Memorandum

To: City Council

From: Scott Hugill, City Manager

Date: September 5, 2017

Subject: Review of Six-Year Financial Forecast

BACKGROUND

The city maintains a Six-Year Financial Forecast as part of the City Council's goal to "protect and enhance the City's Financial Health and Stability while maintaining appropriate and essential public services in a cost effective manner." The forecast lays out the anticipated revenues and expenditures in each of the city's main funds over the next six years in order to ensure spending does not outpace resources, while also balancing and achieving the Council's priorities.

A review of the forecast is done at the end of the summer as one of the first steps in a city's development of a budget for the next calendar year. Although Mountlake Terrace adopts a two year (biennial) budget that would not require a review this year, the City Council has traditionally reviewed the forecast at the end of every summer to ensure the city stays on track financially.

The September 5 agenda includes a review of the city's finances from 2016 (actual) to 2023 (projected). Included in the attached forecast is a column of "2017 Projected," with any changes from the 2017 adopted budget highlighted in yellow.

GENERAL FUND

One of the first things to note in the forecast is the positive change in the 2017 beginning fund balance. The 2017/2018 budget adopted in fall 2016 anticipated a beginning fund balance of just over $26,000. Due to the support of the community, and the actions of the Council and organization in 2016, the beginning fund balance ended up being approximately $1,000,000 higher than budgeted. This put the community on track to add police resources and invest in parks, recreation and economic development.

Development activity has also returned to Mountlake Terrace, with development fees projected to be approximately $290,000 more than budgeted in 2017. As a result the city has brought on contract employees to aid in the review and inspection of development.

The bottom line for the General Fund (highlighted in yellow on Page 3 of the forecast) is that service levels, reserves and the fund balance are on pace to return to healthy levels by 2020, contingent on the passage of a measure to construct a new city hall in November. If the city hall measure is not passed in November, the city will once again draw down reserves or reduce program levels elsewhere to cover the cost of rent at Interim City Hall.

How to ensure we have a budget that spends within annual operating revenues

Spending no more than we bring in comes down to financial planning and prioritizing services. Programs with a lower priority are not funded if the higher priorities use-up the available resources over a multi-year planning period (hence the six-year financial forecast).

The City Council went through an exercise in prioritizing programs in the late 1990s and early 2000s to identify the core services in the General Fund to ensure those programs were funded. Those programs (which remain the core services provided today under the Council's priorities) include the following:

- **Police:** Beginning in 1990, the city sought to reach a staffing level of 1.8 commissioned law enforcement personnel for every 1,000 residents. At the highest level, the City had 32 commissioned personnel in 2000 (a ratio of 1.7). This number was reduced following the loss of motor vehicle excise tax revenue in the early 2000s following a voter-approved initiative.[1]

  Changes in service delivery over the past several years has changed the ratio of commissioned personnel further. In the late 1990s, patrol officers worked shifts of eight hours, which required three officers to fill a 24 hour day. By the early 2000s, patrol officers were working shifts of 12 hours, meaning two officers were needed to fill a 24-hour day.[2]

  Officer staffing has continued to be reduced as other non-commissioned personnel were brought on board to supplement what had traditionally been commissioned positions, such as Code Enforcement Officers, Domestic Violence Coordinator, Custody/Jail Transport Officer, etc. These staff have also reduced through attrition during the Recession.

- **Fire / EMS:** The city has contracted with Fire District 1 since 2005. This contract remains lower than if the city had its own fire department, primarily through a reduction in administrative costs, overtime, and the ability to provide revenue-generated Advanced Life Support (ALS).

- **Municipal Court:** The city contracts with Snohomish County to operate a municipal court through South District Court in Lynnwood. Traffic citations and misdemeanor cases brought about by Mountlake Terrace police are handled by county judges.

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[1] The Motor Vehicle Excise Tax (MVET) was established in 1937. By the 1990s a portion of the funds collected were passed along to cities "for the purposes of police and fire protection and the preservation of the public health in the city or town." When MVET was reduced by the Legislatures in the early 2000s, state funding for city police and fire services went away.

