Special Report

Impact of Management Practices on Municipal Credit

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■ Summary

Management has always been viewed as a crucial component of credit analysis at all levels of government. However, in conjunction with our analysis of historical municipal bond performance, Fitch IBCA has come to the conclusion that management practices are even more important to predicting favorable credit performance than had been appreciated in the past. In its future rating assignments, Fitch IBCA will place greater and more specific weight on management practices, both good and bad, that are employed by issuers in running their financial operations.

This report discusses those management practices Fitch IBCA believes are conducive to strong creditworthiness and those that are detrimental to financial soundness. In our current review of outstanding general obligation and tax-backed ratings, Fitch IBCA is giving more positive credit rating weight to issuers that employ a number of these best practices, and will result in a significant number of rating upgrades when our review is completed later this spring. Going forward, Fitch IBCA will continue to study ways to specify and quantify the value of "best practices" so that management can be more objectively evaluated in assigning ratings.

■ Background

Rating agencies have always given consideration to financial management practices in assigning bond ratings. Policies that call for contingency operating reserve funds, pay-as you-go capital spending, and multiyear budgeting have been encouraged, although their rating value has been left vague in rating agencies' guidelines. In the same spirit, the achievement of budgeting and financial reporting awards by organizations like the Government Finance Officers Association (GFOA) generally have been lauded by rating agencies but given the same lukewarm response as to their value for ratings. Most rating adjustments for management reasons have occurred on a case-by-case basis, rather than by consistent benchmarks that describe their worth in an issuer's ultimate rating assignment.

In analyzing actual financial crises over the past 25 years, it is clear that management has had a significant impact in salvaging, as well as exacerbating situations. In the 1970s, New York City had more than its share of economic problems with declining population, employment, and property values. The financial crisis, however, was precipitated by cash basis accounting, excessive short-term debt, poor management decisions, lack of internal controls, overspending, and poor record keeping. The default by the Washington Public Power Supply System was as much a result of unrealistic projections as it was of a national shift away from nuclear power generation to conservation as a means of addressing energy shortages. Finally, the inappropriately speculative investment strategy and lack of internal controls in Orange County caused the huge investment losses that led the county to seek bankruptcy protection. On the positive side, fiscal discipline and strong management practices have significantly benefited credits. Baltimore, MD has been faced with long-term economic erosion, and urban flight as much as any center city in the U.S. However, the city's budgets are consistently balanced, and its bond ratings have remained in the upper end of the 'A' category by all three major rating agencies. The cities of Detroit and New York have also employed management practices that have resulted in enhanced credit quality.

So, what does this all mean? It means that management practices and policies can add stability to weak credits, maximizing their credit rating potential. Conversely, it also shows that weak financial management can negatively impact even the strongest economies and local government structures. In the extreme, poor management can cause rating downgrades to below investment grade, and, on rare occasions, bankruptcy or missed debt service payments.

■ Best Practices

Best practices promoting efficiency in government and solvency in public finance have been identified or disseminated by the GFOA; the National Associations for State Auditors, Controllers and Treasurers, and Budget Officers; the National Association of Counties; and the International Association of City Managers. In 1997, the National Advisory Council on State & Local Budgeting (NACSLB) was created by these and numerous other government organizations and business leaders. NACSLB published a report of approximately 60 best practices in budgeting and financial management for state and local government in 1998. Its recommendations form the basis of many of the financial management practices that Fitch IBCA recognizes as superior and considers in the credit rating process.

Not all of NACSLB's best practices deal with financial management, many deal with taxpayer communications or assessing programs and services. Fitch IBCA believes that if taxpayers understand the services governments provide, they may be less likely to propose restrictive initiatives or to force dramatic political or management changes through the electoral process. The list below represents those financial management practices in the government sector that Fitch IBCA believes to have the most value in credit analysis.

Best Practices Having Significant Rating Value for Fitch IBCA

1. Fund balance reserve policy/working capital reserves.
2. Multiyear financial forecasting.
3. Monthly or quarterly financial reporting and monitoring.
4. Contingency planning policies.
5. Policies regarding nonrecurring revenue.
6. Depreciation of general fixed assets.
7. Debt affordability reviews and policies.
8. Pay-as-you-go capital funding policies.
9. Rapid debt retirement policies of more than 65% in 10 years.
10. Five-year capital improvement plan integrating operating costs.
11. Financial reporting award (GFOA, ASBO).
12. Budgeting award (GFOA, ASBO).

GFOA – Government Finance Officers Association.
ASBO – Association for School Budgeting Officers.

Fund Balance Reserve Policy/Working Capital Reserves

Maintaining an operating reserve or "rainy day fund" is perhaps the most effective practice that can enhance an issuer's credit rating. Financial reserves may be used to address unanticipated revenue shortfalls or unanticipated expenditures. This provides a first defense against deficit spending and helps maintain liquidity when budgeted drawdowns are inevitable. The appropriate size of such a reserve depends on the potential variability of the entity's revenues and expenses, as well as its working cash needs to handle seasonality of revenue or expenditure.

Governments may issue cash flow notes — tax anticipation notes or revenue anticipation notes — where revenue receipts and/or expenditure disbursements are uneven throughout the fiscal year or mismatched with one another. In such cases, short-term borrowings can be an effective tool to even out lumpy or unbalanced cash flows. However, in a number of instances, governments have been forced to borrow sizable amounts due to unanticipated year-end cash and fund balance deficits. For these borrowers, the need for notes in situations of fiscal stress may be an indication of weakened credit quality and a leading cause of downgrades. Issuers that can meet their seasonal cash needs from working cash on hand can avoid all of the potential problems that might be created from issuing notes in finance shortfalls.

Multiyear Financial Forecasting

The concept of forecasting operating revenues and expenditures over several years has generally developed from issuers that have experienced severe fiscal stress and come under the oversight of financial control boards, such as the cases of New York City, Washington, D.C., and Philadelphia. In the cases of New York and Philadelphia however, multiyear financial forecasting has had longer term beneficial effects long after the financial crises had passed. The multiyear plan's value is to anticipate future challenges that may be encountered due to projected revenue and expense imbalances. This allows executives and legislators to "get in front of" potential budget stress, and take corrective action long before budgetary gaps develop into crises. The multiyear plans for New York and Philadelphia serve as good models that can be emulated by local governments, large and small.

Monthly or Quarterly Financial Reporting and Monitoring

Interim financial reporting and monitoring can head off impending fiscal stress if the financial management system is calibrated properly. The best interim reports give details on the major tax and revenue sources of the issuer, with variance analysis that demonstrates the factors that are affecting revenue inflow. Likewise, interim reports that show spending for the current month, year-to-date, comparisons-to-budget, and previous year results to date are also beneficial. For the reports to be most meaningful, the format and basis of reporting of the interim reports should be consistent with either the adopted budget, last year's GAAP results, or both. The quarterly City Manager's Report put out by Philadelphia is an example of excellent interim reporting. In addition to providing updates on service delivery and important management initiatives, the report gives quarterly results on general fund operations, adjusted to GAAP and comparable to the city's annual financial statements.

Contingency Planning Policies

The last thing that municipal credit analysts like to see in a credit are surprises, particularly negative ones. Issuers that demonstrate forward thinking and planning against unforeseen events, including potential revenue shortfalls despite reasonable economic forecasts, are viewed positively. Sometimes, future challenges are not completely unforeseen. Each year, there are a number of voter initiatives in several states where revenue limits or reductions are being contemplated that have the potential to change an issuer's financial flexibility dramatically. Issuers should have meaningful contingency plans against the possibility of voter-ordered tax cuts. Likewise, issuers that are located in zones that are frequently subject to hurricanes should have a reasonable contingency plan for dealing with the financial, economic, and social challenges posed by storm destruction. Early planning and timely communication of contingency planning can go a long way in helping to maintain creditworthiness in the face of unusual events.

Policies Regarding Nonrecurring Revenue

Over-reliance on nonrecurring revenue items (one shots) to pay for ongoing and recurring expenses is a credit concern, since it frequently contributes to budgetary stress and fiscal structural imbalances. One shots might be sales of fixed assets (such as surplus school buildings or properties); budgetary savings from a debt refinancing; court settlements; or tax collection windfalls resulting from changes at the state or federal government.

From a credit perspective, the best use of nonrecurring revenues is for one-time or discretionary spending that will not entail future year spending pressures. Examples include the deposit of excess nonrecurring revenue into the pension fund to address an unfunded liability or the use of this revenue to provide pay-as-you-go capital expenditures, reducing that year's debt issuance by a similar amount. This concept may see greater use in the future as issuers consider the use of tobacco settlements in their tax and spending plans.

Accounting for Depreciation of General Governmental Fixed Assets

Governmental Accounting Standards Board (GASB) Statement No. 34 calls for issuers to account for and report use and depreciation of capital assets not reported in utility enterprise funds. Initially, it appears that local governments that have not funded depreciation of such assets on a pay-as-you-go basis are likely to report annual operating deficits in the new government-wide financial statements under the new accounting model, even if all other normal expenses are funded or exceeded by normally recurring revenue. Because of the newness of GASB 34, Fitch IBCA does not expect to downgrade issuers in the near term due to deficits resulting solely from new depreciation expenses for general infrastructure, provided that normal revenue/expenditure balance in the general operating fund continues and the liquidity and financial position of the general fund is not compromised. However, as depreciation accounting becomes more standardized and accepted, Fitch IBCA and other municipal credit analysts will look to governments to account for infrastructure maintenance in compliance with GASB requirements and take actions to keep their infrastructure in good repair. Issuers that are already meeting and funding the depreciation identified by GASB 34 will be recognized in our rating process.

Debt Affordability Reviews

Strong debt management practices are evidenced by comprehensive debt policy statements that discuss the types and methods of financing employed by issuers. These include an issuer's policies regarding off balance sheet financings like certificates of participation or lease debt, as well as bond anticipation notes, tax and revenue anticipation notes, and variable-rate demand notes). Conduit debt need not be included, unless this debt draws on taxes and/or fees levied and collected by the issuer as part of traditional government operations. Policy statements should also set forth any self-imposed debt limitations, such as those based on personal income, property market value, or annual recurring revenue or spending. Debt affordability policies like those employed by the State of Maryland and many of its counties are viewed as having the most value in Fitch IBCA's debt management analysis.

Pay-As-You-Go Capital Funding Policies

The analytical benefits of pay-as-you-go capital funding are several and profound. First, significant funding of capital costs from annual budget appropriations help keep an issuer's debt low, which is always a positive credit factor. Second, pay-as-you-go capital appropriations improve an issuer's financial flexibility in the event of sudden revenue shortfalls or emergency spending. A temporary shift away from pay-as-you-go funding for recurring expenditure needs is not automatically viewed as a negative, particularly if the issuer has demonstrated a historical propensity to return to pay-as-you-go funding when possible. In future years, some issuers may choose to increase their pay-as-you-go appropriations in response to GASB 34 (depreciation of general assets). Such a move would have positive implications for local government credit.

Finally, the contribution of capital pay-as-you-go appropriations for projects that are financed with certificates of participation provide insight on the essentiality of the leased project to the issuer. Providing a substantial downpayment from annual resources demonstrates the government's commitment to such projects and creates another incentive for the issuer to keep annual rent payments current, so as not to lose the contributed capital of the pay-as-you-go appropriation if a certificate of participation defaults and the project is taken over by a receiver or trustee.

Rapid Debt Retirement Policies

A basic tenet in credit analysis is that the life of the debt should not exceed the useful life of the asset or project being financed. Useful life, however, should not be the only benchmark considered when structuring the maturity of an issuer's debt. An issuer that frequently sells 30-year debt or continually extends the existing maturities of debt through refinancing and restructuring may still meet the minimum litmus test of matching debt to useful life. From a credit perspective, however, an issuer that pays its debt off rapidly (65% or more of principal in a 10-year period) will be analyzed more favorably than a similar issuer that retires only 50% of its debt during a 10-year span. Tax-backed debt retirement that falls below 40% in 10 years is considered a weak fiscal practice.

One of the positive analytical features that usually results from rapid debt retirement is a declining debt service schedule, thereby providing additional financial flexibility and debt capacity in future years. Issuers that stretch their debt out, through ascending debt service maturities or through the heavy use of capital appreciation bonds, reduce their financial flexibility. Back-ended debt can raise concerns, particularly if repayment is expected to come from future revenue growth that may not be realized.

Five-Year CIPs That Integrate Operating Costs of New Facilities

The existence of a multiyear capital improvement plans (CIPs) is a practice that has reached such widescale acceptance that its absence is noticeable. The more sophisticated and forward-looking government managers not only project future debt issuance, but also build in the incremental operating costs from newly built facilities. Generally, five years is a good planning time frame, although for some communities a longer range plan may be appropriate. Integrating future operating costs from capital construction assumes that the issuer is also doing multiyear forecasting of its operating funds. Implementing both of these practices is viewed as cutting edge, contributing to more favorable rating consideration.

Award for Excellence in Financial Reporting and Distinguished Budget Presentation Award

Awards for excellence in financial reporting and budgeting are granted by the GFOA and the Association for School Budgeting Officers (ASBO). Receipt of these awards does not infer financial strength; in fact, the City of Philadelphia continued to receive such an award in the early 1990s when it was close to bankruptcy. However, the achievement of these awards do give investors and credit analysts increased confidence that information disclosed in the issuer's financial reports and budgets is comprehensive and accurate.

Frequently, reporting requirements beyond the GFOA and ASBO standards are helpful in fully describing an entity's financial operations. Additional items include details of the major transfers in and out of operating funds and a breakout of revenues categorized as

Relative Values of Best Practices in Ratings by Fitch IBCA

Best Practice	Value
Fund balance reserve policy/working capital reserves.	Very Significant
Multiyear financial forecasting.	Significant
Quarterly financial reporting and monitoring.	Significant
Contingency planning policies.	Influential
Policies regarding nonrecurring revenue.	Influential
Depreciation of general fixed assets.	Influential
Debt affordability reviews and policies.	Very Significant
Pay-as-you-go capital funding policies.	Significant
Rapid debt retirement policies of more than 65% in 10 years.	Significant
Five-year capital improvement plan integrating operating costs.	Influential
Financial reporting award (GFOA, ASBO).	Influential
Budgeting award (GFOA, ASBO).	Influential

GFOA – Government Finance Officers Association. ASBO – Association For School Budgeting Officers.

