



INTER-OFFICE MEMO

City Manager's Office

To: Mayor Hopewell, Vice Mayor McKinney, and City Commissioners

From: Kenneth P. Collard, City Manager

A handwritten signature in blue ink, appearing to read 'Kenneth P. Collard'.

Date: April 20, 2009

Subject: 2009 Budget First Quarter Report

Attached please find the Fiscal Year (FY) 2009 Budget First Quarter Report. This document was prepared as promised in various discussions that preceded your adoption of the 2009/2010 "status quo" Budget. The City Administration made a commitment when the budget was adopted that we would:

- 1) Not overreact to changing economic data,
- 2) Fight through the short term budget challenges by making timely and informed decisions, and
- 3) Responsibly address the long term structural, fiscal challenges facing the City.

This First Quarter Report lays the foundation by which we will keep that commitment.

The Management Services staff under the leadership of Tom Skrobola prepared this data rich, 38-page document in an effort to identify and quantify a broad spectrum of dynamic factors affecting the current economic circumstance, establish a baseline and subsequently begin to track key parameters affecting the City's evolving fiscal condition.

The report's data includes Consumer Indicators, Economic Indicators, Budget Highlights, Pension Funding, City Revenues and Expenditures and Management Controls. As we track the data over time, we will be able to draw firmer conclusions about probable trends and offer projections for City revenues and expenditures to assure that we maintain balanced budgets and address long term, fiscal system problems consistent with the goals of the 5-Year Fiscal Plan.

The following comments trace the evolution of the City's recent fiscal circumstances and our understanding of same. In addition, they address the common concern of "what does it all mean?"

Where Did We Start?

PERSPECTIVE @ BUDGET DEVELOPMENT

During the 3rd quarter of 2008, as we anticipated the development of the 2009 Proposed Budget, the US and most particularly the Michigan economy continued to show signs of chronic deterioration. The stock markets continued their slide and the Big 3 automakers struggled to maintain profitability and market share. The seemingly solid, validated projections that undergirded the 5-Year Fiscal Plan and formed the basis for earlier budgets started to come into question on a limited basis particularly relative to State Shared Revenues and capital investments. At the same time, we remained committed to continued efforts to develop a retiree healthcare fund to address accrued liabilities, reduce healthcare obligations through collective bargaining and fully implement the 5-Year Fiscal Plan. We slowly realized that we had to abandon the 5-year fiscal horizon as the foundation for the upcoming 2009-2010 budget preparation.

After seemingly exhaustive review, the administration asked the City Commission to consider adoption of a two year status quo budget with a clear understanding that revenues would be reviewed quarterly and formal budget amendments, if required, would be adopted at mid-year. Our request for a two year status quo budget emanated from the conclusion that due to “the uncertain and unprecedented nature of the current situation” we did not have adequate knowledge to forecast reasonably accurate annualized revenues. This was readily acknowledged as a dramatic departure from the fiscal planning model that had served us well in recent budgeting exercises.

PERSPECTIVE @ BUDGET ADOPTION

As the proposed budget was being tendered for City Commission consideration, the national financial markets systematically collapsed, the level of fiscal uncertainty escalated dramatically and consumer confidence plunged. Locally, parameters that control property tax revenues declined precipitously, substantial losses began to accrue in the Pension Fund, and unemployment accelerated. As the 2009-2010 Budget was adopted, our perspective was that 2010 would be a period of severe budgetary stress with revenues possibly declining 10% or more.

The adopted budget’s goal, as noted in the Transmittal Letter was “maintaining priority services during a period of growing need and high economic uncertainty, while maintaining effective stewardship of our financial and human resources.” We called for an approach that “would maintain a 360 degree perspective, grounded in reality and inspired by the desire of our elected and appointed leadership to **fulfill the common good.**”

CURRENT PERSPECTIVE

Approximately 3 months later, we continue on our learning curve, pause to celebrate our enhanced understanding and accomplishments and note our shortcomings as we continue to prosecute our strategy.

As to understanding, we now know that:

- The Federal government is committed to pumping trillions of dollars into the economies of both Wall Street and Main Street;
- Barack Obama will be our President and lead a Democratic administration for the next four years;
- GM and Chrysler are edging ever closer to some form of bankruptcy or nationalization;
- The financial markets have failed and will be drastically restructured;
- Huge quantities of wealth created in the housing market and the stock markets have vanished possibly never to be regained;
- Jobs have hemorrhaged from the economy in numbers not seen in decades.

Locally, we know that:

- Kalamazoo is faring better than most communities in this troubled economy;
- Our housing market appears to be stabilizing;
- Unemployment, although significantly better than most markets in Michigan, remains at a historical high level;
- Precipitous declines in property taxes will most likely be avoided;
- Legacy costs, including pensions, retiree healthcare obligations and infrastructure obligations may need substantial, new General Fund contributions;
- Legacy cost contributions may severely curtail our ability to allocate resources to delivery of basic public services;
- Identified budgetary savings coupled with potential cost avoidance generated by organizational restructuring and firming revenue projections make 2010 a less fearful budgetary timeframe.

The reality of legacy cost challenges interestingly draws us back to fiscal planning horizons in deference to budget timelines. In essence, we're intellectually evolving away from the budgetary crisis model while continually generating pragmatic real time analyses to "fight" through the recession. We're evolving to a position where macro reviews of legacy assets and obligations will once again demand our attention and best thinking.

In the 1st quarter of 2009, the administration has enhanced its understanding of the evolving economic recession and the prospects for recovery. In addition, we have:

- Exercised additional Management Controls over the activities listed below and identified more than \$450,000 of 2009 Budget savings:
 - Travel and Conferences
 - Telephones
 - Vacancies
 - Overtime
 - Collective Bargaining
 - Contractual Services

- Closely monitored the 2009 Budget and identified:
 - Expenditure relief relative to Energy/Fuel of \$160,000 and relative to Debt Financing of \$175,000;
 - Projected Revenue shortfall for Interest Earnings of \$200,000.
- Reviewed Reserve Funds and identified:
 - Unencumbered reserves in the Internal Insurance Fund of approximately \$4 million.
- Developed contingency plans for each Department to address the possibility of a 5% Revenue loss.
 - These plans represent reductions of programs and services necessary to balance budgets and modify operations after a loss of \$8 million.

Outcomes for 1st Quarter 2009 of the Status Quo Budget Management Process

Relative to an incremental budgeting perspective, the 2009 Budget is “managed.” That means that we foresee no set of circumstances that would preclude achieving the goals identified in the 5-Year Fiscal Plan at the end of 2009.

Relative to an incremental budgeting perspective, the 2010 Budget is “manageable.” That means that we foresee no set of circumstances that would require budgetary reductions in excess of 5% to achieve the goals identified in the 5-Year Fiscal at the end of 2010.

The most challenging circumstances appear to be accruing in relationship to the legacy costs for pensions, retiree healthcare and infrastructure maintenance. Liabilities seemingly will surpass available assets and may require increases of several million dollars in additional annual budgetary contributions as early as 2012. Currently, the resources that may need to be diverted to satisfy legacy costs support service delivery activities. The scope, magnitude and timing of these fiscal challenges will be determined in large part by the “shape” and timing of the recovery as well as decisions made in Lansing relative to state shared revenues. The administration will continue to monitor the developments in these areas and recommend appropriate actions to address the “real” challenges.

In reviewing the totality of circumstances surrounding the recession, its impact on our fiscal circumstances and conditions within our community, I am pleased to announce that the City is holding its own fiscally and helping our own relative to delivery of public services. I was particularly gratified to note the inter-departmental efforts being undertaken this week in the Eastside, Edison and Northside neighborhoods to collaboratively address our concerns about blight and crime. These coordinated efforts by Public Services, Community Planning and Development and Public Safety to clean up trash and take enforcement action against nuisances again demonstrates in a very noticeable and tangible way City staff’s commitment to sustaining a high quality of life in our neighborhoods. It reminded me of our collective commitment to “hold nothing back”

as we navigate our way through the tough economic times and “to manage public resources wisely and work collaboratively with the Commission to provide vital services and maintain a positive work environment for City employees.”

In particular, we’ve pledged as an organization to do the things we can to keep our City clean and safe. As I observe our surroundings; however, I’m particularly troubled by our reduced capacity to meet our current “spring cleaning obligations.” Mother Nature has almost defied us to pick up last fall’s leaves but now we’re almost done with that exercise thanks to cooperation from residents and Public Services staff. However, these efforts have markedly delayed our progress in other areas.

The effect of resource diversion is particularly noticeable on our streets. The last two winters with their wild temperature swings and rain combined with limited funding for street resurfacing and reconstruction have left our streets in bad shape. We don’t have millions of dollars to trigger a massive street construction program and it appears that we’re not going to see any substantial federal funding to help with this reality.

However, we can patch potholes. I’ve challenged staff to develop a plan to accelerate what I have historically called our saturation pothole patching program which is required every spring in Michigan. I would anticipate allocating additional funding from the “savings” identified above to achieve this goal.

Further, I have challenged department leadership to maximize our efforts to achieve the strategic goals of a clean and safe community. I’ve specifically asked them if additional resources may be required to keep up with our “housekeeping” relative to City properties and rights of way during the balance of 2009. You will be advised as additional plans are developed to this end.

In closing, I would like once again thank you “for providing the leadership, direction and support which steer the development of the budget, and for your support of philosophies and strategies that are central to how our City government functions” in these uncertain times and “are vital to the future of our City.”

FY 2009 BUDGET FIRST QUARTER REPORT



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Summary

ECONOMIC CONDITIONS

Employment (page 9): The W.E. Upjohn Institute's 2009 Business Outlook forecasts a 2 percent drop in employment in 2009 and a 0.1 percent drop in 2010 in the metro Kalamazoo area. The greater Kalamazoo area (represented by the Metro Survey Area as defined by the U.S. Census) tracks the national employment data, and makes this region one of the leading regions in Michigan. Kalamazoo County currently has the 4th best unemployment rate among Michigan counties.

Auto Sales (page 14): For the first quarter of 2009, these forecasts have been consistently beaten by a wide margin by actual sales. Although sales are still historically low, perhaps the first quarter of 2009 passes as a positive indicator that consumers are exceeding expectations.

Inflation (page 16): there appear to be three possible scenarios:

1. Deflation: this seems to be a receding threat;
2. Inflation: this has not yet emerged quantitatively as a problem, however the economic recovery, when it occurs, will likely cause inflationary pressures that will require corrective action from the Federal Reserve in raising their discount rate;
3. Stagflation: if the Federal Reserve does not time or scale their response to the economic recovery properly, the result could be both rapidly rising interest rates and inflation, known as Stagflation.

Stock Market (page 17): If the stock market does not acquire a sustained growth pattern by the middle of the year, we will re-run the Pension scenarios and decide how best to address the need to rebalance assets and liabilities within the Pension system.

Mortgage Rates (page 20): Mortgage rates are going to continue to be forced downward by the Federal Reserve, unless inflation becomes an issue.

Pension (page 23): We will carefully monitor the Stock Market's progress over the next 6-9 months, in the context of the national and global economy and the stability of the financial system. It may be necessary (in addition to examining the smoothing mechanism) to seek rebalancing of liabilities with assets.

REVENUE

General Fund Total Revenue (Jan – Feb 09): est. \$590 thousand (2008: \$564 thousand)

Property Taxes (page 27): instead of the \$600 thousand increase in Property Taxes for the General Fund that was projected for 2010, we are anticipating an increase of approximately \$350 - \$450 thousand. Consequently, there will likely be a \$150 – 250 thousand shortfall from the projected FY 2010 revenues.