[2] This is not to say we only need two officers per day to fill a 24-hour day. Each 12-hour patrol shift is made up of at least three personnel (a sergeant and two officers), and each of these positions requires another body to cover for days off or while in training. In addition, a minimum of three detectives are needed outside of patrol. The bottom line is that the city has a need for at least 20 officers and sergeants (four, four-person patrol groups and a four-person detective unit). Additional resources are assigned for collateral assignments outside the department, such as the narcotics task force.

- **Recreation Programs:** Although Recreation is accounted for in a separate fund, the General Fund annually subsidizes about 20 percent of the program. This amounts to between $400,000 and $500,000 per year. Services include aquatics, dance, childcare and league sports.

- **Parks Maintenance:** The city has over 180 acres of park land, ranging from passive open space to ballfields. Because much of this land was acquired or improved with grants that require the property to be maintained for public use, the city has a staff of four maintenance employees who work on parks maintenance; another two maintenance employees work on facilities (e.g., the Pavilion, Police Station, Public Works Shop, Fire Station 19, etc.).

- **Development Services:** Community and Economic Development (CED) provides the review of building and land use plans, the inspection of development, and the update of policies and codes to guide land use and development. CED has a policy of recovering 80 percent of its costs through charges and fees.

- **Street Maintenance:** Although street maintenance is accounted for in a separate fund (due to the need to account for how motor vehicle fuel taxes are used), the General Fund subsidizes street maintenance at a varying degree depending on the project needs above the amount the city receives in fuel tax revenue.

Steps taken under the "control budget"

The term "control budget" refers to the practice of the City Manager limiting discretionary spending to levels below the adopted budget. Examples of the control budget used during the Recession include approving fewer conferences, requiring carpooling to training and not buying new when old will do (or buying new when the old is so broken that it is not safe or generating revenue).

Additional steps taken during the Recession to limit spending included leaving positions vacant. The attached charts show the number of hours worked by city employees for each year from 2008 through 2015. You will see quite a reduction. (If a full time employee is assumed to work 2,000 hours per year, staff has been reduced by about 25 positions since 2008.)

How reserves are used

Reserve funds enable the city to deal with unforeseen emergencies, changes in economic conditions, and to set aside small amounts over time to pay for large capital expenses in future years. The City Council received a copy of an article from the Government Finance Officers Association (GFOA) at the April 18 meeting that recommended a 16 percent General Fund reserve. Mountlake Terrace maintains a 12 percent reserve:

- **Strategic Reserve Fund (formerly the "Revenue Stabilization Fund"):** This fund was created in the 1999 budget. The Strategic Reserve Fund provides funds to offset revenue fluctuations in the General Fund, which may come about due to natural or economic disasters. The Strategic Reserve Fund is targeted at not less than an amount equal to five percent of annual General Fund operating expenditures.

An example where this fund comes into use is during the closure of a casino, and the associated loss of gambling tax revenue. Throughout the Recession we did not use this Fund. If the Fund had been spent in the early stages of the Recession, we would have nothing to use in subsequent years of the Recession. Instead, we reduced costs through staff attrition.

- **Contingency Reserve:** A Contingency Reserve equal to two percent of General Fund operating expenditures is budgeted each year to accommodate unexpected operational changes, legislative impacts, or other economic events affecting the City's operations that could not have been reasonably anticipated at the time the budget was prepared. The City Council determines how the Contingency Fund is spent.

  An example of where this fund comes into would be covering higher-than-anticipated costs of a street construction project.

- **Reserve:** The city keeps a General Fund Reserve for cash flow throughout the year.

ATTACHMENTS

- GFOA: General Fund Reserves Help Boost Bond Ratings
- GFOA Best Practice: Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund (CAAFR, Budget)
- 4 Charts: Employee Hours Worked, 2008-2015

GFOA: General Fund Reserves Help Boost Bond Ratings

Thursday, January 14, 2016

Since the recession of 2008, economic conditions have fluctuated between adequate and poor for the City of Elgin, Illinois, but it has been able to stabilize its bond rating through strong financial policies – most notably, those governing its general fund reserve levels.

