

ATTACHMENT 2

INTRODUCTION

Prudent fiscal reserves are a mark of stability and a cornerstone of financial flexibility. The difficult question is: what constitutes a prudent fiscal reserve? The Government Finance Officers Association (“GFOA”) best practice recommends, at a minimum, that general-purpose governments, regardless of size, maintain an unrestricted budgetary fund balance in their general fund of no less than two months of regular general fund operating revenues or operating expenditures. This means the City should never have less than **\$10,545,967** in General Fund reserves based on GFOA-recommended best practices.

In June 2021, the City Council adopted a Risk Based Reserve Policy. Prior to this policy, the former Reserve Policy directed funding be set aside based on a percentage of General Fund revenues. The former policy did not consider certain specific risk factors (i.e., disasters, unfunded liabilities, emerging issues, liquidity, and growth) that could affect the City. The Risk Based Reserve Policy takes into consideration eight risk factors that could impact the City’s ability to deliver services and assigns a specific dollar amount to each factor. This approach represents a more dynamic, transparent, and effective budgeting tool to help the City Council and staff determine the appropriate level of funding needed in reserve. Staff is to conduct a General Fund Reserve Risk Analysis every two years in tandem with the formulation of the Operating Budget.

The discussion below defines “Reserves” and provides explains their importance to managing the finances of a city.

WHAT ARE RESERVES?

The terms “reserves” and “fund balance” are often used interchangeably. Fund balance is an accounting term to describe the difference between a fund’s assets and liabilities. In general, when municipal leaders are discussing the need for reserves, it is in the context of “reserving” funds for future expenses. Reserve expenses are costs associated with repairs or replacements to existing assets or expenses associated with special circumstances. Like savings for a “rainy day” in a personal budget, reserves can also be used for unplanned expenses related to litigation, economic downturns, and emergencies/natural disasters. Many cities utilize unrestricted reserves to fund capital improvements, avoid debt service costs, and increase the ability to cash flow fund a project during construction. It is

essential to clearly define the intended use for the City's established reserve balance which is the purpose for the risk factors discussed later in this analysis.

WHY DOES THE CITY HAVE RESERVES?

Ideally, a city can maintain a stable set of public services throughout an entire economic lifecycle. Maintaining healthy reserve balances protects the City from economic uncertainties and mitigates risks. Prudent reserves provide the City with options for responding to recessions and other issues and/or emergencies without impacting funds budgeted for day-to-day operations. It is vital that the City take advantage of good economic times by setting aside for those "rainy days" which are bound to occur in the future.

WHY NOT JUST RAISE TAXES OR FEES IF THE CITY NEEDS MORE MONEY?

California voters have passed numerous measures that restrict the tax and fee raising authority of state and local governments. The most recent was Proposition 218, approved in 1996. Proposition 218 added restrictions to taxes, fees, and assessments, making it necessary to obtain voter approval to establish and/or raise many of them. Therefore, cities are best to plan to meet financial obligations utilizing the revenues available to it rather than depending upon voters to provide additional resources.

Table 1 below compares Lake Forest's reserves to a subset of Orange County cities of similar size, operations, and demographics. Data for Table 1 was compiled from the Annual Comprehensive Financial Reports for Fiscal Year Ending June 30, 2022, for each city listed below.

Table 1 - CITY COMPARISON
(IN MILLIONS)

CITY	RESERVES	GENERAL FUND REVENUE	PERCENTAGE OF RESERVES TO REVENUE
Lake Forest	\$91.3	\$60.0	152%
Rancho Santa Margarita	\$27.4	\$20.4	134%
Aliso Viejo	\$30.6	\$24.3	126%
Yorba Linda	\$42.6	\$41.6	102%
Laguna Niguel	\$46.7	\$48.0	97%
SJC	\$35.1	\$37.3	94%
Brea	\$38.7	\$63.1	61%
Laguna Hills	\$13.8	\$24.2	57%
Mission Viejo	\$39.3	\$70.7	56%
Dana Point	\$21.1	\$50.7	42%
San Clemente	\$30.3	\$74.3	41%
Average	\$37.9	\$46.8	88%

On June 15, 2021, the City Council adopted a Target Reserve Level of \$52.3 million and a Minimum Reserve Level of \$49.7 million (5% below the Target Reserve Level amount) based upon a risk analysis conducted by staff. Should the City Council vote to spend funds resulting in funding below the Minimum Reserve Level, staff would identify a plan to replace these funds over the next three to five fiscal years.

Table 2 below describes the City's Discretionary Reserves as reflected in the Annual Comprehensive Financial Report for Fiscal Year Ended June 30, 2022 audited by CliftonLarsonAllen LLP. This table highlights \$9.2 million of assigned General Fund Balance available as of the end of Fiscal Year 2021-2022 which is in addition to the funds identified as target reserve funds.

