

## FINANCE COMMITTEE REPORT

Dear Resident of Sudbury,

This report will assist you in understanding Sudbury's fiscal year 2015 ("FY15") budget – from July 1, 2014 through June 30, 2015 - and the related financial articles that will be presented to you at Town Meeting beginning on May 5<sup>th</sup>. We believe, above all, that the participation of an informed voter is essential for the success of Sudbury's democratic process and continued fiscal health.

The Finance Committee is responsible for reviewing budgets for the town and schools and making recommendations to the Board of Selectmen and to the taxpayers at Town Meeting. In this role, we have no authority to make spending decisions as that is the responsibility of our various elected bodies. Rather, our role is to examine those budgets on your behalf and make independent and informed recommendations regarding the budget and other financial issues. We do so by gathering data and asking numerous questions prior to forming a recommendation.

This diligence process happens throughout the year as we meet with the Sudbury Town Departments (the "Town"), the Sudbury Public School K-8 School System ("SPS"), and the Lincoln-Sudbury Regional High School ("LSRHS" or the "High School") and other entities in regularly scheduled Finance Committee meetings as well as in smaller liaison meetings between one or two FinCom members and the management teams for each cost center.

This report is the culmination of a six month budget process. In October 2013, the FinCom issued budget guidelines to the leaders of the three principal Sudbury cost centers - the Town, SPS and the High School. In preparation for the budget hearing process in February 2014, we asked each cost center to prepare two budget scenarios for FY15:

- a No Override Budget that allows for annual growth up to 2.5% for each cost center and was based upon expectations regarding State aid and local receipts; and
- an optional Level Services (or roll-up) budget that assumes each cost center maintains the same service levels in FY15 as funded through their FY14 budgets

While we recognized that each cost center has certain unique characteristics, FinCom believed it important that a level of consistency exist in all budget submissions. As a result, we asked each cost center to make the following assumptions when constructing their FY15 budget submissions:

- for all cost centers, salary and other cash compensation was relatively straightforward as it was based on the final year of the recent contract negotiations;
- best estimates of expected health and benefit costs increases; and
- best estimates of utilities and, where applicable, transportation and special education cost increases or decreases.

As health and benefit cost increases have become known figures, FinCom has provided guidance to the cost centers to revise budgets based on differences to initial assumptions. The Town and SPS assumed +5% growth in GIC rates and built budgets accordingly. Actual GIC growth rates were only +1%, and so FinCom is presenting an operating budget that is reduced accordingly by \$128,711 for SPS and \$39,790 for The Town.

### Recommended No Override Budget

For FY15, we are recommending only a No Override Budget of approximately \$85.2 million. The No Override Budget represents a residential tax increase of approximately 0.41% (\$48) on the average assessed home value of \$640,277 and a total increase in taxes of approximately \$622,000, including new growth and commercial property taxes, as compared to the FY14 tax levy.

The No Override Budget is in compliance with Proposition 2½ (“Prop 2 ½”), which was approved by Massachusetts voters in 1980 and first implemented in fiscal year 1982 (M.G.L. Ch. 59, sec. 21c). It limits the amount of revenue a city or town may raise, or levy, from local property taxes each year to fund municipal operations without the approval of taxpayers at the ballot box. Prop 2 ½ is not meant to be a “fiscally responsible spending benchmark”. Exceeding this level should not necessarily be construed with negative implications towards a town’s or a schools’ financial management. It is meant to reflect a “check and balance” point at the local level: town officials cannot raise taxes more than allowed under Prop 2 ½ without an affirmative vote of the taxpayers. To spend more money, town officials have to “make their case” to the taxpayers who can apply their own test of reasonableness by their votes at Town Meeting and the polls.

The FY15 No Override Budget represents a 2.5% increase in the operating budget for each cost center compared to the FY14 budget. The difference in growth between the residential property tax increase of 0.41% and the allowable growth in the operating budgets of each cost center is due to the expiration of a one-time \$700K capital exclusion in FY14, a significant reduction, a decrease in the debt exclusion of \$1.36 million and a shift in assessment for LSRHS from Sudbury to Lincoln as compared to FY14.

In the case of the High School, the percentage of students did not shift materially between Sudbury and Lincoln from FY14 to FY15. The principal reason for the decrease in the assessment was an increase in Lincoln’s required statutory minimum contribution as calculated by the DOR. The determination of the overall assessment to each town has two major components in the calculation. The first component is a statutory minimum contribution as calculated by the DOR, which measures relative changes of member towns and incorporates those relative changes into a formula to calculate each member town’s contribution. The second component is based on average student enrollment and is governed by the specific regional agreement between the member towns. As shown in the table set forth below, Lincoln’s statutory minimum contribution increased by nearly 17% from FY14 to FY15 as compared to a more modest +9% increase for Sudbury.

