

CITY OF DANA POINT
FINANCIAL REVIEW COMMITTEE
Agenda Report

DATE: OCTOBER 27, 2017
TO: FINANCIAL REVIEW COMMITTEE
FROM: MIKE KILLEBREW, ASSISTANT CITY MANAGER
SUBJECT: FINANCIAL POLICY UPDATE

RECOMMENDED ACTION:

That the Financial Review Committee consider drafts of the following financial policies and provide input to staff:

- a. User Fee Subsidy Policy
- b. General Fund Reserve Policy

BACKGROUND:

Per its charter, the Financial Review Committee (FRC) is charged with making financial policy recommendations to the City Council to include, but not be limited to, Budget, Reserves, Investments and Debt. Said policies should be directed to ensure the long-term viability of the City by creating prudent reserves for projected short- and long-term economic downturns.

In response to this charge, the FRC agreed with engaging the Government Finance Officers Association (GFOA) to provide consulting services toward developing a new, long-term financial plan. Included in that agreement is assistance with development of certain financial policies. GFOA's work plan is set in three overlapping (not sequential) parts: 1) Present Concept of Long-Term Financial Planning and Policies; 2) Develop Financial Principles; and, 3) Develop Financial Policies.

The first part was conducted at a joint meeting of the City Council and FRC on September 12, 2017. The consultant is using information he gathered from that meeting, and working with staff to produce drafts of both the financial principles and financial policies. While the draft financial policies will be discussed at each of the next several FRC meetings, the principles will be timed to encompass not only what is gathered from the policy development, but will also be shaped by the discussions and results of the strategic planning process the City Council will be conducting over the next few months.

As had been discussed many times during the spring at both the FRC and Council meetings, and as communicated in the City's budget, the plan is to have the financial policies, long-term financial plan and strategic plan update completed by Spring 2018 to inform a discussion about amending the FY19 budget.

DISCUSSION:

The Financial Policy discuss before the FRC today is first of three "waves" of policies as outlined in the GFOA contract, as shown below:

Wave 1: Fees and Reserves

Wave 2: Capital Asset Management and Operating Budget

Wave 3: Long-Term Financial Planning (including long-term liabilities)

Supporting Document A is the first draft of the User Fee Subsidy Policy. The City has no user fee policy, and thus this will be the first such policy to be considered by the City. Based on input at prior FRC meetings, and what our GFOA consultant heard during his meetings with us in September, a base premise is that fees should be set such that no subsidy is provided to uses unless there is a greater public benefit as decided by the City Council. Staff believes the draft policy meets those objectives, and looks forward to further discussion and input from the FRC.

Supporting Document B is the first draft of a Reserve Policy. The City currently has a Reserve Policy adopted by the City Council in 2006 (see Supporting Document C). The proposed policy was drafted by GFOA based on their experience with other agencies across the country, coupled with information gathered by the consultant at his meetings with us in September along with subsequent discussion with staff. The draft Reserve Policy, in my opinion, needs additional work in the form of risk assessment prior to setting reserve amounts.

GFOA has a robust risk assessment process that the consultant and I both agree should be completed. I suggest that the FRC consider assigning two of its members to work through the assessment with the consultant and staff and bring back the results at a future meeting.

Wave 2 of the Financial Policy component of this project will be brought forward at the next FRC meeting.

SUPPORTING DOCUMENTS

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ATTACHMENT A***City of Dana Point User Fee Subsidy Policy***

User Fee Subsidy Policy**Background**

The City of Dana Point charges user fees for certain services, and they serve several purposes:

- User fees allow for maximum discretion in the use of general taxes. If services partially or fully cover their own cost through user fees, then the City of Dana Point has more options for how available general tax dollars can be used to accomplish other goals. This is particularly important given Dana Point's inability to easily realize tax revenues.
- User fees improve the fairness of how the costs for public services are allocated to members of the public. Some services benefit primarily the individual receiving the service, with the community as a whole receiving relatively little benefit when that individual receives the service. User fees allow the City to assign the cost of these kinds of services directly to the individual receiving them, rather than using general tax revenue that would otherwise be available to benefit the whole community.

Establishing and maintaining fees allows the City of Dana Point to realize the benefits described above.

