CITY OF ANNAPOLIS
INTER-OFFICE MEMORANDUM

TO: Gavin Buckley, Mayor
CC: Thomas C. Andrews, City Manager
Ross H. Arnett III, Alderman/Chair of Finance Committee
Frederick C. Sussman, Chair of Financial Advisory Commission

FROM: Bruce T. Miller, Finance Director

DATE: February 22, 2018

RE: Report of the Finance Transition Team

The following memorandum is intended to provide a response to the weaknesses and recommendations highlighted in the Report of the Finance Transition Team prepared by Teresa Sutherland, Dan Nees and Richard Melnick.

Section 1: *Weaknesses identified within: Assessment of the City's Fiscal Condition and Financial Policies and Procedures*

- ***The City has a weak debt and liability profile.*** While some specific debt-related metrics might be above average, the City's overall debt profiles on both the General Fund and Water/Sewer utility side remain manageable according to the rating agencies and evidenced by the fact that the City has had recent positive movement in both ratings which would not have occurred if the rating agencies believed that the City's debt profile was weak..

  Specific observations follow:

  - Moody's notes that ***"Debt burden is above-average 1.7% of full valuation"***
    i. While the debt burden might be above average compared to national peers, when compared to state and regional peers, the average debt burden is 2.2%.
    ii. 1.7% debt burden is still in the "Strong" or "Aa" category on the Moody's scorecard.
    iii. While the debt burden is above average compared to national peers, Moody's also cites that "The city's debt burden is expected to remain manageable over the near-term given modest tax base growth and the self-supporting nature of the city's water and sewer system" in the same June 2017 rating report. Furthermore, that same report also includes the following statement, "Despite future borrowing plans, we believe the city's debt burden will remain manageable given management's policy to maintain debt service costs below 12% of annual expenditures."
    iv. Debt burden is not listed as a challenge in the Moody's June 2017 report.
    v. Moody's would not have kept the positive outlook for the City if they believed the City's debt profile was overleveraged.

  - S&P notes that ***"Debt is 8.6% of total governmental expenditures"***
    i. Industry-accepted threshold for this measurement is 10% of expenditures.
    ii. This metric was not cited as issue in either the Moody's or Fitch rating reports.

   iii. This metric will improve with the implementation of the City's recently adopted BAN strategy.

- Moody's notes that ***"Principal amortization is below average at 51% of principal retired in the first 10 years"***
   i. Includes Water and Sewer debt that has a longer useful life compared to general government debt. As the General Obligation Water and Sewer debt matures, the payout ratio should improve to a level more in line with peers.
   ii. True tax-supported debt of the General Fund had a payout ratio of 62% as of April 2017.

- ***"The City has above average utility debt ratios that are expected to remain high as additional debt is anticipated and existing debt amortizes slowly."***
   i. Despite having above-average debt ratios, Moody's recently upgraded the Water and Sewer Enterprise, and the other system metrics remain strong and offset the debt profile. Those factors primarily being a strong service area, strong coverage, and an annual rate adoption process.
   ii. As compared to general fund activities, utilities have higher debt ratios due to the fact that they provide services that need a highly capitalized asset base; e.g., processing and distribution assets.

- Moody's notes that ***"From FY2012 to FY2017, utility debt increased from $17 million to almost $60 million while operating revenue remained flat at $15 million"***
   i. This increase in debt is primarily reflective of the financing for a new water treatment plant that is a multi-generational project and is in compliance with all environmental regulations.
   ii. While revenues have remained level over the last five years, the City adopted a policy whereby an external rate study would be conducted annually. As such, any needed rate increases that would be required to cover debt service in any given year is adopted through this process.
   iii. In addition, the systems coverage was a strong 2.62x in FY 2016, well above the 1.25x and 1.0x rate covenants for the senior and junior liens, respectively.

- Fitch notes that ***"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."***
   i. As stated above, the system's other factors, such as strong service area, coverage levels, and rate adoption process help to offset debt metrics. In addition, debt metrics are high due to financing of the multi-generational water treatment plant.

