

**CITY OF ROCKVILLE
FINANCIAL ADVISORY BOARD
FY 2021 ANNUAL REPORT**

ADOPTED AT THE BOARD MEETING ON SEPTEMBER 8, 2021

1. *Annually review the City's Annual Financial Report, the Single Audit Report, and all other reports issued by the auditors and published in final form. The review should encompass and include any management letters and audit findings, as appropriate. [Parrish]*
 - a. *Additionally, review the Popular Annual Financial Report*

The board reviewed the Annual Financial Report and associated communications from CliftonLarsonAllen LLP, the city's independent auditors, and reviewed the Popular Annual Financial Report. Questions and comments on these documents were forwarded to Ms. Stacey Webster, the city staff liaison to the Board, via email on December 26, 2020 and December 30, 2020. On January 11, 2021, Ms. Webster replied via email with her commentary, as well as responses provided by Ms. Kimberly Francisco, the city's controller, on the Annual Financial Report. The Board found no material defects in either of the documents and took no further action.

2. *Annually review the City's Financial Management Policies published in the City's budget document to evaluate whether those policies are appropriate. Include the cost recovery policy in the review. [Hsu]*

The Financial Management Policies have been reviewed. City staff has provided responses to the initial sets of questions and comments. Additional comments and questions are being reviewed and discussed among three board members and will be forwarded to staff to address in the fall of 2021.

3. *Annually review the City's investment policy to evaluate whether that policy is appropriate. [Parrish, MacRitchie]*

Open, no action anticipated. Ms. Webster indicated the City's investment policy will not be updated in FY 2021.

4. *Review the City's cash and investment report when published. [Parrish]*

Complete through Q3. The board notes the decline in value for in the investment portfolio tied to rising interest rates, and their effect on bond holdings. We have communicated these comments to Ms. Webster, and there is agreement that this outcome is not unexpected in periods of increasing rates.

5. *Review the City's quarterly financial reports to assess whether spending and revenue collection are tracking with adopted and amended budgets, analyzing variances, and to highlight problem areas, if any. [Parrish, MacRitchie]*

Complete through Q3. All comments and questions were cleared through Ms. Webster. Currently there are no outstanding requests for follow up.

6. *Annually provide comments and recommendations, as appropriate, regarding the next fiscal year's Operating and Capital budgets. [Hsu, et. al.]*

Financial Advisory Board FY 2021 Annual Report

The Financial Advisory Board met on February 24, March 17, and April 7, 2021, to discuss the FY 2022 proposed Operating Budget and Capital Improvement Program (the budget). Board members have reviewed the budget and watched broadcasts of Mayor and Council budget work sessions. The budget is both clearly written and well organized. The Finance Department has done yet another outstanding job in producing the budget for the upcoming fiscal year. Board questions, requests for clarification, and suggestions have been documented (and are available upon request by email to swebster@rockvillemd.gov). The items responded to by the staff were addressed satisfactorily. The questions and comments thus far resulted in only minor changes in wording or presentation. The Board will continue to work with the staff with respect to any outstanding questions not yet addressed.

The COVID-19 pandemic continues to have a significant negative impact on the economy and the City's revenue sources. The proposed FY 2022 budget incorporates known COVID-19 impacts that affected FY 2021 results. Considering the continual uncertainty, the Board recommends that staff continue to take a conservative approach in managing the finances of the city and propose timely and necessary adjustments in the event there are either unanticipated revenue shortfalls or expenditures.

The Board is prepared to assist the Mayor and Council in reviewing any amendments to the budget and CIP that may be necessary.

7. *Review proposed City actions to implement the 2015 Purchasing Study. [Kelly]*

Procurement Annual Report: During the latter part of FY 2020, the Board learned that the Procurement Division had finally received the correct data for Master Agreement spending by fiscal year and had begun preparing a Revised FY 2019 Procurement Annual Report based on the corrected data. Early in the 2nd quarter of FY 2021, the Board received a draft of the Revised FY 2019 report and provided its comments back to the Procurement Director. Most of the Board's comments were incorporated into the version of the Revised FY 2019 report that the Procurement Division proposed to send to the Mayor and Council. At its meeting on October 28, 2020, the Board approved language to be presented in the Boards and Commissions Review section of the agenda item transmitting the Revised FY 2019 report to the Mayor and Council for its November 23, 2020 meeting. In mid-November 2020, the Board received the proposed FY 2020 Procurement Annual Report and provided its comments to the Procurement Director. Mr. Kelly emailed the Procurement Director his comments on the report expressing how impressed he was with the significant formatting changes she had made. There was no time to hold a Board meeting before the FY 2020 report was presented to the Mayor and Council on November 23, 2020, so Mr. Kelly provided his comments during Community Forum.

Procurement Guide: Mr. Kelly received the initial version of the new Procurement Guide late in 2019 and developed extensive comments on it early in 2020. Because of his active engagement with Procurement Division staff during this time regarding the FY 2019 Procurement Annual Report, Mr. Kelly withheld his comments until the first quarter of FY 2021, when he sent his comments to the City Manager and Procurement Director. During the Board meeting on December 9, 2020, Mr. Kelly requested that the City Manager schedule a meeting with the Procurement Director to review his comments. The City Manager initially agreed to schedule such a meeting in January 2021. In January, City staff asked that this meeting be postponed until May 2021. Unfortunately, the meeting was never held as scheduled. The Board will request that the City reschedule this meeting as early in FY 2022 as possible.

