



MANAGER'S OFFICE
Town of Chapel Hill
405 Martin Luther King Jr. Blvd.
Chapel Hill, NC 27514-5705

phone (919) 968-2743 fax (919) 969-2063
www.townofchapelhill.org

June 13, 2011

Dear Mayor Kleinschmidt and Members of the Chapel Hill Town Council:

The adopted annual budget for the Town of Chapel Hill for Fiscal Year 2011-12 is submitted herein, in accordance with the Local Government Budget and Fiscal Control Act.

These are challenging economic times. Although we have technically entered into a period of economic recovery, we are now feeling the effect of stagnant revenues and increasing costs over the last three years. In many ways, we have been treading water since October of 2008 when the world economy teetered on the brink of collapse. Conservative budgeting practices, sound financial management and a local economy that has been less susceptible to fluctuations in property and employment markets have served us well to date and allowed us to avoid drastic measures to maintain service levels. For the coming year we will need to use a number of strategies that are not sustainable in the long-run in order to meet our budget goals of no tax increase, while maintaining excellent core services.

Budget Preparation Goals

In presentations to the Council at your planning retreat February 4-5 and at the April 11 Council meeting, I outlined my goals in preparing the Recommended Budget:

- No tax increase
- No layoffs
- Fund the Comprehensive Plan as the only new Council Goal for the coming fiscal year
- Continue current initiatives as investments for the future:
 - UNC Healthcare Partnership for employee health
 - Ombuds program
- Minimize changes to employee benefits, recognizing that excellent service derives from excellent employees

This Adopted Budget achieves these goals and one more:

- One time \$800 lump sum payment for employees in light of rising fuel and healthcare costs.

Budget Balancing Strategies for 2011-12

To provide a budget that meets Council's objectives of no tax increase while maintaining core services, we employed the following strategies:

- Manage spending, including vacant positions, during the current year (2010-11) to provide additional fund balance to offset potential revenue shortfalls in next year's (2011-12) budget;
- Concentrate efforts on maintaining core service levels and a compensation plan that retains experienced employees;
- Invest in the health and safety of our employees through our innovative partnership with UNC Healthcare to bend the curve of insurance costs;
- Use a limited amount of fund balance to balance the FY2011-12 Budget so that we do not fall below the 12% fund balance target established by Council;
- Pay current OPEB expenses only and forego additional OPEB liability funding until the budget has achieved equilibrium;
- Reduce capital expenditures to minimal levels;
- Rebalance the distribution of property taxes between debt management and operating funds;
- Use non-general fund revenue sources to fund operations that traditionally have been funded through the annual operating budget.

The adopted annual budget is balanced using these strategies, some of which are not sustainable strategies in the long-term.

A Recommendation for the Future

In order to put the Town on a more stable long-term financial footing, we are recommending that the Council implement a two year budget cycle, beginning with the FY2012-13 budget year. This budget planning cycle would be centered on a program prioritization process that includes public input. We propose to work with the Council to structure a public process for reviewing the Town's programs and services, and prioritizing them in light of the community's vision for the future as part of the Comprehensive Plan process. This prioritization would also include a review of revenue sources. By moving away from the traditional annual incremental approach to budgeting, we can better meet future challenges by matching the scope and depth of our services with available revenues.

Our future budgetary challenges include the effect of continuing financial stress on the overlapping governments and non-profits with which we maintain a financial relationship. Intergovernmental revenues make up 13% of the Town's General Fund budget and \$6.5 million in total revenues for all funds. The trickle-down effect of Federal, State and County budget decisions will, in large part, decide how we balance future budgets and how we deliver services.

Use of Fund Balance

Over the past two years we have managed expenditures by delaying hiring for open positions, reducing discretionary expenditures and minimizing new initiatives that could improve the efficiency and effectiveness of operations. In the short term, we have survived the global financial crisis without the level of sacrifice seen in other parts of the country. Our continued success is contingent upon closing the gap between our current revenues and current expenditures.