Stated Shared Revenue (page 30): at this point, there is no indication that the City can make informed budget adjustments in response to the available information about Sales Tax receipts and/or Revenue Sharing decision-making at the State level.

Interest Income (page 30): the General Fund stands to lose approximately \$150-200 thousand in investment returns in 2009 if interest rates do not pick up into more normal territory

Stimulus Package (page 31): The Stimulus funding will result in savings primarily due to cash-financing major street projects and the early warning system, as opposed to having to issue municipal bonds. This will result in savings of \$95 thousand in FY 2009 and \$160 thousand every subsequent year.

EXPENDITURES

General Fund Total Expenditures (Jan – Feb 09): est. \$4.9 million (2008: \$5.1 million)

Health Care (page 32): Savings realized since FY 2007 have created an unencumbered balance of \$4 million in the City's internal Insurance Fund. This provides a potential source of funding for losses in Revenue Sharing and/or Property Tax dollars in the short-term or an investment opportunity to offset accrued retiree healthcare liabilities.

Energy (page 33): Since the 2009 Budget allocated resources for Energy are based on 2008 prices, we can expect some budgetary relief in this area, unless energy prices spike again this year. Taken in total, the overall savings in FY 2009 should be approximately \$160 thousand for the General Fund and \$130 thousand in FY 2010.

Telephones (page 34): so far in 2009, telephone costs are recorded at \$140 thousand, compared to \$169 thousand for the same period in 2008. The savings of \$20 thousand for FY 2009 has been realized by adopted the latest contract pricing from Nextel for cell phones as well as recent improvements in telephonic contract pricing.

MANAGEMENT CONTROLS

Cost Containment (page 37): Reduction plans approximating 5% per department have been submitted by departments to the City Manager. These would represent nearly \$8 million out of the total city-wide budget, and more than \$2.5 million out of the General Fund budget. At this time, nearly \$440 thousand of cost reductions have been identified for FY 2009 without reducing any staff or significantly affecting service levels.

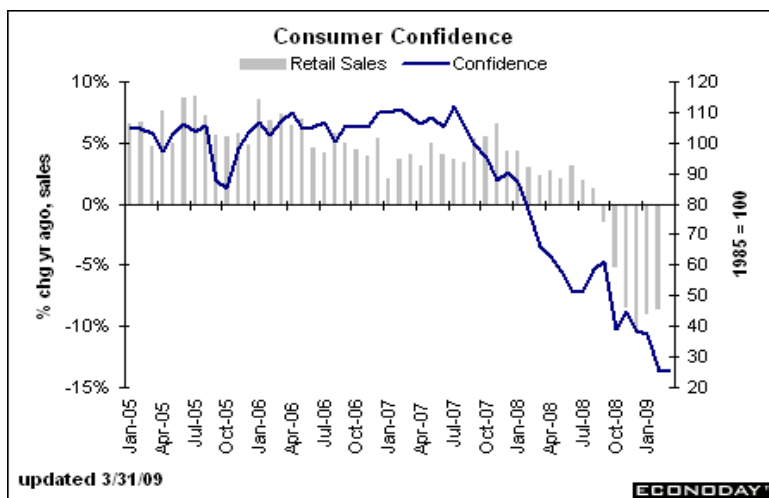
SUMMARY

When all of the above items are netted together, the City is already positioned in FY 2009 to annualize approximately \$485 thousand of net savings for the General Fund relative to the FY 2009 Budget, and about \$360 thousand of net savings for the General Fund beyond the amounts projected in the FY 2010 Budget.

For budget stabilization purposes, the City currently has \$1.6 million in the Budget Stabilization Fund. The Budget Stabilization Fund was designed to be used to help offset some losses due to near term revenue cuts.

Consumer Indicators

Consumer Confidence



Source: Econoday.com

Table 1 Description

The Consumer Confidence Survey is based on a representative sample of 5,000 U.S. households. Questions focus on respondents' outlook on their economic condition, the general economic condition, the business environment and employment. This is a lagging indicator.

Expert Testimony

Says Lynn Franco, Director of The Conference Board Consumer Research Center: "Consumer Confidence was relatively unchanged in March, after reaching an all-time low in February (Index began in 1967). Looking ahead, consumers remain extremely pessimistic about the short-term future and do not foresee a turnaround in economic conditions over the coming six months." – *Econoday.com, March 31, 2009*

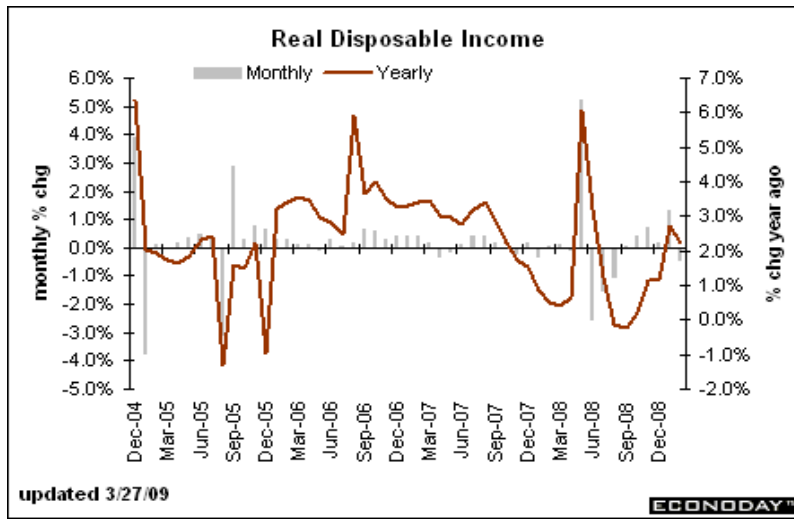
"Economists predicted confidence would rise to 28 from a previously reported record low of 25 in February." *Consumer Confidence Near Record Low*, Linda McGlassen, bankinfosecurity.com, April 1, 2009

"Some glimmers of better economic data of late helped stem further sharp declines in sentiment, which remains the lowest since at least 1967 when the index began. The Consumer Confidence Index issued Tuesday by the New York-based Conference Board edged up to 26.0 in March from a revised 25.3 reading in February. It had fallen from 37.4 in January and is less than half its level of a year ago." *Consumer Confidence Holds Steady in March*, Anne D'Innocenzio, AP, March 31, 2009

Looking Ahead

Consumer Confidence has now declined for 21 months, and has been in negative territory for 15 months. The rate of decline may be moderating, suggesting that consumers are considered that a bottom to the recession may be approaching.

Disposable Income



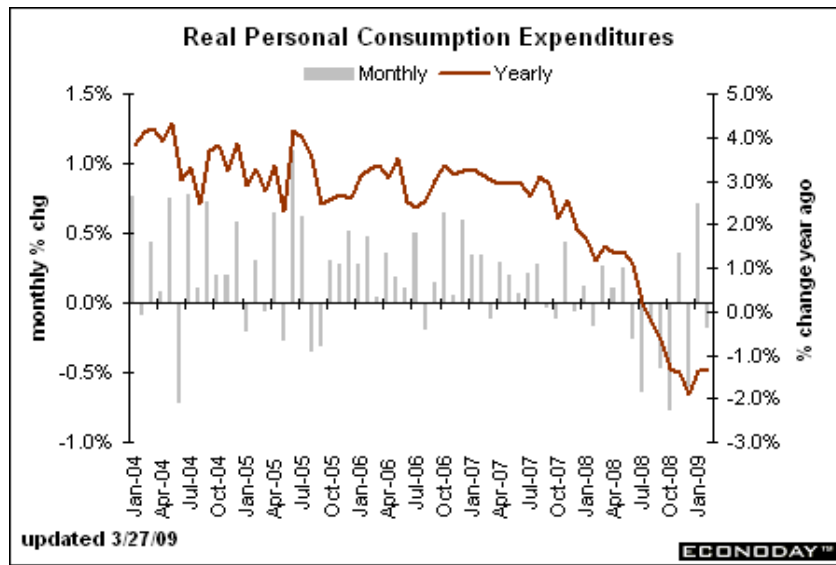
Source: Econoday.com

Table 2 Description

Changes in taxes or social security cost of living adjustments can cause some sharp variations in monthly disposable income growth. However, on the whole, monthly changes in disposable income fluctuate less than monthly changes in personal consumption expenditures.

Disposable income has remained flat due to significant downward pressure on energy prices late in 2008, as well as an increase in the household savings rate.

Consumer Spending



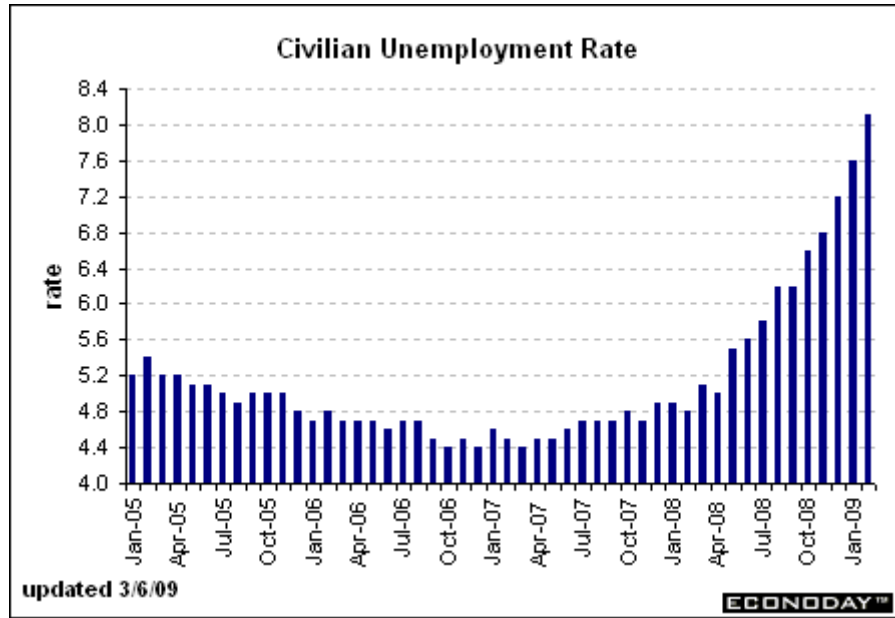
Source: Econoday.com

Table 3 Description

Monthly changes in personal consumption expenditures are usually skewed by large changes in spending on durable goods. Spending on nondurable goods and services tend to be less volatile from one month to the next.

