RESOLUTION NO. 2014-017

CITY OF REEDLEY

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF REEDLEY, ESTABLISHING A FUND BALANCE POLICY FOR THE WATER, WASTEWATER & SOLID WASTE ENTERPRISE FUNDS

WHEREAS, it is essential that a government maintain adequate levels of working capital in its enterprise funds to mitigate current and future risks such as revenue shortfalls and unanticipated expenses, and to ensure stable services and fees; and

WHEREAS, working capital is a crucial consideration in long-term financial planning and credit agencies consider the availability of working capital in their evaluations of continued creditworthiness; and

WHEREAS, the Government Finance Officers Association (GFOA) recommends that local governments adopt a target amount of working capital to maintain in each of their enterprise funds, ideally formally described in a financial policy; and

WHEREAS, Staff has considered numerous factors that could affect available working capital in the Water, Wastewater, & Solid Waste enterprise funds; and

NOW THEREFORE, BE IT RESOLVED by the City Council of the City of Reedley in the exercise of its discretion, as follows:

Section 1. Establish a target amount of working capital in the Water, Wastewater, and Solid Waste enterprise funds that is equivalent to 45 days of operating expenditures for each fund, not including capital outlay, debt service payments, or depreciation expense. The value of 45 days of operating expenditures to be held in reserve shall be re-calculated annually every July, at the close of the previous fiscal year.

Section 2. Working capital for purposes of this policy shall be defined as current assets less current liabilities, and shall include both operating and capital set aside funds, if applicable.

Section 3. Staff shall strive to maintain in each enterprise fund, at least 45 days of operating expenditures, including deferring non-critical purchases until cash on hand remaining after the purchase(s) in applicable funds adheres to this policy.

Section 4. In the event that the working capital balance in an enterprise fund falls below the established minimum threshold, staff will develop a plan to replenish the deficit as soon as possible.

Section 5. This Resolution and resulting Financial Policy shall take effect immediately from and after its adoption, and shall remain in effect until amended by the City Council by future resolution.

PASSED AND ADOPTED by the City Council for the City of Reedley, California, at a regular meeting thereof on February 25, 2014, by the following vote:

AYES: Soleno, Fast, Betancourt, Rodriguez, Beck.
NOES: None.
ABSENT: None.
ABSTAIN: None.

Robert O. Beck, Mayor

ATTEST:

Sylvia B. Plata, City Clerk

FY 2012-13 Water, Wastewater & Solid Waste Enterprise Fund Balance Information

		July 2012	August 2012	September 2012	October 2012	November 2012	December 2012	January 2013	February 2013	March 2013	April 2013	May 2013	June 2013
Water Enterprise Fund													
Cash On Hand		$ 981,852	$ 370,257	$ 408,847	$ 425,662	$ 794,249	$ 648,667	$ 728,491	$ 351,567	$ 547,516	$1,050,502	$ 951,435	$1,073,495
Working Capital		$ 549,537	$ (25,912)	$ 84,714	$ (1,485)	$ 420,628	$ 296,699	$ 8,405	$ (78,835)	$ 71,934	$ 599,069	$ 508,819	$ 623,885
Adjusted Monthly Expenditures*		$ 169,937	$ 193,737	$ 219,145	$ 146,735	$ 152,504	$ 135,020	$ 114,784	$ 131,598	$ 184,519	$ 131,127	$ 167,830	$ 196,864
Average 12-Month Expenditures	$ 161,983												
45-Day Reserve	$ 242,975	*Recommended*											
90-Day Reserve	$ 485,950												
Wastewater Enterprise Fund													
Cash On Hand - Capital Reserve Fund		$1,910,576	$1,911,169	$2,021,484	$2,023,499	$2,025,827	$2,159,199	$2,160,332	$2,161,907	$2,331,137	$2,332,543	$2,335,181	$2,398,398
Cash On Hand - Operating Fund		$ (519,234)	$ (346,154)	$ (318,534)	$ 230,004	$ 376,705	$ 214,529	$ 492,101	$ 723,439	$ 797,121	$ 662,992	$1,017,604	$1,037,964
Working Capital - *Operating Fund Only*		$ (409,781)	$ (313,533)	$ (223,281)	$ 375,701	$ 508,168	$ 365,077	$ 648,681	$ 866,365	$1,404,285	$ 791,850	$1,111,173	$1,126,871
Adjusted Monthly Expenditures*		$ 150,132	$ 180,829	$ 165,680	$ 174,565	$ 186,955	$ 153,339	$ 133,111	$ 111,384	$ 193,588	$ 153,629	$ 142,141	$ 222,566
Average 12-Month Expenditures	$ 163,993												
45-Day Reserve	$ 245,990	*Recommended*											
90-Day Reserve	$ 491,980												
Solid Waste Enterprise Fund													
Cash On Hand		$1,059,226	$1,057,776	$1,034,478	$1,032,340	$1,076,064	$1,102,627	$1,111,107	$1,203,139	$ 213,482	$ 251,657	$ 296,908	$ 325,673
Working Capital		$1,095,155	$1,055,778	$1,090,689	$1,098,036	$1,139,836	$1,150,812	$1,176,384	$1,252,456	$ 282,530	$ 320,429	$ 347,033	$ 303,061
Adjusted Monthly Expenditures*		$ 148,393	$ 222,273	$ 219,108	$ 237,985	$ 207,034	$ 222,780	$ 226,032	$ 189,196	$ 295,660	$ 203,451	$ 210,231	$ 305,698
Average 12-Month Expenditures	$ 223,987												
45-Day Reserve	$ 335,980	*Recommended*											
90-Day Reserve	$ 671,960												

