Report to Montgomery County, Maryland

Regarding Recommendations For Unreserved Undesignated Fund Balance And Revenue Stabilization Fund

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I. Executive Summary

A. Rating History and Recent Rating Action

Montgomery County, Maryland is one of 23 Counties in the Country (as of April 30, 2010) who have been awarded a triple-A rating from all three major rating agencies. This rating category is reserved for the most financially secure, economically wealthy, best run governments. By virtue of its long-term demonstration of prudent financial management practices and the long-term strength of the local and regional economy, Montgomery County has been rated triple-A by Moody's since 1973, Standard & Poor's since 1974 and Fitch since 1993. The County highly values its ratings because it helps the County obtain the lowest cost of capital and most favorable borrowing terms, and assures the County of a ready market for its bonds.

Recently, on April 2 the County was placed on negative watch by Moody's Investors Services. This "Watchlist Negative" category means that Moody's has put the investor community and the County on notice that it intends to take a rating action within 90 days from the date the County was placed on Watch list. Ninety days from April 2 is July 1. While Moody's seeks to take action in 90 days – the practical reality is that the 90 days is a "targeted" period. This will be after the County's fiscal year-end and after the County will have passed its FY 2011 budget, both of which will be a factor in the Moody's analysis and will impact the action to be taken. The rating action taken could be either (1) to remove the County from "Watchlist Negative" and reaffirm the stable outlook, or (2) to downgrade the County, most likely to the Aa1 level. Technically, Moody's could continue the "Watchlist Negative" status (or reaffirm it) if it concludes there is additional near-term information which might meaningfully affect the outcome of the rating review.

A key reason for Moody's actions is the adverse impact the recession has had on the County's revenues, leading to a deterioration of the County's financial position, most notably a three year decline in its Fund Balances. We note that Standard & Poor's and Fitch have also indicated in their written reports that the County's weakened financial condition has highlighted credit concerns. While they have not yet taken a formal action to alter the County's rating status, the two other rating agencies are clearly watching as well to see what actions the County will take in the next few months. Any actions the County takes to protect its Moody's rating will positively affect the Standard & Poor's and Fitch ratings as well.

B. Report Objective

Montgomery County has developed a series of fiscal policies in order to guide management and elected officials in their policy and financial decision making. It is clear that the recession has exposed some areas in the County's fiscal policies which should be re-evaluated and strengthened. In light of the Moody's Watchlist action and concerns regarding the County's reserves raised by all three rating agencies, PFM has been asked to review the County's Fund Balance Policy, Revenue Stabilization Fund (RSF) legal provisions and other related policies in order to determine if these policies are adequate and if not, to suggest alternate policies for the County's consideration. Higher fund balance levels will clearly help preserve the County's Aaa rating; our challenge is to recommend a level that is adequate for the County's specific needs, but not greater than necessary. We understand that in any community there are pressures to limit the size of fund balance; the objective of this report is to identify the appropriate level of fund balance necessary to address Montgomery County's specific needs and in light of these other pressures, to not overstate the level necessary to maintain the Aaa rating.

C. Summary of PFM Recommendations

In order to prepare our report, we have reviewed the County's historical and most recent audited financial statements, proposed FY 2011 Budget, credit ratings reports published by Moody's, Standard & Poors and Fitch and other financial materials provided to us by the County Office of Management and Budget and Finance Department. We have also evaluated the County relative to other Aaa rated counties and have provided that analysis in Exhibit A attached hereto.

Based on our review of the economic volatility of key County revenue streams: the Income Tax, the recordation tax and the transfer tax, and on the average monthly level of cash flow expenditures, PFM is of the opinion that the County should:

#1) Act swiftly and decisively as part of the FY 2011 budget process to significantly restore target fund balance levels

- The combined fund balances of its unreserved, undesignated General Fund Balance and Revenue Stabilization Fund ("RSF") in FY 2011 should be restored to its current policy goal of 6% of tax supported resources.
- Simultaneously, the County should institute a multi-year plan to phase in a new policy which establishes higher unreserved undesignated General Fund Balance and Revenue Stabilization Fund to levels which reflect the County's specific liquidity needs given its cash flow and economically sensitive revenue streams.

#2) Amend local law with respect to the RSF (Please refer to Exhibit C for the section of the County Code that establishes the RSF.)

- Remove the provision which establishes a maximum amount permitted in the RSF.
- Provide for a mandatory contribution to the RSF equal to 0.5% of "Adjusted Governmental Fund Revenues". This provision would require a budgeted annual contribution until the combined ending balances of the General Fund and the RSF equals 10% of Adjusted Governmental Fund Revenues. "Adjusted Governmental Fund Revenues" are defined as revenues of all tax-supported County governmental and agency revenues, including operating grant and capital project revenues and explicitly excludes reserves applied to fund future expenditures.

#3) Establish and meet targets for the combined ending General Fund and RSF balance by FY 2020

- FY 2011 General Fund balance must be restored to 5% of prior year General Fund revenues.
- FY 2011 RSF must be restored to at least 1% of Adjusted Governmental Fund Revenues.
- Establish a planned annual contribution.
- Further, PFM recommends that the County needs to target and maintain a reserve balance (made up of unreserved, undesignated General Fund reserves and the Revenue Stabilization Fund) equal to 10% of Adjusted Governmental Fund Revenues.
- The County should plan to reach the reserve balance target no later than 2020.

#4) Strengthen its budget policy requiring the County to adopt a structurally balanced budget and to eliminate the ability to treat accumulated fund balance as revenue for the purpose of determining structural balance

D. Key Findings

These recommended target reserve levels will provide the County with sufficient reserves to protect itself from both intra-year cash flow shortfalls, as well as multi-year economic downturns similar to the levels experienced without having to resort to a mid-year tax increase.

#1) The proposed combined fund balance goal of 10% of Adjusted Governmental Fund Revenues is equal to approximately 36 days of revenues for all governmental funds. This is a minimum amount to maintain given that the one year drop in tax revenues experienced by the County in 2010 before consideration of the energy tax increase is equal to 16 days of Adjusted Governmental Fund Revenues, or 5.9% of prior year tax revenues.

#2) The County has undertaken an analysis of its economically volatile revenue streams; this analysis shows that the standard deviation during a five year period, which is the longest appropriate period to evaluate, is 5.8% of those revenues. The second largest revenue stream, the income tax, has experienced a 20% drop in a single year, and has a 15.5% standard deviation. This makes it very difficult to budget reliably, and thus requires a larger fund balance than other governments with less volatile revenue streams.

II. Comment on the Moody's, Standard & Poor's and Fitch Reports

All three rating agencies reserve their triple-A rating for the best run governments. The focus of this discussion will be Moody's, however we will also include some observations and concerns raised by the other two rating agencies. It is clear that the other two rating agencies, like Moody's, take negative trends seriously. Moody's analytic approach to rating General Obligation credits is outlined it its October 2009 publication "Moody's U. S. Public Finance Rating Methodology: General Obligation Bonds issued by U.S. Local Governments." This publication outlines the four rating factors Moody's considers and identifies the weighting assigned to each:

- Economic Strength: 40%
- Financial Strength: 30%
- Management & Governance: 20%
- Debt Profile: 10%

The rating agencies key concerns are highlighted below, with a quote from rating reports to substantiate our view of this as an important concern:

Rating Agency Comment #1 - Downward Pressure on the Rating

The County has been rated Aaa by Moody's investors service for 37 years. Based on a review of the Moody's report, we believe they are focusing their concerns on the second and third factors shown in the four bullet points. In taking its April 2nd action to place the County on Watchlist Review for Possible Downgrade Moody's indicated this could affect both the outstanding $1.8 billion of County General Obligation bonds as well as any future debt issued by the County. Moody's made the following statement:

> *"Placement on Watchlist for possible downgrade reflects deterioration of the County's financial position driven primarily by income tax revenue shortfalls, which is expected to result in the use of a significant portion of the County's General Fund and Revenue Stabilization Fund as of fiscal 2010 (year ends June 30th). Future rating reviews will factor (a)*

management's ability to mitigate the projected current year operating deficit, given identification of a number of potential gap closing measures that are largely non-recurring in nature; (b) steps taken in the 2011 budget to restore structurally balanced operations and (c) development of a plan to restore the financial flexibility to levels in keeping with the current rating category."(Moody's Investors Service, April 5, 2010)

Fitch Ratings stated:

"Failure to restore reserves to levels consistent with the 'AAA' rating and the county's long-standing policies could place downward pressure on the rating." (March 25, 2010)

"The county has stated that by fiscal 2012 it will eliminate the currently projected $212 million structural deficit and will restore reserves to its 6% policy. Fitch's current rating and Stable Outlook assume the county will be successful, but failure to achieve the fiscal 2011 and 2012 financial goals could result in a credit profile that is inconsistent with the current rating category." (Fitch Ratings, March 31,2010)

Standard & Poor's stated:

"The stable outlook reflects the inherent strength of the county's economy and Standard & Poor's expectation that the county will continue to take the steps necessary to restore its financial footing by addressing ongoing revenue declines. If the county fails to take actions to stabilize its finances, we may revise the outlook to negative." (Standard & Poors, March 31, 2010)

Rating Agency Comment #2 - Economic and Demographic Strengths and Debt Burden

The rating agencies made very strong statements regarding the downward pressure on the rating. As is typical in a credit report they also commented on the strength of the local economy. These positive comments are not intended and should not be read to offset the concerns and statements regarding negative pressure on the rating.

Moody's comments:

"…diverse and substantial economy, sizable tax base, affluent demographics, and manageable debt burden" – (Moody's Investor Service, April 5, 2010)

Fitch comments:

"A considerable and formidable economic base, anchored by the extensive presence of the U.S. government and expanding broadly into biotechnology, shows excellent prospects for continued expansion. Strong wealth and unemployment indicators underscore the county's economic strengths." – (Fitch Ratings, March 25, 2010)

S&P comments:

"Diversified, resilient, and broad-based economy that is closely tied to the greater Washington, D.C., metropolitan area" (Standard & Poors, March 31, 2010)

"Very strong income levels, coupled with a strong employment base and relatively low unemployment" (Standard & Poors, March 31, 2010)

"Historically stable and diverse property tax base" (Standard & Poors, March 31, 2010)

> "*Strong and well-embedded financial management practices that have aided management in proactively addressing continued budget stresses and revenue shortfalls" (Standard & Poors, March 31, 2010)*

Fitch comments regarding the County's debt burden:

> "*Overall debt levels are moderate, amortization is rapid, and capital needs are expected to remain manageable." (Fitch March 25, 2010)*

> "*Payment on non-general obligation debt issues are subject to annual appropriation, and their ratings depend largely on sound legal provisions and the level of essentiality provided by assets that secure each series of debt." (Fitch March 25, 2010)*

Data comparing the County's Economic Strength, Financial Strength and Debt Profile with other Moody's Aaa-rated Counties of similar population are presented in Exhibit A to this memorandum. The data shows that the County's economy is consistent with the level of other Aaa rated entities; the data also shows that **the County's economic strength, while formidable, is not materially stronger than many other Aaa entities.** The County's debt profile is typical of other triple-A counties. It cannot be counted on to offset significant weakness in the County's financial flexibility as described below.

Rating Agency Comment #3 - Fund Balance Drawdown

The deterioration in the Fund Balances has eroded the County's financial flexibility and weakened its ability to withstand any additional adverse financial events. The Moody's Watchlist established a 90 day timeframe for additional action by Moody's During this 90 day period key financial information will become available to Moody's which will likely be taken into consideration in their actions. We believe that the focus of the evaluation will be the County's fiscal year end results and fund balance, demonstrated progress towards restoration of structural budgetary balance in its FY 2011 budget; multiyear projections that provide a description of how the County will implement a fully structurally balanced budget in 2-3 years, and a plan to replenish the general fund balance and the revenue stabilization reserve to more conservative levels. A multiyear plan to build reserves to the recommended level may be acceptable as long as significant headway is made in 2011 and the plan to restore the remaining fund balance is realistic and the tactics used to accomplish the results are presented and deemed reasonable. Failure to follow a plan, once presented to the rating agencies, will be viewed negatively and would generate significant concern.

The County has a recent history of structurally imbalanced budgets which must be corrected in the 2011 Budget. Moody's highlights its need to see "*steps taken in the 2011 budget to restore structurally balanced operations.*" This practice of adopting structurally balanced budgets and the related fiscal constraint will need to be exercised for a number of years into the future.

Fund Balances have been drawn down and are too low. Moody's states: "*Current projections for end-of-year fiscal 2010 show the county ending the year with an extremely narrow $23.5 million (0.9% of General Fund revenue) in available reserves*." (PFM notes that subsequent to the publication date of the Moody's Report, the County executive has recommended revenue enhancements by increasing the energy tax by 100%, which is anticipated to lead to a slightly higher year end fund balance in the Revenue Stabilization Fund than noted in Moody's report.) PFM believes it is essential that this increase be adopted in time to close the 2010 gap.

