

November 21, 2011

To: Honorable Mayor Howie Reynolds and Common Council

Presented herewith for the Council's consideration is the proposed **2012 Operating and Capital Budget** and related support documentation, which have been amended to incorporate modifications that have occurred since the Budget's release on October 17, 2011. As proposed, the Budget endeavors to offer a financial plan that effectively manages the immediate challenges presented by the continued erosion of state aid and a redefined, more restrictive levy limits law. Perhaps more importantly, the Budget also seeks to provide a financial framework that will accommodate the continuation of current services for several years beyond the immediate fiscal period.

Introduction

Generally regarded to be the most significant statement of public policy adopted each year by local government, the annual budget serves as both a financial and operations plan for the ensuing fiscal period as well as providing a foundation upon which future budgets will be built. In keeping with this budgetary purpose, this letter of transmittal provides a narrative summary of the current financial information contained in the budget document, as well as offering a glimpse of those factors and trends that are likely to influence future budgets.

Before discussing the specifics of the 2012 Budget, it is appropriate to acknowledge the Council for the foresight exhibited several years ago when a comprehensive review of the relationship between financial resources and operational requirements was entertained. As a result of this effort, the Council embraced certain consultant/staff suggested financial management practices that have enabled the City to be better positioned in a tenuous financial environment than might otherwise have been possible. Absent the steps taken over the past several years, the 2012 Budget would certainly be facing serious and immediate challenges to the sustainability of current operations.

At the conclusion of the 2008 financial management planning process the Common Council identified five (5) basic objectives, as follows:

- *Maintain current staffing levels.*
- *Maintain a "responsible" General Fund reserve of not less than 15% of annual expenses*
- *Maintain General Obligation Debt capacity at, or above, 2% of the statutory maximum*
- *Maintain eligibility for Expenditure Restraint Program funding.*
- *Fund all, or a portion, unfunded post-employment benefits payment liability*

Despite the declining financial environment of the past three budget years, the City's annual budgets have met these objectives, and these standards continue to be the benchmark for 2012.

BUDGET PERSPECTIVE

In many respects it is appropriate to state that preparation of the 2012 Budget began soon after Governor Walker unveiled the *Budget Repair Bill* last February, which was followed closely by the release of the Governor's proposed biennial budget. Though mired in controversy, these two proposals offered insight as to the direction in which subsequent legislative action would proceed. And indeed the legislation that followed would substantially mirror the Governor's proposals.

Unquestionably the most impactful factors influencing budget development are *Wisconsin Act 32* and *Wisconsin Act 10* (Budget Repair Bill). While each of these legislative actions has, or will have, a marked effect on municipal operations, it is Act 32 that most directly impacted the 2012 Budget. The Act imposed the most restrictive limitations on local tax authority since levy limits were first implemented in 2005, and also further reduced state aids to local governments. In the case of Act 10, the collective bargaining reforms contained in the legislation did not significantly impact the current budget but will certainly do so as the City's existing collective bargaining agreements expire in December 2012.

Although both of these legislative actions have been well chronicled in recent months, several key factors merit additional comment in order to better appreciate the environment in which the proposed budget was developed.