"taxes" into specific components. In addition, issuers that regularly disclose their management and internal controls assessments from their auditors are recognized as making the best efforts for full and complete disclosure to rating agencies and other industry credit analysts.

■ Best Practices, and Their Impact on Debt Ratings

Historically, analysts have given only limited weight to best practices in assessing a government's credit. The concern has always been that when economic conditions turn tough, government financial managers may loosen their standards and policies, reverting to acts of fiscal or political expediency to maintain or increase services without raising taxes. However, after reviewing the historical performance data, it is clear that most issuers that have been able to garner executive and legislative support for best practices did not scuttle their policies when revenues fell short of budget. Furthermore, disciplines that were adopted as part of long-range financial management improvements helped those issuers during the tough times. Policies that have been legislated into local law are viewed favorably. However, recognizing that policies and statutes can be altered, best practices that have been tested during challenging times are viewed most favorably. Pay-as-you-go financing has been curtailed temporarily, but has generally resumed when revenue collection improved. And self-imposed debt affordability restraints have not generally been abandoned during recession. Rather, they have provided the "steady course" to see an issuer through troubled economic times, shored up investor confidence, and assured continued access to the debt markets. As such, Fitch IBCA believes it is appropriate to explicitly give greater weight to such standards in the credit rating process.

Assessing management can be very subjective. One analyst's view of what constitutes strong management may be substantially different from another's assessment. It seems clear, however, that the management practices cited above are all tangible evidence of good management practices that, in one form or another, have been viewed positively by credit analysts in the public finance sector.

The table above is an attempt to try to weigh the value of the best practices cited as beneficial to an issuer's creditworthiness. Those practices viewed as most valuable are labeled very significant, on down to significant and influential, in that order. Fitch IBCA's rating process will weigh an issuer's achievement of these best practices, and higher ratings will reflect the scope and magnitude of an issuer's adoption of these sound financial management

Worst Practices Having Significant Rating Concern for Fitch IBCA

1. Cash basis accounting.
2. Qualified audit opinion for material weakness.
3. Deficit financing for two of last five years.
4. Slow debt retirement (less than 35% in 10 years).
5. Unfunded accrued pension liability (funding ratio less than 60%).
6. TRANS/RANS growing significantly faster than annual spending.
7. Debt restructuring that defers less than 35% of current debt service.
8. Over-reliance on nonrecurring revenue of less than 15%.
9. Aggressive investment policy for operating funds.
10. Pension contribution deferral in the current budget year.
11. Budgetary impasse beyond legal completion date.
12. Lack of capital improvement plan.
13. Excess interfund borrowing, with no capacity to repay in near future.

TRANs – Tax and revenue anticipation notes. RANs – Revenue anticipation notes.

practices. Finally, many of these practices are indicative of the management for issuers that have received ‘AAA’ rating assignments from Fitch IBCA in the past. Going forward, they will be important criteria for new ‘AAA’ assignments.

■ Practices that Create Concerns for Fitch IBCA

The table at the bottom of page 5 lists some practices that raise an analyst’s concern about an issuer’s fiscal future. In a future report, Fitch IBCA will examine these practices and other negative developments that have had, and will continue to present, negative concern and lower debt ratings.

■ Management is Key to Ratings in the 21st Century

Management analysis, as well as new viewpoints in the analysis of local economies and special tax pledges, form the cornerstones to Fitch IBCA’s revised rating guidelines for tax-backed debt, which will be published shortly. Fitch IBCA feels that its approach will serve as a standard for tax-backed credit analysis in the age of the internet and rapidly expanding technology. As always, Fitch IBCA welcomes comments and debate from issuers, analysts, investors, or academia, among others.

RESEARCH

Top 10 Management Characteristics Of Highly Rated Credits In U.S. Public Finance

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Standard & Poor's Ratings Services has widely disseminated information to investors and issuers outlining how a credit rating is established in U.S. Public Finance. We have also developed representative ranges for key ratios that factor into tax-backed credit quality. These ratios are the foundation of the quantitative measures Standard & Poor's uses when establishing a credit rating. Ratios and comparisons are used to fine-tune credit analysis and help to make credit distinctions. For bond issuers, credit ratios are often used as a framework for making comparisons, with the focus often on improving a credit rating.

In addition to quantitative factors, qualitative information factors heavily into credit analysis. Management factors, administrative characteristics and other structural issues facing a government entity can be an overriding factor in a rating outcome. Management can contribute significantly to many of the individual credit ratios and can positively affect ratings in a number of ways. Conversely, the lack of strong management can be a significant factor in a weak credit profile. The economy will play a key role in determining a rating category, but management will be one of the deciding factors in fine-tuning the rating. The management or administrative structure of a government can move a rating up or down more significantly and swiftly than any other element of a credit review.

When assessing management, Standard & Poor's includes analysis of the political framework that governs it, as well as the day-to-day management staff. There could be a strong management team in place, but if there is political instability or lack of political will to make difficult decisions, management will be ineffective in many cases. Standard & Poor's also focuses on the "whole of government." Oversight and management controls covering all of the disparate operations of a government with a focus on accountability at each department or function are critical to strong credit rating.

The "Top 10" list of management characteristics associated with Standard & Poor's highly rated credits is generally applicable to other enterprise operations of government such as water, sewer, or solid waste. The relative importance of these factors may vary from credit to credit. It is important to remember that credibility is an important part of a rating review process and management assessment. Every government has challenges. Identifying problems or issues, and detailing how these will be addressed establishes credibility and greater transparency in the rating process.

Top 10 List

1. An established rainy day/budget stabilization reserve

A formalized financial reserve policy is a consistent feature of most of Standard & Poor's highly rated credits. It has been standard operating procedure for some governments for decades. Others focused attention on this following the recession of the early 1990s, and again in 2001 when many regions of the country experienced sustained revenue weakness that required severe budget reduction measures. Reserves provide financial flexibility to react to budget shortfalls or other unforeseen circumstances in a timely manner. No one level or type of reserve is considered optimal from Standard & Poor's perspective. Many different types of reserves have factored into an improved government credit profile. Some important considerations when establishing a reserve are:

- The government's cash flow/operating requirements;
- The historic volatility of revenues and expenditures through economic cycles;
- Susceptibility to natural disaster events;
- Will the fund be a legal requirement or an informal policy;
- Are formal policies established outlining under what circumstances reserves can be drawn down; and
- Will there be a mechanism to rebuild reserves once they are used.

It is important to keep in mind that use of budget stabilization reserves is not in and of itself a credit weakness. The reserves are clearly in place to be used. A balanced approach to using reserves is important in most cases, however, because full depletion of reserves in one year without any other budget adjustments creates a structural gap in the following year if economic trends continue to be weak.

2. Regular economic and revenue reviews to identify shortfalls early
Having a formal mechanism to monitor economic trends and revenue performance at regular intervals is a key feature of stable financial performance. This is particularly true if a government relies on income tax or consumption-based taxes that respond rather quickly to economic fluctuations. Evaluating historical performance of certain revenues is important to this analysis because each government will have different leading or lagging economic indicators that signal potential revenue variance issues based on their economic structure. The earlier revenue weakness is identified in the fiscal year, the more effective the budget balancing response can be. It is important to monitor upside growth as well. A surge in revenues is important to understand as well to determine if the trend is an aberration or something that is likely to sustain and require a mid-year adjustment.

3. Prioritized spending plans and established contingency plans for operating budgets
Contingency planning should be an ongoing exercise for governments. Budgets tend to inflate in good times: governments will expand services, fund generous employee pay packages, and accelerate financing for quality-of-life projects that would never be considered in a slow growth or declining economic environment. It is good public policy to have contingency plans and options to address budget imbalance when it occurs. This would include an analysis of the following:

- What part of the budget is discretionary;
- What spending areas can be legally or practically reduced;
- The time frame necessary to achieve reductions of various programs;
- Where revenue flexibility exists; and
- A course of action on the revenue side under various economic scenarios.

4. A formalized capital improvement plan in order to assess future infrastructure requirements
Highly rated credits will have a long-term capital improvement program that comprehensively assesses the infrastructure requirements of the government and a plan to fund these requirements over a five-year (or longer) time frame. Having a realistic plan that is comprehensively developed and updated annually is a requirement of all highly rated local governments. Developing these programs for state government is difficult because the scale of projects and the scope of responsibilities are so broad. Many have accomplished this task despite these obstacles, which is a positive credit factor. It is also important to incorporate the impact of capital projects on the operating budget for the short- and long-term. Governments have been moving into non-traditional projects, whether they are economic development (contributing infrastructure to a developer or industry) or quality of life (stadiums). These projects come with an upfront budget cost, but can have multiyear budget impacts. Projects can be sold as self-supporting, but may potentially be a drain on taxing resources.

5. Long-term planning for all liabilities of a government, including pension obligations, other post employment benefits and other contingent obligations would be optimal and allow for comprehensive assessment of future budgetary risks
This area of analysis should be comprehensive and include the "whole of government" approach. The nature of government services can create unexpected contingent obligations, or "off balance sheet" liabilities that could ultimately affect taxing resources. Unfunded pension liabilities have been disclosed in detail for years and this disclosure has enhanced the transparency of funding obligations in both the current year, and future years. Disclosure of this liability has also focused attention and planning on ways

to improve funding levels. The new GASB Statement 45 requiring disclosure of liabilities associated with other post employment benefits (OPEB) will highlight some significant future liabilities for many governments. Given the rate of growth in health insurance costs and current demographic trends, greater transparency in this area will allow for advance development of funding and management solutions. Other areas of government operations and services have also resulted in budget pressure that may fall out of the traditional general fund focus. Hospital and nursing home operations, as well as various other enterprise operations have caused funding challenges at the local level, even when there is no clear legal responsibility for the government to provide funding. At the state level, local government fiscal difficulties can increase and become a funding challenge for the state.

6. A debt affordability model in place to evaluate future debt profile

Recently, state and local governments have developed debt affordability models. The impact of these models on a long-term credit rating will be dependent on how the model is established and used by the government, and the track record in adhering to the affordability parameters established in the model. There is no question that the process enhances the capital budgeting and related policy decisions regarding debt issuance and amortization.

7. A pay-as-you-go financing strategy as part of the operating and capital budget.

Pay-as-you-go financing can be a sound financing policy. Not only does it lower debt service costs, but also it provides operating budget flexibility when the economy or revenue growth slows. This is a more significant financing option when tax revenue growth in many areas can be considered extraordinary. A better match can be achieved between non-recurring revenues and non-recurring expenditures if this type of financing is used.

8. A multiyear financial plan in place that considers the affordability of actions or plans before they are part of the annual budget.

It is important that this plan is comprehensive. During a sustained economic recovery, program enhancements and tax reductions are natural. Pension funds that performed at record levels can provide incentive to expand or enhance benefits. As these program enhancements and tax reduction programs are incorporated on a long-term basis, it is important that management and elected officials understand the implications of any funding change. Elected officials will be ultimately responsible for the decisions necessary to restore out-year budget balance. Multiyear planning can be an important part of this process. The reality of government finance today is that even when there is legal authority to raise taxes, there may not be a practical ability to do so because it is politically unpopular. Standard & Poor's realizes that the out-years of a multiyear plan are subject to significant change. They provide a model to evaluate how various budget initiatives affect out-year revenues, spending and reserve levels. These plans will often have out-year gaps projected, which allows governments to work out, in advance, the optimal method of restoring fiscal balance.

9. Effective management and information systems

Investing in systems that improve the efficiency and effectiveness of a government unit and enhance overall service delivery is a positive financial management tool. Investment in financial management and information technology infrastructure has been significant during the past decade. To the extent that these changes improve financial reporting and monitoring capabilities, they enhance transparency and are viewed as a positive credit factor.

10. A well-defined and coordinated economic development strategy

Economic development programs have expanded rapidly over the last 20 years. The question for state and local governments now is not whether there should be a formal economic development program, but rather how significant a resource commitment should be dedicated to running these programs and offering incentives. These are clearly government policy decisions involving cost benefit analysis that are generally outside the credit rating process. However, if these economic development programs and strategies create employment, enhance diversification, and generate solid income growth, they could have a positive effect on a government credit rating over the long-term. To the extent that there is a net revenue benefit to a government, it could also be a positive credit factor. Economic development strategies have increasingly become regional in nature and there has been a more coordinated approach between state and local governments.

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Monitoring the City's Fiscal Performance

OVERVIEW

Staying on top of the City's fiscal condition on an ongoing basis—on both the revenue and expenditure side of the equation—is an essential part of our overall strategy for preserving our fiscal health. The following summarizes how we report on this at the Council and staff level.

Core Principles

There are four core principles underlying our fiscal monitoring and reporting efforts:

❶ **Strong Systems.** We need to have an underlying financial management and internal control system that captures and produces both *timely* and *reliable* information (one without the other is worthless).

❷ **Meaningful Reports.** To be useful for policy makers and managers, this raw data then needs to be analyzed and summarized to answer the key question of: *what's it mean?* And setting specific, periodic reporting goals and standards is one of the best ways of ensuring that this kind of analysis is in fact taking place. While this requires more time and effort, it is a critical organizational discipline.

❸ **Timely, Open Reporting.** Full, open, honest and straightforward disclosure of our fiscal condition on an ongoing basis—whether good or bad—to elected officials, senior managers, the organization at-large and the community is a fundamental precept for effective and responsible stewardship of the public resources that have been entrusted to us. In short, we may not always like results—but if we are doing our job, they should never be a surprise.

❹ **Organizational Responsibility.** On the revenue side (especially in the General Fund), the Department of Finance & Information Technology plays the lead role in managing the City's fiscal condition; on the expenditure side, Department Heads have the principal responsibility for ensuring that the City's resources are used wisely and in accordance with adopted plans, policies, service levels and the resources allocated by the Council.

FISCAL HEALTH MONITORING

Council-Focused Reports

The following reports are provided to the Council on an ongoing basis, and except as noted, typically cover both revenues and expenditures. In all cases, these same reports are widely distributed within the organization; and several of these that have broad interest—such as our Sales Tax Newsletter, TOT Newsletter, Quarterly Financial Newsletter and Monthly Investment Report—are distributed externally to others and posted on our web site.

- **Two-Year Financial Plan.** This is the benchmark against which we measure our fiscal performance for revenues, departmental operating expenditures and CIP projects. And while this document primarily looks forward to the next two years, it also includes detailed information about our fiscal performance for both revenues and expenditures for the prior two years.