Fitch also notes:

> *"In response to steep mid-year revenue adjustments in fiscal 2010 totaling $145 million, inclusive of $120 million of projected income tax shortfalls, the county implemented rigorous expenditure controls totaling $100 million and ultimately projected utilizing up to $102 million of the RSF in addition to undesignated general fund balance. Total undesignated reserves across all tax-supported funds including the RSF are expected to decline to a low $77 million on a budgetary basis, and the county projects total reserves to equal approximately 2% of spending, below the* 5% *that was announced as a one-year revision to policy. The unreserved general fund balance coupled with the RSF, a measure consistent with Fitch's analysis of financial flexibility, is projected to equal a slim 2.7% of spending." (Fitch Ratings, March 25, 2010)*

> *"Economic growth is expected to continue at a measured pace, allowing management to address infrastructure expansion and renewal in a timely manner without undue fiscal strain." (Fitch Ratings, March 25, 2010)*

> *"The recent diminishment of reserves from historically sound levels reflects structural budget gaps that were increased by anemic income tax revenues. The fiscal 2008 budget somewhat reversed unsupportable spending growth trends, although at the conclusion of the fiscal year the county's unreserved general fund balance decreased from 11.8% to 5.9% of the $2.8 billion of expenditures, transfers out, and other uses. Fiscal 2009 income tax shortfalls propelled an additional fund balance draw-down, to 3.5% of spending, although inclusive of a fully funded $119.6 million revenue stabilization fund (RSF), total reserves were a sound 7.7% of spending and exceeded the county policy of 6% of total resources." (Fitch Ratings, March 25, 2010)*

S&P similarly states:

> "*In Standard & Poor's view, the risk of further declines in revenues exists because of reduced income tax collections and the full impact of depreciated property values. To date, the impact of reduced real estate prices has been somewhat mitigated by credits from the homestead exemption program. However, in our opinion, the substantial expenditure reduction program undertaken by the county in the past few years indicates its commitment to restoring budget balance." (Standard & Poor's, March 31, 2010)*

> "*In our opinion, these long-term strengths should allow the county to weather a fairly significant weakening of its financial condition since fiscal 2008. The trend continued in fiscal 2009 and worsened in fiscal 2010. In fiscal 2008, following a $144 million drawdown attributable to flat income and real property taxes and declines in transfer and recordation tax revenues, the county's total general fund balance declined to $172.8 million, of which $164 million, or a still-strong 6.57% of expenditures, was unreserved. In addition to the general fund balance, the revenue stabilization reserve fund totaled $119.6 million at June 30, 2008, unchanged from a year earlier. The total general fund balance totaled 6.63% of general fund revenues in 2008, reversing a four-year growth trend tied to strong economic performance earlier in the decade." (Standard & Poor's, March 31, 2010)*

> "*In fiscal 2009, all of the general fund revenue sources, with the exception of property taxes, experienced declines or flat growth." (Standard & Poor's, March 31, 2010)*

PFM believes that the rating agencies will be supportive of our recommendation to increase reserves to at least 10% of Adjusted Governmental Revenues. The Adjusted Governmental Revenues is a broader base, meaning that the combined General Fund and RSF balance target as a percentage of General Fund Revenues is around 14%. In the past, rating agencies have commended the County for maintaining reserves close to those levels during more favorable economic times. In its report from 2008, S&P noted:

> *"Due to various factors, including spending demands exceeding revenue growth, declining state aid, and rising energy costs, fiscal 2008 was a challenge for the county. As previously mentioned, there was a $401 million budget gap that the county needed to address. Midyear, the county was able to generate some savings across four tax-supported agencies; implement a hiring freeze; slow both the operating and capital budget; and offer retirement incentives, all to bridge the revenue shortfall. In addition, a new emergency medical services (EMS) transport fee was implemented, which should provide the county with $7 million in fiscal 2009 and $14 million annualized. Nonetheless, and although unaudited, the county estimates that fiscal 2008 will close with an approximately $166 million deficit and a $143 million ending general fund balance. The revenue stabilization fund should remain at $119 million. Combined, these ending reserves are estimated to be 6.8% of reserves -- still above the county's 6% policy. Combined reserves over the past seven fiscal years have been in excess of 10% of revenues. This level of reserves provides the county significant flexibility to manage economic cycles and revenue volatility."*

Rating Agency Comment #4 - Property Tax Revenues

Property Taxes are politically constrained; the County is constrained to the amount of property tax growth to inflation without a unanimous vote by all nine members of County Council. Moody's has previously felt comfortable that the Council would take the steps necessary to raise property taxes as necessary, but recent actions have eroded their confidence. In March, the rating agencies also expressed concerns that the initial 2011 budget was too optimistic with respect to projected income tax revenues; subsequent Executive and Council actions have adjusted those projections materially downward.

> "*During Fiscal 2010, the county's governing board employed austere budget reduction measures to reduce the structural gap, including the renegotiation of fiscal 2010 salary adjustments ($125 million savings) and the elimination of pay-go-funding ($30 million), but the use of fund balance is tied in part to the county's decision to uphold the 1990 voter-approved county charter amendment that limits property tax to the prior years total plus inflation and revenue derived from new construction. The revenue restriction can be overridden by a unanimous vote of the nine council members. The Council's ability and willingness to override the charter tax limit when necessary is a positive factor. However the constraints of the charter tax limit may challenge the General Fund to stabilize and replenish available reserves to the 6% target level in the near term. Moody's will continue to monitor and evaluate the county's ability to progress toward policy compliance following the planned one-year deviation in fiscal 2010. The failure to restore reserves to the policy requirement and the sustained narrowing of the financial flexibility away from historical levels may introduce negative pressure on the county's credit profile." (Moody's Investors Service, April 5, 2010).*

Fitch makes a similar observation:

> *"Fitch believes the county retains additional flexibility in its proven success in overriding charter limitations on property tax growth, although the income tax rate is currently at the state maximum of 3.2%. The proposed fiscal 2011 budget includes a proposed energy tax increase as well as furloughs, lay-offs, and programmatic reductions that are intended to eliminate the $780 million deficit, restore $37 million to the RSF, and increase the undesignated general fund balance to $126.9 million. Should the county attain its objectives, it will restore reserves to the modified 5% policy, although Fitch is concerned that insufficiently conservative revenue projections may impede the county's attainment of its goal." (Fitch Ratings, March 25, 2010)*

S&P also notes:

> *"The county addressed the budget shortfalls identified in 2010 with a plan to save $100 million across county departments and a continued hiring freeze. In addition, the implementation of a midyear hiring freeze for county schools and the county community college yielded approximately $30 million in savings. The county's finance director has stated that the county will be looking to take further budget action this fiscal year to increase operating reserves and maximize operating flexibility. The county has not raised any significant revenues in 2010. This is because the county's charter limits annual growth in property tax revenues to the consumer price index (currently at 0.2%) plus new construction. The County Council can, however, override this limit with a unanimous vote."(Standard & Poors, March 31, 2010)*

Subsequent to the Moody's reaction, the County Executive has proposed new revenues - notably an increase in energy tax of 100%. An increase in the energy tax was selected because it can be retroactively applied and because it shifts some burden from the homeowner. The property tax was not selected because the average homeowner will have an average increase in the 8-10% range of their property tax bill due to the phase out of the homestead exemption. PFM believes that the actions taken to increase the energy tax which will be used to close the 2010 gap and will help close the 2011 gap is a very important and necessary step. We recommend that the County continue to maintain the energy tax increase until it achieves fiscal stability, or has replaced that revenue with other recurring revenues or has made recurring budgetary cuts. While the 100% energy tax increase will be viewed favorably by the rating agencies, this two-year tax will not be viewed as positively by the rating agencies as a property tax increase would have been valued. From a credit rating perspective there is a qualitative difference between a two year temporary increase in the energy tax and a permanent increase in the property tax. For long term stability in its rating, the County should seriously consider a property tax increase as part of a permanent solution.

Rating Agency Comment #5 - Income tax and other revenues are economically sensitive

The County has economically sensitive revenues and has not adequately reserved against their potential downturn:

> *"The county's revenue base includes a number of economically-sensitive revenue sources (income, recordation and transfer taxes) that generated significant budgetary surpluses during the real estate market boom period of fiscal 2004 to fiscal 2007 but are driving the current financial deterioration." (Moody's Investor Service, April 5, 2010)*

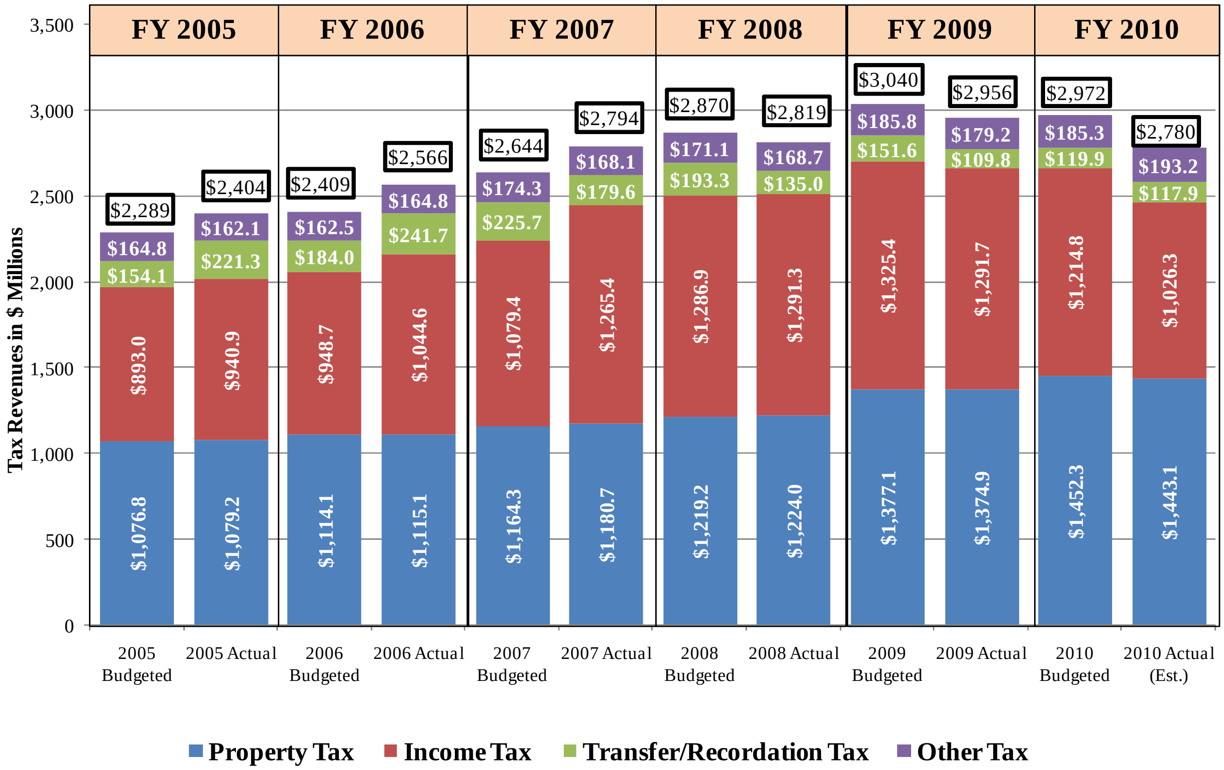
S&P also remarks in their report:

> *"The county's budget situation worsened in fiscal 2010, which began on July 1, 2009. The original adopted budget projected declines in local income tax revenues and flat growth in property taxes and other tax revenues. It projected that the county would end the year with a drawdown of the general fund reserves to $64 million, leaving the revenue stabilization fund intact at $119.6 million. As a result of the 2010 budget process, the county implemented expenditure cuts across its departments. Revenue projections in November 2009 and February 2010 indicated worse-than-projected declines in all general fund revenues, with the most significant decline in income tax collections. Income tax collections into the general fund were projected to have declined 15.2% from fiscal 2009. In addition to these larger-than-expected declines, the county also had to cope with unforeseen expenditure pressures, including the costs of the H1N1 flu outbreak and coping with the unusual December and February blizzards. On a budgetary basis, the county now projects that it will use $102 million of the revenue stabilization fund and end the fiscal year with $10 million, or less than 1% of expenditures, of unreserved fund balance in the general fund." (Standard & Poor's, March 31, 2010)*

> *"The county has a policy of budgeting to maintain total available reserves for tax-supported funds (which include general fund reserves and the revenue stabilization fund) at 6% of total resources of all tax-supported funds. For the purpose of this policy, tax-supported funds are defined as all governmental funds as well as component units that receive tax support from the county. The county has modified this policy to 5% but still will not maintain this level in fiscal 2010. The reserve levels will be 1.97% and 5% in fiscals 2010 and 2011, respectively. For fiscal 2012, the projected level is 6%."(Standard & Poor's, March 31, 2010)*

Figure 1 on the following page outlines the total revenues generated by each of the County's major sources of tax revenues, and compares actual tax revenues to the annual budgets. It is indeed clear from the information presented in Figure 1 that while the County's budget practices allowed for substantial surpluses during the boom years, the past three County budgets have overestimated revenues, resulting in structural imbalances and the need to make substantial draws on reserves. These overestimated projections reflect the difficulty in accurately predicting certain revenues in a recessionary environment.

