City of La Quinta

CITY / SA / HA / FA MEETING DATE: February 17, 2015

ITEM TITLE: RESERVE POLICY REVIEW

AGENDA CATEGORY:

BUSINESS SESSION:

CONSENT CALENDAR:

STUDY SESSION: 1

PUBLIC HEARING:

RECOMMENDED ACTION:

Continue discussing General Fund Reserve policies and provide staff direction.

EXECUTIVE SUMMARY:

- In 1994, the City established General Fund Reserve policies (Attachment 1) to set aside funds for financial emergencies and to fund operations prior to receiving revenue (cash flow reserves).
- In the fall of 2014, the City Council requested the City's Investment Advisory Board (IAB) to review these policies and provide recommendations.
- The IAB recommendations were presented at the February 3, 2015 Council meeting. The Council requested additional time to consider this matter.

FISCAL IMPACT:

None.

BACKGROUND/ANALYSIS:

The City has consistently maintained emergency and cash flow reserves since they were established in 1994. In 2013, the City Council initiated review of the City's reserve policies as a result of the State of California's take of $41.3 million of cash General Fund reserves. The City Council requested that the IAB review the current policies and provide recommendations. The IAB's analysis generated the following recommendations:

- Increase the designated cash reserves from the current 54.25 percent of annual operating budget expenditures to 60 percent of annual operating budget expenditures.
- Allocate the 60 percent designated cash reserves as follows:

- Increase the reserve for cash flow – from the current 8.25 percent of the annual operating budget to 10 percent
- Modify the reserve for emergencies – from the current policy of 35 percent of the annual operating budget plus $4.0 million to 40 percent of the annual operating budget
- Establish a reserve for economic stabilization – of 9 percent of the annual operating budget
- Establish a reserve for Federal/State/County "take aways" – of 1 percent of the annual operating budget.

Overall, the IAB recommended increasing the designated cash reserves by almost six percent. Further, because the current definition governing the use of Emergency Reserves is narrow and relates primarily to catastrophic disasters, the IAB recommended creating the two new categories to provide more flexibility when another economic downturn or state/federal takeaway occurs.

Included in the IAB's draft policy is the guiding principle (Attachment 2) that current expenditures should only be funded with current revenues; and, one-time revenues should only be used for one-time expenditures. This is the "golden rule" of budgeting.

Staff Thoughts – Reserve Policy

Staff offers the following for Council consideration:

- Increase the overall designated reserves to 60 percent of the annual operating budget. This would provide a greater financial cushion to assist the City through difficult times and should buy ample time, in the event of a financial catastrophe, to adjust municipal operations. Based upon the Fiscal Year 2014/15 operating budget, this amount would be $21,568,400.

- Allocate the $21,568,400 as follows:

  - $14,378,900 – Emergency Reserves
  - $ 3,594,700 – Cash Flow Reserves
  - $ 3,594,700 – Economic Stabilization Reserves

- Allocate $2,111,076 of the projected $12,388,474 of undesignated Fiscal Year 2014/15 General Fund balances to increase the current $19,457,324 of designated reserves (Emergency and Cash Flow) to $21,568,400.

- Review the current definition of "emergency" or "disaster" to ensure that the events that must occur to trigger use of these funds are not virtually impossible to achieve and thus severely limits the Council's ability to manage financial events when said disasters do occur.

- Establish a new reserve policy that defines when the Economic Stabilization Reserves may be used.

- Establish a new reserve policy wherein (1) the reserve funds designated for Emergency/Cash Flow/Economic Stabilization purposes are not reduced when the operating budget falls below the Fiscal Year 2014/15 amount, and (2) said reserve funds would be increased, on a parity basis, with operating budget expenditure increases.

Staff Thoughts – The Need for Additional Reserve Funds

Review of the February 3 Council discussion surfaced thoughts regarding allocating reserves for future CalPERS costs, replenishing or increasing equipment, park and technology replace funds, and establishing third-party relationships to guard against potential future State take-aways. Staff does have thoughts regarding these points that will be presented during the February 17 Study Session.

Of final note, if the City Council elected to fund the staff-recommended reserve amounts, the City would have $10,277,398 in cash reserves available to be invested in new endeavors. This amount is scheduled to increase by $1.4 million by June 30, 2015; the City will begin receiving payment of the former Redevelopment Agency General Fund loan.

Staff recommends that the Council discuss whether or not these unassigned reserves should be saved, or designated for capital improvement or economic development investment. If capital improvement investments are considered, they should entail projects that improve the community and cannot be funded from other resources. If economic development investments are considered, the focus should be on projects that would generate recurring General Fund revenue.

ALTERNATIVES:

As this is a study session item, no alternatives are recommended.

