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October 17, 2016

To: Honorable Mayor Howie Reynolds and Common Council

Re: ***Proposed 2017 Operating and Capital Budget***

Presented herewith for Council consideration is the proposed consolidated **2017 Operating and Capital Budget**. As submitted the proposed 2017 Budget establishes spending across all Funds at ***$43,035.216.*** The 2017 Budget relies on a combination of current revenue, unrestricted reserves, and a general property tax levy of ***$4,825,730*** to achieve a balanced position. The proposed levy represents a modest decrease of less than 1/2% and results in a projected tax rate of ***$7.66.***

As has been customary during my tenure, the budget document is accompanied by a *Budget Transmittal Letter* that is intended to provide the Council background information regarding factors that influence budget preparation. The letter does not, however, delve into the details of individual departmental budgets; a process more effectively managed during the review sessions that will be convened over the next several weeks.

Preparation of the annual budget is certainly not the product of individual effort. Rather it represents the collective effort of city staff to deliver a responsible financial and operating plan for the City of Elkhorn. With that said, I want take to this opportunity to acknowledge and thank each department manager and Finance Department employees for their contribution in bringing this document forward for your review. I would be remiss if I did not also acknowledge the contribution of the Common Council in helping to frame the direction of the annual budget.

BUDGET ORIENTATION

Generally recognized to be the most significant statement of public policy enacted each year by local government, the annual budget serves as the principal financial management and operations plan for the ensuing fiscal period. There is little debate that the fundamental purpose of the annual budget is that of a financial management/control document. However, to suggest that the annual budget is only a fiscal control document is to significantly understate its full potential. Expanding upon this rather narrow view of the budget, the Government Finance Officers' Association identified four (4) broader functions (objections) of a municipal budget.

1. *Policy Document: As an operating plan, the budget should propose, identify, and seek to clarify public policies and organizational goals.*
2. *Financial Plan: The budget is the principal mechanism for prompting sound financial management practices regarding the use and distribution of municipal reserves.*

3. *Operations Guide: The budget should provide a framework for the delivery of services and functional responsibilities of various operating units.*
4. *Communications Device: The budget should serve as a means of conveying information to the public about major issues, trends, and decisions affecting the municipal government.*

Although the municipal budget is prepared annually and most often reviewed and evaluated within the context of a single budget cycle, the current budgetary environment suggests this to be a too limited frame of reference. In fact the annual budget is more appropriately considered from the perspective of the next several budget cycles - decisions made in 2017 will influence the decisions that can or *must* be made in future years.

Consistent with this broader view of budgetary purposes, the proposed **2017 Budget** is intended to address three primary objectives: *to provide a financial plan that maintains the City's capacity to deliver a full range of public services; to emphasize long-term financial integrity and sustainability; and to be mindful of the taxpayer impact of proposed spending.*

CURRENT BUDGET YEAR: A BRIEF REFLECTION

Although the general orientation of the budget is forward looking, a brief review of the current year can be of value since it is the foundation upon which the 2017 Budget is built. While every year experiences a mix of "ups and downs", 2016 has been a generally positive year to date. Increased property values, increased new home construction, and the addition of a new manufacturing operation in the Elkhorn Business Park are among the more positive aspects of 2016.

- *Property Valuation: From 2009 through 2013 the Equalized Assessed Value of property* ***throughout the City declined by more than 16%, bottoming out at $630,725,000.*** *In the subsequent three assessment years, values have risen by roughly 8%. Although still well below the high water value of nearly $755,000,000 in 2008, the 2016 community-wide EAV of* ***$679,260,400*** *does provide an indication that property values are slowly recovering from the effects of the "Great Recession".*

- *Net New Construction: This represents the only factor by which local governments may increase base property taxes on a year-to-year basis under current levy limits restrictions; making it a key budgetary element. Beginning in 2008 net new construction became a non-factor in the City's levy determination. Though a slight uptick in building activity has been evident for the past couple of years, the net increase in value due to new construction has averaged less than 2% in each of the past three fiscal years.*

- *NE Water Treatment Plant: At times a controversial project, construction of the NE Water Treatment Plant commenced mid-summer and is scheduled to be completed by July 2017.* The new facility will serve the community for many years and accommodate anticipated future growth and development of both residential and commercial/industrial properties.

