

RESOLUTION NO. 2018 - 73

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF PALM DESERT AUTHORIZING THE CITY MANAGER TO ESTABLISH A RESERVE POLICY

WHEREAS, the City desires to ensure that there is sufficient capital available at all times to meet its operating, equipment replacement, capital project, employment benefits and other substantial obligations; and

WHEREAS, the City desires to formalize its reserve policies; and

WHEREAS, the City desires to reserve monies for financial stability, operational liquidity, unexpected changes in financial condition (including economic uncertainties, emergencies, liabilities), employment benefits, other fund stability, equipment replacement, long-range maintenance, economic development, anticipated and unanticipated capital expenditures; and

WHEREAS, the City desires to establish a reserve should revenue estimates in any year not meet projections; and

WHEREAS, the City Council have been presented with a draft Reserve Policy in the form attached to this Resolution as Exhibit "1" and by this reference incorporated herein.

NOW, THEREFORE, THE CITY COUNCIL OF THE CITY OF PALM DESERT DOES HEREBY RESOLVE, DETERMINE AND ORDER AS FOLLOWS:

Section 1. The above recitals are true and correct.

Section 2. The City Manager is hereby authorized to establish and periodically review and update the reserve policy.

Section 3. The Reserve Policy shall be added to the Administrative Procedures as Policy No. FIN-003.

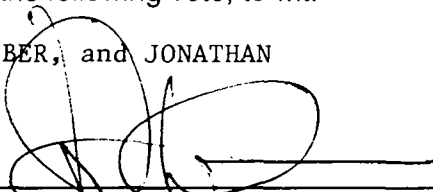
Section 4. This Resolution shall take effect immediately upon adoption.

Section 5. The City Manager, or her designee, are hereby authorized, jointly and severally, to do all things which they deem necessary or proper in order to effectuate the purposes of this Resolution and the transactions contemplated hereby, and any such actions previously taken by such officers are hereby ratified, confirmed and approved.

Section 6. That the City Clerk shall certify the passage and adoption of this resolution and enter it into the book of original resolutions.


PASSED, APPROVED AND ADOPTED at the regular meeting of the Palm Desert City Council held on this 27th day of September, 2018, by the following vote, to wit:

AYES: HARNIK, KELLY, NESTANDE, WEBER, and JONATHAN
NOES: NONE
ABSENT: NONE
ABSTAIN: NONE



SABBY JONATHAN, MAYOR


ATTEST:



RACHELLE D. KLASSEN, CITY CLERK
CITY OF PALM DESERT, CALIFORNIA

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	CITY OF PALM DESERT ADMINISTRATIVE PROCEDURES	
	<i>Subject</i>	Reserve Policy
	<i>Policy No.</i>	FIN - 003
	<i>Date</i>	Issued: September 27, 2018
	<i>Approved by</i>	Resolution No. 2018- <u>73</u> authorizing a Reserve Policy
	<i>Authored by</i>	Finance Department

I. PURPOSE

To outline the policy and procedures for establishing reserves for long-term city infrastructure needs, economic uncertainties, economic development, emergency reserve, equipment replacement, pension and other post-employment obligations.

This Reserve Policy ("Policy") will also set guidelines and priorities for the distribution of excess revenue at the end of each fiscal year to assist in funding and replenishing the identified reserve categories as well as ensuring that funds for current operating needs are available. This Policy will help the City ensure stable service delivery.

II. SCOPE

The City utilizes a variety of government funds for reporting and budgeting revenues and expenditures of the City that are separated broadly by three fund types: governmental funds, proprietary funds and fiduciary funds. This Policy will pertain only to governmental funds and proprietary funds since fiduciary funds are held in trust for others.

Governmental funds include the General Fund, Special Revenue funds, Debt Service funds and Capital Project funds. Proprietary funds include Enterprise funds and Internal Service funds.

