ATTACHMENT 3

INTRODUCTION

Prudent fiscal reserves are a mark of stability and a cornerstone of financial flexibility. The difficult question is: what constitutes a prudent fiscal reserve? The Government Finance Officers Association ("GFOA") best practice recommends, at a minimum, that general-purpose governments, regardless of size, maintain an unrestricted budgetary fund balance in their general fund of no less than two months of regular general fund operating revenues or operating expenditures. This means the City should never have less than **$8,319,016** in General Fund reserves based on GFOA-recommended best practices.

In March 2020, the City Council adopted a Risk Based Reserve Policy. The former Reserve Policy directed funding be set aside based on a percentage of General Fund revenues. The former policy did not consider certain specific risk factors (i.e., disasters, unfunded liabilities, emerging issues, liquidity, and growth) that could affect the City. The Risk Based Reserve Policy takes into consideration nine risk factors that could impact the City's ability to deliver services and assigns a specific dollar amount to each factor. This approach represents a more dynamic, transparent, and effective budgeting tool to help the City Council and staff determine the appropriate level of funding needed in reserve. Staff is to conduct a General Fund Reserve Risk Analysis every two years in tandem with the formulation of the Operating Budget.

The discussion below defines "Reserves" and provides explains their importance to managing the finances of a city.

WHAT ARE RESERVES?

The terms "reserves" and "fund balance" are often used interchangeably, which can be confusing. Fund balance is an accounting term to describe the difference between a fund's assets and liabilities. In general, when municipal leaders are discussing the need for reserves, it is in the context of "reserving" funds for future expenses. Reserve expenses are costs associated with repairs or replacements to existing assets or expenses associated with special circumstances. Like savings for a "rainy day" in a personal budget, reserves can also be used for unplanned expenses related to litigation, economic downturns, and emergencies/natural disasters. Many cities utilize unrestricted reserves to fund capital improvements, avoid debt service costs, and increase the ability to cash flow fund a project during construction. It is essential to clearly define the intended use for the City's established reserve balance which is the purpose for the risk factors discussed later in this analysis.

WHY DOES THE CITY HAVE RESERVES?

Ideally, a city can maintain a stable set of public services throughout an entire economic lifecycle. Maintaining healthy reserve balances protects the City from economic uncertainties and mitigates risks. Prudent reserves provide the City with options for responding to recessions and other issues and/or emergencies without impacting funds budgeted for day-to-day operations. It is vital that the City take advantage of good economic times by setting aside for those "rainy days" which are bound to occur in the future.

WHY NOT JUST RAISE TAXES OR FEES IF THE CITY NEEDS MORE MONEY?

California voters have passed numerous measures that restrict the tax and fee raising authority of state and local governments. The most recent was Proposition 218, approved in 1996. Proposition 218 added restrictions to taxes, fees, and assessments, making it necessary to obtain voter approval to establish and/or raise many of them. Therefore, cities are best to plan to meet financial obligations utilizing the revenues available to it rather than depending upon voters to provide additional resources.

Table 1 below compares Lake Forest's reserves to a subset of Orange County cities of similar size, operations, and demographics. Data for Table 1 was compiled from the Comprehensive Annual Financial Reports for Fiscal Year Ending June 30, 2020, for each city listed below.

Table 1 - CITY COMPARISON
(IN MILLIONS)

CITY	RESERVES	GENERAL FUND REVENUE	PERCENTAGE OF RESERVES TO REVENUE
Aliso Viejo	$32.9	$19.4	168%
Rancho Santa Margarita	$21.4	$18.0	119%
Lake Forest	***$55.9***	***$52.4***	***107%***
Laguna Niguel	$40.8	$44.2	92%
Yorba Linda	$33.6	$38.8	87%
San Juan Capistrano	$22.6	$28.5	79%
Brea	$33.0	$54.9	60%
Dana Point	$17.4	$38.3	45%
Mission Viejo	$27.9	$62.2	45%
San Clemente	$24.5	$61.9	40%
Laguna Hills	$8.1	$21.8	37%
Average	**$28.9**	**$40.0**	**80%**

On March 3, 2020, the City Council adopted a Target Reserve Level of $43.9 million and a Minimum Reserve Level of $41.7 million (5% below the Target Reserve Level amount) based upon a risk analysis conducted by staff. Should the City Council vote to spend funds resulting in funding below the Minimum Reserve Level, staff would identify a plan to replace these funds over the next three to five fiscal years.