Table 2 – Discretionary Reserves Summary
(IN MILLIONS)

	Reserve Amount per Policy		Available Discretionary Fund Balance	Percentage of Policy	Percentage of General Fund Revenues
	Target	Minimum			
June 30, 2022	\$52.3	\$49.7	\$91.3	174%	152%

RISK FACTORS IN DETERMINING PRUDENT RESERVES

GFOA best practices identify several risk factors that should be considered when calculating reserves. The size of reserves is determined primarily by the degree of risk associated with uncertainty, such as economic downturns, natural disasters, and other major events that could affect City finances. The risk factors used for this analysis are:

RISK FACTORS

OPERATING RISK FACTORS

1. Revenue Source Stability
2. Vulnerability to Extreme Events
3. Expenditure Volatility
4. Leverage
5. Liquidity
6. Other Fund Dependency
7. Growth

CAPITAL RISK FACTORS

8. Capital Projects – Infrastructure & Replacement

OPERATING RISK FACTORS

DETERMINING THE RESERVE

Revenue stability is important for the City's consistency and growth. If the City's expenditures outgrow revenue sources, the City would not continue to operate at the same level of service. Property tax, sales tax, and transient occupancy tax revenues are the primary source of revenue for the City. There is more spending discretion over these revenues in comparison to federal grants, user fees, or other funds that must be used for a specific program or purpose. As such, fluctuations in these revenue sources will affect the City's ability to budget for public services.

RISK FACTOR #1 – REVENUE SOURCE STABILITY

How stable is the tax base in the face of adverse economic conditions?

Relative to other revenues, property tax is considered a stable source of revenue. Sales and transient occupancy taxes (i.e., hotel taxes), however, are considered less stable. An excellent example of this is the 2008 recession. Lake Forest did not return to its pre-recession sales tax base until 2016, or eight years after the Great Recession. However, the City benefits from its ability to accommodate and retain profitable businesses in a diverse set of industries. As a result, sales tax revenue is more likely to remain stable due to the fact that the City does not rely heavily on a subset of industries.

PROPERTY TAX:

Property tax revenue steadily decreased from 2010 to 2012. Revenue received during 2011 and 2012 still exceeded pre-recession revenue in 2007 by \$0.24 million. The property tax revenue base only declined \$0.68 million in total during and immediately after the recession began. In 2013, only four years after the recession, property taxes reached a new high of \$14 million and have continued to grow ever since. Property taxes continued to grow even with the onset of the 2020 pandemic.

The City's property taxes continue to increase due to the new homes being constructed. New home building is projected to continue in Lake Forest for the next two years but expected to decrease due to the completion of the new

residential communities. The City's property tax revenue increased by \$1.4 million over the previous fiscal year (FY 20-21). This was primarily due to new residential housing development and historically low mortgage rates. Over the past 10 years, median price of single-family residential homes has increased 60%, demonstrating the strength and stability of the City's property tax base.

SALES TAX:

Sales tax is considered a cyclical tax in that it is often impacted by unemployment and other economic conditions. The City's sales tax revenues declined \$1.57 million in 2009 and 2010 due to the Great Recession. However, sales tax revenue increased in 2011 and continued to rise. In 2020, sales tax revenue decreased to \$15.75 million due to the COVID-19 pandemic, but quickly rebounded to \$17.20 million the following year.

The City receives 1% of the sales tax from purchases at our local retail businesses, receiving one cent of every dollar of taxable sales occurring in Lake Forest. The City's sales tax base is highly diversified, protecting the City from sudden revenue losses from a downturn in any one industry sector.

Due to the pandemic, the shift to online shopping which began several years ago has accelerated faster than the State can determine a "modern" methodology to allocate online sales tax. While sales taxes from online sales are remitted to a countywide pool, the City receives only a proportionate share based on a methodology that does not include point of delivery. The good news is the implementation of the Wayfair decision, which allows states to charge tax on purchases made from out-of-state sellers (even those without a physical presence in state), has resulted in an increase in sales taxes allocated to the countywide pool which, in turn, is allocated to the City.

TRANSIENT OCCUPANCY TAXES:

Transient occupancy taxes ("TOT"), also referred to as hotel taxes, have continued to grow as new hotels are built in Lake Forest. There is now a total of 14 hotels in the city. Between 2013 and 2019, TOT increased by 38% to \$3.88 million. During 2020-2021, TOT revenue decreased by 28% due to the emergence of the coronavirus (COVID-19). In 2022, TOT increased by 86% to a new high of \$5.2 million.

