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MEMORANDUM

To: Teresa Sutherland, City Manager, City of Annapolis, Maryland

From: Joseph Mason, SVP, Davenport & Company

Jennifer Diercksen, FVP, Davenport & Company

Date: May 14, 2019

Subject: Planned Use of Fund Balances

Overview

You have asked Davenport & Company LLC (“Davenport”), in our role as Financial Advisor to the City of Annapolis (“City”), to comment on the City’s planned use of fund balance in various funds (including General, Restricted, Internal Service, and Enterprise funds) as part of the Fiscal Year 2020 budget adoption process. We are in receipt of several excerpted pages from the City’s budget and other planning documents that detail the projected use of fund balance in fiscal years 2019 and 2020, including the “Fund Balances Summary”, “Supplement to Page 18 Showing Compliance with City Code”, and “Supplementary Explanations to Page 18 (Use of Fund Balances in FY2020 Proposed Budget)”. We also have the City’s adopted debt and financial administration polices as set forth in Resolution R-31-18. Based our review of these documents, our experience with best practices in municipal finance and our understanding of rating agency criteria, we offer the following observations:

General Fund Observations

- The City’s debt and financial administration policies (“Policies”) are as carefully constructed as any we have come across in our experience with dozens of state and local governments throughout the region.

- The Policies regarding General Fund unassigned reserves are designed to preserve, and ultimately enhance, the City’s strong Aa2/AA+ credit ratings. They set forth a minimum level of reserves be maintained and require a supermajority vote to spend below the reserve minimum threshold. Any balances that have accumulated above the level required in the Policies are spendable, but only on non-recurring, one-time expenditures.

- Such periodic use of unassigned fund balance, over and above that required by local policy or law, is a common practice throughout Maryland and nationally. Governments can’t predict precisely whether their annual budgets will end in perfect balance, with a deficit, or a surplus. Therefore, most financially responsible local governments will budget revenues and expenditures conservatively and, when economic conditions are sound, this practice often yields an annual budgetary surplus. When these surpluses begin to accumulate in unassigned fund balance, amounts not needed to meet reserve requirements (which exist to protect against an economic downturn) can be spent down.

- By limiting spending of accumulated reserves to non-recurring items, such as pay-as-you-go cash funding of capital projects, a local government eliminates the risk it will have to find another source of revenue to fund spending in subsequent budgets.

- The City’s Budget Stabilization Fund (“BSF”) and Capital Reserve Fund were set up to provide guidance to Council and Staff on how best to divide up any annual surpluses the City might experience. One half of any surplus is to flow the the BSF until it reaches the 3% level prescribed in R-31-18. Once the 3% requirement is met, any monies that would normally flow to the BSF are available for the purposes described in the resolution, including “appropriated for one-time expenditures”. The other one-half of any annual surplus is to flow to the Capital Reserve Fund for use only for “pay-as-you-go funding for capital improvements”.

- The proposed budget documents and the accompanying narrative explanation of the proposed spending are entirely consistent with the Policies as they were designed to work. Moreover, the proposed expenditures and the use of accumulated surplus fund balance for one-time items is consistent with municipal financial best practices and rating agency criteria and expectations.

Other Fund Observations

- As identified in the narrative summary explanations, the use of balances in the various Restricted Funds for the purposes for which the restriction exists are an acceptable practice. One would expect periodic expenditures for program-restricted funds as balances accumulate.

- Spending of balances in the City's Self-Insurance Fund is consistent with the nature of the fund as an Internal Service Fund of the City. Internal service funds provide goods and services to other departments of the government with the goal of "breaking even" over time. Payments go into the fund on annual basis, typically pegged to a supporting analysis or actuarial report that recommends the level of funding. When balances begin to significantly exceed what is needed to support the annual operations of the fund, it is normal and customary to appropriate excess balances.

- The use of a portion of fund balance in the Watershed Restoration Fund to cash fund a capital project that is germane to the fund's purpose is a legitimate use of such balances, particularly in lieu of taking on more debt.

- As an Enterprise Fund of the City, the Refuse Fund should be run as a business, in keeping with a long-range strategic plan. The strategic plan for the Refuse Fund was prepared by Stantec, the City's rate consultant. Instead of calling for increased rates to customers, the Stantec plan calls for use of existing balances for operations. Balances will, presumably, be restored from future rate increases.