within calendar year 2018*

Appendix 1: Details to Assessment of Fiscal Condition and Financial Policies and Processes

Strengths:

The City's financial position is strong.

- The City's $6.4 billion tax base is above the median for other AA2 cities with anticipated growth of 1-2% annually (Moody's, June 2017).
- Wealth and income levels are above state and national medians (Moody's).
- Unemployment rate of 3.2% is below national and state averages (Moody's).
- The fiscal year 2016 General Fund balance was a healthy $38.6 million, or 54.1% of revenues, above the median for similarly rated governments (Moody's).
- General Fund liquidity levels are within the median for AA2 jurisdictions (Moody's).
- The utility system's debt service coverage has stabilized and liquidity has improved after implementing rate increases in the past six years (Moody's, July 2017).
- Utility cash is strong and above the median for the bond rating category (Moody's).

The City has adopted sound financial policies and conservative management practices designed to ensure financial stability.

- The City will not use General Fund equity ("fund balance") to finance current operations.
- The City will not use long-term borrowing to finance current operations or normal maintenance.
- The City will not use tax or revenue anticipation notes for operations.
- The City will maintain an unassigned General Fund balance of no less than 10% of General Fund revenues, with a target of 15%.
    - The City Council may, upon the recommendation of the Mayor and Finance Director, appropriate General Fund balance such that the amount would fall below the 15% target only with a super-majority vote.
    - The City Council may, upon recommendation of the Mayor and Finance Director, appropriate General Fund balance such that the amount would fall below the 10% minimum target only with a super majority vote and a reserve replenishment plan that restores the fund balance to the minimum 10% level within three fiscal years.
    - The unassigned General Fund balance on 6/30/16 was $15.8 million, which is 23% of General Fund revenues.
- The City has established a Budget Stabilization Fund that may accumulate an amount equal to 3% of government-wide expenditures.
    - In any year that the 15% unassigned General Fund balance target is met, 50% of the remaining surplus will be transferred to the Budget Stabilization Fund (BSF).
    - When the accumulated balance meets the 3% maximum, the portion of the General Fund surplus that would normally be allocated to the BSF shall fall to unassigned General Fund balance, which the City Council may appropriate for one-time expenditures.
    - The City Council may appropriate moneys in the BSF for any City government purpose by simple majority vote.
    - The balance in the BSF on 6/30/16 was $1.5 million, which is 2% of government-wide expenditures.

- The City has established a Capital Reserve Fund that may be used only for debt service or pay-go funding of capital projects or other one-time, nonrecurring expenditures.
  - In any year that the 15% unassigned General Fund balance target is met, 50% of the remaining surplus will be transferred to the Capital Reserve Fund. Additionally, the City may dedicate any other future revenue sources to the Capital Reserve Fund as long as the 15% unassigned fund balance target is met.
  - The 6/30/16 balance in the Capital Reserve Fund was $5 million.
  - The City will strive to increase its reliance on pay-go (current revenue) to finance capital improvements.
  - The Finance Director is required to prepare a quarterly report and analysis of budget to actual for current fiscal year. The report is to be reviewed by the Finance Committee and provided to the full City Council.
  - The Finance Director is required to prepare a multi-year comprehensive plan (current budget year plus two ensuing years) to be reviewed annually by the City Council during the budget process.
  - The City must conduct a formal utility rate study every 10 years to ensure the rates and fees will be sufficient to cover debt service and operating costs.
  - Utility rates will be reviewed annually during the budget process to ensure ongoing compliance between formal rate studies.

The City has adopted sound debt policies to ensure both General Obligation and Utility debt remains affordable.

