

FY 2009 BUDGET SECOND QUARTER REPORT



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Summary

ECONOMIC CONDITIONS

Unemployment (page 10): Statewide unemployment in Michigan is projected to approach 16 percent by 2010, with no bottom in sight. Nationally, unemployment is nearing 10 percent. While the growth of the unemployment rolls has slowed, the situation shows no sign of reversal at this time.

Auto Sales (page 16): Projections of 6.5 to 7.0 million domestic sales for GM, Ford and Chrysler for 2009 are ahead of the January projections by the automakers and Wall Street analysts which were between 4.5 and 5.5 million units.

Auto sales have been one of the few bright spots in the economic data this first half, as excess inventory is being offloaded and consolidated at the same time via large-scale forced dealership closures by the auto companies.

The unprecedented bankruptcy process for Chrysler and General Motors has proceeded very rapidly through the courts with the sponsorship of the Obama Administration. The new Chrysler and GM companies will likely be largely owned by a consortium led by the federal government and the United Auto Workers union. The effects of these developments are impossible to determine at this point – however, they appear to signal an improved condition for the Michigan-based automakers, which should help to stabilize the state government's fiscal situation.

Consumer Price Index (page 18): The same three scenarios with regards to inflation present themselves again, just as they did at the end of the 1st Quarter of 2009:

1. Deflation: this continues 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 20): If there is a significant growth pattern in the near future, it would be best to look at the Pension Trust Fund at the end of the 3rd Quarter of 2009 and see if a new baseline for long-term growth has been established or not. Please see the Pension section of this report for more discussion on this topic.

Mortgage Rates (page 24): Mortgage rates are going to continue to be forced downward by the Federal Reserve, unless inflation becomes an issue.

Pension (page 27): Recommendation: It is imperative that the City seek reasonable ways to rebalance its pension liabilities with its anticipated assets.

It is unclear at this point whether altering the smoothing mechanism would be of value. The City should re-examine the fund's experience after the next 6 months and assist the Retirement Investment Committee in their deliberations about the smoothing mechanism, as well as other actuarial methods and assumptions.

REVENUE

General Fund Total Revenue (Jan – May 09): est. \$5.8 million (2008: \$6.3 million)

Property Taxes (page 29): instead of the \$600 thousand increase in property tax revenue for the General Fund that was projected for 2010, we are anticipating a decrease of approximately \$1.5-1.75 million, netting a total loss of property tax revenue of \$2.1 - \$2.35 million to the General Fund for FY 2010.

Stated Shared Revenue (page 33): we are projecting losses of 10 percent in Revenue Sharing by the end of the City's FY 2010. This should amount to a little more than \$1 million of lost revenue for the General Fund for FY 2010. The State may make cuts in Revenue Sharing that affect our FY 2009. However, such cuts, should they occur, are manageable by virtue of our Budget Stabilization fund.

Act 51 Revenue (page 35): if the current trend continues, there should be no need for action regarding our road maintenance funds for FY 2009. However, there is likely to be a loss of roughly \$250 thousand of Act 51 revenue for FY 2010, which will require a combination of additional subsidies from the General Fund to support current Local Street operations and/or reductions in Local Street operations.

Interest Income (page 35): The General Fund stands to lose approximately \$250 thousand in investment returns in 2009 if interest rates do not pick up into more nominal territory.

Stimulus Package (page 36): The Stimulus funding resulted in savings of more than \$1.27 million in bonded indebtedness, primarily due to cash-financing major street projects and the early warning system. When combined with favorable interest rates realized at the sale (due largely to the renewal of the City's bond rating with a "stable" economic outlook by the rating agencies), this will result in savings of \$95 thousand in FY 2009 and \$160 thousand every subsequent year.

EXPENDITURES

General Fund Total Expenditures (Jan – May 09): est. \$18.2 million (2008: \$20.9 million) – net expense of \$12.4 million (2008: \$14.6 million).

Health Care (page 37): 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 38): 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 \$300 thousand for the General Fund and \$350 thousand in FY 2010.

Telephones (page 39): Through May 2009, telephone costs are recorded at \$160 thousand, compared to \$255 thousand for the same period in 2008. The savings of approximately \$100 thousand 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 40): 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 staff or service levels.

SUMMARY

When all of the above items are netted together, the City is already positioned in FY 2009 to annualize approximately \$700 thousand of net savings for the General Fund relative to the FY 2009 Budget.

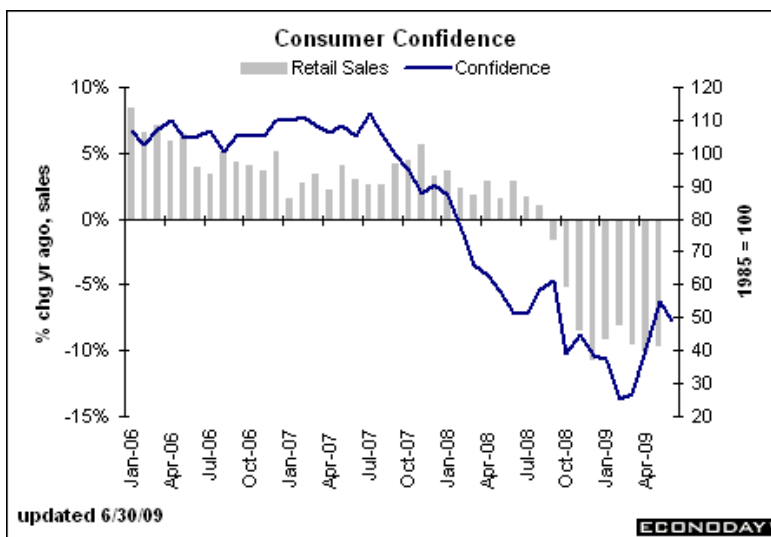
At this time, we are projecting an approximate \$2.75 million (roughly 5 percent) net shortfall in the General Fund when compared to the amounts projected in the FY 2010 Budget. This has the potential to increase to a 10% problem for the General Fund, possibly as early as FY 2010, if Revenue Sharing should be pulled further into the red by the failure of the auto industry and/or decisions by the State Legislature to enact deeper cuts into Revenue Sharing than what is currently being envisioned.

Furthermore, the inauguration of multi-million dollar annual contributions to the Pension system by the General Fund beginning as early as 2013 has the potential to grow the overall scope of the problem for the General Fund to 15 percent within the next five years.

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

The consumer sector appears to have crumbled in June, according to the Conference Board's consumer confidence index which fell 5-1/2 points to 49.3. This index, along with other consumer readings, had been showing big improvement as consumers grew increasingly less pessimistic on current conditions and especially on the outlook. But the expectations component fell back in June, down 6 points to 65.5. The assessment of the present situation, in another setback, fell nearly 5 points to 24.8.

High unemployment and high gas prices are two central reasons for the pessimism. Those saying jobs are plentiful fell 1.3 percentage points to a microscopic 4.5 percent. Those saying jobs are hard to get rose nearly 1 percentage point to 44.8 percent. Inflation expectations jumped 3 tenths in the month to 5.9 percent fed by a roughly 5 percent rise in pump prices during the month. There's no indication that concern over monetary inflation is at play in inflation expectations.

Says Lynn Franco, Director of The Conference Board Consumer Research Center: "After back-to-back months of strong gains, Consumer Confidence retreated in June. The decline in the Present Situation Index, caused by a less favorable assessment of business conditions and employment, continues to imply that economic conditions, while not as weak as earlier this year, are nonetheless weak. Looking ahead, expectations continue to suggest less negative conditions in the months ahead, as opposed to strong growth."

Consumers' appraisal of present-day conditions was less favorable in June. Those claiming business conditions are "good" decreased to 8.0 percent from 8.8 percent, while those saying conditions are "bad" increased to 45.6 percent from 44.5 percent. Consumers' assessment of the labor market was also less favorable. Those stating jobs are "hard to get" increased to 44.8 percent from 43.9 percent. Those saying jobs are "plentiful" decreased to 4.5 percent from 5.8 percent.

Consumers' short-term outlook also waned in June. Consumers anticipating an improvement in business conditions over the next six months decreased to 21.2 percent from 22.5 percent, while those expecting conditions will worsen increased to 20.2 percent from 18.0 percent in May.

The job outlook was also more pessimistic. Those anticipating more jobs in the months ahead decreased to 17.4 percent from 19.3 percent, while those anticipating fewer jobs increased to 27.3 percent from 25.6 percent. The proportion of consumers expecting an increase in their incomes declined to 9.8 percent from 10.8 percent.

– *Conference-Board.org, June 30, 2009*

Americans – whose hope for the economy had been rising since March – are starting to lose faith, pushing down a widely watched barometer of sentiment in June.

The New York-based Conference Board said Tuesday that its Consumer Confidence Index now stands at 49.3, down from its revised May level of 54.8.

Economists surveyed by Thomson Reuters had projected confidence would be virtually unchanged at 55 this month. The dip follows surges in April and May that were helped by a stock market rally.