Report prepared by: Frank J. Spevacek, City Manager

Attachments:
1. General Fund Reserve Policy
2. General Fund Reserve Guidelines

City of La Quinta

General Fund Reserve Policy

The Government Finance Officers Association (GFOA), the association that establishes best practices in the governmental finance profession, recommends a reserve equal to at least 17% (two months of normal operating expenditures). Each organization, depending upon their unique circumstances, needs to determine their reserve level. There is no guidance for “maximum” reserves. There will always be more needs and unanticipated events then there are resources. Governments must balance the need to be fiscally responsible with what is reasonable. Establishing reserves is essentially determining tolerance to risk and how much “insurance” is needed (or the City can afford) to address that tolerance level. The following recommendations attempt to address minimum requirements and tolerance for risk (note: the reserve for OPEB is not included as it will be transferred to a non-revocable trust account in the future).

In addition to the recommendations below, the Council may also reserve funds for specific itemized projects or purposes as they arise (for example, a set aside fund for a community center, branch library, new city hall, special one-time projects, etc.).

Guiding principles:

- In general, one-time revenues should not be utilized for on-going expenditures. One-time revenues should be put into reserves or appropriated for one-time expenditures.

- Reserves for capital improvements, equipment replacement, and infrastructure should be part of the on-going budget process. Based on depreciation, or other relevant criteria, contributions should be made annually (into a “revolving” fund) as part of the budget process toward replacement of equipment, buildings, infrastructure, etc.

- When authorizing the use of reserves, developing a plan to replenish those reserves should also be considered.

- It is important to remember when budgeting that as expenditures increase, so will reserve requirements (reserves are based on a percentage of expenditures).

- The reserve policy should be amended by resolution and require 4/5th approval of the Council.

Total Reserves:

Current: 54.25% **Recommended: 60%**

Based on reserve levels of other cities and categorizing their levels as “high tolerance for risk”; “medium tolerance for risk”; and, “low tolerance for risk”, the City of La Quinta has been categorized as “low tolerance for risk” meaning that a higher level of reserves, relative to other organizations, is desired. After discussing the issues relative to the City of La Quinta and also reviewing the policies of other cities, the recommendation is to increase overall reserves to 60% of normal operating expenditures in the previous year's adopted budget (excludes one-time capital costs or anomalies).

The reserve for emergencies has been adjusted downward so that the City may establish a new category for "economic stabilization." The reserve for emergencies is based on the circumstances in section 2.20.020 of the municipal code which do not allow flexibility for drastic swings in the economy, including state takeaways. Cash flow was slightly increased to a level more consistent with other policies reviewed. Each category is briefly discussed below:

<u>Reserve for cash flow:</u>

Current: 8.25% **Recommended: 10%**

This reserve addresses liquidity. A reserve for cash flow is needed to address the imbalance of monthly income compared to monthly expenditures. Typically, expenditures are consistent month to month. However, the City's largest revenues (property tax, property tax in lieu of MVLF, and property tax in lieu of sales tax) are only made to the City in two annual installments.

<u>Reserve for emergencies</u>:

Current: 35% + $4 million (approx. 46%) **Recommended: 40%**

As used defined in the City's municipal code, the terms emergency or disaster mean:

"*The actual or threatened existence of conditions of disaster or of extreme peril to the safety of persons and property within this city caused by such conditions as air pollution, fire, flood, storm, epidemic, riot, earthquake or other conditions, including conditions resulting from war or imminent threat of war but other than conditions resulting from a labor controversy, which conditions are or are likely to be beyond the control of the services, regular personnel, equipment and facilities of the city and which may require the combined forces of other political jurisdictions to combat."*

<u>Reserve for economic stabilization:</u>

Current: 0% **Recommended: 9%**

This reserve is for the purpose of stabilizing the delivery of city services during periods of operational budget deficits resulting from the following conditions: drastic and unanticipated economic downturns, or unanticipated spikes in operating costs. For example the Great Recession of 2009 resulted in dramatic drops in City revenues. Another example would be a sudden loss of TOT revenue in the event a major hotel stops business. An example of an unanticipated spike in regular operating costs would be a sudden increase in public safety contract costs.

Use of this reserve would be in conjunction with budget planning and is intended to “bridge the gap” in the short term so that a deliberate thought out long-term strategy may be developed.

Reserve for Federal/State/County “Take Aways”:

Current: 0% **Recommended: 1%**

This reserve is for the purpose of stabilizing the delivery of city services during periods of operational budget deficits resulting from revenue takeaways from the federal, state or county government. The loss of Redevelopment funds is an example of a situation where this reserve might be used.

Use of this reserve would be in conjunction with budget planning and is intended to “bridge the gap” in the short term so that a deliberate thought out long-term strategy may be developed.