To effectively utilize and maintain adequate reserves for both known and unknown contingencies, this Policy establishes reserve categories based on the hierarchy of the City's needs and risks:

1. General Fund Operating Reserve
2. Contingency/Emergency Reserve
3. Facilities Maintenance Reserve
4. Capital Improvement Projects Reserve
5. Liability Reserve
6. Employment Benefits Reserve
7. Other Fund Stability Reserve
8. Equipment Replacement Reserve
9. Economic Development/Land Acquisition Reserve

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III. RESERVE CATEGORY DEFINITIONS (in alphabetical order)

- a. Capital Improvement Projects Reserve – A reserve for major capital projects or improvements to the City's infrastructure including recreational facilities, undergrounding, roadways, storm drains, parks and gardens, buildings, and rights of way.
- b. Contingency/Emergency Reserve – A reserve to sustain General Fund operations, service delivery and budgetary stabilization in the event of an unexpected change in financial condition¹ or public emergency. This reserve is not intended to serve as an alternative funding source for new programs.
- c. Economic Development/Land Acquisition Reserve -- A reserve to facilitate economic development partnerships, incentives and property acquisitions to further the City's economic development goals.
- d. Employment Benefits Reserve – A reserve for accumulated compensated leave balances, pension discount rate changes, pension obligations and other post-employment benefits (OPEB) including unfunded pension liabilities.
- e. Equipment Replacement Reserve -- A reserve for the replacement of equipment not identified within the Facilities Maintenance Reserve including vehicles, office furniture, information systems, printers, scanners, communication systems, etc.
- f. Facilities Maintenance Reserve – A reserve to maintain existing City buildings and infrastructure including recreational facilities, parks and gardens, and hiking trails.
- g. General Fund Operating Reserve – A reserve used to finance the daily operations of the City such as public safety, streets maintenance, recreational parks, and special events.
- h. Liability Reserve – A reserve for costs not covered by the City's insurance programs including claim costs within the deductible amounts, certain types of settlements and judgments, or any claims awarded in excess of \$50 million. This reserve may also be used for deductibles, to pay any amount that may be considered a liability to the City consistent with this category, or to pay any contribution or premium to the pool on behalf of the City.
- i. Other Fund Stability Reserve – A reserve for transfers to funds from the General Fund to cover expenses.

IV. ACCOUNTING GUIDANCE

The Government Finance Officers Association (GFOA) suggests that as a best practice, cities should consider their own unique circumstances in order to determine adequate reserves. This includes assessing the needs of the City as well as the uncertainties that could impact the City's revenues and fund balance.

¹ An unexpected change in financial condition could include things such as the economic crisis in 2008, a loss or delay of a major revenue source, a natural disaster, liabilities not covered by insurance, or change in the pension discount rate for the City's unfunded pension liability.

Government Accounting Standards Board Statement No. 54 defines five specific classifications of fund balance. The five classifications are intended to identify whether the specific components of fund balance are available for appropriation (or available to reserve) and are therefore considered "spendable." The classifications are also intended to identify the extent to which fund balance is constrained by special restrictions. The five classifications² of fund balance for governmental funds are as follows:

<u>CLASSIFICATIONS</u>	<u>NATURE OF RESTRICTION</u>
Nonspendable	Cannot be readily converted to cash
Restricted	Externally imposed restrictions
Committed	City Council imposed commitment
Assigned	City Manager assigned purpose/intent
Unassigned	Residual balance not otherwise restricted

This Policy is focused only on the reserve designations that will be Committed, Assigned or identified in Unassigned. Nonspendable and Restricted classifications will be excluded because they are subject to requirements outside the City's control. The City will, however, consider restricted fund balance as spent first when both restricted and unrestricted fund balances are available.

V. RESERVE FUNDING POLICIES

The primary goal of the Policy is to identify and reserve, adequate resources for operational liquidity, future needs and any uncertainties that might affect the City's fund balance. The Policy includes broad reserve categories that are meant to be as inclusive

² *Nonspendable Fund Balance* (inherently nonspendable) – Assets that cannot be converted to cash (i.e., prepaid items and inventories of supplies) and assets that will not be converted to cash soon enough to affect the current period. Examples of nonspendable fund balance are reserves for long term receivables and advances, prepaid assets, City's financial assets which are not due to be received for an extended period, so are not available for appropriation during the budget year.