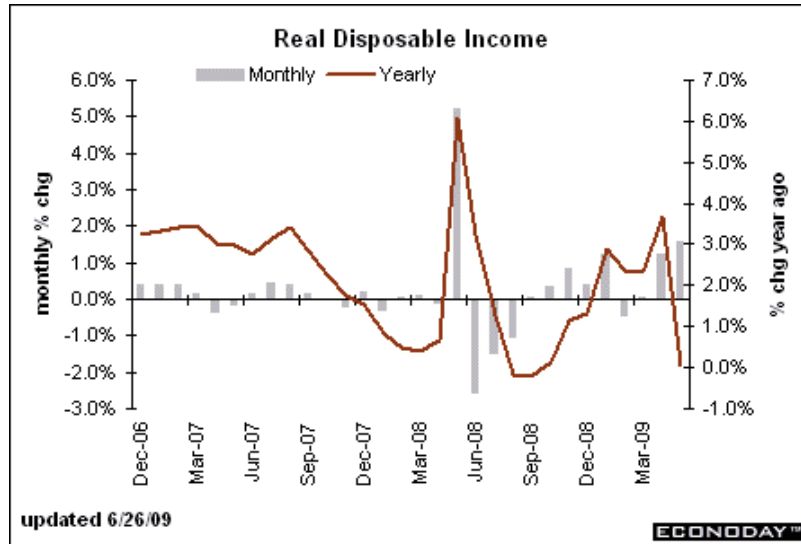
-- *U.S. consumer confidence slips*, Anne D'Innocenzio, AP, June 30, 2009

Looking Ahead

As a lagging indicator, consumer confidence will not likely show gains into positive territory (over 80) until the public feels that the recovery is underway, which will likely be after business investment and jobs begin recovering.

Taken as a whole for the 2nd quarter consumer confidence went up, but given June's retreat it should continue to be monitored for potential future slippage. The sudden deterioration of consumer confidence indicates that the public remains pessimistic about a near-term recovery, and this index will likely remain relatively negative into 2010.

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.

Expert Testimony

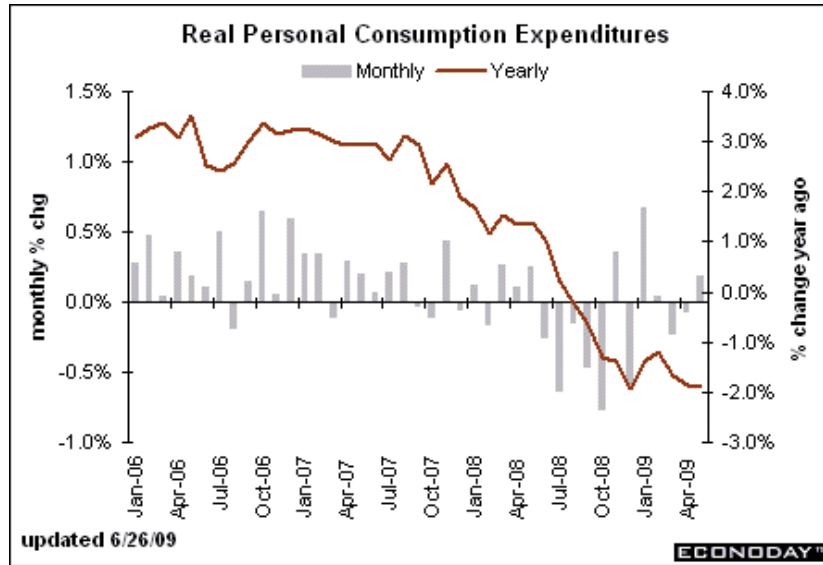
Although the chart above only reflects data through the end of March 2009, which had been flat since the beginning of 2009, personal income increased \$167.1 billion, or 1.4 percent, and disposable personal income (DPI) increased \$178.1 billion (after a \$140 billion increase in April), or 1.6 percent, in May (after a \$78.3 billion increase in April), while personal consumption expenditures (PCE) increased \$25.1 billion (after a \$1.0 billion increase in April), or 0.3 percent, according to the Bureau of Economic Analysis.

Private wage and salary disbursements decreased \$12.4 billion in May, compared with a decrease of \$0.7 billion in April. Goods-producing industries' payrolls decreased \$12.9 billion, compared with a decrease of \$12.2 billion; manufacturing payrolls decreased \$9.8 billion, compared with a decrease of \$4.9 billion. Services-producing industries' payrolls increased \$0.5 billion, compared with an increase of \$11.5 billion. Government wage and salary disbursements increased \$3.9 billion, compared with an increase of \$5.7 billion.

Changes in personal income and in DPI (when viewed in the light of decreases in wages) reflect increases in government activity and assistance associated with the American Recovery and Reinvestment Act of 2009.

— Econoday.com

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.

Expert Testimony

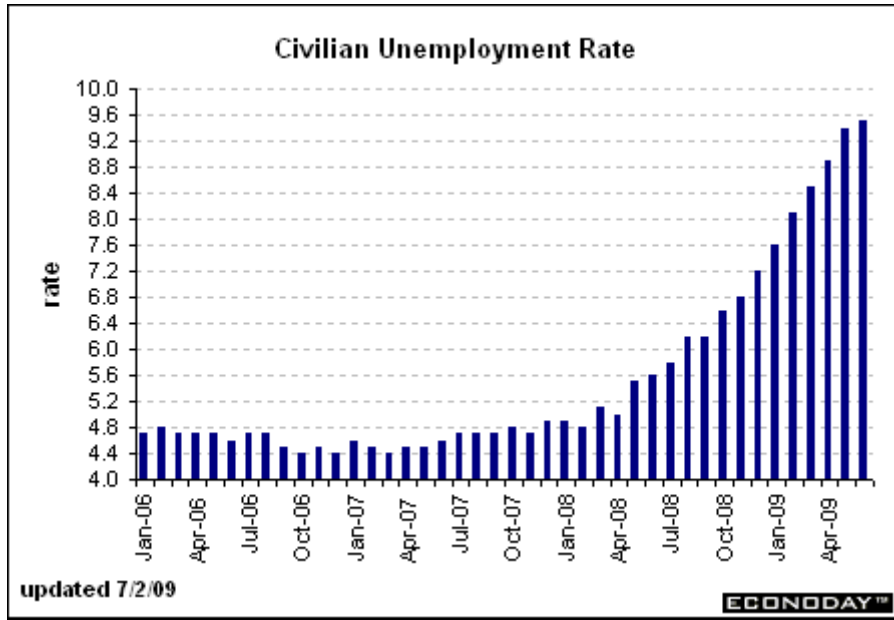
Personal income in May surged far more than expected but it was nearly all related to temporary fiscal stimulus. However, consumers did open up their wallets for a modest spending jaunt. Personal income posted a huge 1.4 percent gain in May, following a 0.7 percent boost in the month before. The rise in the latest month topped the market projection for a 0.4 percent increase. The advance in personal income was led by one-time payments under the American Recovery and Reinvestment Act of 2009.

The boost in consumer spending was led by a 0.8 percent jump in durables in May after dropping 1.3 percent the prior month. Consumers are being cautious with the one-time payments from a special Social Security based stimulus package (which is not being funded from the Social Security trust fund). However, the additional income will likely help consumption in coming months.

Today's report indicates that fiscal stimulus is bolstering the consumer sector somewhat-but not as much as hoped for as consumer spending is lagging the income gain significantly. But the unspent income will help support spending in coming months. Equities should like the numbers while bond yields rose on the news. But equities could head in any direction with the restructuring of the Russell 2000 and the end of the quarter looming.

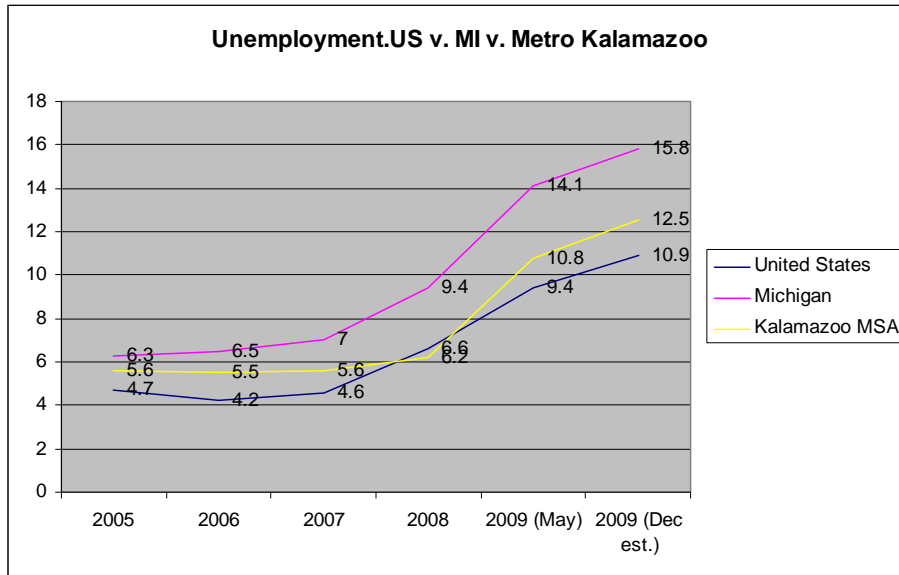
– Econoday.com

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>

Expert Testimony

In April, when nationwide unemployment had climbed above 8 percent, we reported that forecasters “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.” Unemployment is already over 9 percent nationwide, and is on track to reach double-digits by the end of 2009 if a recovery in the commercial and industrial sector does not begin soon.