- Moody's notes that ***"The ratio of total debt to operating revenues is 4.0, which is above average. With plans to issue approximately $5.8 million" in FY2018, the debt/revenue coverage will increase to 4.5 times."***
   i. While this ratio might currently be above national medians, it is still within the "AA" rating category on Moody's Municipal Utility scorecard.
   ii. In addition, this calculation does not factor in any additional revenue growth that might occur over the same timeframe due to subsequent rate increases.

- Fitch notes that ***"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%."***
    i. The same paragraph in Moody's report goes onto state, "…all debt matures within 30 years, in line with the useful life of the assets." While not specifically stated in the Fitch report, the same logic would apply.

- Fitch notes that ***"Debt/customer of $2,460 is well above the "AA" category median of $1,823. With additional debt issuances planned, debt/customer could increase to over $3,200 in fiscal 2022."***
    i. This debt metric should decline with the expected increase in pay-go funding over the medium-term.

- Fitch notes that "***Debt financing will account for 67% of funding of the current CIP. City management has represented to the bond rating agencies that is plans to gradually increase pay-go spending to 40%."***
    i. That same rating report also states that, "Fitch considers prudent the planned annual capital investment as the system's plant age is high at 28 years, as of FY 2016.
    ii. In addition, the report also states that this increased pay-go effort will be supported by upcoming rate increases.
    iii. Ultimately, increasing the pay-go amount will help to bring down some of the currently elevated debt metrics.

- ***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 underfunding of the Police and Fire Pension and OPEB Plans are issues that represent ongoing challenges and, therefore, will need ongoing City oversight. However, as compared to national averages for municipal Pension and OPEB plans, the City plans are well funded and managed. As in the recent past, solutions to increase funding for these plans will continue to be evaluated and implemented when appropriate. Moody's and Fitch both state that total fixed costs (pension, OPEB, and debt service) are "moderate."

  See below for additional comments.
    i. The City's funding of ADC for the Police and Fire Pension Plan has increased in recent years. With the conclusion of Interest Based Bargaining in 2012, the combined employer/employee contribution rates increased to 26%; 18% employer contribution plus 8% employee contribution
    ii. As of June 30, 2017 the City was $390,000 short of meeting the Pension ADC and $1.4M short of meeting the OPEB ADC. Future adjustments to both plans will be part of the union negotiations for FY 2019.
    iii. It should be understood that OPEB is considered a softer liability than Pensions; Fitch categorized the OPEB liability as "low" in their June report. In addition, most local governments are not currently funding the OPEB ARC, while Annapolis funded 50% of its ARC in FY 2016.

- ***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*.**
    - Oversight of the actuarial assumptions is a high priority since they dictate the Plan's financial condition and, as such, they are evaluated on a regular basis. The last review was completed by the City's previous actuarial firm, Cheiron. The next review will be completed after FY 2018 is completed. It should be noted that the City has already had discussions relative to this issue with its new actuarial firm, Boomershine, City Administration and staff, Council members, FAC members and with union membership. It is anticipated that after these assumptions are reviewed comprehensively in late summer/early fall of 2018 changes will be recommended to the City Council.

      Relative to the assumed rate of return, this issue has been discussed regularly. The previous Retirement Plan consultant, Gallagher, considered returns of 7.5% obtainable and defensible which was also articulated by several other consultants. However, in conversation with Boomershine and the current Plan consultant, AndCo, it has been determined that the assumed rate of return of 7.5% may be high. An Experience Study will be conducted to evaluate all of the actuarial assumptions in FY 2019.

    - Boomershine recently concluded an evaluation of the DROP's cost neutrality and determined that it was not cost neutral. However, the DROP is subject to negations so unilateral changes cannot be made, but rather changes need to be bargained as outlined in the union agreements. This is currently being negotiated and the City is working with Boomershine to provide alternatives to make the DROP cost neutral.

    - The Administration is also developing revisions to its fund balance policies to include funding pension and OPEB with current fund balance and/or future excess net revenues.

