

Council Agenda Report

Date: November 14, 2016
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SUBJECT: Policies for General Fund Operating Reserves and Municipal Utilities Commission (MUC) Operating Reserves and MUC Capital Reserves

Recommendations: That Council:

- A. Conceptually approve the Reserve Policy for the General Fund Operating Reserve and Municipal Utilities Commission (MUC) Operating and Capital Reserve and
- B. Direct the City Attorney to draft policy resolutions for Council adoption.

Discussion:

In August, we introduced a potential reserves policy to Council. We are reintroducing this policy for approval but are concentrating on a reserve policy for General Fund operating reserves and the MUC's operating and capital reserves as we work on gathering data and information for operating and capital reserves for other funds. See attached draft policy. This report presents policies for conceptual approval. After Council consideration, it is recommended that the City Attorney develop Resolutions for Council to adopt formalizing the policy. Again, these will be partial with additional reserve policies forthcoming.

A reserve policy is a document which provides guidelines on setting reserve targets and managing reserves. "Reserves provide a government with options to respond to unexpected issues and afford a buffer against shocks and other forms of risks." (GFOA Financial Policies). A reserve policy looks at fund balance and how much is available.

When evaluating reserve policies, we can use different metrics that are meaningful- we can look at the fund balance (an accounting term) and the undesignated portion. We can also use working capital as a metrics (current assets less current liabilities) especially when evaluating the operating reserve for an enterprise fund.

General Fund – Operating Reserves

GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted budgetary fund balance in their General Fund of no less than two months (16%) of their adopted operating budget (See: <http://www.gfoa.org/appropriate-level-unrestricted-fund-balance-general-fund>.) For the City of Cambridge, based on the FY2017

budget, that would be \$1,600,000. As of 6/30/15, the City's undesignated fund balance was \$1,200,000.

The proposed reserve policy recommends building up to a 16% operating reserve over ten years on the following schedule: \$1,000,000 by the end of 3 years and \$1,600,000 by the end of 10 years. A funding plan could be as follows which allows for some flexibility of spending of undesignated fund balances.

Year 1	\$ 750,000	47%
Year 2	\$ 850,000	53%
Year 3	\$1,000,000	62%
Year 4	\$1,100,000	69%
Year 5	\$1,200,000	75%
Year 6	\$1,300,000	81%
Year 7	\$1,400,000	88%
Year 8	\$1,500,000	94%
Year 9	\$1,550,000	97%
Year 10	\$1,600,000	100% *

*Note that this is based on FY17 budget but actual amounts would vary as to the percentage of operating budget.

Municipal Utilities Commission (MUC)

Operating Reserves:

The proposed reserve policy recommends establishing 16% operating reserves (\$320,000) in the first year as funds are available. Unlike the General Fund, we are focusing on working capital or cash as a metric to evaluate reserves at least in the first 3 years. Cash at 6/30/15 was approximately \$1,600,000. The difficulty with using net assets is that unfunded pension and health insurance costs for current employees when they retire (\$1,050,000) are included in the net assets. In FY2018, the governmental accounting standards board will likely change the rules on accounting for future health insurance expense on current employees when they retire. When these regulations are implemented and the anticipated guidance on funding the expense are issued, Council can address how to fund this expense. But for the Reserve Policy, we will look at the next 3 years from a working capital perspective. Because MUC has cash on hand, the operating reserve of \$320,000 can be funded in the first year.

Capital Contingency Reserve:

The MUC Commission has continuously reserved \$150,000 for major unanticipated expenses. In October, the City had a major leak and repair to the water main near Cambridge Creek costing over \$75,000. The reserve for unanticipated expenses is for expenses such as this- major repairs unfunded and unanticipated.

Reserve for Capital Projects

Because the integrity of the water supply and delivery systems are vital, MUC has conscientiously maintained high capital reserves. The proposed policy targets \$1,000,000 in capital reserves in addition to the \$150,000 reserved for unanticipated expenses.

MUC is unique in that it has a master plan, completed in 2008, that management and the Commission have used as a guide in budgeting and setting reserves.

The master plan identifies \$5,400,000 of capital project expenses of which approximately \$500,000 worth of projects have been expended. Due to capital repairs that have arisen over the past 8 years as well as proposed development included in the Master Plan that isn't occurring in the near future, portions of the master plan projects will likely not be needed. The MUC will be doing an updated master plan in 2018. But under the current master plan, the remaining list of projects amount to \$2,770,000.