*** Does NOT include capital outlay, debt service payments or depreciation expense***

BEST PRACTICE

Appropriate Levels of Working Capital in Enterprise Funds (BUDGET & CAAFR) (2011) (new)

Background. Enterprise funds distinguish between current and non-current assets and liabilities. It is possible to take advantage of this distinction to calculate working capital (i.e., current assets less current liabilities). The measure of working capital indicates the relatively liquid portion of total enterprise fund capital, which constitutes a margin or buffer for meeting obligations.

It is essential that a government maintain adequate levels of working capital in its enterprise funds to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenses) and to ensure stable services and fees.

Working capital is a crucial consideration, too, in long-term financial planning. Credit rating agencies consider the availability of working capital in their evaluations of continued creditworthiness. Likewise, laws and regulations may speak to appropriate levels of working capital for some enterprise funds.

Recommendation. The Government Finance Officers Association (GFOA) recommends that local governments adopt a target amount of working capital to maintain in each of their enterprise funds. Ideally, targets would be formally described in a financial policy and/or financial plan.

GFOA recommends that governments use working capital as the measure of available margin or buffer in enterprise funds. Although as previously stated, working capital is defined as current assets minus current liabilities, government finance officers should be aware of certain characteristics of working capital that affect its use as a measure. Specifically, the "current assets" portion of working capital includes assets or resources that are reasonably expected to be realized in cash (e.g., accounts receivable) or consumed (e.g., inventories and prepaids) within a year, which leads to two considerations for an accurate calculation of working capital:

- **Strength of collection practices.** An appropriate allowance for uncollectibles should be established and the amount of the receivable that is expected to be collected in cash within one year should be determined in a manner that is consistent with the collection practices of the government. If the accounts receivable collection practices of the enterprise fund are inconsistent or weak, then less of the accounts receivable amount should be reported as current assets.
- **Historical consumption of inventories and prepaids.** The amount of inventories and prepaids included in current assets should be a realistic estimate of the amount that will be consumed in one year based on a historical usage pattern and current operating levels (inventories) or based on the time periods to which the items relate (prepaids).

Because the purposes, customers, and other characteristics of enterprise funds can vary widely, GFOA recommends that governments develop a target amount of working capital that best fits local conditions for each fund. However, GFOA recommends that under no circumstances should the target for working capital be less than forty-five (45) days worth of annual operating expenses[1] and other working capital needs of the enterprise fund.[*] A target of 45-days would only be appropriate for those enterprise funds with the least amount of need for cushion or buffer.

In order to arrive at a customized target amount of working capital, governments should start with a baseline of ninety (90) days worth of working capital and then adjust the target based on the particular characteristics of the enterprise fund in question (using 45 days as the minimum acceptable level). The primary characteristics to think about when customizing a working capital target are presented below. The appendix to this Best Practices provides more detailed considerations for these characteristics as they pertain to common types of government enterprise funds.