- The life of bonds or capital leases cannot exceed expected useful life of the improvements.
- General Obligation Debt:
  - Debt/assessed value shall be 3% or less, with 2% as the target ratio.
  - Debt service shall be no more than 12% of General Fund expenditures with a target of no more than 10%.
  - Debt shall be structured to have a minimum payout ratio of 55% of principal in first 10 years.
  - Most recent General Obligation bond ratings:
    - Moody's: Aa2/positive
    - Fitch: AA+/stable
    - S&P: AA+/stable
- Utility Debt:
  - The water and wastewater utility cash position is strong and above the median for the bond rating category (Moody's, July 2017). In addition:
    - The utility cash target is 365 days with a floor of 180 days.
    - The utility cash balance at 6/30/16 was $17.6 million (639 days).
    - Cash on hand should remain over 300 days through 2022 (Fitch, July 2017).
  - Utility rates in the City remain affordable compared to median household income and are well under the affordability threshold of 2% of median household income through FY2021 (Fitch).
  - Utility rate increases < 5% do not require City Council approval. The most recent rate study recommends increasing utility rates by 4 - 4.9% over the next five years.
  - The capacity of water and sewer system is sufficient for the long-term, and the systems are in compliance with environmental regulations. Adequate long-term capacity and compliance with environmental regulations will allow the City to focus capital investment in the repair and relining of water distribution and sewage collection piping.
  - The most recent utility debt ratings (revenue bonds) included:
    - Moody's: Aa2
    - Fitch: AA-
    - Standard and Poor's: AA-/stable outlook

The City has adopted sound investment policies that provide for consistent, informed decision-making and mitigation of investment risk.

- The policies establish investment goals and permit asset mixes that are appropriate for the purposes for which the funds are invested (operating funds, pension funds, and other postemployment benefit (OPEB) funds).
  - The City's investment policy for operating funds is consistent with State law and appropriate for investments of a short-term nature.
  - The Board of Trustees for the Police and Fire Retirement Plan recently adopted an investment policy that establishes investment goals, permitted asset mixes, and oversight responsibilities. The policy's provisions are appropriate for longer-term investments.
  - OPEB funds are held in the Maryland Association of County's OPEB Trust and may be invested in accordance with the provisions of the trust. The trust has also adopted an investment policy that establishes oversight responsibility, investment goals, and permitted asset mixes that are appropriate for longer-term investments.

Weaknesses:

The City has a weak debt and liability profile.

- In its June 16, 2017, bond rating summary, Standard and Poor's noted, "In our opinion, Annapolis' debt and contingent liability profile is very weak."
- General Obligation Debt:
  - General Obligation (G.O.) debt:
    - Debt burden is above average at 1.7% of full valuation (Moody's).
    - Debt service is 8.6% of total governmental fund expenditures (S&P).
    - Net direct debt is 107.6% of total governmental fund revenue (S&P).
    - Principal amortization is below average with 51% of principal retired in first 10 years (Moody's).
    - Credit challenges are the City's failure to fully fund required pension and OPEB contributions and large receivables from the enterprise funds.
    - Factors that could lead to a downgrade in the G.O. bond rating are:
      - Decline in tax base and wealth levels.
      - Insufficient recurring revenues to cover recurring expenses.
      - Growth in receivables due to the General Fund from the enterprise funds.
      - Lack of progress towards fully funding the Actuarially Determined Contributions for pension and OPEB.
- Utility Debt:
  - This City has above average utility debt ratios that are expected to remain high as additional debt is anticipated and existing debt amortizes slowly.
    - From FY2012 – FY2017, utility debt increased from $17 million to almost $60 million while operating revenue remained flat at $15 million (Moody's).
    - The ratio of debt to funds available for debt service of 10.4, which is high compared to the median of 6.0 for similarly rated systems (Fitch).
    - The ratio of total debt to operating revenue is 4.0, which is which is above average. With plans to issue approximately $5.8 million in FY2018, the debt/revenue coverage will increases to 4.5 times (Moody's).
    - Payout is slow with 16.2% of principal repaid in 10 years (Moody's). Only 66% of debt amortizes over the next 20 years, compared to the "AA" category median of 86% (Fitch).
    - Debt/customer of $2,460 is well above the "AA" median of $1,823. With additional debt issuances planned, debt/customer could increase to over $3,200 in FY2022 (Fitch).
    - Debt financing will account for about 67% of funding of the current CIP. City management has represented to the bond rating agencies that it plans to gradually increase pay-go spending to 40% (Fitch).
    - Factors that could lead to a downgrade in utility debt rating are:
      - Declines in debt service coverage
      - A significant increase in capital needs beyond the current Capital Improvement Plan (CIP), resulting in larger than expected debt requirements
- Pension and OPEB Contributions:
  - The City's required contributions for pension and OPEB (retiree health insurance) were an elevated 10.2% of governmental fund expenditures in FY2016 (S&P).
  - The calculation of the required contributions to the Police and Fire Retirement Plan assumes a 7.5% return on investments; however, the actual market rate of return from 1996 – 2016 was only 6.5%. Lowering the investment return assumption to 6.5% doubles the net pension liability from $23 million to $46 million and decreases the funded ratio from 87.8% to 78.4%. (Boomershine Consulting Group, LLC November 2017 Actuarial Valuation)