Figure 1.
Montgomery County, Maryland
Budgeted vs. Actual Tax Revenues in FY 2005-2010



Over the past five years the County has experienced mixed results in terms of accuracy in budgeting for tax revenues. In fiscal years 2005 through 2007, the County budgeted conservatively, with budgeted tax revenues consistently lower than actual results by $105 million to $157 million. This under-budgeting provided the County with a defacto contingency, a portion of which was used to grow the RSF in certain years and a portion of which was used to fund budget growth. At the same time, in fiscal years 2008 through 2010, the County was hit with significant shortfalls in tax revenues of $51 million in 2008, $84 million in 2009 and a projected $184 million in FY 2010 when compared to that year's budget.

The County can accurately predict and budget for property tax revenues, with the discrepancy between budgeted and actual property tax revenues for FY 2010 expected to total only about $9 million. Historically, the difference between budgeted and actual property tax revenues has ranged between $1 and $5 million, with the exception of 2007, when actual property taxes were almost $16 million higher than budgeted.

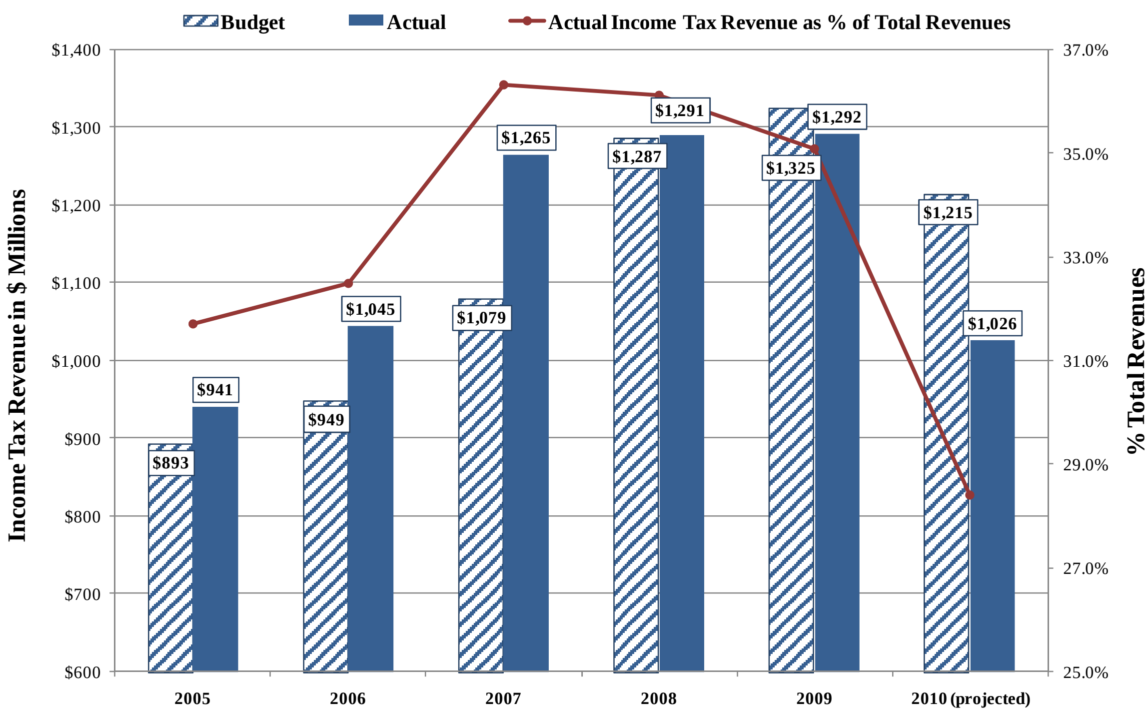
The County has experienced much greater discrepancies between budgeted and actual income tax, transfer tax and recordation tax revenues. Income tax appears to be the most variable tax revenue item, with actual revenues expected to come in over $188 million less than budgeted in FY 2010. Actual income tax revenues deviated substantially from budgeted amounts in prior years as well, notably coming in $186 million over budget in FY 2007. The County's two year underperformance versus budget for income taxes is $222 million. This illustrates the high volatility in the income tax and the related need for the County to have higher levels of fund balance.

Similarly, transfer and recordation tax revenues, while constituting a much smaller proportion of total revenues, also show great variance between budgeted and actual numbers, with actuals higher than budget by as much as $54 million in strong years (FY 2007), and lower than budget by as much as $42 million in weak years (FY 2009).

The County has historically projected that total tax revenues will be equal to or higher than prior year actual revenues in its budgetary process. While this approach worked in fiscal years 2005 through 2007 due primarily to the general economic strength seen nationwide, this same approach became problematic in the face of the current recession, with budgeted revenues overstating actual revenues for the past three years. This became especially problematic in fiscal years 2009 and 2010, as the recession deepened. Total actual tax revenues fell below the budgeted amount by about $84 million in 2009 and by an estimated $184 million in 2010. The 2010 tax revenue shortfall, when compared to the budgeted revenues, is made up of the following: property tax revenues off by $3.6 million, income tax revenues off by $188.5 million, transfer and recordation taxes off by $2 million and other taxes coming in over budget by $15.7 million.

In particular, the income tax revenue is unpredictable, especially in a recessionary environment as illustrated in Figure 2 below.

Figure 2.
Montgomery County, Maryland
Budgeted vs. Actual Income Tax Revenues Only, FY 2005-2010



Source: Montgomery County, Maryland Approved Capital and Operating Budgets, FY 2006 - FY 2011 & Department of Finance, 4/30/2010.

Figure 2 focuses specifically on the County's income tax revenues, highlighting the substantial impact that this year's income tax shortfall is having on the County's budget. It is especially important to note that while the income tax provided over 35% of total County tax-supported revenues in 2009, it contributed less than 29% in 2010, constituting a 6.6% year-to-year decrease in County tax-supported revenues. The magnitude of this decline helps frame the argument for a fund balance policy that calls for a balance greater than 6% of General Fund revenues. The following section provides a detailed discussion of all factors that have to be considered in order to formulate an ample reserve policy.

III. Overview of Best Practices

The purpose of undesignated, unreserved General Fund Balances and general reserve funds like the county's RSF is to provide a ready access to liquid funds to protect against current and future risks and to ensure that the government can provide stable tax rates. Fund balance levels are also critical in long range financial planning. Each government should evaluate the particular risks that it must reserve against, and establish a level of reserves and set of policies that address the specific risk analysis for that government. A government may have a fund balance that is different (either higher or lower) than other government's with the same bond rating.

Specifically, a well crafted fund balance policy for any government will consider:

- The cash flow timing - liquidity needs of a government;
- The need to have contingencies for unexpected expenditures, such as extraordinary snow removal or emergencies;
- The predictability of revenues and the volatility of expenditures – higher levels of unrestricted fund balance may be needed if significant revenue sources are subjected to unpredictable fluctuations or if operating expenditures are highly volatile ;
- The ability to fund unexpected capital situations;
- The ability to respond to any revenues shortfall with expenditure adjustments within a fiscal year
- How a government will replenish any draws on fund balance;
- A policy on structural balance so the budget does not use nonrecurring revenues (which is fund balance, sale of assets, etc) for recurring expenditures.
- How many years (or months) of exposure the government wants to protect for (3 months is often the standard).
- How cyclical the government's revenues really are, and what other exposures are (for example, is the government dependent on a large employer that can cut back with no notice)

For your reference, Exhibit B of the report provides the full statement of the Government Finance Officers Association Best Practices Statement on *Appropriate Level of Unrestricted Fund Balance in the General Fund (2002 and 2009) (BUDGET and CAFR)*. This statement addresses many of the same points listed above.

IV. Current Financial Policy Statement for Montgomery County

Montgomery County has established its Fund Balance policies in the Charter and in local law and has also established written policies in its annual Fiscal Policies section of its budget. The Charter provides a cap on the General Fund Balance. Section 310 of the Charter provides:

> *"The County may accumulate earned surplus in any enterprise fund or unappropriated surplus in any other fund. With respect to the General Fund, any unappropriated surplus shall not exceed five percent of the General Fund revenue for the preceding fiscal year. An unappropriated surplus may be used to fund any supplemental or special appropriations."*

Local Law provides that the Director of Finance may establish a Revenue Stabilization Fund ("RSF") which is designed to allow the County to accumulate surpluses in periods when certain revenues perform strongly. The full text of the law is provided in Exhibit C. The Revenue Stabilization Fund is in addition to any amounts which may be accumulated under Section 310 of the County Charter. The County may contribute annually to the RSF at its discretion unless it is at its cap. In practice, the County has not made any discretionary contributions to the fund since FY 1996. The law provides a formula for the calculating the mandatory contributions to the fund which is 50% of the product of the certified revenues estimated for the current fiscal year and the difference between the average percent increase in certified revenues over the past six years and the anticipated percent increase in certified revenues in the next year. The County made its last mandatory contribution in FY 2007. However, the total amount in the fund is currently capped at 10% of the average revenue derived from the income tax and real property transfer tax, recordation tax and investment income of the General Fund in the three preceding fiscal years.

As a result of the RSF cap, while the calculated mandatory contribution for fiscal year 2005 through 2009 was $86 million only $24 million was actually contributed. Figure 3 below depicts the actual annual contribution to fund balance (shaded dark blue) as well as the additional annual contribution to fund balance that would have been made without an RSF cap (shaded light blue).

Figure 3.
Montgomery County, Maryland
Revenue Stabilization Fund Balances, FY 2000 - FY 2010
Note:FY 2010 Fund Balance is reflective of anticipated FY 2010 Drawdown

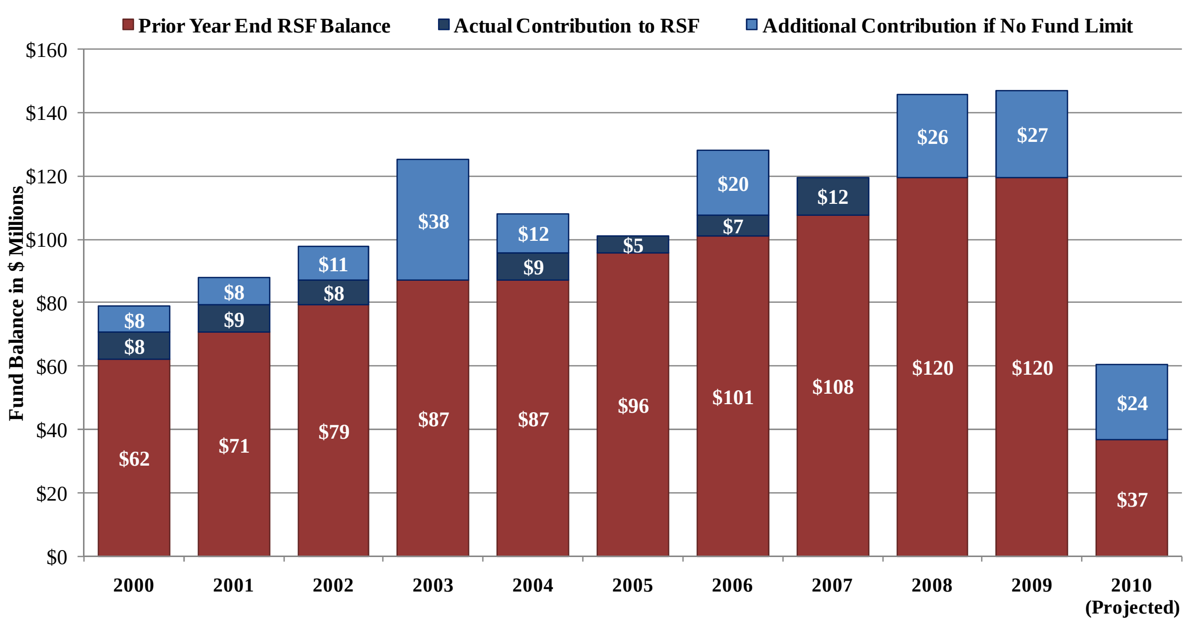
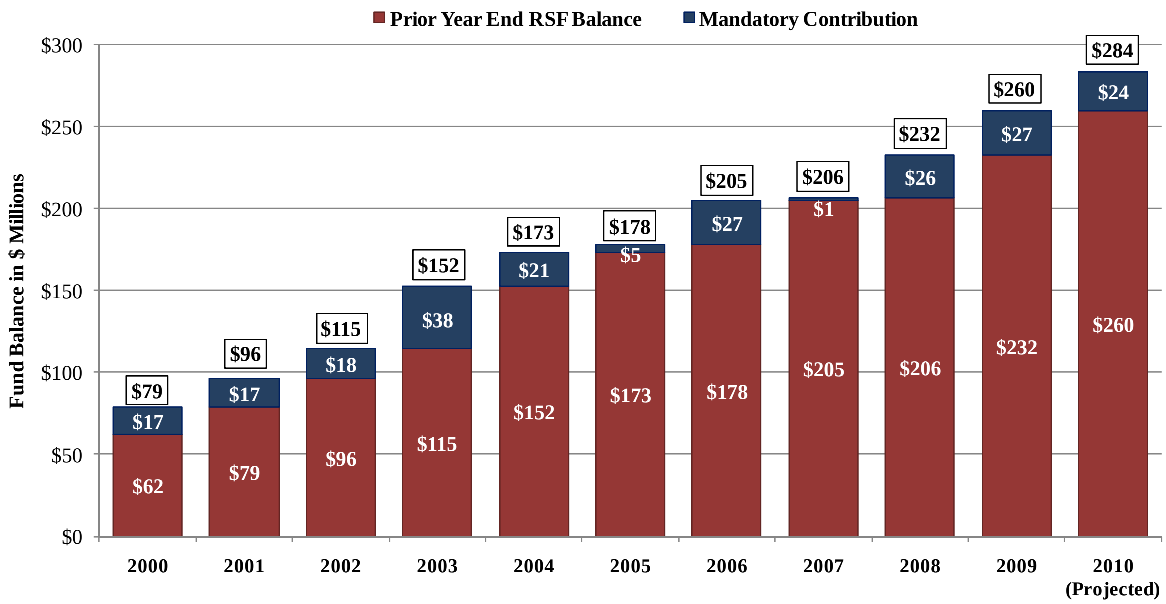


Figure 4 below estimates what the County's annual RSF balances would have been had there been no RSF cap – it shows the RSF growing annually assuming the full mandatory contribution was made every year. As shown below, with a full mandatory contribution made every year starting with fiscal year 2000 and no fund draws, the RSF would have reached $260 million by 2010, which is $140 million higher than the actual 2010 beginning RSF balance. This would have provided much more protection to the County than the current balances.