\$ in Thousands	FY14			FY15			Growth: FY14 vs. FY15		
	Lincoln	Sudbury	Total	Lincoln	Sudbury	Total	Lincoln	Sudbury	Total
Student Ratio Calculation	14.33%	85.67%	100.00%	14.45%	85.55%	100.00%			
LSRHS Operating Budget within Levy			\$26,642			\$27,308			2.50%
Offsets/Re-apportionment									
E&D Usage			\$ (666)			\$ -			
Receipts			\$ (50)			\$ (50)			0.00%
State Aid			\$ (2,650)			\$ (2,686)			1.35%
Regional Transportation			\$ (246)			\$ (294)			19.50%
Encumbrances			\$ -			\$ -			NM
Re-apportionment			\$ -			\$ -			NM
LSRHS Offsets <sup>(a)</sup>			<u>(3,613)</u>			<u>(3,030)</u>			-16.12%
Sub-Total After Offsets			<u>\$23,029</u>			<u>\$24,277</u>			5.42%
Statutory Minimum Contribution <sup>(b)</sup>	\$ 1,925	\$11,952	\$13,878	\$ 2,247	\$13,009	\$15,256	16.70%	8.84%	9.93%
Budget in Excess of Minimum <sup>(c)</sup>	<u>1,311</u>	<u>7,840</u>	<u>9,151</u>	<u>1,304</u>	<u>7,718</u>	<u>9,022</u>	-0.59%	-1.55%	-1.41%
Operating Budget Assessment	\$ 3,237	\$19,792	\$23,029	\$ 3,551	\$20,727	\$24,277	9.69%	4.72%	5.42%
Share of Total Operating Budget	14.06%	85.94%	100.0%	14.6%	85.38%	100.00%			

(a) Offsets include, but are not limited to, State Aid, receipt of fees, E&D usage and regional transportation reimbursement.

(b) The minimum contribution required from each town is calculated by the DOR (called the Statutory Method).

(c) Assessment of the Budget in Excess of Minimum is calculated as per the regional school agreement based on number of students from each respective town.

In round numbers, Sudbury funded roughly 86% of the LS operating budget in FY14 and now will fund roughly 85% of the LS budget in FY15, with the net result that the LSRHS operating budget assessment to Sudbury has increased by +4.72%. This increase should not be confused with the High School's overall budget, which in the context of an FY15 No Override Budget, has the same allowable growth of 2.5% as the other cost centers. The reason for the increase from FY14 to FY15 is that LS used \$666K of E&D as a budget offset in FY14, and is not planning to apply any of the E&D balance to fund FY15 operations.

Sources of revenue and changes from FY14 are set forth below.

- Under Proposition 2 ½, the tax increase is limited to 2 ½% of the overall tax levy; for FY15, this increase is approximately \$1.73 million.
- New growth, the tax on new and upgraded properties, is estimated to generate \$520,000 of new revenue in addition to the allowed increase in the levy (bringing the total levy increase to approximately \$2.3 million or 3.25%), which is consistent with the FY14 assumption on new growth; this number assumes a continued recovery in new home construction and renovation activity from the recent economic downturn.
- The capital exclusion portion of the tax levy is decreasing by \$700K to \$0 as the capital exclusion was a one-time exclusion in FY14 to fund the Town Center traffic improvements.
- The debt exclusion portion of the tax levy (for payment of principal and interest costs) is decreasing by approximately \$1.36 million, or 40%, from FY14 due to maturing debt on prior borrowings and refinancing of existing debt.
- State aid revenue is estimated to increase by approximately \$250,000 from FY14 levels, comprised of no increase in State Aid to Sudbury and an increase in state aid to LSRHS of approximately \$250,000. This projection is based on the Governor's proposed budget and represents our best estimate at the time of publication of the warrant. To date, discussions regarding state aid from the

state legislature are still evolving. Should new information be provided we will update our assumption for state aid heading into Town Meeting as we've done in previous years.

- Local receipts, primarily motor vehicle excise taxes and fees charged for certain town services, are currently estimated at \$4.4 million, an increase of +7.3% from the FY14 budget level of approximately \$4.1 million. Local receipts have rebounded in recent years from the recession to healthy levels, and Sudbury has raised its conservative forecasts of local receipts to align with recent actual growth.
- The annual school debt reimbursement represents aid from the State and is the same as FY14 as this amount will not change for the remainder of the payments scheduled through FY21 (unless the outstanding debt is refinanced); this aid must be used to reduce the amount of school debt issued and is excluded from the normal Proposition 2 ½ tax levy limit.