The City routinely fails to contribute the Actuarially Determined Contributions (ADC) to its Police and Fire Retirement Plan and OPEB Trust for retiree health insurance.

The actuarially determined contributions (ADC) are calculated by an actuary to fully fund the long-term costs of promised benefits while balancing the goals of (1) keeping contributions relatively stable and (2) equitably allocating the costs over the employees' period of active service.

- *Police and Fire Pension Plan:*
  - The City's contributions to the pension plan routinely fall short of the ADC as shown in the excerpt below from the Boomershine actuarial valuation.

Year	Actuarially Determined Employer Contribution	Amount of Actual Contribution	Contribution Deficiency	Covered Payroll	Actual Contribution as % of Covered Payroll
2014	$ 4,052,174	$ 1,535,001	($ 2,517,174)	$ 16,269,356	9.4%
2015	3,234,493	2,351,163	(783,330)	16,529,127	14.8%
2016	3,740,905	2,877,922	(862,983)	16,430,407	17.5%
2017	3,817,433	3,430,988	(386,445)	18,256,495	18.8%

  - The FY2018 ADC is 20.23% of payroll, or approximately $3.8 million. However, the City budgeted only 18% of payroll, or approximately $3.4 million. The anticipated shortfall in FY2018 is slightly more than $400,000. (Boomershine Consulting Group, LLC November 2017 Actuarial Valuation)
  - Per the Boomershine report, the Police and Fire Retirement Plan's funded ratio was 89% in on 6/30/2017, and the net pension liability was $23.4 million.

- *Other Postemployment Benefits:* In the opinion of the Finance Transition Team, the City's OPEB liability for retiree health insurance is of equal importance to the City's pension liability. The funding concept behind both is that today's taxpayers should bear the cost to fund the pensions and retiree health insurance earned by the workers who are currently providing services to those taxpayers. The cost of neither should be the borne by future taxpayers who will receive no services from those employees once they retire. If the City is going to promise pensions and health insurance to its retirees, the City should fund the cost of both as those benefits are earned.

  - The City joined the Maryland Association of Counties (MACO) Other Postemployment Benefit Trust in 2015. Prior to 2015, the City had accumulated no assets to pay OPEB liabilities for retiree health insurance.
  - In FY2016, the ADC for OPEB was approximately $4 million, but the City contributed approximately $2 million, only half of the required amount. The plan's funded ratio on 6/30/16 was only 5%, and the unfunded liability was $50.7 million.
  - The City plans to fund its OPEB liabilities by contributing to the trust an amount equal to 2% more than the amount of benefits that will be paid out in any year. By contributing only 2% more than the pay-go cost of the current year's benefits, it is highly unlikely the City will ever reach the point where it is making the ADC to the OPEB plan.

The actuarial assumptions used to determine the ADC are aggressive in the opinion of the Finance Transition Team, and the Deferred Retirement Option Program (DROP) is not cost-neutral.