Table 2 below describes the City's Discretionary Reserves as reflected in the Comprehensive Annual Financial Report for Fiscal Year Ended June 20, 2020 audited by CliftonLarsonAllen LLP. This table highlights $12 million of unassigned General Fund Balance available as of the end of Fiscal Year 2019-2020 which is in addition to the funds identified as target reserve funds.

Table 2 – Discretionary Reserves Summary
(IN MILLIONS)

	Reserve Amount per Policy		Available Discretionary Fund Balance	Percentage of Policy	Percentage of General Fund Revenues
	Target	Minimum			
June 30, 2020	$43.9	$41.7	$55.9	127%	107%

RISK FACTORS IN DETERMINING PRUDENT RESERVES

GFOA best practices identify several risk factors that should be considered when calculating reserves. The size of reserves is determined primarily by the degree of risk associated with uncertainty, such as economic downturns, natural disasters, and other major events that could affect City finances. The risk factors used for this analysis are:

RISK FACTORS

OPERATING RISK FACTORS

1. Revenue Source Stability
2. Vulnerability to Extreme Events
3. Expenditure Volatility
4. Leverage
5. Liquidity
6. Other Fund Dependency
7. Growth

CAPITAL RISK FACTORS

8. Capital Projects - Infrastructure

9. Capital Asset Replacement

OPERATING RISK FACTORS

DETERMINING THE RESERVE

Revenue stability is important for the City's consistency and growth. If the City's expenditures outgrow revenue sources, the City would not continue to operate at the same level of service. Property tax, sales tax, and transient occupancy tax revenues are the primary source of revenue for the City. There is more spending discretion over these revenues in comparison to federal grants, user fees, or other funds that must be used for a specific program or purpose. As such, fluctuations in these revenue sources will affect the City's ability to budget for public services.

Complicating this analysis is the emergence of the coronavirus (COVID-19) in March 2020. The financial implications of COVID-19 on the City's revenues are significant. The pandemic has changed daily life and increased the prevalence of telecommuting, virtual business meetings, online shopping, BOPUC (Buy Online, Pick-up Curbside), and telemedicine. Patterns in revenue recovery appear to be unlike those seen in previous recessions and impact tax revenue as discussed below.

RISK FACTOR #1 – REVENUE SOURCE STABILITY

How stable is the tax base in the face of adverse economic conditions?

Relative to other revenues, property tax is considered a stable source of revenue. Sales and transient occupancy taxes (i.e., hotel taxes), however, are considered less stable. An excellent example of this is the 2008 recession. As shown in Table 3, Lake Forest did not return to its pre-recession sales tax base until 2016, or eight years after the Great Recession.

PROPERTY TAX:

Property tax revenue steadily decreased from 2010 to 2012. Revenue received during 2011 and 2012 still exceeded pre-recession revenue in 2007 by $0.24 million. The property tax revenue base only declined $0.68 million in total during and immediately after the recession began. In 2013, only four years after the recession, property taxes reached a new high of $14 million and have continued to grow ever since. According to Orange County Assessor data, the City's Assessed Value has increased 60% over the past ten years.

The City's property taxes continue to increase due to the approximately 300 new homes per year added to property tax rolls. New home building is projected to continue in Lake Forest for the next five years, adding to the City's assessed valuation. The City's property tax revenue increased by $300,000 over expected amounts in the Fiscal Year 2020-21 budget. Despite initial concerns, the payment of property taxes has not faltered due to the COVID-19 pandemic.

SALES TAX:

Sales tax is considered a cyclical tax in that it is often impacted by unemployment and other economic conditions. The City's sales tax revenues declined $1.57 million in 2009 and 2010 due to the Great Recession. However, sales tax revenue increased in 2011 and continued to rise. In 2016, the City finally exceeding the revenue generated prior to 2008.

The City receives 1% of the sales tax from purchases at our local retail businesses, receiving one cent of every dollar of taxable sales occurring in Lake Forest. The City's sales tax base is highly diversified, protecting the City from sudden revenue losses from a downturn in any one industry sector.

Due to the pandemic, the shift to online shopping which began several years ago has accelerated faster than the State can determine a "modern" methodology to allocate online sales tax. While sales taxes from online sales are remitted to a countywide pool, the City receives only a proportionate share based on a methodology that does not include point of delivery. The good news is the implementation of the Wayfair decision, which allows states to charge tax on purchases made from out-of-state sellers (even those without a physical presence in state), has resulted in an increase in sales taxes allocated to the countywide pool which, in turn, is allocated to the City.

