CITY OF URBANA, ILLINOIS
FINANCE DEPARTMENT

M E M O R A N D U M

TO: Mayor Diane Wolfe Marlin and City Council Members

FROM: Elizabeth Hannan, Finance Director
Don Ho, Financial Analyst

DATE: March 12, 2020

SUBJECT: **Proposed Changes to the Financial Policies**

Introduction: The purpose of this memo is to discuss recommended revisions to the City's financial policies regarding funding of the Vehicle & Equipment Replacement Fund (VERF) and minimum fund balance requirement for the General Operating Fund.

Discussion:

Vehicle & Equipment Replacement Funding

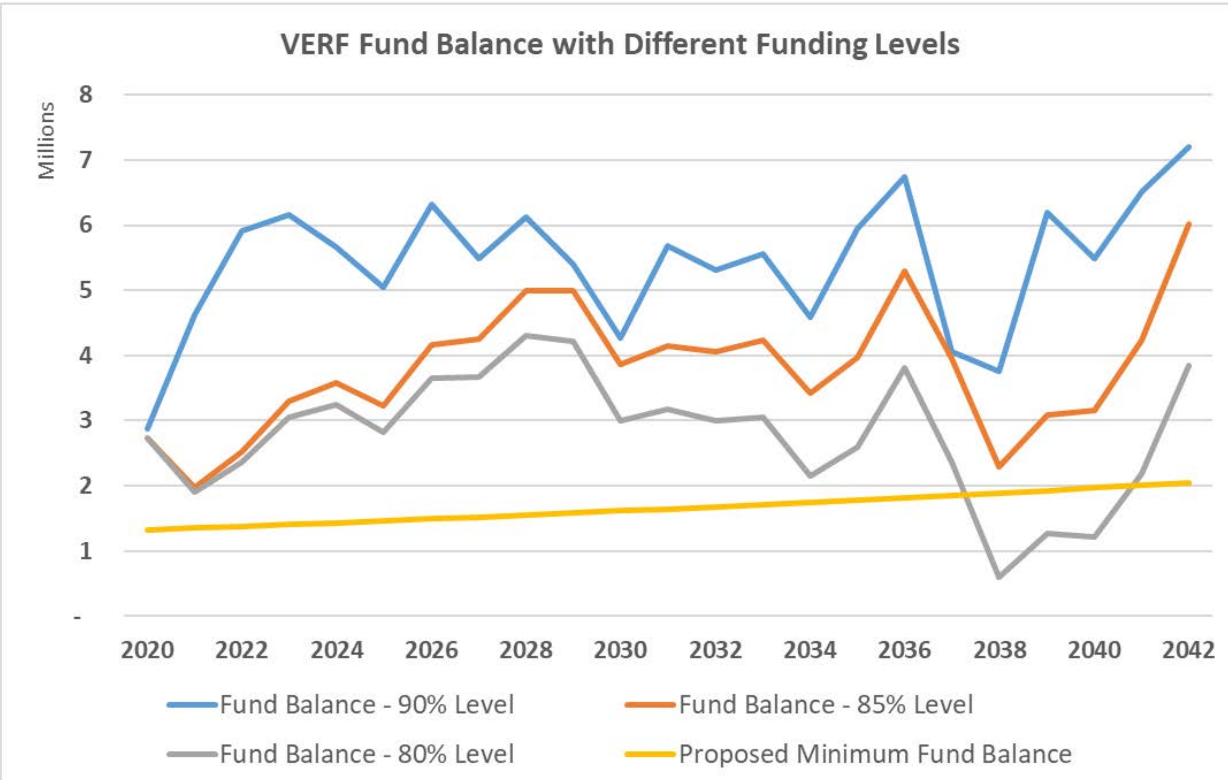
Background: The VERF collects fees from other City funds to pay for replacement of capital assets. Each item in the VERF is required to have a life of more than five years and a value above $5,000. The purpose of the VERF is to ensure that adequate funds are available to purchase vehicles and equipment, to stabilize budgeting for major purchases, and to provide a systematic, citywide approach to procurement and disposition of the capital assets. The goal is to provide sufficient cash flow for annual purchases. The total value of all capital assets included in the VERF is about $13.5 million for FY21.

