STATE OF MICHIGAN
DEPARTMENT OF TREASURY

RICK SNYDER
GOVERNOR

NICK A. KHOURI
STATE TREASURER

DATE: June 1, 2016

TO: Governor Rick Snyder

FROM: Ronald L. Rose, Executive Director
Financial Review Commission

SUBJECT: Detroit Financial Review Commission Biannual Report No. 3

This report is being filed on behalf of the Detroit Financial Review Commission (the "FRC"), by its Executive Director, pursuant to the requirements of Section 6(8) of Public Act 181 of 2014, the Michigan Financial Review Commission Act (the "Act"). A copy of this report is being delivered to the Senate Majority Leader and the Speaker of the House of Representatives, and it is being posted on the FRC's Michigan Department of Treasury website. A copy is also being delivered to the Mayor and City Council President of the City of Detroit (the "City").

Pursuant to Section 6(1) of the Act, the FRC's oversight of the City began on the effective date of the City's plan of adjustment, December 10, 2014. The FRC is responsible for determining the City is complying with the Act and with its plan of adjustment. This is the FRC's third report, following the previous report submitted on November 24, 2015. It reports on the FRC's activities and significant developments in the City's finances and restructuring.

Statutory Oversight Activities

Sections 6 and 7 of the Act include various powers and duties of the FRC in its oversight of the City. Those statutory requirements and compliance with them to date are noted below.

Requirement	**Act Sec. No.**	**Compliance**
Compliance with plan of adjustment, the Act, and other revised statutory requirements	6(2) and 6(3)	City is implementing programs consistent with its plan of adjustment. FRC provided its annual certification of City's statutory compliance on September 28, 2015. The next certification is due by October 1, 2016.
FRC review and approval of annual four-year financial plan	6(4) and 7(b)	City has submitted 2 four-year financial plans to date. FRC has approved both: • FY 2016-FY 2019 plan (approved April 20, 2015) • FY 2017-FY 2020 plan (approved April 18, 2016)
FRC review and approval of all applicable contracts	6(6)	City has submitted 281 applicable contracts and amendments to date. FRC has approved 280 of them.
City and CFO provide needed information and documents and attend FRC meetings when needed	6(7), 7(d), and 7(m)	City and CFO have been responsive to requests for information and documents and have attended meetings when requested.
FRC review and approval of collective bargaining agreements	6(9)	City has submitted 4 collective bargaining agreements and amendments to date. FRC has approved all of them.
Quarterly debt service certifications	6(11)	City has provided all 6 quarterly certifications to date.

Consensus revenue estimates	7(a)	City has held 3 consensus revenue estimating conferences, as required to date. City provided its revenue estimates to FRC for review.
FRC review and approval of budget amendments	7(c)	City has submitted 66 FY 2016 budget amendments to date. FRC has approved all of them.
FRC review and approval of requests to issue debt	7(e)	City has submitted 3 debt issuance requests to date. FRC has approved all of them.
FRC approval of Chief Financial Officer appointment	7(g)	FRC approved the appointment of the City's current Chief Financial Officer on January 26, 2015.

FY 2015 and FY 2016 Year-End General Fund Balances

The City issued its FY15 comprehensive annual financial report (CAFR) on May 31, 2016. It reported a $70.9 million unassigned General Fund ending balance for the fiscal year ending June 30, 2015. This surplus was largely the result of lower operating spending than budgeted and the impact of the City's bankruptcy confirmation, which took effect during FY15 on December 10, 2014. The unassigned balance is in addition to the City's Budget Reserve Fund, which it established by reserving $111.3 million in FY15 and is required by State law to maintain annually, at a minimum balance of 5% of projected expenditures to cover potential budget shortfalls.

In its revised FY16 budget projection as of May 2016, the City estimates it will finish the fiscal year ending June 30, 2016, with a General Fund operating surplus of at least $41 million. The operating surplus is mainly due to vacant positions during the year and reduced debt service. This FY16 operating surplus will add to the City's FY15 unassigned ending balance to provide an estimated FY16 balance of at least $111.9 million ($70.9 million plus $41 million). Of that, the City plans to propose a FY16 budget amendment to designate a portion for additional funding for its legacy pension obligations. The City has also designated $67.9 million of its fund balance for one-time capital and blight spending in FY17. These two actions may consume all or most of this preliminary fund balance estimate. Note, however, that this preliminary estimate is subject to material change as the City revises its FY16 budget projections and once final FY16 revenue and expenditures are recorded.