- **Financial Plan Supplement.** Under the two-year Financial Plan concept, appropriations in the second year of the plan are based upon the framework and foundation developed during the two-year financial process. However, budgets are still adopted annually under this approach. Much like a mid-year budget review, the "second-year" Financial Plan Supplement provides us with a formal opportunity to re-assess our fiscal condition and priorities in the context of current revenue and expenditure trends, and to take corrective action as necessary. Again, this report provides prior and current year information on the status of revenues, departmental expenditures and CIP projects.

- **Mid-Year Budget Review.** Prepared six months into each fiscal year, this is another opportunity to take a formal look at the City's fiscal performance, and take corrective action as needed.

- **Quarterly Financial Newsletters.** In staying focused on the "big picture," we issue a one-page Newsletter (okay, so it's front and back—but it's still one piece of paper) quarterly focusing on key fiscal performance indicators in the General and Enterprise Funds. This includes year-to-date revenues, expenditures and changes in fund balance, "Top 10" General Fund revenues (which account for about 95% of the total) and budget versus actual expenditures for each of the departments. The last quarter report serves as an *Interim Annual Financial Report* for the year pending issuance of the City's Comprehensive Annual Financial Report. This Newsletter is also distributed electronically to all employees.

- **Comprehensive Annual Financial Report.** This includes audited financial statements for all of the City's funds, including budget versus actual for revenues and expenditures. More importantly, it includes a transmittal memorandum from the Director of Finance & IT that concisely analyzes key fiscal results for the year.

- **Sales Tax Quarterly Newsletter**. Based on information provided by our sales tax advisor, these provide a more detailed look at what's happening with our "No. 1" General Fund revenue source.

- **TOT Monthly Newsletter.** This report focuses us on the results of our "No. 3" General Fund revenue source—transient occupancy tax.

- **Monthly Investment Report**. This report shows the City's cash and investment position for all funds held by the City and our trustees. The Investment Oversight Committee meets quarterly for a detailed review of the City's investment performance and conformance with investment policies.

- **Council Agenda Reports.** In every Council agenda report, we assess the fiscal impact of the recommended action, including any budget shortfalls if applicable.

- **Council Notes and Other Ad Hoc Reports.** As key information comes to us with significant revenue or expenditure impacts, we immediately let the Council know through Council Notes or other "ad hoc" reports.

Staff-Focused Reports

As noted above, City staff receive the same reports as those listed above. This is supplemented by more detailed reports as follows (which are also available to the Council upon request).

- **On-Line Access.** Through our network, up-to-date financial information is available on-line to everyone in the organization. This ranges from high-level summaries to detailed, individual transactions.

- **Monthly Financial Reports.** Even though data is available on-line, we produce and distribute detailed monthly financial reports to ensure that records are accurate and up-to-date. (This is one of those "organizational discipline" things.)

- **Quarterly CIP Expenditure Status Reports.** The CIP Review Committee meets at least quarterly to review the status of CIP projects. An important part of their role is to identify any problem areas with upcoming projects (and resolve them); and to ensure smooth coordination of complex projects. These detailed reports on the "project-to-date" budget and expenditure status of all CIP projects are distributed to the CIP Review Committee in preparation for these meetings.

- **Quarterly Expenditure Reviews with the CAO.** Each quarter, the Budget Analysts meet with their assigned departments to review in detail the status of departmental operating expenditures. They then meet with the CAO and other members of the Budget Review Team (Director of Finance & IT, Director of Human Resources and Assistant CAO) to report on the results of these reviews.

- **Daily Cash Balance Reports.** Every day we access the City's bank cash balances on-line and compare them to our general ledger. While the primary reason for this is maximum investment of idle cash, it also keeps us on top of our cash position.

- **Weekly Cash Balance Reports By Fund.** We issue vendor checks weekly. Before releasing them, the Director of Finance & IT personally reviews and approves the check register. Accompanying the check register is a report showing the cash balance in each fund after disbursement of these checks. This not only ensures that adequate funds are available overall to meet these payments, but more importantly, that *each fund* is able to meet its obligations.

SUMMARY

There are two key aspects to our approach in monitoring our fiscal condition: we are committed to an ongoing program of collecting meaningful information and reporting on it; and then ensuring that this information is acted upon in a timely manner.

Section 550-A

BUDGET CARRYOVER: OPERATING PROGRAMS

OVERVIEW

Under the City's Financial Plan policies, operating program appropriations not spent during the first year may be carried over for specific purposes into the second year with the approval of the City Manager (CM). The purpose of the following procedures is to set forth the administrative framework for implementing this aspect of our two-year Financial Plan.

GOALS

Allowing for the carryover of unexpended operating appropriations from the first year of the Financial Plan into the second year assists in achieving three key financial management goals:

- Mitigating against the "use it or lose it" mentality that can exist under one-year budget practices when all unspent appropriations lapse at year-end.

- Providing departments with incentives for effectively using their operating budget.

- Ensuring resource continuity in accomplishing multi-year objectives. Linking resources with what we want to accomplish, and establishing reasonable timeframes for doing so, are underlying principles of our two-year financial planning approach. Because of this, ensuring full funding for multi-year program objectives and projects is the highest priority use of carryover balances.

PROCEDURES

First Year Versus Second Year Unexpended Balances

- ***First Year.*** Under the conditions set forth below, unexpended balances from the first year of the two-year financial plan are available for carryover into the second year with the approval of the City Manager.

- ***Second Year.*** All operating budget appropriations lapse at the end of the second year.

- ***Carryovers for Encumbrances.*** In either year, unexpended funds will be carried-over and reappropriated to meet encumbrance obligations (unexpended balances remaining on contracts or purchase orders).

Annual Reports on Departmental Spending for Operating Programs

At the end of each fiscal year, department fiscal officers are responsible for preparing concise reports that analyze departmental spending for each of their programs. Although the specific contents and deadlines for submitting these reports will vary from year to year, they will generally:

- Compare budget appropriations with actual expenditures by program and by type.

- Identify reasons for any significant budget overages or underages; and analyze their impact on future operating budgets:

  - Are the variances one-time in nature or will they continue into the foreseeable future?

  - If the variances reflect continuing trends, are they reflected in current budgets?

  Reports at the end of the first year will also:

  - Identify specific carryover balances that should be reappropriated in order to maintain overall funding levels for multi-year program objectives or projects. This will be the highest priority use of any carryover funds.

  - Recommend remaining unencumbered balances that should be carried-over for reappropriation by the City Manager.

Determining Balances Available for Carryover into the Second Year

- The total of all favorable non-staffing variances (supplies, services, or minor capital) are available for carryover with the approval of the City Manager, and will be generally aggregated by department at the fund level. Under this approach, program overages within the department may be offset by program underages. However, in no case may departmental overages in one fund be offset by departmental savings in another.

- Favorable variances from staffing related expenditures may be reappropriated by the City Manager on a case-by-case basis depending on the circumstances that generated the savings and their proposed use. Successful requests will usually form some nexus between the reason for the savings and their proposed use. Any such requests and their justification should be included in the department's year-end report.

- The total amount of carryover can never be greater than the net amount that the actual ending fund balance or working capital was greater than projected. This means that the amount available for carryover by each department may be reduced by any amount that revenues or other financing sources (uses) were less than projected, including any departmental budget overages.

- After adjusting for encumbrances and any resource shortfalls or departmental budget overages, the highest priority use of carryover balances will be fully funding multi-year program objectives and projects. This means that the level of carryover funding otherwise available to other departments or programs may be further reduced in order to ensure full funding for these multi-year objectives.

Reappropriation Approvals

The City Manager is authorized to program carryover balances for reappropriation except under the following conditions, when Council approval is required:

- Funding a new CIP project.
- Authorizing increases in regular staffing.
- Implementing new programs that have significant ongoing budget implications.

Any purchases using carryover balances are subject to the City's standard purchasing policies and procedures. This may result in the need for subsequent Council approval from a purchasing— not budgetary—perspective.

Accounting for Carryover Balances

- ***Year-End Reports: Finance***. Finance will provide departments with an initial balance of operating funds available for carryover by August 15 of each year. Departmental year-end reports and any requests for carryover will be based on this report. Although Finance will strive to make these balances as accurate as possible, carryover balances are subject to subsequent modification after completion of the audit. If changes are necessary due to auditor adjustments to operating expenditure balances, or because insufficient ending fund balances are available to support the operating carryovers, the Department Heads will meet to advise the City Manager on the best way to adjust carryover balances.

- ***Year-end Reports: Operating Departments***. In their year-end reports, departments will identify the following:

  - Amounts to be carried over for multi-year program objectives and projects; brief description of these objectives and their status; and basis for determining the amount to be carried-over.

  - Any requested amounts for carry-over from staffing savings; description of proposed use of these amounts; and the relationship of the staffing savings to the proposed use.

  - Amounts to be carried-over for general purposes. This reflects the amount available for "general" carry-over after adjusting for encumbrances, multi-year program objectives, and staffing savings. As described below, this balance will be placed in a general carryover account for each department (line item 930.900).

  - Accompanying the year-end report and request for carryover balances will be a budget amendment request distributing the requested amounts to appropriate line item accounts.

Uses of Carryover Balances

- ***Accounting for Carryover Balances.*** Encumbrance balances and carryovers for multi-year program objectives and projects will be re-budgeted into the appropriate line item accounts based on year-end reports. General carryover balances will be retained on a departmental basis and placed in the "general carryover" account for each department (line item 930.900).

  No expenditures are to be made by departments directly to the “general carryover” account; use of these amounts requires the case-by-case approval by the City Manager and allocation to the appropriate program line item accounts via a budget amendment request form. This is the simplest way of retaining balances for departments. However, for this approach to work, departments must take responsibility for not implicitly (or explicitly) using these balances to compensate for overages in other line item accounts without the specific approval of the City Manager.

- ***City Manager Approval.*** As noted above, use of general carryover balances requires the case-by-case approval of the City Manager via CM Report. More than one specific use of carryover balances may be included in a single report. The use of general carryover balances is most appropriate in the following circumstances:

  - Implementing pilot programs that demonstrate opportunities for improving productivity, enhancing customer service, or meeting an identified community need.

  - Making capital investments that will improve productivity or reduce future operating costs.

  - Funding one-time expenditures that meet identified organizational or community needs, with special emphasis on deferred facility or infrastructure maintenance.

  - Addressing any shortfalls in base second-year operating program budgets.

Originally approved by the City Administrative Officer on July 14, 1994; amended by the City Manager on May 16, 1996.

Budget and Fiscal Policies

FINANCIAL PLAN PURPOSE AND ORGANIZATION

A. **Financial Plan Objectives.** Through its Financial Plan, the City will link resources with results by:

1. Identifying community needs for essential services.
2. Organizing the programs required to provide these essential services.
3. Establishing program policies and goals, which define the nature and level of program services required.
4. Identifying activities performed in delivering program services.
5. Proposing objectives for improving the delivery of program services.
6. Identifying and appropriating the resources required to perform program activities and accomplish program objectives.
7. Setting standards to measure and evaluate the:
    a. Output of program activities.
    b. Accomplishment of program objectives.
    c. Expenditure of program appropriations.

B. **Two-Year Budget**. Following the City's favorable experience over the past twenty-four years, the City will continue using a two-year financial plan, emphasizing long-range planning and effective program management. The benefits identified when the City's first two-year plan was prepared for 1983-85 continue to be realized:

1. Reinforcing the importance of long-range planning in managing the City's fiscal affairs.
2. Concentrating on developing and budgeting for the accomplishment of significant objectives.
3. Establishing realistic timeframes for achieving objectives.
4. Creating a pro-active budget that provides for stable operations and assures the City's long-term fiscal health.
5. Promoting more orderly spending patterns.
6. Reducing the amount of time and resources allocated to preparing annual budgets.

C. **Measurable Objectives.** The two-year financial plan will establish measurable program objectives and allow reasonable time to accomplish those objectives.

D. **Second Year Budget.** Before the beginning of the second year of the two-year cycle, the Council will review progress during the first year and approve appropriations for the second fiscal year.

E. **Operating Carryover.** Operating program appropriations not spent during the first fiscal year may be carried over for specific purposes into the second fiscal year with the approval of the City Manager.

F. **Goal Status Reports.** The status of major program objectives will be formally reported to the Council on an ongoing, periodic basis.

G. **Mid-Year Budget Reviews.** The Council will formally review the City's fiscal condition, and amend appropriations if necessary, six months after the beginning of each fiscal year.

H. **Balanced Budget.** The City will maintain a balanced budget over the two-year period of the Financial Plan. This means that:

1. Operating revenues must fully cover operating expenditures, including debt service.
2. Ending fund balance (or working capital in the enterprise funds) must meet minimum policy levels. For the general and enterprise

funds, this level has been established at 20% of operating expenditures.

Under this policy, it is allowable for total expenditures to exceed revenues in a given year; however, in this situation, beginning fund balance can only be used to fund capital improvement plan projects, or other "one-time," non-recurring expenditures.

FINANCIAL REPORTING AND BUDGET ADMINISTRATION

A. **Annual Reporting.** The City will prepare annual financial statements as follows:

1. In accordance with Charter requirements, the City will contract for an annual audit by a qualified independent certified public accountant. The City will strive for an unqualified auditors' opinion.

2. The City will use generally accepted accounting principles in preparing its annual financial statements, and will strive to meet the requirements of the GFOA's Award for Excellence in Financial Reporting program.

3. The City will issue audited financial statements within 180 days after year-end.

B. **Interim Reporting.** The City will prepare and issue timely interim reports on the City's fiscal status to the Council and staff. This includes: on-line access to the City's financial management system by City staff; monthly reports to program managers; more formal quarterly reports to the Council and Department Heads; mid-year budget reviews; and interim annual reports.

C. **Budget Administration.** As set forth in the City Charter, the Council may amend or supplement the budget at any time after its adoption by majority vote of the Council members. The City Manager has the authority to make administrative adjustments to the budget as long as those changes will not have a significant policy impact nor affect budgeted year-end fund balances.

GENERAL REVENUE MANAGEMENT

A. **Diversified and Stable Base.** The City will seek to maintain a diversified and stable revenue base to protect it from short-term fluctuations in any one revenue source.

B. **Long-Range Focus**. To emphasize and facilitate long-range financial planning, the City will maintain current projections of revenues for the succeeding five years.

C. **Current Revenues for Current Uses.** The City will make all current expenditures with current revenues, avoiding procedures that balance current budgets by postponing needed expenditures, accruing future revenues, or rolling over short-term debt.