GENERAL FUND RESERVES GUIDELINES

(PERCENTAGES ARE OF BUDGETED EXPENDITURES ASSUMING $34.5 MILLION BUDGET-FY 12-13 BUDGET)	CURRENT	CITIES WITH HIGH TOLERANCE FOR RISK	CITIES WITH MEDIUM TOLERANCE FOR RISK	CITIES WITH LOWER TOLERANCE FOR RISK	**RECOMMENDATION**
CASH FLOW	8.25% ($2.8 million)	4% OR LOWER ($1.38 million or less)	4.1% TO 8% ($1.39 million to $2.76 million)	8.1% OR HIGHER ($2.77 million or higher)	10% ($3.45 million)
EMERGENCY (AS DEFINED IN 2.20 OF MUNI CODE)	35% OF BUDGETED EXPENDITURES + $4 MILLION (ROUGHLY EQUATES TO 46%). EMERGENCY AS DEFINED IN MUNICODE SECTION 2.20 ($16 million)	20% OR LOWER ($6.9 million or lower)	20.1% TO 35% ($7 million to $12.08 million)	35.1% OR HIGHER ($12.09 million or higher)	40% ($13.8 million)
STATE, FEDERAL OR COUNTY "TAKE AWAYS"	0% ($0)				1% ($ 350,000)
ECONOMIC STABILIZATION	0% ($0)	5% OR LOWER ($1.73 million or lower)	5.1% TO 10% ($1.74 million to $3.45 million)	10.1% OR HIGHER ($3.46 million or higher)	9% ($3.1 million)
TOTAL RESERVES (NOT INCLUDING OPEB)	54.25% ($18.8 MILLION)	29% OR LOWER ($10.1 MILLION OR LESS)	29.1% TO 53% ($10.02 TO $18.29 MILLION)	53.1% OR HIGHER ($18.30 OR MORE)	60% ($20.70 MILLION)
PROS		*ALLOWS COUNCIL MORE FLEXIBILTY FOR ONE TIME PROJECTS THAT OCCUR DURING THE YEAR*		*GREATER PREPAREDNESS FOR OUT OF THE ORDINARY OCCURRENCES. LESS LIKELY NEED FOR SHORT TERM BORROWING.*	
CONS		*LESS PREPAREDNESS FOR OUT OF THE ORDINARY OCCURRENCES. POSSIBLE NEED FOR SHORT TERM BORROWING.*		*ALLOWS COUNCIL LESS FLEXIBILTY FOR ONE TIME PROJECTS THAT OCCUR DURING THE YEAR*	
AUTHORITY	RESOLUTION	NO COUNCIL APPROVED POLICY	RESOLUTION	ORDINANCE	RESOLUTION W/ 4/5TH APPROVAL NEEDED

Attachment 2

NOTE ON RECOMMENDATION: No correct answer. Based on history, it is far more likely an economic downturn or state take away could occur. Suggest creating new category of Economic Stabilization to give Council access to reserves for this purpose (not covered under emergency). Based on comparison to other cities, La Quinta levels are in the "low risk to tolerance" range. Increased Cash Flow since 8.25% is roughly only 1 months expenditures.

GENERAL FUND GUIDELINES FOR ON-GOING NEEDS

	CURRENT	HIGHER RISK TOLERANCE	MEDIUM RISK TOLERANCE	LOWER RISK TOLERANCE	RECOMMENDATION
OPEB (RETIREE MEDICAL) FLAT $	$1.5 MILLION (100% OF ACTUARIAL)	NONE-PAY AS YOU GO	PAY AS YOU GO PLUS CONTRIBUTION	100% OF ACTUARIAL	100% OF ACTUARIAL MOVE TO IRREVOCABLE TRUST
VEHICLES	BASED ON DEPRECIATION	NONE-PAY AS YOU GO	PAY AS YOU GO PLUS CONTRIBUTION	FULL CONTRIBUTION + ADDITIONAL	FULL CONTRIBUTION + ADDITIONAL
INFRASTRUCTURE	5 YEAR CIP	NONE-PAY AS YOU GO	5 YEAR CIP	5 YEAR CIP WITH DEDICATED GF CONTRIBUTION	5 YEAR CIP WITH DEDICATED GF CONTRIBUTION
TECHNOLOGY	BASED ON DEPRECIATION	NONE-PAY AS YOU GO	PAY AS YOU GO PLUS CONTRIBUTION	MASTER TECHNOLOGY PLAN	MASTER TECHNOLOGY PLAN
FACILITES	BASED ON DEPRECIATION	NONE-PAY AS YOU GO	PAY AS YOU GO PLUS CONTRIBUTION	MASTER FACILITIES PLAN	MASTER FACILITIES PLAN
INSURANCE (NOT FOR SELF INSURED CITIES)	NEW THIS YEAR - INSURANCE FUND FOR PREMIUMS	NONE-PAY AS YOU GO	NONE-PAY AS YOU GO	INSURANCE FUND	INSURANCE FUND

THINGS TO REMEMBER:

*GENERAL FUND RESERVES ARE FOR ONE-TIME AND/OR UNANTICIPATED OCCURRENCES

*ON GOING REPLACEMENT PROGRAMS, RATHER THAN RESERVES, SHOULD BE **BUDGETED ANNUALLY** FOR INFRASTRUCTURE, EQUIPMENT, TECHNOLOGY AND FACILITIES

*ONGOING REVENUES SHOULD COVER ONGOING COSTS