Regarding the Budget Reserve Fund, the City's FY16 budget already assumes $49 million is released for one-time capital and blight spending in FY16. This will leave $62.3 million in the Budget Reserve Fund at the end of FY16, which is $11.8 million larger than what the City is required to maintain for the FY17 adopted budget. This continues to provide an extra financial cushion on top of the 5% minimum requirement. The City's FY17-FY20 financial plan assumes it will not draw upon this reserve, thus continuing to maintain it at $62.3 million, in excess of the 5% requirement.

The City generating annual surpluses is not unexpected. The City has conservatively budgeted both its revenues and expenditures. The plan of adjustment assumed the City would use annual surpluses and one-time exit financing to support capital, blight remediation, and other reinvestment activities. As discussed later in this report, the City plans to budget such one-time expenses when additional surplus, revenue gains, and other funding sources are identified. However, one of the primary reasons for surpluses in FY15 and FY16 has been savings from vacant positions, which may not continue at as high a level as the City succeeds at recruiting and retaining more employees to improve service delivery.

February 2016 Consensus Revenue Estimates

Under Section 4t of the Home Rule City Act (Public Act 279 of 1909), the City is required to hold two consensus revenue estimating conferences per year, one in February and another in September. The conference principals establish the City's forecast of anticipated revenues. The City uses the revenues set at the February conference when adopting its four-year financial plan. The conference principals are the City's Chief Financial Officer (CFO), the State Treasurer (or a designee from the Michigan Department of Treasury), and a person with experience in economic and revenue forecasting from another public entity (e.g., a public university professor). The conference principals for the February 2016 revenue conference were John W. Hill (the City's CFO), Jay Wortley (Chief Economist and Director, Office of Revenue and Tax Analysis, Michigan Department of Treasury), and George A. Fulton, PhD (Research Professor and Director, Research Seminar in Quantitative Economics, University of Michigan).

City of Detroit General Fund Revenues
February 2016 Consensus Revenue Estimates
$ in millions

	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
Income Tax	$ 264.0	$ 266.6	$ 269.3	$ 272.0	$ 274.7
Property Tax	117.0	117.0	117.6	118.2	118.8
Utility Users' Tax	37.0	37.0	37.0	37.0	37.0
Wagering Tax	173.5	175.2	177.0	178.8	180.5
State Revenue Sharing	194.9	195.9	196.9	197.9	198.9
Other Revenues	213.1	218.1	220.9	222.6	224.4
Total*	**$ 999.5**	**$ 1,009.8**	**$ 1,018.7**	**$ 1,026.5**	**$ 1,034.3**
Income Tax		1.0%	1.0%	1.0%	1.0%
Property Tax		0.0%	0.5%	0.5%	0.5%
Utility Users' Tax		0.0%	0.0%	0.0%	0.0%
Wagering Tax		1.0%	1.0%	1.0%	1.0%
State Revenue Sharing		0.5%	0.5%	0.5%	0.5%
Other Revenues		2.3%	1.3%	0.8%	0.8%
Total % Change		**1.0%**	**0.9%**	**0.8%**	**0.8%**

* Excludes use of one-time fund balance: $49 million in FY16 and $67.9 million in FY17.

On February 18, 2016, the City held its consensus revenue estimating conference. The adopted General Fund revenue estimates (shown in the table above) are used in the City's FY17-FY20 financial plan. The City continues to conservatively estimate revenues by using the lower end of forecasted growth ranges and excluding the potential benefits from collection enhancements and economic development activities until they appear in actual results. Major revenues include the income tax, property tax, utility users' tax, wagering tax (casinos), and State revenue sharing. For FY17-FY20, the City assumes less than 1% annual growth in total for its major revenues. Other revenues include various departmental fees, fines, and miscellaneous items. Revenue risks include potential property tax losses from constitutional limitations, chargebacks for unrecovered delinquent taxes, and continued property value reductions and foreclosure activity. State revenue sharing is also at risk from State sales tax losses and competing State budget priorities.

FY 2017-FY 2020 Four-Year Financial Plan

Under Section 4t of the Home Rule City Act (Public Act 279 of 1909), the City is required to annually adopt a four-year financial plan, which is subject to FRC approval. Last year, the City adopted, and the FRC approved, the FY16-FY19 financial plan. That plan was consistent with the emergency manager's FY15-FY16 two-year budget. The City's FY17-FY20 financial plan is the City's first plan developed entirely after the emergency manager's departure.