- ***The Parking and Transportation enterprise funds owe significant amounts to the General Fund. Additionally, the Transportation Fund operates at deficit every year, requiring significant, recurring subsidies from the General Fund.***

  The Parking Fund has been paying down its debt to the General Fund every year. In FY 2016 the City wrote off the net deficit of the Transportation Fund by absorbing it in the General Fund.

    i. In terms of the large receivables, the City has been making progress in reducing these liabilities. Moody's notes that "…while the budget has performed positively in recent years and reserves have increased the city continues to maintain several illiquid receivables on its balance sheet. Approximately, $7.8 million is still owed to the General Fund by the Parking ($5.7 million) and Transportation ($2.1 million) Funds in FY 2016. This is a notable decrease from $17 million in FY 2015 due to the write-off of and the subsequent closure of the Dock and Market Funds and a reduction in the Transportation Fund receivable." In addition, Transportation Funds are typically never self-supporting.

- ***The Self Insurance Fund also has recurring deficits.*** While historically the Self Insurance Fund has operated at a deficit, FY 2017 had a positive net position of $802,488. Further, the city has further delineated insurance activities in order to capture activity separately. This will also allow the Administration to expand rate setting and fund balance policies to ensure adequate coverage.

- **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 has already taken operational steps to reducing worker's compensation claims and has developed new procedures. However, these procedures need to be negotiated with the unions before implementing them. This will be discussed during current union negotiations.

- ***The City vehicle fleet is aging. Maintenance costs are high, and the City has no reserves accumulated for vehicle replacements.*** Historically, the City has budgeted annually for a contribution to the Vehicle Replacement Fund for the replacement of City vehicles in all funds. In FY 2017 the contribution to the Vehicle Replacement Fund was eliminated from the General Fund due to budget restraints; however, the enterprise funds continue to contribute. Furthermore, there is a Capital Reserve Fund from which the City Council could appropriate for vehicle replacement.

- **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.** The City has been working towards funding recurring expenses for vehicle replacements and infrastructure maintenance with pay-go. The FY 2018 Capital Budget included the utilization of the Capital Reserve Fund (Fund Balance) to pay for continuing infrastructure costs. Additionally, there has been ongoing discussion relative to adding additional pay-go 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 City agrees with this assessment; however, it has been very difficult to identify new funding sources within the state budget to allocate to the City.

- **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.** The FY 2017 audit did not include any material weaknesses in the financial reporting or the federal grants. There was one significant deficiency in internal control in the Office of the Fire Marshal due to the inaccurate calculation of permit fees and oversight. The Finance Office has been taking necessary steps in providing staff with adequate resources to expand their knowledge base and enhance their credentials via training, education and certification as a Government Finance Officer.

In conclusion, the City, including; staff/Administration, FAC, City Council and Mayors have been very focused on the City's debt profile and management during recent administrations. Financial policies, including debt policies, have been reviewed and updated where needed along with enhancing relationships with City's financial partners, including Bond Council, Financial Advisors, an external Audit Firm and the Rating Agencies. As part of the budget appropriation process, the City's

Financial Statements/CAFR are reviewed paying particular attention to the balance sheet and relevant indicators. We expect that this discipline will continue.

Section 2: The Budget

- ***The City lacks codified controls on spending.*** This issue has been discussed with FAC and the Administration and a report on the subject has been drafted by FAC which is expected to be presented to the Administration and City Council.

- ***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.*** Although we agree that improvements can always be made to provide information and to communicate priorities, the budget schedules provided to City Council, the Capital Steering Committee and Financial Advisory Commission have been defined by these user groups. We will continue to discuss options with these groups to make improvements.

- ***There is a lack of consistency in budget reporting detail.*** Different municipalities reflect appropriations differently based on the desire to control specific expenditures/line numbers. The appropriation is an ordinance which then has restrictions as to how funds can be expended. Essentially, the more detail the appropriation, the more line item number control. The City of Annapolis appropriates its budget by fund, then by department, and then further delineated by aggregate line numbers for salaries, operating and capital expenditures. Therefore, control is maintained by fund and department; however, transfers between line numbers do not need to be approved by the City Council. However, to provide users greater information, additional and more detailed schedules are provided as supplementary information. This was a policy decision made by the City Council which is discussed each year as part of the budget process.