- The pension actuarial assumptions include a 7.5% return on investments. Given that market rate of return from 1996-2006 was only 6.5%, the Finance transition team believes a 7.5% assumption is aggressive. Lowering the investment return assumption to 6.5% doubles the net pension liability from $23 million to $46 million and decreases the funded ration from 88% to 78%. (Boomershine). The fiscal impact of the

DROP depends on how it affects retirement patterns. It is designed to be cost-neutral, but a recent valuation from Boomershine shows it is not.

- Boomershine evaluated the cost of the DROP under three different scenarios that make different assumptions about retirement patterns. Under one scenario, the DROP costs approximately $700,000; under a second scenario, it costs approximately $1.2 million; and under the third, it saves approximately $1.2 million. Under no scenario is it cost-neutral.
- Under the provisions of the pension plan, the DROP is to be evaluated every three years, and if it is not cost-neutral, the City and the public safety unions are required to negotiate amendments to achieve cost-neutrality. If they are unable to reach an agreement, no new participants may be enrolled in the DROP.

The Parking and Transportation Enterprise Funds owe significant amounts to the General Fund. Additionally, the Transportation Fund operates at a deficit every year, requiring significant, recurring subsidies from the General Fund.

- As of 6/30/16, the Parking Fund owed the General Fund $5.7 million.
- As of 6/30/16, the Transportation Fund owed the General Fund $2.1 million.
- Additionally, the General Fund provides significant, recurring subsidies to the Transportation Fund.
  - FY2012: $817,033
  - FY2013: $2,80,101
  - FY2014: $3,624,230
  - FY2015: $2,467,054
  - FY2016: $7,479,098

The Self Insurance Fund also has recurring deficits.

- The Self Insurance Fund had deficits at the end of each fiscal year 2013 – 2016.
  - FY2012: ($3,717,433)
  - FY2013: ($3,703,006)
  - FY2014: ($3,769,268)
  - FY2015: ($3,372,849)
  - FY2016: ($785,498)
- Unaudited information provided by the Office of Finance shows the fund's position improved in FY2017, and the Finance Office is projecting an $800,000 surplus. However, when broken down to its components (health insurance vs. workers compensation, general liability, and other insurances), the unaudited FY2017 numbers show a negative position of approximately $112,000 for health insurance, and a surplus of approximately $915,000 for workers compensation and other insurances.

The City is unnecessarily paying more than required by State law for workers' compensation disability payments and more than necessary to make an employee "whole."

- Under State law, when a worker is temporarily totally disabled, the worker is entitled to workers' compensation equal to two-thirds of the worker's average weekly wage, not to exceed a limit on the weekly wage imposed by the State (currently $1,094/week). These disability payments are not subject to income taxes or FICA (social security and Medicare taxes. The State ordered amount of two-thirds of pay, on which the employee pays no income taxes or FICA, is commensurate with the employee's regular full pay with income taxes and FICA.

  The City has structured its payments for temporary total disabilities such that the employee is paid their full regular pay, subject to FICA and income taxes. Consequently, for an employee earning $56,888 or less, the City is unnecessarily FICA at 7.65% ($4,352 for an employee earning $56,888), and the employee is unnecessarily paying both FICA and income taxes. Structuring the payments this way is clearly more costly for the City, and it may be more costly for the employee, depending on the employee's income tax bracket.

The City's vehicle fleet is aging. Maintenance costs are high, and the City has no reserves accumulated for vehicle replacements.

- The City has approximately 210 automobiles, pickup trucks, and SUVs.
  - Approximately 85 of these vehicles are 10 years old or more (2007 and prior). The oldest vehicle is 21 years old.
  - Approximately 60 of these vehicles have more than 100,000 miles. The highest mileage is approximately 192,000 miles.
- The Fire Department has expressed the need to purchase a new ladder truck with a cost of approximately $1.2 million.
- The City's fleet of buses is aging as well.
  - The useful life of a bus is approximately 10 years/350,000 miles.
  - This City transit department has 17 buses that range in age from 2004 – 2011 models.
  - Mileage ranges from approximately 38,000 – 450,000 miles.