The City submitted its FY17-FY20 Four-Year Financial Plan (hereinafter the "financial plan") to the FRC by the statutory deadline of March 23, 2016. On March 28, 2016, the City presented the financial plan at the FRC's regular public meeting. Following a one-month review, which included a question-and-answer session at a special meeting of the FRC on April 13, 2016, the FRC approved the City's financial plan on April 18, 2016 (summarized in the table below).

City of Detroit General Fund Appropriations
FY 2017-FY 2020 Four-Year Financial Plan
$ in millions

	FY 2016*	FY 2017	FY 2018	FY 2019	FY 2020
Departmental Budgets	$ 675.3	$ 756.7	$ 766.2	$ 766.5	$ 771.1
Capital Reinvestment	92.5	27.9	-	-	-
Blight	40.5	40.0	11.4	11.4	11.4
Spending from Fund Balance	*(49.0)*	*(67.9)*	-	-	-
LTGO Debt Service	81.0	75.4	75.4	88.5	97.8
Legacy Pension**	24.0	34.0	33.9	33.7	13.7
All Other	141.1	143.7	131.1	126.0	140.3
Total from Ongoing Sources	**$ 1,005.4**	**$ 1,009.8**	**$ 1,018.0**	**$ 1,026.1**	**$ 1,034.3**
% Change		0.4%	0.8%	0.8%	0.8%

* FY16 budget includes FRC staff adjustments for comparability to FY17-FY20. FY16 projected spending is below the above budget amount.
** Does not include forthcoming proposal to increase funding for pension obligations in FY16.

Compared to FY16, the City's financial plan provides increases for ongoing departmental operations. It reduces new capital funding as available capital resources are spent down and following the completion of various up-front investments included in its plan of adjustment (e.g., the City's new financial management system). It proposes total General Fund spending of nearly $1.078 billion in FY17 ($1.010 billion from ongoing sources, $67.9 million from prior-year fund balance). It also forecasts ongoing spending of $1.018 billion in FY18, $1.026 billion in FY19, and $1.034 billion in FY20 from ongoing sources. Separately, the financial plan includes over $800 million in proposed spending from the City's grant funds, special revenue funds, and enterprise funds, which are supported by restricted revenues (nearly half is the Detroit Water and Sewerage Department Retail funds).

The City's plan of adjustment contemplated substantial spending on reinvestment initiatives intended to improve City operations and the quality of life for residents. Reinvestment was originally grouped into three high-level categories: (1) enhanced operations (which is built into departments' ongoing budgets in FY17), (2) capital investments, and (3) blight remediation. The City has initially funded many of these activities through one-time exit financing debt and the FY16 budget. While many of these initiatives were first proposed during the City's bankruptcy proceedings, future reinvestment choices will necessarily evolve in line with the City's ongoing assessment of its needs and priorities.

The City has continued to include standalone allocations for one-time capital reinvestment and blight in its financial plan. It includes $40 million for blight in FY17 and $27.9 million for capital projects in FY17. For FY18-FY20, it only includes a recurring $11.4 million for blight to support the Detroit Land Bank Authority's operations. These blight amounts only include General Fund contributions and do not include the federal Hardest Hit Fund (HHF) grants. The HHF grants are going directly to the Detroit Land Bank Authority. Despite the lack of funding currently allocated in FY18-FY20 for blight and capital, the City plans to continue supporting reinvestment in those years. The City will evaluate and determine capital, blight, and other reinvestment spending commitments through its budget process as additional surplus, revenue gains, and other funding sources are identified.

While the City's current revenue projections are conservative, it will nevertheless prove challenging to sustain its enhanced operations while also meeting all its reinvestment needs. As discussed in the next section, the City also faces a long-term challenge to fund its legacy pension obligations. The City is taking a prudent approach before committing new funding to reinvestment and pensions. It is preparing an analysis on its legacy pension obligations and funding strategy, with the assistance of Cheiron, Inc. (subject to City Council approval of the contract), due in the fall of 2016. It is also preparing its five-year capital plan due in the fall of 2016. The results of both analyses may necessitate significant changes to the City's financial plan to balance these needs against ongoing operations and other reinvestment priorities.