TRANSIENT OCCUPANCY TAXES:

Transient occupancy taxes ("TOT"), also referred to as hotel taxes, have continued to grow as new hotels are built in Lake Forest. Over the past two years, the City saw three new hotels constructed, which increased the number of hotels to 13. Between 2013 and 2019, TOT increased by 38% to $3.88 million. As of 2019, TOT represented 8% of the City's tax revenues.

Table 3 - 14-YEAR PROGRESSIVE REVENUE SOURCE TABLE

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Property Tax	12.28	13.02	13.20	12.87	12.52	12.52	14.01	14.56	14.98	15.56	16.65	17.65	19.75	20.7
Dollar Change	1.26	0.74	0.18	(0.33)	(0.35)	0.00	1.49	0.55	0.42	0.58	1.09	1.00	2.10	.95
Percentage Change	0.11	6.03%	1.38%	- 2.50%	- 2.72%	0.00%	11.90 %	3.93%	2.88%	3.87%	7.01%	6.01%	11.90 %	4.8
Sales Tax	15.07	15.21	12.48	10.91	12.63	13.05	13.06	13.33	13.81	15.43	15.64	16.05	17.10	15.75
Dollar Change	0.77	0.14	(2.73)	(1.57)	1.72	0.42	0.01	0.27	0.48	1.62	0.21	0.41	1.05	(1.35)
Percentage Change	5.38%	0.93%	- 17.95 %	- 12.58 %	15.77 %	3.33%	0.08%	2.07%	3.60%	11.73 %	1.36%	2.62%	6.5%	-7.9%
Transient Occupancy Tax	2.66	2.81	2.23	1.94	2.44	2.67	2.82	3.14	3.41	3.58	3.78	3.81	3.88	2.9
Dollar Change	0.49	0.15	(0.58)	(0.29)	0.50	0.23	0.15	0.32	0.27	0.17	0.20	0.03	0.06	(1.0)
Percentage Change	22.58 %	5.64%	- 20.64 %	- 13.00 %	25.77 %	9.43%	5.62%	11.35 %	8.60%	4.99%	5.59%	0.79%	1.71%	(25.77 %)

New hotels are drawn to Lake Forest to serve non-leisure travel. In other words, these hotels are serving the business community and tend to be booked on weekdays. Because these hotels are not related to tourism, this revenue is vulnerable to downturns in the economy along with the shift to virtual meetings brought on by the COVID-19 pandemic. According to the California Office of Tourism, hotels that are not serving leisure travel are projected to have the longest road to recovery.

TAX REVENUE DIVERSITY:

A secondary vulnerability to the City's revenue sources is lack of revenue diversity. Lake Forest is heavily dependent upon three tax revenues: property taxes, sales taxes, and TOT. For example, cities with limited public parking, such as beach cities and cities with vibrant commercial districts, receive large amounts of revenue from parking meters, parking structures and parking citations. Utility users taxes and business license taxes are also common General Fund revenue resources. Lake Forest does not collect any of these taxes.

Cities with a less diversified base of General Fund revenue will require a greater amount in reserves to weather a downturn in just one revenue area. For FY 2020-21, the City is projected to receive $49.9 million in General Fund revenue. Of this amount, $38.2 million is from taxes with the balance of $11.7 million from License and permits, user fees, fines and forfeitures and other miscellaneous sources. Of the $49.9 million tax revenue, $20.3 million is from property taxes, $15.8 million is from sales taxes, and $2.1 million is from transient occupancy taxes. The balance is generated by other taxes such as Real Property and Franchise Fees tax. As mentioned earlier, the City cannot increase taxes without voter approval because of Proposition 218. This limits the City's ability to increase taxes should funding shortfalls occur. In short, the City has a narrow base of General Fund tax revenues.

Over the course of the Great Recession, the City lost $17.20 million of sales tax revenues, $0.97 million of property tax revenues, and $.29 million in TOT revenues. In total, the City lost almost $20.52 million in resources from the beginning of the recession through 2016. While it appears that the rate of COVID-19 vaccinations is helping to reopen the economy, it is not possible to predict the timing of a recovery from the economic impacts of the pandemic. California's Governor has not set a firm date to sunset the eviction prohibition and other pandemic related policies that is postponing some economic impacts.

A resurgence of the virus or a virus variant is also possible, causing more uncertainty.