As shown in the following table, the Town has experienced significant shortfalls in budgeted revenues compared to planned expenditures. In past years the Town has had sufficient fund balance to fill the gap between revenues and expenditures. The gaps have also been reduced by holding expenditure levels well below the amount budgeted and thereby using less fund balance. As budgets have grown tighter, the amount of fund balance used has increased. For FY2010-11, the amount of fund balance used is estimated to be about \$4.4 million, which will reduce year-end fund balance to slightly above the Council's target minimum balance of 12%.

General Fund Budget GAP (Original Budget)						
	FY2006-07	FY2007-08	FY2008-09	FY2009-10	FY2010-11	FY2011-12
GF Revenue	\$ 47,368,000	\$ 47,814,000	\$ 46,877,126	\$ 46,681,627	\$ 47,537,000	\$ 49,418,395
GF Expenditures	<u>49,247,000</u>	<u>52,129,000</u>	<u>49,621,000</u>	<u>49,816,000</u>	<u>52,604,000</u>	<u>50,540,000</u>
Gap (Fund Balance)	\$ 1,879,000	\$ 4,315,000	\$ 2,743,874	\$ 3,134,373	\$ 5,067,000	\$ 1,121,605

For FY2011-12, we have created a budget that uses far less fund balance in order to preserve the minimum fund balance level in the General Fund. We are appropriating \$1,121,605 from the Town's fund balance to balance the General Fund budget and accomplish the Council's goals. We believe it is important to hold the use of fund balance at or below this amount in order to ensure that we do no harm to our credit rating by dropping below our adopted minimal level.

Based on our preliminary estimates, it appears we will finish the current fiscal year with an undesignated General Fund balance of approximately 12%. While this is our current target fund balance, it is below the average for the triple A rated peer group. Maintaining an adequate level of fund balance is critical to meet the cash flow requirements of this municipal corporation and to provide an emergency fund to safeguard the Town against the costs of recovering from unforeseen economic, emergency and natural disasters.

Balancing revenues and expenditures in future years will require a mix of changes in service levels, increasing revenue from existing sources and identifying new revenue sources.

UNC Health Initiative

The Town's services are highly valued by our residents, as evidenced by their comments and the community survey. The Town's ability to consistently deliver high quality services is dependent on our ability to retain and attract a high quality work force. Part of

the Town's on-going strategy has been a competitive compensation package, including comprehensive medical benefits for full-time employees.

In recent years, the increasing costs of health insurance have made it very difficult to maintain the Town's benefit package. Over the past 5 years the Town has experienced double digit increases in health care costs every year. Although the numbers in the Recommended Budget document show a 12.9% increase in health insurance costs, my recommendation is for a 10.1% increase. This reduction in the rate of medical insurance increase is based on recent negotiations that take into consideration the effect of the UNC Health Initiative and a change to the deductible for emergency room visits. This increase is consistent with the national trend in healthcare costs but it is unsustainable. We must control the rate of increase in our healthcare costs in the long-run if we are to avoid either watering down our benefits plan to the point where it no longer offers employees adequate coverage or reducing the number of employees that are covered under our plan.

To address the trend in health care cost, the Town has entered into a partnership with UNC Healthcare to develop and implement a unique and innovative approach to delivering health care to employees. We believe this approach will ultimately improve employee health, make our employees better consumers of health care services and significantly reduce our costs. The Health Initiative will provide an on-site clinic that will serve as a first line care provider for non-emergency employee health needs and a wellness/health risk assessment program that will help identify and treat employee health issues before they become debilitating both physically and financially.

We have chosen to invest in employee health and safety as a means to controlling healthcare expenditures. We believe that through this initiative we can provide a valuable benefit to employees while reversing the trend of annual double digit cost increases.