Current Practice: The replacement schedule is updated periodically. The City's current practice is to set aside funds in advance of asset replacement in the VERF. For example, for a vehicle that is expected to be replaced at the end of 10 years, an annual transfer would be made to pre-fund the expected replacement cost. Rather than pre-funding 100% of the replacement cost, the City's current policy is to funds 90% of the replacement cost because this provides for adequate cash flow in the VERF.

This is a common method for funding equipment replacement programs in municipalities. The advantage of this approach is that a level, annual payment provides for future replacement. This eliminates large fluctuations that would occur if vehicle replacements were paid directly from operating funds and ensures that funds are available for scheduled replacements. A replacement schedule also makes budgeting for purchases less complex.

In addition, the City currently has no minimum fund balance requirement for the VERF.

<u>Analysis:</u> The chart in the next page shows what the fund balance in the VERF would look like with three different funding levels (90%, 85%, and 80%) from FY20 to FY42. The yellow line represents the proposed minimum fund balance requirement for the VERF. Staff recommends adding language specifying a minimum fund balance requirement of at least 10% of the value of assets requirement for the VERF.



At the 90% level of funding, fund balance for the VERF remains about $2 million above the proposed minimum fund balance requirement for the majority of the forecast period, which is positive. However, this means more money than necessary would be taken out of the General Fund since the majority of the transfers come from the General Fund.

At the 80% level of funding, fund balance for the VERF will be below the proposed minimum fund balance requirement from FY38 to FY41, so it is not a feasible option.

At the 85% level of funding, fund balance for the VERF stays above the proposed minimum fund balance requirement for the whole forecast period.

Staff found that the 85% funding level would not only allow the VERF to be sustainable without issuing debt, but also provide some relief on the General Fund (about $80,000 in FY21).

Minimum Fund Balance Requirement for the General Fund

Background: Reserves are the cornerstone of financial flexibility. Reserves provide a government with options for responding to unexpected issues and a buffer against financial downturns, natural disasters, and other forms of risk. Managing reserves, however, can be a challenge.

Emergencies or unanticipated situations can happen at any time. A snowier than predicted winter can rapidly exhaust a city's snow removal budget. Economically sensitive revenues such as sales or income taxes may plunge far more than originally forecast as an economic downturn occurs.

The National Advisory Council on State and Local Budgeting (NACSLB) and the Government Finance Officers Association (GFOA) recommend that all governments develop a formal, written fund balance policy that is made publicly available.

Current Practice: The City's current policy regarding the fund balance of the General Operating Fund is as follows –

- The City will maintain reserves of at least 15% of recurring expenditures in the General Operating Fund. This is in addition to any reserve that is established for a specific purpose.
- The reserve will be depleted below 10% only in the event of a catastrophic need.
- If the reserve dips below 15%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.

Analysis: In order to figure out the appropriate amount of reserve for the General Fund, staff followed the GFOA guidelines to analyze the risks that influence the level of reserves the City needs as a hedge against uncertainty and loss.

Three primary risks were identified: volatility of sales tax revenue; the potential for the City's infrastructure to fail; and the dependency of other funds on the General Fund. Secondary risk factors were also examined, including cash flow and the potential for unexpected spikes in expenditures. In addition, a comparison of the reserves held by comparable cities provided context:

City	Population	FY20 General Fund Expenditures	Minimum Fund Balance
Rolling Meadows	23,748	$34.9M	30% of recurring expenditures
North Chicago	29,770	$23.4M	30-40% of recurring expenditures
Crystal Lake	40,339	$28.8M	50% of recurring expenditures
Quincy	40,531	$33.4M	10% of recurring expenditures
Urbana	41,989	$35.7M	15% of recurring expenditures
DeKalb	42,611	$38.1M	25% of recurring expenditures
Wheaton	53,150	$43.6M	40% of recurring expenditures
Normal	54,264	$69.3M	15% of recurring expenditures
Champaign	86,637	$90.9M	12.5% of recurring expenditures

According to the risk analysis, the City has a moderate level of risk to manage through reserves. The analysis indicates that the City should consider adopting a target amount of reserves 20%-30% of recurring expenditures.

Staff recommends revising the minimum fund balance in the General Fund to at least 20% for FY21. In the FY22 budgeting process, staff will re-evaluate to determine whether the City can increase the minimum fund balance to 25%.