Risk Factor #1 Revenue Source Stability	**Reserve Amount**
How stable is the tax base in the face of adverse economic conditions?	$7,800,000

RISK FACTOR #2 – VULNERABILITY TO EXTREME EVENTS

As it pertains to this risk factor, extreme events are defined as extreme government funding take backs. In other words, the potential for funds that local jurisdictions receive from the state to be withheld.

2a: Is any City revenue source at risk due to State or Federal political action?

Cities have paid a heavy price over the years when the State faced on-going fiscal challenges. Tax shifts, borrowing and other taking of certain funds allocated to local governments began in the 1990's with the Educational Revenue Augmentation Fund ("ERAF") I and II shift, followed by a number of other actions. To this day, the original ERAF shifts remain in place.

Risk Factor #2a Vulnerability To Extreme Events - Political	**Reserve Amount**
Is any City revenue source at risk due to State or Federal political action?	$1,000,000

Governor Brown initiated and carried out the dissolution of redevelopment, which redirected funds from local governments to school districts. In January 2019, Governor Newsom threatened to withhold Senate Bill 1 Gas Tax revenue to cities if they do not do enough to increase affordable housing in their jurisdictions. While Senate Bill 1 funding does not flow through the General Fund, any taking of these funds will compromise the City's ability to continue to maintain our City streets in a "good" pavement condition. In 2020, Governor Newsom tied the use of CARES Act funds, of which the City received $1,045,000, to compliance with

California Department of Public Health guidance and Blueprint for a Safer Economy.

Risk Factor #2b Is the City susceptible to natural disaster? What is the level of insurance?

The City's Southern California location is susceptible to earthquakes and wildfires. Incorporated in 1991, the City has never suffered severely from a natural disaster. However, the City is not immune to such a circumstance and has previously experienced losses from winter storm damage. For the most recent storms in 2019, the City incurred costs of approximately $500,000. Wildfires in past years have occurred along city borders. In 2020, the Orange County Sheriff issued mandatory evacuations in Lake Forest due to the Silverado fire and Bond fire. Fortunately, the City did not experience any injuries or property damage due to these fires. However, fire season starts sooner and lasts longer than in the past.

The City procures insurance through the California Joint Powers Insurance Authority ("CJPIA"). The City's deductible is negligible for any non-earthquake or flood related loss at any City facility. The City also has earthquake and flood insurance on most City facilities. Earthquake claims have a minimum $100,000 deductible; however, the deductible could reach as high as 5% of the value of property, which could exceed $700,000 on some of the City's facilities. Risk of damage from flood or earthquake is considered low and existing insurance coverage is considered robust; however, it would be prudent to set aside an amount approximately equal to the City's deductible for one instance of damage to a City facility in the event of an earthquake.

Risk Factor #2b Vulnerability to Extreme Events - Disaster	Reserve Amount
Is the City susceptible to natural disaster? What is the level of insurance? **Wildfire Damage $500,000** **Storm Damage 500,000** **Earthquake 700,000** **$1,700,000**	$1,700,000

<u>Risk Factor #2c Are there current City services and/or emerging issues that are prone to legal challenges</u>?

Cities spend millions annually responding to lawsuits involving injuries on public property, environmental issues, and a range of other legal challenges. It is difficult to predict when and if the City may be involved in litigation and the costs involved. The GFOA has found that municipalities have a category in their reserves for cost spikes from legal challenges. Due to the unpredictability of litigation, it is prudent to set aside funds for this purpose.

Risk Factor #2c Vulnerability to Extreme Events - Legal	Reserve Amount
Are there current City services and/or emerging issues that are prone to legal challenge?	$1,000,000

Risk Factor #2 Vulnerability To Extreme Events - Total	Total Reserve Amount
Are there events related to state or federal action, natural disaster, contract obligations, and issues prone to legal challenge?	$3,700,000

<u>RISK FACTOR #3 – EXPENDITURE VOLATILITY</u>

What future contractual obligations does the City have that dictate required expenditure levels?

This analysis excludes unfunded liabilities and debt service, which are considered under Risk Factor #4. This risk factor refers to potential spikes in expenditures, usually arising from a special, non-recurring circumstance. These expenses have generally been related to the City paying its proportionate share of a regional system. For example, the City paid $611,228 for its share of the new Orange County Animal Care Center in 2017. Another example is the City's share of the 800 MHz II radio system in the amount of $569,821. Each time, the City used cash for its portion of the expense and avoided paying interest. There are no expenditures identified at this time that would be considered special and non-recurring. However, a reserve for unknown special and re-occurring expenses is prudent.