D. **Interfund Transfers and Loans.** In order to achieve important public policy goals, the City has established various special revenue, capital project, debt service and enterprise funds to account for revenues whose use should be restricted to certain activities. Accordingly, each fund exists as a separate financing entity from other funds, with its own revenue sources, expenditures and fund equity.

Any transfers between funds for operating purposes are clearly set forth in the Financial Plan, and can only be made by the Director of Finance & Information Technology in accordance with the adopted budget. These operating transfers, under which financial resources are transferred from one fund to another, are distinctly different from interfund borrowings, which are usually made for temporary cash flow reasons, and are not intended to result in a transfer of financial resources by the end of the fiscal year.

In summary, interfund transfers result in a change in fund equity; interfund borrowings do not, as the intent is to repay in the loan in the near term.

From time-to-time, interfund borrowings may be appropriate; however, these are subject to the following criteria in ensuring that the fiduciary purpose of the fund is met:

1. The Director of Finance & Information Technology is authorized to approve temporary interfund borrowings for cash flow purposes whenever the cash shortfall is expected to be resolved within 45 days. The most common use of interfund borrowing under this circumstance is for grant programs like the Community Development Block Grant, where costs are incurred before drawdowns are initiated and received. However, receipt of funds is typically received shortly after the request for funds has been made.

2. Any other interfund borrowings for cash flow or other purposes require case-by-case approval by the Council.

3. Any transfers between funds where reimbursement is not expected within one fiscal year shall not be recorded as interfund borrowings; they shall be recorded as interfund operating transfers that affect equity by moving financial resources from one fund to another.

USER FEE COST RECOVERY GOALS

A. **Ongoing Review**

Fees will be reviewed and updated on an ongoing basis to ensure that they keep pace with changes in the cost-of-living as well as changes in methods or levels of service delivery.

In implementing this goal, a comprehensive analysis of City costs and fees should be made at least every five years. In the interim, fees will be adjusted by annual changes in the Consumer Price Index. Fees may be adjusted during this interim period based on supplemental analysis whenever there have been significant changes in the method, level or cost of service delivery.

B. **User Fee Cost Recovery Levels**

In setting user fees and cost recovery levels, the following factors will be considered:

1. ***Community-Wide Versus Special Benefit.*** The level of user fee cost recovery should consider the *community-wide* versus *special service* nature of the program or activity. The use of general-purpose revenues is appropriate for community-wide services, while user fees are appropriate for services that are of special benefit to easily identified individuals or groups.

2. ***Service Recipient Versus Service Driver.*** After considering community-wide versus special benefit of the service, the concept of *service recipient* versus *service driver* should also be considered. For example, it could be argued that the applicant is not the beneficiary of the City's development review efforts: the community is the primary beneficiary. However, the applicant is the *driver* of development review costs, and as such, cost recovery from the applicant is appropriate.

3. ***Effect of Pricing on the Demand for Services.*** The level of cost recovery and related pricing of services can significantly affect the demand and subsequent level of services provided. At full cost recovery, this has the specific advantage of ensuring that the City is providing services for which there is genuinely a market that is not overly-stimulated by artificially low prices.

   Conversely, high levels of cost recovery will negatively impact the delivery of services to lower income groups. This negative feature is especially pronounced, and works against public policy, if the services are specifically targeted to low income groups.

4. ***Feasibility of Collection and Recovery.*** Although it may be determined that a high level of cost recovery may be appropriate for specific services, it may be impractical or too costly to establish a system to identify and charge the user. Accordingly, the feasibility of assessing and collecting charges should also be considered in developing user fees, especially if significant program costs are intended to be financed from that source.

C. **Factors Favoring Low Cost Recovery Levels**

Very low cost recovery levels are appropriate under the following circumstances:

1. There is *no* intended relationship between the amount paid and the benefit received. Almost all "social service" programs fall into this category as it is *expected* that one group will subsidize another.

2. Collecting fees is not cost-effective or will significantly impact the efficient delivery of the service.

3. There is *no* intent to limit the use of (or entitlement to) the service. Again, most "social service" programs fit into this category as well as many public safety (police and fire) emergency response services. Historically, access to neighborhood and community parks would also fit into this category.

4. The service is non-recurring, generally delivered on a "peak demand" or emergency basis, cannot reasonably be planned for on an individual basis, and is not readily available from a private sector source. Many public safety services also fall into this category.

5. Collecting fees would discourage compliance with regulatory requirements and adherence is primarily self-identified, and as such, failure to comply would not be readily detected by the City. Many small-scale licenses and permits might fall into this category.

D. **Factors Favoring High Cost Recovery Levels**

The use of service charges as a major source of funding service levels is especially appropriate under the following circumstances:

1. The service is similar to services provided through the private sector.

2. Other private or public sector alternatives could or do exist for the delivery of the service.

3. For equity or demand management purposes, it is intended that there be a direct relationship between the amount paid and the level and cost of the service received.

4. The use of the service is specifically discouraged. Police responses to disturbances or false alarms might fall into this category.

5. The service is regulatory in nature and voluntary compliance is not expected to be the primary method of detecting failure to meet regulatory requirements. Building permit, plan checks, and subdivision review fees for large projects would fall into this category.

E. **General Concepts Regarding the Use of Service Charges**

The following general concepts will be used in developing and implementing service charges:

1. Revenues should not exceed the reasonable cost of providing the service.

2. Cost recovery goals should be based on the total cost of delivering the service, including direct costs, departmental administration costs and organization-wide support costs such as accounting, personnel, information technology, legal services, fleet maintenance and insurance.

3. The method of assessing and collecting fees should be as simple as possible in order to reduce the administrative cost of collection.

4. Rate structures should be sensitive to the "market" for similar services as well as to smaller, infrequent users of the service.

5. A unified approach should be used in determining cost recovery levels for various programs based on the factors discussed above.

F. **Low Cost-Recovery Services**

Based on the criteria discussed above, the following types of services should have very low cost recovery goals. In selected circumstances, there may be specific activities within the broad scope of services provided that should have user charges associated with them. However, the primary source of funding for the operation as a whole should be general-purpose revenues, not user fees.

1. Delivering public safety emergency response services such as police patrol services and fire suppression.

2. Maintaining and developing public facilities that are provided on a uniform, community-wide basis such as streets, parks and general-purpose buildings.

3. Providing social service programs and economic development activities.

G. **Recreation Programs**

The following cost recovery policies apply to the City's recreation programs:

1. Cost recovery for activities directed to adults should be relatively high.

2. Cost recovery for activities directed to youth and seniors should be relatively low. In those circumstances where services are similar to those provided in the private sector, cost recovery levels should be higher.

   Although ability to pay may not be a concern for all youth and senior participants, these are desired program activities, and the cost of determining need may be greater than the cost of providing a uniform service fee structure to all participants. Further, there is a community-wide benefit in encouraging high-levels of participation in youth and senior recreation activities regardless of financial status.

3. Cost recovery goals for recreation activities are set as follows:

   High-Range Cost Recovery Activities (60% to 100%)

   a. Adult athletics
   b. Banner permit applications
   c. Child care services (except Youth STAR)
   d. Facility rentals (indoor and outdoor; excludes use of facilities for internal City uses)
   e. Triathlon

   Mid-Range Cost Recovery Activities (30% to 60%)

   f. Classes
   g. Holiday in the Plaza
   h. Major commercial film permit applications

   Low-Range Cost Recovery Activities (0 to 30%)

   i. Aquatics
   j. Batting cages
   k. Community gardens
   l. Junior Ranger camp
   m. Minor commercial film permit applications
   n. Skate park
   o. Special events (except for Triathlon and Holiday in the Plaza)
   p. Youth sports
   q. Youth STAR
   r. Teen services
   s. Senior/boomer services

4. For cost recovery activities of less than 100%, there should be a differential in rates between residents and non-residents. However, the Director of Parks and Recreation is authorized to reduce or eliminate non-resident fee differentials when it can be demonstrated that:

   a. The fee is reducing attendance.

   b. And there are no appreciable expenditure savings from the reduced attendance.

5. Charges will be assessed for use of rooms, pools, gymnasiums, ball fields, special-use areas, and recreation equipment for activities not sponsored or co-sponsored by the City. Such charges will generally conform to the fee guidelines described above. However, the Director of Parks and Recreation is authorized to charge fees that are closer to full cost recovery for facilities that are heavily used at peak times and include a majority of non-resident users.

6. A vendor charge of at least 10 percent of gross income will be assessed from individuals or organizations using City facilities for moneymaking activities.

7. Director of Parks and Recreation is authorized to offer reduced fees such as introductory rates, family discounts and coupon discounts on a pilot basis (not to exceed 18 months) to promote new recreation programs or resurrect existing ones.

8. The Parks and Recreation Department will consider waiving fees only when the City Manager determines in writing that an undue hardship exists.

H. **Development Review Programs**

The following cost recovery policies apply to the development review programs:

1. Services provided under this category include:

   a. Planning (planned development permits, tentative tract and parcel maps, rezonings, general plan amendments, variances, use permits).

   b. Building and safety (building permits, structural plan checks, inspections).

   c. Engineering (public improvement plan checks, inspections, subdivision requirements, encroachments).

   d. Fire plan check.

2. Cost recovery for these services should generally be very high. In most instances, the City's cost recovery goal should be 100%.

3. However, in charging high cost recovery levels, the City needs to clearly establish and articulate standards for its performance in reviewing developer applications to ensure that there is "value for cost."

I. **Comparability With Other Communities**

In setting user fees, the City will consider fees charged by other agencies in accordance with the following criteria:

1. Surveying the comparability of the City's fees to other communities provides useful background information in setting fees for several reasons:

   a. They reflect the "market" for these fees and can assist in assessing the reasonableness of San Luis Obispo's fees.

   b. If prudently analyzed, they can serve as a benchmark for how cost-effectively San Luis Obispo provides its services.

2. However, fee surveys should never be the sole or primary criteria in setting City fees as there are many factors that affect how and why other communities have set their fees at their levels. For example:

   a. What level of cost recovery is their fee intended to achieve compared with our cost recovery objectives?

   b. What costs have been considered in computing the fees?

   c. When was the last time that their fees were comprehensively evaluated?

   d. What level of service do they provide compared with our service or performance standards?

   e. Is their rate structure significantly different than ours and what is it intended to achieve?

3. These can be very difficult questions to address in fairly evaluating fees among different communities. As such, the comparability of our fees to other communities should be one factor among many that is considered in setting City fees.

ENTERPRISE FUND FEES AND RATES

A. **Water, Sewer and Parking.** The City will set fees and rates at levels which fully cover the total direct and indirect costs—including operations, capital outlay, and debt service—of the following enterprise programs: water, sewer and parking.

B. **Golf.** Golf program fees and rates should fully cover direct operating costs. Because of the nine-hole nature of the golf course with its focus on youth and seniors, subsidies from the General Fund to cover indirect costs and capital improvements may be considered by the Council as part of the Financial Plan process, along with the need to possibly subsidize direct operating costs as well.

C. **Transit**. Based on targets set under the Transportation Development Act, the City will strive to cover at least twenty percent of transit operating costs with fare revenues.

D. **Ongoing Rate Review.** The City will review and adjust enterprise fees and rate structures as required to ensure that they remain appropriate and equitable.

E. **Franchise Fees.** In accordance with long-standing practices, the City will treat the water and sewer funds in the same manner as if they were privately owned and operated. This means assessing reasonable franchise fees in fully recovering service costs.

   At 3.5%, water and sewer franchise fees are based on the mid-point of the statewide standard for public utilities like electricity and gas (2% of gross revenues from operations) and cable television (5% of gross revenues).

   As with other utilities, the purpose of the franchise fee is reasonable cost recovery for the use of the City's street right-of-way. The appropriateness of charging the water and sewer funds a reasonable franchise fee for the use of City streets is further supported by the results of recent studies in Arizona, California, Ohio and Vermont which concluded that the leading cause for street resurfacing and reconstruction is street cuts and trenching for utilities.

REVENUE DISTRIBUTION

The Council recognizes that generally accepted accounting principles for state and local governments discourage the "earmarking" of General Fund revenues, and accordingly, the practice of designating General Fund revenues for specific programs should be minimized in the City's management of its fiscal affairs. Approval of the following revenue distribution policies does not prevent the Council from directing General Fund resources to other functions and programs as necessary.

A. **Property Taxes.** With the passage of Proposition 13 on June 6, 1978, California cities no longer can set their own property tax rates. In addition to limiting annual increases in market value, placing a ceiling on voter-approved indebtedness, and redefining assessed valuations, Proposition 13 established a maximum county-wide levy for general revenue purposes of 1% of market value. Under subsequent state legislation, which adopted formulas for the distribution of this countywide levy, the City now receives a percentage of total property tax revenues collected countywide as determined by the State and administered by the County Auditor-Controller.

   Accordingly, while property revenues are often thought of local revenue sources, in essence they are State revenue sources, since the State controls their use and allocation.

   With the adoption of a Charter revision in November 1996, which removed provisions that were in conflict with Proposition 13 relating to the setting of property tax revenues between various funds, all property tax revenues are now accounted for in the General Fund.

B. **Gasoline Tax Subventions.** All gasoline tax revenues (which are restricted by the State for street-related purposes) will be used for maintenance activities. Since the City's total expenditures for gas tax eligible programs and projects are much greater than this revenue source, operating transfers will be made from the gas tax fund to the General Fund for this purpose. This approach significantly reduces the accounting efforts required in meeting State reporting requirements.

C. **Transportation Development Act (TDA) Revenues.** All TDA revenues will be allocated to alternative transportation programs, including regional and municipal transit systems, bikeway improvements, and other programs or projects designed to reduce automobile usage. Because TDA revenues will not be allocated for street purposes, it is expected that alternative transportation programs (in conjunction with other state or federal grants for this purpose) will be self-supporting from TDA revenues.

D. **Parking Fines.** All parking fine revenues will be allocated to the parking fund, except for those collected by Police staff (who are funded by the General Fund) in implementing neighborhood wellness programs.

INVESTMENTS

A. **Responsibility**. Investments and cash management are the responsibility of the City Treasurer or designee. It is the City's policy to appoint the Director of Finance & Information Technology as the City's Treasurer.