The labor sector continued to contract in June with payroll jobs falling more than expected while the unemployment rate rose just marginally. Nonfarm payroll employment in June declined 467,000, following a fall of 322,000 in May and a decrease of 519,000 in April. The June contraction in jobs was worse than the market forecast for a 350,000 decrease. May and April revisions were up a net 8,000. Payroll losses were widespread.

By major categories, goods-producing jobs dropped 223,000 in June, led by a 136,000 drop in manufacturing employment with motor vehicles & parts down 27,000. Construction decreased 79,000 while natural resources & mining slipped 8,000. Service-providing payrolls dropped 244,000 in June after falling 107,000 in May. Weakness was especially pronounced in professional business services which plunged 118,000. Notable declines were also seen in trade & transportation, down 51,000, and in government, down 52,000.

From the household survey, the civilian unemployment rate rose to 9.5 percent from 9.4 percent in May and was lower than the consensus forecast for 9.6 percent. But the number of unemployed hit 14.7 million, a record high. The June unemployment rate is the highest since 9.5 percent for August 1983.

– *Econoday.com*

Looking Ahead

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 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.

The national and global economies have failed to initiate a recovery. The recession is now in its 20th month, making it one of the longest and deepest in the last 100 years. Statewide unemployment in Michigan is projected to approach 16 percent by 2010, with no bottom in sight. Nationally, unemployment is nearing 10 percent. While the growth of the unemployment rolls has slowed, the situation shows no sign of reversal at this time.

The lack of a recovery is being evinced by the lack of demand in the construction, mining, and service-providing sectors of the economy, which represent the areas that should see demand pick up as a recovery finds its footing.

Housing Starts and Existing Home Sales

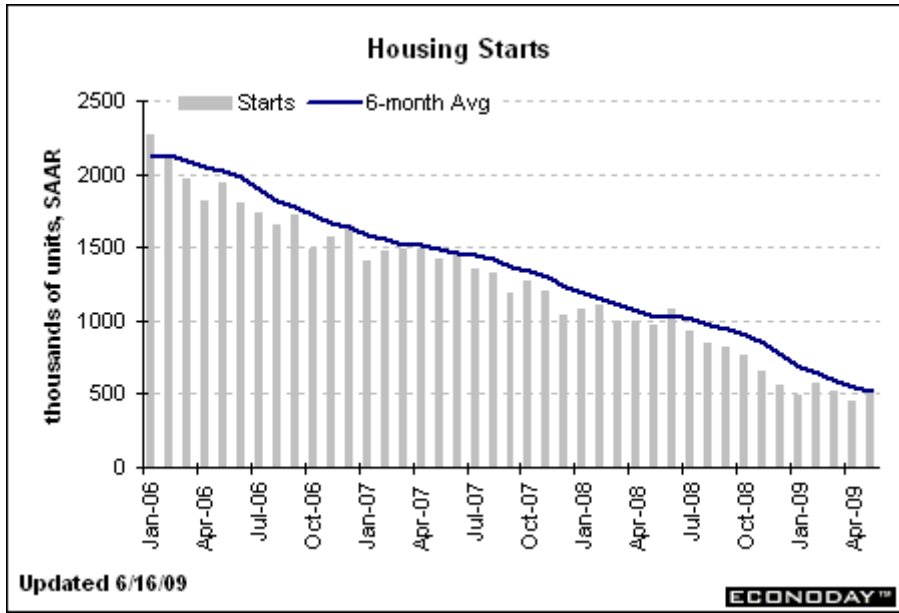
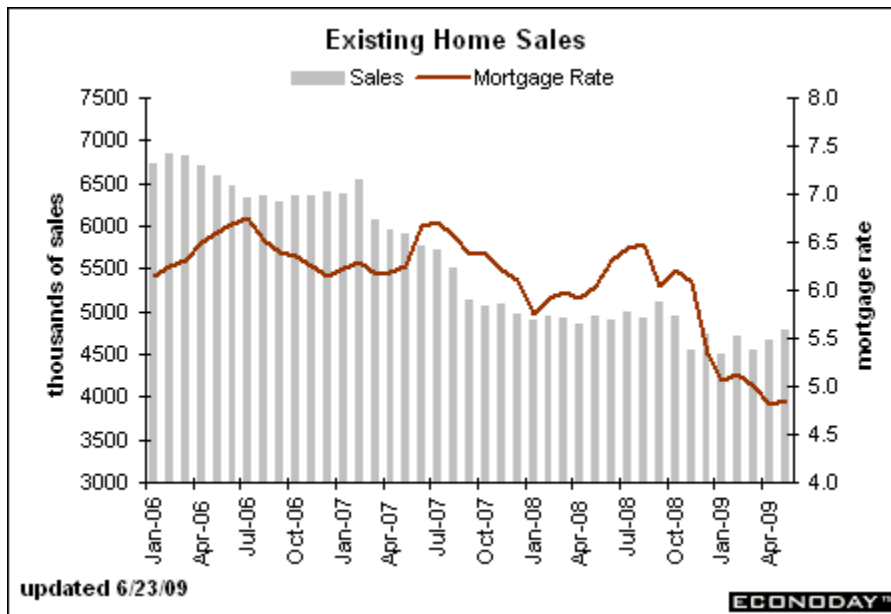


Table 6



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

Housing starts in May showed surprising strength-even in the single-family component. Starts rebounded 17.2 percent, following sharp 12.9 percent drop the month before. The May pace of 0.532 million units annualized was down 45.2 percent year-on-year and was above the market projection for 0.500 million units. The rebound in May was led by the multifamily component which posted a 61.7 percent comeback after falling 49.4 percent in April. But the single-family component gained 7.5 percent, following a 3.3 percent rise the month before.

Existing home sales weren't that bad in May, up a sharp 2.4 percent but to a 4.770 million annual rate that is below expectations for 4.850 million. Supply is down which is good news, at 9.6 months vs. 10.1 in April. Prices also firmed, up 3.8 percent in the month to a median \$173,000 though the year-on-year decline actually deepened slightly, at -16.8 percent. Data are steady from region to region with the Midwest leading the month.

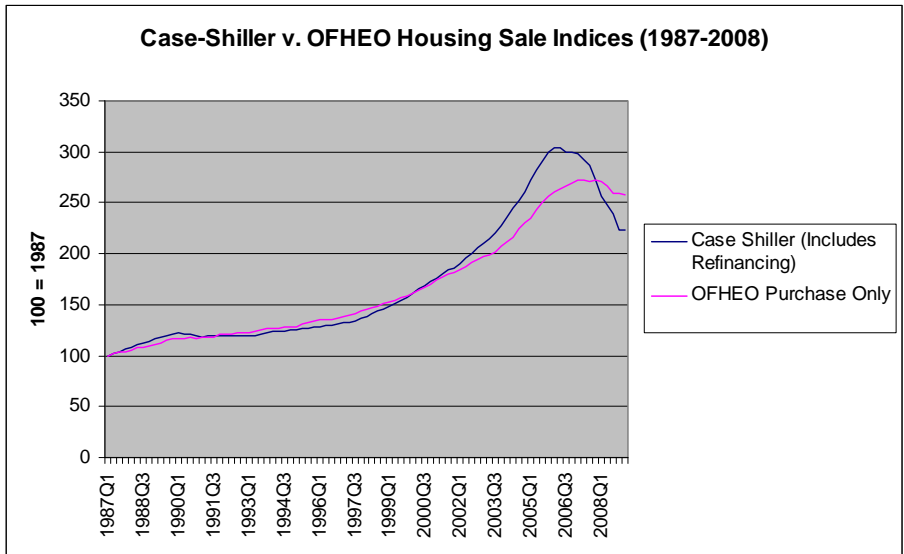
Of note, Realtors report a steep drop in the proportion of distressed sales, at about one-third of all sales vs. half in prior months. The text of the report didn't know what to make of the drop, suggesting that it may not be meaningful. But the report noted strongly that unrealistically low appraisals are scuttling sales and slowing the housing recovery.

– *Econoday.com*

Looking Ahead

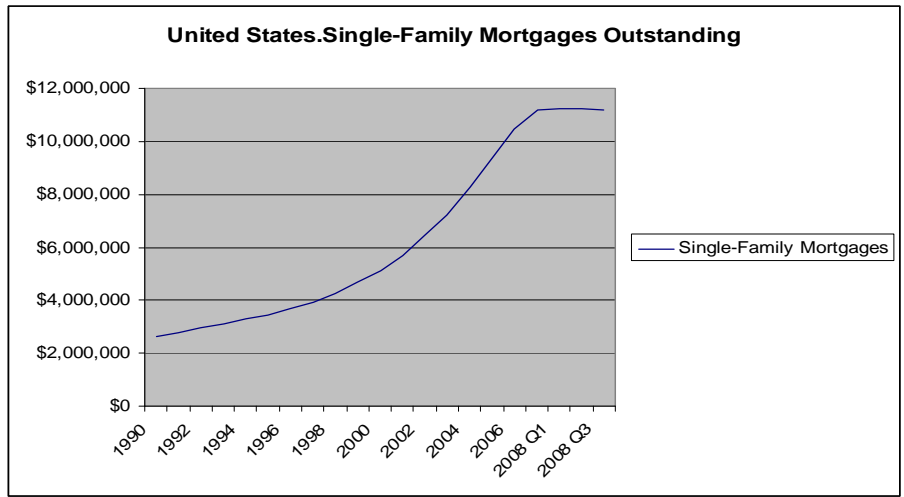
The analysis above suggests that a curious change has taken place in the mortgage industry. Before the housing and economic crisis there had been years of upward pressure imposed by lenders on appraisers to enable larger loans to be processed. Now, it appears that lenders are imposing downward pressure on appraisers to enable people to qualify under the now re-imposed traditional lending restrictions of 20% down payment, credit-worthiness, income-to-loan ratio maximums, and so on.