When User Fees are Appropriate

For services where an individual member of the public is the sole or primary beneficiary of a service, the City may establish user fees according to the cost of the service provided to the recipient of the service. Conversely, if the entire community benefits from a service, then general taxes are an appropriate funding mechanism. In some cases, a service will have both individual and community-wide benefits. In these cases, the service might be partly subsidized by general taxes and partly paid for through fees.

The City of Dana Point charges user fees for services related to planning, building, engineering, and recreation services, among others.

Cost Recovery

Where data is available to do so and to the fullest extent possible, the full cost of providing a good or service, including operating expenses, administrative costs, and capital expenses (including depreciation) should be considered when calculating a user fee.

Subsidies

In some cases, it might be appropriate to subsidize a fee for a certain service. For example, some services might provide benefits to the entire community, beyond the individual who is the immediate recipient, or the City might wish to encourage people to use the service more widely than they would if the service were not subsidized. In these cases Council may determine to set a fee at a level below full cost and thus subsidize or waive the fee. For example, the City had not updated its user fees for many years, and may want to continue subsidizing certain services (e.g. senior recreation classes, water heater permits and/or planning commission appeals).

City of Dana Point User Fee Subsidy Policy

Balancing Cost-Recovery and Subsidies

City staff shall develop and recommend to the Council subsidy levels for services that assess user fees.

Policy factors to consider in setting subsidy policies should include:

1. **Cost-benefit nexus.** Where there is a strong nexus between the amount paid by the individual who receives the service and benefit received by that same individual, the subsidy should usually be lower.
2. **Similar to private sector service.** Sometimes a City service may be similar to those offered by the private sector. The City should consider not subsidizing services that might be competitors to private offerings.
3. **Limiting demand is a goal.** Higher fees discourage people from using a service and thus prevent demand from exceeding the City's capacity to supply the service. The City's capacity includes the capacity of its physical assets, as well as other factors needed to produce services.
4. **The service is regulatory.** The service is required to enforce laws and/or the ordinances of the City and those being regulated cause the City to incur costs.

Policy factors suggesting that subsidies might be appropriate include:

1. **Community benefit.** The service creates significant benefit for the community, not just the immediate recipient of the service.
2. **Difficult collection.** Collecting the fee is not cost-effective.
3. **Emergency service.** The service in question is emergency in nature and not planned, or the issue foreseeable, by the user.
4. **Creates the wrong incentives.** For example, a regulatory fee that is too high may create disincentives to comply with the regulation.

Based on the guidelines above, the City will set subsidy levels for its fees.

Review of Fees

Fees will be reviewed and updated on an ongoing basis in order to ensure they keep pace with changes in the cost of providing a service, as well as changes in methods or levels of service delivery. A comprehensive analysis of a service's costs, the level of service provided, the means by which it is provided, and the fees charged should be made at least every five years, including

City of Dana Point User Fee Subsidy Policy

a recommendation to the Council for any changes to the fee structure and explanation of any subsidies recommended. Such analysis should be coordinated by the Administrative Services Department.

In the interim, recommendations should be made to the Council for any adjustments to fees that may be necessary to keep up with known cost increases, or that may be needed for the service to meet its cost recovery goals. Generally speaking, smaller, more regular adjustments to fees are better than waiting several years and making larger adjustments to fees. Use of an inflation factor, such as the consumer price index (CPI) may be an appropriate method to adjust fees in the years where a cost study is not conducted, as long as such an adjustment does not raise the fees above the cost to provide those services.

[Review of Cost of Services](#)

In addition to considering if fees are sufficient to cover the cost of services, the City should always consider if the cost of providing the service is reasonable, including any promising alternative methods for providing the service to the public.

Date adopted: INSERT DATE

Date last updated: INSERT DATE

ATTACHMENT B

City of Dana Point General Fund Reserve Policy

I. Background

A General Fund reserve is one of the City of Dana Point's most important hedges against risk. It helps ensure that the City can provide consistent, uninterrupted municipal services in the event of economic disruption or an extreme event. For example, the City's primary revenue source is transient occupancy tax (TOT), which has proven to be sometimes very sensitive to economic downturns. Further, like many other California cities, Dana Point could be damaged by extreme events, like earthquakes or tsunamis. Holding a sufficient amount of reserves also helps Dana Point maintain a high level of creditworthiness, and allow it to meet its fiscal obligations as described in the adopted budget, despite normal cash flow fluctuations.

This policy establishes the amount the City will strive to maintain in General Fund reserve, how the reserve will be funded, and the conditions under which the reserve may be spent.