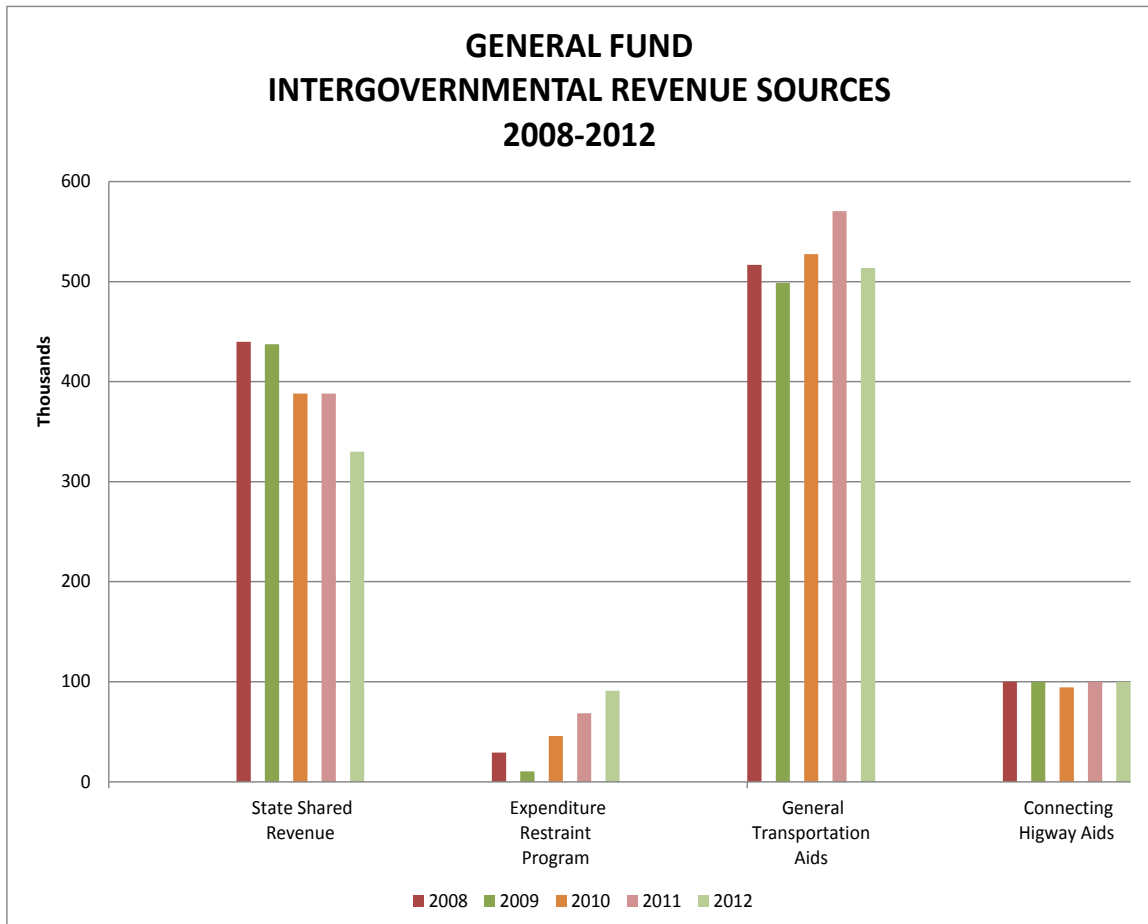
- *State Revenue Reductions*

Act 32 contained reductions to local governments in two key areas; *State Shared Revenue* and *General Transportation Aid*. As enacted, the State Budget reduced the payments in these two programs by 15% and 10% respectively. In the City's case funding in these two programs will decline by \$115,000 from 2011 levels. This most recent reduction to state aids continues a pattern of declining inter-governmental revenues that has been at play for the better part of six budget years. As recently as 2005, intergovernmental payments accounted for 26% of General Fund revenue. In

2012 these same sources represent 20.5% of the revenue stream. Coinciding with the decline in state aids there has been an increased reliance on property taxes to fund operations. Since 2005, which is the first tax year in which levy limits applied, the property tax levy has grown from 38% of the General Fund revenue stream to 44% in 2012.

- Expenditure Restraint Program (ERP)

Following several years of declining payments (2005-09), ERP funding increased in 2011 and is projected to increase again in 2012. In fact the estimated increase of \$26,000 nearly restores ERP to the high-water mark of \$92,000 received in 2005. Act 32 redefines the budget eligibility test that will be applied beginning with the 2013 budget. The revised program eliminates the “floor” inflation factor (3% in 2011) in favor of CPI-indexing and a 0% floor. In redefining the floor the revised budget test restricts the growth in municipal budgets to the rate of change in the CPI unless net new construction allows for a greater increase. Given the current development climate, coupled with the time period that elapses between construction and the value being realized in the assessment process, near-term budgets increases will likely be restricted to CPI, which may be insufficient to meet actual operating cost increases. Should this scenario occur, the loss of ERP funding becomes a possibility.



- Levy Limits Redefined

As difficult as it has been to manage the effects of levy limits from the inception of this legislative control on local tax authority, Act 32 has made it even more so. The extension of levy limits under Act 32 created a substantially more restrictive standard for determining levy increases. In the re-authored form, levies may increase only as a function of “net new construction”, with no buffer against inflation-driven operating cost increases being provided in the redefined levy law. By contrast, previous iterations of levy limits recognized inflation to be factor in the cost of service delivery by establishing a “floor” increase (2% in 2011) that helped to offset the effect of ordinary inflation on operating costs. With passage of Act 32 the “floor” was re-set at 0%, which means that levies may increase only in direct response to community growth and development. The impact of this formula change is not a significant factor in 2012 because of the closing of TID 2 (see comments below) but will become a critical factor in subsequent years; particularly if development activities continue to languish.