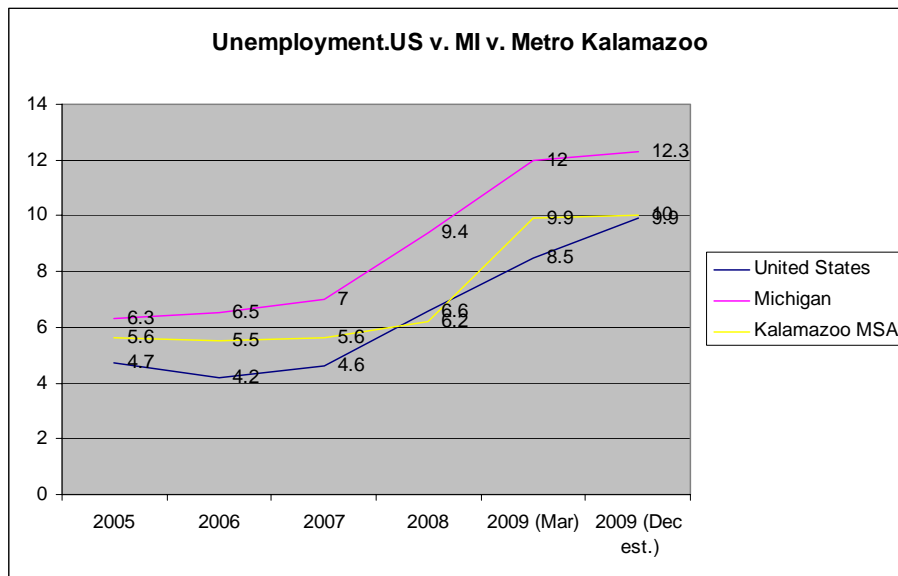
Consumer spending dropped even more rapidly in conjunction with the household savings rate entering positive territory for the first time since 2004. Consumer spending has stabilized in the last few months, possibly signaling a bottom to the economic cycle.

Unemployment



Source: Econoday.com

Table 4



Sources: 2005-2008: Bureau of Labor Statistics; 2009 (Mar): Econoday/Haver Analytics; 2009 (Dec. est.): Composite sources

**Table 5
Description**

The civilian unemployment rate is a lagging indicator. The Bureau of Labor Statistics counts as unemployed “those who were not employed during the reference week (based on the definition above), had actively looked for a job sometime in the 4-week period ending with the reference week, and were currently available for work...as a percentage of the labor force.” <http://www.bls.gov/news.release/metro.tn.htm>

Looking Ahead

Forecasters agree that nationwide unemployment will worsen throughout 2009 as businesses struggle with excess inventory and capacity, as well as massive consumer retrenchment. Generally speaking, it is expected that the United States unemployment rate will rise above 9 percent by the end of this year. Some believe that it could move into the low double-digits by early 2010.

The most prominent study of Michigan unemployment is the University of Michigan's RSQE "Michigan Economic Outlook for 2009-2010". This includes a prediction of a 3% drop in employment by the end of 2009, and an additional 1% drop in 2010.

The W.E. Upjohn Institute's 2009 Business Outlook forecasts a 2 percent drop in employment in 2009 and a 0.1 percent drop in 2010 in the metro Kalamazoo area. This is echoed by IHS Global Insight in a study published for the U.S. Council of Mayors.

The City of Kalamazoo has an estimated 12% unemployment rate within the City proper, which compares favorably to the estimated unemployment in many other larger cities in Michigan such as Detroit, Flint, Southfield and Pontiac which range from 15% upward to almost 30%.

The greater Kalamazoo area (represented by the Metro Survey Area as defined by the U.S. Census) tracks the national employment data, and makes this region one of the leading regions in Michigan. Kalamazoo County currently has the 4th best unemployment rate among Michigan counties.

Housing Starts and Existing Home Sales

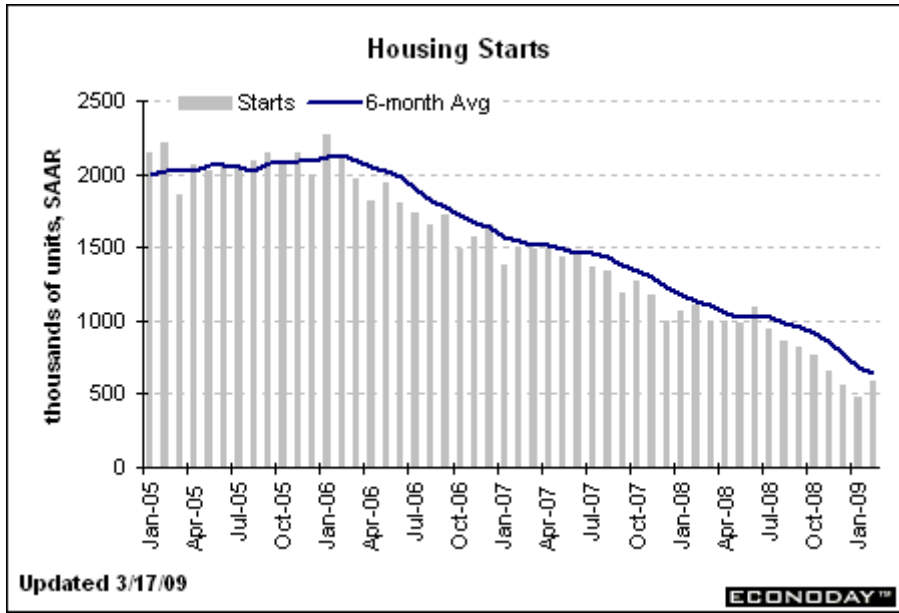
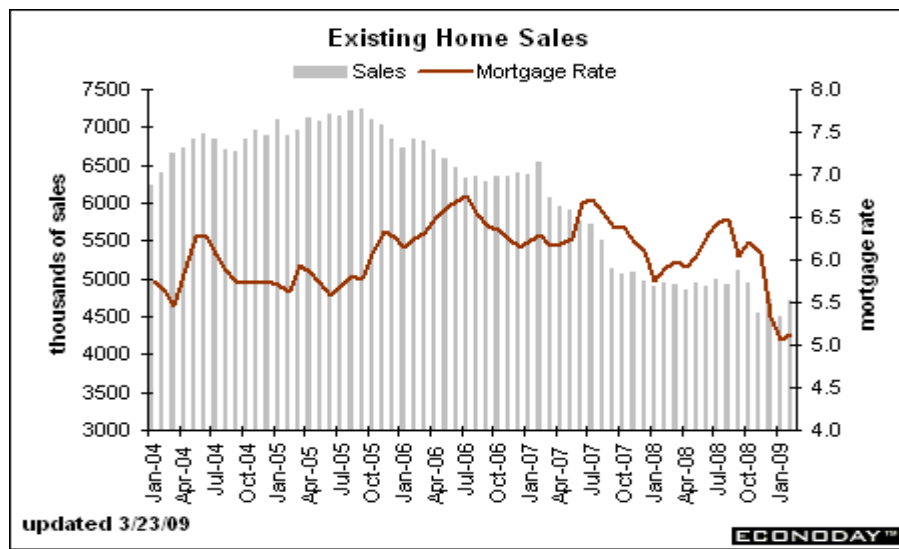


Table 6



Source: Econoday.com

Table 7
Description

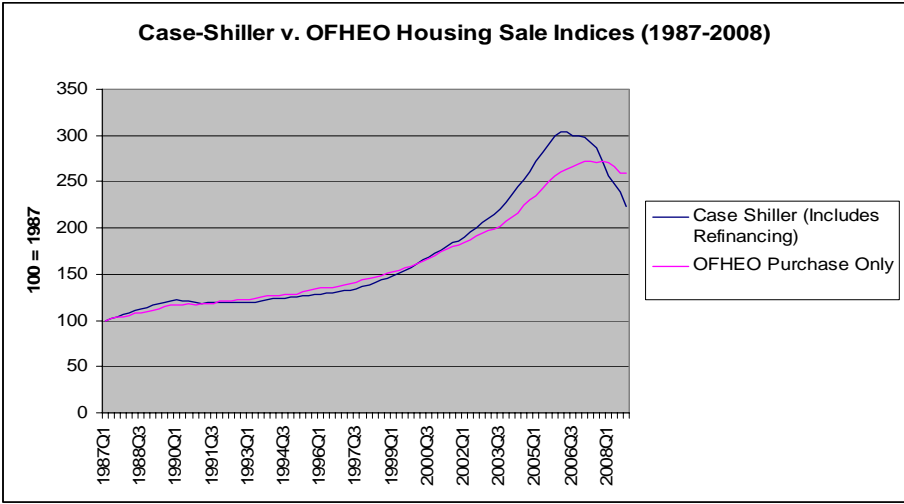
This table shows a change in the historical pattern involving mortgage rates and home sales. Typically, a distinct reverse relationship exists between home sales and mortgage rates. Mortgage Rates traditionally move in the same direction as the Federal Reserve Bank's discount rate policy. The Federal Reserve eased lending rates throughout 2008 to counteract the onset of a recession. However, the rate easing did not overcome a huge drop in demand for housing, which despite the easing of interest rates was based partially on the recession, but also on the tightening of mortgage practices at financial institutions around the country. Many banks now will not offer mortgages with principal amounts above 80% of the property's value, whereas less than a year ago it was possible to obtain jumbo loans for 95% of the property's value.

Expert Testimony

“Recovery for housing is the theme of February's existing home sales report that shows a 5.1 percent month-to-month gain for a year-on-year rate that is showing significant improvement at -4.6 percent. Prices even firmed, up 0.4 percent in the month to a median \$165,400 for a year-on-year rate that however continues to slide, now at -14.8 percent. Supply on the market is steady on a sales-adjusted basis, at 9.7 months.” – *Econoday.com, March 23, 2009*

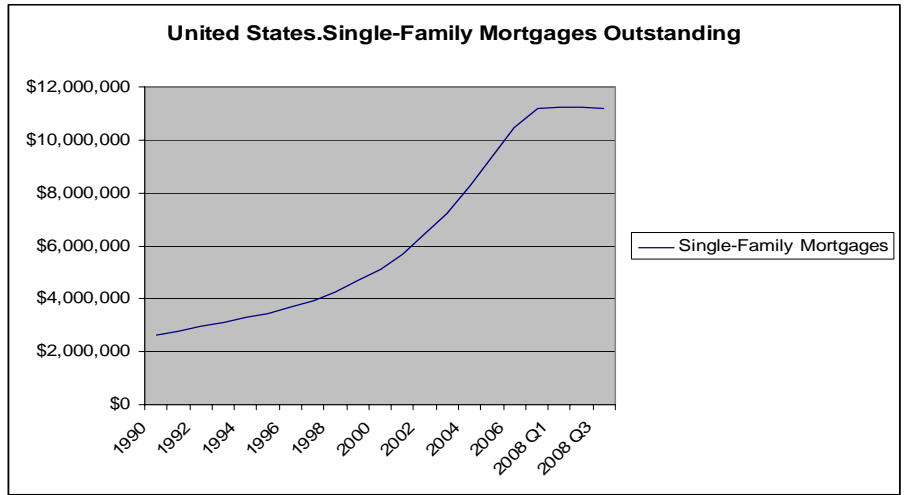
Looking Ahead

“The report is upbeat saying the effects of government programs could start appearing in three to five months and could add 1 million resales in the year. The report said the housing recovery may prove to be V-shaped, an outlook that today's report points to. Good news on the housing sector is rare and today's report is likely to raise demand for investment risk. Stocks moved higher in immediate reaction to the data.” – *Econoday.com, March 23, 2009*