Other Employee Related Costs

In addition to the increasing cost of health insurance, this budget also includes a 7% increase in the employer contribution to the Local Government Employees Retirement System (LGERS). The poor investment performance of this state-managed retirement plan during the economic downturn of recent years presents the need for increased contributions to put the plan back on a course of full funding. Future increases are dependent on the fund's performance over the next year.

The Town's ability to maintain a high level of service delivery and high customer satisfaction, as shown in the recent community survey, is directly attributable to the quality and dedication of our workforce. Like most local governments the Town did not provide a salary adjustment to employees last year. Although the general rate of inflation has been very low, Town employees who pay for dependent care have received double digit increases in that cost for the last three years without an increase in base pay to help offset the expense. Despite the difficult nature of this year's budget, we feel that the effect of health care costs and increased cost of other necessities, such as fuel, on lower paid employees creates a strong argument to provide some relief in the form of additional compensation. Based in part on the savings from the recently negotiated medical

insurance renewal I am recommending an \$800 one-time flat rate payment for permanent employees employed by the Town as of June 30, 2011. This payment would be made in August 2011 and is similar to the payment made in the current fiscal year. I am also recommending that we evaluate the Town's financial performance at mid-year and consider adding the payment to employee's base pay so that it becomes a permanent increase effective July 1, 2012.

Departmental Budget Reductions

In order to balance the budget, I instructed departments to submit proposed departmental budgets at the level of actual departmental expenditures for FY2009-10 plus 50% of identified savings in their current (FY2010-11) budgets. For some departments, this target was below the current year's budget amount and therefore required departments to find savings in the current year's budget or make significant reductions in order to absorb cost increases such as medical insurance and the employer contribution to the retirement system. To meet their budget targets, departments are employing a number of different strategies including:

- Focusing on local and internet training opportunities to reduce travel expenses
- Delaying lower priority projects or initiatives
- Deferring replacement of equipment
- Holding vacant positions open

Despite the strain on departmental budgets, I believe we can continue to provide the same high level of service due to the dedication and ingenuity of our employees who continue to do more with less.

Planning Retreat

The Council held a planning retreat with members of the Senior Management Team on February 4-5, 2011. The Council Goals that result from that retreat are focused on planning for the future. Funding for these goals is included in the Recommended Budget.

Goal 1. Govern with Quality, Responsiveness and Efficiency

POLICY AGENDA

- Adopt a format for strategic planning aligned with the Comprehensive Plan vision and priorities for action, including measurable milestones to guide decision-making and an annual strategic plan
- Adopt compensation philosophy that balances retention and recruitment, employee interests and financial sustainability to retain and attract the best employees to maintain quality, responsive and efficient services
- Adopt a workforce plan that identifies jobs for the future and a future job structure aligned with the priorities of the Comprehensive Plan
- Define roles and responsibilities for advisory boards and commissions
- Ensure success of the organizational approach to strengthening community connections and resolving issues of discrimination & mistreatment

- Adopt an asset management policy that identifies assets to be aligned with and used in a way consistent with the priorities of the Comprehensive Plan

Goal 2. Champion Downtown

POLICY AGENDA

- Adopt a Comprehensive Plan that defines the vision of Downtown as a key element in economic vitality, social justice, and environmental protection.
- Compare alternative approaches from successful peer communities and modify ordinances and policies as appropriate in key downtown policy areas

Goal 3. Focus Economic Development, Land Use and Transportation for a Balanced and Sustainable Future

POLICY AGENDA

- Adopt a Comprehensive Plan based on the principles of economic vitality, social justice, environmental protection with measurable implementation steps to guide all activities of the Town
- Identify policy aspects of the development review process for revision and adopt timetable for review and action
- Define Town role in transportation
- Make best effort to coordinate land use plan with UNC, UNC Healthcare and Chapel Hill-Carrboro school system

Goal 4. Maintain and Improve Community Facilities and Services

POLICY AGENDA

- Adopt a Comprehensive Plan that will guide public investments and the delivery of community services
- Decide Library expansion policy issues
- Decide municipal solid waste disposal strategy for the future in response to County landfill decision

Goal 5. Set Course for a Sustainable Financial Future

POLICY AGENDA

- Adopt a Comprehensive Plan that can be implemented through a strategic planning process that links the annual budget as a means for allocating resources and financial policies that support the plan

Other budget issues

Outside agency funding remains at about the same level as the current year. The Human Service Advisory Board and staff will come to Council with recommendations on specific agencies.