It appears that housing starts will not begin to pick up nationwide for at least a year, if not two years, due to massive amounts of excess inventory, both due to excess construction in recent years, as well as unprocessed/unsold foreclosure inventory.



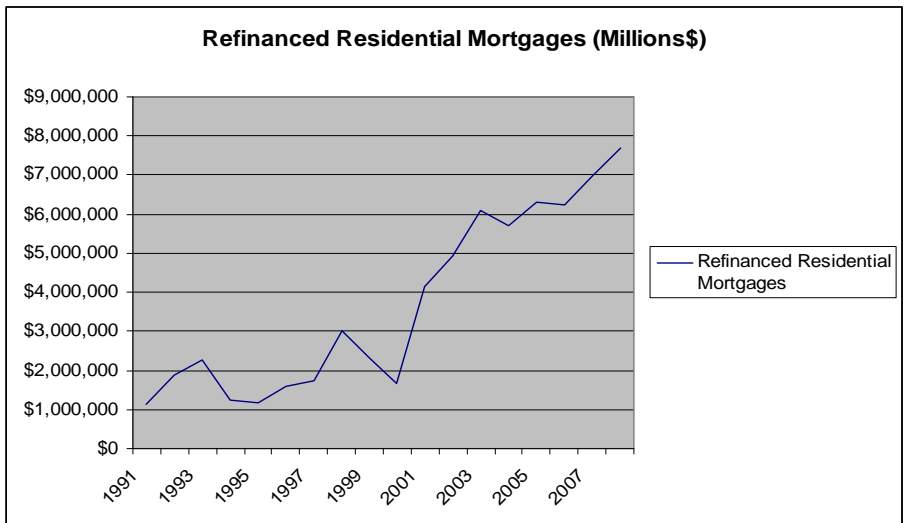
Source: fhfa.gov

Table 8



Source: fhfa.gov

Table 9



Source: fhfa.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.

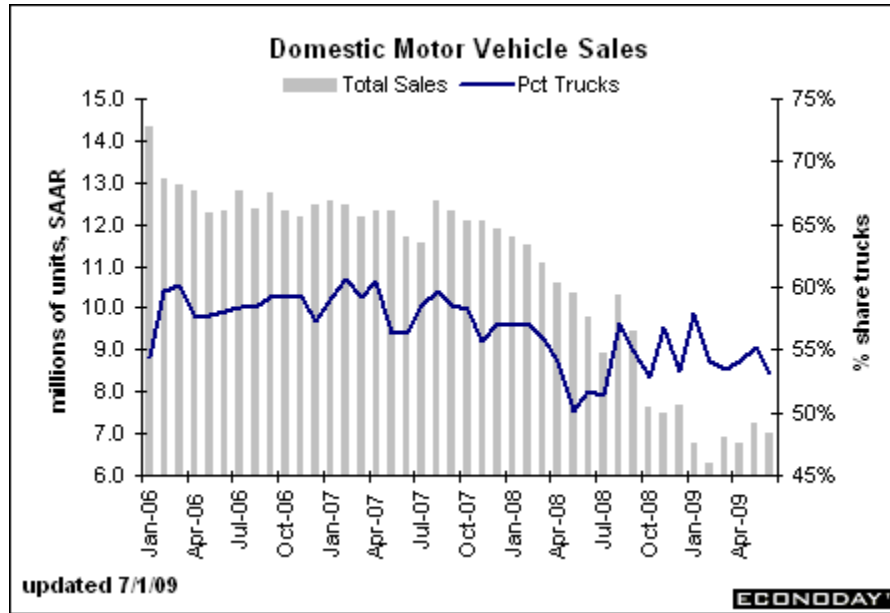
Thus, a home ownership and refinancing boom was born this decade that lasted until the recent economic crisis forced many banks to adopt more traditional mortgage lending criteria, such as requirements for 20% down payment and mortgage payments that would not exceed 38% of the mortgager's income. Subprime 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 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.

Nevertheless, we are continuing to see foreclosure pressure in the form of an uptick in foreclosures in the 2nd Quarter of 2009. While there may not have been a price bubble in housing in Kalamazoo, there is still a bubble of excess mortgage lending that will need to work its way out.

There are reports from experts in the mortgage industry that indicate that financial institutions are attempting to be prudent in holding back some foreclosure inventory, so as to not flood the marketplace with too many cheap homes all at once, and also to put some on the market after the recovery begins. If this strategy were successfully employed by enough financial institutions, it would avoid some downward pressure on the City's tax base.

Auto Sales



Source: Econoday.com

Table 11
Description

This chart represents 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

Vehicle sales proved very strong in May compared to April, at a total domestic and import annual rate of 9.9 million units vs. April's 9.3 million. This is very good news for next week's May retail sales report where an overall gain would end two straight months of disappointment. An indication of improving consumer strength is seen in truck sales, this despite a 20 percent jump in gasoline prices during the month.

Vehicle sales gave a rare lift to the last retail sales report but don't look for that to happen with the June report. Sales came in at a total domestic/import annual adjusted unit rate of 9.7 million, down from 9.9 million in May. Incentives are heavy but consumers are not interested in making major purchases. Chain stores will report their June results a week from Thursday. Weekly chain-store reports are warning that June sales were unusually weak.

- Econoday.com

Looking Ahead

The Michigan House Fiscal Agency recently projected about 6.5 million sales domestically for GM, Ford and Chrysler in 2009 (http://www.house.mi.gov/hfa/PDFs/Rev_5-09.pdf).

The Michigan Senate Fiscal Agency recently reported sales of light vehicles and trucks that trended towards approximately 7 million sales for GM, Ford and Chrysler in 2009 (http://www.senate.michigan.gov/sfa/Publications/EconInd/MEI_MAY09.PDF).

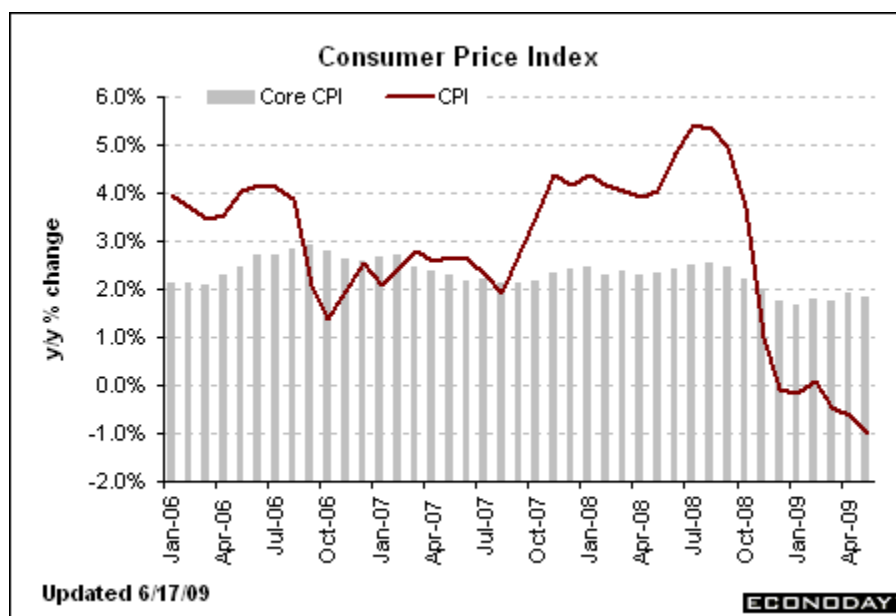
Projections of 6.5 to 7.0 million domestic sales for GM, Ford and Chrysler for 2009 are ahead of the January projections by the automakers and Wall Street analysts which were between 4.5 and 5.5 million units.

Auto sales have been one of the few bright spots in the economic data this first half, as excess inventory is being offloaded and consolidated at the same time via large-scale forced dealership closures by the auto companies.

The unprecedented bankruptcy process for Chrysler and General Motors has proceeded very rapidly through the courts with the sponsorship of the Obama Administration. The new Chrysler and GM companies will likely be largely owned by a consortium led by the federal government and the United Auto Workers union. The effects of these developments are impossible to determine at this point – however, they appear to signal an improved condition for the Michigan-based automakers, which should help to stabilize the state government’s fiscal situation.

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

In May, consumer price inflation was tame despite higher energy costs. The boost in energy costs was due to a 3.1 percent gain in gasoline prices after a 2.8 percent drop in April. Heating oil declined 1.8 percent while piped gas and electricity fell 3.1 percent.