B. **Investment Objective.** The City's primary investment objective is to achieve a reasonable rate of return while minimizing the potential for capital losses arising from market changes or issuer default. Accordingly, the following factors will be considered in priority order in determining individual investment placements:

1. Safety
2. Liquidity
3. Yield

C. **Tax and Revenue Anticipation Notes: Not for Investment Purposes.** There is an appropriate role for tax and revenue anticipation notes (TRANS) in meeting legitimate short-term cash needs within the fiscal year. However, many agencies issue TRANS as a routine business practice, not solely for cash flow purposes, but to capitalize on the favorable difference between the interest cost of issuing TRANS as a tax-preferred security and the interest yields on them if re-invested at full market rates.

As part of its cash flow management and investment strategy, the City will only issue TRANS or other forms of short-term debt if necessary to meet demonstrated cash flow needs; TRANS or any other form of short-term debt financing will not be issued for investment purposes.

As long as the City maintains its current policy of maintaining fund/working capital balances that are 20% of operating expenditures, it is unlikely that the City would need to issue TRANS for cash flow purposes except in very unusual circumstances.

D. **Selecting Maturity Dates.** The City will strive to keep all idle cash balances fully invested through daily projections of cash flow requirements. To avoid forced liquidations and losses of investment earnings, cash flow and future requirements will be the primary consideration when selecting maturities.

E. **Diversification.** As the market and the City's investment portfolio change, care will be taken to maintain a healthy balance of investment types and maturities.

F. **Authorized Investments**. The City will invest only in those instruments authorized by the California Government Code Section 53601.

The City will not invest in stock, will not speculate and will not deal in futures or options. The investment market is highly volatile and continually offers new and creative opportunities for enhancing interest earnings. Accordingly, the City will thoroughly investigate any new investment vehicles before committing City funds to them.

G. **Authorized Institutions.** Current financial statements will be maintained for each institution in which cash is invested. Investments will be limited to 20 percent of the total net worth of any institution and may be reduced further or refused altogether if an institution's financial situation becomes unhealthy.

H. **Consolidated Portfolio.** In order to maximize yields from its overall portfolio, the City will consolidate cash balances from all funds for investment purposes, and will allocate investment earnings to each fund in accordance with generally accepted accounting principles.

I. **Safekeeping.** Ownership of the City's investment securities will be protected through third-party custodial safekeeping.

J. **Investment Management Plan.** The City Treasurer will develop and maintain an Investment Management Plan that addresses the City's administration of its portfolio, including investment strategies, practices and procedures.

K. **Investment Oversight Committee.** As set forth in the Investment Management Plan, this committee is responsible for reviewing the City's portfolio on an ongoing basis to determine compliance with the City's investment policies and for making recommendations regarding investment management practices.

Members include the City Manager, Assistant City Manager, Director of Finance & Information Technology/City Treasurer, Finance Manager and the City's independent auditor.

L. **Reporting.** The City Treasurer will develop and maintain a comprehensive, well-documented investment reporting system, which will comply with Government Code Section 53607. This reporting system will provide the Council and the Investment Oversight Committee with appropriate investment performance information.

APPROPRIATIONS LIMITATION

A. The Council will annually adopt a resolution establishing the City's appropriations limit calculated in accordance with Article XIII-B of the Constitution of the State of California, Section 7900 of the State of California Government Code, and any other voter approved amendments or state legislation that affect the City's appropriations limit.

B. The supporting documentation used in calculating the City's appropriations limit and projected appropriations subject to the limit will be available for public and Council review at least 10 days before Council consideration of a resolution to adopt an appropriations limit. The Council will generally consider this resolution in connection with final approval of the budget.

C. The City will strive to develop revenue sources, both new and existing, which are considered non-tax proceeds in calculating its appropriations subject to limitation.

D. The City will annually review user fees and charges and report to the Council the amount of program subsidy, if any, that is being provided by the General or Enterprise Funds.

E. The City will actively support legislation or initiatives sponsored or approved by League of California Cities which would modify Article XIII-B of the Constitution in a manner which would allow the City to retain projected tax revenues resulting from growth in the local economy for use as determined by the Council.

F. The City will seek voter approval to amend its appropriation limit at such time that tax proceeds are in excess of allowable limits.

FUND BALANCE AND RESERVES

A. **Minimum Fund and Working Capital Balances**. The City will maintain a minimum fund balance of at least 20% of operating expenditures in the General Fund and a minimum working capital balance of 20% of operating expenditures in the water, sewer and parking enterprise funds. This is considered the minimum level necessary to maintain the City's credit worthiness and to adequately provide for:

1. Economic uncertainties, local disasters, and other financial hardships or downturns in the local or national economy.
2. Contingencies for unseen operating or capital needs.
3. Cash flow requirements.

B. **Fleet Replacement**. For the General Fund fleet, the City will establish and maintain a Fleet Replacement Fund to provide for the timely replacement of vehicles and related equipment with an individual replacement cost of $15,000 or more. The City will maintain a minimum fund balance in the Fleet Replacement Fund of at least 20% of the original purchase cost of the items accounted for in this fund.

The annual contribution to this fund will generally be based on the annual use allowance, which is determined based on the estimated life of the vehicle or equipment and its original purchase cost. Interest earnings and sales of surplus equipment as well as any related damage and insurance recoveries will be credited to the Fleet Replacement Fund.

C. **Future Capital Project Designations.** The Council may designate specific fund balance levels for future development of capital projects that it has determined to be in the best long-term interests of the City.

D. **Other Designations and Reserves.** In addition to the designations noted above, fund balance levels will be sufficient to meet funding requirements for projects approved in prior years which are carried forward into the new year; debt service reserve requirements; reserves for encumbrances; and other reserves or designations required by contractual obligations, state law, or generally accepted accounting principles.

CAPITAL IMPROVEMENT MANAGEMENT

A. **CIP Projects: $15,000 or More.** Construction projects and equipment purchases which cost $15,000 or more will be included in the Capital Improvement Plan (CIP); minor capital outlays of less than $15,000 will be included with the operating program budgets.

B. **CIP Purpose.** The purpose of the CIP is to systematically plan, schedule, and finance capital projects to ensure cost-effectiveness as well as conformance with established policies. The CIP is a four-year plan organized into the same functional groupings used for the operating programs. The CIP will reflect a balance between capital replacement projects that repair, replace or enhance existing facilities, equipment or infrastructure; and capital facility projects that significantly expand or add to the City's existing fixed assets.

C. **Project Manager.** Every CIP project will have a project manager who will prepare the project proposal, ensure that required phases are completed on schedule, authorize all project expenditures, ensure that all regulations and laws are observed, and periodically report project status.

D. **CIP Review Committee.** Headed by the City Manager or designee, this Committee will review project proposals, determine project phasing, recommend project managers, review and evaluate the draft CIP budget document, and report CIP project progress on an ongoing basis.

E. **CIP Phases.** The CIP will emphasize project planning, with projects progressing through at least two and up to ten of the following phases:

1. ***Designate.*** Appropriates funds based on projects designated for funding by the Council through adoption of the Financial Plan.

2. ***Study.*** Concept design, site selection, feasibility analysis, schematic design, environmental determination, property appraisals, scheduling, grant application, grant approval, specification preparation for equipment purchases.

3. ***Environmental Review.*** EIR preparation, other environmental studies.

4. ***Real Property Acquisitions.*** Property acquisition for projects, if necessary.

5. ***Site Preparation.*** Demolition, hazardous materials abatements, other pre-construction work.

6. ***Design.*** Final design, plan and specification preparation and construction cost estimation.

7. ***Construction.*** Construction contracts.

8. ***Construction Management.*** Contract project management and inspection, soils and material tests, other support services during construction.

9. ***Equipment Acquisitions.*** Vehicles, heavy machinery, computers, office furnishings, other equipment items acquired and installed independently from construction contracts.

10. ***Debt Service.*** Installment payments of principal and interest for completed projects

funded through debt financings. Expenditures for this project phase are included in the Debt Service section of the Financial Plan.

Generally, it will become more difficult for a project to move from one phase to the next. As such, more projects will be studied than will be designed, and more projects will be designed than will be constructed or purchased during the term of the CIP.

F. **CIP Appropriation.** The City's annual CIP appropriation for study, design, acquisition and/or construction is based on the projects designated by the Council through adoption of the Financial Plan. Adoption of the Financial Plan CIP appropriation does not automatically authorize funding for specific project phases. This authorization generally occurs only after the preceding project phase has been completed and approved by the Council and costs for the succeeding phases have been fully developed.

Accordingly, project appropriations are generally made when contracts are awarded. If project costs at the time of bid award are less than the budgeted amount, the balance will be unappropriated and returned to fund balance or allocated to another project. If project costs at the time of bid award are greater than budget amounts, five basic options are available:

1. Eliminate the project.
2. Defer the project for consideration to the next Financial Plan period.
3. Rescope or change the phasing of the project to meet the existing budget.
4. Transfer funding from another specified, lower priority project.
5. Appropriate additional resources as necessary from fund balance.

G. **CIP Budget Carryover.** Appropriations for CIP projects lapse three years after budget adoption. Projects which lapse from lack of project account appropriations may be resubmitted for inclusion in a subsequent CIP. Project accounts, which have been appropriated, will not lapse until completion of the project phase.

H. **Program Objectives.** Project phases will be listed as objectives in the program narratives of the programs, which manage the projects.

I. Public Art. CIP projects will be evaluated during the budget process and prior to each phase for conformance with the City's public art policy, which generally requires that 1% of eligible project construction costs be set aside for public art. Excluded from this requirement are underground projects, utility infrastructure projects, funding from outside agencies, and costs other than construction such as study, environmental review, design, site preparation, land acquisition and equipment purchases.

It is generally preferred that public art be incorporated directly into the project, but this is not practical or desirable for all projects; in this case, an in-lieu contribution to public art will be made. To ensure that funds are adequately budgeted for this purpose regardless of whether public art will be directly incorporated into the project, funds for public art will be identified separately in the CIP.

Given the City's fiscal situation for 2009-11, public art will be funded at the same level required by the private sector: 0.5% rather than 1%.

J. General Plan Consistency Review. The Planning Commission will review the Preliminary CIP for consistency with the General Plan and provide is findings to the Council prior to adoption.

CAPITAL FINANCING AND DEBT MANAGEMENT

A. **Capital Financing**

1. The City will consider the use of debt financing only for one-time capital improvement projects and only under the following circumstances:

   a. When the project's useful life will exceed the term of the financing.

b. When project revenues or specific resources will be sufficient to service the long-term debt.

2. Debt financing will not be considered appropriate for any recurring purpose such as current operating and maintenance expenditures. The issuance of short-term instruments such as revenue, tax or bond anticipation notes is excluded from this limitation. (See Investment Policy)

3. Capital improvements will be financed primarily through user fees, service charges, assessments, special taxes or developer agreements when benefits can be specifically attributed to users of the facility. Accordingly, development impact fees should be created and implemented at levels sufficient to ensure that new development pays its fair share of the cost of constructing necessary community facilities.

4. Transportation impact fees are a major funding source in financing transportation system improvements. However, revenues from these fees are subject to significant fluctuation based on the rate of new development. Accordingly, the following guidelines will be followed in designing and building projects funded with transportation impact fees:

   a. The availability of transportation impact fees in funding a specific project will be analyzed on a case-by-case basis as plans and specification or contract awards are submitted for City Manager or Council approval.

   b. If adequate funds are not available at that time, the Council will make one of two determinations:

      - Defer the project until funds are available.
      - Based on the high-priority of the project, advance funds from the General Fund, which will be reimbursed as soon as funds become available. Repayment of General Fund advances will be the first use of transportation impact fee funds when they become available.

5. The City will use the following criteria to evaluate pay-as-you-go versus long-term financing in funding capital improvements:

   Factors Favoring Pay-As-You-Go Financing

   a. Current revenues and adequate fund balances are available or project phasing can be accomplished.

   b. Existing debt levels adversely affect the City's credit rating.

   c. Market conditions are unstable or present difficulties in marketing.

   Factors Favoring Long Term Financing

   d. Revenues available for debt service are deemed sufficient and reliable so that long-term financings can be marketed with investment grade credit ratings.

   e. The project securing the financing is of the type, which will support an investment grade credit rating.

   f. Market conditions present favorable interest rates and demand for City financings.

   g. A project is mandated by state or federal requirements, and resources are insufficient or unavailable.

   h. The project is immediately required to meet or relieve capacity needs and current resources are insufficient or unavailable.

   i. The life of the project or asset to be financed is 10 years or longer.

B. **Debt Management**

1. The City will not obligate the General Fund to secure long-term financings except when marketability can be significantly enhanced.

2. An internal feasibility analysis will be prepared for each long-term financing which analyzes the impact on current and future

budgets for debt service and operations. This analysis will also address the reliability of revenues to support debt service.

3. The City will generally conduct financings on a competitive basis. However, negotiated financings may be used due to market volatility or the use of an unusual or complex financing or security structure.

4. The City will seek an investment grade rating (Baa/BBB or greater) on any direct debt and will seek credit enhancements such as letters of credit or insurance when necessary for marketing purposes, availability and cost-effectiveness.

5. The City will monitor all forms of debt annually coincident with the City's Financial Plan preparation and review process and report concerns and remedies, if needed, to the Council.

6. The City will diligently monitor its compliance with bond covenants and ensure its adherence to federal arbitrage regulations.

7. The City will maintain good, ongoing communications with bond rating agencies about its financial condition. The City will follow a policy of full disclosure on every financial report and bond prospectus (Official Statement).

C. **Debt Capacity**

1. ***General Purpose Debt Capacity.*** The City will carefully monitor its levels of general-purpose debt. Because our general purpose debt capacity is limited, it is important that we only use general purpose debt financing for high-priority projects where we cannot reasonably use other financing methods for two key reasons:

   a. Funds borrowed for a project today are not available to fund other projects tomorrow.

   b. Funds committed for debt repayment today are not available to fund operations in the future.

   In evaluating debt capacity, general-purpose annual debt service payments should generally not exceed 10% of General Fund revenues; and in no case should they exceed 15%. Further, direct debt will not exceed 2% of assessed valuation; and no more than 60% of capital improvement outlays will be funded from long-term financings.

2. ***Enterprise Fund Debt Capacity.*** The City will set enterprise fund rates at levels needed to fully cover debt service requirements as well as operations, maintenance, administration and capital improvement costs. The ability to afford new debt for enterprise operations will be evaluated as an integral part of the City’s rate review and setting process.