Table 3 - 14-YEAR PROGRESSIVE REVENUE SOURCE TABLE

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Property Tax	13.20	12.87	12.52	12.52	14.01	14.56	14.98	15.56	16.65	17.65	19.75	20.70	22.30	23.70
Dollar Change	0.18	(0.33)	(0.35)	0.00	1.49	0.55	0.42	0.58	1.09	1.00	2.10	0.95	1.60	1.40
Percentage Change	1.38%	-2.50%	-2.72%	0.00%	11.90%	3.93%	2.88%	3.87%	7.01%	6.01%	11.90%	4.80%	7.73%	6.28%
Sales Tax	12.48	10.91	12.63	13.05	13.06	13.33	13.81	15.43	15.64	16.05	17.10	15.75	17.20	19.00
Dollar Change	(2.73)	(1.57)	1.72	0.42	0.01	0.27	0.48	1.62	0.21	0.41	1.05	(1.35)	1.45	1.80
Percentage Change	-17.95%	-12.58%	15.77%	3.33%	0.08%	2.07%	3.60%	11.73%	1.36%	2.62%	6.50%	-7.90%	9.21%	10.47%
Transient Occupancy Tax	2.23	1.94	2.44	2.67	2.82	3.14	3.41	3.58	3.78	3.81	3.88	2.90	2.80	5.20
Dollar Change	(0.58)	(0.29)	0.50	0.23	0.15	0.32	0.27	0.17	0.20	0.03	0.06	(1.00)	(0.10)	2.40
Percentage Change	-20.64%	-13.00%	25.77%	9.43%	5.62%	11.35%	8.60%	4.99%	5.59%	0.79%	1.71%	-25.77%	-3.45%	85.71%

New hotels are drawn to Lake Forest to serve non-leisure travel. In other words, these hotels are serving the business community and tend to be booked on weekdays. Because these hotels are not related to tourism, this revenue is vulnerable to downturns in the economy along with the shift to virtual meetings.

TAX REVENUE DIVERSITY:

A secondary vulnerability to the City's revenue sources is lack of revenue diversity. Lake Forest is heavily dependent upon three tax revenues: property taxes, sales taxes, and TOT. For example, cities with limited public parking, such as beach cities and cities with vibrant commercial districts, receive large amounts of revenue from parking meters, parking structures and parking citations. Utility users taxes and business license taxes are also common General Fund revenue resources. Lake Forest does not collect any of these taxes.

Cities with a less diversified base of General Fund revenue will require a greater amount in reserves to weather a downturn in just one revenue area. For FY 2022-23, the City is projected to receive \$60.8 million in General Fund revenue. Of this amount, \$50.6 million is from taxes with the balance of \$3 million from license and permits, user fees, fines and forfeitures and other miscellaneous sources. Of the \$50.6 million tax revenue, \$23.7 million is from property taxes, \$18.75 million is from sales taxes, and \$4.5 million is from transient occupancy taxes. The balance is generated by other taxes such as real property and franchise fees tax. As mentioned earlier, the City cannot increase taxes without voter approval because of Proposition 218. This limits the City's ability to increase taxes should funding shortfalls occur. In short, the City has a narrow base of General Fund tax revenues.

Over the course of the Great Recession, the City lost \$17.20 million of sales tax revenues, \$0.97 million of property tax revenues, and \$.29 million in TOT revenues. In total, the City lost almost \$20.52 million in resources from the beginning of the recession through 2016.

Over the course the Covid-19 Pandemic the City lost \$1.35 million of sales tax revenues, had growth of \$0.95 million of property tax revenues, and a loss of \$2.06 million in TOT revenues. In total, the City lost almost \$2.46 million until a full recovery was seen.

	Amount
How stable is the tax base in the face of adverse economic conditions?	\$9,600,000

RISK FACTOR #2 – VULNERABILITY TO EXTREME EVENTS

As it pertains to this risk factor, extreme events are defined as extreme government funding take backs. In other words, the potential for funds that local jurisdictions receive from the state to be withheld.

2a: Is any City revenue source at risk due to State or Federal political action?

Cities have paid a heavy price over the years when the State faced on-going fiscal challenges. Tax shifts, borrowing and other taking of certain funds allocated to local governments began in the 1990's with the Educational Revenue Augmentation Fund ("ERAF") I and II shift, followed by a number of other actions. To this day, the original ERAF shifts remain in place.

<u>Risk Factor #2a Vulnerability To Extreme Events - Political</u>	Reserve Amount
Is any City revenue source at risk due to State or Federal political action?	\$1,000,000

Governor Brown initiated and carried out the dissolution of redevelopment, which redirected funds from local governments to school districts. In January 2019, Governor Newsom threatened to withhold Senate Bill 1 Gas Tax revenue to cities not seeking to increase affordable housing. While Senate Bill 1 funding does not flow through the General Fund, any taking of these funds will compromise the City's ability to continue to maintain City streets in a "good" pavement condition. In 2020, Governor Newsom tied the use of CARES Act funds, of which the City received \$1,045,000, to compliance with California Department of Public Health guidance and Blueprint for a Safer Economy.

Risk Factor #2b Is the City susceptible to disaster? What is the level of insurance?

The City's Southern California location is susceptible to earthquakes and wildfires. Incorporated in 1991, the City has never suffered severely from a natural disaster. However, the City is not immune to such a circumstance and has previously experienced losses from winter storm damage. During the winter storms in 2019, the City incurred costs of approximately \$500,000. Wildfires in past years have occurred along city borders. In 2020, the Orange County Sheriff issued mandatory evacuations in Lake Forest due to the Silverado fire and Bond fire. Fortunately, the City did not experience any injuries or property damage due to these fires. However, fire season starts sooner and lasts longer than in the past.

