



CITY COUNCIL AGENDA REPORT

MEETING DATE: 6/6/2023

DEPARTMENT: Finance

SUBJECT:

MISCELLANEOUS BUDGET ITEMS

RECOMMENDED ACTION(S):

1. Receive presentations on the Financial Management and Budgetary Policy and General Fund Reserve Risk Analysis.
 2. Approve the proposed changes to the City's Financial Management and Budgetary Policy.
 3. Review and provide feedback regarding the General Fund Risk Reserve Analysis.
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EXECUTIVE SUMMARY:

The Financial Management and Budgetary Policy was originally adopted in October of 2020. The City Council reviews this policy during each budget development process and considers any staff-recommended revisions with the adoption of the budget. Staff has conducted this review and suggests the following revisions detailed in Table 1 below.

Table 1: Suggested Revisions to Financial Management & Budgetary Policy

Policy Section	Suggested Revision(s)
2h/2l (Attachment 1)	Align policy with City's new Program Based Budgeting approach
4c	Align policy with proposed revisions in the General Fund Risk Reserve analysis
4k	Define a target level of funding for the City's pension plan in conjunction with the General Fund Risk Reserve analysis
4l	Define a target level of funding for the City's Other Post Employment Benefit ("OPEB") plan in

	conjunction with the General Fund Risk Reserve analysis
9a/b	Align policy with City's Statement of Investment Policy

Staff recommends the City Council approve all proposed changes to the Financial Management and Budgetary Policy. These changes are described in blue and yellow highlighted text in Attachment 1.

In addition, a Risk Analysis was performed in coordination with the development of the operating budget (Attachment 2). The City's Risk Based Reserve is designed to develop standards for setting reserve levels for various significant City funds. Adequate reserve levels are a necessary component of the City's overall financial management strategy and a key factor in external agencies' measurement of the City's financial strength.

The draft Risk Analysis recommends a \$56.6 million Target Reserve Level and a Minimum Reserve Level of \$53.77 million (5% below the Target Reserve amount). The two most significant changes to the recommended reserves are to the Expenditure Volatility and Other Fund Dependency-Annual risk categories. These recommended reserve increases are due to the inflationary pressures increasing contract service costs and diminishing fuel tax-related revenues due to the rising popularity of electric vehicles.

Staff recommends the City Council review and provide feedback regarding the General Fund Risk Reserve Analysis. The Risk Analysis and Target Reserve Level will be presented for final adoption at the June 20, 2023, City Council meeting alongside the 2023-2025 Operating Budget.

BACKGROUND:

The Financial Management and Budgetary Policy was originally adopted in October of 2020. The City Council reviews this policy during each budget development process and considers any recommended revisions with the adoption of the budget. Table 2 summarizes the history and purpose of the Financial Management and Budgetary Policy.

Table 2: Financial Management and Budgetary Policy

Policy/Process	First Adopted	Last Revision	Purpose
Financial Management and Budgetary	10/20/2020	01/03/2023	Provides the framework and direction for financial planning and decision

			making by the City Council and staff.
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The Risk Analysis is performed biennially in coordination with the development of the operating budget. The City's Risk Based Reserve is designed to develop standards for setting reserve levels for various significant City funds. Adequate reserve levels are a necessary component of the City's overall financial management strategy and a key factor in external agencies' measurement of the City's financial strength.

Established reserves will be based on an analysis of the risks that influence the needs for reserves as a hedge against uncertainty and loss. A risk is defined as probability and magnitude of a loss, disaster, or other undesirable event. The Risk Analysis will review the following risk factors and the City's level of exposure to each risk factor impacting the City's General Fund.

The eight required risk factors per the Policy are:

1. Revenue Source Stability
2. Vulnerability to Extreme Events
3. Expenditure Volatility
4. Leverage
5. Liquidity
6. Other Fund Dependency
7. Growth
8. Capital Projects – Infrastructure & Asset Replacement

The Risk Analysis identifies the reserve level for each risk factor and the recommended Target General Fund Reserves based on all risk factors. Pursuant to the Financial Management and Budgetary Policy, the Total Minimum Reserve shall be established 5% below the Target General Fund Reserve Level. Also, the Target General Fund Reserves and Total Minimum Reserve must be established and updated by resolution based on each biennial analysis. Finally, spending beyond the Total Minimum Reserve requires a four-fifths vote of the City Council.

DISCUSSION:

Financial Management and Budgetary Policy

As stated in the policy, the City Council reviews this policy during each budget development process and considers any recommended revisions with the

adoption of the budget. Staff is recommending updates to the policy as well as correcting minor errors.

The most recent review and adoption of the Financial Management and Budgetary Policy was on January 3, 2023. Unfortunately, the incorrect attachment was provided along with the staff report that was distributed ahead of the City Council's consideration of these changes. As a result, staff are proposing two categories of changes to the Financial Management and Budgetary Policy for the City Council's consideration (Attachment 1).

The first category of staff-proposed changes is highlighted in yellow. These changes would modify the Financial Management and Budgetary Policy to what should have been attached to the City Council staff report ahead of January 3, 2023 meeting. These yellow-highlighted changes simply correct the clerical error made in compiling the agenda document for the January 3, 2023, City Council meeting.

The second category of staff-proposed changes highlighted in blue are newly proposed revisions as outlined in Table 2.