- *Business Park Development: The decision by US Packaging to locate a facility on a 30 acre parcel in the Elkhorn Business Park marked the first significant manufacturing buildout in more than 10 years. The new facility will not only expand the community's job base, it is expected to add more than $10M to the City's tax base when it is fully operational.*

BUDGET DEVELOPMENT FACTORS

The annual budget is influenced by a variety of factors, many of which are outside the direct control of the Common Council or staff (i.e. state legislative initiatives/mandates). Past budget transmittal letters have addressed most, if not all, of these external factors to the extent that exhaustive discussion is no longer a productive exercise. Suffice to say that factors such as levy limits and flat inter-governmental revenues continue to be significant influences, which are recognized to be embedded budget factors that are not likely to change any time soon.

- ***Levy Limits: Property Tax Management***

Since its enactment in 2006, Levy Limits Law has been an embedded fact of "budget life", the influence of which cannot be stated too frequently or too emphatically. It is fair to say that this Law (Act 32) has fundamentally altered the process of budget management for local governments. The Law not only place limits on the current tax year levy, it may also produce a cumulative negative impact on future levy capacity if the annual levy is not prudently "managed". It is the potential of a cumulative negative impact that makes it unwise to consider the levy solely within the context of the current budget year.

Pursuant to Act 32, the annual levy may be increased year-to-year only by the percentage increase in Equalized Valuation (EV) attributable to *"net new construction".* There is, of course, an inherent flaw in a model that presupposes that the cost of operations remains static unless there is growth. In reality, the City's operating costs are affected by a myriad of factors other than growth. Not only does the Law restrict levy increases to the "net new construction" factor, the allowable increase is essentially a "*use it or lose it"* proposition. Coupled with the marginal "growth factor" allowed, the *use it or lose it* feature of the Law, it is generally thought to be in the City's interest to maximize its levy authority in any given year.

The proposed 2017 Budget is based on the premise that it is necessary for the City to exercise its full levy authority each year in order to minimize future financial difficulties. Based on the Department of Revenue's *Report of Changes in Equalized Values*, the city's net new construction factor for the 2016 levy is 1.17%, which translates to a maximum levy increase of slightly more than a ***$35,000*** in the non-debt related base levy.

- **Expenditure Restraint Program (ERP) – Maintenance of Future Funding**

As previously discussed, WDOR reinterpreted the eligibility standards for the Expenditure Restraint Program requiring ***all*** property taxes levied to be accounted for as General Fund revenue/expenditures rather than being assigned as direct levies to other operating Funds.. At the time that this was communicated to the City, it was thought that ERP eligibility for 2017 would be lost, resulting in a $120,000 revenue shortfall. Fortunately DOR did not apply the new eligibility standards in retroactively so the City will retain its eligibility for the 2017 ERP payment. Although ERP funding will be maintained in 2017, the revised eligibility standards represent a further limitation on the City's financial management flexibility. As submitted, the proposed Budget would preserve ERP funding in 2018 but it may necessary to adjust certain discretionary levy amounts if the WDOR determined eligibility threshold varies from the *1.015%* that is projected in the budget.

- **Wages and Benefits**

Wages and benefits tend to be the largest single expenditure in all operating units of the City, which is consistent with the "service industry" nature of municipal government. Although this factor's impact varies across operating departments, the range is between 52% and 80% of departmental budgets. For planning purposes, the proposed Budget assumes a 2.5% wage adjustment factor. With 2016 wages/benefits amounting to about $3.6M, the applied adjustment equates to a $90,000 budget increase. It should be noted that the adopted Compensation Plan is performance-based system so actual pay adjustments will vary from employee to employee but, it is reasonable to project an overall average in the 2.5% range.

BUDGET PROPOSALS

Given the resource limitations of the City in 2017, the proposed budget contains only one proposal that has an impact on true spending levels.