The City procures insurance through the California Joint Powers Insurance Authority ("CJPIA"). The City's deductible is negligible for any non-earthquake or flood related loss at any City facility. The City also has earthquake and flood insurance on most City facilities. Earthquake claims have a minimum \$100,000 deductible; however, the deductible could reach as high as 5% of the value of property, which could exceed \$700,000 on some of the City's facilities. Risk of damage from flood or earthquake is considered low and existing insurance coverage is considered robust; however, it would be prudent to set aside an amount approximately equal to the City's deductible for one instance of damage to a City facility in the event of an earthquake.

Another type of disaster could be in the form of a cybersecurity incident. A cybersecurity attack can result in identity theft, extortion attempts, or loss of data. The City services and operations rely heavily on the availability, functionality, and security of technology system and data. Successful cyber-attacks against City technologies and data would have a serious impact on the City's ability to deliver services.

While the City takes cyber security seriously and utilizes a variety of robust tools to prevent cybersecurity incidents, a successful cybersecurity attack is possible. It would be prudent to set aside an amount approximately equal to the City's deductible for one instance of damage due to cyber criminal activity.

Risk Factor #2b Vulnerability to Extreme Events - Disaster	Reserve Amount
Is the City susceptible to natural disaster? What is the level of insurance? <div> <div>Wildfire Damage</div> <div>\$500,000</div> </div> <div> <div>Storm Damage</div> <div>500,000</div> </div> <div> <div>Earthquake</div> <div>700,000</div> </div> <div> <div>Cyber Security</div> <div><u>250,000</u></div> </div> <div> <div></div> <div>\$1,950,000</div> </div>	\$1,950,000

Risk Factor #2c Are there current City services and/or emerging issues that are prone to legal challenges?

Cities spend millions annually responding to lawsuits involving injuries on public property, environmental issues, and a range of other legal challenges. It is difficult to predict when and if the City may be involved in litigation and the costs involved. The GFOA recommends that municipalities have a category in their reserves for cost spikes from legal challenges. Due to the unpredictability of litigation, it is prudent to set aside funds for this purpose.

Risk Factor #2c Vulnerability to Extreme Events - Legal	Reserve Amount
Are there current City services and/or emerging issues that are prone to legal challenge?	\$1,000,000

Risk Factor #2 Vulnerability To Extreme Events - Total	Total Reserve Amount
Are there events related to state or federal action, natural disaster, contract obligations, and issues prone to legal challenge?	\$3,950,000

RISK FACTOR #3 – EXPENDITURE VOLATILITY

What future contractual obligations does the City have that dictate required expenditure levels?

This analysis excludes unfunded liabilities and debt service, which are considered under Risk Factor #4. This risk factor refers to potential spikes in expenditures, usually arising from a special, non-recurring circumstance. These expenses have generally been related to the City paying its proportionate share of a regional system. For example, the City paid \$611,228 for its share of the new Orange County Animal Care Center in 2017. Another example is the City's share of the 800 MHz II radio system in the amount of \$569,821. Each time, the City used cash for its portion of the expense and avoided paying interest. There are no expenditures identified at this time that would be considered special and non-recurring. However, a reserve for unknown special and non-reoccurring expenses is prudent.

Other factors affecting expenditure volatility include sustaining the cost of maintaining the current service levels. In the last budget cycle, a trend of contracts increasing beyond typical CPI levels raised concerns about funding levels progressing at a pace more rapidly than current revenues. Prevailing wage laws can have a significant impact on contract costs. These laws require contractors and subcontractors to pay their workers a predetermined wage rate, typically based on the average wages in a particular region or industry. This, in turn, may result in higher contract prices for public projects, and maintenance as contractors' factor in the higher wages they are required to pay. Consequently, prevailing wage laws can have a direct impact on the budget.

Risk Factor #3 Expenditure Volatility	Reserve Amount
What future contractual obligations does the City have that dictate required expenditure levels?	\$4,000,000

Risk Factor #4 – Leverage

Financial leverage is defined as the use of borrowed funds to purchase assets with the expectation that the return from the transaction will exceed the borrowing cost. A highly leveraged organization has less flexibility. Examples of leverage include long-term debt, pension, and other post-employment healthcare benefit obligations. Reserves are a critical source of financial flexibility, so higher leverage may call for higher reserves. The City has no structured debt obligations, so the City's reserve strategy does not need to account for reduced financial flexibility from debt.

Risk Factor #4a Does the City have debt?

The City has no general fund bonded debt as compared to other Orange County cities shown in Table 4. This table illustrates two commonly used measures of indebtedness. The first, debt per capita, measures the burden placed on citizens by municipal indebtedness. The second measure is debt service (principal and interest payments) as a percent of city non-capital expenditures. This measures the pressure placed on the budget by debt payments. Like a household budget, flexibility in spending is limited by debt payments. Lake Forest proudly sits at zero debt, well below both the average of the debt per capita measure and percent of expenditures measure among the comparative agencies.