### Ongoing Savings from Healthcare Changes

The significant rate of growth in health insurance costs for current and retired employees over the past decade has placed significant pressure on municipal operating budgets. Historically, making changes to these plans has been constrained by the requirements of collective bargaining. Fortunately, changes negotiated in our labor contracts four years ago helped to decrease that rate of growth in healthcare from prior levels. This resulted in significant savings from prior budget levels for the Town and SPS as well as for the High School.

Three years ago, the Legislature provided municipalities with an important tool to continue to reign in the significant growth of healthcare costs and provide significant and immediate savings to local governments. On July 12, 2011, Governor Duval Patrick signed An Act Relative to Municipal Health Insurance which amends Massachusetts General Laws Chapter 32B. This legislation provided a mechanism for municipalities to move to the Group Insurance Commission (the "GIC") outside the collective bargaining process. Prior to this recent change in legislation, entry into the GIC was subject to approval by all labor unions.

The Board of Selectmen voted to accept the provisions of sections 21-23 of Chapter 32B of the General Laws in November 2011. After following the prescribed process, the outcome for the Town and SPS was a decision to join the GIC. On July 1, 2012, all active employees and retirees for the Town and SPS migrated to the Commonwealth's GIC health benefits system. Collectively, the move to the GIC generated savings of more than \$2 million in FY14. Similarly, as we head into FY15, the GIC announced in March 2014 that health insurance premium rate increases would be held to an average increase of 1% across its offering of health plans, below both the state and national averages.

Similarly, the LSRHS School Committee embarked on a process in FY12 to determine what changes to make to their health insurance coverage. The outcome of this process was for the School Committee to drive savings by making GIC-like changes to the local plans offered by their current purchasing coalition, Minuteman Nashoba Health Group ("MNHG"). In addition, the High School made other changes in cooperation with the LSRHS teachers by decreasing the contribution rate on the high cost indemnity plans and implementing an opt-out incentive to drive further savings. Collectively, these changes along with the MNHG announcement have resulted in the High School budgeting flat healthcare expense growth in FY15, and these costs have been flat going back to FY12.

The Finance Committee commends the actions taken by the Town, SPS and the High School to implement these healthcare changes over the past several years. These savings have been a critical piece of lessening any potential adverse impacts that might result from the constraints of operating within a No Override budget.

## OPEB Liabilities

The Commonwealth's Department of Revenue defines OPEB as post-employment benefits other than pensions which generally take the form of health insurance and dental, vision, prescription, or other healthcare benefits provided to eligible retirees, including in some cases their beneficiaries. They may also include some type of life insurance. For decades, state and local governments have promised defined benefit pensions together with retiree healthcare benefits as part of the compensation package provided to government employees. While funds were often set aside to cover the cost of the pension payments when they came due, generally no funds were set aside to cover the cost of the promised healthcare premiums. As a result, most towns today (including Sudbury) have an operating budget that includes salaries and healthcare benefits for active employees, plus healthcare benefits for retired employees who are no longer actively employed. Operating budgets are paying for the cost of operating government today plus part of the cost of operating government in the past - that unfunded liability to pay for healthcare in retirement. It has only been in the last five years that the Government Accounting Standards Board ("GASB"), which governs municipal accounting, required municipalities to calculate the amount of this liability and include it in the footnotes to their financial statements.

Every other year, The Town and SPS ("Town/SPS") and LSRHS obtain actuarial valuation reports to determine the estimated value of their respective OPEB liabilities. These reports also determine the Town/SPS's and LSRHS' annual required contribution ("ARC") for OPEB purposes. The ARC represents a level of funding that, if paid on an ongoing basis, is projected (i) to cover the normal cost per year (the cost that year of the promises of retiree healthcare benefits made to active employees) and (ii) amortize the actuarial accrued liability (the unfunded cost of the promises of retiree healthcare benefits made in prior years to employees now retired) over a period of thirty years. As of the last actuarial report as of July 1, 2011, the ARC for the Town/SPS and LSRHS was \$3,663,686 and \$4,457,705, respectively (copies of which are available on the Town's website).

