



**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: May 30, 2019
SUBJECT: **Vehicle and Equipment Replacement Fund (VERF) and Financial Policies**

Introduction: The purpose of this memo is to discuss the VERF and a recommendation to revise the City's Financial Policies.

Discussion:

Funding Equipment Replacement

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 \$15 million in FY20.

Current Practice: The replacement schedule is updated periodically. The City's current practice is to set aside funds in advance of vehicle 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 currently funds 90% of the replacement cost because this provides for adequate cash flow in the VERF. These contributions are in addition to the annual transfer of \$119,000 from the General Fund, which would need to continue through FY31.

Annual charges for each item are calculated based on quantity, useful life, and future replacement costs. For example, a copier that has a life of five years and costs \$10,000 in FY17 will be due for replacement again in FY23. Assuming inflation is 2%, the replacement cost in FY23 will be $\$10,000 \times 1.02^5 = \$11,040$ (rounded). Since the funding level is at 90%, the total amount charged for this copier would be $\$11,040 \times 90\% = \$9,936$ (rounded). The schedule of annual charges for this copier would look like this:

FY19	FY20	FY21	FY22	FY23	
\$1,910	\$1,948	\$1,986	\$2,026	\$2,066	\$9,936

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.

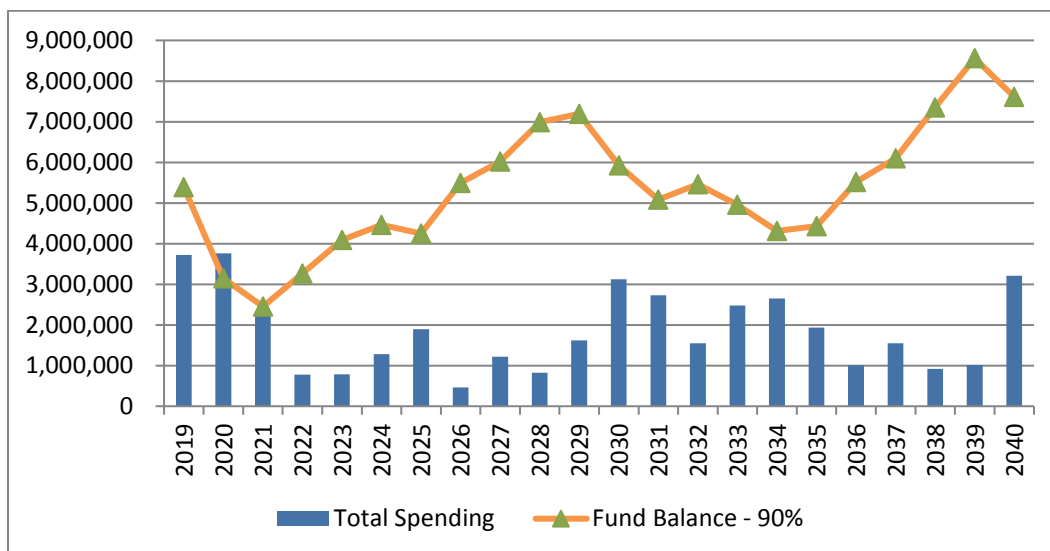
Evaluation of Funding Issues: When an evaluation of the VERF was performed by Finance staff in 2015, staff determined that the VERF would be \$2.7 million short of what was needed to replace scheduled equipment. The solution included in the proposed budget for FY16 was to transfer additional funds from the City’s General Fund over three years to correct the funding problem. As budgets became tighter, this amount was reduced and the period for making the correction was extended.

In the FY18 budget, an annual transfer of \$180,000 was included. In the FY19 budget, the amount was reduced to \$119,000 after the approval of the vehicle leasing program by City Council. The vehicle leasing program was introduced by staff with a goal to eliminate the need to pre-fund some vehicle replacements, reducing the underfunding problem in the VERF, while allowing the City to benefit from reduced life cycle costs as vehicles are turned over more frequently.

Analysis: Following further review of the VERF, staff found it more cost-effective to continue to purchase vehicles with City funds, rather than leasing, and plan to issue debt at appropriate times to avoid a deficit in this fund. This will eliminate the need for an annual transfer of \$119,000 to address the projected VERF deficit. That is in addition to a reduction of \$61,000 that was included in the FY19 budget related to the plan to lease some vehicles.

This year’s VERF review included adjusting the purchase price or scheduled life of some items. The most significant change is that the expected cost to replace radio equipment for Police, Fire, and Public Works in FY20 increased by more than \$450,000. Other adjustments were relatively modest.