D. **Independent Disclosure Counsel**

The following criteria will be used on a case-by-case basis in determining whether the City should retain the services of an independent disclosure counsel in conjunction with specific project financings:

1. The City will generally not retain the services of an independent disclosure counsel when all of the following circumstances are present:

   a. The revenue source for repayment is under the management or control of the City, such as general obligation bonds, revenue bonds, lease-revenue bonds or certificates of participation.

   b. The bonds will be rated or insured.

2. The City will consider retaining the services of an independent disclosure counsel when one or more of following circumstances are present:

   a. The financing will be negotiated, and the underwriter has not separately engaged an underwriter’s counsel for disclosure purposes.

   b. The revenue source for repayment is not under the management or control of the City, such as land-based assessment districts, tax allocation bonds or conduit financings.

c. The bonds will not be rated or insured.

d. The City's financial advisor, bond counsel or underwriter recommends that the City retain an independent disclosure counsel based on the circumstances of the financing.

E. ***Land-Based Financings***

1. ***Public Purpose.*** There will be a clearly articulated public purpose in forming an assessment or special tax district in financing public infrastructure improvements. This should include a finding by the Council as to why this form of financing is preferred over other funding options such as impact fees, reimbursement agreements or direct developer responsibility for the improvements.

2. ***Eligible Improvements.*** Except as otherwise determined by the Council when proceedings for district formation are commenced, preference in financing public improvements through a special tax district shall be given for those public improvements that help achieve clearly identified community facility and infrastructure goals in accordance with adopted facility and infrastructure plans as set forth in key policy documents such as the General Plan, Specific Plan, Facility or Infrastructure Master Plans, or Capital Improvement Plan.

   Such improvements include study, design, construction and/or acquisition of:

   a. Public safety facilities.

   b. Water supply, distribution and treatment systems.

   c. Waste collection and treatment systems.

   d. Major transportation system improvements, such as freeway interchanges; bridges; intersection improvements; construction of new or widened arterial or collector streets (including related landscaping and lighting); sidewalks and other pedestrian paths; transit facilities; and bike paths.

   e. Storm drainage, creek protection and flood protection improvements.

   f. Parks, trails, community centers and other recreational facilities.

   g. Open space.

   h. Cultural and social service facilities.

   i. Other governmental facilities and improvements such as offices, information technology systems and telecommunication systems.

   School facilities will not be financed except under appropriate joint community facilities agreements or joint exercise of powers agreements between the City and school districts.

3. ***Active Role.*** Even though land-based financings may be a limited obligation of the City, we will play an active role in managing the district. This means that the City will select and retain the financing team, including the financial advisor, bond counsel, trustee, appraiser, disclosure counsel, assessment engineer and underwriter.

   Any costs incurred by the City in retaining these services will generally be the responsibility of the property owners or developer, and will be advanced via a deposit when an application is filed; or will be paid on a contingency fee basis from the proceeds from the bonds.

4. ***Credit Quality.*** When a developer requests a district, the City will carefully evaluate the applicant's financial plan and ability to carry the project, including the payment of assessments and special taxes during build-out. This may include detailed background, credit and lender checks, and the preparation of independent appraisal reports and market absorption studies. For districts where one property owner accounts for more than 25% of the annual debt service obligation, a letter of credit further securing the financing may be required.

5. ***Reserve Fund.*** A reserve fund should be established in the lesser amount of: the maximum annual debt service; 125% of the annual average debt service; or 10% of the bond proceeds.

6. ***Value-to-Debt Ratios.*** The minimum value-to-date ratio should generally be 4:1. This means the value of the property in the district, with the public improvements, should be at least four times the amount of the assessment or special tax debt. In special circumstances, after conferring and receiving the concurrence of the City's financial advisor and bond counsel that a lower value-to-debt ratio is financially prudent under the circumstances, the City may consider allowing a value-to-debt ratio of 3:1. The Council should make special findings in this case.

7. ***Appraisal Methodology.*** Determination of value of property in the district shall be based upon the full cash value as shown on the ad valorem assessment roll or upon an appraisal by an independent Member Appraisal Institute (MAI). The definitions, standards and assumptions to be used for appraisals shall be determined by the City on a case-by-case basis, with input from City consultants and district applicants, and by reference to relevant materials and information promulgated by the State of California, including the Appraisal Standards for Land-Secured Financings prepared by the California Debt and Investment Advisory Commission.

8. ***Capitalized Interest During Construction.*** Decisions to capitalize interest will be made on case-by-case basis, with the intent that if allowed, it should improve the credit quality of the bonds and reduce borrowing costs, benefiting both current and future property owners.

9. ***Maximum Burden.*** Annual assessments (or special taxes in the case of Mello-Roos or similar districts) should generally not exceed 1% of the sales price of the property; and total property taxes, special assessments and special taxes payments collected on the tax roll should generally not exceed 2%.

10. ***Benefit Apportionment.*** Assessments and special taxes will be apportioned according to a formula that is clear, understandable, equitable and reasonably related to the benefit received by—or burden attributed to—each parcel with respect to its financed improvement. Any annual escalation factor should generally not exceed 2%.

11. ***Special Tax District Administration.*** In the case of Mello-Roos or similar special tax districts, the total maximum annual tax should not exceed 110% of annual debt service. The rate and method of apportionment should include a back-up tax in the event of significant changes from the initial development plan, and should include procedures for prepayments.

12. ***Foreclosure Covenants.*** In managing administrative costs, the City will establish minimum delinquency amounts per owner, and for the district as a whole, on a case-by-case basis before initiating foreclosure proceedings.

13. ***Disclosure to Bondholders.*** In general, each property owner who accounts for more than 10% of the annual debt service or bonded indebtedness must provide ongoing disclosure information annually as described under SEC Rule 15(c)-12.

14. ***Disclosure to Prospective Purchasers.*** Full disclosure about outstanding balances and annual payments should be made by the seller to prospective buyers at the time that the buyer bids on the property. It should not be deferred to after the buyer has made the decision to purchase. When appropriate, applicants or property owners may be required to provide the City with a disclosure plan.

F. **Conduit Financings**

1. The City will consider requests for conduit financing on a case-by-case basis using the following criteria:

   a. The City's bond counsel will review the terms of the financing, and render an opinion that there will be no liability to the City in issuing the bonds on behalf of the applicant.

b. There is a clearly articulated public purpose in providing the conduit financing.

c. The applicant is capable of achieving this public purpose.

2. This means that the review of requests for conduit financing will generally be a two-step process:

a. First asking the Council if they are interested in considering the request, and establishing the ground rules for evaluating it

b. And then returning with the results of this evaluation, and recommending approval of appropriate financing documents if warranted.

This two-step approach ensures that the issues are clear for both the City and applicant, and that key policy questions are answered.

3. The workscope necessary to address these issues will vary from request to request, and will have to be determined on a case-by-case basis. Additionally, the City should generally be fully reimbursed for our costs in evaluating the request; however, this should also be determined on a case-by-case basis.

G. **Refinancings**

1. ***General Guidelines.*** Periodic reviews of all outstanding debt will be undertaken to determine refinancing opportunities. Refinancings will be considered (within federal tax law constraints) under the following conditions:

a. There is a net economic benefit.

b. It is needed to modernize covenants that are adversely affecting the City's financial position or operations.

c. The City wants to reduce the principal outstanding in order to achieve future debt service savings, and it has available working capital to do so from other sources.

2. ***Standards for Economic Savings.*** In general, refinancings for economic savings will be undertaken whenever net present value savings of at least five percent (5%) of the refunded debt can be achieved.

a. Refinancings that produce net present value savings of less than five percent will be considered on a case-by-case basis, provided that the present value savings are at least three percent (3%) of the refunded debt.

b. Refinancings with savings of less than three percent (3%), or with negative savings, will not be considered unless there is a compelling public policy objective.

HUMAN RESOURCE MANAGEMENT

A. **Regular Staffing**

1. The budget will fully appropriate the resources needed for authorized regular staffing and will limit programs to the regular staffing authorized.

2. Regular employees will be the core work force and the preferred means of staffing ongoing, year-round program activities that should be performed by full-time City employees rather than independent contractors. The City will strive to provide competitive compensation and benefit schedules for its authorized regular work force. Each regular employee will:

a. Fill an authorized regular position.

b. Be assigned to an appropriate bargaining unit.

c. Receive salary and benefits consistent with labor agreements or other compensation plans.

3. To manage the growth of the regular work force and overall staffing costs, the City will follow these procedures:

   a. The Council will authorize all regular positions.

   b. The Human Resources Department will coordinate and approve the hiring of all regular and temporary employees.

   c. All requests for additional regular positions will include evaluations of:

      - The necessity, term and expected results of the proposed activity.
      - Staffing and materials costs including salary, benefits, equipment, uniforms, clerical support and facilities.
      - The ability of private industry to provide the proposed service.
      - Additional revenues or cost savings, which may be realized.

4. Periodically, and before any request for additional regular positions, programs will be evaluated to determine if they can be accomplished with fewer regular employees. (See Productivity Review Policy)

5. Staffing and contract service cost ceilings will limit total expenditures for regular employees, temporary employees, and independent contractors hired to provide operating and maintenance services.

B. **Temporary Staffing**

1. The hiring of temporary employees will not be used as an incremental method for expanding the City's regular work force.

2. Temporary employees include all employees other than regular employees, elected officials and volunteers. Temporary employees will generally augment regular City staffing as extra-help employees, seasonal employees, contract employees, interns and work-study assistants.

3. The City Manager and Department Heads will encourage the use of temporary rather than regular employees to meet peak workload requirements, fill interim vacancies, and accomplish tasks where less than full-time, year-round staffing is required.

   Under this guideline, temporary employee hours will generally not exceed 50% of a regular, full-time position (1,000 hours annually). There may be limited circumstances where the use of temporary employees on an ongoing basis in excess of this target may be appropriate due to unique programming or staffing requirements. However, any such exceptions must be approved by the City Manager based on the review and recommendation of the Human Resources Director.

4. Contract employees are defined as temporary employees with written contracts approved by the City Manager who may receive approved benefits depending on hourly requirements and the length of their contract. Contract employees will generally be used for medium-term (generally between six months and two years) projects, programs or activities requiring specialized or augmented levels of staffing for a specific period.

   The services of contract employees will be discontinued upon completion of the assigned project, program or activity. Accordingly, contract employees will not be used for services that are anticipated to be delivered on an ongoing basis.

C. **Overtime Management**

1. Overtime should be used only when necessary and when other alternatives are not feasible or cost effective.

2. All overtime must be pre-authorized by a department head or delegate unless it is assumed pre-approved by its nature. For example, overtime that results when an employee is assigned to standby and/or must respond to an emergency or complete an emergency response.

3. Departmental operating budgets should reflect anticipated annual overtime costs and departments will regularly monitor overtime use and expenditures.

4. When considering the addition of regular or temporary staffing, the use of overtime as an alternative will be considered. The department will take into account:

    a. The duration that additional staff resources may be needed.
    b. The cost of overtime versus the cost of additional staff.
    c. The skills and abilities of current staff.
    d. Training costs associated with hiring additional staff.
    e. The impact of overtime on existing staff.

D. **Independent Contractors**

Independent contractors are not City employees. They may be used in two situations:

1. Short-term, peak workload assignments to be accomplished using personnel contracted through an outside temporary employment agency (OEA). In this situation, it is anticipated that City staff will closely monitor the work of OEA employees and minimal training will be required. However, they will always be considered the employees of the OEA and not the City. All placements through an OEA will be coordinated through the Human Resources Department and subject to the approval of the Human Resources Director.

2. Construction of public works projects and delivery of operating, maintenance or specialized professional services not routinely performed by City employees. Such services will be provided without close supervision by City staff, and the required methods, skills and equipment will generally be determined and provided by the contractor. Contract awards will be guided by the City's purchasing policies and procedures. (See Contracting for Services Policy)

PRODUCTIVITY

Ensuring the "delivery of service with value for cost" is one of the key concepts embodied in the City's Mission Statement (San Luis Obispo Style—Quality With Vision). To this end, the City will constantly monitor and review our methods of operation to ensure that services continue to be delivered in the most cost-effective manner possible.

This review process encompasses a wide range of productivity issues, including:

A. Analyzing systems and procedures to identify and remove unnecessary review requirements.

B. Evaluating the ability of new technologies and related capital investments to improve productivity.

C. Developing the skills and abilities of all City employees.

D. Developing and implementing appropriate methods of recognizing and rewarding exceptional employee performance.

E. Evaluating the ability of the private sector to perform the same level of service at a lower cost.

F. Periodic formal reviews of operations on a systematic, ongoing basis.

G. Maintaining a decentralized approach in managing the City's support service functions. Although some level of centralization is necessary for review and control purposes, decentralization supports productivity by:

    1. Encouraging accountability by delegating responsibility to the lowest possible level.

    2. Stimulating creativity, innovation and individual initiative.

    3. Reducing the administrative costs of operation by eliminating unnecessary review procedures.

    4. Improving the organization's ability to respond to changing needs, and identify and implement cost-saving programs.

5. Assigning responsibility for effective operations and citizen responsiveness to the department.

CONTRACTING FOR SERVICES

A. **General Policy Guidelines**

1. Contracting with the private sector for the delivery of services provides the City with a significant opportunity for cost containment and productivity enhancements. As such, the City is committed to using private sector resources in delivering municipal services as a key element in our continuing efforts to provide cost-effective programs.

2. Private sector contracting approaches under this policy include construction projects, professional services, outside employment agencies and ongoing operating and maintenance services.

3. In evaluating the costs of private sector contracts compared with in-house performance of the service, indirect, direct, and contract administration costs of the City will be identified and considered.

4. Whenever private sector providers are available and can meet established service levels, they will be seriously considered as viable service delivery alternatives using the evaluation criteria outlined below.

5. For programs and activities currently provided by City employees, conversions to contract services will generally be made through attrition, reassignment or absorption by the contractor.

B. **Evaluation Criteria**

Within the general policy guidelines stated above, the cost-effectiveness of contract services in meeting established service levels will be determined on a case-by-case basis using the following criteria:

1. Is a sufficient private sector market available to competitively deliver this service and assure a reasonable range of alternative service providers?

2. Can the contract be effectively and efficiently administered?

3. What are the consequences if the contractor fails to perform, and can the contract reasonably be written to compensate the City for any such damages?

4. Can a private sector contractor better respond to expansions, contractions or special requirements of the service?

5. Can the work scope be sufficiently defined to ensure that competing proposals can be fairly and fully evaluated, as well as the contractor's performance after bid award?