- ***Budget amendments adopted by the City Council are not disclosed in published budget documents.*** We will evaluate ways to improve reporting budget amendments.

- ***The City budget is prepared using extensive and complex Excel spreadsheets that are time consuming to prepare and subject to data entry errors.*** The City's financial system does not provide capability to forecast or to prepare other financial modeling. Rather, it is used to enter departments zero based budgets and then to report/control expenditures during the fiscal year. Furthermore, reporting is limited. That said, it is agreed that other options need to be evaluated in the future. The Office of Finance will continue to work with the Administration and City Council to ensure that they are given effective tools to set policy and communicate priorities. We are currently in the process of implementing budget software to assist in the budget preparation process, and will continue to utilize MUNIS for budget entry. Finance staff monitors the budget to actual revenues and expenses on an ongoing basis to ensure compliance with the budget as adopted.

Section 3: Procurement

The assessments made relating to procurement are accurate and do not differ from what we have been working towards implementing.

Section 4: Infrastructure Financing

- ***The City needs to move towards self-sufficient and balanced enterprise funds for its transportation, parking, and stormwater/green infrastructure programs.***

- While we agree with the assessment that road maintenance should be pay-go, the report categorizes road maintenance as part of the Transportation Enterprise Fund which it is not. As mentioned previously, the City has been working towards funding roadways and other routine infrastructure maintenance via pay-go.

- The City's current enterprise funds are Water, Sewer, Transportation, Parking and Storm-water. These funds are operated to be self-sufficient, and as part of that assessment the City commissions an annual rate study for the water, sewer and storm-water funds. The Parking Fund provides a subsidy to the Transportation Fund, by Code, in the amount $2.4 million during recent years. Therefore, the only enterprise fund that remains challenging is the Transportation Fund which is monitored on an ongoing basis.

- The status of the Hillman Parking Garage has been a topic of discussion in the Capital Budget process for years. It continues to be a concern for the City as to the reduction of revenue when it goes offline, and we have entertained the possibility of revenue bonds to fund the replacement project. The Administration is considering ear-marking a sinking fund as part of fund balance in the event Hillman Garage is taken off-line and a source of funds are needed to replenish on-going revenues.

- The City wrote off the Transportation Fund net deficit in FY 2016 and will continue to do so moving forward.

- ***The City should endeavor to lower its utility debt profile.*** Despite having above-average debt ratios, Moody's recently upgraded the Water and Sewer enterprise, and the other system metrics remain strong and offset the debt profile. Those factors primarily being a strong service area, strong coverage, and annual rate adoption process. We agree that additional pay-go in the near-term will help to lower the system's above-average debt metrics. Through a combination of current cash and additional revenues to be generated from potential rate increases, the City could look to expand its pay-go program. That being said, keeping an adequate amount of cash for unexpected events will also be importance not only from a fiscal standpoint, but also from a credit rating perspective. Another consideration that is part of the debt/pay-go analysis is the sensitivity that current rate payers should not incur an undue percentage of future costs so that future rate payers will share in the infrastructure costs for services they use. Finally, driving all of these decisions is maintaining appropriate rate structures.

Section 5: Preparing for the Future

We agree with the assessment that environmental/climate changes will have a significant financial impact to the City and that appropriate steps need to be initiated.

- ***The City's resilience financing effort must enable more effective engagement and participation with the private sector.*** While we are not opposed to resilience procurement and financing, collaboration with the Office of Finance including the Procurement Office, the City's Financial Advisors and Bond Council is essential for successful outcomes. Because of the potential complexity of these future endeavors, there is an equal need to ensure that activities do not become individual siloes, but are part of a comprehensive process that include all disciplines within the City.

- ***Create a resilience director position.*** As noted above, we agree that the City's future resiliency is imperative; however, because of the complexities of municipal finance, including accounting/financial reporting, procurement and debt management, it is imperative that future endeavors will need to be collaborative.