- **Support from general government.** Some enterprise funds may be supported by general taxes or transfers from a general government. These enterprise funds may require lower levels of working capital if they are supported by these contributors. For a heavily subsidized enterprise fund the 45-day minimum working capital recommendation contained in this Best Practice might be met through support from the general government, if a financial buffer or cushion for the enterprise fund is to be provided by the general government (or other outside contributor).
- **Transfers out.** If the enterprise fund is expected to make a transfer to the general government or to some other fund, then this sort of claim on the enterprise fund's assets may call for higher levels of working capital to maintain flexibility. Transfers could include an enterprise fund's contributions to overhead/support functions, subsidies granted to other operations, or any other transfer of resources. Regardless of the rationale of the transfer, governments should take into account the claim on working capital when setting a target amount.
- **Cash cycles.** Does the enterprise fund experience large peaks and valleys in its cash position during the year? For example, a water enterprise fund may experience significantly higher levels of cash on hand during the summer months compared to the winter. Volatile cash cycles call for higher levels of working capital. Another consideration is the length of the billing cycle. A longer billing cycle would call for higher levels of working capital because the enterprise fund will have longer durations between major infusions of cash.
- **Customer concentration.** Is the enterprise fund dependent on a few customers for a large portion of its revenues or is the customer base diversified? For example, a port enterprise fund may be dependent on a few major shippers or commerce in a niche product. Lower customer concentration may mean that the enterprise fund can safely operate with lower levels of working capital.
- **Demand for services.** Does the enterprise fund face a steady demand for service or is demand potentially volatile, thereby leading to volatility in of income? For example, the demand for utility services is steady compared to demand for air travel. Also consider the impact of competitive position on demand. Direct competitors or the availability of reasonable substitutes could lead to greater volatility in demand for the enterprise fund's services. More volatility implies greater need for working capital margins.

- **Control over rates and revenues.** Does the enterprise fund have the ability to change rates, implement new charges, or otherwise raise revenues from its customers in a simple fashion? For example, transit enterprise funds are often constrained from raising rates by political pressure. Other enterprise funds may be subject to a rate control board. Those that face competitors in their market may have less effective control over their rates and revenues. More revenue constrained enterprise funds may need higher levels of working capital.

[1] The recommendation is to use annual operating expenses which include depreciation expense. If, however, annual depreciation expense is significantly more or less than the anticipated capital outlays of the next period to be paid from working capital consideration should be given to adjusting the benchmark. An appropriate adjusted benchmark may be annual operating expenses – annual depreciation expense + capital outlays of the next period to be paid from working capital.
[*] Subject to the exception for heavily subsidized enterprises, described later in this Best Practice.

- **Asset age and condition.** What is the age and condition of the enterprise fund's infrastructure? Older infrastructure has greater exposure to extraordinary repair needs. Enterprise funds with newer and/or well maintained capital assets may be able to operate with less working capital than other enterprise funds.
- **Volatility of expenses.** Are the expenses of the enterprise fund volatile or does the enterprise fund have a high degree of control over its expenses? For example, the expenses of a solid waste enterprise fund tend to be fairly stable throughout the year. In another example, water or sewer enterprise funds may be more vulnerable to large expense spikes from extreme weather. Enterprise funds with more stable expenses can safely operate with less working capital than other enterprise funds.
- **Control over expenses.** Consider the enterprise fund's level of fixed and variable costs and the ability to reduce variable costs in response to lower revenues. For instance, if a convention center does not book an event, it does not need to hire temporary help and incur other expenditures in support of the event. An enterprise fund with a high percentage of operational costs which vary depending upon revenues or operating levels may operate with lower levels of working capital.
- **Management plans for working capital.** Working capital includes assets, which can include both truly unrestricted resources and resources that have internal limitations placed upon them (e.g., board-designated) and/or that may be committed for future capital spending. These amounts may appear as unrestricted on the balance sheet but, in actuality, may be unavailable in the future to serve as a buffer or tool to help manage financial risk. If these types of limitations exist, the working capital target should be adjusted to arrive at an amount that represents a true amount available as a tool to manage financial risk.
- **Separate targets for operating and capital needs.** Depending on the nature of the enterprise fund, governments might also consider designating separate targets for operating and capital needs, especially when the enterprise fund is very capital intensive. For example, there might be a separate amount identified for equipment replacement or debt service. In such a case, targets should be separately evaluated based on the particular features of the isolated amounts.
- **Debt position.** Enterprise funds often carry significant amounts of debt, which is used to acquire capital assets. The amount and type of debt an enterprise fund carries can have important ramifications for working capital targets. For example, an enterprise fund with a large amount of variable rate debt may need additional buffer to manage the risk associated with interest rate volatility. In addition, uneven and increasing or lump-sum debt principal payments to be made in future years may raise the amount of working capital that the enterprise fund should maintain. Viewing the amount of working capital in this broader context will help ensure that resources are available to make debt payments as they come due.