Restricted Fund Balance (externally enforceable limitations on use) – Limitations imposed by creditors, grantors, contributors, or laws and regulations of other governments and limitations imposed by law through constitutional provisions or enabling legislation. Examples of restricted fund balance are reserves for debt service, developer impact fee, capital bonds and grants.

Committed Fund Balance (self-imposed limitations on use set in place prior to the end of the fiscal year) – Limitation imposed at the highest level of decision making that requires formal action at the same level to remove (City Council). Examples of committed fund balance are the aquatic center, energy loan programs and the housing authority capital asset replacement.

Assigned Fund Balance (limitation resulting from intended use) – Intended use is established by highest level of decision-making, then may be implemented by an official designated for that purpose (delegated by the City Council to the City Manager). Examples of assigned fund balance are the library fund, building maintenance fund, capital project reserve fund, and economic development fund.

Unassigned Fund Balance (residual net resources) – Excess of nonspendable, restricted, committed, and assigned total fund balance. Unassigned Fund Balance reserves are residual positive net resources in excess of what can properly be classified in one of the other four components. Unassigned General Fund Balance (unobligated general fund reserves) and can be used for any lawful purpose.

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as possible, yet flexible enough to address needs or risks as they arise. Each reserve category may include multiple funds some of which may have a restricted fund balance component. At the discretion of the City Manager, monies held in reserve may be used in any year when the General Fund is not balanced in order to offset operating costs consistent with these reserve categories.

The identified reserve funding policies are as follows:

1. *General Fund Operating Reserve* – On June 30, the Finance Director shall set aside twenty five percent (25%) of the projected annual General Fund expenditures. This reserve will be adjusted at the end of each fiscal year to the recommended level based on the next year's projected expenditures. This reserve will be classified in fund balance as ASSIGNED.
2. *Contingency/Emergency Reserve* – At the beginning of each fiscal year, the Finance Director shall reserve an amount equal to twenty percent (20%)³ of the projected annual General Fund revenues. This reserve will be adjusted at the beginning of each fiscal year to the recommended level based on that year's projected revenues. This reserve will be classified in fund balance as COMMITTED.
3. *Facilities Maintenance Reserve* – Upon the approval of this Policy, the Finance Director is directed to commit the amount identified in the Capital Replacement Reserve Study, as the initial deposit, less amounts available from other funding sources to this reserve. The Policy-designated goal for funding this reserve, will be between sixty and one hundred percent (60-100%) of the 'Fully Funded' amount in the Capital Replacement Reserve Study. The annual recommended funding amount identified in the Capital Replacement Reserve Study will be considered as part of the annual budget. This reserve will be classified in fund balance as COMMITTED.
4. *Capital Improvement Projects Reserve* – At the financial closing of each fiscal year, the Finance Director shall set aside twenty percent (20%) of the total Capital Improvement Program projects for the next five years. The Finance Director will adjust this amount annually to the Policy-designated level plus any additional amounts so directed by the City Council under Section VI of this Policy. This reserve will be classified in fund balance as both RESTRICTED and COMMITTED depending on the project funding. Unless otherwise specified, at such time as a project or any portion thereof has been awarded the amount will be allocated (committed) to the project and will not be available for other projects.

³ After the financial crisis in 2008 the fluctuation in the City's revenue was approximately twenty percent (20%) of the 2007-08 budget or \$11 million dollars. While the City also reduced its budget at that time to offset the reduction in revenues to the extent possible, the core services were still rising. It took approximately eight years to reestablish the revenue base to pre-2008 levels. Based on these actual events staff believes that 20% of the annual operating revenue would be prudent as a reserve, with a consideration to review from time to time as information becomes available to the City that might suggest the amount to be increased.