Figure 4.
Montgomery County, Maryland
Projected Revenue Stabilization Fund Balances FY2000 - FY2010
(Assumes full mandatory contribution made each year with no cap/contribution limit)



We understand that the Charter provision is not subject to change without substantial effort and process, accordingly any modifications to the Fiscal Policies should be done assuming Section 310 will remain unchanged. In light of the County's request that PFM focus a review on Fund Balance policy, and other Fiscal Policies that may be relevant given the Moody's comments in its April 5 report PFM has highlighted the following current Fiscal Policies for consideration:

#1) Balanced Budget Policy

> *"It is the fiscal policy of Montgomery County to balance the budget. A balanced budget has its funding sources (revenues, undesignated carryover, and other resources) equal to its funding uses (expenditures, reserves, and other allocations). No deficit may be planned or incurred."*

#2) Reserves and Revenue Stabilization (The full text of the RSF is summarized here and has been provided with PFM's recommended changes as Exhibit C.)

> *"The County will maintain total reserves for tax supported funds that include both an operating margin reserve and the RSF (or "rainy day fund"). For tax-supported funds, the budgeted total reserve of the operating margin and the RSF should be at least 6.0 percent of total resources (i.e. revenues, transfers, prior year undesignated and designated fund balance)."*

> *"An operating margin reserve (or un-appropriated fund balance) will be budgeted for tax supported funds in order to provide sufficient funds for unanticipated revenue shortfalls or unexpected expenditure requirements."*

> *"The County's Revenue Stabilization Fund was established to accumulate funds during periods of strong economic growth in order to provide budgetary flexibility during times of funding shortfalls. Fifty percent of selected revenues in excess of budgeted amounts must be transferred to the Fund: discretionary contributions may also be made. Unless decided otherwise by six or more council members, withdrawals may be made only under certain economic conditions and may be used only to support appropriations which have become unfunded.*
>
> *"The budgeted reserve levels for non-tax supported funds are established by each government agency and vary based on the particular fiscal requirements and business functions of the funds as well as any relevant laws, policies, or bond covenants"*

PFM believes that the County should strengthen its policies with respect to these two points, and take care to strictly adhere to the revised policies going forward. The rating agencies will be watching closely to see that the County follows its plans. The rating agencies will be expecting that by 2011, the County will return to the 6% fund balance level as stated in its current policy. They will understand the need for the County to implement its goals over a multi-year period and will not necessarily require the County to replenish fund balances up to appropriate levels within the span of one fiscal year.

V. Current County Risk Exposure

Below is a specific list of risk issues which we believe should be taken into consideration as we establish the County's fund balance needs

1. **Ability to take action mid-year to raise revenues:** The County has limited ability to raise additional revenues during the year if revenues fall short.

2. **Challenges Raising Property Taxes:** Property taxes are a core revenue stream and are highly predictable, making them a very important revenue stream from a credit perspective. The County has limitations (as in a high bar in the guise of a unanimous vote) in the ability to increase property taxes beyond inflation plus growth in any given year.

3. **The County does not Control a Majority of its Expenditures** The County is constrained in its ability to adjust expenditures during the year due to the substantial payments for education. The county cannot adjust this during the year, and must maintain the required maintenance of effort. This is 58% of the general fund expenditures and transfers out. This means, for example, that 5% drop in revenues would mean about a 12% cut in all other expenditures.

4. **The County may experience unexpected expenditures for which no contingency has been budgeted:** The County recently experienced a severe winter weather season, incurring nearly $60 million more in snow removal costs than budgeted.

5. **Monthly Cash flow expenditures average approximately $363 million.**

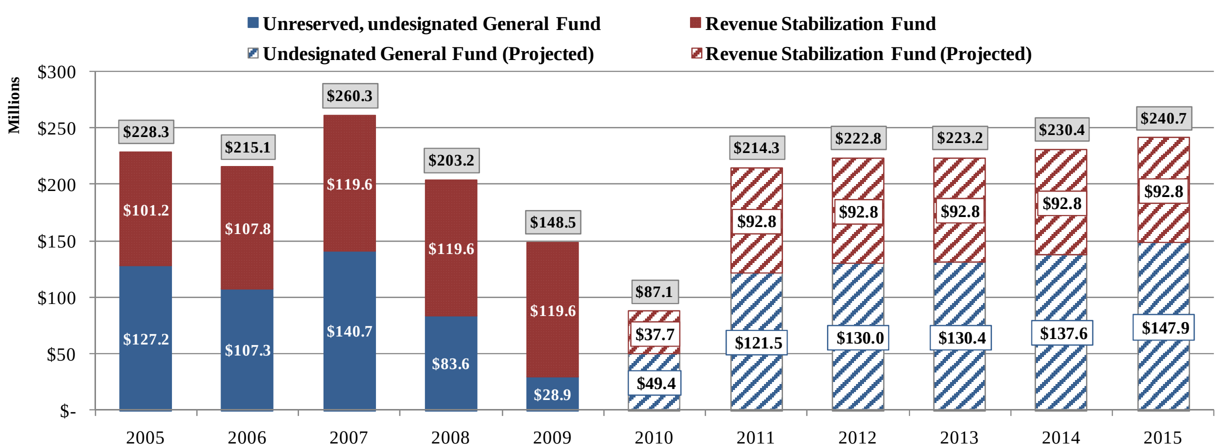
6. **Other Risks to Consider:** While most of the county's exposure resides in taxes, it also has other risk exposures: For example the two most notable risks are the County's variable interest rate exposure and its a practice of spending funds in anticipation of receipt of grants - accordingly higher reserve levels are appropriate to protect against this risk.

7. **General Fund Functions as the Bank to the other Funds:** The County needs to include the other Tax Supported Governmental funds as the basis for measuring the size of the reserve the General Fund is the "bank" or final guarantor of those funds.

VI. PFM Recommended Policy Standards

The County has experienced a multi-year economic downturn, loosing over $300 million in budgeted revenues. In FY 2010, the County was hit with large one-time expenditures for snow removal equal to $60 million in excess of budget. As reflected in Figure 5 below, the County has had to draw down on its two key unreserved, undesignated reserve funds: the General Fund and the Revenue Stabilization Reserve to pay for current operations. In order to close 2010 with positive fund balances, the County has had to undertake multiple midyear budget cuts and midyear tax increases. Even with these actions, the County's 2010 projected ending combined General Fund and Revenue Stabilization Fund balance is perilously low at $38 million, down from its highest combined fund balance of $260 million in 2007. The County is not currently in a position to withstand another large unanticipated negative budget variance without interruption in service or other highly undesirable action.

Figure 5.
Montgomery County, Maryland
Ending Fund Balances (Actual & Projected) by Fiscal Year



NOTE: General Fund Balance projections are based on the projected FY11 ratio of undesignated GF balance to projected total tax-supported governmental undesignated fund balance, or ~86%. Total tax-supported governmental undesignated fund balance projections are taken from FY2011-2016 Fiscal Plan, revised April 22, 2010 by the Montgomery County, Maryland Management & Budget Office.

Source: Montgomery County, Maryland Comprehensive Annual Financial Reports, FY 2005-2010 and Departments of Budget & Finance.

As shown in Figure 5 above, while the County expects to restore its combined fund balance to about $214 million in 2011, the County's projections beyond FY2011 show only a modest growth in combined General Fund and Revenue Stabilization Fund balance thereafter. PFM believes that such reserve levels are insufficient and leave the County exposed to future risk. We believe that the combined value of these two funds should be the basis of fund balance reserve policies that establish minimum levels and goals of reserve fund sufficiency since they are available for unforeseen events during the year. As discussed below, we recommend that the County restore by year-end FY 2011 its fund balances to the current policy levels and adopt a new policy with higher reserve targets. The new reserve targets can be phased in over time. These actions, together with other actions recommended in this report, are the best course for the County to take given the realities of the County's current circumstances, in order to have the best chance of preserving the Moody's Aaa, and avoiding downward pressure on its ratings from Standard & Poor's and Fitch.

In developing our recommendation for the level of appropriate reserves, we have considered both our independent view of what we believe to be the appropriate level of reserves for Montgomery County, and the method by which to evaluate it, as well as Moody's ratio analyses. Moody's generally reports General Fund balance as a percent of General Fund revenues. However there is wide variability in the level of general fund reserves for governments, and the level needed should be based on the particular circumstances of the government. **PFM believes that the County should base its target reserve levels as a percentage of total Adjusted Governmental Fund Revenues, which includes the other funds that are primarily supported with the same tax base as the activities in the General Fund.** PFM believes that projected restorations as shown in Figure 1 above are also not sufficient because they don't adequately protect the County in the event of a sudden unpredictable decline in its financial position similar to the $223 million of fund balance decline the County has experienced in this extended recessionary period. This is a risk to the County, given its revenue streams that are sensitive to downturns in the economy, which can occur midyear.

We recommend that the County remove the cap on the RSF and add a stronger mandatory contribution provision which requires the County to budget to add 0.5% of total Adjusted Governmental Fund Revenues per year until the total of the combined General Fund Balance and RSF has reached 10% of Total Adjusted Governmental Funds revenues, as provided in the County's audited financials. We understand that this could take ten years to accomplish unless the County enters into another period of very robust economic growth, however a ten year plan should be acceptable as long as the initial steps for 2011 are sufficient to restore the General Fund to 5% of prior year General Fund revenues and make a substantial contribution to the RSF.

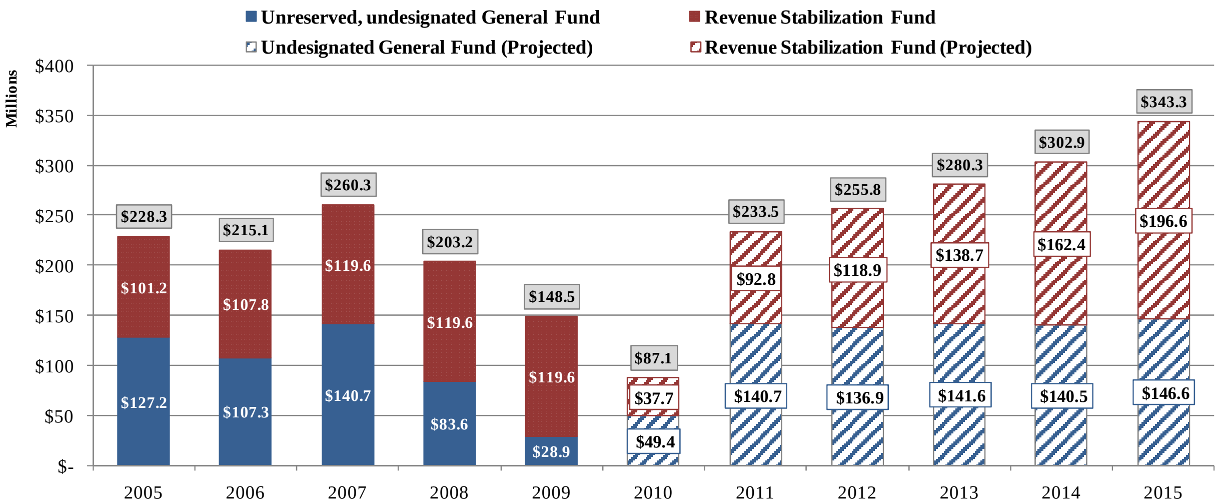
Figure 6.
Montgomery County, Maryland
Expected General Fund Balances as a % of General Fund Revenues

Fiscal Year Ending	General Fund Revenues ($MM)	General Fund (Unreserved,Undesignated)	
		Fund Balance ($MM)	% of Prior Year General Fund Revenues
2010	2,501.60	49.40	0.2%
2011	2,738.00	140.70 (1)	5.0% (2)
2012	2,832.00	136.90	5.0%
2013	2,810.00	141.60	5.0%
2014	2,932.00	140.50	5.0%
2015	3,102.00	146.60	5.0%

(1) Includes fund balance in the County's General Fund (approximately $125.1 million) plus balances in the County's other tax-supported funds and outside agencies
(2) Percent of Prior Year General Fund Revenues reflective of General Fund balance ONLY (approximately $125.1 million in FY2011)

Figure 7 on the following page depicts the total projected County reserve balances reflective of the policy changes described above. Note that the total reserve fund balance grows every year by roughly an equal amount, and ends 2015 with a significantly higher total fund balance than shown in Figure 5.