Risk Factor #3 Expenditure Volatility	**Reserve Amount**
What future contractual obligations does the City have that dictate required expenditure levels?	$1,000,000

Risk Factor #4 – Leverage

Financial leverage is defined as the use of borrowed funds to purchase assets with the expectation that the return from the transaction will exceed the borrowing cost. A highly leveraged organization has less flexibility. Examples of leverage include long-term debt, pension, and other post-employment healthcare benefit obligations. Reserves are a critical source of financial flexibility, so higher leverage may call for higher reserves. The City has no structured debt obligations, so the City's reserve strategy does not need to account for reduced financial flexibility from debt.

Risk Factor #4a Does the City have debt?

The City has no general fund bonded debt as compared to other Orange County cities shown in Table 4. This table illustrates two commonly used measures of indebtedness. The first, debt per capita, measures the burden placed on citizens by municipal indebtedness. The second measure is debt service (principal and interest payments) as a percent of city non-capital expenditures. This measures the pressure placed on the budget by debt payments. Like a household budget, flexibility in spending is limited by debt payments. Lake Forest proudly sits at zero debt, well below both the average of the debt per capita measure and percent of expenditures measure among the comparative agencies.

Table 4 – City Debt Comparison
(in Millions)

	Lake Forest	Laguna Hills	San Juan Capistrano	Brea	Mission Viejo with Mall Bonds	Aliso Viejo	Mission Viejo w/o Mall Bonds
Debt	0.0	4.7	49.6	43.8	20.0	13.2	12.5
Population	84,485	31,508	36,318	45,629	94,267	50,044	94,267
Debt per Capita	0.0	$149	$1,065	$960	$329	$264	130
Debt Service as % of Expenditures	0.0	8.02%	7.12%	4.41%	4.39%	2.03%	1.58%

Risk Factor #4a Leverage - Debt	**Reserve Amount**
Does the City have debt?	**$0**

Risk Factor #4b Does The City Have Any Unfunded Accrued Liabilities (UAL)?

The City participates in the California Public Employees Retirement System (CalPERS). As of June 30, 2019, the pension plan funded status for classic CalPERS employees is 97.7% with a $753,190 CalPERS unfunded liability while the pension plan funded status for PEPRA employees is 94.4% with a $45,977 CalPERS unfunded liability. Approximately 60% of Lake Forest employees are classic CalPERS members. Given the uncertainty around pension issues, it is difficult to say when increases would occur or how much they might be, especially when the pension board makes changes to pension assumptions that negatively impact the pensions funded status. Accordingly, it would be prudent to set aside reserves to help make a more gradual adjustment to any potential large increase in contribution rates. The City also provides a healthcare post-employment benefit. See Table 5 for a list of unfunded actuarial liabilities ("UAL") in neighboring cities.

Table 5 – Unfunded Pension Accrued Liabilities Comparison to Neighboring Cities

City	Normal Costs (FY 20-21)	UAL Payment (FY 20-21)	PERS Projected Covered Payroll (FY 20-21)	Total Percentage of Payroll	Unfunded Liability Balance (FY 20-21)	Average Balance of Unfunded UAAL Outstanding (End of FY 18/19)
Aliso Viejo	221,480	71,561	2,219,516	13%	1,117,458	12%
Brea	3,830,900	9,637,194	28,641,411	47%	139,822,469	31%
Dana Point	636,428	397,858	6,094,458	17%	6,824,185	15%
Laguna Niguel	645,531	591,369	6,711,379	18%	9,721,201	14%
Laguna Hills	309,044	278,383	3,246,866	18%	4,699,112	15%
Lake Forest	**684,307**	**42,991**	**6,719,966**	**11%**	**860,426**	**4%**
Mission Viejo	1,391,736	1,804,167	11,920,662	27%	21,715,815	23%
Rancho Santa Margarita	220,444	117,006	2,231,852	15%	1,927,566	14%
San Clemente	1,477,144	2,194,064	15,307,194	24%	29,902,869	25%
Yorba Linda	1,088,065	1,693,244	9,857,463	28%	22,809,793	30%
Average Amounts	**1,050,508**	**1,682,784**	**9,295,077**	**22%**	**23,940,089**	**18%**

Table 6 – Unfunded Other Post-Employment Benefits Accrued Liabilities Comparison to Neighboring Cities