- *Econoday.com*

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://wfhummel.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 has 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.

The same three scenarios with regards to inflation present themselves again, just as they did at the end of the 1st Quarter of 2009:

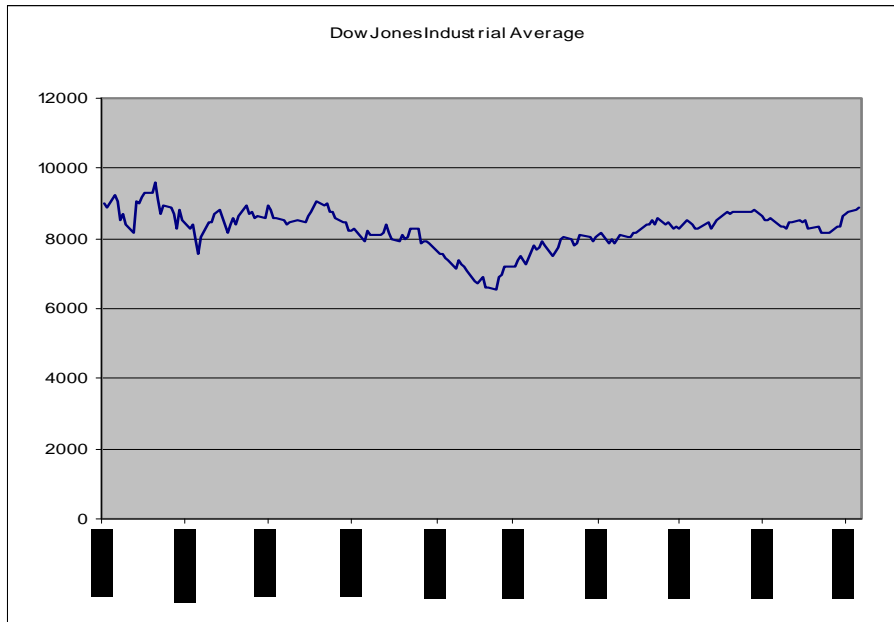
- 1. Deflation: this continues to be a receding threat;**
- 2. Inflation: this has not yet emerged quantitatively as a problem, however the economic recovery, when it occurs, will likely cause inflationary pressures that will require corrective action from the Federal Reserve in raising their discount 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
July 2008 to June 2009**

Table 13



**Dow Jones Industrial Average Index Historical Chart
October 16, 2008 to July 21, 2009**

Table 13a

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

“We are in a stocks stealth bull market that has already delivered a powerful 35% gain to date, so whilst a stock market correction is expected into the end of June, it is still just a correction against the trend.”
- *Stocks Stealth Bull Market Quick Update*, Nadeem Walayat, <http://www.marketoracle.co.uk/Article11074.html>, June 3, 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

“Cracks are beginning to appear in the medium-term picture, and any correction should not be fully embraced as positive until it is clear that it is over.”
- *Another Ascending Wedge*, Carl Swenlin, decisionpoint.com, June 15, 2009

Looking Ahead

The so-called “expert” testimony above is indicative of the general incoherency involved in market-timing strategies.

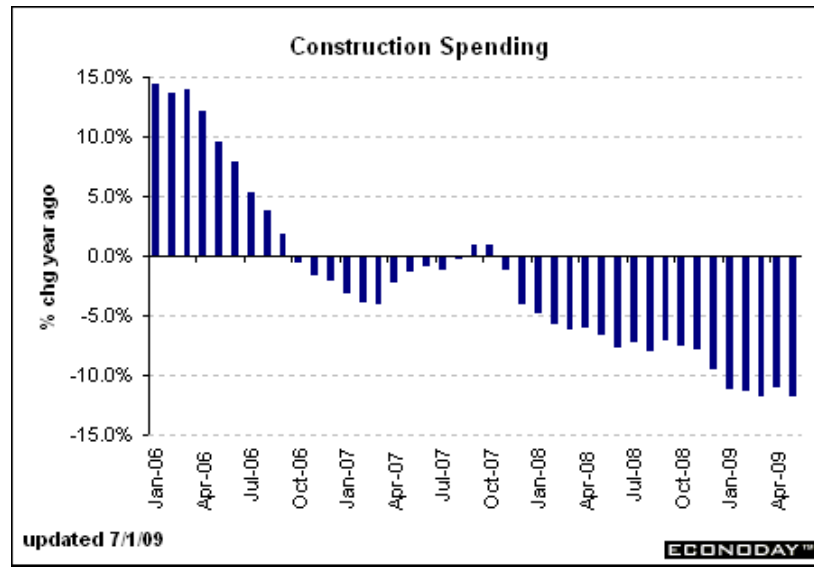
As was discussed in the 1st Quarterly Report for 2009, traditional chart analytics and similar wisdom have suggested since late March that the market would have one more significant correction before its last upward push to the starting point of the new long-term trend/cycle. Indeed, the Dow Jones Industrial Average has dropped 600 points in the last two weeks.

Table 13a is the product of an analysis that counts the number of days backwards from July 21st to the lowest point on March 9th, 2009. Counting the identical number of days backwards from March 9th results in October 16, 2008. Interestingly, the Dow Jones was at approximately 8,900 points on both October 16, 2008 and July 21, 2009. Although the volatility of the curve is higher on the left-side of the curve, the slope is virtually the same. Chart analysts have been looking for this classic “head-and-shoulders” form, as was mentioned in the First Quarterly Review in April.

If the above chart analysis demonstrates a pattern that is indicative of a recovery from the bottom and also the new “Alpha” or beginning of the new stock market cycle, this would be relatively good news. It must be remembered, however, that the beginning date on this graph (October 16, 2008) began at a point (8,900) that was already 37 percent lower than the peak of the Dow Jones in October 2007, when it was over 14,200.

If a sustained growth pattern is developing, this should be evident in the balance of the Pension Trust Fund at the end of the 3rd Quarter of 2009. Please see the Pension section of this report for more discussion on this topic.

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 outlays in May slipped back into contraction after April's unexpected boost. Construction spending declined 0.9 percent after gaining 0.6 percent in April. The reversal in outlays in May was led by a 3.4 percent drop in residential outlays, followed by a 0.6 percent decline in public construction. Nonresidential outlays gained 0.5 percent.

On a year-on-year basis, overall construction outlays slipped to minus 11.6 percent in May, from minus 10.9 percent the month before.

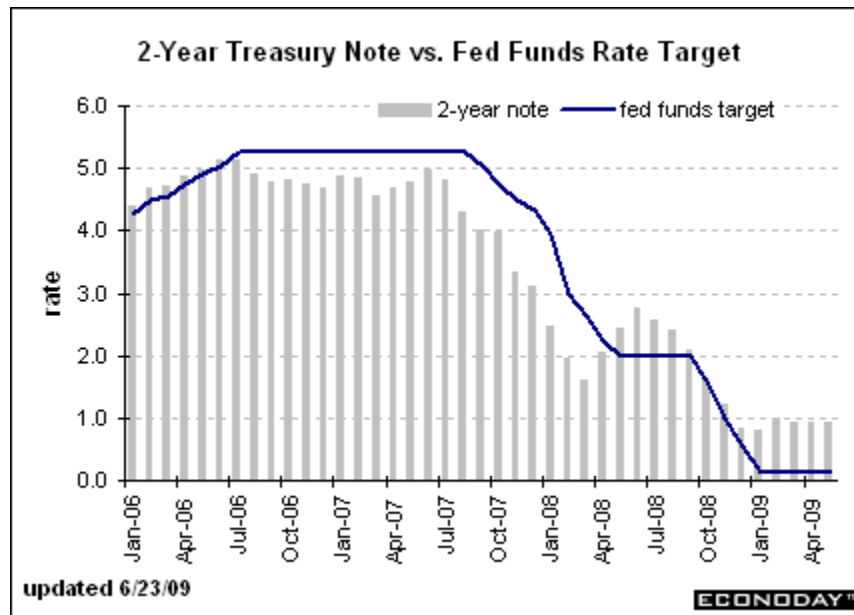
Overall, construction is still in recession as homebuilders wait for unsold supply to dwindle, commercial builders are still hamstrung by reduced corporate profits, and public outlays have been curtailed by a decline in government revenues.

- Econoday.com

Looking Ahead

The recovery and job growth cycle is still anticipated nationwide sometime in 2010. Since construction is a “coincident” indicator of economic activity, when we do see this index recover, it should spell positive news generally speaking.

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.