8. *As part of the annual review of the Operating Budget, also review the Performance Measures in the budget. [Spagnuolo, Kelly]*

Mr. Spagnuolo reviewed the performance measures sections of the proposed FY 2022 Budget document. His initial review took place in early/mid-March and a later follow up review was performed on Memorial Day 2021. The review spanned 396 pages of the document, based both on a manual scroll through and a search via the term “performance measures” to get directly to the areas of interest.

The review itself consisted of several items:

1. The reading of the goal and review of past and current results
2. The investigation for typographical errors or comments that did not make sense
3. The questioning of targets or results that were not clear
4. The juxtaposition of the performance measures vs. the budgeted expense/revenue or other comments to determine if they were consistent

The initial review sent to Ms. Stacey Webster of Rockville City’s Finance Department on March 14, 2021, consisted of six questions. Her responses were provided on March 17, 2021 (a composite report of the Board’s questions and suggestions and city staff responses, dated June 2021, for the proposed FY 2022 budget is available from Ms. Stacey Webster, Deputy Director of Finance). The questions and comments consisted of the identification of a typographical error, the questioning of the appropriateness of a procurement performance measure goal, and several questions related to the attempt to juxtapose the budget figures to the performance measures to see if they were aligned.

The typographical error was addressed. The procurement department changed their error rate target between actual and system Inventory counts from $\leq 20\%$ to $\leq 5\%$. Mr. Spagnuolo asked for clarification regarding what appeared to be inconsistent goals between the proposed FY 2022 budget and the adopted FY 2021 budget. He received satisfactory responses from staff. Lastly, there were some areas affected by the pandemic he wanted clarified, especially around position vacancy days and caregiver agencies receiving a formal site visit.

Mr. Spagnuolo forwarded a second set of questions on May 31, 2021, to the Board’s city staff liaison. Those questions were based on a follow up review of the proposed FY 2022 budget. On June 15th Ms. Stacey Webster forwarded the staff’s responses to those questions. The responses were satisfactory, and no further questions arose from the answers provided.

Lastly, Mr. Spagnuolo did not ask directly about the resumption of the biennial Citizen’s Survey for the city. His colleague on the Financial Advisory Board, Mr. Jack Kelly, raised this issue at several Board meetings.

9. *Review updates to the Water and Sewer Rates. Review the water and the sewer rate structure study. [Wright, Hodges]*

In the Fall of 2020 Stantec completed a full financial plan, cost of service, and rate design study for Rockville’s water and sewer service. Stantec has been a consultant for the City’s water and sewer rates for the past 5 years. They completed the study and informally presented the results of their study to members of Mayor and Council individually. The first presentation took place in September 2020 and the second presentation took place in December 2020. Mr. Wright, a Board member, via virtual conferencing participated in receiving both presentations.

The key findings by Stantec:

- a) Additional rate adjustments are required in FY 2022 to achieve target fund balances
- b) Modest future rate increases will be required to maintain target balance
- c) Cost of service analysis indicates different usage and service characteristics for single family, multi-family, and non-residential customers
- d) The availability of detailed customer usage data (automated meter reading) will enhance future cost of service allocations
- e) Creating customer classes and modifying the rate structure in FY 2021 will help move toward overall revenue recovery consistent with cost-of-service results

Stantec addressed the above findings and made recommendations. The most significant recommendation being a new cost of service structure to be used in customers' water and sewer bills. The city's current water and sewer rates are tiered based on meter size, with no differentiation between property types. Fees go toward payments to repair and re-place aging water and sewer pipes and other infrastructure vital to providing these services, and for required payments to the Washington Suburban Sanitary Commission related to a regional wastewater treatment plant. The new cost of service rates will be based on property type, such as single-family, multi-family or nonresidential. The existing cost of service structure is based on the size of the water meter, ½-inch, ¾-inch, 1-inch, 2-inch, etc. Except for those with small diameter meters, i.e., ½-inch and ¾-inch, the change in a resident's water and sewer bill is small. Today, the most common size meter for a resident property is a 1-inch meter. Those with the smaller diameter water meters, older properties, will experience the greatest increase in their water bill. Overall, the new cost of service structure is more equitable to the residents and business as a whole who use Rockville's water service. However, the Mayor and Council choose to not adopt a change in water and sewer rate structure and requested staff work with Stantec to explore alternatives that might be more equitable than that proposed.

The unknown financial impacts to Rockville residents and businesses in the City from the coronavirus pandemic presented challenges. Mayor and Council had approved increases in water and sewer rates in FY 2021, but those were postponed once the pandemic arrived. To bring reserve funds up to the target levels recommended by Stantec increases in rates will still be required but pushed further out in future fiscal years along with the changes in the cost-of-service structure.