City	Accrued Liability	Fund Assets	Plan Net Unfunded Liability	Percentage of Total
Aliso Viejo	363,669	-	363,669	0%
Brea	25,865,288	259,184	25,606,104	1%
Dana Point	1,341,315	(185,346)	1,526,661	-14%
Laguna Niguel	1,691,558	(789,536)	2,481,094	-47%
Laguna Hills	-	-	-	0%
Lake Forest	**990,856**	**533,036**	**457,820**	**54%**
Mission Viejo	9,497,771	10,463,882	(966,111)	110%
Rancho Santa Margarita	441,374	(223,467)	664,841	-51%
San Clemente	3,999,654	1,027,016	2,972,638	26%
Yorba Linda	16,995,487	776,453	16,219,034	5%
Average Amounts	**6,118,697**	**1,186,122**	**4,932,575**	**8%**

Risk Factor #4b Leverage – Unfunded Liabilities	Reserve Amount
Does the City have unfunded accrued liabilities (UAL)?	$3,000,000

Risk Factor #5 – Liquidity

What are the cash flow needs of the City?

Cities have consistent, year-round expenses, yet major revenues are received periodically. Some amount of fund balance reserves is needed to avoid cash flow problems caused by an uneven stream of revenue. As reported earlier, property tax revenue is the City's largest revenue source. The majority of property tax revenue is received in December, January, April, and May each fiscal year. This means that cash outflow could exceed cash inflow for eight months out of the fiscal year. If there were insufficient reserves, the City would have to borrow funds to cover the cash needed for the first half of the fiscal year.

Table 7 depicts cash flow during FY 2018-19 and is generally representative of cash flow in any given year.

Table 7 - FY 2018/19 Cash Flow

Month	Beginning Balance	Net Cash Flow	Ending Balance	Running Total
July	39,149,974	(319,797)	38,830,177	(319,797)
August	38,830,177	(3,972,008)	34,858,169	(4,291,806)
September	34,858,169	921,135	35,779,304	(3,370,671)
October	35,779,304	(4,780,023)	30,999,281	(8,150,693)
November	30,999,281	209,373	31,208,654	(7,941,320)
December	31,208,654	4,345,908	35,554,563	(3,595,412)
January	35,554,563	3,395,045	38,949,608	(200,366)
February	38,949,608	(1,536,452)	37,413,156	(1,736,818)
March	37,413,156	626,110	38,039,266	(1,110,708)
April	38,039,266	2,220,515	40,259,781	1,109,807
May	40,259,781	4,439,204	44,698,985	5,549,011
June	44,698,985	(567,266)	44,131,719	4,981,744

Table 8 reflects cash flow for fiscal year 2019/20 which differs from previous years due to receipt of one-time revenues.

Table 8 - FY 2019/20 Cash Flow

Month	Beginning Balance	Net Cash Flow	Ending Balance	Running Total
July	31,765,036	(686,062)	31,078,974	(686,062)
August	31,078,974	(2,840,091)	28,238,883	(3,526,153)
September	28,238,883	(443,683)	27,795,200	(3,969,836)
October	27,795,200	(1,242,312)	26,552,888	(5,212,148)
November	26,552,888	(169,181)	26,383,707	(5,381,329)
December	26,383,707	2,324,495	28,708,202	(3,056,834)
January	28,708,202	5,251,894	33,960,096	2,195,060
February	33,960,096	803,093	34,763,189	2,998,153
March	34,763,189	6,390,614	41,153,803	9,388,767
April	41,153,803	3,188,883	44,342,686	12,577,650
May	44,342,686	4,274,216	48,616,902	16,851,866
June	48,616,902	1,237,520	49,854,422	18,089,386

Based on this analysis, the City generates a $5 million to $8 million in negative cash flow before beginning to receive sufficient revenue resources to adequately offset monthly disbursements. Over the City's history, the amount of negative cash flow has fluctuated annually. Therefore, a conservative reserve is necessary to ensure the City's "bills" are paid on a timely basis and avoids the need to engage in short-term borrowing for cash flow purposes.

Risk Factor #5 Liquidity	**Reserve Amount**
What are the cash flow needs of the City?	$8,000,000

Risk Factor #6 – Other Fund Dependency

What other funds have a significant dependence on the General Fund?

Two City funds that have dependency on the General Fund by way of annual subsidies for timing of cash flow purposes: Community Development Block Grant ("CDBG") and Measure M2. These amounts can fluctuate from year to year.