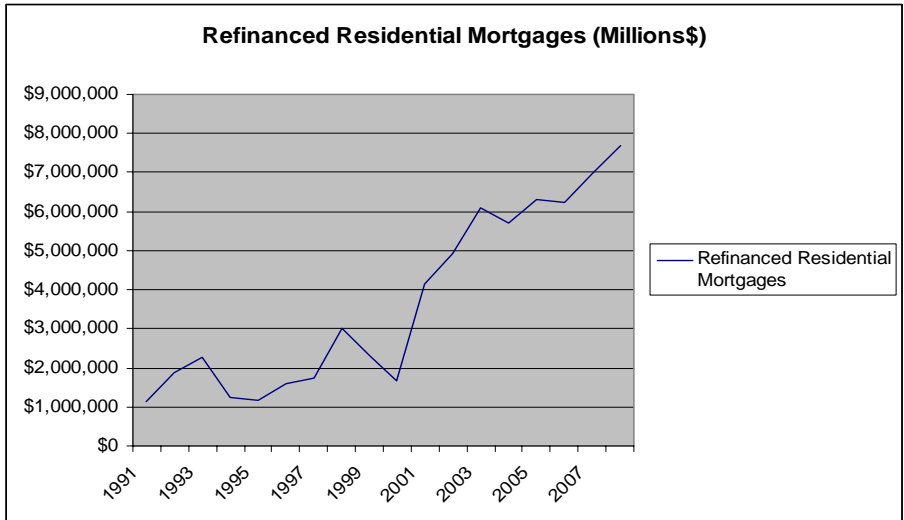
Source: ofheo.gov

Table 8



Source: ofheo.gov

Table 9



Source: ofheo.gov

Table 10

Analysis (Tables 8 – 10)

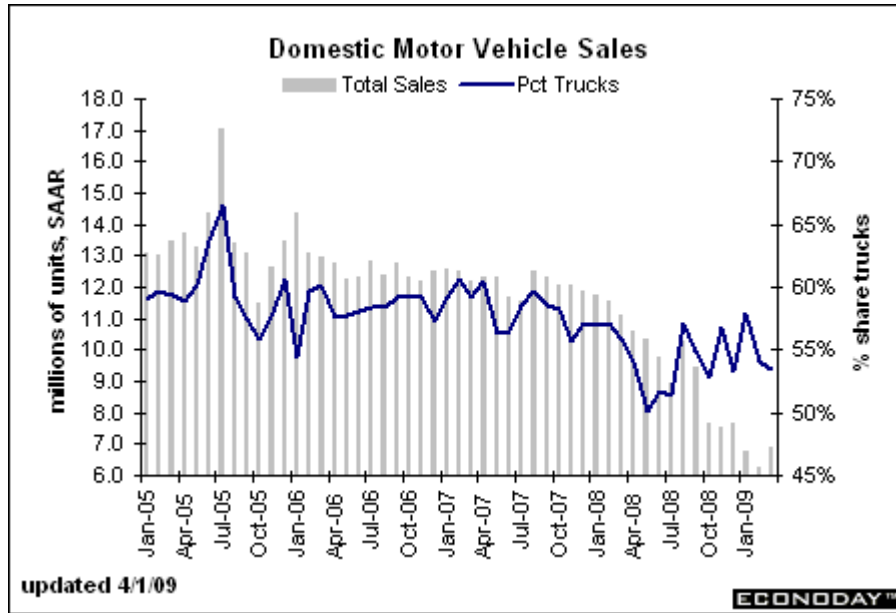
The Case-Shiller index measures the value attached to residential property. It includes sales and financing. By contrast, the OFHEO Purchase-Only index only includes sales. The presence of appraised values used for refinancing mortgages most likely caused the recent bubble in the Case-Shiller curve.

The overall level of outstanding mortgages increased dramatically in the wake of the 2001 recession and recovery. The sharp trend towards refinancing began during 2001, as the Federal Reserve's extended easing of interest rates to overcome the 2000 – 2001 recession effectively enhanced an environment of loosening mortgage credit standards. These factors combined with federal policies in the Clinton and Bush Administrations to encourage home ownership as a tool of community revitalization.

Thus, a home ownership and refinancing boom was born this decade that lasted until the recent economic crisis forced many banks to adopt more traditional mortgage lending criteria, such as requirements for 20% down payment and mortgage payments that would not exceed 38% of the mortgager's income. Subprime mortgages are estimated to represent approximately 20% of all outstanding mortgages in the United States, and this percentage is estimated to be significantly higher within the City of Kalamazoo.

The difference that we see between the Case-Shiller and OFHEO curves is somewhat similar to the difference we see between the housing markets of Kalamazoo and those previously "hot" coastal areas of California and Florida and the sun belt states of Arizona and Nevada. Just as the OFHEO curve does not contain the effect of refinancing activity that the Case-Shiller curve did, the Kalamazoo housing market never expected the kind of sales price bubble that was seen in some parts of the country.

Auto Sales



Source: Econoday.com

Table 11
Description

Unit sales of domestically produced cars and light duty trucks (including sport utility vehicles and mini-vans). Individual manufacturers report usually report sales on the first business day of the month. Motor vehicle sales are good indicators of trends in consumer spending.

Expert Testimony

Domestic sales were at an annualized rate of 6.9 million units in March 2009, higher than the consensus range outlook of 6.4 million, with a range of 5.2 – 7.3 million. It is also a bump up from the 6.4 million rate of vehicles sold in February and 6.7 million sold in January. This is still well below the 10-13 million figure that had been seen for many years.

Looking Ahead

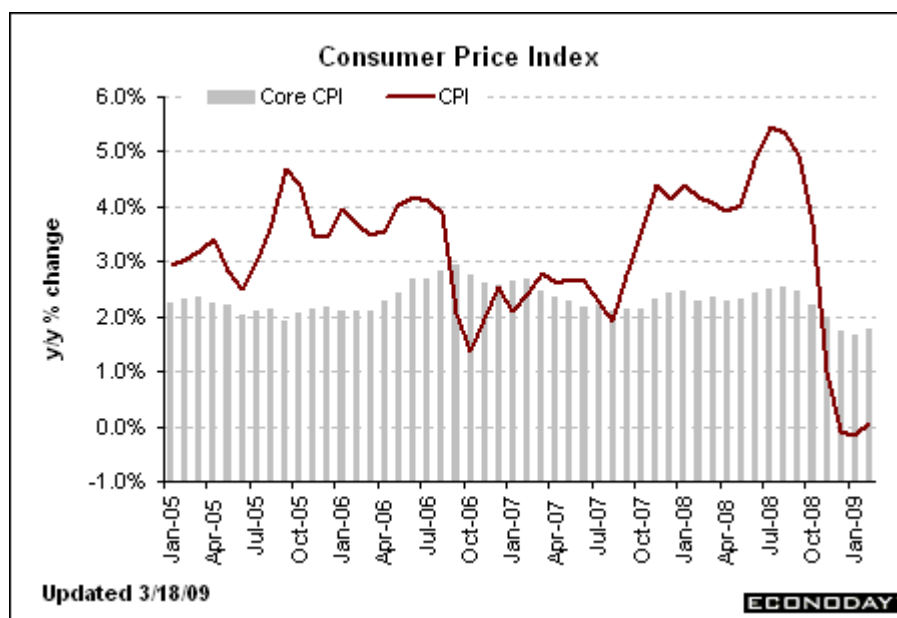
The following forecasts were made in January and February 2009 for domestic-built autos only:

- Ford – 5.0m to 5.5m
- GM – 4.6m
- Chrysler – 4.6m
- Wall Street Consensus – 5.0m

For the first quarter of 2009, these forecasts have been consistently beaten by a wide margin by actual sales. Although sales are still historically low, perhaps the first quarter of 2009 passes as a positive indicator that consumers are exceeding expectations.

Economic Indicators

Consumer Price Index



Source: Econoday.com

Table 12
Description

The Consumer Price Index is a measure of the average price level of a fixed basket of goods and services purchased by consumers. Monthly changes in the CPI represent the rate of inflation.

Expert Testimony

The increase in the headline CPI in February was led by a 3.3 percent jump in energy costs, after a 1.7 percent rise in January. Gasoline spiked 8.3 percent in the latest month. Turning to the other big component in the headline CPI, food actually slipped 0.1 percent.

The latest CPI report showed widespread and moderate gains within the core, basically putting to rest fears over deflation at least for now. Today's number is not good news for inflation hawks but the Fed is still going to be focusing on boosting credit markets during today's FOMC debate.

There has been considerable concern about the recent increase in the money supply affecting inflation. However, the money supply has constantly lagged inflation for almost 50 years, rather than leading it. (<http://wfhumel.cnchost.com/inflationgraph.html>)

Both inflation forecasts that staff identified (forecast.com and cxoadvisory.com) indicated that inflation would remain well in check for the next 18 months, below 3%. Traditionally, cyclical activity in economic production, as expressed by movements in the Producer Price Index and seasonal cycles have been seen as the keys to forecasting inflation.

Looking Ahead

Concern about inflation has hovered for years due in large part to the consistently large account balance between the United States and large exporting nations like China, Japan and India, and also because of the enormous Treasury holdings that China and Japan hold. Indeed, China's Finance Minister recently called for the International Monetary Fund to replace the U.S. Dollar as their chief reserve currency, and to replace it with a synthetic global currency. China has also started to require the use the Yuan with some of its global trading partners.

In summary, there appear to be three possible scenarios:

- 1. Deflation: this seems to be a receding threat;**
- 2. Inflation: this has not yet emerged quantitatively as a problem, however the economic recovery, when it occurs, will likely cause inflationary pressures that will require corrective action from the Federal Reserve in raising their discount rate;**
- 3. Stagflation: if the Federal Reserve does not time or scale their response to the economic recovery properly, the result could be both rapidly rising interest rates and inflation, known as Stagflation.**

Stock market



Dow Jones Industrial Average Index Historical Chart
March 2004 to March 2009

Table 13 Expert Testimony

"[There will be a] bear market trend into [mid July 2009]. However it is increasingly unlikely that DJIA 6,600 will hold and therefore the bear market is targeting a trend towards a break of the lower target of 6,000." - *Dow Jones Stock Market Index Forecast 2009 – Update 1*, Nadeem Walayat, fxstreet.com, Feb. 25, 2009

"During bear market rallies, the market can persist in positive behavior, so that many people think a new bull market has begun. But eventually, the bear reasserts and the down trend resumes. We can see that there is a short-term line of resistance just above current price levels. Even if the rally is destined to continue, it is likely that we will experience a short-term pull-back as the market prepares to break through the resistance." – *Bear Market Rally*, Carl Swenlin, decisionpoint.com, Mar. 27, 2009

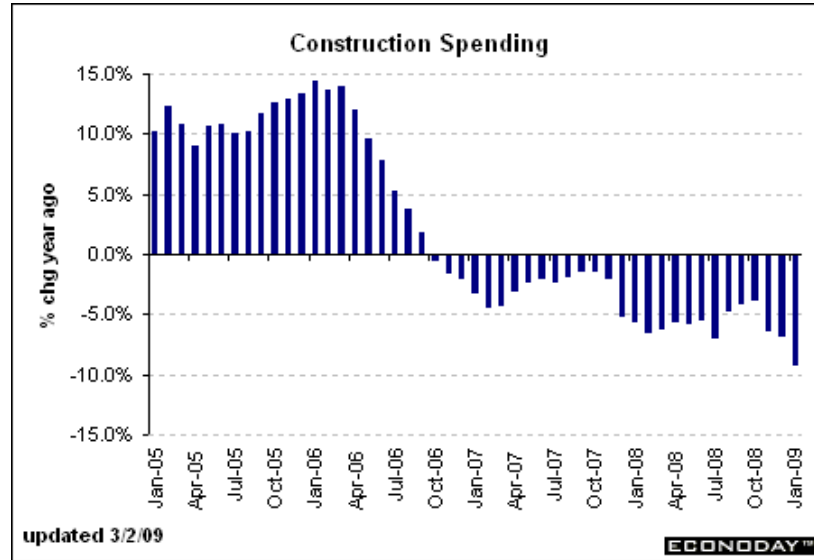
"So as the market reaches back up to the 7,200-7,400 congestion area, most will expect it to decline as the flood of bad news continues. That skepticism creates the Bull's favorite exercise, "climbing the wall of worry." – Charles Hugh Smith, oftworldminds.com, Mar. 10, 2009

Looking Ahead

Nobody can predict the stock market. As Bob Salisbury and Chris Ruppel of the Retirement Investment Committee point out, market timing is simply not a workable long-term strategy. By the same token, there seems to be a general sense among pundits and prognosticators that the current upward trend is a "Bull Market rally" and will subside with another run of losses to another low, possibly higher than the last low point of 6,500 in February. However, there are models that suggest that the recovery in the stock market began in early March, and others that suggest that the market will recover later, some by mid-year, some by next year.