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5. *Liability Reserve* -- The Finance Director shall commit at least the pooled retention requirement for both Liability and Workers' Compensation, which is currently \$4 million (\$2 million each). This reserve will be classified in fund balance as COMMITTED.
6. *Employment Benefits Reserve* – Internal Service Funds have been established for the purpose of reserving monies for compensated balances and Other Post-Employment Benefits (OPEB). On June 30 of each year, the Finance Director shall set aside one hundred percent (100%) of the compensable accrued unused vacation, sick leave, and compensatory time and the current year's OPEB requirements to the appropriate internal service funds. This amount will be COMMITTED. The Finance Director shall also set aside fifty percent (50%) of a one percent (1%) difference in the Public Employees Retirement System (PERS) discount rate. This amount will be COMMITTED in the General Fund.
7. *Other Fund Stability Reserve* - Upon the approval of this Policy, the Finance Director shall be directed to commit \$3.3 million to this reserve. At the end of each fiscal year, the Finance Director shall adjust the amount to be the projected annual transfers to other funds. This reserve will be classified in fund balance as COMMITTED.
8. *Equipment Replacement Reserve* – An Internal Service Fund has been established for the purpose of equipment replacement. At the financial closing of each fiscal year, the Finance Director shall adjust this reserve to be at least 100% of the total historical cost of equipment assets as noted in the CAFR and may include amounts set aside in excess of 100% for any approved one-time expenditures. This reserve will be classified in fund balance as COMMITTED.
9. *Economic Development/Land Acquisition Reserve* -- Upon approval of this Policy, the Director of Finance shall deposit an additional \$4,000,000 as a reserve for land/property acquisitions. In addition, within a reasonable amount of time from when the City receives its share of the proceeds of the former redevelopment agency's land sales, from the County of Riverside, the Finance Director shall commit the City's share to this reserve. This reserve will be classified in fund balance as COMMITTED.

VI. CITY COUNCIL DESIGNATION OF RESERVES

The City Council will take action to COMMIT fund balance and unless otherwise specified in this Policy, hereby designates the City Manager or his/her designee to ASSIGN fund balance when appropriate. The City Council may designate portions of General Fund unassigned or unobligated fund balance for any other municipal purpose that the City Council deems prudent or necessary.

VII. ANNUAL DISTRIBUTION OF EXCESS REVENUE

The distribution of excess revenue at the end of each fiscal year will be according to the following guidelines and priorities. Excess revenue, for purposes of this Policy, is the difference between revenues and expenses in the General Fund at the end of a fiscal year after all required transfers are made to other funds.

The priority for distributing or reserving excess revenue at year end is as follows:

1. All excess revenue shall first be used to replenish the General Fund Operating Reserve until it reaches the Policy-designated level.
2. The amount necessary to reserve for continuing appropriations and encumbrances that are not funded by other methods, if any.
3. The amount necessary to fund an adequate reserve for potential liabilities, compensated absences, and other post-employment benefits to be paid during the next fiscal year that are not funded by other methods, if any.
4. The amount necessary to fund the Contingency/Emergency Reserve to maintain General Fund operations, service delivery and budgetary stabilization in the event of an unexpected change in financial condition⁴ or public emergency. Or, if there is insufficient amounts available to fully fund the Contingency/Emergency Reserve, an amount necessary to temporarily reserve for any known and/or anticipated economic downturns during the next fiscal year that are expected to be more than three percent (3%) of the previous year's General Fund revenues.
5. Other considerations for the allocation of excess revenues will be at the discretion of the City Manager after review of the City's outstanding obligations, approved goals, or level of reserves within each category.

VIII. REPLENISHMENT OF RESERVES

After consideration of the use of excess revenue in Section VI., the City Manager will annually review the level of each approved reserve category, and after determining what is reasonably necessary and appropriate for the City's needs, may direct replenishment of critical reserves (General Fund Operating Reserve and Contingency/Emergency Reserve) from other reserves or may assign any remaining excess revenues accordingly.

If a transfer is required from one reserve to another, the City Manager shall notify the City Council at the next regularly scheduled City Council meeting of such transfer.