The current financial policies require annual charges to various operating budgets at a minimum of 90% of calculated straight-line depreciation for each capital asset accounted in this fund. The chart below shows what the fund balance in the VERF would look like in this scenario, which assumes that the annual transfer of an additional \$119,000 continues through FY31:



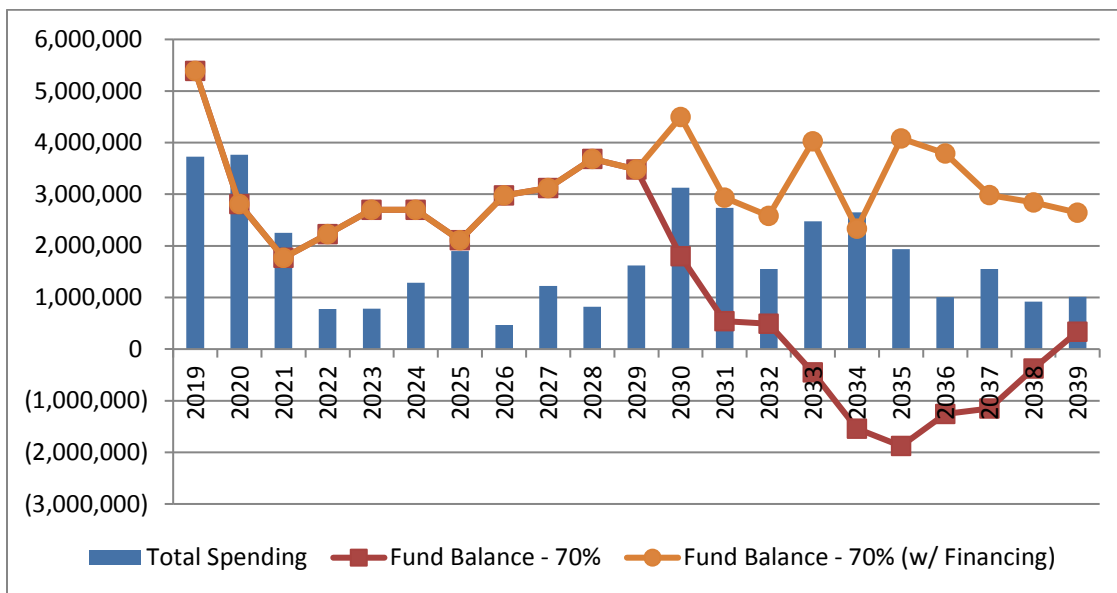
At this level of funding, fund balance for the VEF would remain healthy through FY40. However, this means more money would be taken out of the General Fund since the majority of the transfers come from the General Fund. At a time when the City is still in the process of correcting a structural deficit, this has placed some constraints on the process.

Proposed Changes: After performing extensive analysis, staff found a solution that would not only relieve the burden on the General Fund but also create a framework allowing the VEF to function without additional help from the General Fund. This solution consists of two changes to current practices:

1. Reduce the annual charges made to various operating budgets from 90% to 70% of calculated straight-line depreciation for each capital asset accounted in the VEF.
2. Use long-term borrowing to finance equipment purchases during periods when the fund balance would fall below 10% of the total value of assets included in the VEF. Debt issued to finance equipment purchases would not have maturities exceeding 10 years.

The chart below shows the difference in fund balance between issuing debt and not issuing debt:

- The red line shows how the fund balance at the 70% funding level would be affected without issuing debt
- The orange line shows how the fund balance at the 70% funding level would perform when the City issues debt in an amount of \$3 million at a 3% interest rate in FY30, FY33, and FY35



Without issuing debt, the fund balance would decrease significantly in FY30 when spending is high, then would go in a deficit in FY33, and would not get out of the deficit until FY39. However, if the City issues debt when the fund balance is below 10% of the total value of assets, the fund balance would remain stable through FY39. This would have a significant impact because the VEF would be able to stay healthy, reducing transfers from the General Fund.

Although the funding level will decrease from 90% to 70%, the transfer amount from the General Fund to VEF will not decrease significantly mostly due to the rising costs of assets. In FY19, the

transfer amount from the General Fund to VVERF is \$1.44 million, including \$119,000 related to fixing the projected deficit. In FY20, the transfer amount would be \$1.14 million, giving the City more flexibility in the budgeting process.

Implementation: Staff would continue to update the VVERF annually and monitor the fund balance periodically. When staff expects that the fund balance will go below 10% of the total asset value in the future, a plan to issue debt will be presented to the City Council for approval.

Financial Policies

Changes Related to VVERF 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 revising the funding level from 90% to 70%, adding language regarding the use of debt financing when fund balance drops below 10% of the value of assets, and revising the section on debt accordingly.

Minor Change: There is also a minor change in wording in regards to the General Fund reserve that is unrelated to the VVERF. The new policy would now require the City to maintain a reserve of **at least**, instead of approximately, 15% of recurring expenditures in the General Operating Fund. The reason is that staff wants to make it clear that the reserve level of 15% is a minimum and not a goal.

Fiscal Impact: The proposed changes to the Financial Policies would eliminate the additional annual transfer of \$119,000 from the General Fund to the VVERF permanently.

Recommendation: The revised Financial Policies will be presented for review at the Committee of the Whole meeting on June 10. Staff will recommend that the revised Policies be forwarded for City Council approval on June 17.

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% 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.

This level of reserveA reserve level of no less than 15% 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 for planned replacement of capital equipment. The goal of the VERF is to provide funding to replace aged capital equipment with like equipment, when replacement is needed to maintain services to the community. 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.~~

~~B.~~ Annual charges will be made to various operating budgets at ~~9070%~~ of calculated straight-line depreciation for each capital asset accounted for in this fund. ~~The City will use debt financing to cover purchases during periods when the fund balance would drop below 10% of the total value of assets included in the VERF.~~ 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.

VII. The City may also use long-term borrowing to finance equipment purchases. Debt issued to finance equipment purchases will not have maturities exceeding ten years.