- ***DPW Staffing***

  Since 2005, DPW personnel have been reduced in number from 9 full-time employees to the current complement of 6 full-time slots; one of which is a working supervisor. During this same 11-year period the City population increased by nearly 35%, parks facilities were expanded and street miles have increased as subdivisions and annexed territory were added. A recent man hour inventory (2015) of DPW operations indicated that there are insufficient *productive* hours available to meet essential workload requirements. I would hasten to point out that within the context of the inventory; "essential" tasks are defined in terms of minimally required as opposed to optimal. In a number of areas the available man hours do not allow for "best practice" efforts to be followed. This man hour gap has been bridged by part-time seasonal employees but this strategy covers only about 5 months of the year. To address this long-standing employee deficit, the preliminary budget includes funding for two (2) additional full-time DPW crewman positions at a total cost of $110,000. Wages/benefits will be assigned to General Fund (75%) and Waste Water Utility (25%).

- ***Funding Vehicle Replacement Fund***

  Established as a "sinking fund" that was to have been supported with inter-departmental contributions, the **Vehicle and Equipment Replacement Fund** was an early "victim" of reduced state shared revenue payments and levy limits. Responding to these revenue reductions, contributions to the Fund were suspended in 2009. Partial funding was subsequently restored but the Fund's reserves are not sufficient to sustain the scheduled replacement of vehicles and equipment. Despite having implemented various interim measures to extend life cycle replacements the Fund remains short-funded. In order to augment the Fund balance, each of the past several budgets have included a direct tax levy to the Fund and the proposed 2017 budget continues this approach with a $170,000 tax levy.

- ***TID 3 Closure***

  Although the closing of TID 3 in 2017 will have limited impact on the 2017 Budget, it does have several future impacts worth mentioning. Three highly desirable outcomes will accrue upon closure of the TID, as follows: *1) an estimated $50M will be added to the City's tax base; 2) 50% of the added tax base will be considered "net new construction" for purposes of the 2018 levy limit; and 3) an estimated $1.2M TID surplus will remain; 30% of which is the City pro-rata share*. The latter of these impacts is of importance for the 2017 Budget. Inasmuch as the distribution of the TID surplus is likely to occur in the Q3 or Q4 of 2017 resulting in a one-time capture of an estimated $300,000. Use of the surplus funds is discretionary; however, it probably best to allocate these one-time funds to one or more Funds that are most in need of supplemental revenue. To that end, the Budget proposes to allocate two-thirds (67%) of the TID surplus to the Vehicle Replacement Fund and the remaining one-third (33%) to the Community Development Fund. The rationale for something other than a 50/50 split is based simply on the fact the Vehicle Replacement Fund has been under-funded for several years and that the demand on the Fund is likely to be more immediate and more sizeable than that of the Community Development Fund.

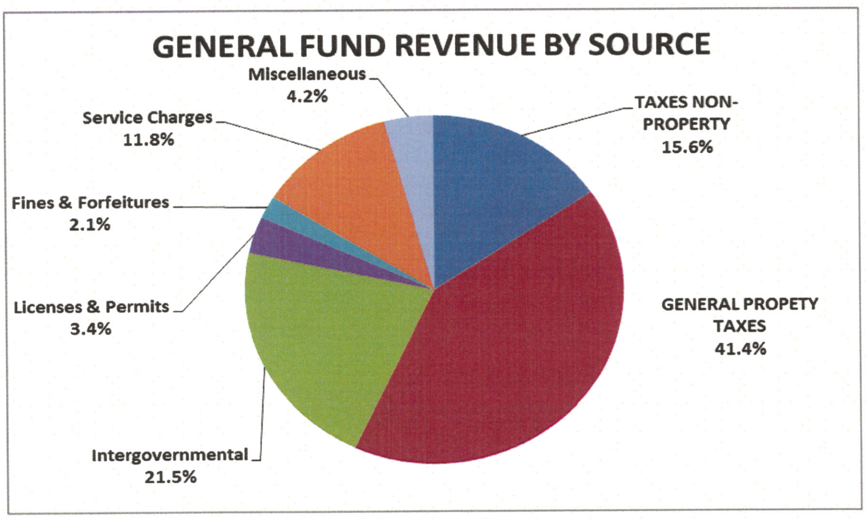
BUDGET IN BRIEF

As noted, it is not the intent of this document to address in detail all aspects of the proposed budget. Rather, the following comments provide a broad overview of financial operations for each of the principal operating Funds of the City. More in-depth review may be undertaken during the several budget review sessions that will be convened prior to passage of the 2016 Budget.