The Library budget takes into consideration the fact that they will be operating in a new location while the Library is being expanded. In order to maintain service levels as close as possible to what currently exists, I am recommending the use of bond funds to pay rent, moving costs, and up-fit of the temporary space. When the expanded library opens in FY2012-13, additional operating costs will be the equivalent of 1 penny on the tax rate.

Re-evaluating long-term commitments such as CIP projects and debt issuance

In the past few years, the Town has made significant investments in public facilities. As a result of those investments, annual debt service on outstanding debt increased from \$2.4 million to more than \$6.6 million. For the FY2008-09 budget, a debt management plan was adopted to provide a better system for management of the Town’s debt and its effect on the Town’s operating budget. The current tax rate dedicated to the Debt Fund was established based on the assumption that the balance of the 2003 General Obligation Bonds would be issued in FY2009-10.

The delay in issuance and the greatly reduced rates achieved through use of a hybrid debt issuance structure (including both Build America Bonds and conventional tax exempt bonds) greatly reduced the projected annual debt service costs. As a result, the Debt Management Fund needs less tax support to pay the existing debt service and the distribution of the property tax rate can be adjusted to provide additional support for the Town’s operations. The Adopted Budget includes shifting 1.8 cents of the 9.3 cent Debt Management Fund property tax to the general Fund as shown below:

Property Tax Rates			
	FY2009-10	FY2010-11	FY2011-12 Adopted
General Fund	36.0	36.0	37.8
Debt Fund	9.3	9.3	7.5
Transit Fund	4.1	4.1	4.1
Total	49.4	49.4	49.4

One result of shifting the tax rate to increase the General Fund operating allocation is that major debt funded capital projects will be delayed. This includes the new facilities for Public Safety and Parks and Recreation. Under the proposed tax rate allocation, capacity to pay debt service for these projects will not be available until FY2015-16. Depending on the growth of General Fund revenues as the economy improves, this allocation can be adjusted to accelerate capacity growth for new large scale projects.

CIP

In recent years the Town has tried to dedicate about \$1 million of the General Fund annually for non-major capital projects. This year we are recommending that this investment be cut back significantly to increase funding for General Fund operations. The projects listed below represent our highest priority projects. They are, for the most part, minimal levels of major maintenance and facility improvements. The Fiber Optic

Network Project represents a one-time opportunity to install a municipal fiber optic system in conjunction with NCDOT's traffic signal project, consistent with Council's stated priorities. This project will create a fiber-optic infrastructure for the Town at approximately one tenth the cost of building it ourselves. Total funding for capital projects in the CIP is recommended at \$487,300. Projects included in the CIP for this year include the following:

Extraordinary Maintenance - Emergency Repairs	\$ 70,000
Street Maintenance	50,000
Curb Repairs: ADA Compliance	15,000
Fiber optic cable	90,000
Small Park Improvements	45,000
Playground Replacement	50,000
Greenways	40,000
Parking Lots/Paths/Trails	25,000
Parks ADA Improvements	20,000
Police Technology Upgrades	<u>82,300</u>
Total	<u>\$ 487,300</u>

General Fund Budget

As shown in the following table, the recommended General Fund Budget represents a 3.9% decrease from the current year's original budget. The major changes from FY2010-11 include the following:

- Reduction in CIP funding (\$740,500)
- Reduction in Street Paving (\$661,000) - Replaced by bond funds
- Elimination of Project Turn Around (\$76,844)
- Elimination of 4th of July celebration (\$37,100)
- Suspension of contribution to OPEB liability (\$400,000)
- Use of bond funds for Library transition costs (\$229,700)
- Misc. budget cuts (\$584,346)
- Reduction in Matching Funds for Fire Grant (247,669)
- Comprehensive Plan funding \$250,000
- Addition of Ombuds Program \$75,000
- Increase in Group Medical Insurance cost \$520,250
- Increase in employer contribution for state retirement system \$128,620

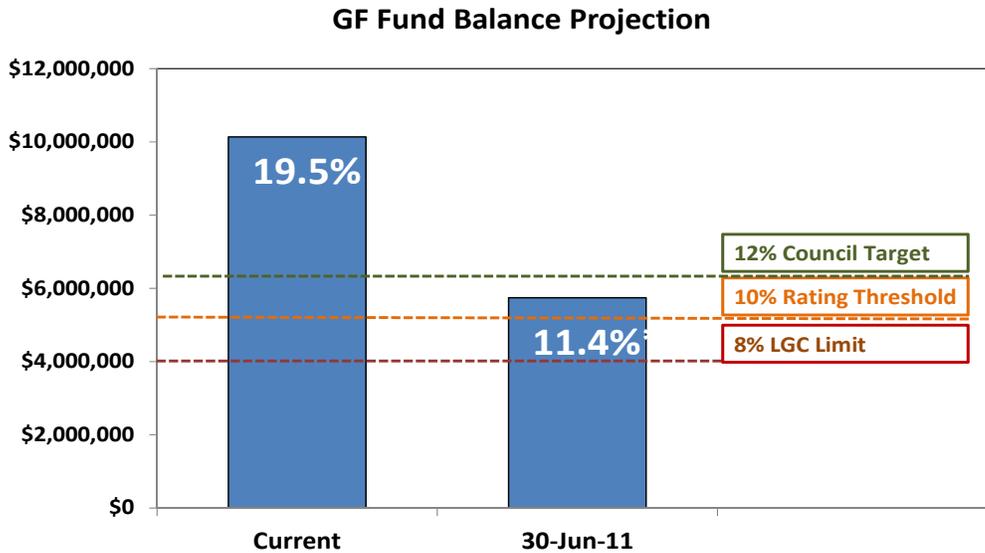
General Fund Expenditures			
Department	FY2010-11 Original Budget	FY2011-12 Adopted Budget	% Change
General Government	11,300,504	9,931,696	-12.1%
Environment and Development	13,351,009	13,000,796	-2.6%
Public Safety	19,352,451	19,412,433	0.3%
Leisure	8,600,036	8,195,075	-4.7%
General Fund Budget	52,604,000	50,540,000	-3.9%

Fund Balance

With respect to budget preparation, there are two sources of available or “spendable” fund balance. The first is the residual fund balance accumulated from prior years and the second is the excess of revenues over expenditures from the current year’s budget. The limitation on using fund balance as a funding source in the next year’s budget is the need to maintain a prudent level of fund balance to deal with circumstances such as a sudden loss of revenue or extraordinary unplanned expenses from which the Town cannot recover in the same budget period.

For the Town of Chapel Hill, given our status as a triple A rated municipality, the minimum level of fund balance should be 12%. This also represents the Council’s minimum target fund balance level. In recent years, the Town has become more dependent on the excess of revenues over expenditures from the current year to fill the revenue gap in the next year’s budget. Because the General Fund Budget has become much tighter as it has absorbed cost increases with no increase in revenues, there is no excess in the current year to balance next year’s budget. For FY2011-12, we are planning to use \$1,075,403 from residual fund balance. This number is considerably lower than previous years and reflects a much leaner budget.

As shown in following graph, we expect fund balance to drop significantly at the end of the current fiscal year, with the worst case scenario resulting in a fund balance below 12%.