⁴ An unexpected change in financial condition could include things such as the economic crisis in 2008, a loss or delay of a major revenue source, a natural disaster, liabilities not covered by insurance, or change in the pension discount rate for the City's unfunded pension liability.

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When reserves are used for any intended purpose, or as allowed under this Policy, and a replenishment source is not identified at the time of use, the City Manager will advise the City Council during the annual budget process as to the status of reserves including any recommendations for replenishment.

IX. COMPREHENSIVE ANNUAL FINANCIAL REPORT

In accordance with generally accepted accounting principles and practices, all classifications of General Fund fund balance will appear in the Notes to Financial Statements of the CAFR and be classified in accordance with GASB 54.

STAFF REPORT
CITY OF PALM DESERT
FINANCE DEPARTMENT

MEETING DATE: September 27, 2018

PREPARED BY: Janet M. Moore, Director of Finance

REQUEST: Adopt Resolution No. 2018- 73, a Resolution of the City Council of the City of Palm Desert approving a Reserve Policy

Recommendation

Waive further reading and adopt Resolution 2018- 73 approving a Reserve Policy and the allocation of fund balance based on the Reserve Policy and this staff report.

Strategic Plan Objective/City Manager 2018 Goals

This request does not directly apply to a specific strategic plan goal; however, the request will assist in implementing the goals of the plan. The development of a Reserve Policy is included in the City's 2018 Department Goals.

Executive Summary

In 2008 the City Council approved a memorandum policy establishing a General Fund working capital reserve equivalent to one hundred percent (100%) of the annual General Fund Operating Budget. The existing policy has provided the City with the financial flexibility it needed over the last ten years, although best practice recommends that levels of reserve be determined by assessing the needs of, and risks to, the City's revenues and fund balance.

The primary goals of maintaining adequate reserves are for financial stability, operational liquidity, future needs and potential risks to the City's fund balance. To ensure these goals are met, staff analyzed the needs of the City and the risks to revenues and identified the following categories for reserve designations, which are described more fully in the next sections of this report.

- General Fund Operating Reserve
- Contingency/Emergency Reserve
- Facilities Maintenance Reserve
- Capital Improvement Projects Reserve
- Liability Reserve
- Employment Benefits Reserve
- Other Fund Stability Reserve
- Equipment Replacement Reserve
- Economic Development/Land Acquisition Reserve

The amounts recommended to be reserved are identified in the Fiscal Analysis at the end of the report. For illustration, a chart in that section also provides comparisons for reserving fund balance on three percentage based levels (100%, 75%, and 50%) with the exception of the General Fund Operating Reserve and the Contingency/Emergency Reserve which shall remain at one hundred percent (100%) funded for annual operations.

In addition, the Policy sets priorities for the distribution of excess revenue at the end of each fiscal year to assist in funding and replenishing the identified reserve categories as well as ensuring that current operating needs are funded.

Background Analysis

In 2008, the nation was faced with one of the worst financial crises in history. In order to ensure adequate resources were available to provide City services, the City Council approved a memorandum policy establishing a General Fund working capital reserve equivalent to one hundred percent (100%) of the annual General Fund operating budget. This policy provided the City with the financial flexibility it needed to weather the financial crisis that was affecting the national economy and still maintain service delivery.

While this policy has continued to be sufficient for the last ten years, the Government Finance Officers Association (GFOA) suggests that as a best practice cities should, from time to time, consider their own unique circumstances in order to determine adequate reserves. This includes assessing the needs of, and risks to, the City's revenues and fund balance and allocating reserves accordingly.

Staff assessed the needs of the City which include ongoing operations for service delivery, operating cash flow, future capital projects, facilities maintenance, pension obligations and equipment replacement. The risks to the City's fund balance include rising public safety costs, fund stability¹, and unexpected changes in financial condition² including economic uncertainties, emergencies, revenue volatility, one-time expenditures, and pension obligation stability.

Establishing reserves based on these considerations also assists the City to demonstrate to interested parties, the City's financial strength and stability. This information is also often considered for financial ratings for debt issuance and annual disclosures.