General Fund

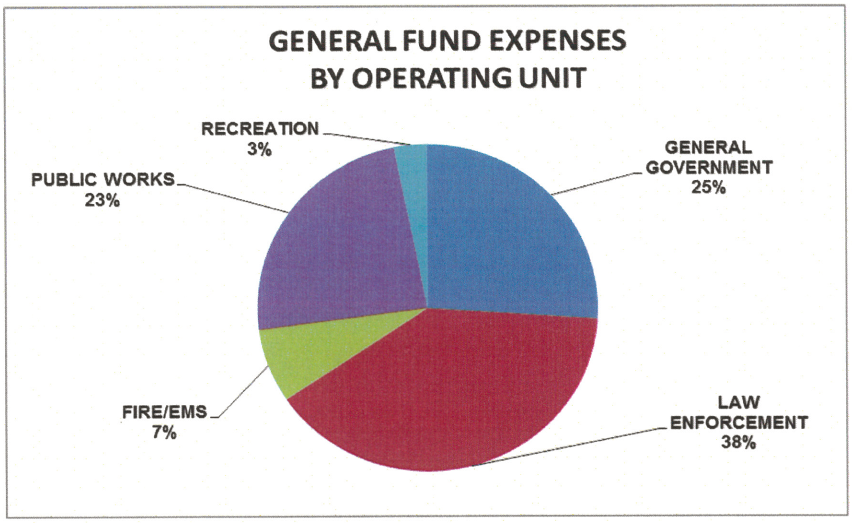
- **Revenues**

Revenue supporting these services is derived from five (5) primary categories as follows: *Taxes $3,195,466 Intergovernmental Revenues 1,132,308; Licenses/Permits $192,110; Fines & Forfeitures $101,026 and Service Charges $640,526.* An additional $222,250 is expected from Interest Earnings and inter-fund transfers. The percentage of total revenue stream attributable to each of these sources is illustrated in the following chart.