In fiscal 2009, on the heels of the largest economic downturn in recent history, Elgin's revenue picture looked uncertain. The city had demonstrated sound financial stewardship but couldn't escape the impact of broader, nation-wide, economic conditions. And despite cutting spending by approximately 10%, as well as adopting a new service delivery model, Elgin was worried about its bond rating – the city simply wasn't in a position to absorb increased borrowing costs.

The Finance Department therefore identified several financial objectives for the coming years and drafted them into formally adopted financial policies. One objective was to maintain or upgrade Elgin's bond rating by Standard and Poor's (AA+), Fitch Ratings Services (AA+) and/or Moody's Investors Service (Aa2). Making such an explicit statement provided focus, giving the city a clear and easily quantifiable target.

Determining how to achieve this goal was the next step. The city met the challenge by creating additional policies requiring the city to keep cash reserves at 16% to 19% of annual expenditures. The commitment did not go unnoticed by the rating agencies, ultimately resulting in the city gaining AAA status on its general obligation bonds from Fitch Ratings in 2015. Among the positive factors the agency noted were "very strong liquidity in unrestricted government cash and short-term investments" and "very strong budgetary flexibility [due to] available reserves." The rating agency's Financial Management Assessment methodology also found the city's management conditions to be very strong because of it financial policies and practices.

GFOA Best Practice: Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund (CAAFR, Budget) (2015)

Background. In the context of financial reporting, the term *fund balance* is used to describe the net position of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net position of governmental funds calculated on a government's budgetary basis. While in both cases *fund balance* is intended to serve as a measure of the financial resources available in a governmental fund; it is essential that differences between GAAP *fund balance* and budgetary *fund balance* be fully appreciated.

1. GAAP financial statements report up to five separate categories of fund balance based on the type and source of constraints placed on how resources can be spent (presented in descending order from most constraining to least constraining): *nonspendable fund balance*, *restricted fund balance*, *committed fund balance*, *assigned fund balance*, and *unassigned fund balance*.2 The total of the amounts in these last three categories (where the only constraint on spending, if any, is imposed by the government itself) is termed *unrestricted fund balance*. In contrast, budgetary fund balance, while it is subject to the same constraints on spending as GAAP fund balance, typically represents simply the total amount accumulated from prior years at a point in time.

2. The calculation of GAAP fund balance and budgetary fund balance sometimes is complicated by the use of sub-funds within the general fund. In such cases, GAAP fund balance includes amounts from all of the subfunds, whereas budgetary fund balance typically does not.

3. Often the timing of the recognition of revenues and expenditures is different for purposes of GAAP financial reporting and budgeting. For example, encumbrances arising from purchase orders often are recognized as expenditures for budgetary purposes, but never for the preparation of GAAP financial statements.

The effect of these and other differences on the amounts reported as *GAAP fund balance* and *budgetary fund balance* in the general fund should be clarified, understood, and documented. It is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. In most cases, discussions of fund balance will properly focus on a government's general fund. Nonetheless, financial resources available in other funds should also be considered in assessing the adequacy of unrestricted fund balance in the general fund.

Credit rating agencies monitor levels of fund balance and unrestricted fund balance in a government's general fund to evaluate a government's continued creditworthiness. Likewise, laws and regulations often govern appropriate levels of fund balance and unrestricted fund balance for state and local governments.

Those interested primarily in a government's creditworthiness or liquidity (e.g., rating agencies) are likely to favor higher levels of fund balance. Opposing pressures often come from unions, taxpayers and citizens' groups, who may prefer that fund balance in excess of a government's formal policy requirements, be used for other purposes.

Recommendation. GFOA recommends that governments establish a formal policy on the level of unrestricted fund balance that should be maintained in the general fund for GAAP and budgetary purposes.3 Such a guideline should be set by the appropriate policy body and articulate a framework and process for how the government would increase or decrease the level of unrestricted fund balance over a specific time period.4 In particular, governments should provide broad guidance in the policy for how resources will be directed to replenish fund balance should the balance fall below the level prescribed.