As of the last actuarial report as of July 1, 2011, the estimated OPEB liability for the Town/SPS employees is \$34.3 million. Due to the move to the GIC, the OPEB liability actually decreased by nearly \$16 million as compared to the prior actuarial assumptions. The estimated OPEB liability for LSRHS is \$46.1 million. These amounts assume that the Town/SPS and LS continue the current practice with regard to retiree healthcare liabilities of "Pay-As-You-Go" (i.e. - pay the bills for retirees' health costs as they are presented without setting aside funds for future costs). In addition to the specific plans available to each cost center's employees, differences in per employee liabilities for a cost center are also impacted by employee contribution levels towards their insurance costs.

The Town/SPS and LSRHS are in the very early stages of looking at funding mechanisms to address this potential future burden, having established an OPEB working group in 2013 to review this issue. While the Commonwealth has not mandated that communities with OPEB trusts make their ARC each year, the Finance Committee believes it is prudent to determine a mechanism to begin to fund the OPEB trust on a sustainable basis.

## Analysis of Free Cash

The accumulation and subsequent usage of free cash is a central issue to the FY15 budgeting process. The Mass Division of Local Services defines Free Cash as follows:

*"Free cash is a revenue source which results from the calculation, as of July 1, of a community's remaining, unrestricted funds from operations of the previous fiscal year based on the balance sheet as of June 30. It typically includes actual receipts in excess of revenue estimates and unspent*

*amounts in departmental budget line-items for the year just ending, plus unexpended free cash from the previous year.”*

Free cash in and of itself is not a bad thing – sound fiscal budgeting ensures that revenues are being forecasted conservatively, and expense budgets plan for potential overages in items like health care, overtime, and other items – rather than have to either go back to the taxpayers mid-year to ask for more money, or make unexpected and disruptive midyear budget cuts. However, the amount of free cash that is generated should be monitored to ensure that the taxpayers are not unnecessarily bearing the cost of tax increases without proper justification.

<u>Certified as of July 1,</u>	<u>Results from</u>	<u>Certified Amount</u>
2008	FY08	\$15,235
2009	FY09	\$488,595
2010	FY10	\$249,418
2011	FY11	\$674,860
2012	FY12	\$2,388,556
2013	FY13	\$2,380,250

In FY12 and FY13, Sudbury generated significant amounts of free cash, and that pattern is expected to persist in FY14. The reason for this surplus free cash is due both to under-forecasting of revenues and over-forecasting of expenses. On the revenue side, in FY08-FY11, there had been a precipitous drop in both state aid and local receipts. Both sources of revenue rebounded by FY12, however budgeting happens a year and a half before results are known, and the FY12 and FY13 budgets were developed with a high amount of conservatism as that rebound had not yet been observed. The result was a revenue forecast that was below actuals by \$1.11 million for FY12 and \$1.08 million for FY13. Assumptions on local receipts increased for FY14, although it is still expected that free cash will be generated. In the current FY15 budget, assumptions for local receipts have been increased significantly, which suggests that Sudbury will no longer see free cash from conservative revenue forecasting after FY14.

On the expense side, it should be expected that Sudbury should generate some free cash each year, due to conservative budgeting and contingency planning. In FY13, this amount was significantly higher than previous years due to uncertainty around health care costs. Beginning July 1, 2012, the Town and SPS moved to the GIC health plan. The savings from this move were largely unknown, as the number of employees that would subscribe to various plans or opt out of any health plan was unknown. Because of these unknowns, there was a lot of conservatism built into the budgeting process, which resulted in \$555K of free cash from FY13 health care, for a total of \$1.13 million in free cash from expenses. It is expected that additional free cash will be generated for similar reasons from FY14, however the insurance assumptions are much more grounded in actual historical results for the FY15 budget and there should be a much lower amount of free cash generated.

FY12 was the first year in several years in which there was a significant amount of free cash generated. At Town Meeting in 2013, the Town voted to move \$2.09 million to the stabilization fund, the first such contribution in many years. At Town Meeting in 2014, the voters will need to decide what to do with the sizable balance of free cash that was generated in FY13. Some of the options include using the cash for one-time expenses such as capital purchases, using it to fund the growing OPEB liability, continuing to build reserve balances, or even applying it as revenue in the operating budget, which effectively returns the cash to the taxpayers by lowering the increase on the tax levy.



Following extensive debate, opinions on FinCom were split as to how to best deploy this free cash. Some members advocated for using free cash for one-time capital expenses as presented by the Town Manager in the Warrant. Other FinCom members advocated for an alternative approach that would still fund much of the capital expenses but would also apply \$850-\$900K of free cash towards the operating budget to reduce the tax levy

As the voters evaluate these options, it is important to take a historical view on how Sudbury has used free cash in the past. In the 2000's, Sudbury would regularly generate a healthy amount of free cash, and then would apply that free cash to the operating budget. Because the free cash was generated with consistency and regularity, this practice was not a problem as free cash was viewed a dependable source of revenue. However, in FY08 and FY09, the revenues from local receipts and state aid dropped precipitously, and free cash was not generated. This created a significant hole in the revenue side of the budget, and combined with mid-year cuts to state aid forced the Town to make very painful and broad-based mid-year budget cuts.