* Estimated at June 30, 2011

Transit Fund

The Transit Fund continues fare-free service initiated in FY2001-02. The adopted Transit Budget for 2011-12 includes a 1.5% increase over last year's budget. This increase is due in part to the increases in administrative costs, demand response and vehicle maintenance. Overall operating costs for vehicle maintenance and Demand Response are up 19.4% and 15.8%, respectively. State assistance is expected to be the same as budgeted for 2010-11, while federal assistance is expected to decline by 14.6%. Contributions from the transit funding partners, Carrboro and the University remain unchanged from 2010-11. The FY2011-12 Transit Budget is balanced using \$1.4 million in Transit Fund reserves (fund balance). Significant challenges lie ahead in FY 2012-13 and beyond as the continued availability of state and federal funds is not guaranteed. Included in the recommended budget are service reductions based on an evaluation of route performance that are designed to create a more efficient system.

Future Budgets

As we have previously discussed, we are currently in uncharted territory trying to adjust to living in the post economic meltdown environment. Although we have seen some positive signs of recovery in the past year and we have been able to survive to this point without using drastic measures, it is clear that we must refocus on creating a sustainable financial model to regain our footing. In addition to recovering from revenues lost in the past three years, we must also be poised to react to further revenue losses resulting from budget decisions of overlapping government units.

In using the annual budget as a financial planning tool, it is easy to fall into the trap of incremental thinking, using the prior year as a stepping off point for all future budget decisions without examining and challenging the underlying assumptions. Now that we are in an unfamiliar economic environment, facing uncertainty in our revenue sources and finding challenges in providing a consistently high level of service, it is time to discard the incremental approach to budgeting.

As we begin the process of developing a new comprehensive plan that will help shape the future of Chapel Hill, it makes sense to incorporate a vision for what services the Town will provide, how they will be provided and how we will pay for those services. Included in that effort are work force planning and long-term capital planning/asset management. This will provide insight into how we develop the workforce that will provide Town services and how we build, finance and manage public property and facilities to support our mission.

In order to change the way we think about budgeting and its relationship to the comprehensive planning process, we plan to work on shifting to a priority-based budgeting model that will refocus our efforts toward rebalancing service levels to match available revenues, creating a flexible, professional workforce that can adapt to the changing needs of residents and efficiently managing capital resources to support the Town's needs.

The priority-based budget model includes public input into the establishment of service priorities and therefore we are recommending a two-year cycle for gathering public input. This process will provide adequate time to conduct the public input process and will provide a two year time period to address the established priorities through the budget process before the priorities are updated.

Conclusion

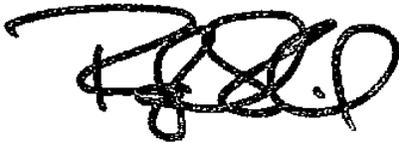
The focus for the FY2011-12 Adopted Budget is to continue to mitigate the effect of stagnant revenues on our ability to deliver services, while making strategic investments to accomplish Council's goals and to achieve long-term financial stability. We believe this Adopted Budget achieves our goal of maintaining service levels at or near current levels, continuing funding of performance agreements with outside agencies, maintaining salaries and benefits for employees, and investing in key public initiatives. To accomplish these goals, we are recommending a number of aggressive budget balancing techniques that are not sustainable in the long-term.

The budget as presented is balanced without a tax increase. Long-term projections suggest that we must reset service levels to meet available revenues in order to put the town on stable financial footing in the long-term.

The development of this Adopted Budget has been a team effort of the Town's Senior Management Team with assistance from a number of others who work for the Town. We are fortunate to have a talented and creative workforce. Our sustainable future is dependent on retaining and attracting that talent for the future as we reset service levels, seek process improvements and identify new revenue sources in a systemic and strategic approach.

I look forward to working with the Council and staff to refine our strategic focus for the future.

Respectfully Submitted,

A handwritten signature in black ink, appearing to read 'R. Stancil', with a large, sweeping flourish extending to the left.

Roger L. Stancil
Town Manager