Appropriate Level. The adequacy of unrestricted fund balance in the general fund should take into account each government's own unique circumstances. For example, governments that may be vulnerable to natural disasters, more dependent on a volatile revenue source, or potentially subject to cuts in state aid and/or federal grants may need to maintain a higher level in the unrestricted fund balance. Articulating these risks in a fund balance policy makes it easier to explain to stakeholders the rationale for a seemingly higher than normal level of fund balance that protects taxpayers and employees from unexpected changes in financial condition. Nevertheless, 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 of regular general fund operating revenues or regular general fund operating expenditures.5 The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a government's particular circumstances.6 Furthermore, a government's particular situation often may require a level of unrestricted fund balance in the general fund significantly in excess of this recommended minimum level. In any case, such measures should be applied within the context of long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unrestricted fund balance in the general fund at any one time. In establishing a policy governing the level of unrestricted fund balance in the general fund, a government should consider a variety of factors, including:

1. The predictability of its revenues and the volatility of its expenditures (i.e., higher levels of unrestricted fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile);

2. Its perceived exposure to significant one-time outlays (e.g., disasters, immediate capital needs, state budget cuts);

3. The potential drain upon general fund resources from other funds, as well as, the availability of resources in other funds;

4. The potential impact on the entity's bond ratings and the corresponding increased cost of borrowed funds;

5. Commitments and assignments (i.e., governments may wish to maintain higher levels of unrestricted fund balance to compensate for any portion of unrestricted fund balance already committed or assigned by the government for a specific purpose). Governments may deem it appropriate to exclude from consideration resources that have been committed or assigned to some other purpose and focus on unassigned fund balance, rather than on unrestricted fund balance.

Use and Replenishment.
The fund balance policy should define conditions warranting its use, and if a fund balance falls below the government's policy level, a solid plan to replenish it. In that context, the fund balance policy should:

1. Define the time period within which and contingencies for which fund balances will be used;

2. Describe how the government's expenditure and/or revenue levels will be adjusted to match any new economic realities that are behind the use of fund balance as a financing bridge;

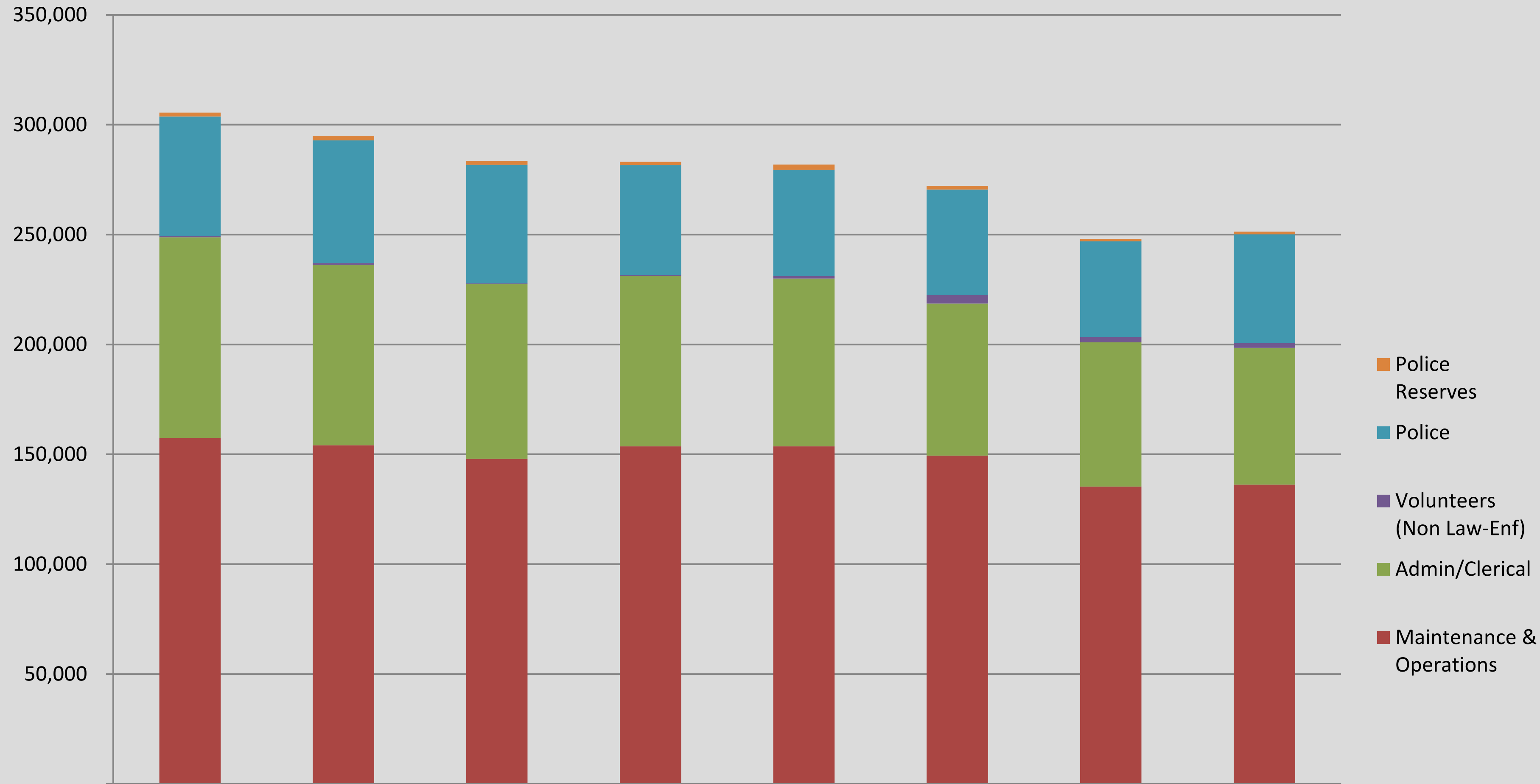
3. Describe the time period over which the components of fund balance will be replenished and the means by which they will be replenished. Generally, governments should seek to replenish their fund balances within one to three years of use. Specifically, factors influencing the replenishment time horizon include:

a. The budgetary reasons behind the fund balance targets;
b. Recovering from an extreme event;
c. Political continuity;
d. Financial planning time horizons;
e. Long-term forecasts and economic conditions;
f. External financing expectations.

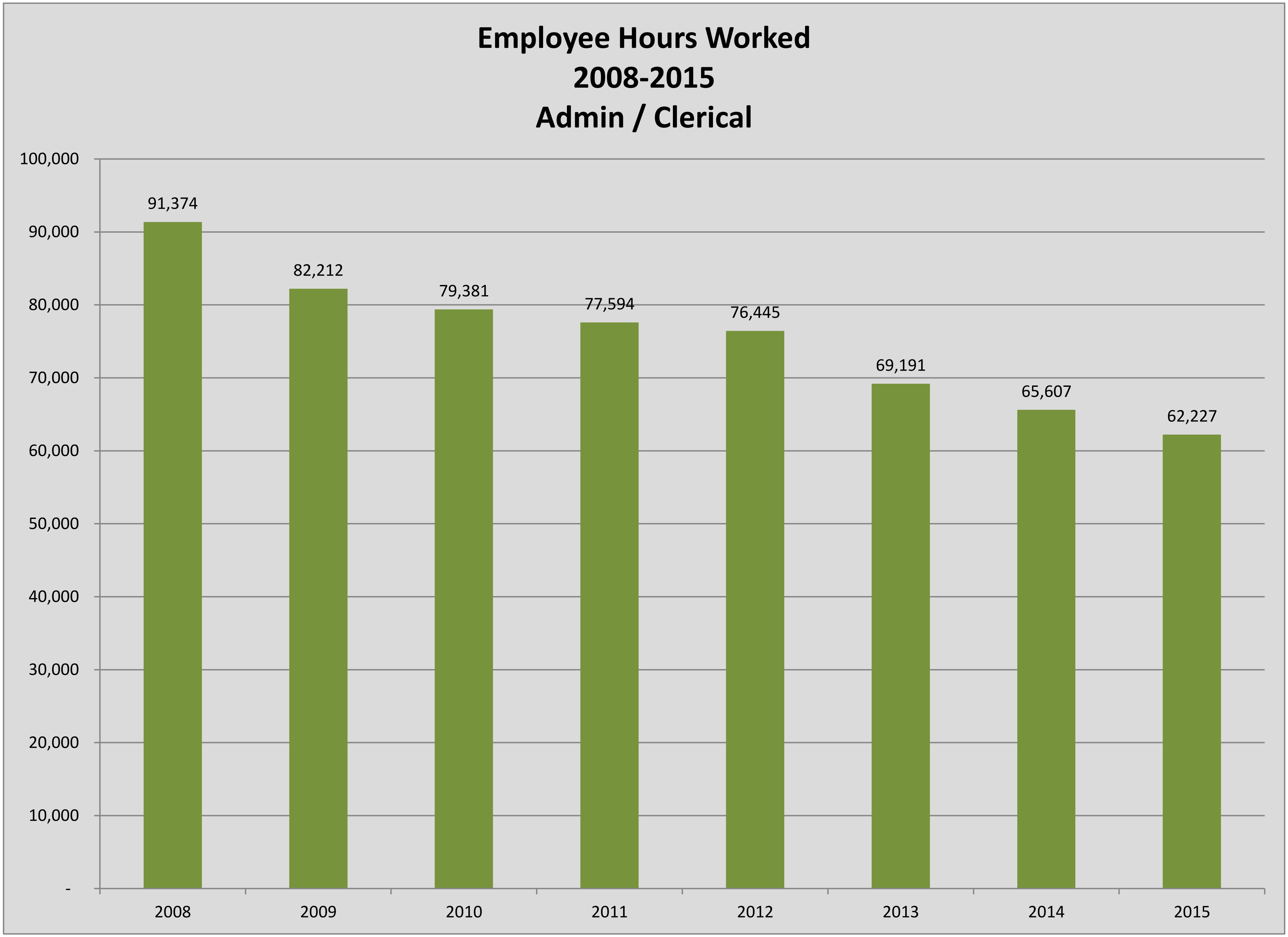
Revenue sources that would typically be looked to for replenishment of a fund balance include nonrecurring revenues, budget surpluses, and excess resources in other funds (if legally permissible and there is a defensible rationale). Year-end surpluses are an appropriate source for replenishing fund balance.