Figure 7.
Montgomery County, Maryland
Revised Ending Fund Balances Reflective of New Reserve Plan



Source: Montgomery County, Maryland Comprehensive Annual Financial Reports, FY 2005-2010 and Departments of Budget & Finance.

PFM is recommending that the County establish and meet targets for the combined ending General Fund Balance and RSF Balance as shown in Figure 8 below. Figure 8 below also shows the same fund balance dollar amounts as a percentage of Adjusted Governmental Funds revenues. PFM believes that the County should consider all potential sources of budgetary risk, some of which are outside of the General Fund, when setting fund balance goals. For this reason, it is important to compare fund balance to total tax-supported budget size. Further, PFM is recommending that the County continue to make contributions to the RSF beyond 2015 based on a formula presently employed by the County, but without any defined maximum fund size. The recommended 2011-2020 fund balance contributions are detailed in Figure 8.

Figure 8.
Montgomery County, Maryland
Recommended General Fund and Revenue Stabilization Fund Balances
as a % of General Fund Revenues and All Governmental Funds Revenues for FY2011 - FY2015

Fiscal Year Ending	General Fund Revenues ($MM)	Adj. Gov'tal Fund Revenues ($MM)	General Fund (Unreserved,Undesignated)			Revenue Stabilization Fund			Total		
			Fund Balance ($MM)	% of Prior Year General Fund Revenues	% of Gov'tal Fund Revenues	Fund Balance ($MM)	% of General Fund Revenues	% of Gov'tal Fund Revenues	Fund Balance ($MM)	% of General Fund Revenues	% of Gov'tal Fund Revenues
			County Projected								
2010	2,501.60	3,388.49 (2)	49.40	0.2%	0.1%	37.70	1.5%	1.1%	87.10	3.5%	2.6%
			PFM Recommended								
2011	2,738.00	3,891.67	140.70 (3)	5.0% (4)	3.1%	92.80	3.4%	2.4%	233.50	8.5%	6.0%
2012	2,832.00	4,060.32	136.90	5.0%	3.4%	118.90	4.2%	2.9%	255.80	9.0%	6.3%
2013	2,810.00	4,062.32	141.60	5.0%	3.5%	138.70	4.9%	3.4%	280.30	10.0%	6.9%
2014	2,932.00	4,206.94	140.50	5.0%	3.3%	162.40	5.5%	3.9%	302.90	10.3%	7.2%
2015	3,102.00	4,400.00	146.60	5.0%	3.3%	196.70	6.3%	4.5%	343.30	11.1%	7.8%
2016	3,226.08 (1)	4,569.05	155.10	5.0%	3.4%	228.70	7.1%	5.0%	383.80	11.9%	8.4%
2017	3,355.12 (1)	4,751.81 (1)	161.30	5.0%	3.4%	254.99	7.6%	5.4%	416.29	12.4%	8.8%
2018	3,489.33 (1)	4,941.88 (1)	167.76	5.0%	3.4%	286.12	8.2%	5.8%	453.88	13.0%	9.2%
2019	3,628.90 (1)	5,139.56 (1)	174.47	5.0%	3.4%	330.23	9.1%	6.4%	504.70	13.9%	9.8%
2020	3,774.06 (1)	5,345.14 (1)	181.45	5.0%	3.4%	354.76	9.4%	6.6%	536.21	14.2%	10.0%

(1) Projected at 4% Growth Per Annum
(2) Adjusted Governmental Funds Revenues Projected at 4% Growth Per Annum Using Audited FY09 Value of $3.258 billion
(3) Includes fund balance in the County's General Fund (approximately $125.1 million) plus balances in the County's other tax-supported funds and outside agencies
(4) Percent of Prior Year General Fund Revenues reflective of General Fund balance ONLY (approximately $125.1 million in FY2011)

PFM proposes the following replacement language for the current County Balanced Budget Policy:

#1) Structural Budgetary Balance Recommendations:

Montgomery County will have a structurally balanced budget, that is, budgeted expenditures should not exceed projected recurring revenues for that fiscal year. Recurring revenues should fund recurring expenses. No deficit may be planned or incurred. In the event that the County determines that reserves have been fully funded, then to the extent that there are surplus reserves, these funds should be budgeted to fund any of the following non-recurring expenditures which are one-time in nature, fund pay-go for capital in excess of the County's targeted goal for pay-go or to advance fund unfunded liabilities such as OPEB. (The County may want to add in other non-recurring items)

#2) Fund Balance Recommendations:

According to the Government Finance Offers Association, "*Accountants distinguish up to five separate categories of fund balance, based on the extent to which the government is bound to honor constraints on the specific purposes for which amounts can be spent: Nonspendable fund balance, restricted fund balance, committed fund balance, assigned fund balance and unassigned fund balance, the total of the last three categories, which include only resources without a constraint on spending or for which the constraint on spending is imposed by the government itself, is termed unrestricted fund balance.*" PFM's recommendation is addressing ***unrestricted fund balance*** levels in the General Fund and the level in the Revenue Stabilization Fund as a percentage of total Governmental Fund Revenues.

Given the County's strong financial management practices, we recommend that the county maintain a reserve balance (made up of unreserved, undesignated General Fund reserves and the Revenue Stabilization Fund) target equal to 10% of Adjusted Governmental Fund Revenues which provides an absolute minimum of 36-days of working capital reserves. This amount should be sufficient to withstand shocks created by another recession of the same severity as the 2008-2010 recession if it is also combined with several severe unplanned expenditure requirements.

VII. Summary of Recommended Policy Changes

The table on the following two pages presents a summary of all suggested policy changes and compares them to the policies that are currently in place.

	CURRENT POLICY/PRACTICE	PFM and FINANCE RECOMMENDED POLICIES
Structurally Balanced Budget	**<u>Current Fiscal Policy:</u>** ***It is the fiscal policy of Montgomery County to balance the budget. A balanced budget has its funding sources (revenues, undesignated carryover, and other resources) equal to its funding uses (expenditures, reserves, and other allocations). No deficit may be planned or incurred.***	**<u>Recommended Policy:</u>** ***Montgomery County will have a structurally balanced budget, that is, budgeted expenditures should not exceed projected recurring revenues for that fiscal year. Recurring revenues should fund recurring expenses. No deficit may be planned or incurred.***
Reserves	**<u>Current Fiscal Policy:</u>** ***The County will maintain total reserves for tax supported funds that include both an operating margin reserve and the RSF. For tax supported funds, the budgeted total reserve of the operating margin and the RSF should be at least 6.0 percent of total resources (i.e., revenues, transfers, prior year undesignated and designated fund balance).***	**<u>Recommended Policy:</u>** ***Montgomery County will have a goal over 10 years (by 2020) of building up and maintaining the sum of Unrestricted General Fund Balance and Revenue Stabilization Fund to an amount equal to approximately 10% of Adjusted Governmental Fund revenues.*** Higher reserves are recommended in keeping with: 1) revenue volatility 2) expenditure volatility 3) working capital needs 4) more in line with other large AAA jurisdictions
General Fund Reserves	Section 310 of Charter: *With respect to the General Fund, any unappropriated surplus shall not exceed five percent of the General Fund revenue for the preceding fiscal year.*	Retain, but policy reserves above Charter limitation will be included in target for RSF. *(continued on next page)*

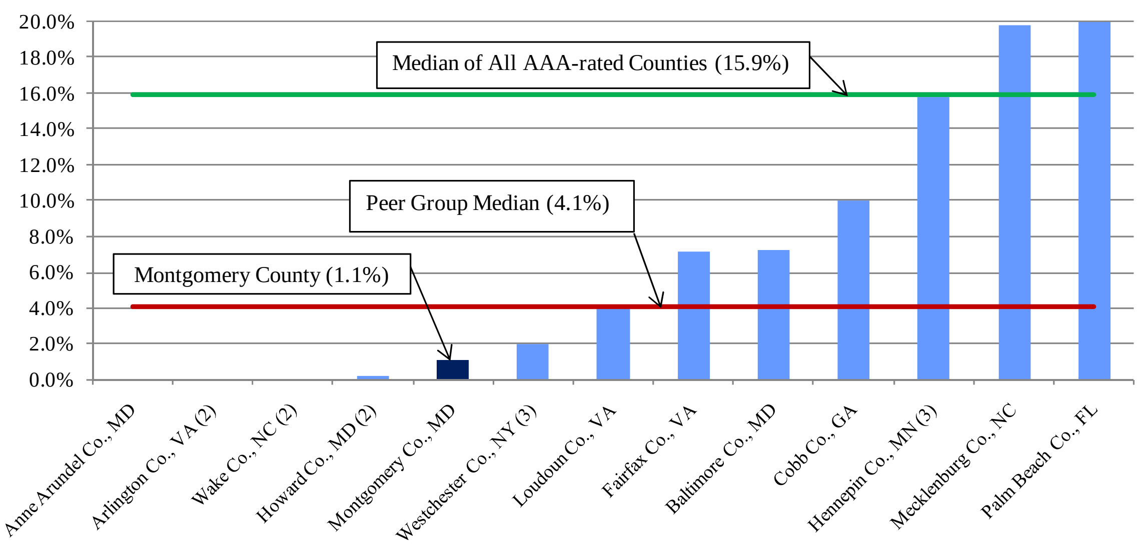
	CURRENT POLICY/PRACTICE	PFM and FINANCE RECOMMENDED POLICIES
Revenue Stabilization Fund (RSF)	RSF is currently capped at 10% of average of prior 3 years specific revenue sources. Interest earned is transferred to PAYGO, and mandatory contributions are based on revenues exceeding estimates. (See County Code Ch 20 Article XII) If actual total revenues from the income tax, real property transfer tax, recordation tax, and investment income of the General Fund for the next fiscal year exceed the original projection, then 50 percent of the excess must be transferred to the Fund.	Remove cap, retain interest earned in RSF, and require mandatory contributions to achieve total reserves of 10% and when revenues exceed estimates: ***Mandatory annual contributions to the Fund must equal the greater of:*** ***50 percent of the amount by which actual total revenues from the income tax, real property transfer tax, recordation tax, and investment income of the General Fund for the next fiscal year exceed the original projection for these amounts.*** ***An annual amount not to exceed 0.5 percent of the Adjusted Governmental Revenues for the current year, but which does not result in the sum of the current year-end projected Unrestricted General Fund fund balance and the Revenue Stabilization Fund to exceed 10 percent of the Adjusted Governmental Revenues.***
Use of One-time Revenues	**<u>Current Fiscal Policy:</u>** ***Except for excess revenues which must go to the Revenue Stabilization Fund, the County will, whenever possible, give highest priority for the use of one-time revenues from any source to the funding of capital assets or other nonrecurring expenditures so as not to incur ongoing obligations for which revenues may not be adequate in future years.***	**<u>Recommended Policy:</u>** ***One-time revenues and revenues in excess of projections will be applied first to restoring reserves to policy levels or as required by law. In the event that the County determines that reserves have been fully funded, then one-time revenues should be applied to expenditures which are one-time in nature, PAYGO for the CIP in excess of the County's targeted goal, or to unfunded liabilities such as Pension or OPEB.***

Exhibit A

Peer Group Financial Statistics Comparison: Montgomery County vs. other Aaa-rated counties

PFM has selected a group of similar Aaa rated Counties to compare with Montgomery County – they are large suburban counties with strong economics and demographics as well as Aaa rated Counties in Maryland and northern Virginia. Set forth below in Figures 1-3 are comparisons of the County's General Fund and Revenue Stabilization Fund combined balance to similarly designated fund balance levels within the County's peer group. Figure 1 presents unreserved, undesignated General Fund balances as a percentage of General Fund revenues, a key credit metric used by Moody's. The County's General Fund balances do not compare favorably with other Aaa rated Counties in its peer group. Most triple-A rated counties maintain a higher level of undesignated reserves as a percentage of General Fund revenues throughout the economic cycle (the 2009 median is just under 16%). It is clear from the drawdown on the reserves that in the past several years, the County has not maintained a balanced budget, and has needed to expend its fund balances to the point where the County's fund balances are among the very lowest of any Aaa rated county, and much lower than many counties in the double-A category.

Figure 1.
Unreserved, Undesignated General Fund Balance as a % of General Fund Revenues, Excludes Other Contingency Reserves
(Data as of FY 2009 Unless Otherwise Noted)



(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.

(2) County either designates entire general fund balance, or designates portions to budget stabilization, subsequent year's expenditures or working capital.