Identifying Reserve Categories and Funding Analysis

The primary goal of the Reserve Policy (Policy) is to identify and reserve, or have an ongoing funding plan to reserve, adequate resources for operational liquidity, future needs and assessed risks to the City's fund balance. The Policy includes broad reserve categories that

¹ Fund stability includes the risk to the General Fund of other funds that may depend on a transfer from the General Fund if revenues didn't cover expenses, such as the Palm Desert Aquatic Center.

² An unexpected change in financial condition could include things such as the economic crisis in 2008, a loss or delay of a major revenue source, a natural disaster, liabilities not covered by insurance, or change in the pension discount rate for the City's unfunded pension liability.

are meant to be as inclusive as possible, yet flexible enough to address needs or risks as they arise. Except as noted, the main funding source for the recommended reserve categories is the General Fund Unobligated (or unassigned) Reserves. These reserve categories are similar to having savings accounts for intended uses but still available if something unexpected surfaces.

- General Fund Operating Reserve – The General Fund is the primary fund used to finance the daily operations of the City, such as public safety, streets maintenance, recreational parks, and special events. The General Fund accounts for all general revenues of the City not specifically levied or collected for special or restricted purposes. Because the General Fund's revenue is received at varying times throughout the year and is not consistent with the timing of expenditures, operating funds are necessary for cash flow.

Staff recommends initially reserving an amount to equal twenty five percent (25%) of the projected annual General Fund expenditures. This reserve will be adjusted at the end of each fiscal year to the recommended level based on the next year's projected expenditures.

- Contingency/Emergency Reserve – In the event of an unexpected change in financial condition or public emergency, this contingency reserve would be used to supplement any monetary needs for General Fund operations to ensure service delivery. This could include a public emergency such as a natural disaster, some other unforeseen catastrophic event, economic uncertainties, unexpected operating or capital expenditures, unexpected spike in public safety costs or loss of a major revenue source.

The GFOA recommends a reserve of no less than two months of regular general fund operating revenues or expenditures to protect against unexpected changes in financial condition. After the financial crisis in 2008, the fluctuation in the City's revenue was approximately twenty percent (20%) of the 2007-08 budget or \$11 million dollars. While the City also reduced its budget at that time to offset the reduction in revenues to the extent possible, the cost of core services was still rising. It took about eight years for the City's revenue base to recover to pre-2008 levels.

Based on these actual events, twenty percent (20%) of the annual operating revenue would be prudent as a reserve, understanding that the percentage reserved should be reviewed from time to time to determine whether the amount should be increased for the current circumstances.

In order to reserve for these types of uncertainties, staff recommends reserving an amount equal to twenty percent (20%) of the projected annual General Fund revenues. This reserve will be adjusted at the beginning of each fiscal year to the recommended level based on that year's projected revenues.

- Facilities Maintenance Reserve -- In 2017, the City Council authorized a Capital Replacement Reserve Study ("Study") to identify the long-term maintenance and replacement needs of the City. The Study is now complete and the summary is attached in Exhibit A. The Study is comprised of over 35 components that include City buildings,

infrastructure, parks and gardens, recreation facilities and hiking trails. The Study contains a recommendation for an initial deposit as well as annual deposits looking forward 30 years.

Many of the reserve components identified have multiple sources of funding. The total initial deposit recommendation is \$25,000,000. To be fully funded, the Study suggests a total reserve of \$31,489,392. Staff has identified approximately \$18,629,783 that is available from various sources, some of which are restricted for these purposes, to fund a portion of the reserve. The balance needed from the General Fund to fully fund this reserve is \$12,859,609.

Staff recommends reserving the fully funded amount of \$31,489,392 from the identified sources to fully fund this reserve. Annually, this reserve will be reviewed to identify projects that have been completed with alternative funding, have been completed at a lower/higher cost, or are no longer needed. Staff will then compare the balance along with the recommended Annual Capital Contribution and adjust the reserve accordingly. If this reserve is not fully funded, it will be the goal to keep the reserve funded percentage to at least sixty percent (60%).