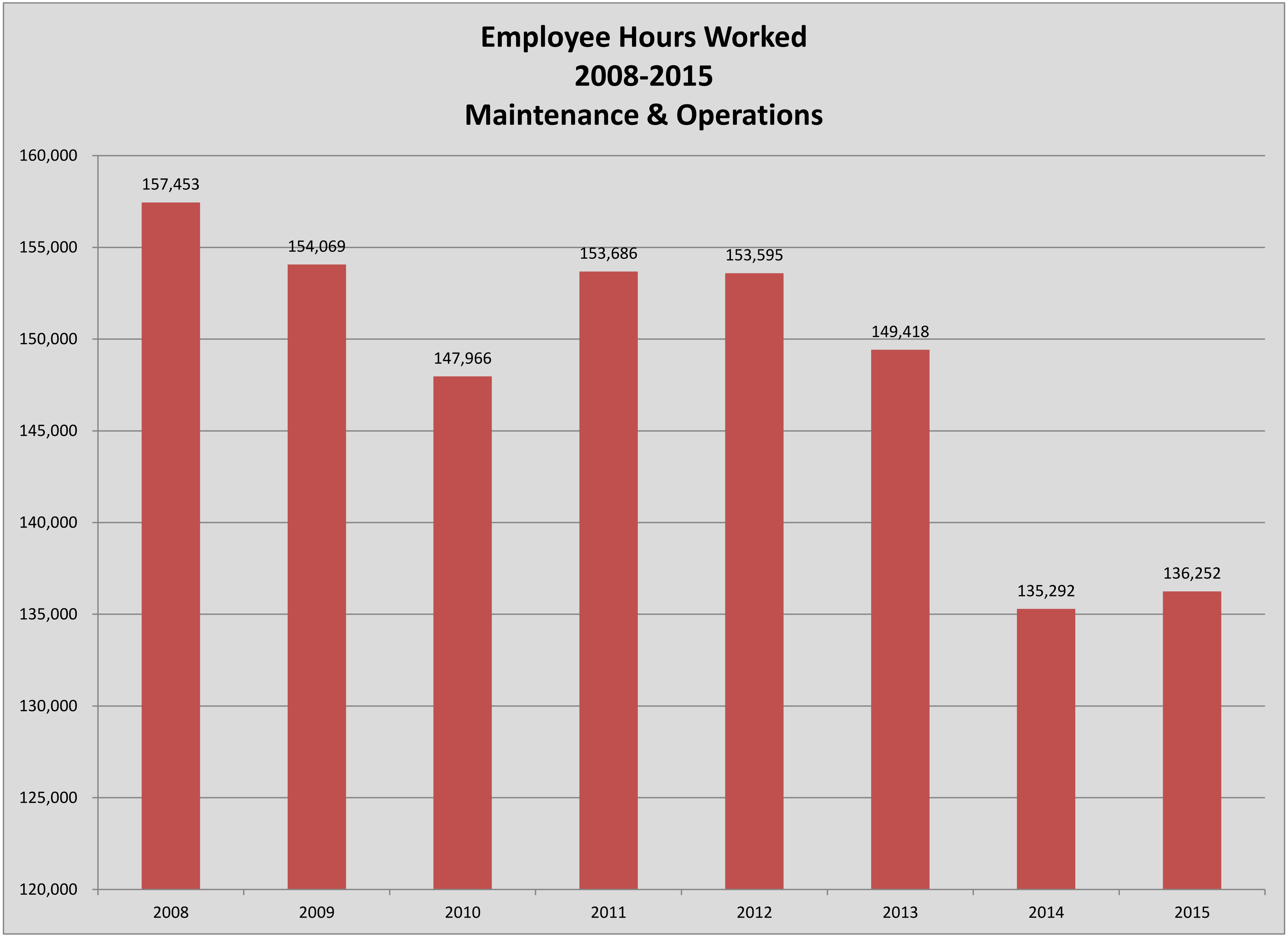
Unrestricted Fund Balance Above Formal Policy Requirement. In some cases, governments can find themselves in a position with an amount of unrestricted fund balance in the general fund over their formal policy reserve requirement even after taking into account potential financial risks in the foreseeable future. Amounts over the formal policy may reflect a structural trend, in which case governments should consider a policy as to how this would be addressed. Additionally, an education or communication strategy, or at a minimum, explanation of large changes in fund balance is encouraged. In all cases, use of those funds should be prohibited as a funding source for ongoing recurring expenditures.