II. Amounts Held in Reserve

The City will strive to hold the amount listed below in its unrestricted General Fund balance, expressed as a percentage of the City's annual, budgeted operating expenditures for the General Fund. Some of these amounts are expressed as goal ranges, recognizing that fund balance levels can fluctuate from year to year in the normal course of operations for any local government. The reserves are broken into the following two separate categories, each with their associated target amount [RANGES BELOW TO BE DEFINED BASED ON RISK ANALYSIS]:

- **X% - 12% of annual operating expenditures - Economic Stability Reserve.** Available to protect and preserve City services from dramatic drops in General Fund revenues that are highly sensitive to economic conditions, mainly transient occupancy tax.
- **X% - 7% of annual operating expenditures – Extreme Event Reserve.** Available to respond quickly and decisively to man-made or natural extreme events. This reserve could fund the initial public safety response or repairs and reconstruction of public property required in the aftermath of an event.

If, based on the City staff's analysis and forecasting, the target balance is not being met or is likely not going to be met at some point within a five-year time horizon, then a plan to meet the target balance will be developed. This plan will be presented to the City Council for consideration.

In addition to the amounts above, the City may choose to reserve additional amounts for purposes other than those described above. For example, the City may wish to set aside monies for a one-time investment in a special project or program. Any such reserve will be accounted for separately from the Economic Stability Reserve and Extreme Event Reserve; this separation is to prevent the funds the City needs to respond quickly and decisively to emergency situations from being tied up by other potential uses.

City of Dana Point General Fund Reserve Policy

Finally, the City shall maintain an adequate amount of working capital on hand in order ensure smooth operations through normal differences between the timing of the City's revenue inflows and expenditure outflows. Generally, an amount equal to about 3% of City expenditures will be maintained as a minimum, unassigned fund balance.

Funding Reserve Targets

Funding of unrestricted fund balance targets will come generally from one-time revenues (e.g., unusually high yields from transit occupancy taxes or sales taxes), and projected revenues in excess of projected expenditures. They will generally be reserved in the following priority order:

1. Extreme event reserve
2. Economic stability reserve
3. Working capital (unassigned fund balance)

III. Conditions for Use of Reserves

A. Use of Reserves

It is the intent of the City to limit use of the General Fund reserves to address unanticipated, non-recurring needs or known and planned future obligations. Reserves shall not normally be applied to recurring annual operating expenditures. The reserves may, however, be used to allow time for the City to restructure its operations in a deliberate manner (such as might be required in the case of a severe economic downturn), but such use will only take place in the context that the City will adopt a long-term plan to reach a sustainable budget structure.

However, the City may only use up to 50% of the reserve for Economic Stability to continue operations, without reductions to operations, in any one year of economic difficulty. The use of the reserve is limited in this way so that the balance of the reserve would be available to help the City address any additional financial problems it could confront after adoption of a subsequent year's budget.

B. Authority to Use Reserves

The City Council may authorize the use of reserves. In all cases, the City Council and management shall only use reserves for purposes consistent with the purposes described in this policy.

C. Replenishment of Reserves

In the event reserves are used in an amount that takes them below the City's target amounts, the City Manager shall propose a plan to the City Council for the replenishment of the reserves. The City will strive to replenish the reserves within one year of use, but will fully replenish it within five years of use.

ATTACHMENT C

City of Dana Point**General Fund Reserve Policy****I. Purpose**

General Fund reserves are created to:

- a) Ensure that the City has sufficient funds on hand at all times to meet its fiscal obligations as embodied in the adopted budget;
- b) Maintain a high level of credit worthiness for the City;
- c) Provide a source of funding for unanticipated contingencies that could result from major uninsured claims against the City, natural disasters, major economic downturns and other situations of this nature;
- d) Ensure sufficient funds are available for the future repair or replacement of major existing capital infrastructure.