Since FY10, FinCom and the Town have followed a policy of not applying free cash towards the operating budget, recognizing that due to budget to actual variances, it is unreliable and therefore should be appropriated in budget planning with great caution. This philosophy has allowed Sudbury to recover from the great recession, build up appropriate reserves for a town of our size, and put conservative budgeting policies in place to ensure that future budget shortfalls are avoided.

With the appropriation of Free Cash in recent years, the stabilization fund is now considered to be a healthy balance which should provide Sudbury with a safety net not felt in many years. With free cash from 2013 of \$2.3 million and some free cash also expected to be generated in FY14, voters must decide what to do with the free cash. Whether the utilization of free cash is done via investing in capital assets, lowering overall debt obligations, reducing the tax levy, or retained to begin addressing the OPEB liability, voters should be informed and make this decision with great consideration. If the voters choose to use free cash to reduce the tax levy, effectively, Sudbury must continue to generate the same levels of free cash in order to support recurring expenses. If the level of free cash drops, the only other two alternatives are to fund the shortfall via an operating override or cut the budget by the amount of free cash previously used.

### Conclusions

Within the context of what is still an uncertain economic environment, and like many other communities across the Commonwealth, achieving a balanced budget in Sudbury is not without its challenges. Over the past several years, the Town's fiscal situation has been constrained by negotiated increases in the cost of wages and benefits which have risen faster than the rate of inflation. As is common to towns where education is placed at a priority in investment, our student population, though in decline, is still considered sizeable. Our schools as well as other town assets and resources must be preserved.

The challenge in protecting our assets and preparing a sustainable budget is that our cost structure is constrained by the fact that our revenue structure is heavily dependent on property taxes with only 7% of Sudbury's total revenues coming from commercial property taxes and 70% coming from residential taxes. As a result, residents bear the brunt of any tax increases.

Fortunately, changes negotiated in our labor contracts several years ago helped to decrease that rate of growth in wages and benefits, particularly healthcare, significantly. These changes helped to lessen the collective impact of lower State Aid and non-property tax related revenues during the economic downturn. To be clear, layoffs and the elimination of services were still required in many areas to collectively allow us to balance our budget during the downturn. However, on a relative basis, Sudbury still fared better than many other communities in the Commonwealth during this time. More recently, the move to the GIC by the Town and SPS as well as healthcare changes made at the High School have yielded significant cost savings.

The Finance Committee expresses great appreciation to the cost centers in their initiatives to help manage healthcare expenses. This was an enormous step in addressing Sudbury's structural deficit.

We encourage the Selectmen and School Committees to continue their efforts to reduce our structural costs. They have already begun the process of implementing several initiatives including reductions in the rate of growth in wages, reductions in the cost of employee health insurance, enhancing cooperation among school administrations, achieving clean energy benefits through the Energy and Sustainability Committee, and sharing staff with neighboring communities. Moreover, we continue to support the Selectmen's on-going efforts to sustain and grow our commercial sector so that we might diversify our tax base and secure revenue opportunities beyond the traditional residential property tax, which we believe is critical.

We strongly urge you to be informed on the budgets being presented for your consideration. You have several avenues to increase your understanding of how each budget will affect the level of services, schooling and quality of life in Sudbury. Please review the Finance Committee Report section of the Town Warrant; attend budget forums; watch the Finance Committee budget hearings, which will be rebroadcast on Channels 8 (Comcast) and 31 (Verizon) during March and April; and review the vast array of budget materials available on the town and school websites. Also, do not hesitate to ask questions of your elected officials and committee members.

Whether or not you agree with our findings and recommendations, please make sure that when you cast your vote, it is an informed one.

Lastly, the Finance Committee would like to recognize and extend thanks to the employees of the Town, SPS and LSRHS, and the various committees for their support and contributions during the preparation of the FY15 budget.

Respectfully yours,  
Sudbury Finance Committee

Douglas Kohen, Chair  
Joan Carlton, Vice Chair  
Susan Berry  
Tammie Dufault  
Robert Jacobson

William Kneeland, Jr.  
Mark Minassian  
Robert Stein  
Andrew Sullivan