Table 4 – City Debt Comparison
(in Millions)

	Lake Forest	Laguna Hills	San Juan Capistrano	Brea	Mission Viejo with Mall Bonds	Aliso Viejo
Debt	0.0	1.3	24.8	42.9	45.4	12.02
Population	86,775	30,750	34,798	46,872	92,515	50,782
Debt per Capita	0.0	\$53	\$474	\$991	\$490	\$237
Debt Service as % of Expenditures	0.0	7.96%	5.14%	0.70%	4.52%	2.44%

<u>Risk Factor #4a Leverage - Debt</u>	Reserve Amount
Does the City have debt?	\$0

Risk Factor #4b Does The City Have Any Pension Unfunded Accrued Liabilities (UAL)?

The City participates in the California Public Employees Retirement System (CalPERS). As of June 30, 2021, the pension plan funded status for classic CalPERS employees is 106.7% funded, while the pension plan funded status for PEPRAs employees is 105.7% funded. New unfunded liabilities can emerge in future years due to assumption or method changes, changes in plan provisions, and actuarial experience different than assumed. The unfunded liability fluctuates based on the gains or losses of CalPERS investments and is anticipated to return to the funded status of prior years' high ninety percentile. Due to current assumptions, there are no unfunded liability payments in Fiscal Year 2023-24. Approximately 45% of Lake Forest employees are classic CalPERS members. Given the uncertainty around pension issues, it is difficult to say when increases would occur or how much they might be, especially when the pension board makes changes to pension assumptions that negatively impact the pensions funded status. Accordingly, it would be prudent to set aside reserves to help make a more gradual adjustment to any potential large increase in contribution rates. See Table 5 for a list of unfunded actuarial liabilities ("UAL") in neighboring cities.

City of Lake Forest
2023 General Fund Reserve Risk Analysis
June 2023

Table 5 – Unfunded Pension Accrued Liabilities
Comparison to Neighboring Cities

City	Normal Costs (FY 22-23)	UAL Payment (FY 22-23)	PERS Projected Covered Payroll (FY 22-23)	Total Percentage of Payroll	Unfunded Liability Balance (FY 22-23)	Average Balance of Unfunded UAAL Outstanding (End of FY 20/21)
Aliso Viejo	250,489	101,859	2,661,726	13%	347,790	-1%
Brea	3,613,979	12,075,583	28,421,350	55%	107,518,973	22%
Dana Point	596,978	577,579	6,135,478	19%	3,927,826	4%
Laguna Niguel	604,845	823,686	6,711,612	21%	6,337,275	4%
Laguna Hills	310,761	405,469	3,391,700	21%	2,706,650	4%
Lake Forest	625,415	100,875	6,365,381	11%	(2,966,596)	-6%
Mission Viejo	1,388,240	2,161,927	12,484,176	28%	11,377,815	12%
Rancho Santa Margarita	245,253	166,415	2,644,150	16%	1,073,815	3%
San Clemente	1,619,269	2,773,043	16,998,513	26%	16,370,929	8%
Yorba Linda	1,245,375	2,034,470	11,499,309	29%	15,046,865	19%
Average Amounts	1,050,060	2,122,091	9,731,340	24%	16,174,134	7%

Risk Factor #4b Leverage – Pension Unfunded Liabilities	Reserve Amount
Does the City have unfunded accrued liabilities (UAL)?	\$3,000,000

Risk Factor #4c Does The City Have Any Additional Unfunded Accrued Liabilities?

The City also provides healthcare post-employment benefit. See Table 6 for a list of unfunded other post-employment benefits (“OPEB”) in neighboring cities.

**Table 6 – Unfunded Other Post-Employment Benefits Accrued Liabilities
Comparison to Neighboring Cities**

City	Accrued Liability	Fund Assets	Plan Net Unfunded Liability	Percentage of Total
Aliso Viejo	544,976	-	544,976	0%
Brea	29,180,581	(1,075,299)	30,255,880	-4%
Dana Point	1,397,265	(269,585)	1,666,850	-19%
Laguna Niguel	2,726,547	980,135	1,746,412	36%
Laguna Hills	-	-	-	0%
Lake Forest	1,155,283	620,230	535,053	54%
Mission Viejo	10,527,599	12,664,140	(2,136,541)	120%
Rancho Santa Margarita	856,773	(142,899)	999,672	-17%
San Clemente	4,321,810	1,443,015	2,878,795	33%
Yorba Linda	17,030,082	1,633,785	15,396,297	10%
Average Amounts	6,774,092	1,585,352	5,188,739	21%

Risk Factor #4c Leverage – Additional Unfunded Liabilities	Reserve Amount
Does the City have additional unfunded accrued liabilities (UAL)?	\$1,250,000

Risk Factor #4 Leverage	Total Reserve Amount
Are there events related to state or federal action, natural disaster, contract obligations, and issues prone to legal challenge?	\$4,250,000

Risk Factor #5 – Liquidity

What are the cash flow needs of the City?