II. Definition of Designated Reserves

Designated reserves represent discretionary funds set aside by the City Council for specific purposes. Although there is no *legally binding* restriction on such reserves the City Council has administratively placed budgetary restrictions on the amounts of such reserves and when these funds may be used. Designated reserves are distinct from those reserves which are mandated either legally or under specific governmental accounting requirements, such as encumbrances or restricted assets. The City has established the following designated reserves:

- a) Cash Flow Reserve – this reserve is established to provide a cushion for normal fluctuations in monthly revenue inflows and expenditure outflows, such that a sufficient amount of monies are always on-hand to meet the City's fiscal obligations. Such a reserve also helps to ensure that the City maintains a strong rating among credit rating agencies.
- b) Emergency Reserve – this reserve is established to provide a source of fiscal resources that can be tapped immediately to deal with the types of situations described in I.c). In order to tap this reserve, a minimum 4/5 vote of the City Council is required.
- c) Capital Projects Sinking Fund Reserve – this reserve is established to accumulate funds for the future repair and/or replacement of existing capital infrastructure.

III. Amounts of Designated Reserves

Based upon the recommendation of the Investment Review Committee, as ratified by the City Council, the following amounts have been established for the designated reserves described in section II.)

- a) Cash Flow Reserve – an amount equal to 10% of total General Fund revenues.
- b) Emergency Reserve – an amount equal to 20% of total General Fund revenues.
- c) Capital Projects Sinking Fund Reserve – an amount not less than \$2.5 million. (Concurrent with each budget cycle, the City Manager and the Director of Public Works shall provide the City Council with a report recommending a sufficient sinking fund reserve amount, and listing the City's progress towards accumulating the required funding for future infrastructure repair or replacement projects).

Approved by the City Council on _____
DATE

City of Dana Point

Capital Infrastructure Funding Policy

II. Annual Funding to be Transferred into the Capital Improvements Projects ("CIP") Fund

Each fiscal year an amount will be transferred from the General Fund to the CIP Fund equal to the projected General Fund operating surplus, if any, for that fiscal year plus the excess (if any) of any General Fund operating surplus from the preceding year.

The operating surplus is defined as the excess of General Fund revenues and operating transfers-in over expenditures and operating transfers-out, as increased or decreased by any amounts necessary to fully fund or replenish all General Fund reserves and designations.

IV. Annual Listing of Proposed Capital Infrastructure Projects

For each fiscal year the City Manager and Public Works Director shall prepare and provide the City Council with a prioritized list of capital infrastructure projects and their estimated costs.

New capital infrastructure projects for Council consideration shall be prioritized for budgeting in the CIP Fund as follows:

- a) Priority 1 – recommended new capital infrastructure projects (if funding levels allow within budget)
- b) Priority 2 – potential future capital infrastructure projects (unfunded)

Note: Projects classified as “repairs, replacements and mandates” to *existing* infrastructure shall be included in the General Fund operating budget.

In connection with the bi-annual budget process the City Council will consider the City Manager and Public Works Director’s recommendations for the purpose of reaching consensus on the proposed new capital infrastructure projects, their funding level and their prioritization (1 or 2), with consideration given to associated future costs as identified in section III of this policy.

V. Funding Priorities for Capital Infrastructure Projects

Funding priorities shall be based upon the level of available General Funds (as determined in section I.), combined with any outside funding available from other sources such as the Federal government, State government, County government, the private sector, etc.:

- a) All new capital infrastructure projects identified as Priority 1 shall receive the first allocation of available funding equal to 100% of the estimated capital infrastructure project cost.
- b) Each fiscal year a CIP budget reserve equal to 10% of the required funding for Priority 1 new capital infrastructure projects shall be created. Unless otherwise directed by the City Council this reserve may only be used to fund changes in cost estimates, quantities or project scope of Priority 1 capital infrastructure projects.
- c) When sufficient funds are not available to fully fund a designated Priority 1 capital infrastructure project, then a multi-year funding plan will be presented and a portion of the total required funding shall be allocated in each fiscal year so that adequate funds will be accumulated over time to construct the capital infrastructure project as scheduled.

Priority 2 capital infrastructure projects are new capital infrastructure projects which are listed for the purpose of consideration of future construction funding and are incorporated into the backlog of unfunded capital infrastructure projects. They shall not receive any funding allocations until such time as they are classified as Priority 1 capital infrastructure projects.

VI. Supplemental Information to be Provided on Agenda Reports

When capital infrastructure projects are presented to the City Council for approval the fiscal impact section shall include the following information:

- a) The full program cost to develop and build the project
- b) The future annual ongoing operation and maintenance costs (if applicable)
- c) The estimated useful life of the project
- d) The estimated annual funding required to accumulate monies for the future replacement of the project (if applicable)

Approved by the City Council on _____
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