If the stock market does not acquire a sustained growth pattern by the middle of the year, we will re-run the Pension scenarios and decide how best to address the need to rebalance assets and liabilities within the Pension system.

Construction Activity



Source: Econoday.com

Table 14
Description

“Construction spending” represents the dollar value of new construction activity on residential, non-residential, and public projects. This is a coincident indicator of economic activity, meaning that it moves with the economy as a whole.

Expert Testimony

“Construction spending in February fell again but not as much as expected. Construction outlays dropped another 0.9 percent in February, after plunging 3.5 percent in January. February's decline was not as severe as the market projection for a 1.5 percent drop. The single-family subcomponent dropped 10.9 percent while the multifamily portion slipped 2.1 percent.

On a year-on-year basis, overall construction outlays improved marginally to down 10.0 percent in February, from down 10.1 percent in January.” – *Econoday.com*, March 2, 2009

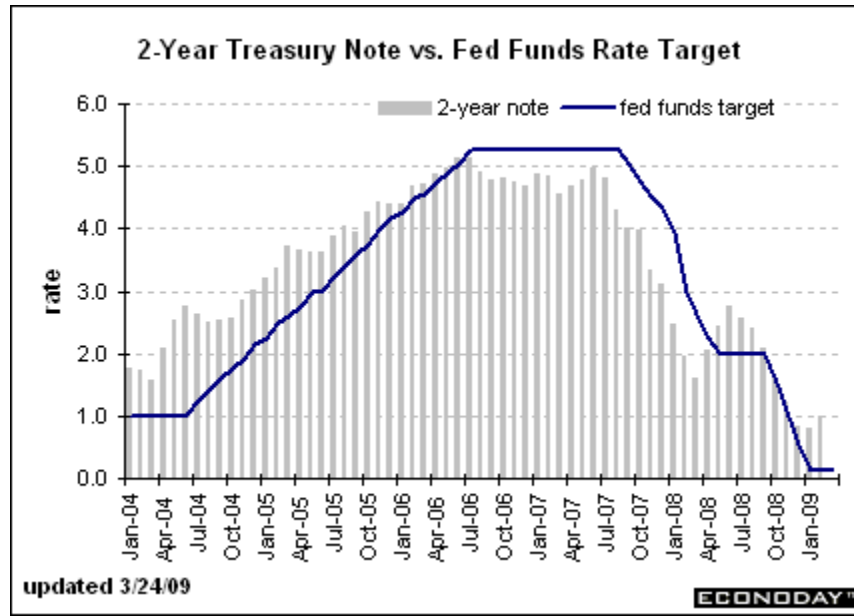
“Our outlook for 2009 is pretty dark. It's going to take some time for the stimulus to really take hold, and it won't be until the second half of 2009 [or into 2010], that it really starts to affect the broader economy as well as our construction industry.” - Dave Zwiche, a regional economist for the Skokie, Ill.-based Portland Cement Association.

“Until we can get a clearer sense of credit lines being made available by banks, it will be hard to gauge when a lot of projects that have been put on hold can get back online.” - AIA chief economist Kermit Baker
<http://www.forconstructionpros.com/article/article.jsp?siteSection=4&id=12214&pageNum=6>

Looking Ahead

The general expectation is that the economy will begin to recover and add jobs in 2010. That is when a large amount of the stimulus money for infrastructure is planned to be expended. It would be reasonable to assume that 2010 will show a moderate recovery in this industry.

Treasury Indices



Source: Econoday.com

Table 15 Description

Treasury notes are sold at regularly scheduled public auctions. Competitive bids at these auctions determine the interest rate paid on each Treasury note issue.

Expert Testimony

Federal Funds Futures are heavily tilted towards the assumption that the Federal Reserve will enact a 25 basis point increase in its April 2009 meeting and again at its June 2009 meeting. This is based both on current 0.25 rate being unsustainable over the long-term. The report of the Federal Reserves' deliberations should provide valuable insight into their concerns about inflation, as well.

Traditional monetary policy has been exhausted by the near zero federal funds rate. There is a danger of extending cheap interest rates too far and encouraging too much risk in the bond market in response, much like what occurred in the last economic cycle that caused many exotic credit instruments to appear on the market.

Mortgages and Mortgage Rates



**Table 16
Description**

HSH's Fixed-Rate Mortgage Indicator (FRMI) averages 30-year mortgages of all sizes nationwide, including conforming, the new expanded conforming, and jumbo.

Expert Testimony

“The Federal Reserve said last month it would buy up to an additional \$750 billion of mortgage-backed securities in an effort to lower rates by reducing the supply of outstanding mortgage bonds. Boosting the price of mortgage-backed securities and lowering their yields would allow banks to reduce the rates on new mortgages and still sell mortgage securities at a profit.”

“Falling mortgage rates and lower prices have lifted demand for U.S. homes. The number of Americans signing contracts to buy previously owned homes rose 2.1 percent in February, the National Association of Realtors said yesterday. The index of signed purchase agreements, or pending home resales, rose to 82.1 from 80.4 in January.”

“The Mortgage Bankers Association’s index of applications rose 3 percent to 1,194.4 in the week ended March 27 from 1,159.4 the prior week. The group’s refinancing gauge gained 3.7 percent, following a 41 percent gain the prior week. The purchase index rose 0.1 percent.” - *Mortgage Rates in U.S. Decline to Record Low of 4.78%*, Brian Louis, April 2, 2009, Bloomberg.com

Looking Ahead

Mortgages are going to continue to be forced downward by the Federal Reserve, unless inflation becomes an issue.

FY 2009-10 Budget Highlights

- **FY 2009-10 Budget Cost Containment:** At this time, nearly \$440 thousand of cost reductions have been identified without reducing any staff or significantly affecting service levels.
- **5-Year Fiscal plan:** this is the third Budget that contains a detailed projection of General Fund balances for five years beyond the target fiscal period.
- **2-Year Budget framework:** we have lengthened the budgeting perspective and shortened the fiscal perspective to align with uncertainty. This affords the potential for “smoothed” cuts in FY2009 that can minimize cuts that are needed for balancing the FY2010 budget.
- **Health Care cost containment:** the City negotiated agreements with our labor units that have saved the City approximately \$7 million in health care costs during FY2006 – FY2008. Savings realized since FY 2007 has created an unencumbered balance of \$4 million in the City’s internal Insurance Fund.
 - The City Commission recently agreed to a new contract with AFSCME that indexed health care contributions for FY 2009 – 2011. The recently ratified KMEA contract mirrors this as well. The new AFSCME and KMEA contracts and the non-bargained for benefits also include a Pharmacy Initiative, which will increase our employees’ use of generic drugs, providing the same health care results for much lower costs to the City.
 - The new KMEA contract and the non-bargained for benefits package now provide a stipend and tax-free savings account for retiree health care for new employees, in place of the defined benefit retiree health care that existing employees enjoy. This is a critical step towards containing health care costs and establishing predictability in the long term.
- **Budget Stabilization Fund:** by adding \$1.3 million in FY2009, this fund is estimated to have a balance of \$1.6 million by the end of FY2009;
- **Capital Contingency Fund:** this is estimated to have a balance of \$300 thousand by the end of FY 2009, to assist in the repair/replacement of unexpected City property damage and loss.
- **Tax Installments:** enactment of Public Act 512 by the Governor shortens the City Tax Installments from 12 payments to 6 payments (due December 31st).
 - The conversion process will begin effective with the Summer 2009 tax billing cycle.
- **Bond Ratings:** due to the quality of the City’s fiscal management, our bond rating has been renewed at AA with a stable economic outlook by both Fitch and Standard and Poors.
- **Tax Anticipation Notes:** due to the renewed bond ratings, the City realized savings of \$100,000 of interest costs for 2009 TANs based on 1.28% interest rates from the competitive bid process. The shortened tax installment program will reduce TAN borrowing from \$6 million in FY2009 to possibly as low as \$3 million in FY2010.

Pension Funding

December 31, 2008: Historic losses of nearly \$150 million in 2008 (representing approximately 28% of the Pension Trust Fund market value) will have to be recognized over a five-year “smoothing” period. As of December 31, 2008, the Pension Fund had approximately \$370 million in market assets, and an actuarial value estimated at \$515 million.

Experience in 2009: The stock market continued to take heavy losses through the first two months of 2009. By the end of February 2009, the Dow Jones Industrial Average had lost an additional 25% of its value, beyond the 40% decline suffered in 2008, totaling a 55% loss from its peak in October 2007.

During the first quarter of 2009, the Pension Trust Fund lost approximately \$90 million of market value before recovering \$50 million in March. Its current market value is approximately \$330 million which represents a 40% drop from the peak of \$550 million in October 2007.

Projections: 2009 – 2029: A number of informal projections have been run for the pension system for the next 20 years, using various assumptions regarding rates of return on investment to begin to identify contribution requirements.

The Michigan Constitution requires that the normal cost of the benefits be paid to the Pension Trust Fund of the municipality each year. The normal cost of benefits is the value accrued in benefits by employees from a year of service. For the year ending 2008, the normal cost for all active employees totaled a little more than \$6 million.

For the purposes of comparison, it was assumed that the fund’s market value will be approximately 5% lower on December 31, 2009 (\$350 million) than it was on December 31, 2008 (\$370 million), giving it an actuarial value of \$518 million.

The following rate of return scenarios are based on a range of reasonably foreseeable outcomes in the market over the next 20 years. It must be noted that level-percent rate of return assumptions are simplified scenarios for the purposes of problem identification:

- **5% Rate of Return:** the City would be required to contribute almost \$4 million to the Pension Trust Fund in 2012. This amount would continue to increase indefinitely.
- **7.5% Rate of Return:** the City would be required to contribute more than \$3 million to the Pension Trust Fund in 2012. This amount would continue to increase indefinitely.
- **10% Rate of Return:** At 10%, the City would be required to contribute more than \$2.5 million in 2012. Contributions would be required for a total of 13 years totaling more than \$70 million.
- **12.5% Rate of Return:** At 12.5%, the City would be required to contribute more than \$2 million in 2012. Contributions would be required for a total of 6 years totaling almost \$30 million.

- **Average History:** this is a completely different approach of estimating returns. It involves using the “slope” of past recoveries during the 25 year history of the Retirement Investment Committee. There have been four stock market drops followed by recoveries over that period of time. Each year of recovery, from the first to the fifth, has been averaged to come up with a normal scenario. Using the approach, the City would be required to contribute almost \$4 million in 2013, then diminishing amounts over 6 years totaling a little over \$10 million.

