

Lompoc City Council Agenda Item



City Council Meeting Date: March 25, 2014

TO: Patrick Wiemiller, City Administrator

FROM: Brad Wilkie, Management Services Director
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SUBJECT: Development of Financial Reserve Policies and Guidelines

Recommendation:

Staff recommends the City Council:

- 1) Review presentation regarding the City's Mid-Year review for Fiscal Year (FY) 2013-14; and
- 2) Approve Resolution No. 5902(14) adopting a set of Financial Principles to provide for policies and procedures for appropriate levels of City reserves and to set interim reserve levels for certain funds and functions of the City; or
- 3) Provide alternate direction.

Background:

The City has experienced significant financial challenges over the past eight to ten years. The economic downturn beginning in 2006 significantly affected prior General Fund budgets of FY 2009-11, FY 2011-13, and the current FY 2013-15 Budget. The General Fund relies on taxes for a significant portion of its funding and tax revenue is generally a lagging component of the economy. It is anticipated future City budgets will continue to feel the effects of slower growth, due primarily to the economic downturn of the mid-2000s.

In addition to the City's General Fund, the City's major utilities have been affected by the economy and by cost challenges as well. The Electric Utility has historically had a relatively large exposure to market power purchase costs. The City approved rate increases beginning in 2007, just as market power purchase costs were escalating significantly. Primarily due to the unanticipated and unprecedented run-up of market power purchases, the City approved a second round of rate increases in 2009, before the first set had been fully implemented. Cash reserves have recovered almost to reserve policy levels, but structural costs have increased since 2007, resulting in much less flexibility for the Utility than it had prior to 2007.

Fund Financial Condition Discussion

The Water and Wastewater Utilities implemented significant capital projects during the 2002 to 2009 period, based on the City's 15-year Capital Improvement Plan approved in December 2002. Wastewater initiated the largest public works project in the City's history, with the State mandated replacement of the Lompoc Regional Wastewater Reclamation Plant (LRWRP). The cumulative debt service obligation already committed to by the City due to the LRWRP and other Wastewater capital projects is approximately \$106,000,000, with varying terms to maturity between 2028 and 2037. While the City's actual annual debt obligation is not evenly spread over 20 years, the per capita amount per year would be equivalent to \$135 per person per year, if the debt was evenly spread over 20 years.

For roughly the same 2002 to 2009 timeframe, annual water consumption (the basis for calculating Wastewater rates) dropped by seven percent, resulting in lower revenues even while the per unit rates were approved for increases between 2006 and 2010. The resulting shortfall in revenues required a new rate study initiated in 2012, resulting in a series of rate increases beginning in November 2013, with scheduled increases through June 30, 2018. The initial years of increases are designed to reduce the growth of operating losses and return the Utility to a positive net income and positive cash balance in the second or third year of the planned increases. Only the later rate increases are going to provide resources for replacement of aged collection infrastructure. In addition, little or no replacement funding is scheduled for the LRWRP until 2030.

The water consumption drops affecting Wastewater revenue collections directly impacted Water revenue as well. The Water Utility also had rate increases approved for the 2006 to 2009 period, to generate funds to pay for debt service on debt issued in 1998, 2005 and 2007 to finance capital projects, such as reservoir tanks south of the City that increase the capacity to deliver water at pressure for household and fire suppression needs. The drop in water consumption reduced overall Water Utility revenues, while Utility costs continued to grow. The rate study implemented in 2012 for Wastewater was also implemented for the Water Utility and likewise resulted in a series of rate increases beginning in November 2013, with scheduled increases through June 30, 2018. Only the later rate increases are going to provide additional resources necessary to provide funding to allow for the ongoing replacement of collection system infrastructure.

The Solid Waste Utility has typically scheduled rate reviews every two to three years. The last review included anticipated costs related to the Landfill for a gas collection system, funding to repay operational deficits incurred over the prior three fiscal years and to set aside an operating reserve of 20 percent of annual expenditures. While the gas collection system is now a mandate, the rates approved in 2010 did not provide for funding of the system and were set to create a reserve of 10 percent of expenditures,

rather than 20 percent. The Solid Waste Utility is currently finishing up their next rate review and will soon be presenting their findings at the April 1 City Council meeting.

Financial Reserve Goals, Principles, and Policies

The above background provided for the General Fund and the four major Utilities is to put into context the advantages of having policies related to minimum financial targets. Adequate fund balance reserves and unrestricted cash reserves provide flexibility to the City during economic downturns, for unexpected occurrences (earthquakes or droughts, for example), ordinary cash flow variations, and to allow for implementation of policy goals that may otherwise remain unavailable if reserves are not adequate.