Cities have consistent, year-round expenses, yet major revenues are received periodically. Some amount of fund balance reserves is needed to avoid cash flow problems caused by an uneven stream of revenue. As reported earlier, property tax revenue is the City's largest revenue source. The majority of property tax revenue is received in December, January, April, and May each fiscal year. This means that cash outflow could exceed cash inflow for eight months out of the fiscal year. If there were insufficient reserves, the City would have to borrow funds to cover the cash needed for the first half of the fiscal year.

Halfway through the fiscal year, which is December 31st, it would be expected that 50% of expenditures and revenues have been spent and received. However, typically 35% of revenues have been received, while 50% of expenditures have been spent.

Based on this analysis, by December 31st, the City generates an \$8 million differential between revenues and expenditures before beginning to receive sufficient revenue resources to adequately offset monthly disbursements. Over the City's history, the amount of negative cash flow has fluctuated annually. Therefore, a conservative reserve is necessary to ensure the City's "bills" are paid on a timely basis and avoids the need to engage in short-term borrowing for cash flow purposes.

Risk Factor #5 Liquidity	Reserve Amount
What are the cash flow needs of the City?	\$8,000,000

Risk Factor #6 – Other Fund Dependency

What other funds have a significant dependence on the General Fund?

Risk Factor #6a – Other Fund Short Term Borrowing

Two City funds that have dependency on the General Fund by way of annual subsidies for timing of cash flow purposes: Community Development Block Grant (“CDBG”) and Measure M2. These amounts can fluctuate from year to year.

The City is a regular recipient of grant and developer fee funding, specifically for capital improvement program (“CIP”) projects. A common characteristic of grant and developer fee funding is that most awarding agencies expect that project expenditures be incurred before requests for reimbursement are submitted to the granting agency. Essentially, most grants are on a reimbursement basis. Provided grant regulations are followed, the City will be repaid for these expenditures. However, there is a timing difference in which the General Fund will advance funding for these projects.

Looking historically at the last five fiscal years, funds for CDBG projects, Measure M2, and other miscellaneous grants have “borrowed” General Fund resources for project expenditures.

A reserve for fund dependence will ensure the City does not lose an opportunity for grant funding due to the timing of a reimbursement.

Risk Factor #6a Other Fund Dependency Short Term Borrowing	Reserve Amount
<i>What other funds have a significant dependence on the General Fund?</i>	\$1,000,000

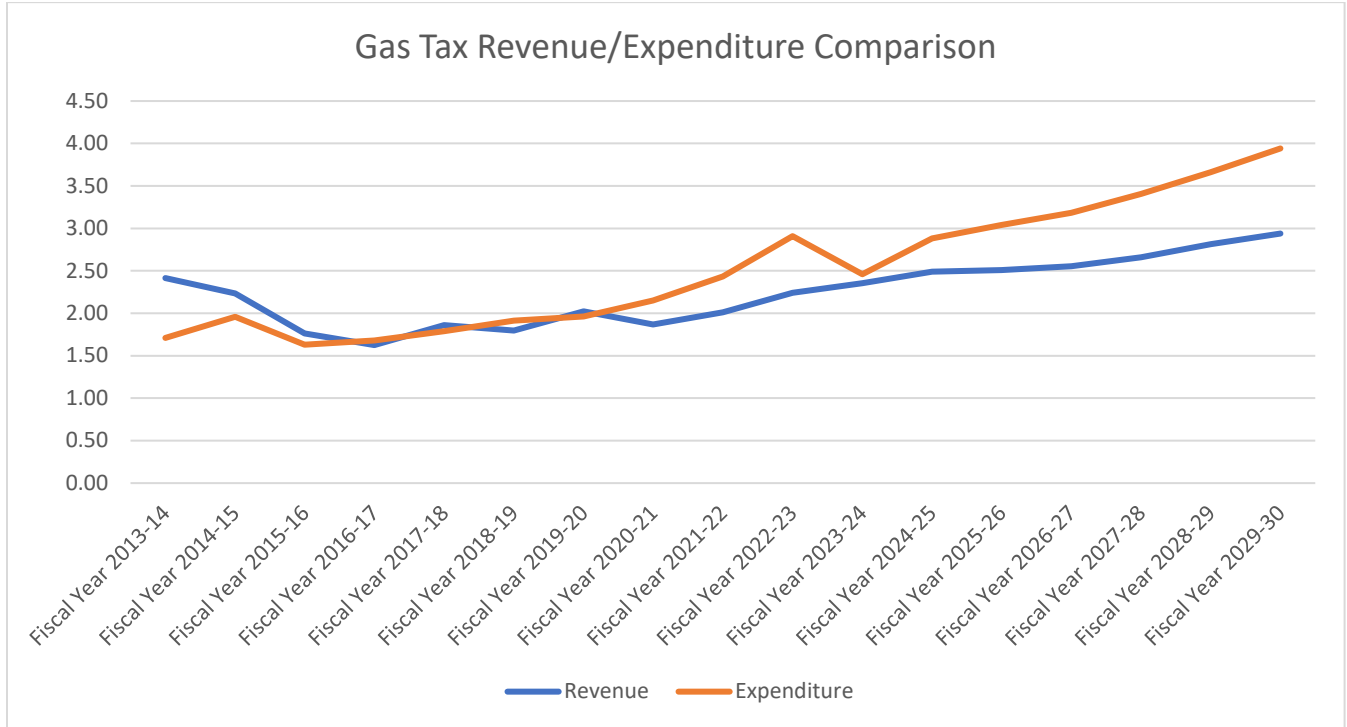
Risk Factor #6b – Other Fund Annual Subsidy