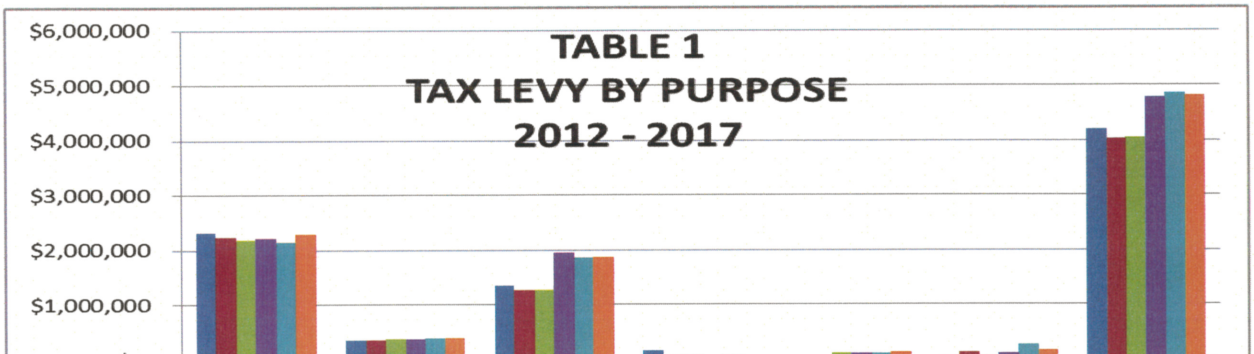
- **Expenses**

The General Fund supports the operations of the major non-utility municipal departments/services, including: *Law Enforcement; Fire/EMS; Public Works; Parks & Recreation; Municipal Court; Legal Services; and Administration & Finance*. As a group these various operating elements are budgeted at $5,488,000, which is less than a 1% increase over 2016 budgeted levels. By operating unit, General Fund expenditures are as follows: *Law Enforcement $2,103,011; Fire/EMS $426,193; Public Works $1,230,239; Recreation $393,199 and General Government $1,344,858.* It should be noted the General Fund contribution to the Health Insurance Retention Account is incorporated with General Government expenses, which accounts for $597,250 (36%) of departmental expenditures. The chart on the following page illustrates the distribution of operating expenses by functional category.



- **<u>City Property Taxes</u>**

As noted in the opening paragraph of this section, the 2017 Budget proposes a general purpose tax levy totaling $4,825,851; a decrease of approximately 1%. Please refer to Table 1 for a comparison of the proposed levy and those in each of the previous four (4) years for each of the various operations supported by the levy.



	General Operations	Library Fund	Debt Service	Ins. SIR	EMS	Vehicle Replaceme nt	Total Levy
2012	$2,325,377	$355,111	$1,343,772	$157,702		$25,000	$4,206,962
2013	$2,241,487	$358,493	$1,263,714	$38,568		$125,000	$4,027,262
2014	$2,175,194	$374,938	$1,263,434	$52,919	$120,000	$55,000	$4,041,485
2015	$2,218,244	$382,446	$1,947,716		$120,000	$120,000	$4,788,406
2016	$2,139,179	$393,685	$1,863,213	$57,513	$121,171	$275,000	$4,849,761
2017	$2,279,888	$395,247	$1,855,595		$125,000	$170,000	$4,825,730

The above Table makes clear the impact of debt service on the annual tax levy, which accounts for about 65% of the total levy increase that has occurred since 2013 and nearly 40% of the 2016 levy. The other major factor impacting the levy has been the EMS *contract-for-service* that was implemented in 2014 and added $120,000 to the levy that same year. EMS had previously operated as an enterprise activity that required no general tax support. In contrast to these two levy elements, the General Fund levy has actually declined slightly since 2012.

Please refer to Table 2 below for a comparison of the household impact of the tax levy on a median valued single-family residential property in each of the most recent tax/budget periods.

TABLE 2
ASSESSED VALUE, LEVY RATE AND HOUSEHOLD IMPACTS
2013-2017

TAX YEAR	BUDGET YEAR	ASSESSED VALUE	LEVY RATE	TAX PAYMENT
2012	2013	$184,683	6.82	$1,259
2013	2014	$179,142	6.89	$1,232
2014	2015	$188,995	7.89	$1,482
2015	2016	$190,885	7.97	$1,521
2016	2017	$196,612	7.66	$1,525

Utility Operations

Frequently overlooked during budget discussions, the City's four Enterprise activities represent a significant segment of the annual budget, accounting for approximately 58% of total operating expenses.

- ***Wastewater Utility***

Following several years of operating on an extremely thin margin with limited or no annual operating surplus, the Utility generated a surplus in each of the last three (3) years, but may end with a deficit for 2016. High flow in the winter and spring months were reflected in exceedingly high WalCoMet charges through May. Volume flows have returned return to expected levels in June-September; however, if the high early months of 2016 are not offset for the remainder of the year a revenue shortfall may be present at yearend. Customers rates are a direct reflection of the rates charged by WalCoMet to its member entities and are based on a 3-year rolling average. It is likely that WalCoMet will adjust rates between 2% and 3%, which would require a similar adjustment to the City's user rates. Any adjustment in City rates will be established once the WalCoMet rates have been adopted..

- ***Water Utility***

The Water Utility is expected to experience a negative cash flow in 2016, which is largely due to deferred maintenance issues that must be addressed as well as a substantial increase in debt service payments While a negative operating position is certainly not desirable, the Fund has accumulated sizeable reserves and will rely on the use of those funds to meet the anticipated shortfall. A rate case filing is currently being prepared by Ehlers for submittal to the Public Service Commission by the end of 2016, which should allow for rate adjustments sufficient to meet the operating and debt service requirements of the Utility.