The Capital Budget (FY2018) and Capital Improvement Plan (FY2019 – 2023) rely heavily on bond funding, including bond funding for large vehicle replacements and continuing infrastructure maintenance. Recurring expenses for vehicle replacements and infrastructure maintenance are more appropriately funded with recurring revenue, not bonds or one-time funding.

- Only $1.6 million of the City's $18.1 million FY2018 capital budget is funded with pay-go. Bond funding is budgeted for large vehicle replacements and recurring infrastructure maintenance, such as water and sewer rehabilitation projects. Recurring vehicle replacements and infrastructure maintenance are more appropriately funded with recurring revenue. According to City management, the City plans to begin funding 40% of utility capital projects with pay-go funding in FY2019, unless there are significant changes in the utility rates study due to be completed in May 2018.

The City has been unsuccessful in receiving an increase in the payment received from the State to help offset costs the City incurs because the State capital is located here. The $367,000 payment has not changed since 2006.

- The City has not been successful in working with the State to develop an agreed-upon, objective formula to determine the amounts the State will pay to help offset the costs incurred by the City, as recommended in 2008 by the Annapolis Blue Ribbon Commission on the City of Annapolis Finances.
- The schedule attached to the letter sent by former Mayor Pantelides to Governor Hogan listing $3 million of expenses includes items that the Finance Transition Team believes would be incurred by the City regardless of whether it were the State capital or not, such as $1.5 million to replace and staff a ladder truck in the Fire Department.

The City's independent auditors (CliftonLarsonAllen, LLP, or CLA) have repeatedly found material weaknesses and significant deficiencies in internal control over financial reporting and federal grants, and in fiscal year 2016, CLA issued a qualified (not "clean") audit opinion on the City's federal transportation grants.

- A "material weakness" is a deficiency or combination of deficiencies in internal control such that there is a reasonable possibility that a material misstatement to the financial statements would not be prevented or detected and corrected on a timely basis. A "significant deficiency" is a deficiency or combination of deficiencies in internal control that is less severe than a material weakness, but important enough to warrant the attention of the Mayor and City Council. Details of the material weaknesses and significant deficiencies are found in the Single Audit Reports obtained from the Office of Finance.

- The following audit findings are of particular concern to the Finance Transition Team members:
  - CLA issued a qualified (not "clean") audit opinion on the City's compliance with "prevailing wage" requirements on Federal Transit Cluster grants.
  - CLA has repeatedly noted material weakness attributable to (1) limited staffing and turnover in the Office of Finance and lack of review over financial data; (2) management's unfamiliarity with federal grant compliance requirements; and (3) lack of controls to ensure accurate identification and reporting of federal grants on the Schedule of Expenditures of Financial Awards.
  - The Office of Finance has been unable to issue its audited financial statements timely and by the deadline established in state law for at least the last six years.
    - The City Code requires the Director of Finance to submit an annual report to the City Council no later than the second Monday in October following the end of the fiscal year, and State law requires the City to submit its annual audited financial statements to the State Office of Legislative Audits by October 31 following the end of the fiscal year.
    - Fiscal year 2012 – 2016 audited financial statements were issued in February or March following the end of each fiscal year.
    - The Fiscal Year 2017 audited financial statements have not yet been issued as of January 22, 2018.

Appendix 2: Details to Support Our Budget Assessment

The City lacks codified controls on spending.

- The City Charter and City Code do not include provisions that make it a violation of City law for a department to spend or enter into a contract to spend amounts in excess of those appropriated in the budget.
- There is no provision requiring the Finance Director to certify the availability of funds and sufficient appropriations before a department spends money or incurs a liability.
- There is no requirement prohibiting the Administration from executing a multi-year contract that would bind a future City Council to appropriate funds.