The City pays for the majority of contract street maintenance services with State Gas Tax HUTA resources. Contract street maintenance services include day-to-day street maintenance repair work and biennial citywide street striping. The cost of the current service level for bi-annual striping cannot be maintained by the Gas Tax HUTA resources at this time. Historically, contractual street maintenance services remained within budget despite recent declines in State Gas Tax HUTA revenue. However, historical trends show this is not viable in future years.

Statewide, Gas Tax HUTA funds are projected to be flat or decrease slightly in the near term due to the increased public reliance on electric vehicles and reduced gas consumption related to the telecommuting policies popularized during the COVID-19 pandemic. As a result, many local governments will likely need to adjust their traditional reliance on Gas Tax HUTA funds to cover the costs of road maintenance activities.

Over the next seven-year financial forecast range, if the City chooses to maintain the current service level, a \$4.3 million subsidy will be needed for funding as shown in Table 7. This graphic utilizes the last ten fiscal years of actuals and projected budget to form a trend of expected funding and expenditures.

Table 7 – Anticipated Gas Tax Shortfall



Based on this analysis it would be prudent to reserve this level of funding for future uses in order to maintain service levels.

Risk Factor #6b Other Fund Dependency Annual Subsidy	Reserve Amount
<i>What other funds have a significant dependence on the General Fund?</i>	\$4,300,000

Risk Factor #6 Other Fund Dependency	Reserve Amount
<i>What other funds have a significant dependence on the General Fund?</i>	\$5,300,000

Risk Factor #7 – Growth

What new program areas will be required in the future and how will the City pay for these?

The City has a significant contract with the Orange County Sheriff's Department (OCSD) that provides the City limited flexibility as to the scope and costs. In recent years, new OCSD programs, along with increasing pension costs, have resulted in sharp increases in contract costs. Program costs previously added to the City's OCSD contract include the Lake Forest sub-station, the Field Training Bureau ("FTB"), and body-worn cameras. OCSD contract information for previous fiscal years are summarized in Table 8.

Table 8 – OCSD Contract by Fiscal Year

Fiscal Year	Contract Amount	Increase from Prior Year	Percentage Increase	Percentage of General Fund
2014-15	\$13,336,803	-	-	35.08%
2015-16	14,210,900	874,097	6.55%	35.41%
2016-17	14,869,720	658,820	4.64%	34.70%
2017-18	16,134,298	1,264,578	8.50%	34.85%
2018-19	17,062,663	928,365	5.75%	36.00%
2019-20	17,659,961	597,238	3.5%	35.68%
2020-21	18,348,264	335,384	3.9%	39.46%
2021-22	19,003,498	655,234	3.6%	37.10%
2022-23	19,707,131	703,633	3.7%	37.44%
2023-24*	20,890,858	1,183,454	6.0%	35.00%

*As of preparation of analysis, the contract amount is proposed.

At the time of this analysis, the estimate from OCSD for the FY 2023-24 fiscal year is \$20.9 million, a 6% increase over the 2022-23 contract. Contract costs are also influenced by the current collective bargaining agreement between the Orange County Board of Supervisors and Deputy Sheriffs.

The OCSD contract is a recurring annual contract and should not normally be addressed through reserves. However, it is prudent to set aside funds for use during an economic crisis because: (1) the City cannot significantly modify the

terms of the law enforcement contract; (2) the City cannot quickly raise additional revenues and, (3) the City cannot control mid-contract increases. This reserve should be able to fund two years of contract fluctuations in order to maintain a high level of service at an additional \$1.0 million per year.

Risk Factor #7 Growth	Reserve Amount
<i>What new program areas will be required in the future and how will the City pay for these?</i>	\$2,000,000

CAPITAL RISK FACTORS

Risk Factor #8 – Capital Projects – Infrastructure & Replacement

Does the City have any infrastructure and capital asset replacement needs?

The term capital assets is used to describe assets that are used in operations and have initial useful lives extending beyond a single reporting period. Capital assets include facilities, infrastructure, equipment, and networks that enable the delivery of municipal services. The performance and continued use of these capital assets is essential to the health, safety, economic development, and quality of life of a community.