Master Plan	\$ 5,400,000
Projects Completed	< \$ 500,000 >
Projects not needed due to changes in system and/or repairs:	< \$ 980,000 >
Projects for proposed development that did not occur:	< \$ 1,150,000 >
	\$ 2,770,000

The master plan identifies capital project needs and the continuous monitoring of the system also identifies needed capital project (repairs/replacement) that are not included in the plan. When proposing the annual budget and when seeking grants, both are considered. However, in consideration of the master plan, the City has accumulated year-end fund balances (revenues over expenses) in excess of \$1,000,000. If MUC recommends and Council approves appropriations from this reserve for implementation of master plan projects, then it will be replenished from year-end fund balances (excess operating revenue) as is past practice. With a new master plan in two years, including an implementation schedule, we can reevaluate the appropriate capital reserve level.

All MUC Reserves in dollar amounts

Here follow the proposed MUC reserves in dollar amounts:

Operating	\$ 320,000	16% of op. budget
Capital Contingency	<u>\$ 150,000</u>	
Subtotal:	\$ 470,000	23% of op. budget
Capital Projects Reserve	<u>\$1,000,000</u>	36% of remaining master plan projects
Total	\$1,470,000	
Total cash available	\$1,600,000	

Summary of Recommended Reserves Levels

General Fund Operating Reserve:	16% of adopted operating budget
MUC Fund Operating Reserve:	16% of adopted operating budget
MUC Contingency Capital Reserve:	\$ 150,000
MUC Capital Reserve:	\$1,000,000

Use and Replenishment of Reserves

As outlined in the policy, the use of reserves will require City Council action by supermajority. In addition, the City will strive to replenish these funds to the established policy levels within five (5) years.

Approved by: 

City of Cambridge

DRAFT RESERVES POLICY NUMBER ONE

Reserves: The objectives of reserve policies are: (1) to maintain services during economic downturns and during natural disasters that interrupt normal City revenues, i.e., for contingency purposes; and 2) provide funding for unanticipated capital needs and for major capital replacements that require more funds than can reasonably be budgeted in an annual budget cycle, while maintaining reasonable tax rates.

GENERAL FUND

Operating Reserve

Within 3 years (FY2019) the City shall maintain the following reserve threshold:

- a) A minimum unallocated General Fund balance of 10% (1,300,000) of the following year's revenue budget amount to be used for unanticipated expenditures of a non-recurring nature, or to meet unexpected increases in service delivery costs.

Within 10 years (FY2027), the City shall maintain the following reserve threshold:

- a) A minimum unallocated General Fund balance of 16% of the following year's revenue budget amount to be used for unanticipated expenditures of a non-recurring nature, or to meet unexpected increases in service delivery costs. The 16% is 2 months of operating expenses that will pay help expenditures if a natural disaster or economic disaster occurs.

Enterprise Funds

Municipal Utilities Commission – Operating and Capital Reserves

Within 3 years (FY2019) the City/MUC shall maintain the following reserves:

- a) A minimum unallocated Municipal Utilities Commission Fund balance of 16% of the following year's revenue budget amount to be used for cash flow purposes, unanticipated expenditures of a non-recurring nature, or to meet unexpected increases in service delivery costs. The 16% is 2 months of operating expenses that will pay help expenditures if a natural disaster or economic disaster occurs.
- b) A minimum capital reserve for unanticipated capital expenses of \$150,000.
- c) A minimum capital reserve of \$1,000,000 for future acquisitions and the replacement of large capital items

USE AND REPLENISHMENT OF RESERVES

Use of Reserves (Fund Balances):

Fund balance is the cumulative years' excess or deficit of all revenues and expense. In the case of proprietary funds, this is termed unrestricted net assets. For the purposes of the budget document, revenue and expense activity includes bond proceeds and debt service.

- a) Council Action by supermajority will be required to appropriate from reserves in order to expend reserved funds.
- b) Available fund balances shall not be used for ongoing operating expenditures, unless a determination has been made that available balances are in excess of these reserve guidelines and that plans have been adopted to address any future operating budget shortfalls.
- c) Reserves should be used for one-time costs that achieve future operating cost reductions.
- d) If reserve funds are appropriated for operating costs – due to economic downturn or natural disaster, then Council will at the same adopt a replenishment plan and schedule.

Replenishment of Reserves:

When reserves are appropriated and a reserve balance drops below policy thresholds, the City will strive to replenish these funds to the established policy levels within five (5) years. Year-end revenues over expenditures will be the first source of replenishment. Council will consider replenishment as part of budget development and adoption as well.