10. *Review potential financial impacts from repurposing the King Farm Farmstead and be aware of proposals for remediation and improvements of the facilities at the King Farm Farmstead. [Hodges]*

Ongoing, no report.

11. *Review the Retirement Board's proposal for a "Supplemental Employee Contribution" to the defined benefit part of the City of Rockville pension plan for employees. [Wright, Hodges and Hsu]*

In FY 2021 the Financial Advisory Board (the Board) continued to review the Supplemental Employee Contribution to the defined benefit part of the Rockville retirement plan. The Board discussed the Supplemental Employee Contribution at meetings on July 1, September 2, October 28, and December 9, 2020. At the meeting on December 9, 2020, the Board unanimously approved a memorandum to Mayor and Council stating:

Implement an SEC: The City should implement the Supplemental Employee Contribution because it encourages a more equitable distribution of resources; and

helps mitigate the current underfunded status of the City's Defined Benefit Plan. Undoubtedly, the economic impact of the COVID-19 pandemic has severely strained City government resources. The Financial Advisory Board recognizes the many challenges underlying implementation in the current environment, highlighted by factors such as: the elimination of step and merit pay increases for all city employees; the delay in the implementation of the Compensation and Classification Study; and various cost reduction measures affecting city employees. Immediate implementation would impose yet another negative economic impact on the City's employees where the costs would more than likely outweigh the benefits.

Continue Employee Engagement: The City should continue engaging with affected employees to increase their understanding of its overall benefits. The City should consider developing innovative educational opportunities, as indicated by some examples below:

- Sponsor periodic forums (virtual or in-person) that includes the Retirement Board and city employees.
- Create hands-on educational series inviting locally based financial advisors and financial planners to hold seminars on basic economic and investment principles. These series would provide an excellent way to diminish fears, and increase buy in.
- Set up an interactive retirement plan calculator on the City's website, where employees could readily make calculations and see impacts of the SEC to their pocketbooks. Such activities would signal Mayor and Council commitment to the welfare of its employees, while potentially increasing the success rate in the eventual transition to full Supplemental Employee Contribution implementation.

Implementing the Supplemental Employee Contribution: The Board recommends no specific steps on how to implement the Supplemental Employee Contribution. Further, we believe it is the responsibility of the Mayor and Council to confer closely with the Retirement Board and the City Manager before determining the timeline and process for implementing the program.

12. Request by Mayor and Council to review and comment on "Credited Interest" [Board]

When an individual leaves City employment and is not vested in the City of Rockville's retirement plan (the plan), their contributions to the plan are returned to them. In doing so they currently are paid interest on their contributions. The amount paid above their cumulative contributions is referred to as "credited interest." Credited interest is paid by the plan, not the City, and is an expense to the plan.

At the Mayor and Council meeting on December 11, 2020 Councilmember Beryl Feinberg, the Mayor and Council liaison to both the Retirement Board and the Financial Advisory Board, asked the Council if they wanted the Financial Advisory Board to comment on the interest rate used in calculating credited interest. The Mayor, verbally supporting the essence of the question, asked other Councilmembers their position regarding Councilmember Feinberg's question. As no

Councilmember objected, the sense is that the Council supports doing so, but no motion was put forward.

The final authority for a change in the interest rate used in calculating credited interest in the retirement plan rests with Mayor and Council as they are the only body that can amend the plan. The Retirement Board has affirmed recently that they support the 6% interest rate currently used to continue in the calculation of credited interest. Mayor and Council considered the matter at their meeting on January 11, 2021.

The credited interest is paid by the pension fund, not the City. It is an expense to the plan. What conflates the issue is that the expense of the plan is shared by the plan and the City, though not in a constant proportion or by specific category. How the expense is shared between the plan and the City varies as the analytics are complex. It could be argued that a reduction in the plan's overall expense also reduces the part of the expense paid by the City.

It would be reasonable (and fair) that an employee's contributions to the plan earn interest. The lowest rate of interest paid could be the rate on a 10-year U.S. Treasury Note—a little less than 1% as of December 2020.

According to the U.S. Inflation Calculator the average inflation rates for 2015, 2016, 2017, 2018 and 2019 were 0.7%, 2.1%, 2.1%, 1.9% and 2.3%, respectively. These recent inflation rates suggest an interest rate of 2% provides credited interest that keeps the person whole but provides no real return.

Another option could be to pay the return of the stable value fund in the plan—approximately 3%. Information shared with the City of Rockville Retirement Board reveals that a reduction in the interest rate currently paid, from 6% to 3%, would reduce the expense to the plan, on a present value basis, by \$42,000 per annum. If the interest rate were 0%, i.e., eliminated, then the credited interest is \$0, and the savings would be \$84,000 per annum.

Given current market interest rates, which are at historical lows and recent low rates of inflation, retaining the 6% interest rate preferred by the Retirement Board seems overly generous. In our opinion the rate of the stable value fund, 3%, is a more appropriate interest rate that reflects better the current short-term interest rate available for a very safe federal government issued security, and also accounts for recent rates of annual inflation. The continued use of the return for the stable value fund was recommended for future credited interest.