- ***Electric Utility***

The Electric Utility is expected to realize a "profit" of slightly more than $200,000, a "*return on investment* that is at the lower end of the PSC's allowed rate of return (2.55). Despite the marginal profit generated, the need for a rate adjustment is not considered to be imminent as the Utility will be operating debt-free by the end of 2016. In fact, unrestricted reserves are projected to increase by more than $ 264,000 due to the release and redistribution of previously restricted debt service related funds that are no longer necessary. The balance of the *Bond & Interest* and *Bond Reserve* accounts will be transferred to the Replacement and Capital accounts, which operate as unrestricted reserve accounts.

- ***Solid Waste Services***

The contract with Advanced Disposal, which renewed on January 1, 2016 for eight (8) years, includes a price freeze through December 31, 2017. As a result of this contract provision, the 2017 Budget remains relatively unchanged from the current year. A slight increase for "force account" labor used during leaf/brush collection programs is projected.

CAPITAL IMPROVEMENT PROGRAM: 2017-21

The *2017 Capital Budget* includes three primary project elements as follows: S. *Jackson Street Reconstruction; East Market Street Extension*, and *Intermediate-Level Street Maintenance*. The specific streets to be addressed in the maintenance program will be identified at a later date and the East Market Street extension is a two-year project with the majority of costs to be incurred the following year (2018). One project not budgeted is the installation of a second T-Ball field at Tasch Park. Although the Council previously voted to fund this project, discussion with the Recreation Director indicated that the current complement of fields is adequate to meet the scheduling demands of the Department. For this reason the project has been removed from the 2017 CIP projects' schedule.

The "out years" of the 2017-21 CIP embrace a range of projects that have been under consideration for a number of years but never funded. Included in this group are: *City Hall Replacement or Rehab; East & West Centralia Streets Reconstruction; Annual Street Maintenance Program* and *DPW Maintenance Facility Replacemen*t. If all 2017-21 CIP projects are completed within the next five years, the aggregate cost is estimated to be ***$12,595,000.*** It is assumed that financing will be derived from a combination of General Obligation Notes, General Obligation Bonds, and Inter-Governmental cost-sharing.

A summary of current year projects, as well as those to be considered in future years, is outlined in the text of the budget document, including a proposed financing methodology.

FUTURE CONSIDERATIONS

Much of the narrative of this letter as well as that of the past several years have emphasized the need for a longer term perspective in regard to budgets and financial management. A majority of the issues enumerated, both now and in prior years, are conditions that may be grouped within the broad category of "sustainability, a factor whose importance cannot be overstated. As the City deliberates projects, services, and funding decisions it must be mindful of not only the immediate impact of such decisions but also account for the long-term consequences that may arise "downstream" as a result of an action taken. This is of particular concern when evaluating service expansion matters, which affect operating costs for an extended timeframe. Following are several specific matters for future consideration.

- ***Debt Management***

Prudent debt management is certainly a fundamental consideration in any conversation about financial management and fiscal well-being. The City's adopted *Financial Performance Standards* addresses this factor by establishing two debt related standards: 1*) a maximum level for outstanding General Obligation debt at 70% of the statutory limit; and 2) debt service costs maintained at not more than .2% of equalized assessed value* .The first of these standards seeks to ensure that the City maintains available capacity in the event of unforeseen or emergency borrowing. With the sale of $6M GO Notes in 2014, the outstanding debt load at the outset of 2016 is nearly $22M, which is within the 70% standard. A second and equally important standard establishes a maximum desired debt levy rate at $2.00 per $1,000 EV. With the additional debt service cost on the 2014 issue, the levy rate attributable to debt service exceeds the performance standard by 50%. Although the debt load is at a manageable level, the levy rate for debt service is arguably unacceptable. Given the existing debt structure, the debt load will decrease by roughly $2M annually for the next several years but the levy rate will remain substantially elevated. The economic realities of the current municipal finance environment does require a greater reliance on debt issuance in order to maintain necessary public improvements, making it unlikely that the levy rate standard will be achievable going forward for several years. It is also worth noting that funds borrowed in conjunction with a Tax Increment Financing project, though not having a direct impact on the general debt service levy, does impact total debt capacity.

