

**CITY OF NAPA CITY COUNCIL
AGENDA REPORT**

ADMIN CALENDAR
AGENDA ITEM 15.C.
Date: April 07, 2015

To: Honorable Mayor and Members of City Council

From: Michael Parness, City Manager

Prepared by: Deanna Andrews, Finance Manager

Subject: Risk Assessment of General Fund Reserve Requirements

ISSUE STATEMENT:

Receive and review the Government Finance Officers Association Risk-Based Analysis of General Fund Reserve Requirements.

DISCUSSION:

In October 2014, the City executed an agreement with the Government Finance Officers Association (GFOA) to perform a risk assessment analysis of the City's General Fund reserves and to develop recommendations for the appropriate level of reserves to maintain to mitigate various risk factors. The goal of this analysis was to determine the major areas of risk to the stability of the General Fund and to identify appropriate levels of reserves to mitigate those risk factors. The City Council reviewed a preliminary draft GFOA report at the February 13, 2015 Council Workshop. The GFOA has now completed its analysis and has issued a final report which is provided as Attachment 1.

The GFOA analysis identified three primary risk factors which could impact the stability of the General Fund as revenue volatility, vulnerability to extreme events/public safety, and potential capital repair and replacement costs of major City infrastructure. The analysis also considered secondary risk factors (not as critical as the primary risk factors) including anticipated community growth, expenditure volatility and leverage/cash liquidity.

Revenue Volatility

The three main sources of revenue to the General Fund are property tax, transient occupancy tax and sales tax. While property tax has provided a fairly stable revenue stream, both transient occupancy tax and sales tax revenue have proven to be highly volatile with significant annual variations over the past twenty year period. Other General Fund revenues such as business licenses, permits and interest earnings have also exhibited significant volatility over the period analyzed. Based upon the analysis conducted, a reserve of \$7.5 million is recommended to counteract the effects of General Fund revenue volatility.

Public Safety and Extreme Events

Reserve funds are essential for responding quickly to natural disasters such as earthquakes and flooding. The City of Napa has experienced both of these events during the past ten year period. In addition to earthquakes and floods, other possible disasters such as wildfires and acts related to terrorism could place a demand on reserve funding. The 2005 flood disaster resulted in \$4.1 million in damage costs to the City. The damage to City infrastructure caused by the 2014 earthquake is estimated to be \$25 million, with approximately \$12 million of this amount related to public utilities. While it is anticipated that a major portion of these costs will be reimbursed from federal and state funds, the City is initially experiencing a significant cash outlay pending that reimbursement. The GFOA analysis recommends that the City consider maintaining a reserve between \$5.8 million and \$15.2 million for immediate response to public safety and extreme events. The GFOA further recommends that a reserve closer to \$15.2 million would be more prudent given the limited number of events available to be analyzed which makes it more difficult to predict future costs.

Capital Repair and Replacement

The GFOA analysis also included a review of the risk profile of the City's bridges. Based upon that analysis, the GFOA recommends that the City develop an asset management policy to provide guidance in allocating funding over time for the orderly maintenance and repair/replacement of major City infrastructure. This asset management policy would be separate from the General Fund reserves.

Secondary Risk Factors

Several less significant factors impacting the General Fund reserve strategy which are included in the GFOA analysis are community growth, expenditure volatility including potential environmental clean-up costs, and cash liquidity for funding pension liabilities.

Population growth in the City has averaged 0.5 percent annually since 2000. Over the next several years, additional housing units and commercial development are anticipated. As there is typically a one year lag before the City collects property tax revenue from new development the GFOA recommends that the City consider funding a reserve between \$172,000 and \$860,000 to cover the costs of providing City services to new development before the additional tax revenue becomes available.

In reviewing potential expenditure volatility, the GFOA considered potential State actions impacting City finances, including changes in the Municipal Separated Storm Sewer (MS4) permit compliance requirements and the storm water system service assessment which is scheduled to sunset in May 2016. In addition, the City has experienced instances of unanticipated environmental clean-up costs in recent years. The GFOA analysis indicated that it would be prudent to set aside funding of \$939,000 to fund potential expenditure volatility.

The City budgets for its annual pension obligation as part of the biennial budget process. With the significant projected increase in CalPERS employer contribution rates over the next several years, the City could encounter difficulty funding these costs should a situation occur where revenues were flat or declining. The GFOA recommends a reserve of \$1.4 million for increasing pension costs which would provide time for the

City to make an orderly adjustment to other costs in the event of flat or declining revenues.

