

**CITY OF DANA POINT
FINANCIAL REVIEW COMMITTEE REPORT**

DATE: MAY 22, 2019
TO: MEMBERS OF THE FINANCIAL REVIEW COMMITTEE
FROM: MIKE KILLEBREW, ACTING CITY MANAGER / TREASURER
SUBJECT: REVIEW OF GENERAL FUND RESERVE POLICY

RECOMMENDED ACTION:

That the Financial Review Committee review, discuss and make a recommendation in regards to the City's proposed General Fund Reserve Policy.

BACKGROUND:

The City Council conducted several Budget Workshops leading up to adopting several new financial policies in FY18. Included in those discussions were many comments about the draft changes to the City's General Fund Reserve Policy ("Policy"), and it was decided to continue discussions regarding this policy. Current General Fund Reserve Policy was adopted in 2006 (See Supporting Document B).

The City Council continued discussing the Policy at a publicly noticed budget workshop on March 5, 2019, at which the Council took action to send the draft Policy to the Financial Review Committee for their recommendation. Discussion that took place during the workshop included seeking input on increasing the unassigned maximum up from 7% to 10%; whether to retile the term "max" as used in the draft policy to "max target"; conditions regarding use of reserves relative to 50% number mentioned in the Policy; and, whether the Policy should include language to require City Council approval prior to use of reserves.

Based on budget discussions at subsequent workshops and individual briefings with City Council members, Staff has proposed adjusting the Unassigned Fund Balance maximum amount back to the 7% originally recommended last year; and, a new financial policy entitled "Community Investment Account Policy" that directs 3% of the growth in General Fund Revenues and any excess fund balance into a Community Investment Account in the City's Capital Improvement Fund (See Supporting Document C). The City Council will be discussing these updated recommendations at its May 21, 2019 budget workshop. Staff will provide a verbal update as to the results of the City Council's discussion.

SUPPORTING DOCUMENTS:

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SUPPORTING DOCUMENT A – Current General Fund Reserve Policy

CITY OF DANA POINT COUNCIL POLICY

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General Fund Reserve Policy	1 of 2	08/23/06	224

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.

BACKGROUND:

The City has not had a consistent policy with respect to the establishment of General Fund reserve balances. The policy is needed to ensure the purposes outlined above are consistently applied during each budget cycle.

POLICY:

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.

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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).

SUPPORTING DOCUMENT B – Proposed General Fund Reserve Policy

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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 was shown to be sensitive to the Great Recession's economic downturn. Further, like many other cities, Dana Point could be damaged by extreme events like an earthquake, tsunamis, or landslide, among others. Maintaining sufficient financial reserves would assist in maintaining a high level of creditworthiness which would be helpful should the City need access to financing; furthermore, it allows the City to meet its fiscal obligations per the adopted budget, despite normal cash flow fluctuations.

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

AMOUNTS HELD IN RESERVE

The City will strive to hold the amount listed below in its designated (not legally restricted) General Fund balance, expressed as a percentage of the City's budgeted and ongoing General Fund operating revenue. One-time revenues should be excluded from this annual calculation. 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 designated reserves are broken into the following two separate categories, each with their associated target amount:

- **7% - 11% of annual operating revenue - 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.
- **6% - 9% of annual operating revenue – 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.

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If, based on use and/or the City staff's analysis and forecasting, the target range 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. It is also a stated Council priority to aim to fund at the top of the range. This plan will be presented to the City Council for consideration.

In addition to the amounts above, the City may choose to designate 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; or, to fund an unfunded pension or other post-employment benefit liability. Any such designated 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. Funds designated for capital projects or facility projects should be transferred to and set aside in a specific, designated reserve in the Capital Projects Fund or Facilities Fund, respectively.

Finally, though not a designated reserve, 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 4% to ~~7~~10% of General Fund budgeted, ongoing revenue will be maintained as a minimum, unassigned fund balance.

Priority Funding of the Designated Reserve Targets

Funding of the unassigned fund balance and the two designated (not legally restricted) reserves, to be within their targeted amounts, will come generally from one-time revenues (e.g., unusually large receipts from transient occupancy, property, sales taxes, etc.), and projected General Fund revenues in excess of projected expenditures.

Replenishing these accounts will generally occur in the following priority order:

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

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CONDITIONS FOR USE OF RESERVES

A. Use of Reserves. ~~It is the intent of t~~The City ~~shall~~ limit use of the General Fund's designated reserves to address unanticipated, non-recurring needs or known and planned future obligations. Designated reserves shall not under normal circumstances be applied to recurring, annual operating expenditures. The Economic Stability reserve may 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 concurrently adopt a plan to reach a sustainable, balanced budget structure.

If necessary, the City should only use up to 50% of either designated reserve to continue operations. The use of the reserves is limited in this way so that a reserve balance will be available to help address additional financial issues or extreme events encountered in the subsequent year. Further, use of a significant portion of the Economic Stability Reserve in any given year should be accompanied by analysis of the fiscal outlook and, if necessary, consideration of reductions to ongoing operations to ensure fiscal sustainability.

B. Authority to Use Reserves. The City Council may authorize the use of the designated 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 designated 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 reserve(s). The City will strive to replenish the reserves within one year of use, but will fully replenish it within five years of use.

SUPPORTING DOCUMENT C – Proposed Community Investment Account Policy

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Community Investment Account Policy	1 of 1	TBD	234

BACKGROUND

This Policy is established to direct investment of the General Fund's excess fund balance, which is defined any funds remaining after all budgeted revenues and expenses are taken into account, and the General Fund Reserves (as defined in Policy 233) are fully funded. These funds will be accounted for separately in the Capital Improvements Fund #11, in a designated fund balance account entitled Community Investment Account.

USE OF FUNDS

Funds in this account are to be considered non-recurring, and given that should be used for one-time expenditures, including but not limited to projects listed on the Unfunded Projects List in the Capital Improvement Fund budget, reduction of long-term liabilities, special studies, events, etc. Use of these funds should also be consistent with other financial policies, and should not supplant funding required by other financial policies.

The City Council may appoint a subcommittee to evaluate and make recommendations regarding potential uses of funds in this account; however, City Council action is required to commit these funds.