- Capital Improvement Projects Reserve – With the adoption of the annual budget, the City Council approves a five year Capital Improvement Program (CIP). Projects included in the CIP are for major capital projects or improvements to the City's infrastructure including recreational facilities, undergrounding, roadways, storm drains, parks and gardens, buildings, and rights of way. Many of these projects have other sources of funding identified during the annual budget process; however, the future availability of these funds is limited. For example, the City collects a developer impact fee for new park facilities. As development slows, the collection of the park fee and other similar fees will diminish.

CIP projects tend to be one-time expenditures unlike facilities maintenance which are cyclical in nature, i.e. building a bridge vs. painting a building. For purposes of this reserve, property and land acquisitions, including right of way, easements, or properties for strategic redevelopment may be considered as an appropriate use of the reserve. To ensure that projects can be accomplished when they are needed, and are not dependent on the fluctuations in year to year revenues and expenditures, a reserve of an amount equal to twenty percent (20%) of the five year CIP project total is practical.

Staff recommends reserving an amount equal to a total of twenty percent (20%) of the current adopted five year CIP at the end of each fiscal year.

- Liability Reserve -- The City is responsible for costs not covered by the City's self-insurance programs including claim costs within the deductible amounts, certain types of settlements and judgments, or any claims awarded in excess of \$50 million. The City belongs to a self-insurance pool administered by the California Joint Powers Insurance Authority. The City has a \$10,000 deductible per claim for property damage. Premiums are determined annually by the City's payroll and claims experience relative to the members within the risk-sharing pool. Premiums and claims fluctuate from year to year so the annual cost can often fluctuate as well. This reserve could also be used for

deductibles, to pay any amount that may be considered a liability to the City consistent with this category, or to pay any contribution or premium to the pool on behalf of the City.

In order to reserve for these liabilities, staff recommends reserving \$4 million which is the minimum amount of the pooled retention (\$2 million each) for both Liability and Workers' Compensation.

- Employment Benefits Reserve – Internal Service Funds have been established for the purpose of reserving monies for compensated balances and Other Post Employment Benefits (OPEB), however, several other factors outside of the City's control can affect the cost of annual employment benefits. For example, a one percent (1%) change in the pension discount rate can impact the City's current unfunded liability by almost \$16 million dollars.

On December 21, 2016, the CalPERS Board of Administration voted to lower the discount rate from 7.5% to 7% over three years. The City took a proactive approach to leveling the effects of the change by making additional payments toward its unfunded liability, which has resulted in an increase in the City's 'funded ratio' from 66.2% to 70.7% for the year ended June 30, 2017. However, the employer's normal contribution rates are still climbing, which will cause the annual employer payroll contributions to increase by approximately \$100,000. Since this increase would be cumulative, by the end of the 2021 fiscal year, the City will have paid a total of approximately \$600,000 in increased normal contributions. If the rates continue upward, this amount will continue to cumulatively rise as well.

In order to maintain budget stability which may include these increases or any other extraordinary change in the cost of employment benefits, this reserve could be used to offset the increases, retire pension liability so that annual costs are in line with available revenues or to offset the cost of any other employment benefits during any year. (See attached Exhibit B - examples of pension amortization schedules and alternatives)

Consistent with current practice, staff recommends on June 30 of each year, reserving one hundred percent (100%) of existing obligations of accrued unused vacation, sick leave, and compensatory time as well as the current year's OPEB requirement in the appropriate internal service funds. In addition, staff recommends reserving fifty percent (50%) of a one percent (1%) difference in the Public Employees Retirement System (PERS) discount rate.

- Other Fund Stability Reserve - Some funds are not sufficiently funded by other revenues (e.g. fire services, aquatic center operations) and require a transfer of funds from the General Fund each year to cover expenses. While some other funds are currently self-sustaining, looking forward, this may not always be the case. For example, the City's affordable housing rental programs are currently self-sustaining as many of the needed capital improvements are funded from restricted monies reserved prior to the elimination of redevelopment. These funds, however, are finite and once exhausted, staff will need to seek alternative funding sources (i.e. General Fund) for deferred maintenance.