Summary of Proposed Changes for the Financial Policies

Changes Related to VERF Funding: Two specific changes in the Financial Policies relate to the proposed funding plan, as shown on the attached strikeout version of the Policies. Changes include –

- Annual charges will be made to various operating budgets at 85% of projected replacement cost spread over the life of the asset accounted for in this fund.
- The City will maintain reserves of at least 10% of the total value of assets included in the VERF for planned replacement of capital equipment.

Changes Related to General Operating Fund: Two specific changes in regards to the General Fund reserve, as shown on the attached strikeout version of the Policies. Changes include –

- The City will maintain reserves of at least 20% of recurring expenditures in the General Operating Fund.
- The reserve will be depleted below 15% only in the event of a catastrophic need.
- If the reserve dips below 20%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.

Fiscal Impact: The proposed changes to the Financial Policies would reduce General Fund recurring transfers to VERF by at least $80,000, compared to funding at the 90% level, as required by the current policy.

Governments that maintain adequate reserves are better positioned to deal with funding issues in bad times. Therefore, in good economic times it is prudent for governments to use a portion of budget surpluses to help create, sustain or increase the size of general fund reserves. Putting money into reserves is a more fiscally prudent action than spending surplus funds on new or expanded programs.

Recommendation: Forward the revised Financial Policies for approval at the City Council meeting on March 23, 2020.

RESOLUTION NO. 2020-03-015R

A RESOLUTION ADOPTING FINANCIAL POLICIES

(2020)

WHEREAS, Section 8-1-1 of the Illinois Municipal Code (65 ILCS 5/8-1-1) provides that the corporate authorities of each municipal corporation may control the finances of the corporation; and

WHEREAS, the City Council is the fiscal authority for the City of Urbana ("City") and is responsible for passing the annual budget ordinance and controlling the fiscal operations of the City; and

WHEREAS, the City Council is further responsible for ensuring that the City manages public funds appropriately; and

WHEREAS, on June 6, 2016, the City Council passed Resolution No. 2016-06-033R, adopting certain financial policies for the City to establish goals and targets for the City's financial operations, provide for a consistent approach to planning and budgeting, and support the City's long-term financial stability; and

WHEREAS, the City Council, after due consideration, finds that the adoption of revised financial policies as herein provided is in the best interests of the residents of the City and is desirable for the welfare of the City's government and affairs.

NOW, THEREFORE, BE IT RESOLVED by the City Council, of the City of Urbana, Illinois, as follows:

Section 1.

The financial policies attached hereto and hereby incorporated by reference, be and the same are hereby adopted.

Section 2.

Upon approval of this Resolution, the Finance Director shall administer these policies.

PASSED BY THE CITY COUNCIL this _____ day of ____________, _________.

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Charles A. Smyth, City Clerk

APPROVED BY THE MAYOR this ___ day of _____________, _______.

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Diane Wolfe Marlin, Mayor

FINANCIAL POLICIES

I. **Purpose:** Financial policies establish goals and targets for the City's financial operations. Formal policies provide for a consistent approach to planning and budgeting, and support the City's long-term financial stability.

II. **Long-term Planning:** Each year the City's Finance Department will prepare a five-year financial forecast for the City's General Operating Fund to assess the City's future fiscal condition. The purpose of the forecast is to give context to decisions that will be made in the budget process.

III. **Balanced Budget:** The City considers the budget to be balanced if budgeted, recurring expenditures in the General Operating Fund do not exceed 98.5% of budgeted, recurring revenues. In other City funds, unless specific reserve targets have been established, expenditures will not exceed the total of budgeted revenues and unassigned fund balance at the beginning of the year.

IV. **Reserves:** The city will maintain adequate reserves to establish a cushion of available cash during economic downturns, finance cash flow needs, provide stable tax rates, and provide for unanticipated needs or unexpected opportunities.

A. **General Fund:** The City will maintain reserves of ~~approximately~~ at least ~~15~~20% of recurring expenditures in the General Operating Fund. This is in addition to any reserve that is established for a specific purpose. The reserve will be depleted below ~~10~~15% only in the event of a catastrophic need. If the reserve dips below ~~15~~20%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.