Smoothing recognition of gains/losses to assets (5 years vs. 10 years): The City has the option of changing the smoothing period for recognition of gains and losses in the portfolio. They currently utilize a 5-year smoothing period, which means that gains and losses are cut into 5 equal units and spread over a 5-year period. The vast majority of public pension systems utilize smoothing periods between 5 and 10 years.

The City’s actuarial firm of Gabriel, Roeder and Smith has been asked to produce alternative forecasts of City contributions based on the City changing to a 7 year or 10 year smoothing period. This will be presented to the Retirement Investment Committee for consideration at their next regular meeting in May, along with the draft Actuarial Report for the period ended December 31, 2008.

Calculations indicate that extending to a 10-year smoothing period would delay the need for making a contribution to the Pension Fund by 2-4 years, depending on the rate of return that is realized, and also the “shape” of the return curve.

- **Less than a 11% Rate of Return:** if the Pension Fund were to realize level gains less than 10 percent for the foreseeable future, changing to a 10-year smoothing period would delay contributions indefinitely, making the required contributions smaller in any given year while increasing the total funding obligation. In this scenario, the Pension Fund would take decades to reach fully funded status.
- **Greater than a 11% Rate of Return:** at this level, changing to a 10 year smoothing period would delay the need to fund the Pension System, and would allow interest earnings to satisfy the financing requirements. At a rate of return of 12.5% and higher, the larger rate of return is able to offset the negative effect of delaying contributions.

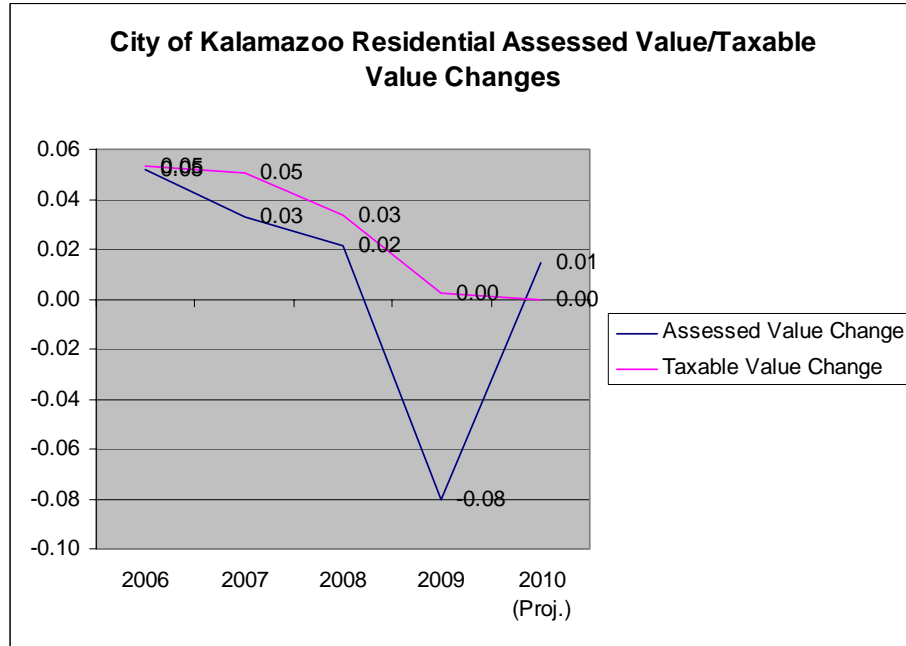
Decision-making process: Staff will examine the smoothing issue with the Retirement Investment Committee who, in their capacity, may make recommendations to the City Commission regarding actuarial assumptions. The City Commission ultimately makes the determination whether to change these assumptions, including the smoothing period.

Recommendation: We should carefully monitor the Stock Market’s progress over the next 6-9 months.

It may be necessary (in addition to examining the smoothing mechanism) to seek rebalancing of liabilities with assets.

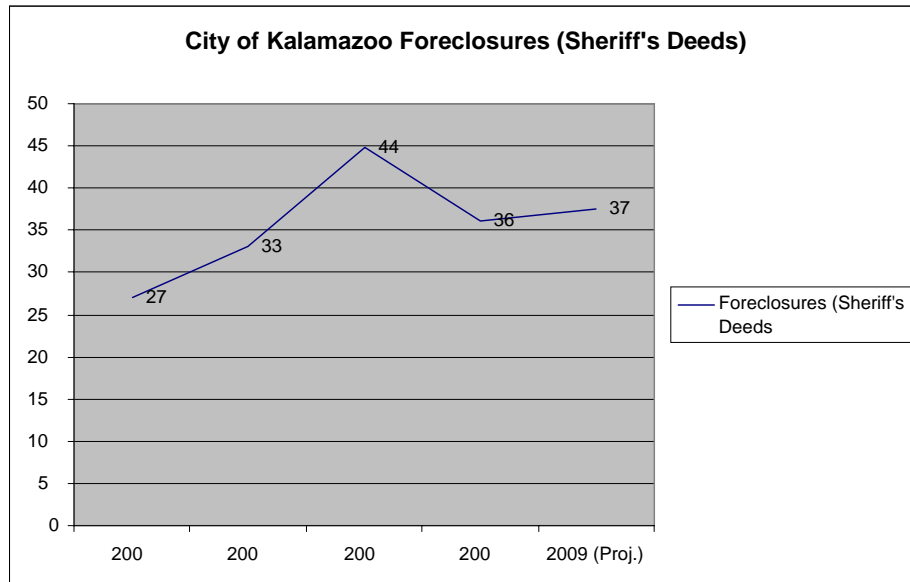
Revenues

Property Taxes



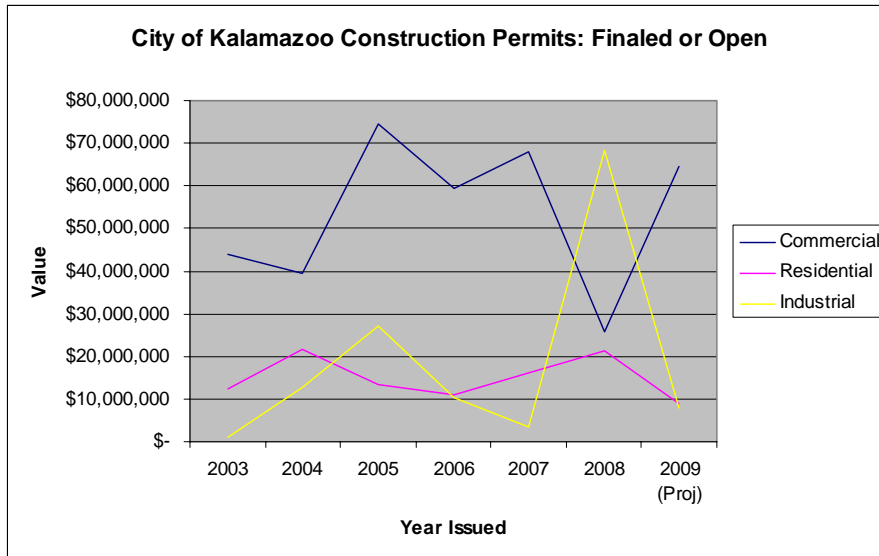
Source: City of Kalamazoo Assessor's Office

Table 17



Source: City of Kalamazoo Assessor's Office

Table 18



Source: City of Kalamazoo Assessor's Office

Table 19 Description (Tables 17 – 19)

2008 and prior: Table 17 shows that City of Kalamazoo residential assessed value (which is based on property sales and moves with the market value of property) had been rising steadily at 5% (which is the City's historical average for the last 15 years) dropped to 3% for the 2008 Assessment Roll.

2009: The 2009 Assessment Roll utilized a residential sales study period of October 1, 2007 – September 30, 2008, which showed a substantial loss of 8% compared to the previous Assessed Value. Because there was a substantial gap between the Assessed Value and the Taxable Value for most properties, this change did not cause a downturn in Residential Value for 2009. In combination with inflation, the Taxable Value for the City's residential properties stayed relatively flat for 2009.

2010: There are two possible scenarios for setting the 2010 Assessment Roll. Either (a) sales data for the current period (October 1, 2008 – September 30, 2009) will be used (if it shows declining sales prices when compared to 2009 Assessed Values), or (b) sales from April 1, 2007 through March 31, 2009 will be used.

While sale volumes are still relatively low (the trend suggests between 400 – 500 sales for the year, compared to 450 sales the previous 1-year sales period), nevertheless sales prices are slightly ahead of 2009 Assessed Values. The same holds true for our preliminary 2-year sales study (April 1, 2007 through March 31, 2009). This means that there would be a slight increase (perhaps 1%) in Assessed Value for Residential properties for the 2010 Assessment Roll.

Table 18 shows that In 2007 a seemingly temporary spike in residential mortgage foreclosures occurred (as represented by Sheriff's Deeds). Historically we have seen 250-300 foreclosures a year. In 2007 we experienced nearly 450, after rising to 330 in 2006. In 2008, the number of residential mortgage foreclosures fell to 365. The pace suggested by the first several months of 2009 for which data is available would be approximately 375. This is still higher than historical averages, so some excess inventory will likely remain on the market.

Table 19 shows that the City experienced five strong years of combined construction totaling over \$470 million of value. Annual totals varied between \$70 million and \$115 million, driven primarily by commercial construction.

Last year, industrial construction was the largest driver, with Pfizer's \$50 million project on Building 300 as the largest single piece. While residential construction remained steady in 2008 with historical levels at about \$20 million, commercial construction slowed to \$25 million, whereas it had averaged about \$55 million from 2003 – 2007. The large commercial projects completed in 2008 (such as the Miller Canfield building) were based on permits issued prior to 2008.

For 2009, Commercial construction has begun at a much higher pace than 2008, primarily because of the \$4.7 million Catheterization Lab project at Bronson Hospital. Even without that project, however, Commercial permits are on pace with 5 out of the last 6 years for January and February activity.

Residential construction has slowed dramatically in the first two months of the year, with only ½ of the total activity seen in the last two years at the same time.

There are historically only a handful of industrial permits issued so historical comparisons are difficult. There have been two issued in 2009, including a \$1.275 million project at Pfizer's Building #300. This is in addition to the \$50 million permit for Building #300 that was issued for Pfizer in 2008.

Looking Ahead

Despite the continued deterioration in the local economy, including the spike in unemployment to over 12%, housing prices in the City seem to be stabilizing. It appears that the spike in foreclosures in 2007, which caused a temporary glut in very low-priced homes on the market, was the primary cause for the downward pressure on home sale prices. If the foreclosure situation continues to stabilize and eventually return to normal, home prices should follow the same trend, meaning that we should see positive sales figures into the future.

For the purposes of revenue generation, 2010 will be the first year in at least 25 years where there is almost certain to be negative inflation, causing 2009's residential taxable value to increase by zero for 2010.

When compared to the projected 2% increase in Taxable Value in the General Fund, a 0% increase in residential taxable value would result in a \$350,000 shortfall versus projected General Fund revenue for 2010.