The City is a regular recipient of grant and developer fee funding, specifically for capital improvement program ("CIP") projects. A common characteristic of grant and developer fee funding is that most awarding agencies expect that project expenditures be incurred before requests for reimbursement are submitted to the granting agency. Essentially, most grants are on a reimbursement basis. Provided grant regulations are followed, the City will be repaid for these expenditures. However, there is a timing difference in which the General Fund will advance funding for these projects.

Looking historically at the last five fiscal years, funds for CDBG projects, Measure M2, and other miscellaneous grants have "borrowed" General Fund resources for project expenditures. More recently, the City was approved for a $350,000 Local Early Action Planning ("LEAP") grant from the state on a reimbursement basis, thus requiring "borrowing" from the General Fund.

A reserve for fund dependence will ensure the City does not lose an opportunity for grant funding due to the timing of a reimbursement.

Risk Factor #6 Other Fund Dependency	**Reserve Amount**
What other funds have a significant dependence on the General Fund?	$1,000,000

Risk Factor #7 – Growth

What new program areas will be required in the future and how will the City pay for these?

The City has a significant contract with the Orange County Sheriff's Department (OCSD) that provides the City limited flexibility as to the scope and costs. In recent years, new OCSD programs, along with increasing pension costs, have resulted in sharp increases in contract costs. Program costs added to the City's OCSD contract include the Lake Forest sub-station and the Field Training Bureau ("FTB"). Recently, OCSD has notified contract cities that an additional program – management of body worn camera recordings – will be added to the contract within the next three years. OCSD contract information for previous fiscal years are summarized in Table 9.

Table 9 – OCSD Contract by Fiscal Year

Fiscal Year	Contract Amount	Increase from Prior Year	Percentage Increase	Percentage of General Fund
2014-15	$13,336,803	-	-	35.08%
2015-16	14,210,900	874,097	6.55%	35.41%
2016-17	14,869,720	658,820	4.64%	34.70%
2017-18	16,134,298	1,264,578	8.50%	34.85%
2018-19	17,062,663	928,365	5.75%	36.00%
2019-20	17,659,961	597,238	3.5%	35.68%
2020-21*	18,348,264*	335,384	3.9%	39.46%
2021-22	$19,003,498**	655,234	3.6%	

*The City Council approved a contract amendment to the law enforcement contract midway through the fiscal year. **As of preparation of analysis, the contract amount is proposed.

At the time of this analysis, the estimate from OCSD for the FY 2021-22 fiscal year is $19.0 million, a 3.6% increase over the 2020-21 contract. Contract costs are also influenced by the current collective bargaining agreement between the

Orange County Board of Supervisors and Deputy Sheriffs which provide a 3.5% pay increase for the next three fiscal years.

The OCSD contract is a recurring annual contract and should not normally be addressed through reserves. However, it is prudent to set aside funds for use during an economic crisis because: (1) the City cannot significantly modify the terms of the law enforcement contract; (2) the City cannot quickly raise additional revenues and, (3) the City cannot control mid-contract increases.

Another consideration is the ongoing increase to minimum wage and its resulting impact on both city and contract pay rates. The California Legislature has set a schedule to increase California's minimum wage to $15.00 per hour, in increments, by the year 2023. Every year until 2023, minimum wage will increase in California by $1 per hour.

Risk Factor #7 Growth	**Reserve Amount**
What new program areas will be required in the future and how will the City pay for these?	$1,000,000

CAPITAL RISK FACTORS

Risk Factor #8 – Capital Projects - Infrastructure

Are there any planned high priority capital projects without a funding source?

The term capital assets is used to describe assets that are used in operations and have initial useful lives extending beyond a single reporting period. Capital assets include facilities, infrastructure, equipment, and networks that enable the delivery of municipal services. The performance and continued use of these capital assets is essential to the health, safety, economic development, and quality of life of a community.

In some agencies, budgetary pressures can impede capital program expenditures or investments for maintenance and replacement. This is especially true for local governments that do not prepare a multi-year capital plan or properly consider the impact of capital projects on the operating budget. This lack of investment makes it increasingly difficult to sustain the asset in a condition necessary to provide expected service levels. Ultimately, deferring essential maintenance or asset replacement could reduce the organization's ability to provide services and could threaten public health, safety, and overall quality of life. In addition, as the physical condition of the asset declines, deferring maintenance and/or replacement could increase long-term costs and liabilities.