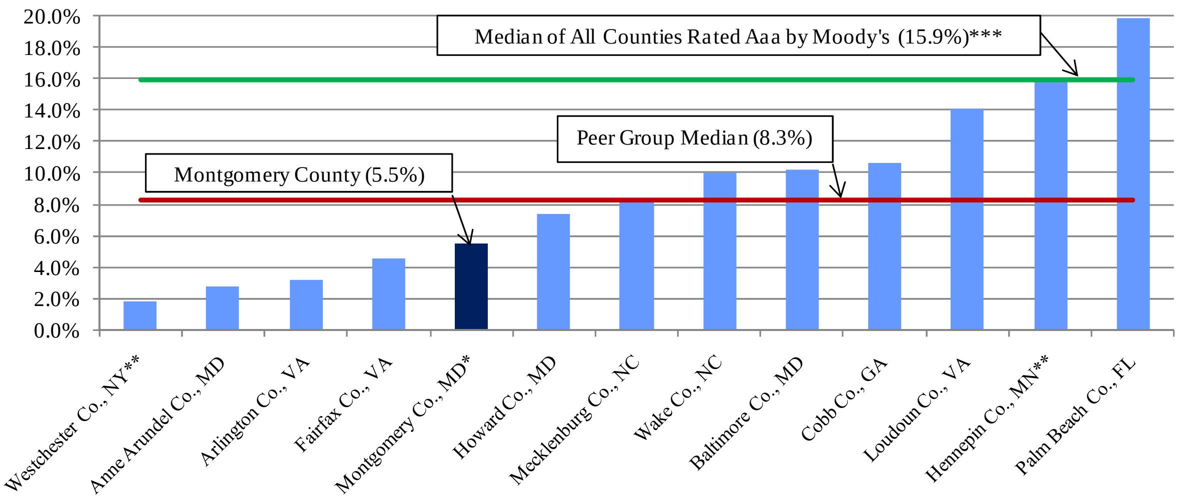
(3) Data as of 12/31/2008. FY 2009 data not yet available.

Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.

The published Moody's data shown in Figure 1 considers only unreserved, undesignated fund balances as a percentage of General Fund revenues, and disregards other contingency and working capital reserves that may be used for budgetary relief. As a result, several counties that don't keep a substantial portion of their reserves as unreserved, undesignated fund balance appear to have very limited contingency resources. In the case of Montgomery County, the above calculation considers the County's stated fiscal year 2009 unreserved, undesignated General Fund balance of $28.854 million as a percentage of the County's total General Fund revenues of $2.713 billion, or about 1.1%.

In order to better account for available fund balances, PFM has undertaken our own analysis using 2009 data, shown in Figure 2 below. PFM has used our own methodology, making sure to include not only unreserved, undesignated General Fund Balances, but also any other contingency reserves, such as the Revenue Stabilization Fund in the case of Montgomery County, that may be separately provided for. Including this data significantly altered the results for several counties that carry a substantial proportion of their reserves outside of unreserved, undesignated fund balance (though it did not change the relative ranking of Montgomery County). The calculation for Montgomery County below includes the unreserved, undesignated General Fund balance of $28.854 million, as well as the Revenue Stabilization Fund balance of $119.648 million, as a percentage of the County's total general fund revenues of $2.713 billion, or about 5.5%.

Figure 2.
Unreserved, Undesignated and General Contingency Reserve Fund Balances as % of General Fund Revenues
(Data as of FY 2009 Unless Otherwise Noted)

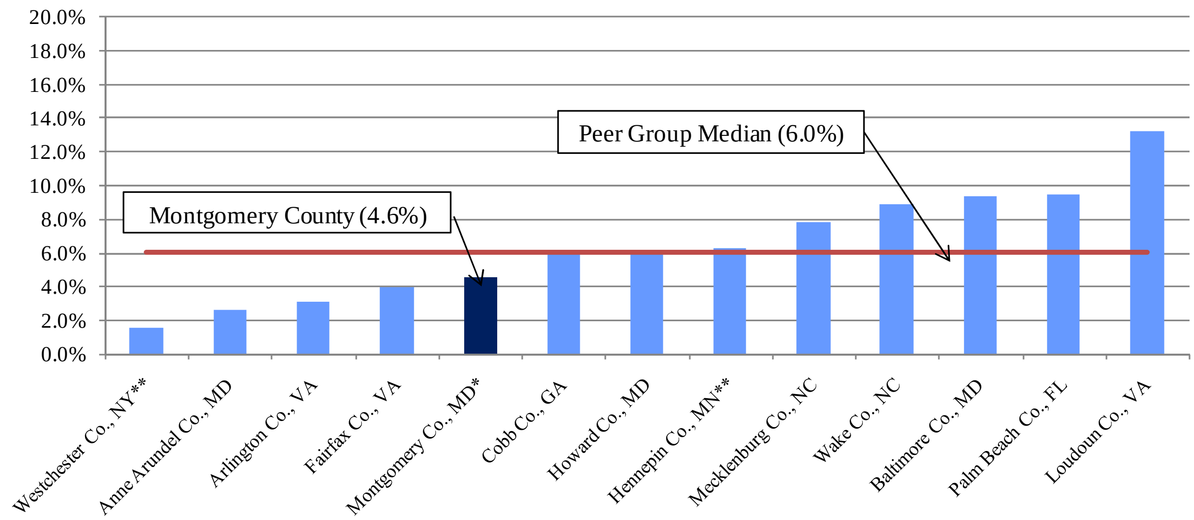


**Includes Revenue Stabilization Fund*
***Fiscal Year 2008 data. No 2009 data available (FY ending 12/31)*
****Medians exclude other general working capital reserves not held in General Fund.*

Montgomery County's unreserved, undesignated fund balances are well below its peer group median. As discuseed in detail below, PFM believes the County should maintain unreserved, undesignated fund balances above the peer group median because the County General Fund has greater risk exposure to volatile revenue streams and has defacto responsibility for other tax-supported funds in the event of a decline in resources or increase in need.

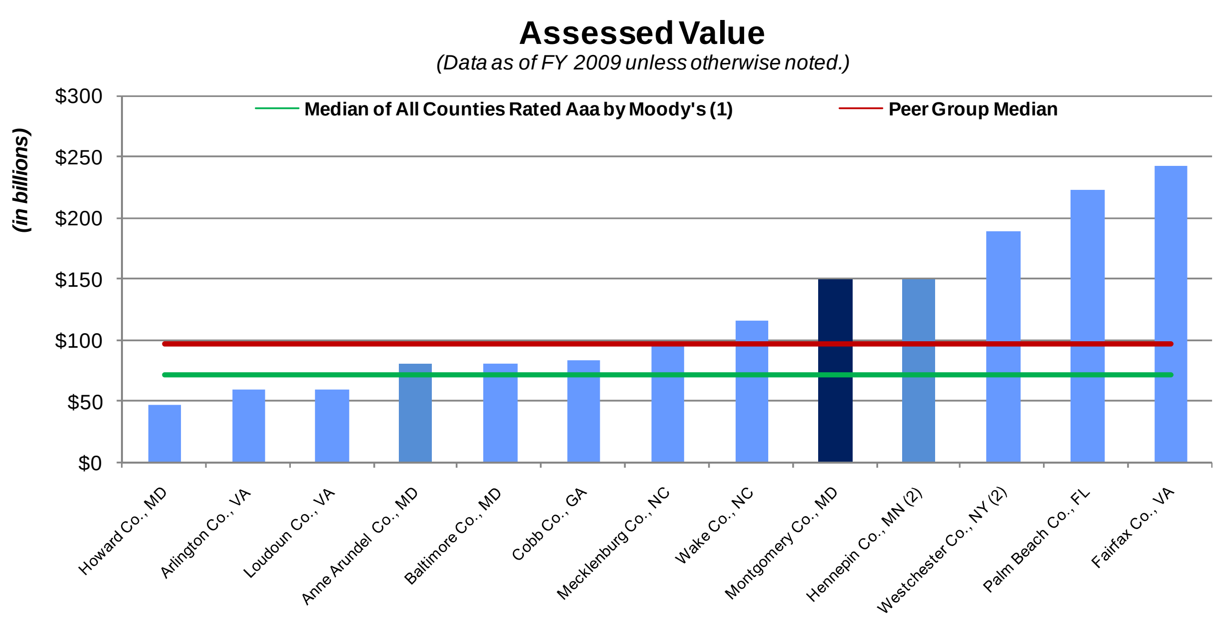
Figure 3 analyzes the same peer group of AAA-rated counties as Figure 3, depicting total available unreserved, undesignated fund balance, along with any other available general contingency reserves, as a percentage of revenues in All Governmental Funds. Because every county is ultimately exposed to cash flows in all funds, not just the General Fund, PFM believes that Figure 3 provides a more accurate measure of the level of budgetary protection provided by the available fund balances. Since revenues outside the General Fund differ between the various counties in the analysis, the ranking in Figure 3 is somewhat different from the ranking in Figure 2, even though the general trends are still preserved. For Montgomery County, the 2009 CAFR states Total Governmental Funds revenues were $3.258 billion, compared to a total fund balance of $148.5 million, composed of the unreserved, undesignated General Fund balance and the Rate Stabilization Fund, or 4.6% of Total Governmental Funds revenues.

Figure 3.
Unreserved, Undesignated and General Contingency Reserve Fund Balances as % of All Governmental Funds Revenues
(Data as of FY 2009 Unless Otherwise Noted)



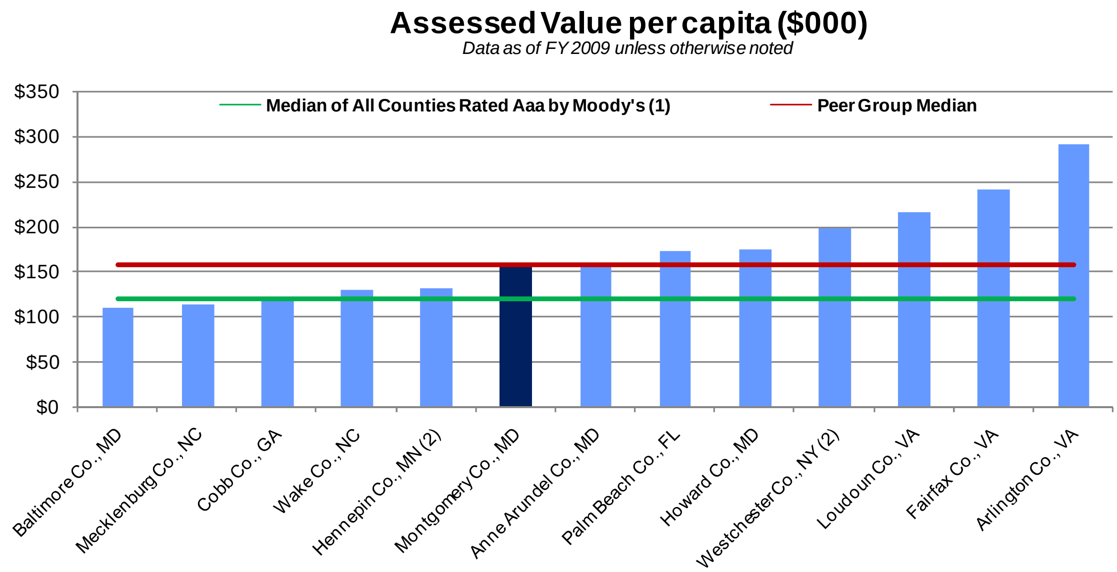
**Includes Revenue Stabilization Fund*
***Fiscal Year 2008 data. No 2009 data available (FY ending 12/31)*

The tables below present some additional key economic indicators for Montgomery County and its peer group.



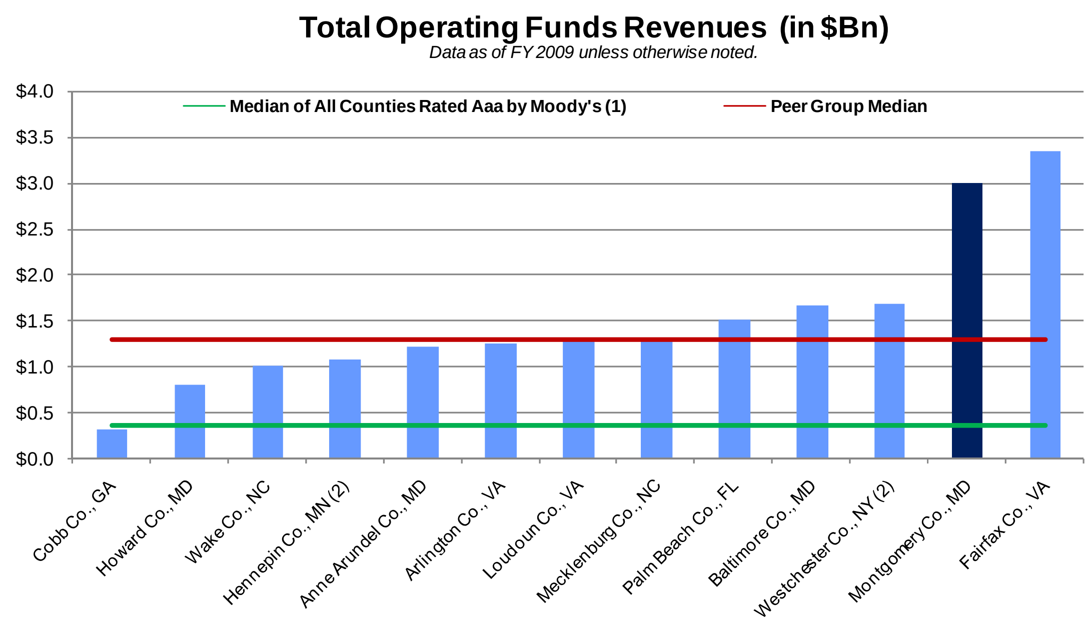
(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.
(2) Data as of 12/31/2008. FY 2009 data not yet available.

Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.



(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.
(2) Data as of 12/31/2008. FY 2009 data not yet available.

e *Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.*

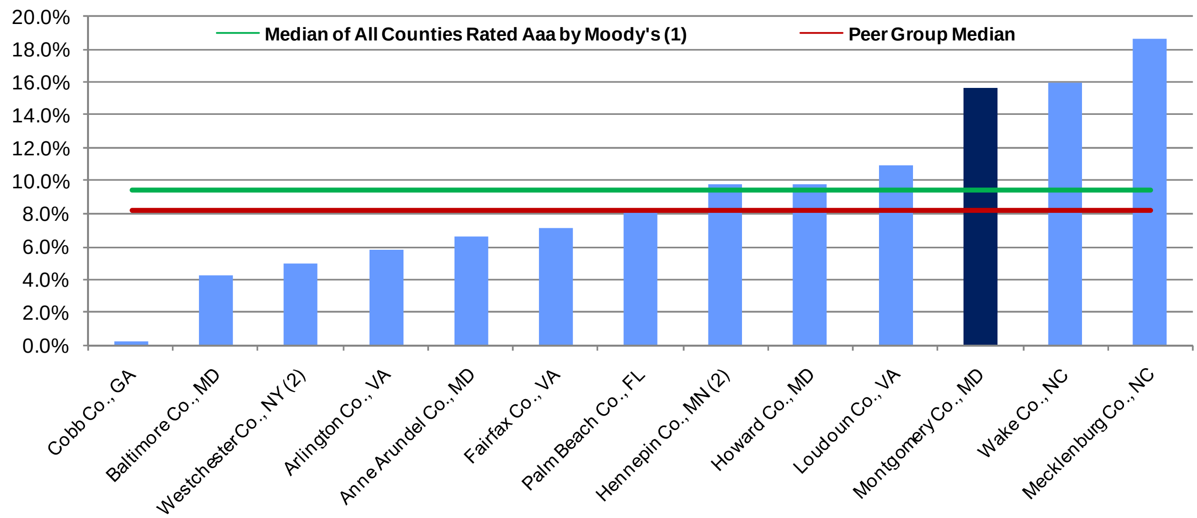


(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.
(2) Data as of 12/31/2008. FY 2009 data not yet available.

Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.

Debt Service as a % of Operating Expenditures

Data as of FY 2009 unless otherwise noted

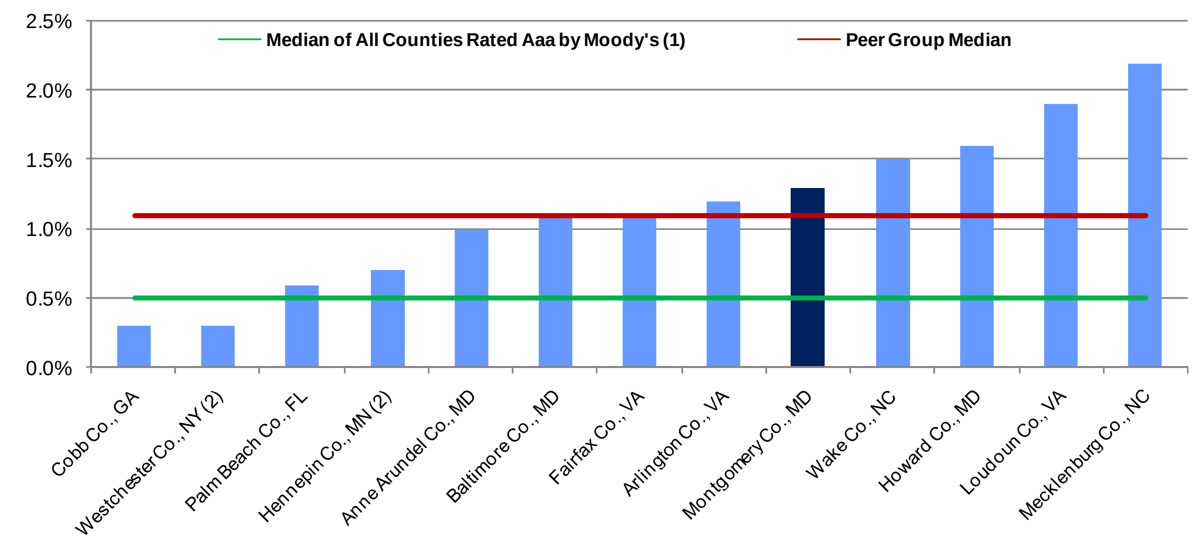


(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.
(2) Data as of 12/31/2008. FY 2009 data not yet available.

Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.

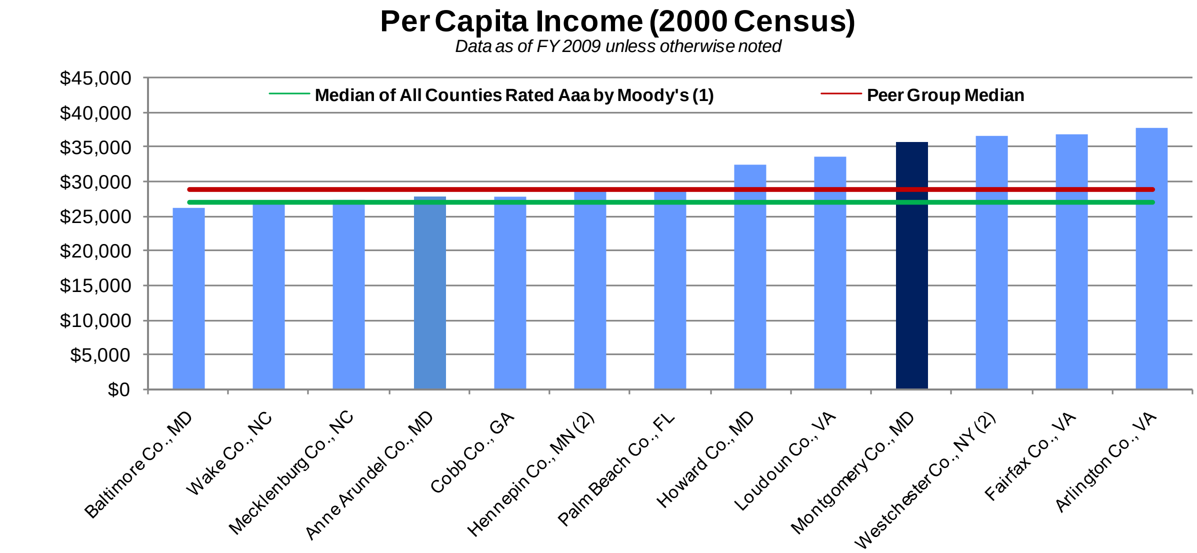
Direct Net Debt as a % of Assessed Value

Data as of FY 2009 unless otherwise noted



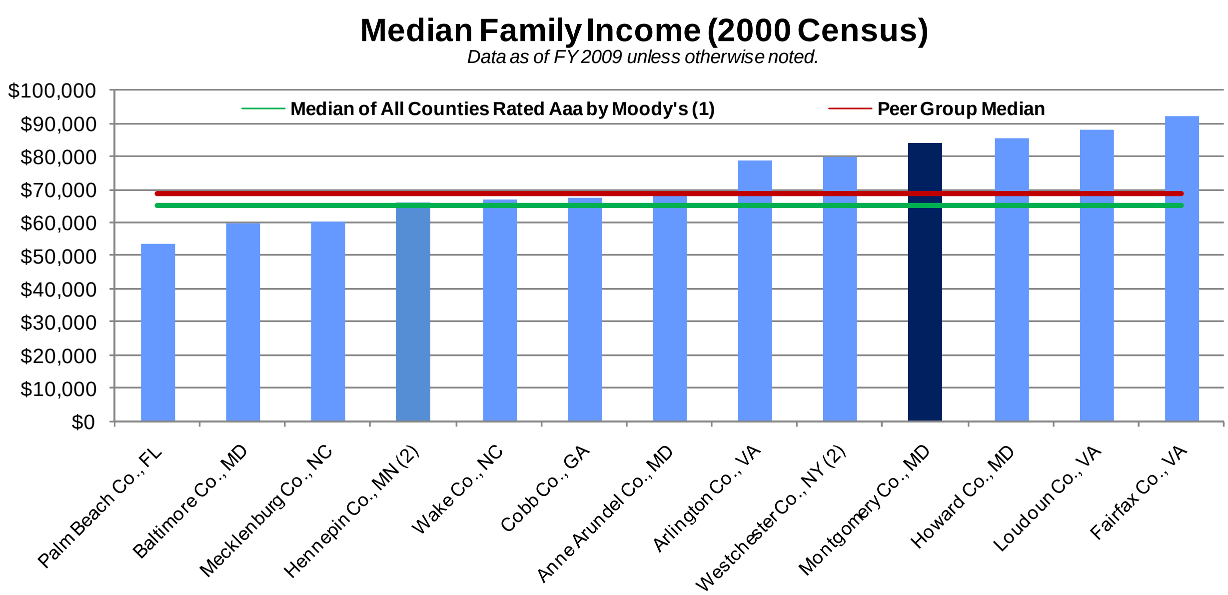
(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.
(2) Data as of 12/31/2008. FY 2009 data not yet available.

Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.



(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.
(2) Data as of 12/31/2008. FY 2009 data not yet available.

Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.



(1) Aaa-rated Counties median includes 67 counties and reflects currently available financial data . For some counties, FY 2009 data is not yet available and is not reflected in the 2009 median.
(2) Data as of 12/31/2008. FY 2009 data not yet available.

Source: Moody's Municipal Financial Ratio Analysis database as of April 30, 2010.

Exhibit B

Government Finance Officers Association Recommended Best Practices:

Appropriate Level of Unrestricted Fund Balance in the General Fund (2002 and 2009) as adopted October 2009

Background. Accountants employ the term *fund balance* to describe the net assets of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net assets of governmental funds calculated on a government's budgetary basis.[1] In both cases, fund balance is intended to serve as a measure of the financial resources available in a governmental fund.

Accountants distinguish up to five separate categories of fund balance, based on the extent to which the government is bound to honor constraints on the specific purposes for which amounts can be spent: *nonspendable fund balance*, *restricted fund balance*, *committed fund balance*, *assigned fund balance*, and *unassigned fund balance*.[2] The total of the last three categories, which include only resources without a constraint on spending or for which the constraint on spending is imposed by the government itself, is termed *unrestricted fund balance*.

It is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Fund balance levels are a crucial consideration, too, in long-term financial planning. In most cases, discussions of fund balance will properly focus on a government's general fund. Nonetheless, financial resources available in other funds should also be considered in assessing the adequacy of unrestricted fund balance (i.e., the total of the amounts reported as committed, assigned, and unassigned fund balance) in the general fund.

Credit rating agencies monitor levels of fund balance and unrestricted fund balance in a government's general fund to evaluate a government's continued creditworthiness. Likewise, laws and regulations often govern appropriate levels of fund balance and unrestricted fund balance for state and local governments.

Those interested primarily in a government's creditworthiness or economic condition (e.g., rating agencies) are likely to favor increased levels of fund balance. Opposing pressures often come from unions, taxpayers and citizens' groups, which may view high levels of fund balance as "excessive."
Recommendation. The Government Finance Officers Association (GFOA) recommends that governments establish a formal policy on the level of unrestricted fund balance that should be maintained

[1] For the sake of clarity, this recommended practice uses the terms GAAP fund balance and budgetary fund balance to distinguish these two different uses of the same term.
[2] These categories are set forth in Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions,* which must be implemented for financial statements for periods ended June 30, 2011 and later.

in the general fund.[3] Such a guideline should be set by the appropriate policy body and should provide both a temporal framework and specific plans for increasing or decreasing the level of unrestricted fund balance, if it is inconsistent with that policy.[4]

The adequacy of unrestricted fund balance in the general fund should be assessed based upon a government's own specific circumstances. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.[5] The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a government's particular circumstances.[6] Furthermore, a government's particular situation often may require a level of unrestricted fund balance in the general fund significantly in excess of this recommended minimum level. In any case, such measures should be applied within the context of long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unrestricted fund balance in the general fund at any one time.