- Act 10: Wage/Benefit Impact

Much has been written about the “tools” that Act 10 places at the disposal of local government to help cope with the revenue reductions of Act 32. Unfortunately these tools, which focus principally on collective bargaining reform, are not fully available to the City in 2012. Owing to the fact that collective bargaining agreements are in force through 2012, only the City’s non-represented employees are presently subject to the provisions of Act 10. Despite the rather limited number of employees affected by Act 10, net General Fund savings of approximately \$18,000 are anticipated in 2012. A key issue to be addressed in 2012-13 will be the transition from a collective bargaining environment to one that emphasizes employer flexibility with respect to the provision of wages and benefits. A measured and thoughtful application of this new-found flexibility will not only produce cost reduction but also shape the environment of employer-employee relations for the foreseeable future.

- TID 2 Closing

Closing TID 2 in 2011 is a major factor impacting the proposed 2012 Budget. Not only did the availability of post-closure surplus increment allow the City to supplement several marginal accounts within the General Fund, the incremental value of the TID provides a critical buffer against the effects of redefined levy limits. Pursuant to TID Law, one-half of the TID incremental valuation at closing is considered to be “new construction” for purposes of calculating the allowable levy increase. By using the incremental value of TID 2 the new construction factor is 5.27% rather than the .15% that would result from using development data for the community at-large. Applying the TID- valued construction factor accommodates a \$148,000 levy increase, whereas, the community factor would allow for only a \$42,000 increase. This differential in the allowable levy is important not only for 2012 but it also protects future tax capacity by lifting the base levy that will be used in calculating allowable levies in subsequent years. If the 2012 levy were to be

limited to the lower increase, the City would stand to lose more than \$500,000 of tax levy capacity over the next five years. *Of course, in order to realize the benefit of the TID closure in the 2012 Budget as well as future years, the Council must be willing to exercise its tax authority at near-maximum level for 2012.*

BUDGET PROPOSALS

- Wages & Benefit Costs

As discussed above, the benefits of Act 10 will not be realized in full until 2013. In an effort to maximize the savings derived from non-union employees' contributions toward WRS retirement, the 2012 Budget incorporates an across-the-board wage freeze. This wage freeze follows a year in which wages increased at an annualized rate of only 1%.

A major factor in the cost of providing employee benefits; health insurance increased 15% at renewal in July 2011 and may be expected to increase an additional 10%-15% in July 2012. As a self-funded program, the cost of health insurance is driven not by premiums but, rather is a reflection of utilization (claims paid). To ensure that adequate funds are available to meet claim demands, the Budget includes a \$50,000 contribution to the Fund Retention Account. This set aside is in addition to the amount budgeted for anticipated claim payments.

- Partial Funding of Vehicle Replacement Fund

Restoration of contributions to the **Vehicle Replacement Fund** was a significant step in the 2011 Budget and is proposed to be continued in 2012 with a \$100,000 General Fund contribution. Although not at the level necessary to amortize the full cost of scheduled replacements, the contributions of 2011 and 2012 will help to stabilize the Fund for a period of 2-3 years, which will in turn lessen the likelihood of a need to use short-term borrowing for scheduled replacement of fleet vehicles.

- Electric Utility Rate Case

In response to a declining return-on-investment (ROI), the 2012 Budget incorporates a 5% across-the-board utility rate adjustment. The actual increase will be determined by the Public Service Commission, subject to approval of the Common Council. It is conceivable that PSC may authorize a ROI that would require greater than 5% rate adjustment; however, it is believed that a 5% lift will be sufficient to meet short-term demands (2-3 years) and, therefore, it is recommended that the Council cap any rate increase at the 5% level. It should be noted that the last electric rate increase was implemented in 2005 and certainly the costs of operating the system have increased substantially since then.