6. Does the use of contract services provide us with an opportunity to redefine service levels?

7. Will the contract limit our ability to deliver emergency or other high priority services?

8. Overall, can the City successfully delegate the performance of the service but still retain accountability and responsibility for its delivery?

Council Agenda Report

February 22, 2012

TO: City Council

FROM: Arne Croce, Interim City Administrative Officer
Bill Statler, Pro Bono Budget Advisor

SUBJECT: BUDGET AND FISCAL POLICIES

RECOMMENDATION

Conceptually approve the proposed *Budget and Fiscal Policies* in guiding preparation of the Preliminary Budget, with final adoption in June 2012 in conjunction with approval of the 2012-13 Budget.

DISCUSSION

Background

As discussed on November 9, 2011 when the Council approved the budget process for 2012-13, clearly articulated budget and fiscal policies provide an essential foundation for effective financial decision-making and in protecting the City's fiscal health.

The City's fiscal health is a lot like personal health: it isn't what you live for; but it is hard to enjoy your life without it. Cities don't exist to be fiscally healthy: they exist to make communities better places to live, work and play. However, this requires the fiscal capacity to link community goals with the resources needed to achieve them. In short, fiscal health is not an end in itself; but it is an important part of the tool kit in achieving "ends."

And like personal health, fiscal health is rarely luck. The strength of the local economy is obviously an important fiscal health factor – just as genes are in personal health. However, regardless of the strength of its local economy, no agency is immune from economic downturns or unexpected expenditure needs.

Formal statements of key budget and fiscal policies provide the foundation for assuring long-term fiscal health by establishing a clear framework for effective and prudent financial decision-making.

For this reason, clearly articulated policies are a city's "north star" in guiding the preparation and implementation of budgets and financial plans. They help make tough decisions easier by stating an organization's values before they are placed under stress by adverse circumstances. The organization might still choose to do something different – effective policies are guides, not straightjackets – but they are a powerful starting point: *but for "this," the organization should do what?*

Stated simply, articulating and then following prudent fiscal policies is the most effective and proven way for government agencies to ensure their long-term fiscal health. They are both preventative and curative: clearly articulated policies help prevent problems from arising in the good times; and help respond to bad times when they do occur. They also help provide continuity as elected officials and staff change. Lastly, they are most powerful when it put in place before the need for them arrives.

In summary, adopting key fiscal policies is an essential factor for effective stewardship of the City's resources, both in the short and long-term. Based on "best practices" recommended by professional organizations like the Governments Finance Officers Association of the United States and Canada (GFOA) and the California Society of Municipal Finance Officers (CSMFO) as well as the major credit rating agencies, fiscal policy areas that the City will want to address include:

- Budget purpose and organization (including a balanced budget policy and what this means)
- Revenue management
- User fee cost recovery: when should user fees fund services versus general purpose revenues?
- Minimum fund balance and reserves
- Financial reporting and budget administration
- Investments
- Appropriations limit
- Capital improvement plan (CIP) management
- Capital financing and debt management
- Human resources management
- Productivity
- Contracting for services

Proposed Budget Policies

"One size does not fit all" in setting fiscal policies Careful consideration needs to be given in developing policies that are appropriate given the unique circumstances of each city. Fully addressing all of the areas noted above is planned in the coming year. However, in preparing for the next fiscal year, attached are six *Budget and Fiscal Policies* that we recommend focusing on at this time:

- Budget purpose and organization
- Revenue management
- User fee cost recovery
- Minimum fund balance and reserves
- Financial reporting and budget administration
- Contracting for services

Each of these will provide an important foundation and guidance for staff preparation of the Preliminary Budget for 2012-13, as well for the Council's review of it at the workshops and hearings that follow will its issuance by May 25, 2012.

In considering the proposed *Budget and Fiscal Policies*, it is important to note that in several cases, the City may not have yet achieved the policy goal – and it may take more than one year to do so. Even so, it is important to articulate the goal: clearly stating where the City wants to be (versus where it may be today) will significantly enhance the City's ability to achieve it. For this reason, each policy area is followed by a brief summary of "compliance status." Where the City has not yet achieved the goal, a status summary on the City's progress in doing so is provided.

Minimum Fund Balance and Reserves

While each of the policy areas speak for themselves, minimum fund balance is an especially important policy in determining the City's ability to respond to unexpected fiscal hardships such as local disasters, downturns in the economy, external revenue hits like (State budget takeaways) and unforeseen operating or capital needs.

The proposed policy sets the City's policy goal for minimum General Fund balance at 25% of operating expenditures. This target was developed based on the City's fiscal circumstances using a draft methodology under preparation by the Government Finance Officers Association of the United State and Canada (GFOA). It uses a structured assessment of a city's exposure to the following eight fiscal risks:

1. **Vulnerability to extreme events and public safety concerns.** Major extreme events the community could reasonably be subject to and the likelihood and potential magnitude of loss for each event.

2. **Revenue source stability.** Volatility of each major revenue source based on factors such as past experience and trends with that revenue, characteristics of the tax or rate payers, state or federal revenue takeaways and economic factors.

3. **Expenditure volatility.** Spikes in expenditures, usually arising from special, non-recurring circumstances such as lawsuits; critical special projects without a funding source; or new state or federal spending requirements and unfunded mandates.

4. **Leverage.** Common examples include pensions, unfunded asset maintenance and debt: is the source of leverage very large? Does it have an off-setting funding source or asset?

5. **Liquidity (cash flow).** Intra-period cash imbalances, such as property taxes that are only received at one or two points during the year.

6. **Other funds.** Are there other funds that have a significant dependence on the General Fund?

7. **Growth.** This factor is only relevant if significant growth is a realistic possibility in the next three to five years. Includes assessing likely potential marginal costs associated with serving new growth compared with marginal revenues, and resulting gaps.

8. **Capital projects.** Are there high priority projects without a funding source, where reserves may be looked to as a funding source?

Depending on the results of this assessment, the draft GFOA methodology provides recommended targets ranging from a minimum of 17% of expenditures (60 days cash flow) to circumstances where more than 35% might be warranted. Based on this structured assessment methodology relative to the City's fiscal situation, a target of 25% of operating expenditures is recommended, which represents 90 days of cash flow.

This compares with the City's existing circumstances, where reserves at the end of the current fiscal year are projected to be 12% of operating expenditures. Given the fiscal challenges facing the City, it is not reasonable to achieve this goal in the coming year: doing so will need to be a multi-year process.

In addressing this circumstance now and in the future, the proposed policy recommends that whenever the City's General Fund reserves fall below this target, the City will strive to restore reserves to this level within five years. As revenues versus expenditures improve, the City will allocate about half to reserve restoration, with the balance available to fund outstanding liabilities, asset replacements, service levels restoration, new operating programs or capital improvement projects.

Circumstances where taking reserves below policy levels would be appropriate include responding to the risks that reserves are intended to mitigate, such as:

- One-time uses in meeting cash flow needs; closing a projected short term revenue-expenditure gap; responding to unexpected expenditure requirements or revenue shortfalls; and making investments in human resources, technology, liability reductions, economic development and revenue base improvements, productivity improvements and other strategies that will strengthen City revenues or reduce future costs.

- And where a fiscal forecast shows an ongoing structural gap, in providing a strategic bridge to the future.

Next Steps

If conceptually approved by the Council at this time, staff will use these principles – in concert with the Major City Goals set by the Council for the coming year – as the foundation in guiding preparation of the Preliminary Budget for 2012-13. Final adoption of the policies will occur in June 2012 in conjunction with approval of the 2012-13 Budget. For future reference, the City's *Budget and Fiscal Policies* will be included the budget document (as will any future additions or revisions).

ATTACHMENT

Budget and Fiscal Policies

Budget and Fiscal Policies

BUDGET PURPOSE AND ORGANIZATION

A. **Balanced Budget.** The City will maintain a balanced budget. This means that:

1. Operating revenues must fully cover operating expenditures, including debt service.
2. Ending fund balance must meet minimum policy levels or other target levels established by the Council for the fiscal year.

Under this policy, it is allowable for total expenditures to exceed revenues in a given year; however, in this situation, beginning fund balance should only be used to fund capital improvement plan projects or other "one-time," non-recurring expenditures. (See *Fund Balance and Reserves* policy for other circumstances when it would be appropriate to use beginning fund balance.)

B. **Council Goal-Setting, Transparency and Meaningful Community Engagement in the Budget Process.** The Council will set goals for the coming year early in the budget process that provides transparent and clear policy direction in linking goals with resources. The community will be provided with meaningful opportunities to be engaged in the goal-setting and budget process.

C. **Budget Objectives.** Through its Budget, the City will link resources with goals and results by:

1. Identifying community needs for essential services.
2. Organizing the programs required to provide these essential services.
3. Establishing program policies and goals, which define the nature and level of program services required.
4. Identifying activities performed in delivering program services.
5. Proposing objectives for improving the delivery of program services.
6. Identifying and appropriating the resources required to perform program activities and accomplish program objectives.
7. Setting standards to measure and evaluate the:
    a. Output of program activities.
    b. Accomplishment of program objectives.
    c. Expenditure of program appropriations.

D. **Measurable Objectives.** The Budget will establish measurable program objectives and allow reasonable time to accomplish those objectives.

E. **Goal Status Reports.** The status of major program objectives will be formally reported to the Council on an ongoing, periodic basis.

F. **Mid-Year Budget Reviews.** The Council will formally review the City's fiscal condition, and amend appropriations if necessary, six months after the beginning of each fiscal year.

Status: In Compliance. *These practices are either in place or the Council has adopted a budget process for 2012-13 that meets these policy objectives. However, as noted in the November 2011 report to the*

Council on the proposed budget process for 2012-13, linking resources to outcomes and measuring performance will always be a work in progress, with ongoing improvements.

GENERAL REVENUE MANAGEMENT

A. Current Revenues for Current Uses; One-Time Revenues for One-Time Purposes. The City will make all current expenditures with current revenues, avoiding procedures that balance current budgets by postponing needed expenditures, accruing future revenues or rolling over short-term debt. The City will avoid using one-time revenues to fund ongoing program costs.

B. Revenue Distribution. The Council recognizes that generally accepted accounting principles for state and local governments discourage the "earmarking" of General Fund revenues, and accordingly, the practice of designating General Fund revenues for specific programs should be minimized in the City's management of its fiscal affairs. In those cases where it does occur, the basis and methodology for earmarking should be clearly articulated in the City's Budget and Fiscal Policies.

C. Special Tax and Assessment Levies. The City will seek to lower special tax rates and assessments whenever possible through expenditure reductions and other cost containment strategies. However, the City will not use General Fund resources to subsidize reductions in allowable levies in the General Obligation Bond Fund, Retirement Fund, Assessment Districts or other similar funds.

Status: In Compliance. *These practices are either in place or the Council has adopted a budget process for 2012-13 that meets these policy objectives.*

USER FEE COST RECOVERY

A. **Ongoing Review**

Fees should be reviewed and updated on an ongoing basis to ensure that they keep pace with changes in the cost-of-living as well as changes in methods or levels of service delivery. In implementing this goal, a comprehensive analysis of City costs and fees should be made at least every five years. In the interim, fees will be adjusted by annual changes in the Consumer Price Index as well whenever there have been significant changes in the method, level or cost of service delivery.

B. **User Fee Cost Recovery Levels**

The following factors will be considered in setting user fees and cost recovery levels,

1. ***Community-Wide Versus Special Benefit.*** The level of user fee cost recovery should consider the *community-wide* versus *special service* nature of the program or activity. The use of general-purpose revenues is appropriate for community-wide services, while user fees are appropriate for services that are of special benefit to easily identified individuals or groups.

2. ***Service Recipient Versus Service Driver.*** Cost recovery goals should also consider the concept of *service recipient* versus *service driver*. For example, it could be argued that the applicant is not the beneficiary of the City's development review efforts – the community is the primary beneficiary. However, the applicant is the *driver* of development review costs, and as such, cost recovery from the applicant is appropriate.

3. ***Effect of Pricing on the Demand for Services.*** The level of cost recovery and related pricing of services can significantly affect the demand and subsequent level of services provided. At full cost recovery, this has the specific advantage of ensuring that the City is providing services for which there is genuinely a market that is not overly-stimulated by artificially low prices.

Conversely, high levels of cost recovery will negatively impact the delivery of services to lower income groups. This negative feature is especially pronounced, and works against public policy, if the services are specifically targeted to low income groups.

4. ***Feasibility of Collection and Recovery.*** Although it may be determined that a high level of cost recovery may be appropriate for specific services, it may be impractical or too costly to establish a system to identify and charge the user.

C. **Factors Favoring Low Cost Recovery Levels**

1. There is *no* intended relationship between the amount paid and the benefit received. Almost all "social service" programs fall into this category as it is *expected* that one group will subsidize another.
2. Collecting fees is not cost-effective or will significantly impact the efficient delivery of the service.
3. There is *no* intent to limit the use of the service. Again, most "social service" programs fit into this category as well as parks and many public safety (police and fire) emergency response services.
4. Collecting fees would discourage compliance with regulatory requirements and adherence is primarily self-identified, and as such, failure to comply would not be readily detected by the City. Many small-scale licenses and permits might fall into this category.

D. **Factors Favoring High Cost Recovery Levels**

1. The service is similar to services provided through the private sector.
2. Other private or public sector alternatives could or do exist for the delivery of the service.
3. For equity or demand management purposes, it is intended that there be a direct relationship between the amount paid and the level and cost of the service received.
4. The use of the service is specifically discouraged. Police responses to disturbances or false alarms might fall into this category.
5. The service is regulatory in nature and voluntary compliance is not expected to be the primary method of detecting failure to meet regulatory requirements. Building permit, plan check and subdivision review fees for large projects would fall into this category.

E. **General Concepts Regarding the Use of Service Charges**

1. Revenues should not exceed the reasonable cost of providing the service.
2. Cost recovery goals should be based on the total cost of delivering the service, including direct costs, departmental administration costs and organization-wide support costs.
3. The method of assessing and collecting fees should be as simple as possible in order to reduce the administrative cost of collection.
4. A unified approach should be used in determining cost recovery levels for various programs based on the factors discussed above.

F. **Low Cost-Recovery Services**

Based on the criteria discussed above, the following types of services should have very low cost recovery goals, although in selected circumstances, there may be specific activities within the broad scope of services provided that should have user charges associated with them.