The rate hearings for Water and Wastewater resulted in significant increases in rates for the two Utilities. At the time of the public hearing to set the rates, Council requested the Finance Division to return with recommendations regarding reserve levels for the General Fund and the City's major Utilities. Prior to and subsequent to the hearings, Finance Staff has been researching the development of policies related to reserves and has contracted the development of a General Fund reserve policy based on the Governmental Finance Officers Association (GFOA) standard for General Fund reserves. The contracted General Fund reserve policy is attached. Significant assistance in policy implementation was obtained by Finance staff at the recent California Society of Municipal Finance Officers' (CSMFO) conference. Several sessions at the CSMFO conference focused on reserve policies. The following section outlines the suggested path for development of interim and permanent policies that will assist the City during good and bad times ahead.

Discussion:

In preparation for developing fiscal reserve policies, several sources were researched and professional resources were obtained. Additional resources were obtained at the CSMFO conference attended by Finance staff. Publications from GFOA that were reviewed include, "Financial Reserve Policies" and "How to Enact Reserve Policies," as well as the "General Fund Reserve Policy." The research, in conjunction with the specific circumstances of Lompoc's fund structure, suggests a comprehensive solution to the reserve policy request. Because of this, interim operating reserve policies in the following funds have been developed:

- General Fund;
- Water Utility;
- Electric Utility;
- Wastewater Utility;
- Solid Waste Utility; and
- Insurance and Benefit Internal Service Fund;
 - Workers' Compensation Self-Insurance Program; and
 - General Liability Self-Insurance Program.

A session at the CSMFO conference entitled "Presenting Financial Information During Good Times and Bad" was presented by Jimmy Forbis, Utilities Business Manager for the City of Morgan Hill. The session provided recommendations for successful policy implementation. The presentation suggested the basis for successful financial policies are the underlying financial principles. The City of Morgan Hill has 16 separate and distinct financial principles it uses to assist with implementation of a wide-range of policy goals, including reserve policies. The 16 principles are listed below and most would likely be transferrable to the City of Lompoc. The City Council's six goals and objections can and should be incorporated in the principles chosen, if the Council chooses to utilize financial principles in setting reserve policies.

For the purposes of governmental accounting, the definition of principle is "a fundamental or general truth, that helps people determine the appropriate decision. They are guidelines that provide an indication of what to do, but not how to do it." For practical purposes, an example of the differences between a policy and a principle follows:

- Policy: Reserves shall never be depleted below a minimum level of 15 percent of revenues, which shall be maintained as an ongoing reserve for emergencies.
- Principle: Reserves and one-time revenues should be used first to invest in capital outlay items.

A policy is the rule (don't break your rule!) and the principle is guidance for developing plans or budgets.

Why develop a set of principles first rather than simply moving to the development of policies? Policies, reserve policies in particular, are a powerful tool for providing guidance to govern and manage resources. Determining specific policy goals requires a framework that can be effectively communicated to several different audiences. A benefit of developing principles first, is that principles help audiences understand the "why." In communicating finance-related information, the audience will almost never be accounting or governmental peers and the message needs to be clear and concise so the message can be delivered effectively. In addition, a well-developed set of principles would assist in communicating successfully with a wide range of audiences such as:

- City Council;
- Management;
- Line Staff;
- Community Groups;
- Civic Groups;
- Youth Groups;
- Senior Groups; and
- Labor Organizations.

Furthermore, financial principles have the following beneficial attributes:

- They are written in easy to understand language;
- They mean something to many different groups;
- They allow for a consistent message regardless of audience;
- They provide justification for staff's recommendations; and
- They link policies with priorities.

While the City of Lompoc is unique and should not use a one-size-fits-all model, the principles adopted by the City of Morgan Hill can serve as a guideline for the development of principles for the City of Lompoc, and the GFOA guidelines assist with setting policy levels here as well. There are similarities between Lompoc and Morgan Hill that support our use of principles developed at Morgan Hill. For instance, Morgan Hill has approximately 39,000 residents, while Lompoc has 39,328. Morgan Hill's General Fund budget is approximately \$28 million annually, while Lompoc's is also approximately \$28 million.

If desired, once a set of principles is agreed to, City staff can work to implement permanent, well-designed policies. Those would be based on the agreed-to principles and our circumstances over the next year-and-a-half to two years, such that a complete set of reserve policies is available for consideration during the implementation of the FY 2015-17 Budget.

The following are 16 principles developed by the City of Morgan Hill several years ago:

1. Critical services should be maintained to the greatest extent possible.
2. Resources should be allocated to the highest priority services.
3. No city services or functions should be exempt from evaluation.
4. "Across the board" approaches shall be avoided because they are not aligned with the Council's and community's priorities.
5. Reductions in service should position the City to take advantage of economic recovery.
6. Budget cuts should be ongoing and not simply "one-time only."
7. Council should commit to support employees during the transition, and assist those who may be adversely impacted.
8. Employees and their recognized bargaining units should be actively involved in developing options and implementing the transition.
9. The City should continue to invest in building organizational capacity by supporting training and employee development.
10. Community-wide tax resources should be allocated first to support community-wide services.
11. Special services designed for only a few should be paid for by user charges and fees.
12. Administrative and operational efficiencies should be maximized before pursuing new tax revenue.