- Sewer Utility Rate Adjustment

Sewer use rates are primarily a function of the charges assessed by WalCoMet for the treatment of municipal wastewater stream. As WalCoMet rates increase, the City

must pass these adjustments through to its customer base. Historically, WalCoMet rates have increased between 4% and 5% annually and a similar increase is anticipated for 2012. In addition to the cost for WalCoMet services, sewer rates must generate revenues sufficient to meet the cost of collection system operations and maintenance, and should also provide a "reasonable" operating surplus. In order to meet these objectives, the budget proposes a rate adjustment that varies between 8% for residential customers and 12% for commercial customers. This variance in the effective rates is due to the manner in which each of the several rate parameters is applied to the rate structure.

- *Building Inspection and Zoning Administration Services*

An additional \$10,000 to support code enforcement activities is proposed in the 2012 Budget. Although permit generating activity has retracted the past couple years, there has been an increasing demand for code enforcement. The additional funds will be used to increase the contract hours of the building inspector and/or zoning administrator so as to accommodate an increased focus on code enforcement actions.

- *Police Department Auxiliary*

In response to the demand for cost reductions, the Police Department decided to eliminate staffing the Reserve Officer position during 2011. As an alternative approach, Chief Christensen has proposed the formation a Police Auxiliary that will function similar to the Community Service Officer program and provide supplemental staffing for special events and traffic control.

The projected first year cost to implement this program is \$18,000, which includes the expense of uniforms. By comparison, the cost for staffing and scheduling of reserve officers has run between \$55,000 and \$60,000 annually. A copy of the Chief's program summary accompanies this letter of transmittal.

- *EMS Shift Sign-up Stipend Program*

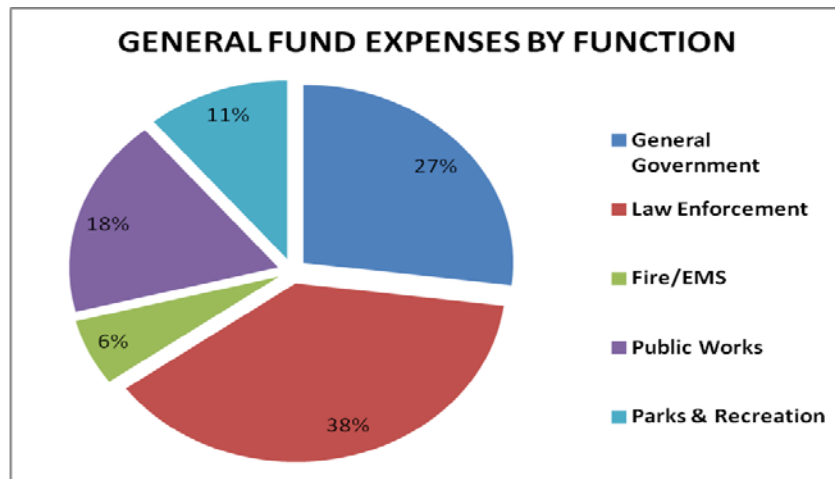
Providing adequate staffing on certain shifts has been an issue for an extended period of time. Responding to continuing difficulties with the staffing of those shifts, the Fire/EMS Division proposes the implementation of a "Shift Sign-up Stipend" in 2012. The objective of this program is to ensure adequate coverage by offering EMS personnel an incentive to sign-up for those shifts that have been identified as "problem" shifts. The program, which is to be implemented on a trial basis, will increase EMS operating costs by an estimated \$36,000, which will be met with current user fees. Continuation of the program beyond 2012 will depend upon the results of the trial year of operation.

FINANCIAL REVIEW: BUDGET IN BRIEF

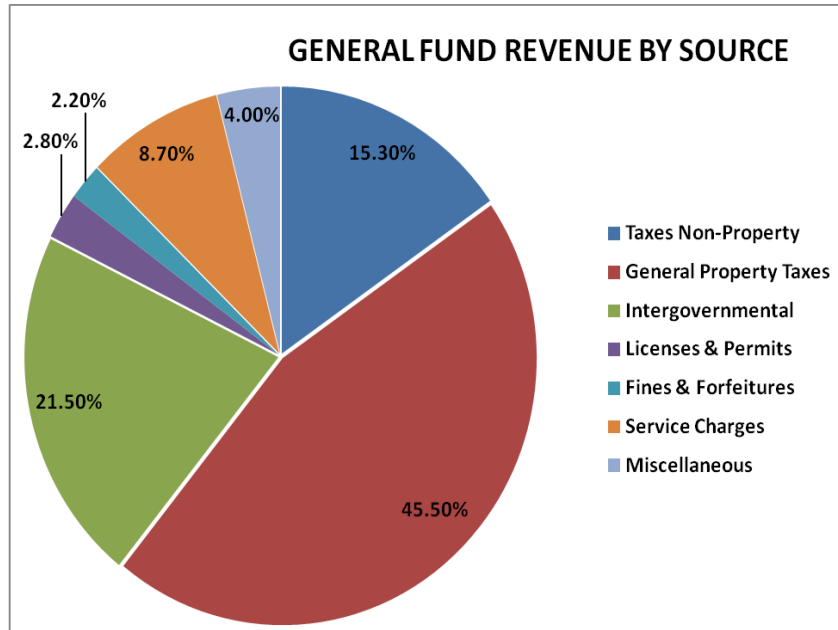
The proposed 2012 Budget establishes spending across all Funds at \$29,595,221, a decrease of 15% as compared to projected 2011 year-end expenditures. With non-property tax generated revenue projected to be \$25,192,303 the 2012 Budget relies on surplus reserves and a general property tax levy of \$4,206,958 to achieve a balanced position.