Neither the operating nor capital budgets are specific enough to serve as an effective tool for the Mayor and City Council to set policy and communicate priorities.

- *Capital Improvement Program (CIP):*

    - The CIP does not disclose or define how capital projects are linked to the City's Comprehensive Plan.
    - The CIP does not define the scope of each project and limit expenditures to the defined scope.
    - The CIP does not disclose the current status of existing capital projects, including the amounts of prior approved appropriations, expenditures, and encumbrances to date.
    - The CIP does not identify changes in cost, scope, timing, and funding sources from one year to the next.
    - The CIP does not define "Other" funding sources for current year capital projects.
    - The CIP does not identify any funding sources for capital projects programmed in the "outyears." The CIP does not disclose amounts that will be needed in years beyond the last year of the CIP. For example, the CIP would not disclose the total cost of a $5 million project if $4 million were programmed in the last (sixth) year of the CIP, but the remaining $1 million would be incurred in year 7. In the CIP, this project would appear to be only a $4 million project.

- *Operating Budget:*

    - The proposed operating budget shows (1) the revenues and expenditures requested for the upcoming year, (2) the budget for the current year, and (3) a three-year average for the preceding three fiscal years (e.g., the FY2018 request, the FY2017 budget, and average for FY2014 – FY2016). It does not, however, show (1) projected revenues and expenses for the current year, or (2) the actual revenues and expenditures for each of the previous three fiscal years (it shows only the average).

      Providing a comparison of the current year budget to (1) projected revenues and expenditures for the current year, and (2) actual revenues and expenditures for each of the three previous years would enhance the Mayor, the City Council, and the public's ability to understand and evaluate the budget request for the upcoming year, including whether the projected revenues are attainable and whether the appropriations requested are adequate, more than needed, or insufficient.

      Example: The Police Department's expenditures exceeded its appropriations in FY2013 – FY2016, from amounts ranging from $158,000 to $647,000. According to the Director of Finance, the department overspent its budget again in FY2017, and the Police Department might overspend its budget again in FY2018, depending on overtime expenditures.

      This pattern of excess expenditures is not disclosed in any budget documents – not in the budget spreadsheets compiled by the Office of Finance or in the MUNIS budget reports provided to the alderpersons. (MUNIS is the City's financial management software). While the MUNIS reports purport to show the FY2017 budget compared to projected expenditures, the projected expenditures are equal to, not in excess of, the budget, even though the FY2017 over-expenditures could have been projected when the City Council and Mayor were deliberating on the FY2018 budget.

Also, when a department's appropriations are not sufficient for its needs, best budget practices would require the department to seek additional appropriations before the end of the fiscal year, providing an opportunity for the alderpersons to question of why the original appropriations were not sufficient.

- Nonallocated costs in the General Fund (those costs that aren't assigned to a particular department) comprise Debt Service, Other Financing Uses and Transfers, Contingencies, Insurance Fund Contributions, and OPEB/Pension Contributions. However, the level of detail shown is not sufficient to determine or evaluate the appropriations requested. For example:
  - The appropriation from the General Fund to the Self Insurance Fund combines amounts for employee health insurance with amounts for workers' compensation, general liability, etc. Combining these contributions into one appropriation makes it impossible to evaluate whether the City has set the appropriate rates to generate sufficient revenue for each segment.
  - Combining the appropriations for pension and OPEB contributions into one line item makes it impossible to determine how much is budgeted for each compared to the actuarially determined contribution.

There is a lack of consistency in budget reporting detail. Budget amendments adopted by the City Council are not disclosed in published budget documents.

- The proposed operating budget published on the City's website includes details by fund, department, and line item expenditure category, but the final budget published on the website does not include the same level of detail.
  - The proposed FY2018 published on the website is 33 pages: The first 8 pages summarize revenue and appropriations for expenditures by fund and department, followed by 25 pages of line item detail.
  - The final FY2018 budget published on the website is only the first 8 pages that summarize revenues and expenditures by fund and department. It does not include the 25 pages of line item detail.
  - In the proposed FY2018 budget, General Fund expenditures total $74,005,023, but the final budget was $74,141,524, an increase of $136,501. However, the amendments enacted by the Mayor and City Council are not disclosed, and one cannot tell which line items changed. This lack of transparency and detail makes it impossible to tell from the published documents what action was taken by the Mayor and City Council.