In some agencies, budgetary pressures can impede capital program expenditures or investments for maintenance and replacement. This is especially true for local governments that do not prepare a multi-year capital plan or properly consider the impact of capital projects on the operating budget. This lack of investment makes it increasingly difficult to sustain the asset in a condition necessary to provide expected service levels. Ultimately, deferring essential maintenance or asset replacement could reduce the organization's ability to provide services and could threaten public health, safety, and overall quality of life. In addition, as the physical condition of the asset declines, deferring maintenance and/or replacement could increase long-term costs and liabilities.

A target reserve percentage for infrastructure replacement is 5%. There is the option to set up an annual noncash depreciation expense where actual cash is moved from the general fund account to an assigned reserve account for infrastructure replacement. Applying this option to the City would result in the

need to allocate \$6.7 million annually, which is a funding level not currently feasible. Table 9 below is a summary of depreciating assets.

The City has \$142.5 million in depreciable non-infrastructure capital assets. Of this amount, \$100.4 are categorized as buildings and improvements, \$37.5 improvements other than buildings, and \$4.6 million categorized as machinery and equipment. The City's capital assets now reflect the Lake Forest Civic Center which opened in December 2019.

Table 9 – SUMMARY OF COMBINED INFRASTRUCTURE ASSETS/CAPITAL ASSET REPLACEMENT

Summary of Assets					
	Infrastructure	Building and Improvements	Improvements other than Building	Machinery and Equipment	Total
Capital Assets Being Depreciated	265,060,622	100,421,374	37,453,286	4,550,741	407,486,023
Accumulated Depreciation	150,007,332	10,367,541	9,551,939	4,427,114	174,353,926
Net Book Value	115,053,290	90,053,833	27,901,347	123,627	233,132,097
Depreciation Expense	6,728,993	3,937,228	1,350,367	96,080	12,112,668
Annual Depreciation percentage	2.54%	3.92%	3.61%	2.11%	2.97%
Target Reserve Percentage	5%	10%	10%	10%	-
Target Reserve	\$ 13,253,031	\$ 10,042,137	\$ 3,745,329	\$ 455,074	\$27,495,571

The City's 2023-2030 Capital Improvement Plan includes the use of \$6.5 million of general fund resources. The planned capital spending can be met on a pay-as-you-go basis with the operating surplus' anticipated during the seven-year financial forecast. As a result, no reserve for capital is necessary during the seven-year financial forecast period to meet the capital needs as currently

planned. In order to refine the amount identified to set aside for capital asset replacement, the City is in the process of developing an asset management plan. The asset management plan will be a transformative and accurate tool the City can use to financially plan for the continued maintenance of all City assets. By considering the City's maintenance and replacement needs in advance, it allows the City to determine an annual amount capital asset replacement.

During the current development of this plan, it is prudent to reserve funding for these future needs.

Risk Factor # 8 Capital Projects – Infrastructure & Replacement	Reserve Amount
<i>Does the City have any infrastructure and capital asset replacement needs?</i>	\$27,500,000

SUMMARY OF RESERVE LEVELS PER RISK FACTOR

Eight risk factors have been analyzed to ascertain what constitutes a prudent reserve level for the City of Lake Forest. Table 10 demonstrates the results of each analysis. Risk factor 5 – Liquidity has not been used in calculating the target reserve level. For liquidity, the resources needed overlap with the other risk factors. As long as there is at least \$8.0 million in reserves as a result of all the other factors combined, this same \$8.0 million could be used to satisfy cash flow needs.

Table 10 – RESERVE LEVELS PER RISK FACTOR

1	Revenue Source Stability	\$9.60
2a	Vulnerability to Extreme Events - Political	1.00
2b	Vulnerability to Extreme Events - Disaster	1.95
2c	Vulnerability to Extreme Events – Legal	1.00
3	Expenditure Volatility	4.00
4a	Leverage-Debt Service	0.00
4b	Leverage- Pension Unfunded Liabilities	3.00
4c	Leverage – Other Unfunded Liabilities	1.25
6a	Other Fund Dependency – Short Term	1.00
6b	Other Fund Dependency – Annual	4.30
7	Growth	2.00
8	Capital Projects -Infrastructure & Replacement	27.5
	Total	\$56.6
	% Based on Projected 2023-24 Revenue	89.4%
	Optional Factors Not Used in Calculation	
5	Liquidity	8.00

Therefore, the Target Reserve Level is set at \$56.6 million with a Minimum Reserve Level set at \$53.77 million (5% below the Target Reserve amount).

CONCLUSION

The City’s Risk Reserve Policy is a component of the City’s Financial Management and Budgetary Policy which establishes financial parameters to guide the development of the budget. The desired policy outcome is that the long-term implications of financial decisions are fully understood and considered in the decision-making process. Accordingly, the General Fund Risk Reserve Analysis provides a funding plan that analyzes the risks that influence the level of reserves the City needs to protect the organization against uncertainty and loss.

Lessons learned by municipalities after the Great Recession, coupled with California municipal revenue raising restrictions, emphasize the importance of establishing reserves. More recently, the COVID-19 pandemic demonstrated how reserves are used to reduce the budgetary impacts of economic downturns and continue the delivery of basic services during an unforeseen emergency.