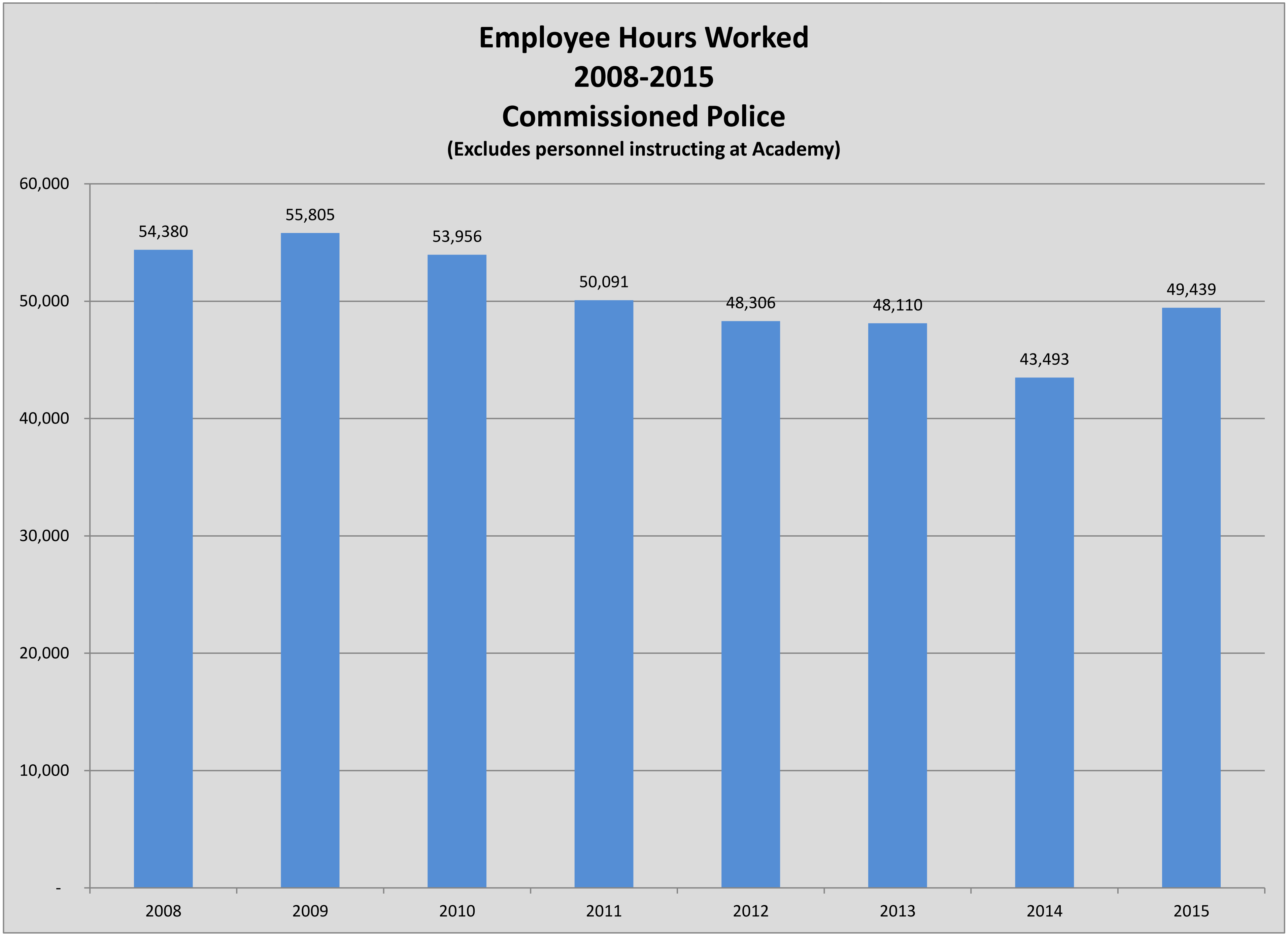
Employee Hours Worked
2008-2015



	2008	2009	2010	2011	2012	2013	2014	2015
Police Reserves	1,761	2,061	1,701	1,487	2,284	1,535	1,119	1,143
Police	54,380	55,805	53,956	50,091	48,306	48,110	43,493	49,439
Volunteers (Non Law-Enf)	501	806	464	272	1,229	3,845	2,510	2,274
Admin/Clerical	91,374	82,212	79,381	77,594	76,445	69,191	65,607	62,227
Maintenance & Operations	157,453	154,069	147,966	153,686	153,595	149,418	135,292	136,252


Employee Hours Worked
2008-2015
Admin / Clerical
100,000
90,000
80,000
70,000
60,000
50,000
40,000
30,000
20,000
10,000
-
91,374
82,212
79,381
77,594
76,445
69,191
65,607
62,227
2008
2009
2010
2011
2012
2013
2014
2015


Employee Hours Worked
2008-2015
Maintenance & Operations
160,000
155,000
150,000
145,000
140,000
135,000
130,000
125,000
120,000
157,453
154,069
147,966
153,686
153,595
149,418
135,292
136,252
2008
2009
2010
2011
2012
2013
2014
2015


Employee Hours Worked
2008-2015
Commissioned Police
(Excludes personnel instructing at Academy)
60,000
50,000
40,000
30,000
20,000
10,000
-
54,380
55,805
53,956
50,091
48,306
48,110
43,493
49,439
2008
2009
2010
2011
2012
2013
2014
2015