General Fund Operations

The majority of basic municipal services are supported by the General Fund, 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 \$5,095,419, which represents a 5.8% increase over projected 2011 spending. By operating unit, General Fund expenditures are as follows: *Law Enforcement \$1,944,435 (38%); Fire/EMS \$301,854 (6%); Public Works \$894,809 (18%); Parks & Recreation \$567,735 (11%); General Government \$1,386,782 (27%)*. It should be noted the General Fund contribution to the Health Insurance Retention Account is incorporated with General Government, accounting for approximately \$509,000 (40%) of departmental expenditures.



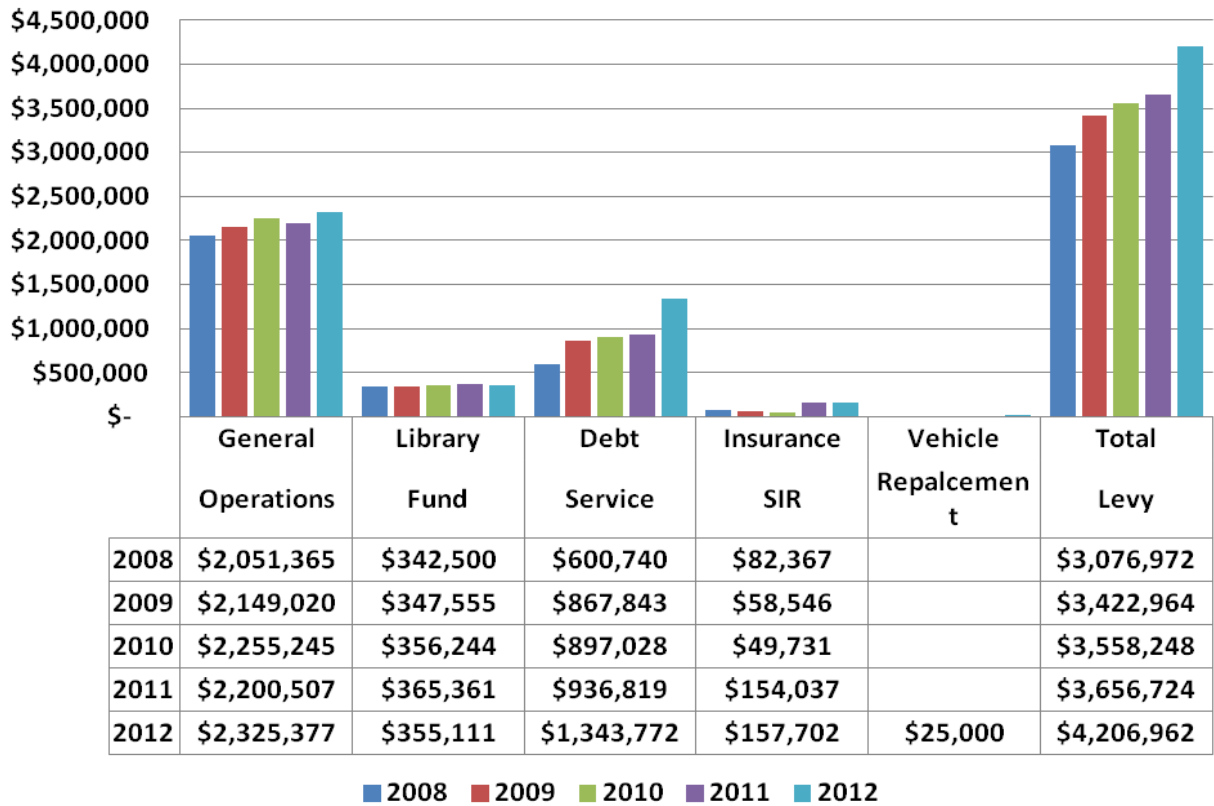
Revenue supporting these services is derived from five (5) primary categories as follows: *Taxes \$3,095,746 (60.8%); Intergovernmental Revenues \$1,091,638 (21.5%); Licenses and Permits \$146,665 (2.8%); Fines & Forfeitures \$108,750 (2.2%); and Service Charges \$443,690 (8.7%)*. An additional \$205,930 (4%) is expected from a number of miscellaneous sources including: interest earnings, insurance recoveries, and inter-fund transfers. It should be noted that within the category of "Taxes" the portion attributable to the property tax levy is \$2,325,377.