Table 2: Summary of Newly Suggested Revisions

Policy Section	Suggested Revision(s)
2h/2l (Attachment 1)	Align policy with City's new Program Based Budgeting approach
4c	Align policy with proposed revisions in the General Fund Risk Reserve analysis
4k	Define a target level of funding for the City's pension plan in conjunction with the General Fund Risk Reserve analysis
4l	Define a target level of funding for the City's OPEB plan in conjunction with the General Fund Risk Reserve analysis
9a/b	Align policy with City's Statement of Investment Policy

As required by the Financial Management and Budgetary Policy, the City maintains a Pension Employer Contribution Stabilization Trust Fund and an Other Post-Employment Benefits Trust Fund as part of its risk-based reserve approach. The City has established a trust with Public Agency Retirement Services ("PARS") to meet this requirement. The Policy requires an update on the balance of the available resources and any recommendations for the budget

period. The PARS annual report is attached, which provides the required annual update (Attachment 3).

4k – Pension

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 investment return assumptions 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.

4l - OPEB

In connection with the pension retirement benefits for employees, the City is required to contribute to an Other Post Employment Benefit (“OPEB”) plan to provide postemployment health-care benefits through the California Public Employees Medical and Hospital Care Act (PEMHCA). These benefits are available to employees who meet the CalPERS eligibility requirement and also retire from the City. The retiree is entitled to participate in the City-sponsored medical plan, and the City contributes up to \$143 per month toward the premium for employee-only coverage under the City sponsored medical plans.

According to the latest Financial Statements issue for the City, the current OPEB funded status is 54%. The average OPEB funded status of the 10 comparable agencies in the City’s Risk Analysis is 21% (Attachment 2). It would be prudent to set aside reserves to fund this liability related to OPEB. Staff is recommending a target of 100% funded status of the OPEB Plan and to make any ongoing annual required contributions based on the most recent actuarial valuation of the OPEB Plan.

Given the uncertainty around pension and OPEB issues, it is difficult to determine when increased employer liabilities (the financial contribution requirements of employers) will occur or how much they might be.. Accordingly, it would be prudent to set aside reserves to help make a more gradual adjustment to any potential large increase in contribution rates.

General Fund Risk Reserve Analysis

The Risk Analysis should be performed biennially in coordination with the development of the operating budget. The City's Risk Based Reserve is designed to develop standards for setting reserve levels as detailed in Table 4.

The City's Risk Reserve Policy (Attachment 2) 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.

Table 4: Reserve Levels Per Risk Factor

Policy Section	Risk Factor	2021 Analysis	2023 Analysis
1	Revenue Source Stability	\$7.8	\$9.60
2a	Vulnerability to Extreme Events - Political	1.0	1.00
2b	Vulnerability to Extreme Events - Disaster	1.7	1.95
2c	Vulnerability to Extreme Events – Legal	1.0	1.00
3	Expenditure Volatility	1.0	4.00
4a	Leverage-Debt Service	0.00	0.00
4b	Leverage- Pension Unfunded Liabilities	3.00	3.00
4c	Leverage – Other Unfunded Liabilities	0.00	1.25
5	Liquidity	8.00	8.00
6a	Other Fund Dependency – Short Term	1.00	1.00
6b	Other Fund Dependency – Annual	0.00	4.30
7	Growth	1.00	2.00
8	Capital Projects -Infrastructure & Replacement	26.80	27.50
	Total Reserve Per Risk Factor	\$52.30	\$64.60
	Optional Factors Not Used in Calculation		
5	Liquidity	0.00	(8.00)
	Target Reserve Level	\$52.30	\$56.60
	Minimum Reserve Level	\$49.70	\$53.77

	(5% below)		
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The draft Risk Analysis recommends a \$56.6 million Target Reserve Level and a Minimum Reserve Level of \$53.77 million (5% below the Target Reserve amount). Changes between the prior 2021 Risk Analysis and the 2023 Risk Analysis are detailed below.

Revenue Source Stability: Proposed increased reserve level due to the growing revenue base.

Vulnerability to Extreme Events – Disaster: Proposed increased reserve level due to increased exposure to criminal cyber activity.

Expenditure Volatility: Proposed increased reserve level due to a trend of contract increases beyond typical CPI-based levels to maintain current services. This represents one of the biggest increases in reserves proposed as inflationary pressure is impacting contract service costs.

Leverage- Pension Unfunded Liabilities: Proposed increased reserve level to make a more gradual adjustment to any potential large increase in contribution rates.

Leverage – Other Unfunded Liabilities: Proposed increased reserve level to make a more gradual adjustment to any potential large increase in contribution rates.

Other Fund Dependency – Annual: Proposed increased reserve levels due to the annual subsidy needed to maintain street maintenance service levels while gas tax revenues are diminishing. A significant reserve increase is recommended for this risk factor category, as the shift to electric vehicles is having an impact on taxes related to fuel consumption.

Growth: Proposed increased reserve levels to maintain Orange County Sheriff's Department contract for a total of two years.

Capital Projects -Infrastructure & Replacement: Proposed increased reserve levels for the funding of future asset management plan replacement needs.

Optional Factor not used in determining Target Reserve - Liquidity: 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.

This proposed risk reserve growth helps to ensure funds are available for capital projects, asset replacement, and emerging issues that may result in significant

future expenditures. It also represents a more dynamic, transparent, and effective budgeting tool to help the City Council and staff determine the appropriate level of funding.

Staff recommends the City Council approve all proposed changes to the Financial Management and Budgetary Policy. Staff also recommends the City Council review and provide feedback regarding the Risk Analysis. The Risk Analysis and Target Reserve Level will be presented for final adoption at the June 20, 2023, City Council meeting alongside the 2023-2025 Operating Budget.

FISCAL IMPACT:

There is no fiscal impact associated with the recommended action.

ATTACHMENTS:

1. Financial Management Budgetary Policy
2. Risk Reserve Analysis
3. PARS Annual Report

Initiated By: Amy Lewis, Assistant Director of Finance

Submitted By: Kevin Shirah, Director of Finance/City Treasurer

Approved By: Debra Rose, City Manager