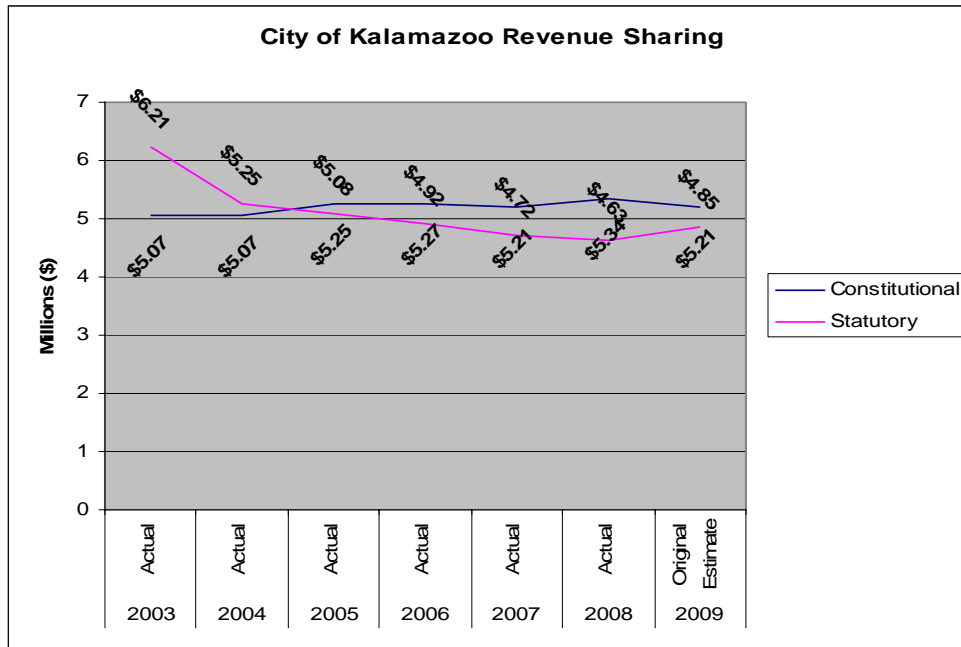
- **2009:** The Assessment Roll has been set for 2009 after the Board of Review completed its work. We are slightly above the level anticipated in the 2009 Adopted Budget, which may result in approximately \$10 thousand of additional revenue, depending on the result of assessment appeals at the state level this year.
- **2010 Residential:** As indicated in the Housing discussion above, we anticipate 0% growth in residential Taxable Value for 2010 due to a zero inflation factor. The City's FY 2009-10 budget had projected \$350 thousand of tax revenue increases from Residential property value inflation for 2010.
- **2010 Commercial:** We generally anticipate a nominal increase of 2-3% in commercial property. This increase is projected to be worth about \$250 thousand for the 2010 Fiscal Year.
- **2010 Industrial:** There are several industrial projects in process (Pfizer and Graphics Packaging) which are not yet complete. If these were completed this year, they would add between \$5-10 million of value for the 2010 Assessment Roll, translating to \$100 – \$200 thousand of revenue for 2010.

Overall construction has slowed, but appears to be fairly nominal in the commercial sector. At their Economic Review in February, Grubb & Ellis reported that commercial vacancy rates are above normal but

not at alarming levels. A downward pull on local commercial construction as the year progresses would not be surprising due to the overall economy. However, indicators at this time are nominal, so we are projecting a nominal year for Commercial and Industrial construction and taxable value growth for 2010.

Summary: instead of the \$600 thousand increase in Property Taxes for the General Fund that was projected for 2010, we are anticipating an increase of approximately \$350 - \$450 thousand. The negative difference of \$150 - \$250 thousand is mostly due to the Residential inflation multiplier being zero.

State Revenue Sharing



Source: Treasury.gov and Michigan Department of Treasury

Table 20

REVENUE SHARING SCENARIOS

(Millions \$)	0708 Actual	0809 Budget	0809 Revenue Estimating Conference	0809 Projection*	0809 Projection*
State of Michigan				"Cities Harmless"	"Even Cuts"
TOTAL	6,765	6,645	6,492	6,088	6,088
SCHOOLS	4,958	4,833	4,700	4,349	4,428
LOCALS	1,076	1,086	1,086	1,086	995
GF/GP	736	727	707	654	666
		Vs. 0708 Actual	Vs. 0809 Budget	Vs. 0809 Budget	Vs. 0809 Budget
TOTAL	Pct. Chg.	-1.77%	-2.30%	-8.38%	-8.38%
SCHOOLS	Pct. Chg.	-2.53%	-2.75%	-10.02%	-8.38%
LOCALS	Pct. Chg.	0.93%	0.00%	0.00%	-8.38%
STATE GEN.	Pct. Chg.	-1.22%	-2.75%	-10.02%	-8.38%
* - Projections based on collections from October 2008 through February 2009, which according to the Department of Treasury are down 10% as compared to the 0708 Actual amount.					
City of K-zoo	FY2008	FY2009	FY2009	FY2009	FY2009
Budgeted	9.97	10.00	10.00	10.00	9.16
Projected +/-				0.00	-0.84
Sources:					
City of Kalamazoo: 2007 CAFR, 2008 Adopted Budget, 2009 Adopted Budget					
http://www.senate.michigan.gov/sfa/Publications/MonthRev/mrrfeb09.pdf					
http://www.house.mi.gov/hfa/PDFs/source0608.pdf					
http://www.senate.michigan.gov/sfa/Publications/Approps/Initial2009.pdf					

Table 21

Analysis

According to the Michigan Department of Treasury, the latest numbers from the end of February show that sales tax collections for the state from October through February (the State's fiscal period is October – September) are down 8.38% vs. the State's FY 08-09 budgeted amount, and 10% vs. FY 07-08 collections.

The State budgeted \$6.645 billion in Sales Tax revenue for FY 08-09. Schools are budgeted to receive \$4.833 billion. Another \$1.086 billion of Sales Tax revenue is budgeted through Revenue Sharing for cities, villages, townships and counties.

The remaining \$727 million of Sales Tax revenue is budgeted in FY 08-09 for General Fund General Purpose expenditures by the State. It should be noted that the Statutory Revenue Sharing formula would provide \$1.636 billion to cities, villages, townships and counties in FY 0809, according to the House Fiscal Agency (<http://www.house.mi.gov/hfa/PDFs/source0608.pdf>). However, the State of Michigan has appropriated away \$550 million of that formula amount from local government over the last 9 years.

The January 2009 Revenue Estimating Conference pegged revised Sales Tax receipts at \$6.492 billion for FY 08-09, or a 2.3% drop vs. the budget, and a 4% drop vs. FY 07-08 Actual received.

The February 2009 Sales Tax figures, which were released in early March, dropped so dramatically that the rolling average for the State's current fiscal year (October – February) was dragged to a negative 8.38% vs. the FY 08-09 budgeted amount, and 10% vs. FY 07-08 Actual receipts. Jeff Guilfoyle, the Director of Revenue Estimation at the Department of Treasury, reported that February Sales Tax receipts were so out-of-phase with recent history that he feels that it is too early to project these losses for their entire FY 08-09. Indeed, losses in Sales Tax collections in March 2009 seem to have trended back towards a 4-5% loss compared to the FY 08-09 Budget.

Despite the relative optimism that the March 2009 figures present, a worst-case scenario given the available data has been developed for the purposes of conducting due diligence. Accordingly, if we were to project the current period losses for State Sales Tax revenue for the State's entire FY 08-09 period, there are a couple of possible outcomes for the City's Revenue Sharing distributions in our FY 2009. The right columns above show two different possible scenarios.

The first scenario ("Cities Harmless") is based on current law, specifically Public Act 261 of 2008, which stipulates that local government Revenue Sharing distributions are to be "held harmless." If sales tax revenue is below the level projected, and Constitutional distributions are thus down, the Statutory distributions will be increased to make up the difference, and the City would experience no change in Revenue Sharing distributions for FY 2009.

The second column ("Even Cuts") shows what the effects of spreading the projected losses evenly to the different recipients of State Sales Tax revenue. The result would be a loss of about \$840 thousand of Revenue Sharing distributions to the City in FY 2009.

If the State were to decide to make the cuts to Revenue Sharing indicated in the "Even Cuts" scenario above in June, the result would be to cut \$840 thousand of cash-flow from the City for the second half of the City's Fiscal Year 2009. Accordingly, the City could respond by making budgetary adjustments in the same amount.

Looking Ahead

Summer Minnick, Assistant Legislative Director for the Michigan Municipal League, does not feel that the State Legislature is prepared to decide where to prioritize cuts at this point. First, they have not yet decided how to allocate the \$1.3 billion of federal Recovery Act budget stabilization dollars that the State is slated to receive.

Second, Governor Granholm has indicated a willingness to utilize Recovery Act dollars to help stave off State budget cuts. Ms. Minnick indicated that it seems likely that the State Legislature is going to wait until after the May Revenue Estimating Conference to make final budget cut decisions for the State's FY 08-09.

Ms. Minnick reported that local government is on at least equal footing in eyes of the Legislature relative to the other recipients of Sales Tax monies. Ms. Minnick indicated that Governor Granholm has made it a priority to hold Revenue Sharing to local governments steady, so as to preserve Public Safety funding and to avoid forcing more governments into Public Act 72 financial management under the direction of the State.

Summary: at this point, there is no indication that the City can make informed budget adjustments in response to the available information about Sales Tax receipts and/or Revenue Sharing decision-making at the State level.

Act 51 Revenue

Finance Director Ed Timpf of the Act 51 Division of MDOT reported through his staff that the State is receiving gas tax revenues for FY 08-09 at a rate about 4% lower than last year. The City budgeted for about a 4% decline in Act 51 revenue in the Major and Local Street Funds combined. **If the current trend continues, there should be no need for action regarding our road maintenance funds for FY 2009.**

Interest earnings

The City's General Fund is budgeted to receive \$428,000 in interest earnings in 2009, slightly less than the \$435,000 returned to the General Fund in 2008. This is likely to be hampered in the first quarter of 2009 due to the historically low Federal Funds rate, which has suppressed short-term interest rates.

While the City generally keeps about 40% of its cash in liquid investments (which are basically tied to the Federal Funds rate), the City has been successful in maintaining a little more than \$20 million dollars in intermediate investments. As these investments come due over the next year, the City will keep more dollars short in an attempt to avoid locking in low rates any longer than necessary to maintain reasonable maturity diversification.

The General Fund stands to lose approximately \$150-200 thousand in investment returns in 2009 if interest rates do not pick up into more nominal territory.

American Recovery and Reinvestment Act (ARRA or “Stimulus Package”)

Staff is continuing to review the "American Recovery and Reinvestment Act" to determine the funding that the City of Kalamazoo is eligible to receive by formula and what programs they may apply for. To date we have identified \$6.9 million in formula funding that the City will receive and another \$1.7 million from last year's Neighborhood Stabilization program for a total of \$8.6 million.

Stimulus funds include one-time new program funding in the form of \$495 thousand from the Community Development Block Grant program, \$758 thousand for Homeless Prevention, and \$1.7 million in Neighborhood Stabilization Funding to assist in post-foreclosure programs.

Stimulus funds are available in the amount of \$762 thousand from the Energy Efficiency and Conservation Block Grant program. Approximately \$220 thousand of this will be used to finance City Hall facilities improvements that were budgeted to be financed by municipal bonds. This will preserve roughly \$10 thousand of bond financing costs in FY 2009 and \$20 thousand in every subsequent year beginning with FY 2010.

Stimulus funding for existing capital projects include \$1.5 million for major street construction. This will supplant the same need for bond financing, preserving over \$500 thousand in estimated General Fund financed debt service over the next 5 years, beginning with \$70 thousand in FY 2009 and \$140 thousand in every subsequent year beginning with FY 2010.