~~This level of reserve~~A reserve level of no less than 20% is appropriate given-

- the City's reliance on cyclical revenue sources (e.g., sales tax)
- the reliance of other funds (e.g., Retained Risk and Capital Improvements) on the General Fund as a source of revenue
- the current backlog of unmet capital needs, which could result in an immediate demand for funds due to infrastructure failures
- the potential for unavoidable cost increases imposed by the State of Illinois
- concerns about the potential impact of the State's fiscal situation, including potential reductions in State-shared revenues

B. Vehicle & Equipment Replacement Fund (VERF): The City will maintain ~~adequate~~ reserves of at least 10% of the total value of assets included in the VERF for planned replacement of capital equipment. Annual charges will be made to various operating budgets at 85%~~90%~~ of ~~calculated straight-line depreciation for each capital asset~~projected replacement cost spread over the life of the asset accounted for in this fund. The replacement schedule will be updated ~~on an annual basis~~at least biennially. A capital asset is defined as equipment with an initial purchase price of $5,000 or more and a useful life of 5 years or more.

Other funds, including the Landscape Recycling Center Fund and the Equipment Services Fund, may retain reserves for equipment replacement separate from the Vehicle and Equipment Replacement Fund. Adequate funds will be reserved in fund balance for planned equipment replacement.

C. Retained Risk: Retained Risk Fund reserves will be maintained to provide funding in the event of large workers compensation and liability claims. The reserve amount will be established based on a periodic actuarial review. Annual transfers will be made from operating budgets to support risk management activities such as insurance premiums and routine claims, as well as to replenish the reserve, when necessary. Reserves will be replenished over time to minimize impact on the operating budget.

V. Property Taxes: The City's goal is to maintain a property tax rate equal to that of the City of Champaign, and to work with overlapping taxing districts to create an overall tax rate equal to the City of Champaign.

A. Pension Funds: The City will levy property taxes to provide funding for a 20-year closed period amortization of 100% of unfunded liability, including a five-year transition to the higher funding level, beginning with the 2018 property tax levy. Contributions will be calculated using the entry age normal (level percent of pay) method. Asset smoothing will be used over a five-year period to reduce the effects of market volatility. 8.12% of the pension funding requirement will be allocated from personal property replacement tax, also consistent with State law.

Prior to levying taxes in 2028, staff will recommend to the City Council an appropriate strategy to minimize volatility as the funds move closer to the goal of being fully funded.

B. **Library General Fund:** The City levies property taxes for the Library to support operations, which are funded from the Library's General Fund. The City Council approves the Library's budget, including estimated property tax revenues necessary to support the expenditure budget. When the City Council approves the property tax levy, it will include a levy sufficient to support the approved Library General Fund budget. (The City also allocates a portion of the Ameren franchise fee to the Library, based on the Library's proportionate benefit from free gas therms provided by Ameren prior to the franchise agreement approved in 2015. This allocation will continue in the same proportion.)

C. **Corporate Tax Levy:** Remaining funds that can be raised within the City's target tax rate will be allocated to the General Operating Fund to pay for public safety services.

VI. Capital Improvements: Capital improvements are defined as a project or activity costing more than $10,000 resulting in construction, renovation, or acquisition of land, infrastructure, or buildings, with an expected life of at least 10 years.

A. **Capital Improvement Fund:** The Capital Improvement Fund is used to pay for capital improvements that do not have another source of funding, or for which other sources are insufficient. The City's goal is to increase funding for capital improvements each fiscal year by at least the amount of increase in the construction cost index for the prior calendar year. This funding is to be used only for the purpose of funding capital improvements.

As the budget allows, the City will consider additional one-time transfers to provide additional funding for infrastructure maintenance and improvements; or increasing the base level of the recurring transfer to provide a stable, ongoing source of funding.

B. **Stormwater and Sewer Improvement Funds:** These enterprise funds are established to provide ongoing funding for maintenance and improvements to the City's stormwater and sanitary sewer systems. Fees will be established to provide funding consistent with long-term plans for operation and maintenance of these systems.

C. **State and Local Motor Fuel Tax Funds:** These funds are reserved for transportation improvements.

VII. **Debt:** The City may use long-term borrowing for capital projects that cannot be funded from current resources, when the improvements have a useful life of 25 years or more. Debt maturities will not exceed the useful life of the improvement. Combined debt service payments will not exceed 10% of recurring General Operating Fund revenues, regardless of the source of repayment. The City will generally use bank qualified bonds because of the lower cost of borrowing and reduced administrative burden.