City Property Taxes

As noted in the opening paragraph of this section, the 2012 Budget proposes a general purpose tax levy totaling \$4,206,958, an increase of \$550,254 over last year. It is worth noting that the proposed levy is more than \$200,000 lower than that which is authorized by state levy limits. The levy increase is primarily attributable to debt service payments, which are scheduled to increase slightly more than \$190,000 in 2012. Coupled with the fact that available reserves in the *GO Debt Service Fund* will decline approximately \$220,000; the net change within this Fund accounts for about 75% of the property tax increase. 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.

**TABLE 1
TAX LEVY BY PURPOSE
2008-2012**



In spite of the sizeable levy increase, the impact on individual tax payments is projected to be less than \$.50 per \$1,000 of assessed value. The levy rate that results from the proposed levy is estimated at \$6.75 per \$1,000 AV. At this rate, a home valued at \$175,000 would pay property taxes of \$1,112 in 2011-12, which represents an increase of roughly \$40.00 from the previous year. It is worth noting that most homeowners will probably see a modest decrease in their tax bill due to lowered assessed valuations. Table 2 below illustrates the effects of changes in the assessed value and levy rates on the "same" property in each of the past five (5) years.

**TABLE 2
ASSESSED VALUE, LEVY RATE AND HOUSEHOLD IMPACTS
2008-2012**

TAX YEAR	BUDGET YEAR	ASSESSED VALUE	LEVY RATE	TAX PAYMENT
2007	2008	\$221,952	5.12	1,152
2008	2009	\$219,754	5.55	1,283
2009	2010	\$213,161	5.95	1,285
2010	2011	\$204,635	6.52	1,334
2011	2012	\$194,403	6.75	1,312

Note: For the purpose of comparison accuracy the information provided in the above TABLE 2 is based on the year-to-year change in assessed value, levy rate, and the property taxes paid by the "same" homeowner over a five-year period. The levy rates are not adjusted for TID increment.

Utility Operations

Though frequently overlooked during budget discussions, the City's four Enterprise Fund activities represent a significant segment of the annual budget, accounting for approximately 53% of total operating expense.

- Wastewater Utility

The City's wastewater utility has been operating on a narrow margin for the past several years. In part, the problem stems from the impact of clear water flow that results in volumes reaching WalCoMet for treatment that far exceeds the flow billed to customers. Another significant factor impacting the Utility cash flow is the debt service expense associated with various capital projects that have been completed in recent years. The 2011 Budget seeks to restore a positive cash flow and accommodate the accrual of surplus reserves. To accomplish these objectives, the budget proposes an across-the-board rate increase of 11%. The proposed rate adjustment is projected to generate revenue totaling \$2,325,538. With operating expenses projected to be \$2,281,760, the system will generate a modest surplus of \$83,024.

- Water Utility

The water utility is expected to generate a positive cash flow in 2011 as a result of the rate increases that were enacted in mid-2010. The anticipated operating surplus will be used to meet added debt service costs that will result from bonds that will be issued to finance the development of two (2) new wells and a treatment facility that will replace the Centralia Street Treatment Plant. Operating expenses are budgeted at \$2,032,616 against projected revenues of \$2,689,726.