The City budget is prepared using complex, extensive Excel spreadsheets that are time-consuming to prepare and subject to data entry errors.

- The MUNIS system has a budget module, but the Office of Finance does not use it to develop and present the budget to the Mayor and City Council. Instead, the department develops the budget using extensive and complex Excel spreadsheets that time-consuming to prepare and subject to data entry errors. Some stakeholders found it difficult to follow the spreadsheets and understand how they interfaced with MUNIS documents that were provided to the Mayor and City Council.
- The spreadsheets used to develop and present the budget are highly dependent on the knowledge of the Director and Assistant Director of Finance. Turnover in those key positions could affect the development of the budget.

Appendix 3: Details to Support Our Procurement Assessment

The Charter and Code of the City of Annapolis, at Section 2.20.030, establish the City's purchasing and procurement function under the responsibility of the Director of Finance. In turn, the Director of Finance must appoint a purchasing agent who must manage all phases of the purchasing and procurement process. Further, the Director of Finance must promulgate regulations to implement a centralized purchasing and procurement process, which become effective 45 days after transmission to the City Council, unless the City Council registers an objection by a resolution.

The documents the Finance transition team found online or received from Office of Finance were:

1. City of Annapolis Procurement Policy and Procedure Statement (undated, 5 pp.)

2. Central Purchasing – New City Council Transition Notes – December 2017 (1 p.)

3. A Purchasing/Procurement document (70 pp.) that begins with a "Statement of Policy" and includes seven sections: I. Introduction; II. Organization; III. Purchasing Principles; IV. Purchasing Policies; V. Purchasing Department, Forms and Their Use; VI. Purchasing Department Procedures; and, VII. Intra-Departmental Policies.

   At first glance the Finance Transition Team thought the policies in this document collectively constituted the City's procurement law or regulation or policies. However, the Office of Finance staff informed that this document is no longer in effect. This left us wondering whether any Procurement Regulation was ever adopted or implemented and what presently codifies or states the comprehensive procurement policy of the City. This remains unclear.

4. City of Annapolis Procurement Function Review and Recommendations (Dated April 1, 2014; 46 pp.). This document references Document 3 above and makes findings and recommendations regarding the creation and adoption of a comprehensive procurement policy document.

5. Sample boilerplate language used by the purchasing agent for invitations for bids (IFBs) – Construction Services, Bywater Park Improvements (IFB 17-17).

6. Sample boilerplate language used by the purchasing agent for requests for proposals (RFPs) - Stormwater and Flood Mitigation, Engineering and Design Services (RFP 17-14).

7. Boilerplate language used by the purchasing agent for construction invitations for bids (IFBs) and requests for proposals (RFPs), including AIA documents.

8. Sample Engineering Contract.

9. Sample Construction Contract.

A main take-away from the information provided is that the City's Director of Finance currently has not adopted and promulgated regulations to implement a centralized purchasing and procurement process, despite the requirement to do so under Charter Section 2.20.030.

<u>Document 1: City of Annapolis Procurement Policy and Procedure Statement</u>

Document 1 is a five-page "Procurement Policy and Procedure Statement." The document includes bullets denoting different methods for soliciting goods, services, or construction based on different dollar thresholds. It specifies, among other things, that a purchase less than $25,000 (in other places it says "up to $25,000," leaving an ambiguity regarding the handling of a solicitation valued at precisely $25,000) requires "the exercise of sound business practices," while a procurement over $25,000 ($50,000 for construction) requires a formal competitive bid/proposal process.