Analysis

Federal Funds Futures are heavily tilted towards the assumption that the Federal Reserve will enact a 25 basis point increase in its August or September 2009 meetings. This is based on the 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

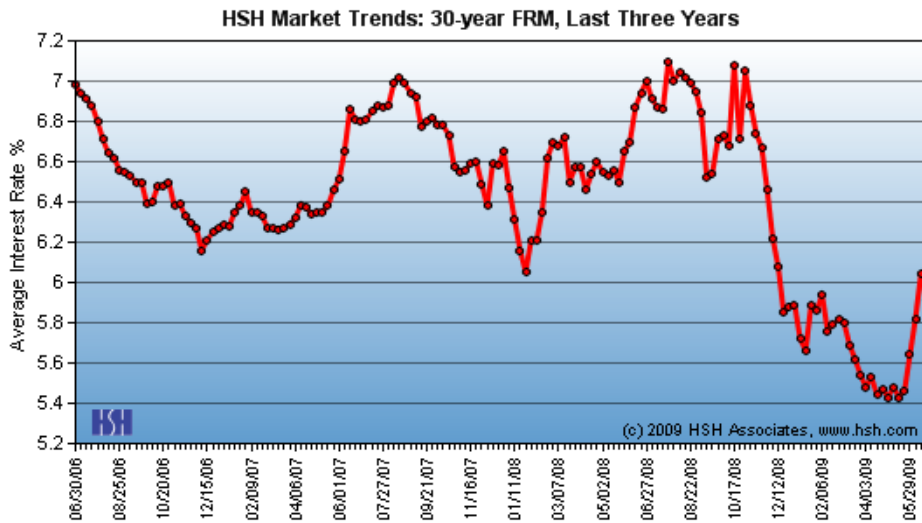


Table 16
Description

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 benchmark 30-year, fixed-rate mortgage edged up 4 basis points, to 5.8 percent, according to the Bankrate.com national survey of large lenders. A basis point is one-hundredth of 1 percentage point. The mortgages in this week's survey had an average total of 45 discount and origination points. One year ago, the mortgage index was 6.62 percent; four weeks ago, it was 5.45 percent.

Also in Bankrate's weekly survey, the benchmark 15-year, fixed-rate mortgage dipped 3 basis points, to 5.16 percent. The benchmark 5/1 adjustable-rate mortgage declined 11 basis points, to 5.26 percent.

- *Econoday.com*

Looking Ahead

Massive efforts by the Federal Reserve to bring down mortgage rates have so far been a success, but homeowners had better act fast because analysts say record low rates could be gone as soon as this summer.

Thirty-year mortgage rates dropped to a low of 5.01 percent this week -- their lowest since 1971 -- after the Federal Reserve unveiled a plan in late November to buy as much as \$500 billion of securities backed by Fannie Mae, Freddie Mac and Ginnie Mae.

They could touch as low as 4.50 percent, but the cheap loans will not last long, mortgage experts warned.

"The downward trend we have seen in mortgage rates will not last beyond the first half of this year," said Celia Chen, senior director of housing economics at Moody's Economy.com in West Chester, Pennsylvania.

"By then, the Federal Reserve's program will have run its course and other issues will move to the forefront that could push mortgage rates higher," she said.

The Fed has also embarked on a program to buy up to \$100 billion in unsecured debt of Fannie Mae, Freddie Mac and the Federal Home Loan Banks in a move also aimed at lowering interest rates on mortgages.

The prospect of affordable home financing has provided a glimmer of hope for the U.S. economy with the housing market in the worst downturn since the Great Depression.

- *Economy.com*

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 \$560 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 has begun 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 Poor’s. The City realized savings of over \$160 thousand of debt service payments for each of the next 15 years on the 2009 Capital Improvement Project Bond, based both on the federal American Recovery and Reinvestment Act (ARRA) or “stimulus package”, which provided over \$1.27 million in capital grants to the City to reduce planned bonded indebtedness, but also low coupon rates of 4.06%, which were at least 25 basis points below expectations.
- **Tax Anticipation Notes:** due to the renewed bond ratings, the City realized savings of \$100 thousand 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 \$150 million in 2008 (representing approximately 29% 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 \$368 million in market assets, and an actuarial value estimated at \$506 million.

Experience in 2009: After a steep slide of an additional \$90 million of market value losses through the end of February 2009, which left the Pension Trust Fund at around \$280 million of market asset value as of March 1st. However, the market has recovered somewhat, and as of July 24, 2009, the Pension Trust Fund is at \$379 million of market value of assets, or about 3% higher than it was on January 1, 2009.

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. In application, the normal cost is adjusted up or down by an amortized portion of the current funded level to determine the actual contribution.

The normal cost of benefits is the value accrued in benefits by employees from a year of service. For the year ending 2008, the net normal cost for all active employees totaled a little more than \$6 million (when roughly \$1.5 million of employee contributions are netted out).

For the purposes of comparison, it has been assumed that the Pension Trust Fund’s market value will achieve a rate of return of 7% in 2009, resulting in the Pension Trust Fund balance being 3 percent higher on December 31, 2009 (net of more than \$15 million in expenses) than it was on December 31, 2008, giving it an actuarial value of roughly \$500 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 nearly \$1 million to the Pension Trust Fund in 2012, and \$7.1 million in 2013. This amount would continue to increase indefinitely.
- **7.5% Rate of Return:** the City would be required to contribute more than \$250 thousand to the Pension Trust Fund in 2012, and \$5.7 million in 2013. This amount would continue to increase indefinitely.
- **10% Rate of Return:** At 10%, the City would be required to contribute more than \$4.2 million in 2013. Contributions would be required for a total of 10 years totaling more than \$21 million.
- **12.5% Rate of Return:** At 12.5%, the City would be required to contribute more than \$2.7 million in 2013. Contributions would be required for a total of 3 years totaling almost \$5 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 avoid making contributions.

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 in conjunction with their periodic review of methodology and assumptions.

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 an 11% Rate of Return:** if the Pension Fund were to realize level gains less than 11 percent for the foreseeable future, changing to a 10-year smoothing period would delay contributions for 3-5 years, 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 an 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.

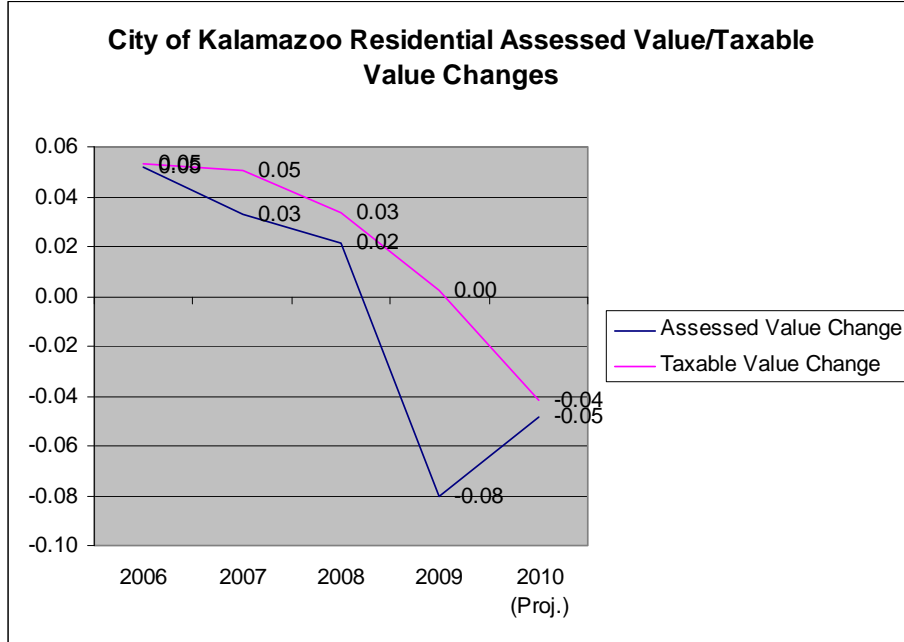
Decision-making process: Staff will examine the smoothing issue with the Retirement Investment Committee who, in their capacity, may make recommendations to the City Commission regarding actuarial assumptions. The City Commission ultimately makes the determination whether to change these assumptions,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

Recommendation: It is imperative that the City seek reasonable ways to rebalance its pension liabilities with its anticipated assets.

It is unclear at this point whether altering the smoothing mechanism would be of value. The City should re-examine the fund’s experience after the next 6 months and assist the Retirement Investment Committee in their deliberations about the smoothing mechanism, as well as other actuarial methods and assumptions.