Legacy Pension Obligations[1]

As discussed at greater length in the FRC's previous biannual report (dated November 24, 2015), the City's legacy pension obligations present a significant long-term budgetary challenge for the City. The City's plan of adjustment contemplated a ten-year period (FY14-FY23) when the City would only be required to make a relatively small amount of pension contributions from the General Fund, so that it could instead spend on reinvesting in the City's operations and revitalization. During this period, third-party contributions, such as those from the State of Michigan and philanthropic foundations, would support the pension funds. The Detroit Water and Sewerage Department (DWSD) and the newly formed Great Lakes Water Authority (GLWA) would also make significant accelerated contributions during this period. Under this funding arrangement in the plan of adjustment, however, the unfunded accrued actuarial liability (UAAL) of the pension funds would nonetheless continue to grow. Beginning in FY24, the City is required to make annual contributions to amortize the pension funds' UAAL. While a funding policy has not yet been established for FY24 and beyond, those recurring annual contributions will represent a significant portion of the annual City budget.

[1] "Legacy pension obligations" refers to the previous pension plans that were modified, frozen, and closed in the City's chapter 9 bankruptcy proceedings (also referred to as the "Component II" plans). It does not include the City's obligations under the new pension plans (also referred to as the "hybrid" or "Component I" plans).

In recognition of this approaching budgetary challenge, the City has allocated additional near-term funding for its pension obligations above what is required by the plan of adjustment. It plans to propose at least an additional $20 million to $30 million through an FY16 budget amendment. It has also included an extra $10 million annually in its FY17-FY20 financial plan. As referenced in the previous section, the City has submitted a contract to City Council to retain Cheiron to analyze the City's legacy pension system, estimate future pension funding requirements, provide leading practice research, and assist the City with funding recommendations and strategy design. The City expects to complete this pension study in the fall of 2016, which may lead to further changes in the proposed funding allocated for pension obligations.

Other Recent Highlights

On January 1, 2016, the Great Lakes Water Authority officially launched, formally separating management of the regional water and sewer system from the local Detroit system. The City retains ownership of the entire regional system. The City's water and sewer department (the Detroit Water and Sewerage Department-Retail, or DWSD-R) runs the local system.

The Michigan Department of Treasury is processing Detroit's individual income tax returns, having begun with tax year 2015 in January 2016. Taxpayers can now e-file their individual city income tax returns along with their State of Michigan income tax returns. The City will continue to process and collect income taxes for tax years 2014 and prior, as well as all other city taxes. In January 2017, the State will begin processing Detroit's income tax returns for businesses and fiduciaries as well as the City's employer withholding.

On March 9, 2016, the City went live with its new financial management system. The City is using the new system through the remainder of FY16 and is now closing its books on a monthly basis. FY17 will be the first full year under the new system. The City anticipates its new human resources and payroll system, as well as additional financial management system functions, will go live in the fall of 2016.

On May 3, 2016, the Michigan State Housing Development Authority approved $42 million in additional residential blight removal funding for the City from the federal Hardest Hit Fund (HHF). To date, the City has been awarded $170 million in federal HHF residential blight removal funding. The additional federal funding has reduced the burden on the City's General Fund and allowed it to target City funds on non-residential blight and other blight activities that are not HHF-eligible. The federal government recently awarded an additional $188 million to the State of Michigan from the Hardest Hit Fund, of which the City expects to receive a substantial portion for additional blight removal funding.

Other Upcoming Activities

In addition to monitoring ongoing developments in the many issues discussed above, the FRC also plans to examine, among other things, the following areas over the next six months:

- During its meetings in the summer of 2016, the FRC plans to hear presentations on and discuss the City's economic development strategy, projects, assistance programs, and the associated financial impact.

- The City will begin working on its FY16 CAFR during the summer of 2016 using its new financial management system. The City plans to complete it by December 2016.

- In September 2016, the City will hold its next formal consensus revenue estimating conference, at which it will update its forecast of revenues for FY17 through FY21.

- By the end of December 2016, the City expects to complete its reappraisal project for all residential properties for use in tax year 2017 assessments. It expects to reappraise commercial and industrial properties by December 2017.

- Under current law, the FRC will assume oversight of Detroit Public Schools upon the departure of the school district's emergency manager. The FRC is preparing itself organizationally for this forthcoming responsibility.