A target reserve percentage for infrastructure replacement is 5%. There is the option to set up an annual noncash depreciation expense where actual cash is moved from the general fund account to an assigned reserve account for infrastructure replacement. Applying this option to the City would result in the need to allocate $6.3 million annually which is a funding level not currently feasible. Table 12 below is a summary of depreciating assets.

Table 10 – SUMMARY OF INFRASTRUCTURE ASSETS

	2020
Capital Assets Being depreciated	
Infrastructure	254,639,711
Accumulated Depreciation	
Infrastructure	136,836,807
Net Book Value	
Infrastructure	117,802,904
Depreciation Expense	
Infrastructure	6,297,067
Annual deprecation percentage	2.47%
Target Reserve 5% of Original Cost	12,731,986

Risk Factor #8 Capital Projects - Infrastructure	**Reserve Amount**
Are there any planned high priority capital projects without a funding source?	$12,700,000

RISK FACTOR #9 – CAPITAL ASSET REPLACEMENT

Does the City have any capital asset replacement needs?

The City has $141.1 million in depreciable non-infrastructure capital assets. Of this amount, $99.7 are categorized as buildings and improvements, $37.0 improvements other than buildings, and $4.5 million categorized as machinery and equipment. The City's capital assets now reflect the Lake Forest Civic Center which opened in December 2019.

To refine the amount identified to set aside for capital asset replacement, the City should develop a master capital replacement schedule. Such a schedule would allow for advance planning for the maintenance and/or replacement of City assets, as needed. By considering the City's maintenance and replacement needs in advance, it allows the City to determine an annual amount capital asset replacement. The current recommended reserve, shown in the table below, shows the target reserve as 10% of the original capital asset cost, which is $14.1 million.

Table 11 – SUMMARY OF CAPITAL ASSET REPLACEMENT

	2020
Capital assets being depreciated	
Building and improvements	$99,664,702
Improvements other than buildings	36,969,358
Machinery and equipment	4,484,600
	141,118,660
Accumulated Depreciation	
Building and improvements	2,523,111
Improvements other than buildings	6,865,957
Machinery and equipment	3,853,067
	13,242,135

	2020
Net Book Value	
Building and improvements	97,141,591
Improvements other than buildings	30,103,401
Machinery and equipment	631,533
	127,876,525
Depreciation Expense	
Building and improvements	409,012
Improvements other than buildings	1,169,176
Machinery and equipment	478152
	2,053,340
Annual deprecation percentage	1.4%
Target Reserve 10% of Original Cost	$14,111,866

Risk Factor #9 Capital Replacement	**Reserve Amount**
Does the City have any capital asset replacement needs?	**$14,111,866**

SUMMARY OF RESERVE LEVELS PER RISK FACTOR

Nine risk factors have been analyzed to ascertain what constitutes a prudent reserve level for the City of Lake Forest. Table 12 demonstrates the results of each analysis.

Table 12 – RESERVE LEVELS PER RISK FACTOR

1	Revenue Source Stability	$7.80
2a	Vulnerability to Extreme Events - Political	1.00
2b	Vulnerability to Extreme Events - Disaster	1.70
2c	Vulnerability to Extreme Events – Legal	1.00
3	Expenditure Volatility	1.00
4a	Leverage-Debt Service	0.00
4b	Leverage-Unfunded Liabilities	3.00
5	Liquidity	8.00
6	Other Fund Dependency	1.00
7	Growth	1.00
8	Capital Projects -Infrastructure	12.70
9	Capital Asset Replacement	14.10
	Total	$52.30

Therefore, the Target Reserve Level is set at $52.3 million with a Minimum Reserve Level set at $49.7 million (5% below the Target Reserve amount).

CONCLUSION

The City's Risk Reserve Policy is a component of the City's Financial Management and Budgetary Policy which establishes financial parameters to guide the development of the budget. The desired policy outcome is that the long-term implications of financial decisions are fully understood and considered in the decision-making process. Accordingly, the General Fund Risk Reserve Analysis provides a funding plan that analyzes the risks that influence the level of reserves the City needs to protect the organization against uncertainty and loss.

Lessons learned by municipalities after the Great Recession, coupled with California municipal revenue raising restrictions, emphasize the importance of establishing reserves. More recently, the COVID-19 pandemic demonstrated how reserves are used to reduce the budgetary impacts of economic downturns and continue the delivery of basic services during an unforeseen emergency.