Additionally, the document has bulleted items stating information related to notice; opening of offers; evaluation by the procurement officer or review committee based on criteria that must be included in an IFB or RFP; addressing mistakes in bids; and selection of the lowest responsible, responsive bidder (IFB) or highest-ranked responsible offeror (RFP). The document also discusses several procurement methods that may be used as exceptions to the solicitation methods and dollar thresholds noted earlier, including a sole source procurement, emergency procurement, "for the public good procurement" (not clear what this means exactly), contract scope expansion, cooperative purchasing, specialized professional services, and independent contractors to augment personnel services. The specifics of each type of solicitation method are not clear, and the document appears to be missing other potential solicitation methods, including bridge contracts, public entity contracts, and competitive negotiations.

The document also limits contract terms to five years and states that the City shall not enter into a contract unless funds are available for the first year of the contract. ***This language should be modified to be clear that any purchase under the contract is subject to and contingent upon the available appropriated funds encumbered to the contract.*** The document also contains bulleted items for when the City may increase the quantity of supplies or services, or both, in a contract. The language in the document is somewhat cryptic, incomplete, and not comprehensive; it should be reviewed for content and clarity; and it does not appear to be an adopted regulation or policy.

Document 2: Central Purchasing – New City Council Transition Notes – December 2017

Document 2 is a brief, bulleted description of some of the functions undertaken by Central Purchasing. It is not, and does not purport to be, a law, regulation, or policy.

Document 3: A Purchasing/Procurement document that begins with a "Statement of Policy"

Documents 3 is a compilation of policies that were effective in or around 1996. The status of these policies is unclear. The policies include language that may be useful in putting together a comprehensive procurement regulation, but the document does not itself serve that purpose. Additionally, it is incomplete in many respects and redundant in others, so a careful review of the document would be required in order to create a clear, concise, complete, and comprehensive procurement policy.

Document 4: City of Annapolis Procurement Function Review and Recommendations

Document 4 appears to have been an effort in 2014 to enlist the services of NIGP Consulting to review, analyze, and make recommendations concerning Document 3 and to better develop a Procurement Manual that encompasses purchasing policies and procedures, procurement processes, existing documents and templates, and the proposed P-Card program documents. By analyzing and drafting language that draws from and uses provisions in Document 3, in a manner in accordance with the recommendations in Document 4, these documents may serve as a good starting point for City management to draft a proposed procurement and purchasing regulation.

While a detailed explanation and analysis of Document 4 is beyond the scope of this memorandum, suffice it to say that this document contains a helpful synopsis of all of the policies contained in Document 3 and provides suggestions on improving each of the policies, as well as identifying redundant or overlapping policies that should be reorganized, combined, or eliminated. It also highlights the need to ensure that the provisions capture the City's intent regarding how it wishes its purchasing function to operate, as well as applicable law at the time of the drafting of a regulation. Additionally, provisions need to take into account current industry, market, and economic conditions so that the provisions are meaningful and appropriate in the current purchasing environment. For example, the $25,000 threshold beyond which a full, formal competitive solicitation is required ($50,000 for construction) may need to be revisited to determine whether efficiency would be enhanced by increasing these dollar thresholds to allow less formal solicitations up to a higher amount without compromising open, fair, and impartial processes. Also, the City needs to be sure the dollar amount for construction solicitations, performance bonds, labor and material bonds, and retainage comport with the Maryland "Little Miller Act" and other federal and state laws. In short, Document 4 appears to be a good place to start in identifying the subject areas and developing policy language that would be helpful to include in a regulation.

Documents 5 through 9 are samples of solicitation and contract documents the City is using. A detailed analysis of these documents is beyond the scope of our analysis. However, these documents include language for goods, services, or construction that delineates how the City addresses many issues related to purchases including contract disputes, solicitation protests, termination for cause, liquidated damages, FLSA Standards, Equal Opportunity and other laws, assignment of contracts, subcontracting, governing law, modification of contracts, and termination for convenience that may be helpful to include in purchasing regulations and in solicitations and contracts.