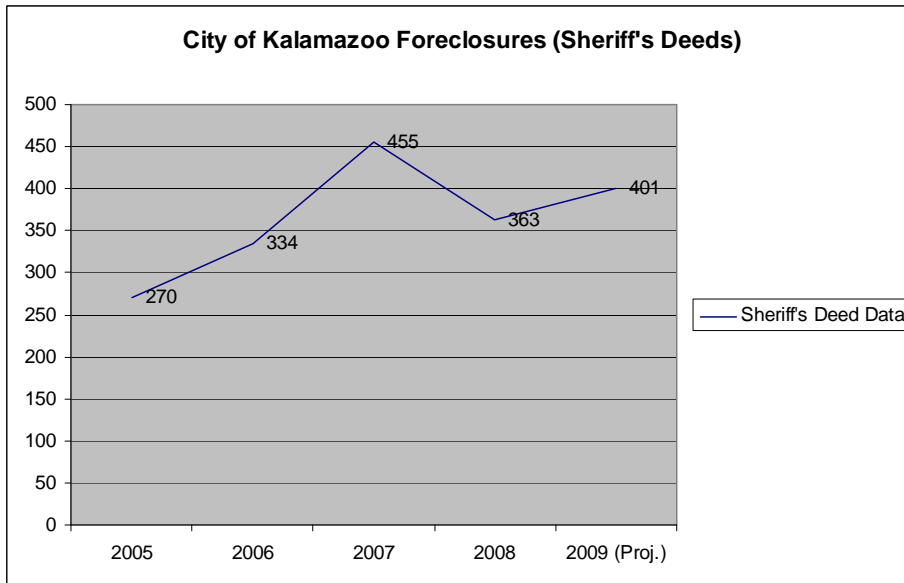
Revenues

Property Taxes



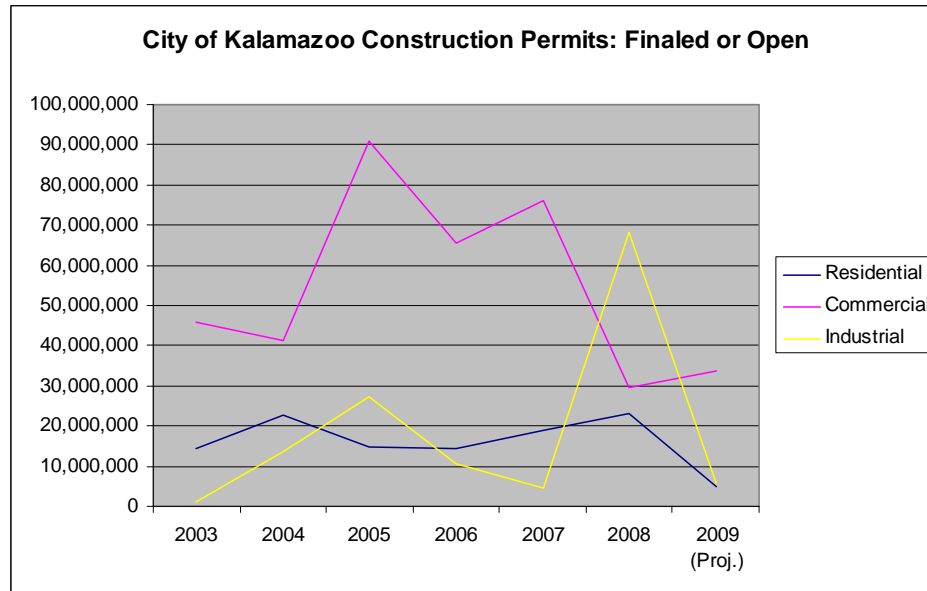
Source: City of Kalamazoo Assessor's Office

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) increased 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: The 2010 Assessment Roll will be determined for Residential and Commercial property by utilizing sales data for the period of October 1, 2008 – September 30, 2009.

Residential sales study: Sale volumes continue to be relatively low (the trend suggests approximately 400 sales for the year, compared to 450 sales the previous 1-year sales period). In the first quarterly report it was reported that sales prices for October 2008 through February 2009 were slightly ahead of 2009 Assessed Values, and that projected a slight increase (perhaps 1%) in Assessed Value for Residential properties for the 2010 Assessment Roll. However, residential sales prices have been averaging 8% lower than 2009 Assessed Values for April through June 2009.

At this point, if we project the volume of sales along with sales prices for residential property through the end of October 2009, the 1-year sales study would produce a roughly 4-6% drop in Assessed Value for residential property in 2010. This would translate to a 4-5% drop in Taxable Value for residential properties, equivalent to \$600 – 750 thousand of lost revenue for the General Fund.

Commercial sales study: Commercial real property (land and buildings) taxable value had increased from the 2008 to the 2009 Assessment Roll by 1.5%. Despite the nominal start for 2009 in terms of commercial construction activity, the aggregate value of commercial real property sales (despite their relatively small number) has plummeted since October 2008 by an average of 16% compared to the 2009 Assessed Value.

If we project the volume of sales along with sales prices for residential property through the end of October 2009, the 1-year sales study would produce a roughly 16% drop in Assessed Value for residential property in 2010. This would translate to a 10% drop in Taxable Value for commercial properties, equivalent to \$1 million of lost revenue for the General Fund.

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.

At the end of March 2009, Federal agencies Fannie Mae and Freddie Mac ended their moratorium on foreclosures, which has resulted in an industry-wide increase in foreclosures in April, May and June.

The pace suggested by the first six months of 2009 would project to a little more than 400 residential mortgage foreclosures for all of 2009. This represents an uptick from 2008. Resultantly, excess residential inventory will likely remain on the market for some time.

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 began at a much higher pace than 2008, primarily because of the \$4.7 million Catheterization Lab project at Bronson Hospital. In the last few months, permit activity has slowed somewhat. Commercial permits are on pace with 2008 activity, which is slower than the previous 5 years.

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

The continued deterioration in the local economy has caused housing prices in the City to continue to slide, and foreclosed residential properties continue to represent excess low-price inventory that will dampen values for some time. Once the foreclosure situation stabilizes and eventually returns to normal, home prices should follow the same trend.

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.

- **2009:** The Assessment Roll has been confirmed by the City Commission for 2009. We are almost exactly at the level anticipated in the 2009 Adopted Budget.

An elevated number of commercial property appeals have been filed with the Michigan Tax Tribunal. There are over 25 appeals filed for the 2009 Assessment Roll, compared to 13 in 2008 and 7 in 2007.

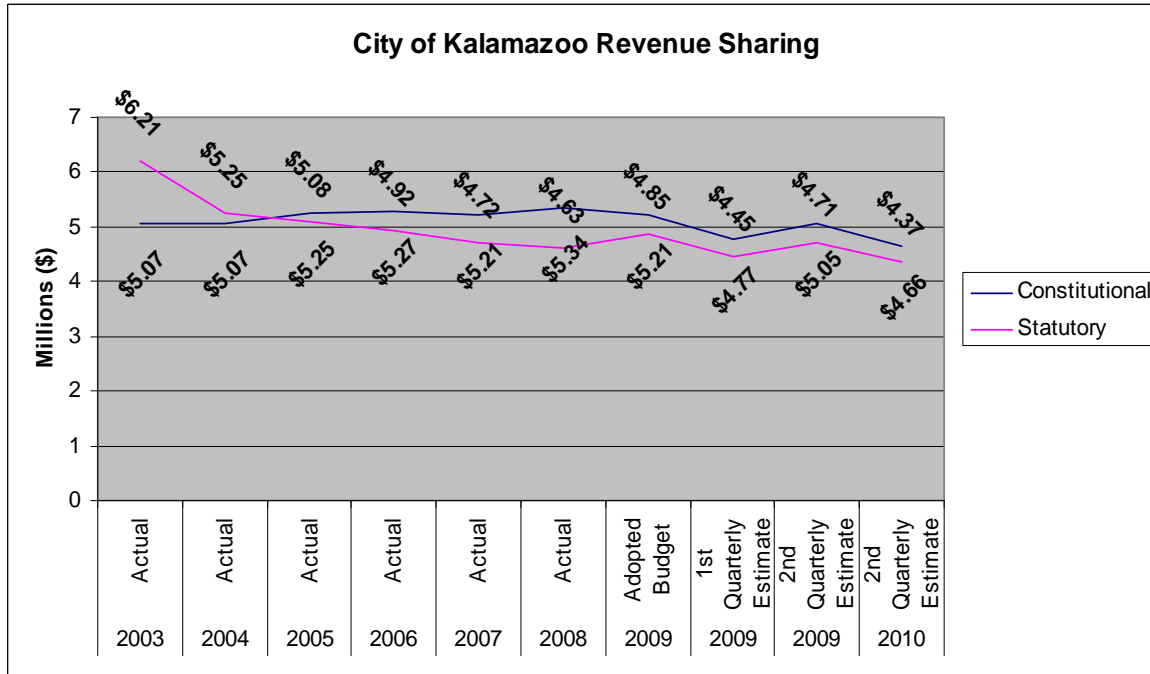
In order to provide the most effective response to the increased level of appeals, we are retaining additional consultation to try and minimize the impact.

The aggregate value of commercial appeals filed exceeds \$35 million of taxable value. Normally, we could expect commercial property appeals to result in about 1/4 success for the appellant. **This provides a range of \$25 – 75 thousand of potential lost tax revenue due to appeals.**

- **2010 Residential:** The City's FY 2009-10 Budget had projected \$300 thousand of tax revenue increases from residential property value inflation for 2010. **When combined with the \$650 – 750 thousand that would be lost by virtue of falling residential taxable value discussed above, the net loss in tax revenue would be roughly \$1 million.**
- **2010 Commercial:** The City's FY 2009-10 Budget had projected \$300 thousand of tax revenue increases from commercial property value inflation for 2010. **When combined with the \$1 million that would be lost by virtue of falling commercial taxable value discussed above, the net loss in tax revenue would be roughly \$1.3 million.**
- **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 increased revenue for 2010.**

Summary: instead of the \$600 thousand increase in property tax revenue for the General Fund that was projected for 2010, we are anticipating a decrease of approximately \$1.5-1.75 million, netting a total loss of property tax revenue of \$2.1 - \$2.35 million to the General Fund for FY 2010.