- Electric Utility
With operating expenses of \$9,971,593, the Electric Utility is the largest of the City's enterprise operations. Following several years in which the Utility engaged in an aggressive program of capital improvements, 2011 reflects more of a maintenance orientation. As a result of this change in focus, the Utility is projected to return a modest operating surplus on projected revenue totaling \$10,096,589.
- Solid Waste Services
The terms of the contract with Veolia Environmental Services allows for an annual rate adjustment equal to the greater of 2.5% or the actual change in CPI but not to exceed 5%. It is anticipated that Veolia will exercise its contractual right to adjust rates, which is reflected at 3% in the budgeted operating expenses of the Solid Waste Fund. A corresponding increase to the user fee assessed to customers is also embedded in the proposed Budget.

Capital Improvements Program

The 2011 Capital Budget includes seven individual projects that are budgeted at \$3,523,790. Project funding will rely on a combination of accumulated reserves, prior year borrowing, and new Utility Revenue debt of \$1,400,000. Specific projects proposed for 2011 include the following:

- S. Broad Street reconstruction
- Deere Road rehabilitation
- Environmental remediation at the former Oak Industry site.
- Well No. 7 elevated storage tank maintenance
- Phase I Centralia Street Water Plant replacement

A limited scope of sewer improvements targeting inflow & infiltration problem areas is also budgeted for 2012. The specific improvements are to be identified after flow monitoring and televising of lines have been completed next spring.

Debt Management

The management of municipal debt is among those factors generally considered to be key indicators of a government's financial well-being. Recognizing the importance of a sound debt management strategy, the City's Financial Performance Standards established a maximum level for outstanding General Obligation debt at 60% of the statutory limit. A secondary standard sets debt service at .2% of assessed valuation. At the beginning of 2012 the City's outstanding G.O. debt will total \$19,519,340, or approximately 57% of the statutory limit. With no additional GO debt contemplated in the 2012 Budget, the level of outstanding debt will decrease by \$2,000,000 and is projected at 53% of the statutory maximum. With regard to debt service costs, the picture is not as good. In 2012 debt service costs will approximate .288% of assessed valuation, which moderately exceeds the desired standard. However, with off-setting contributions from the Utilities and Matheson Library, the effective percentage is reduced to .220%.

FUTURE CONSIDERATIONS: 2013 AND BEYOND

There is little doubt that the effects of Acts 10 and 32 will linger well beyond the immediate budget cycle, impacting financial management and service delivery decisions for several years into the future. In fact, the impact of the Act 32 restrictions on the tax levy and *Expenditure Restraint Program* funding are expected to be most in evidence in 2013 and 2014. Absent a swift and significant up-turn in development activity the City's near-term tax levies will be effectively frozen at the 2012 level under the re-defined levy limits of Act 32, and the City is also likely to experience a loss of Expenditure Restraint Program payments in 2013 and probably 2014 as well. Assuming this scenario plays out as suggested, it will be necessary to rely on surplus reserves in order to maintain existing service levels. Alternatively the Council may opt for service reductions (e.g. employee layoffs) and/or create new sources of revenue (i.e. wheel tax, street utility, etc.). Whether the Council opts for cost reductions, revenue enhancement measure, or a combination of the two, the likelihood that difficult choices will be required in the near term has been elevated as a result of the Legislature's efforts to control local government spending/taxation practices. The simple fact is that the sustainability of municipal services is threatened by factors outside of local control, which significantly limits the range of response options available to local officials.

Given current economic conditions and the legislative posture in Madison, it is difficult to conceive of any short-term improvement in the financial condition of local government. Perhaps the best case scenario is maintenance of effort and no dramatic service reductions. This environment accentuates the need for the annual budget process to assume a longer term perspective regarding financial management practices and decisions; one that measures the impact(s) that current actions may have on future conditions.

SUMMARY

The proposed Budget seeks to facilitate local operating flexibility by maintaining a financial structure that enhances the City's ability to respond to expected future financial challenges arising from Act 32, without the need for significant service and/or staff reductions. To achieve this objective, the proposed 2012 Budget relies; in part, on maximizing the impact that the closing of TID 2 has on the City's current and future tax levy capacity. In so doing the Budget protects existing reserves, which may be more effectively applied to support operations in 2013 and 2014. Admittedly this is but one possible approach to managing the City's financial well-being and it may not be the Council's option of choice. If the Council does indeed prefer to pursue a different course, the City staff is prepared to take the steps necessary to ensure that the adopted Budget meet the Council's expectations.

Respectfully submitted,

Samuel E. Tapson, Jr.
City Administrator