1. Delivering public safety emergency response services such as police patrol services.
2. Maintaining and developing public facilities that are provided on a uniform, community-wide basis such as streets, parks and general-purpose buildings.
3. Providing social service programs and economic development activities.

G. **Recreation Programs**

1. Cost recovery for activities directed to adults should be relatively high.
2. Cost recovery for activities directed to youth and seniors should be relatively low. In those circumstances where services are similar to those provided in the private sector, cost recovery levels should be higher.
3. For cost recovery activities of less than 100%, there should generally be a differential in rates between residents and non-residents. However, the Community Services Director is authorized to reduce or eliminate non-resident fee differentials when this is reducing attendance and thus cost recovery and there are no appreciable expenditure savings from the reduced attendance.
4. The Community Services Director is authorized to offer reduced fees such as introductory rates, family discounts and coupon discounts on a pilot basis (not to exceed 18 months) to promote new recreation programs or reenergize existing ones .

H. **Development Review Programs**

Cost recovery for planning, building and safety (building permits, structural plan checks, inspections) and engineering (public improvement plan checks, inspections, subdivision requirements, encroachments) services should be very high: in most instances, it should be 100%.

I. **Comparability With Other Communities**

Surveys of fees charged by other comparable agencies should not be the sole or primary criteria in setting City fees. As outlined below, there are many factors that affect how and why other communities have set their fees at their levels. Accordingly, comparability of Bell's fees to other communities should be one factor among many that is considered in setting City fees.

1. What level of cost recovery is their fee intended to achieve compared with Bell's cost recovery objectives?
2. What costs have been considered in computing the fees?
3. When was the last time that their fees were comprehensively evaluated?
4. What level of service do they provide compared with our service or performance standards?
5. Is their rate structure significantly different than ours and what is it intended to achieve?

Status: In Progress. *The City has not prepared a comprehensive analysis of its user fees. Doing so will require significant resources and may not be possible in the coming year. However, focused reviews in areas where a compelling need is identified will be presented to the Council.*

FUND BALANCE AND RESERVES

A. **General Fund Minimum Balance.** The City will strive to maintain a minimum unassigned fund balance of at least 25% of operating expenditures in the General Fund. This represents 90 days of cash flow and is based on the GFOA's draft methodology for setting reserve levels in adequately providing for:

1. Economic uncertainties, local disasters and other financial hardships or downturns in the local or national economy.
2. Contingencies for unseen operating or capital needs.
3. Unfunded liabilities such as self-insurance, pensions and retiree health obligations.
4. Institutional changes, such as State budget takeaways and unfunded mandates.
5. Cash flow requirements.

Whenever the City's General Fund reserves fall below this target, the City will strive to restore reserves to this level within five years. As revenues versus expenditures improve, the City will allocate about half to reserve restoration, with the balance available to fund outstanding liabilities, asset replacements, service levels restoration, new operating programs or capital improvement projects.

Circumstances where taking reserves below policy levels would be appropriate include responding to the risks that reserves are intended to mitigate, such as:

- One-time uses in meeting cash flow needs; closing a projected short term revenue-expenditure gap; responding to unexpected expenditure requirements or revenue shortfalls; and making investments in human resources, technology, liability reductions, economic development and revenue base improvements, productivity improvements and other strategies that will strengthen City revenues or reduce future costs.
- Where a forecast shows an ongoing structural gap, in providing a strategic bridge to the future.

B. **Facilities, Equipment, Fleet and Infrastructure Replacement**. The City will establish an Asset Replacement Fund and strive to set annually aside funds to provide for the timely replacement of long-lived capital assets such as facilities, equipment, vehicles and infrastructure. The annual contribution to this fund will generally be based on the annual use allowance or depreciation, which is determined based on the estimated life of the asset vehicle or equipment and its original purchase cost. Interest earnings and sales of surplus equipment as well as any related damage and insurance recoveries will be credited to this fund.

C. **Future Capital Project Fund Balance Assignments.** The Council may assign specific fund balance levels for future development of capital projects or other long-term goals that it has determined to be in the best interests of the City.

D. **Other Commitments and Assignments.** In addition to the assignments noted above, fund balance levels will be sufficient to meet funding requirements for projects approved in prior years which are carried forward into the new year; debt service reserve requirements; commitments for encumbrances; and other reserves, commitments or assignments required by contractual obligations, state law or generally accepted accounting principles.

Status: In Progress. *The City currently has reserves of about 12% of General Fund expenditures; and no funds have been set aside for asset replacement. Achieving this goal is likely to be a multi-year endeavor.*

FINANCIAL REPORTING AND BUDGET ADMINISTRATION

A. **Annual Reporting.** The City will prepare annual financial statements as follows:

1. In accordance with Charter requirements, the City will contract for an annual audit by a qualified independent certified public accountant. The City will strive for an unqualified auditors' opinion.
2. The City will use generally accepted accounting principles in preparing its annual financial statements and will strive to meet the requirements of the Award for Excellence in Financial Reporting program of the Government Finance Officers Association of the United States and Canada (GFOA).
3. The City will issue audited financial statements within 180 days after year-end.

B. **Interim Reporting.** The City will prepare and issue timely interim reports on the City's fiscal status to the Council and staff. This includes on-line access to the City's financial management system; monthly reports to program managers; more formal quarterly reports to the Council and Department Heads; mid-year budget reviews; and interim annual reports.

C. **Budget Administration.** As set forth in the City Charter, the Council may amend or supplement the budget at any time after its adoption by majority vote of the Council members. Council approval is required for all new appropriations from fund balance. The City Manager has the authority to make administrative adjustments to the budget as long as those changes will not have a significant policy impact nor affect budgeted year-end fund balances.

Status: In Progress. *The City has not issued audited financial statements since 2009. The City has contracted with Macias Gini & O'Connell for the preparation of an independent audit for the fiscal years ending 2010, 2011 and 2012. Since more than 180 days have lapsed since the end of the last two completed fiscal years, it will not be possible to present these reports to the GFOA's Award for Excellence in Financial Reporting program. However, the City will strive to submit its comprehensive annual financial report for 2011-12 to the GFOA. The City is also making progress in improving interim financial reporting. For example, the Council will receive its first mid-year budget review in February 2012. However, the City's current financial management information system is limited in its ability to provide timely information and on-line access to City staff. An evaluation of ways to improve the City's financial reporting is currently underway.*

CONTRACTING FOR SERVICES

A. **General Policy Guidelines**

1. Contracting with the private sector or other public agencies for the delivery of services provides the City with a significant opportunity for cost containment and productivity enhancements. As such, the City is committed to using private sector resources or partnering with other public agencies in delivering municipal services as a key element in its continuing efforts to provide cost-effective programs.

2. Contracting approaches under this policy include construction projects, professional services, outside employment agencies and ongoing operating and maintenance services.

3. In evaluating the costs of private sector or other public agency contracts compared with in-house performance of the service, indirect, direct, and contract administration costs of the City will be identified and considered.

4. Whenever private sector or other public agency providers are available and can meet established service levels, they will be seriously considered as viable service delivery alternatives using the evaluation criteria outlined below.
5. For programs and activities currently provided by City employees, conversions to contract services will generally be made through attrition, reassignment or absorption by the contractor.

B. **Evaluation Criteria**

Within the general policy guidelines stated above, the cost-effectiveness of contract services in meeting established service levels will be determined on a case-by-case basis using the following criteria:

1. Is a sufficient private or public sector market available to competitively deliver this service and assure a reasonable range of alternative service providers?
2. Can the contract be effectively and efficiently administered?
3. What are the consequences if the contractor fails to perform, and can the contract reasonably be written to compensate the City for any such damages?
4. Can a private sector contractor or other public agency better respond to expansions, contractions or special requirements of the service?
5. Can the work scope be sufficiently defined to ensure that competing proposals can be fairly and fully evaluated, as well as the contractor's performance after bid award?
6. Does the use of contract services provide the City with an opportunity to redefine service levels?
7. Will the contract limit the City’s ability to deliver emergency or other high priority services?
8. Overall, can the City successfully delegate the performance of the service but still retain accountability and responsibility for its delivery?

Status: In Compliance. *These practices are either in place or the Council has adopted a budget process for 2012-13 that meets these policy objectives.*

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Fiscal Policy ■ Financial Planning ■ Analysis ■ Training ■ Organizational Review

Setting Reserve Levels

The following is based on a "white paper" I prepared when I was the Director of Finance & Information Technology for the City of San Luis Obispo.

What's the Right Amount?

In comparing reserve levels between government agencies, it is important to recognize that "one size does not fit all." In short, other than having a reserve at all, there is no "right" level: it depends on the circumstances in each agency.

Strong Reserves Reflect Ability to Manage Risk, Not Fiscal Strength

Reserves – whether large or small – do not *per se* reflect on an agency's financial capacity or underlying fiscal strength. There are much better indicators than fund balance for this, most notably the ability over time for ongoing revenues to adequately meet day-to-day service needs, capital improvement goals and debt service requirements.

Then what does retaining a prudent level of fund balance reflect?

It measures an agency's ability to manage risk. How much can things adversely turn-out differently than "usual?" And how much fiscal capacity (measured in time) does the organization think is prudent in developing and implementing plans to respond to unexpected circumstances?

First Step: Assess Risk in Determining Reserve Policy

Based on this, the first step in assessing an appropriate reserve level is to assess fiscal risks, which fall into seven categories:

1. ***Economic.*** How dependent are the agency's key revenues on local economic performance? And how dependent is it on the fortunes of a few key taxpayers – or are revenue sources broadly distributed? In short, are all of the agency's revenue "eggs in one basket?" And if so, how large and strong is the basket?

   For example, property taxes are usually viewed as stable, dependable revenue sources (although the "Great Recession" has resulted in many rethinking this "conventional wisdom," at least in California). As such, if this is a large part of an agency's revenue base (as it is in many states), then its fiscal risks are lower, and accordingly, its reserve levels can be lower. However, sales tax is the most important revenue source for many California cities and it can be highly volatile. So, where sales tax is a key revenue source, this argues for higher reserves.

And within any one revenue source, agencies also need to assess their vulnerability (the "eggs" thing). For example, if one or two key property owners account for a large part of property tax revenues, then any adverse circumstances for them will adversely affect the agency.

How likely is this to happen? And what's the consequence if it does? The same is true for sales taxes: already a volatile revenue source, it's even worse if one or two outlets (like a single car dealership or major retailer) account for a large part of an agency's sales tax revenues.

2. ***Cash Flow.*** What cash resources does an agency need in balancing when it receives key revenues, and when it incurs expenses? For example, in California, local agencies must operate for six months before receiving their first installment of property tax revenues (which in California includes "triple flip" reimbursements and special assessments). Additionally, are there significant grant programs where the General Fund has to support expenditures before cash can be received? Again, this requires each agency to review their own unique circumstances in evaluating "lumpy" receipts and disbursements, and other cash flow commitments for other funds. In short, every agency has a different cash flow story to tell.

3. ***Expenditure Flexibility.*** How much of an agency's costs are relatively "fixed" or ongoing, like debt service and regular staffing; versus more flexible costs, like capital projects or other "one-time" costs? The more "flexible" an agency's costs, the more flexibility it will have in not disrupting day-to-day services in responding to adverse circumstances while it figures out a longer-term strategy.

4. ***Reliance by Other Funds***. How dependent are other funds on the General Fund? This could include other units of government, like a housing authority or redevelopment agency (now, "successor agencies"); enterprise funds, like water, harbor or transit; or special revenue funds, like lighting and landscape maintenance districts.

5. ***General Contingencies.*** What is the likelihood of a major, unanticipated cost?

6. ***Disasters***. What is the likelihood (and frequency) of natural or human disasters like floods, fires or earthquakes in increasing response and recovery costs, or reducing revenues?

7. ***Stability of State-Local Government Relationships.*** How likely is it that the federal or state government will structurally change revenue sources, such as no longer providing a key subvention that it routinely provided to an agency in the past? Or no longer allowing an agency to set a key fee or a tax that it has relied upon for many years? Or assessing agencies for services that the state or federal agency has traditionally provided at no cost? Placed in context, over the past thirty years, even with constitutional protections due to the passage of Proposition 1A in November 2004 and Proposition 22 in 2010, State budget takeaways have consistently been the largest single fiscal threat to local government in California.

GFOA Structured Assessment Tool

The Government Finance Officers Association of the United States and Canada (GFOA) has developed an excellent analytical resource in translating these conceptual risks into specific reserve targets. It does this by creating a structured assessment of the risk factors facing each agency. It is available on-line on the GFOA's web site at:

http://www.gfoa.org/index.php?option=com_content&task=view&id=2320

Using Reserves

When adverse circumstances do arise, appropriate reserves provide agencies with the ability to:

- Absorb "one-time" problems without disrupting day-to-day operations and services.
- Or if the problems are more systemic and ongoing, then they provides the fiscal capacity to take the time needed to fully identify how big the problem is, and then develop and implement a thoughtful longer-term strategy tailored to the problem, without resorting to extreme crisis actions.

Along with setting minimum reserve policies, agencies should also consider adopting policies for when use of reserves is appropriate, especially below the policy minimum. There are a number of circumstances where doing so makes sense. For example, reserves are often referred to as "rainy days funds," so it makes sense to use them when it rains – at least, when it rains unexpectedly.

For rain that can be reasonably expected every year, however, it doesn't make sense to use reserves. This surfaces the second point about the use of reserves: you can only spend then once. And accordingly, they should only be used for one-time purposes. While capital improvements are an obvious example, this could include servings as a bridge in tough times as part of a multi-year strategy to close a systemic gap in bringing operating costs in line with lower ongoing revenues (the "new normal"). However, smart agencies will strongly resist using reserves to fund operating costs – let alone operating cost increases, such as labor agreements.

Restoring Reserves

Agencies should also consider setting policies for how reserves should be restored to policy after they've been used. In recognition that as things improve, there will be a legitimate public policy interest in restoring/improving service levels and capital projects, an example might be:

- Restore reserves to policy level within 5 years.
- And as revenues improve, split the improved financial condition evenly ("50/50") between services and reserve restoration.

Summary

Reserves act as an insurance policy, a risk management tool. Accordingly, in setting appropriate reserve policies, an agency should ask itself:

- How much risk is it exposed to?
- And how much risk is it willing to take in the event that adverse circumstances emerge?

Knowing how other agencies answer these questions can be helpful; but ultimately, each agency needs to be guided by its own circumstances.