13. Reserves and one-time revenues should be used first to invest in capital outlay items that could reduce long-range operating costs and, thereafter, fund transition expenses.
14. New services should not be added nor existing services expanded, unless they are highly valued by the community and there is a willingness to pay for them.
15. There should be regular monitoring of financial performance and opportunities to make mid-course corrections as warranted.
16. City policies that may inhibit economic development should be reviewed regularly and modified.

The City Council has a set of priorities which can assist with the development of appropriate financial principles. The goals (in order of importance) are:

- Economic Development and Jobs;
- Public Safety;
- Efficiencies;
- Accountability/Compliance/Transparency;
- Code Enforcement/Graffiti Abatement; and
- Miscellaneous.

Many of the 16 named principles above seem to be directly aligned with the City Council's priorities, while others expand on the priorities.

Financial Reserve Policies Directive

Finance staff was directed to bring to the City Council policies regarding reserve levels for the General Fund and the "major" Enterprise Funds. As mentioned above, the circumstances for each of the five funds identified for policies require a comprehensive evaluation of the specific requirements for each fund. However, the reserve policies requested by the Council provide for operational needs rather than specific regulatory requirements. As such, operational reserve policies created by the City of San Luis Obispo (SLO) or those provided with the Water and Wastewater Rate Study (Rate Study) can likely serve as examples for Lompoc's operational reserve policies while more comprehensive evaluations of recommended reserves (operational, regulatory, contractual, capital, etc) are completed over the next 18 to 24 months.

SLO has a relatively simple fund structure compared with the City of Lompoc with only Water and Wastewater Utilities and the General Fund. SLO's reserve policy for their two utilities is set to be a working capital balance of 20 percent of operating expenditures. The recently completed Rate Study recommends a 25 percent or three-month reserve. While only the Electric Utility has a reserve policy (and reserves) in excess of either the 20 or 25 percent levels, the three-month reserve level can be the interim goal for working capital reserves for the Water, Wastewater and Solid Waste Reserves, while the Electric Utility reserve policy will remain in place until a full evaluation can be made for it as well.

In preparation for the FY 2013-15 Budget, Management Services contracted with the former SLO finance director, Bill Statler, to develop a reserve policy for the General Fund, based on the GFOA's recently published standards for reserves. Mr. Statler is highly regarded in the world of governmental finance and was a contributor to the GFOA's published standards. He has previously done a presentation of the value of reserve policies around the Central Coast. Several local agencies established General Fund reserve policies and Mr. Statler was able to evaluate the successes of the agencies in a before and after scenario, where almost every agency attained their policy level or significantly improved their position relative to when no policy existed.

Fiscal Impact:

Enacting principles for financial policies will not have a direct effect on the City's General Fund or the "major" Enterprise Funds. Setting financial reserve policies (interim or permanent) will also not have a direct effect on the General Fund or the "major" Enterprise Funds. However, the implementation of budget decisions, reserve procedures and programs will have an effect on General Fund and Enterprise Fund activities. Future decisions to implement or modify programs or services can be based on reserve policies and underlying financial principles.

Conclusion:

Staff recommends the City adopt the General Fund reserve policy (attached) and provide direction to Finance staff to modify the existing Fund Balance Policy to reflect the changes suggested in the General Fund Policy. One such recommendation is to close the Economic Uncertainty Fund into the General Fund. The Economic Uncertainty Fund is reported as unrestricted fund balance in the General Fund regardless of its separate status in the City's fund structure.

Staff recommends the City adopt the financial principles identified in the proposed resolution and the related interim operational reserve policies for the City's "major" Enterprise Funds (Water, Wastewater, and Solid Waste Utilities and the Workers' Compensation and General Liability self-insurance programs of the Insurance and Benefit Fund). The Electric Fund's existing policy will continue in its current form.

City staff proposes next steps in regards to the Mid-Year review, including returning to the City Council with recommendations for mid-year adjustments to the FY 2013-15 Budget to account for changes occurring since the approval of the budget on June 4, 2013.

Respectfully submitted,



Brad Wilkie, Management Services Director

APPROVED FOR SUBMITTAL TO THE CITY COUNCIL:



Patrick Wiemiller, City Administrator

- Attachments:
- 1) Resolution No. 5902(14)
 - 2) Transmittal letter – General Fund Draft Reserve Policy and supporting documentation dated May 31, 2013.