Approved by the GFOA's Executive Board, February, 2011.

REEDLEY CITY COUNCIL

- ☐ Consent
- ☒ Regular Item
- ☐ Workshop
- ☐ Closed Session
- ☐ Public Hearing

ITEM NO: 10

DATE: February 25, 2014

TITLE: ADOPT RESOLUTION 2014-017 ESTABLISHING A FUND BALANCE POLICY FOR THE WATER, WASTEWATER & SOLID WASTE ENTERPRISE FUNDS

SUBMITTED: Paul A. Melikian, Director of Finance & Administrative Services
Russ Robertson, Director of Public Works

APPROVED: Nicole R. Zieba, City Manager

RECOMMENDATION

That the City Council adopt Resolution 2014-017 establishing a Fund Balance Policy for the Water, Wastewater, and Solid Waste Enterprise funds that defines a minimum target amount of working capital of 45 days be kept on hand which constitutes a margin or buffer for meeting obligations and ensuring stable services and fees.

EXECUTIVE SUMMARY

The City Council recognizes that good fiscal management comprises the foundational support of all City operations. The attached resolution would establish for the first time, a Fund Balance Policy for the City's Water, Wastewater, and Solid Waste Enterprise Funds. A Fund Balance Policy is intended to provide guidelines during the preparation and execution of the annual budget to ensure that sufficient reserves are maintained for unanticipated expenditures or revenue shortfalls. It also is intended to preserve flexibility throughout the fiscal year to make adjustments in funding for operating and capital requirements approved in connection with the annual budget. The Fund Balance Policy should be established based upon a long-term perspective recognizing that stated thresholds are considered minimum balances. The main objective of establishing and maintaining a Fund Balance Policy is for the City to be in a strong fiscal position that will allow for better position to address unanticipated expenses and weather negative economic trends.

The Government Finance Officers Association (GFOA) has issued a Best Practice dated February 2011 that specifically deals with this subject. After consideration of numerous factors that impact a sufficient level of fund balance in an enterprise fund, staff recommends establishing a target amount of working capital in the Water, Wastewater, and Solid Waste enterprise funds that is equivalent to 45 days of operating expenditures for each fund, not including capital outlay, debt service payments, or depreciation expense. The attached GFOA Best Practice recommends starting with a baseline of 90 days worth of working capital and then to adjust the target based on the particular characteristics of the enterprise fund in question, using 45 days is the minimum acceptable level. The attached Best Practice also details the recommended factors that were considered by staff, such as strength of collection practices, historical consumption, cash cycles, and control over rates & revenues.

BACKGROUND

The value of 45 days of operating expenditures to be held in reserve shall be re-calculated annually every July, at the close of the previous fiscal year. Working capital for purposes of this policy shall be defined as current assets less current liabilities, and will include both operating and capital set aside funds, if applicable. For example, the Wastewater enterprise has an established capital and debt service set aside fund, as required by the State of California's Clean Water State Revolving Fund Program. In other words, the policy allows for available operating and capital set aside funds to be considered for purposes of calculating a 45 day reserve.

The policy calls for staff to strive to maintain in each enterprise fund, at least 45 days of operating expenditures, including deferring non-critical purchases until cash on hand remaining after the purchase(s) in applicable funds adheres to the policy. In the event that the working capital balance in an enterprise fund falls below the established minimum threshold, staff will develop a plan to replenish the deficit as soon as possible. The attached resolution and resulting financial policy would take effect immediately, and will remain in effect until amended by the City Council by future resolution.

FISCAL IMPACT

There is no adverse impact of adopting this financial policy, rather the operations and services within each enterprise fund will be strengthened over the long-term by maintaining adequate levels of working capital to meet obligations. Credit agencies and lenders have also looked favorably upon agencies that have these financial policies in place as it demonstrates a commitment to sound financial management.

ATTACHMENTS

Resolution 2014-017
FY 2012-13 Water, Wastewater & Solid Waste Enterprise Fund Balance Information
GFOA Best Practice: Appropriate Levels of Working Capital in Enterprise Funds, February 2011