There is \$3.1 designated for Transportation capital projects, equipment and vehicles. These will not supplant any existing resource allocations, so no net savings to the Transportation system will be realized.

Out of \$364 thousand directed towards Public Safety, \$125 thousand is for a new emergency warning system, \$29 thousand is for a temporary grant-funded meth lab coordinator position, and \$210 thousand is for a new DVR system.

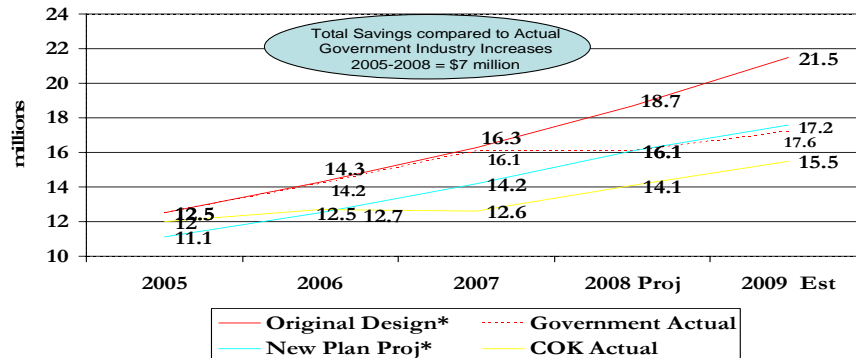
The emergency warning system was budgeted as a bonded capital project, so the savings in bond payments will be about \$5 thousand per year beginning in FY 2009.

The Stimulus funding will result in savings primarily due to cash-financing major street projects and the early warning system, as opposed to having to issue municipal bonds. This will result in savings of \$95 thousand in FY 2009 and \$160 thousand every subsequent year.

Expenditures

Health Care

Health Care Cost Comparison



*Source: Mercer Health Benefits Report 1/26/07

Table 22

Between 2005 and 2008, the City saved over \$7 million dollars by virtue of consolidating the employee health care plans from three a la carte offerings to one, as well as increasing cost-sharing measures such as monthly employee health care contributions, as well as co-pays and deductibles for care visits.

The change in employee behavior has been significant and very critical for the City as we attempt to constrain general health care inflation that continuously outstrips our growth in revenues.

In the latest round of bargaining, the following changes were made:

- **Retiree Health Care:** new hires in KMEA (and the non-bargained for group) will receive a monthly stipend of \$75 to place into a health savings retirement account through MERS. This will result in approximately \$5 – 10 thousand of new annual expenditures over the next five years. This money is pre-tax for the employee and its use for health care costs is also tax-free.
- **Pharmacy Initiative:** A pharmacy initiative has been agreed to. This pledges the employees to taking steps to replace their use of name-brand drugs with generic drugs that come at much lower prices. The City spends over \$1 million in prescriptions every year, and a full 85% of drugs purchased by our employees are name-brand products.
- **Cost-Sharing:** existing cost-sharing amounts have been inflated nominally.

Savings realized since FY 2007 have created an unencumbered balance of \$4 million in the City's internal Insurance Fund.

Energy

Energy costs for the first two months of the year are down over 25% versus the same period last year, and are up only 6.8% versus 2007 during the same period. The large spike in 2008 versus both 2007 and 2009 is primarily due to the spike in prices for gasoline and diesel fuel in 2008.

According to the estimates of the Energy Information Administration (EIA) of the U.S. Department of Energy:

Gasoline: Based on budgeted amounts for the General Fund for FY 2009 and projected amounts for FY 2010, projected gasoline prices could result in **savings to the General Fund of approximately \$100 thousand for 2009 and another \$100 thousand for FY 2010.**

“Regular-grade gasoline prices, which averaged \$3.26 per gallon in 2008, are projected to average \$1.96 per gallon in 2009 and \$2.18 per gallon in 2010.” <http://www.eia.doe.gov/steo>

Diesel: There is relatively small amounts budgeted for diesel fuel directly from the General Fund, however large overages or savings on fuel in the Local Street Fund are usually picked up by the General Fund. For FY 2009 and projected amounts for FY 2010, projected gasoline prices could result in **savings to the General Fund of approximately \$50 thousand for 2009 and another \$50 thousand for FY 2010.**

“On-highway diesel fuel retail prices are projected to average \$2.19 per gallon in 2009 and \$2.51 in 2010. The expected continuing decline in diesel fuel consumption in the United States this year as well as the growing weakness in distillate fuel usage outside the United States are projected to result in a narrowing of refining margins for distillate throughout the forecast period. Because of the global weakness in industrial output, it is possible that we will see diesel prices fall below gasoline prices this summer.”
<http://www.eia.doe.gov/steo>

Natural Gas: rates are forecasted by the EIA to remain flat in 2009. However, if there is an economic recovery by early 2010, the EIA expects there to be an increase of approximately 20% for 2010. This would net to a \$60 thousand increase in 2010 versus a projected increase of \$30 thousand, or **a negative \$30 thousand difference to the General Fund through the end of FY 2010.**

“The Henry Hub spot price averaged \$4.65 per Mcf in February, \$0.75 per Mcf below the average spot price in January. The Henry Hub spot price is expected to average \$4.67 per Mcf in 2009 and \$5.87 per Mcf in 2010.” <http://www.eia.doe.gov/steo>

Electricity: rates are forecasted to rise by 1.1% in 2009 and 1.8% in 2010. This is against a budgeted increase of 3%. This difference, if realized would **save the General Fund about \$10 thousand a year for FY 2009 and 2010.**

“Despite the recent drop in generation fuel costs, some electric utilities have proposed slight rate increases. Residential electricity prices are projected to rise at annual rates of about 1.1 percent in 2009 and 1.8 percent in 2010.” <http://www.eia.doe.gov/steo>

Since the 2009 Budget amounts for Energy are based on 2008 prices, we can expect some budgetary relief in this area. Taken in total, the overall savings in FY 2009 should be approximately \$160 thousand for the General Fund and \$130 thousand in FY 2010.

Overtime

Public Safety OT: Over the first two months of the year, Public Safety has utilized \$96 thousand out of \$978 budgeted for KPSOA overtime, and \$44 thousand out of \$372 thousand budgeted for KPSA overtime, totaling \$140 thousand out of \$1.35 million budgeted.

Public Services OT: Public Services overtime expenses were \$140 thousand for January and February 2009, up from \$124 thousand in January and February 2007 and \$130 thousand for January and February 2008.

The reason for the increase in Public Services OT was a heavier snow removal schedule and cold patch repair crews working more frequently due to two successive hard winters of salt applications.

Travel/conferences

Education and Training expenses totaled \$18.8 thousand for January and February 2009, compared to \$21 thousand during the same period in 2008, and \$10 thousand for the same period in 2007.

Telephone/Cell phones

So far in 2009, telephone costs are recorded at \$140 thousand, compared to \$169 thousand for the same period in 2008. The savings has been realized by adopted the latest contract pricing from Nextel for cell phones as well as recent improvements in telephonic contract pricing.

Management Controls

Phase I (immediate)

Travel and Conferences: Limitations and Creative Solutions

Out-of-state travel has been limited to those events that are required to retain professional certification and other demonstrated needs. Employees are being encouraged to adopt creative ways to achieve professional development, including webinars and other on-line learning opportunities.

Telephone Cell Phone Usage Review

The Information Technology Department is working with staff from Budget and Accounting to develop a comprehensive review of telephony. Telephone units will be matched up to physical phone lines, and cell phones will be reviewed for business necessity.

Take-Home Vehicles and Car Allowance Review

The need for take-home vehicles is being reviewed at this time.

Selective Hiring Freeze

The Deputy City Manager, Human Resources Director and CFO have collaborated already on reviewing a number of requests to post job openings. Already several studies have been launched to see about re-designing tasks to achieve greater efficiency without simply replacing existing staff. In several cases, this review resulted in hiring a lower level staffperson.

Overtime: Monitor and Control

The Public Safety Chief and Public Services Director have instituted a review of overtime, and are monitoring data and practices in order to limit the almost \$2 million of overtime spent in these departments. Other departments are being asked to do the same.

Phase II (if needed)

Furloughs: Voluntary and Involuntary

A Preliminary analysis indicates that if all employees who are paid directly by the General Fund were given an unpaid day off, the savings to the City would save roughly \$100,000. General Fund staff other than sworn Public Safety officers total about \$30,000 - \$35,000 a day. Minimum staffing levels in Public Safety would have to be examined carefully in order to determine furlough parameters within the sworn officer ranks and to avoid creating overtime replacements.

Early retirement

Due to the deteriorated state of the Pension Trust Fund, this is not currently a preferred option for staff reduction.

Outsourcing and Operational Reductions, Program elimination

These opportunities are being looked at in many areas, particularly as it relates to the reduction plans that are being reviewed between department heads and the City Manager.

Future Wage/Benefit Constraints

In light of the current state of the pension system, as well as issues with revenue sharing and property taxes, a heightened sense of the City's ability to pay to maintain staffing and service levels has been shared between the City management and collective bargaining leadership. The City has successfully negotiated economically rational agreements with AFSCME and KMEA recently, as well as the KPSOA.

Short term: If the outlook for revenue sharing and/or property taxes worsens significantly in the near term, the City would likely approach the bargaining units in an effort to restructure existing agreements as a way to preserve jobs and service levels.

Long-term: If the outlook for the pension trust fund does not improve considerably by the end of the year, the City will approach the bargaining units and open discussions about retaining the defined benefit Pension benefit to existing retirees and employees, while closing it to new hires.

Although converting new hires to defined contribution pension (similar to the change that was negotiated with KMEA to convert new hires to defined contribution health care) would involve a guaranteed annual expense to fund their retirement investment account, nevertheless such a change would gradually lessen the risk of very high and unpredictable payments into the Pension Trust Fund as described in the Pension write-up earlier in this report.

Furthermore, there is a wage opener in the KMEA and AFSCME contracts for 2011, which provides flexibility should the economic situation worsen (or improve) significantly.

Capital deferment

The City is planning to bond for over \$4 million in capital projects this year (not including the \$1.5 million of road projects being funded by the U.S Recovery Act). While deferring capital improvements is by no means a preferred option, cutting out about \$1 million of projects from that list would save about \$500 thousand in interest payments every 5-7 years.

Reduction/Restructuring Plans

Reduction plans approximating 5% per department have been submitted by departments to the City Manager. These would represent nearly \$8 million out of the total city-wide budget, and more than \$2.5 million out of the General Fund budget.

At this time, nearly \$440 thousand of cost reductions have been identified without reducing any staff or affecting service levels.

Confidential reviews between the City Manager and Department heads will ensure that the Manager is able to employ the most comprehensive judgment when and if the decision to employ budget cuts becomes necessary.

The City Manager has asked department heads to design cost containment efforts by first identifying alternative methods to reduce cost while preserving services such as collaboration with other departments or organizations, as well as any new concepts that would alter how we do business and substantially reduce cost within an individual department or the entire organization.

It must be stressed that any cuts that are enacted will be sensitized to maintain service levels to the community, so that across-the-board cuts are out of the question. Management will strive to achieve greater efficiencies and change the way we do business in order to keep the focus on delivering high-quality services to the public.

I wish to thank the dedicated staff in Management Services for their assistance and support in this process, particularly Patsy Moore, Jennifer Clark, Phil Miller, Wade Carlson, Connie Darling and Wayne Nelson.

Thomas C. Skrobola
Director of Management Services/CFO