Report Summary

The GFOA analysis recommends the following implied risk reserve levels for the City's General Fund:

Revenue Volatility	\$ 7.5 million
Community Growth	\$172,000 to \$860,000
State Intervention/Environmental Clean-up	\$939,000
Pension Obligations	\$ <u>1.4 million</u>
Subtotal excluding Extreme Events/Public Safety	\$10.0 to \$10.7 million
Extreme Event/Public Safety	\$ <u>5.8 to \$15.2 million</u>
Total	\$15.8 to \$25.9 million

Given the City's \$70.5 million General Fund budget, this would indicate a level of reserves ranging from 22 percent to 36 percent of the operating budget. To determine the appropriate reserve level for the City of Napa, the factors of risk interdependency (relationship between the different risk factors), risk's probability of occurring and the City's ability to reduce expenditures in the event of a downturn in revenues should be considered. The decision as to the appropriate level of reserves is dependent upon the level of risk that the City is willing to assume. A conservative risk adverse philosophy would set the General Fund reserves at the higher 36 percent level. A less risk adverse approach would set the reserves at the lower 22 percent level.

The City's current General Fund Reserve Policy provides for reserves of 16 percent of the annual operating budget as follows:

- Emergency Reserves at a level at least equal to 12 percent of budgeted operating expenditures
- Operating Reserves at a level of 3 percent of the General Fund operating budget. The policy also provides that any amount of Unassigned Fund Balance in excess of 3 percent of the operating budget be transferred to the Capital Facilities Replacement Reserve Fund and CIP General Fund Reserve.
- Contingency Reserves at a level no less than 1 percent of the General Fund operating budget

The City Council authorized the draw-down of \$4.0 million of Emergency Reserves in 2014 to fund immediate repair costs associated with the August 2014 earthquake. It is anticipated that funding from federal and state agencies (FEMA/OES) will replenish the major portion of Emergency Reserves with any shortfall funded from future General Fund operating surplus. The Contingency Reserve is also currently below the target level but is expected to be increased annually to meet the one percent target by Fiscal Year 2017-18. A summary of General Fund Reserves is provided below.

	Current Policy Level*	Balance as of June 30, 2014*	Balance as of March 31, 2015*
Emergency Reserve (12%)	\$8.4	\$8.4	\$4.4
Operating Reserve (3%)	\$2.1	\$2.1	\$2.1
Contingency Reserve (1%)	\$0.7	\$0.4	\$0.4
Total Reserves	\$11.2	\$10.9	\$6.9

- \$ million

A comparison of the current General Fund Reserve Policy to the GFOA recommendation is presented below.

	City of Napa		GFOA Recommendation	
	\$ million	% of Budget	\$(million)	% of Budget
Reserve (excl. Emergency)	\$2.8	4%	\$10.0 to \$10.7	14% to 15%
Emergency Reserve	<u>\$8.4</u>	<u>12%</u>	<u>\$5.8 to \$15.2</u>	<u>8% to 21%</u>
Total	\$11.2	16%	\$15.8 to \$25.9	22% to 36%

The GFOA recommended reserve level range of 22 to 36 percent is considerably higher than the current Reserve Policy of 16 percent. Based upon the likelihood of multiple risk events occurring at the same time, a target General Fund Reserve of 20 percent would seem reasonable. It is staff's recommendation that the General Fund Reserve Policy be amended during the upcoming budget approval process to increase the target Emergency Reserve level from 12 percent to 14 percent, increase the target Operating Reserve level from 3 percent to 5 percent with no change to the 1 percent Contingency Reserve. Based upon the 2014-15 fiscal year budget of \$70.5 million, the target reserve level would increase from \$11.2 million to \$14.1 million. It will be recommended that the increase in reserves be phased in gradually over a five year period beginning with the 2015-16 fiscal year.

FINANCIAL IMPACTS:

There is no financial impact at this time as the GFOA Analysis is presented for review and discussion purposes only. An amendment to the current Reserve Policy will be considered during the upcoming budget review process.

CEQA:

The Finance Manager has determined that the recommended actions described in this agenda report are not subject to CEQA, pursuant to CEQA Guidelines Section 15060(c).

DOCUMENTS ATTACHED:

1. Attachment 1: Government Finance Officers Association Risk-Based Analysis of General Fund Reserve Requirements for the City of Napa

NOTIFICATION:

None.

RECOMMENDED ACTION:

City staff recommends that the City Council move, second and approve each of the actions set forth below, in the form of the following motion stated as: Move to:

Receive and review the Government Finance Officers Association Risk-Based Analysis of General Fund Reserve Requirements.