In the event the General Fund operating budget, in any year, is not balanced, this reserve fund could be used to offset transfers to other funds that are not self-sustaining.

Staff recommends initially reserving the expected transfers out for FY 2017-18 of \$3.3 million in this reserve. This amount will be adjusted annually based on the needed or anticipated transfers out to other funds.

- Equipment Replacement Reserve – An Internal Service Fund has been established for the purpose of equipment replacement. This includes equipment not identified within the Facilities Maintenance Reserve (generally the items included in the Facilities Maintenance Reserve are affixed to the facility in some way) including vehicles, office furniture, information systems, printers, scanners, communication systems, etc. Due to the nature of the replacements, this reserve will be the most fluid as most items in this category typically have relatively short life cycles of between 3-10 years.

This reserve is currently funded at 100%. For future years, staff recommends setting aside at least one hundred percent (100%) of the total historical cost of equipment assets as noted in the CAFR and may include amounts set aside in excess of one hundred percent (100%) for any approved one-time expenditures such as those identified in the Information Technology Master Plan.

- Economic Development/Land Acquisition Reserve - This reserve was established to facilitate economic development partnerships, incentives and property acquisitions to further the City's economic development goals. This reserve is partially funded by a portion of the proceeds from the former redevelopment agency's land sales and currently has a balance of \$737,246. As agency properties close escrow the City's portion will be deposited into this reserve as well. This reserve may be used in connection with any economic development strategic plan goals adopted by the City that may include acquiring properties to assist with economic development in the area.

To facilitate the City's economic development goals, staff recommends setting aside an additional \$4,000,000 in this reserve for economic development that may include the need to acquire strategic land or properties.

Replenishing Reserve Categories with General Fund Excess Revenue

In addition, the Policy sets guidelines and priorities for the distribution of excess revenue at the end of each fiscal year to assist in funding and replenishing the identified reserve categories as well as ensuring that current operating needs are funded.

The proposed priority for distributing or reserving excess revenue at year end is as follows:

1. All excess revenue shall first be used to replenish the General Fund Operating Reserve until it reaches the Policy designated level.
2. The amount necessary from excess revenue needed to reserve for continuing appropriations and encumbrances that are not funded by other methods, if any.

3. The amount necessary from excess revenue to fund an adequate reserve for potential liabilities, compensated absences, and other post-employment benefits to be paid during the next fiscal year that are not funded by other methods, if any.
4. The amount necessary to fund the Contingency/Emergency Reserve to maintain General Fund operations, service delivery and budgetary stabilization in the event of an unexpected change in financial condition³ or public emergency. Or, if there are insufficient amounts available to fully fund the Contingency/Emergency Reserve, an amount necessary to temporarily reserve for any known and/or anticipated economic downturns during the next fiscal year that are expected to be more than three percent (3%) of the previous year's General Fund revenues.
5. Other considerations for the allocation of excess revenues will be at the discretion of the City Manager after review of the City's outstanding obligations, approved goals, or level of reserves within each category.

Fiscal Analysis

Having adequate reserves for the City's continued fiscal stability, regardless of economic climate, is the main reason for staff's recommendations below. The chart below provides comparisons for reserving fund balance based on three percentage levels, although the General Fund Operating Reserve and the Contingency/Emergency Reserve remain at one hundred percent funded for annual operations.

Staff reviewed the comparisons in funding levels and staff recommends that, based on the reasoning and rationale in the Identifying Reserve Categories and Funding Analysis section of this report, reserves should be funded at the full recommended levels for a total in reserves of \$68,374,953. By comparison, under the current reserve policy, the City would have reserved \$58,009,613 last year for all of the above purposes.

³ An unexpected change in financial condition could include things such as the economic crisis in 2008, a loss or delay of a major revenue source, a natural disaster, liabilities not covered by insurance, or change in the pension discount rate for the City's unfunded pension liability.