In establishing a policy governing the level of unrestricted fund balance in the general fund, a government should consider a variety of factors, including:

- The predictability of its revenues and the volatility of its expenditures (i.e., higher levels of unrestricted fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile);
- Its perceived exposure to significant one-time outlays (e.g., disasters, immediate capital needs, state budget cuts);
- The potential drain upon general fund resources from other funds as well as the availability of resources in other funds (i.e., deficits in other funds may require that a higher level of unrestricted fund balance be maintained in the general fund, just as, the availability of resources in other funds may reduce the amount of unrestricted fund balance needed in the general fund);[7]

- Liquidity (i.e., a disparity between when financial resources actually become available to make payments and the average maturity of related liabilities may require that a higher level of resources be maintained); and

[3] Sometimes restricted fund balance includes resources available to finance items that typically would require the use of unrestricted fund balance (e.g., a contingency reserve). In that case, such amounts should be included as part of unrestricted fund balance for purposes of analysis.
[4] See Recommended Practice 4.1 of the National Advisory Council on State and Local Budgeting governments on the need to "maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees because of temporary revenue shortfalls or unpredicted one-time expenditures" (Recommended Practice 4.1).
[5] In practice, a level of unrestricted fund balance significantly lower than the recommended minimum may be appropriate for states and America's largest governments (e.g., cities, counties, and school districts) because they often are in a better position to predict contingencies (for the same reason that an insurance company can more readily predict the number of accidents for a pool of 500,000 drivers than for a pool of fifty), and because their revenues and expenditures often are more diversified and thus potentially less subject to volatility.
[6] In either case, unusual items that would distort trends (e.g., one-time revenues and expenditures) should be excluded, whereas recurring transfers should be included. Once the decision has been made to compare unrestricted fund balance to either revenues or expenditures, that decision should be followed consistently from period to period.
[7] However, except as discussed in footnote 4, not to a level below the recommended minimum.

- Commitments and assignments (i.e., governments may wish to maintain higher levels of unrestricted fund balance to compensate for any portion of unrestricted fund balance already committed or assigned by the government for a specific purpose).

Furthermore, governments may deem it appropriate to exclude from consideration resources that have been committed or assigned to some other purpose and focus on unassigned fund balance rather than on unrestricted fund balance.

Naturally, any policy addressing desirable levels of unrestricted fund balance in the general fund should be in conformity with all applicable legal and regulatory constraints. In this case in particular, it is essential that differences between GAAP fund balance and budgetary fund balance be fully appreciated by all interested parties.

Approved by the GFOA's Executive Board, October, 2009.

Exhibit C
Proposed Legislation Sent to County Council May 20, 2010 Regarding Changes to RSF Law

Bill No. ______________
Concerning: _
Revised: _ Draft No. _
Introduced: ___
Expires: _____
Enacted: _____
Executive: ___
Effective: _____
Sunset Date: _
Ch. _, Laws of Mont. Co. ______

COUNTY COUNCIL
FOR MONTGOMERY COUNTY, MARYLAND

By: Council President at the Request of the County Executive

AN ACT to:
(1) make certain changes to the Revenue Stabilization Fund law, including changing the mandatory contributions to the Fund, removing the maximum size.

By amending
Montgomery County Code
Chapter 20, Finance
Sections 20-65, 20-66, 20-68, 20-69, 70, 20-71 and 20-72

By repealing
Montgomery County Code
Chapter 20, Finance
Section 20-67

Boldface	*Heading or defined term.*
Underlining	*Added to existing law by original bill.*
[Single boldface brackets**]**	*Deleted from existing law by original bill.*
Double underlining	*Added by amendment.*
[[Double boldface brackets**]]**	*Deleted from existing law or the bill by amendment.*
* * *	*Existing law unaffected by bill.*

The County Council for Montgomery County, Maryland approves the following Act:

Sec. 1. Sections 20-65, 20-66, 20-68, 20-69, 20-70, 20-71 and 20-72 are amended and Section 20-67 is repealed as follows:

ARTICLE XII. REVENUE STABILIZATION FUND

20-65. Definitions.

In this Article the following terms have the following meanings, unless the context clearly indicates a different meaning:

(a) *Actual total revenues* means the combined total of income tax, real property transfer tax, recordation tax, and investment income as reported in the County's annual financial report.

(b) *Adjusted Governmental Revenues* means tax-supported Governmental Funds revenues including Grants Fund and Capital Projects Fund revenues plus, for Montgomery County Public Schools, Montgomery College, and the Montgomery County portion of the Maryland-National Capital Park and Planning Commission, the revenues of their tax supported funds, exclusive of the County's local contribution.

[(b) *Certified revenues* means revenues derived each fiscal year from the income tax, real property transfer tax, recordation tax, and investment income of the General Fund as certified by the Director on or before June 15.]

[(c) *Debt Service Fund* means the fund used to accumulate funds to pay general long-term debt principal, interest and related costs.]

[(d)](c)*Director* means the Director of the Department of Finance.

[(e)](d)*Fund* means the Revenue Stabilization Fund created under this Article.

[(f)](e)*General Fund* means the general operating fund of the County which is used to account for all revenues and expenditures, except revenues and expenditures required to be accounted for in another fund.

[(g)](f)*Income tax* means the County income tax imposed under state law.

[(h)](g)*Investment income of the General Fund* means income from the investment of revenues that is reported in the General Fund.

[(i)](h)*Original projection* means the projection of total General Fund revenues for the next fiscal year approved by the County Council in the "Schedule of Revenue Estimates and Appropriations" resolution or any similar resolution.

[(j)](i)*Real property transfer* tax means the tax imposed under Sections 51-19 et. seq.

[(k)](j)*Recordation tax* means the tax imposed under Sections 12-101 et. seq., Tax-Property Article, Annotated Code of Maryland.

[(l)](k)*Revised forecast* means any revised projection of total General Fund revenues for the next fiscal year prepared by the Department of Finance.

(l) *Unrestricted General Fund Balance* means the residual portion of the General Fund fund balance that is not restricted or nonspendable for financial accounting purposes, and is not encumbered for subsequent years' expenditures. This amount has previously been referred to as Unreserved Undesignated General Fund fund balance.

20-66. Revenue Stabilization Fund.

(a) The Director may establish a Revenue Stabilization Fund to support appropriations which have become unfunded.

(b) The Fund is continuing and non-lapsing.

(c) The Fund is in addition to any surplus that may be accumulated under Section 310 of the County Charter.

20-67. [Fund sources and maximum size.] Reserved.

[(a) The Fund must not exceed 10 percent of the average aggregate annual revenue derived from the income tax, real property transfer tax, recordation tax, and investment income of the General Fund in the 3 preceding fiscal years.

(b) The Director must compute the maximum amount of the Fund annually and report that amount to the County Council not later than June 15.

(c) The Fund is in addition to any surplus that may be accumulated under Section 310 of the County Charter.]

20-68. Mandatory contribution to Fund.

[(a) Subject to the limit set in Section 20-67(a), the] The mandatory annual contribution to the Fund must equal the greater of (a) or (b):

(a) 50 percent of the amount by which actual total revenues from the income tax, real property transfer tax, recordation tax, and investment income of the General Fund for the next fiscal year exceed the original projections for these amounts. [50 percent of the product of the certified revenues estimated for the current fiscal year times the difference between:

(1) the annual percentage increase in the certified revenues projected for the next fiscal year, and

(2) the average annual percentage increase in the certified revenues collected in the 6 fiscal years immediately preceding the next fiscal year.]

(b) An annual amount not to exceed 0.5 percent of the Adjusted Governmental Revenues for the current year, but which does not result in the sum of the current year-end projected Unrestricted General Fund Balance and the Fund to exceed 10 percent of the

Adjusted Governmental Revenues.

[(b) A growth or decline in certified revenues which results from either an increase or decrease in County tax rates must be:

(1) excluded from revenues projected for the next fiscal year, and

(2) phased in in the average annual percentage increase calculation in the third, fourth, fifth and sixth years.

(c) If actual total revenues from the income tax, real property transfer tax, recordation tax, and investment income of the General Fund for the next fiscal year exceed the original projection, then 50 percent of the excess must be transferred to the Fund if doing so will not result in the 10 percent limit in Section 20-67(a) being exceeded.**]**

20-69. Discretionary contributions to Fund.

The County Executive may recommend and the County Council may by resolution approve additional contributions to the Fund **[**if doing so will not result in the 10 percent limit in Section 20-67(a) being exceeded**]**.

20-70. Transfer of contributions.

The Director must transfer the mandatory contributions required by Section 20-68 and any discretionary contributions under Section 20-69 from the General **[**fund**]** Fund to the Fund at the end of each fiscal year.

20-71. Interest.

All interest earned on the Fund must be added to the Fund. **[**However, the Director must transfer interest earned on the Fund when the Fund exceeds 50 percent of the maximum Fund size authorized by Section 20-67(a) to the Debt Service Fund as an offset to the approved issuance of general obligation debt.**]**

20-72. Use of Fund.

(a) After holding a public hearing and seeking the recommendation of the Executive, and if the Council finds that reasonable reductions in expenditures are not sufficient to offset the shortfall in revenue, the Council may by resolution approved by the Executive transfer an amount from the Fund to compensate for no more than half of the difference between the original projection of total General **[**fund**]** Fund revenues for that fiscal year and a revised forecast of the General Fund revenues projected for the same fiscal year. If the Executive disapproves a resolution within 10 days after it is transmitted and the Council readopts it by a vote of 6 Councilmembers, or if the Executive does not act within 10 days after it is transmitted, the resolution takes effect.

(b) However, a transfer must not be approved unless 2 of the following conditions are met:

(1) The Director estimates that total General Fund revenues will fall more than 2 percent below the original projected revenues.

(2) Resident employment in the County has declined for 6 consecutive months compared to the same month in the previous year.

(3) The **[**local**]** most recent regional index of leading economic indicators, published by the Center for Regional Analysis, George Mason University, or a successor index determined by the Department of Finance has declined for 3 consecutive months.

(c) The cumulative transfers from the Fund in any single fiscal year must not exceed half of the balance in the Fund at the start of that fiscal year.

(d) The funds transferred may only be used to support appropriations which have become unfunded.

(e) By an affirmative vote of 6 Councilmembers the Council after holding a public hearing and seeking the recommendation of the Executive may transfer amounts from the Fund without regard to the limits and conditions in subsections (a)—(c).

Approved:

Nancy M. Floreen, President, County Council	Date

Approved:

Isiah Leggett, County Executive	Date

This is a correct copy of Council action.

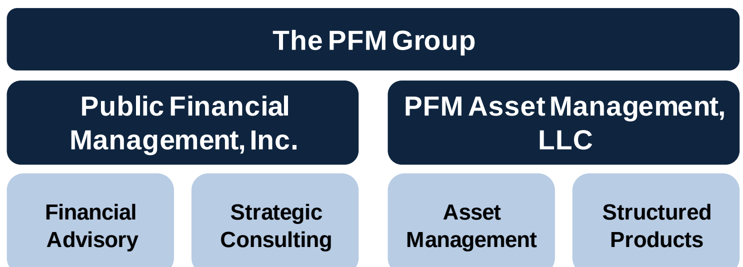
Linda M. Lauer, Clerk of the Council	Date

Exhibit D
About the PFM Group

Public Financial Management, Inc. was founded in 1975 with the principle of providing independent financial advice to state and local governments and other tax-exempt entities. In May 2009, Public Financial Management, Inc. and PFM Asset Management LLC reorganized into a holding company structure named The PFM Group, LLC.

With 32 offices throughout the nation, and over 400 professionals, PFM is the nation's leading financial advisory firm by any measure: the experience of our professionals, the clients we serve, our resources, the number of transactions completed annually, and the par amount of bonds on which we have advised. PFM has now been ranked the nation's #1 Financial Advisor for seven consecutive years, serving on 5,441 transactions totaling over $286 billion in par in that time period.

Our clients have access to any of our five primary business activities:



- **Financial Advisory:** PFM engages in capital planning, revenue forecasting and evaluation, resource allocation, debt management policy development and debt transaction management.
- **Strategic Consulting:** PFM also serves as a strategic consultant, offering clients the most effective capital and operating budget advice available with a proven track record in using various techniques for performance management, benchmarking, revenue enhancement and privatization.
- **Investment Management:** PFM Asset Management LLC ("PFMAM") is devoted primarily to providing investment advice and portfolio management services for governmental entities, not-for-profit organizations, corporations, pension funds and other institutions.
- **Investment Consulting:** PFMAM provides investment and retirement plan consulting services to pension funds, endowments and similar fund through its specialized component, PFM Advisors.
- **Structured Products and Derivatives:** PFMAM also has a group of professionals dedicated to advising clients on the use of cutting edge structured financial projects. This group structures and restructures advance refunding escrow portfolios for PFM's clients. In addition, the Structured Products Group has the expertise and is certified to structure and procure interest rate swaps, caps and collars, forward delivery agreements, guaranteed investment contracts, flexible repurchase agreements and asset swaps to help clients reduce financing costs.

Locally, with eight offices in the Mid-Atlantic region, PFM is an active participant in Maryland and the surrounding areas. We consistently rank as one of the top financial advisory firms in the area, while delivering an unparalleled array of services that we can offer our clients by proactively tapping into our nationwide knowledge base and market presence. Since 2005, PFM has served as Financial Advisor on 84 transactions in Maryland, totaling a par amount of more than $7.8 billion. PFM has served as financial advisor to Montgomery County for over twenty years.