- ***Fire/EMS Operations***

The issue of staff shortages that occur during certain peak call periods of the day has been well-documented over the past two years. An interim step toward addressing this issue was taken in 2013 when the Fire/EMS Department entered into a contract-for-service with Para-Tech to provide 24/7/365 staffing with one (1) EMT-Technician.. Although this additional layer of coverage has helped improve call response and generally elevated the level of service available, however, it appears clear that continuing to rely on a *majority* volunteer staff will not be able to sustain desired service levels in the future. Chief Smith has advocated for a *Paid-on-Premises* that is essentially a staffing strategy that provides full-time coverage (24/7/365) with part-time Firefighter/EMT personnel. Although this may well be a viable staffing option, the costs associated with implementation of such a program are thought not to be sustainable within the current operating and financial structure of the City. Recognizing Fire/EMS to be essential services, the staffing problems of the Department must be considered a priority matter that the Council will need to address in the near term. Barring an unforeseen change in legislative posture or a substantial increase to the tax base, a referendum to allow the City to exceed its allowable levy appears to be inevitable at some future date – perhaps November 2018. I would caution the Council not to rely on a successful levy referendum as the only option since the success rate for this type of initiative is not high. That being the case, the Council will need to evaluate current services and perhaps eliminating or substantially reducing some services in order to generate "new" revenue to support an expanded Fire/EMS operation.

- ***Public Facilities Improvements***

The construction of Sunset Pool in 2014-15 marked a significant step forward in addressing the deteriorating nature of public buildings/facilities. With construction of the NE Water Treatment Plant to be completed in the summer of 2017, the effort to address outdated and inefficient facilities assumed an even more aggressive posture. Maintaining the momentum of these two projects, the replacement of both City Hall and the DPW Maintenance should be viewed as the next logical step in addressing the quality of public buildings/facilities.

Parks improvements, which were a core element of capital projects in 2014-16, do not appear an area of primary focus for the near term. Though not thought to be a priority consideration, there has been discussion regarding the revitalization of Babe Mann Park. If the Council is supportive of such a project, it is strongly suggested that a *comprehensive* plan be developed and implemented incrementally. A concept plan for the rehab of the park was prepared several years ago and could provide a tool for the Council's use in developing an improvement plan for Babe Mann.

- ***Multi-Year Budget/Financial Plan***

In keeping with the theme of "sustainability", the use of a multi-year budget plan could provide a framework for evaluating the capacity of the City to maintain and/or expand services over an extended timeframe (sustainability). Recognizing that a multi-year budget cannot be formally adopted, the informal use of a multi-year budget could prove to be a useful financial management tool that the Council may wish to consider in the future.

- **External Agency Funding**

The City presently provides funding for three external agencies: ***Elkhorn Area Chamber of Commerce/Tourism Bureau, Holton Band, and Elkhorn Economic Development Alliance (EEDA).*** As the City's designated *tourism entity* the Chamber receives 70% of all Room Tax pursuant to statutory requirements. Each of the other agencies represents discretionary spending on the part of the City. Although the proposed budget continues support for these agencies, the Council needs to be aware that the principal revenue source supporting these external agencies is limited and Fund reserves have declined in each of the past three years.

CLOSING

As proposed, the **2017 Budget** offers a financial and operating framework that I believe to be responsive to the objectives outlined in the opening paragraph of this letter. I realize, however, that the Council may not agree with certain aspects of the proposed budget and it is understood that the annual budget must be a reflection of the Council's vision for the community. Therefore, should a different course of action(s) be preferred by the Common Council, the City staff is prepared to take the steps necessary to ensure that the adopted Budget meets the Council's expectations.

Respectfully submitted,

Sam Tapson

Samuel E. Tapson, Jr.
City Administrator