State Revenue Sharing



Source: Treasury.gov and Michigan Department of Treasury

Table 20

REVENUE SHARING SCENARIOS

(Millions \$)	0809 Budget	May 09 FY0809 Rev. Est. Conf.	May 09 Exec. Order	FY0910 Exec v. House v. Senate Budget	FY0910 City Staff Estimate
STATE SALES TAX REVENUE	\$6,645	\$6,211	N/A	N/A	\$6,000
STATE-TO-LOCALS	\$1,086	\$1,045	\$1,045	Exec: \$1,086 House: \$1,005 Senate: \$931	\$978
	Pct. Chg ->	-6.50%	-6.50%	Exec: 0%, House: -7%, Senate: -14%	@10%
CITY	FY2009		FY2009	FY2010	FY2010
CITY	\$10.063		\$9,705	Exec: \$10,063 House: \$9,358 Senate: \$8,540	\$9,029
CITY	\$ Change From 0809 Budget ->		-\$358	Exec: \$0 House: -\$705 Senate: -\$1,523	-\$1,034

Sources:

- <http://www.senate.michigan.gov/sfa/Publications/MonthRev/mrrmay09.pdf>
- <http://www.house.mi.gov/hfa/PDFs/source0608.pdf>
- <http://www.senate.michigan.gov/sfa/Publications/Approps/Initial2009.pdf>
- <http://www.senate.michigan.gov/sfa/Revenue/RevenueSharingPayments.pdf>

Table 21

Analysis

According to the Michigan Department of Treasury, the latest numbers from the end of May 2009 show that sales tax collections for the state from October through May (the State's fiscal period is October – September) are still down 8.3% vs. the State's FY 08-09 budgeted amount, and roughly 10% vs. FY 07-08 collections. These are the same respective percentages that were noted for the period of October 2008 through February 2009.

Interestingly, both the month of February and the month of May saw reductions of over 20% in sales tax receipts statewide versus the same time last year. Oddly, the other months since October 2008 has only been approximately 4-6% lower than the previous year.

As we anticipated in the last Quarterly Review, Governor Granholm utilized Recovery Act dollars to help stave off State budget cuts. Additionally, as we expected, the State Legislature waited until after the May Revenue Estimating Conference to make budget cut decisions for the State's FY 08-09. These resulted in an estimated reduction of FY 2009 State Shared Revenue to the City of approximately \$358 thousand versus our FY 2009 Adopted Budget amount.

The Governor's Executive Budget for the State's FY 2009-10 calls for a reinstatement of all lost Revenue Sharing disbursements to cities back to the level of our original FY 2009 Budget. The Michigan House of Representatives recently passed a budget bill that would make about 7.3% cuts in Revenue Sharing disbursements to cities, villages and townships, effective for their FY 2009-10, and the Michigan Senate recently passed a budget bill that would make about 14% cuts.

Looking Ahead

While many state revenue sources have been declining by more than 20 percent, the latest economic forecasts project losses of wage and salary income of 7-10 percent by the end of 2010. This would tend to support the projection that sales tax revenues will also suffer a 7-10 percent loss over that same period.

There's also the unknown ripple effect of GM and Chrysler proceeding through bankruptcy at this time.

We believe that local government is on at least equal footing in eyes of the Legislature relative to the other recipients of Sales Tax monies. 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.

In attempting to forecast which one of the three budget proposals for Revenue Sharing will be adopted, in the context of the State's economic situation, it seems prudent to choose a figure that best represents the overall projected decline in sales tax revenue (10 percent). This also happens to be about halfway between the worst-case proposal by the Senate (14 percent cut) and the House (7.3 percent cut).

Summary: we are projecting losses of 10 percent in Revenue Sharing by the end of the City's FY 2010. This should amount to a little more than \$1 million of lost revenue for the General Fund for FY 2010. The State may make cuts in Revenue Sharing that affect our FY 2009. However, such cuts, should they occur, are manageable by virtue of our Budget Stabilization fund.

Act 51 Revenue

According to the latest analysis conducted by the Michigan House Fiscal Agency on June 18, 2009 (see: <http://house.michigan.gov/hfa/transportation.asp>), the State is still receiving gas tax revenues for FY 08-09 at a rate about 5% lower than last year, which is the same rate of decline experienced in the first quarter of 2009. The City budgeted for about a 4% decline in Act 51 revenue in the Major and Local Street Funds combined. The State disbursed about \$344 million to cities in Act 51 money in 2008, is estimated to disburse about \$328 million in 2009, and about \$324 million in 2010.

Several weeks ago, the Michigan House, Senate and Governor's Office agreed to reduce the cities' amount to \$317 million for 2010. This would translate to a roughly 8% decline in the City's allocation for 2010, but would be dependant on the State's gas tax revenue experience. **If the current trend continues, there should be no need for action regarding our road maintenance funds for FY 2009. However, there is likely to be a loss of roughly \$250 thousand of Act 51 revenue, which will require a combination of additional subsidies from the General Fund to support current Local Street operations and/or reductions in Local Street operations.**

Interest earnings

The City's General Fund is budgeted to receive \$818 thousand in interest earnings in 2009, slightly less than the \$905 thousand 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 it's 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 \$250 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 that we may apply for. To date we have identified over \$16 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 over \$17 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 \$300 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 \$754 thousand 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 \$40 thousand in FY 2009 and \$80 thousand in every subsequent year beginning with FY 2010.

There is \$3.1 million 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.

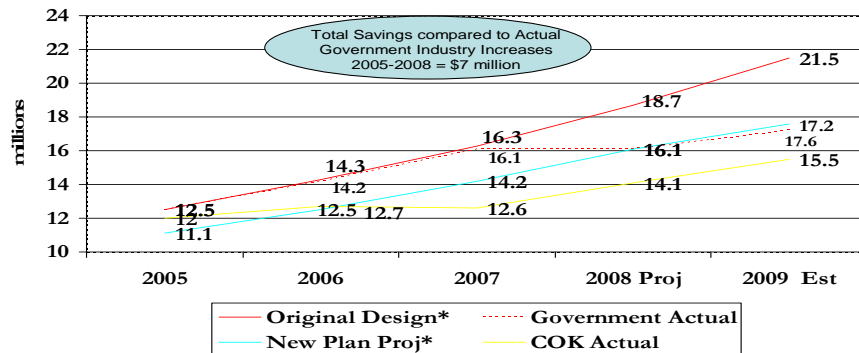
The emergency warning system was budgeted as a bonded capital project, so the savings in bond payments will be about \$5 thousand per year beginning in FY 2009.

The Stimulus funding resulted in savings of more than \$1.2 million in bonded indebtedness, primarily due to cash-financing major street projects and the early warning system. When combined with favorable interest rates realized at the sale (due largely to the renewal of the City's bond rating with a “stable” economic outlook by the rating agencies), this will result in savings of \$90 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.

Other opportunities exist for the City to realize significant health care savings. Chief among them is mandating participation among KPSA and KPSOA retirees in the federal Medicare Part B program (which is currently optional in the respective collective bargaining agreements for these groups). **Savings of**

between 5-10% of the City's annual retiree health care cost could be realized by this one change alone.

Energy

Energy costs for the first five months of the year are down over 15% versus the same period last year, and are down 6.4% versus 2007 during the same period.

Based on the first five months of consumption and prices, the total projected savings in energy for the City would be 14.5% versus 2008.

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: averaged \$3.26 per gallon in 2008, are averaging \$2.36 per gallon in 2009 and \$2.69 in 2010. <http://www.eia.doe.gov/steo>

Diesel: averaged \$3.80 per gallon in 2008, are averaging \$2.46 in 2009 and are projected to average \$2.79 in 2010. <http://www.eia.doe.gov/steo>

Natural Gas: averaged \$13.67/mcf in 2008, are averaging \$11.38 in 2009 and are projected to average \$11.63 in 2010. <http://www.eia.doe.gov/steo>

Electricity: averaged 11.4 cents/kwh in 2008, are averaging 11.9 in 2009 and are projected to average 12.3 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 \$300 thousand for the General Fund and \$350 thousand in FY 2010.

Overtime

Public Safety OT: Over the first six months of the year, Public Safety has utilized \$586 thousand out of \$978 budgeted for KPSOA overtime, and \$160 thousand out of \$372 thousand budgeted for KPSA overtime, totaling \$746 thousand out of \$1.35 million budgeted.

If we project the Public Safety actual overtime in 2007 and 2008 from July to December onto the rest of 2009, KPSOA overtime would total at least \$1.2 million, and KPSA overtime would total at least \$400 thousand. **The combined projected overtime expense would exceed the Public Safety budget by approximately \$250 thousand.**

Non-Public Safety OT/non-Metro Transit (primarily Public Services OT): over the first six months of the year, non-Public Safety/non-Metro Transit overtime has totaled \$409 thousand out of \$986 thousand budgeted. This is down from \$434 thousand at the same time in 2008.

If we project the non-Public Safety/non-Metro Transit actual overtime from 2007 and 2008 onto the rest of 2009, it would total more than \$1.2 million. **This would exceed the budgeted amounts for this overtime by approximately \$250 thousand.**

Travel/conferences

Education and Training expenses (not including amounts to be reimbursed by the State of Michigan) totaled \$69 thousand through May 2009, compared to \$81 thousand during the same period in 2008, and \$62 thousand for the same period in 2007.

Telephone/Cell phones

Through May 2009, telephone costs are recorded at \$160 thousand, compared to \$255 thousand for the same period in 2008. **The savings of approximately \$100 thousand 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 staff person.

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 has bonded for over \$4.6 million in capital projects this year (not including the \$1.27 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 \$560 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