

EL DORADO LAFCO

LOCAL AGENCY FORMATION COMMISSION

AGENDA OF JANUARY 22, 2014

REGULAR MEETING

TO: Don Mette, Chair, and
Members of the El Dorado County Local Agency Formation
Commission

FROM: José C. Henríquez, Executive Officer

AGENDA ITEM #9: PROVIDE DIRECTION ON THE ESTABLISHMENT OF A
RESERVE AND SELECTION OF THE BUDGET AD HOC
COMMITTEE

RECOMMENDATION

Staff recommends that the Commission receive the following information on reserves and provide direction to staff. The Commission should also direct the formation of an ad hoc committee to provide guidance to staff as it prepares the Fiscal Year 2014-15 budget.

REASON FOR RECOMMENDED ACTION

Currently, this agency does not have a reserve; however, some archived records indicate that LAFCO had one in the past. The Commission expressed an interest in reestablishing a reserve at the time it adopted the Fiscal Year 2013-14 budget and instructed staff to return at a later date with options to consider.

BACKGROUND

Historically, LAFCO had a budget reserve, though that practice stopped some time ago and the reserve account was drawn down. Staff has raised the question of reestablishing a reserve for the past eight years, but no interest had been shown. The question was raised again at the time of the adoption of the budget for Fiscal Year 2013-14, but this time by the Commission. Before it would authorize the creation of a reserve, however, the Commissioners wanted some questions answered and for staff to return with options to consider.

Current Practice

LAFCO does not currently have any reserves. The Commission does have two contingency funds built into its budget.

1. The first is an operating contingency, which the Commission's Policies and Guidelines section 2.1.7 calls a "reserve," is defined as 10% of the operating expenses. This has assisted staff when actual expenses have increased beyond the budgeted amounts. For example, the Commission budgeted \$905 for membership into the California Special District Association in FY2013-14. The actual cost was \$1,005, and the \$100 difference was covered by the contingency to compensate. Because operating costs have decreased over the past eight years, there have been very few instances in which the contingency was more than \$10,000.
2. The second is called "Accrued Leave" and it was created at the recommendation of LAFCO's accountant, Terrie Prod'hon. This fund covers the agency's liability in the instance of paying off an employee's vested time off if said employee leaves his/her employment at LAFCO. The budget assumes the worst-case (and the least likely, but also not improbable) scenario of all employees leaving within a fiscal year and funds this account accordingly. At no time in the past eight years has this account been funded more than \$30,000 annually. Typically, the funding is in the mid \$20,000s and all funds are carried over into the following year if they are unused.

A contingency is different from a reserve in that the contingency refers to costs that will probably occur based on past experience, but with some uncertainty regarding the rate or change in cost. When budgeting, staff attempts to determine not only the probable cost of an item but also its rate of change if it is not set by contract. Unfortunately, some of these costs and their rate of change can vary in uncertain ways. If the costs end up being lower than the budget anticipated, then savings are used as carryover. If the costs are more, the expectation is that the variance will be no more than 10% from the budgeted amount.

So if a contingency is used to manage "known unknowns," a reserve is used to manage "unknown unknowns," usually a completely unexpected, sudden and sharp increase in price of a budgeted item or the encountering of a large, catastrophic or unexpected expense that is outside of the budget. For example, a contingency would cover an 11% increase in the cost of SDRMA membership, but a reserve would be used to replace LAFCO's furniture and equipment in case of fire. Because this agency does not have a reserve and because the size of the contingency is small, it has an exposed risk that could easily derail the budget.

Legal Authority

LAFCO law is silent in the matter on whether reserves can be established. The LAFCO budget is governed by Government Code §§56381 and 56381.6. These sections address the timelines for adoption and the transmittal of the LAFCO budget [GC §56381(a)]; the apportionment methodology to be used by the County Auditor [GC §56381(b)] and an alternate methodology for LAFCOs with different representation (GC §56381.6); and the requirements for payment by the funding agencies [GC §56381(c)].

The only limit to the Commission's authority on setting its own budget relates to ensuring the adequate funding for this agency. The second paragraph in GC §56381(a) reads:

At a minimum, the proposed and final budget shall be equal to the budget adopted for the previous fiscal year unless the commission finds that reduced staffing or program costs will nevertheless allow the commission to fulfill the purposes and programs of this chapter.

According to various sources, the impetus for this sentence was to prevent funding agencies from "choking" a LAFCO by withholding funds. In the past, several home counties rendered their LAFCOs irrelevant by underfunding them. Without adequate revenues, those LAFCOs could not hire staff or otherwise meet their obligations or mandate. Consequently, the Legislature inserted this language into the Cortese-Knox-Hertzberg Act (CKH) to prevent such punitive measures.

Since no other sections of CKH concern LAFCO's budget, there is no statutory restriction on establishing reserves. Consequently, establishing a reserve is helpful for:

- Minimizing the impact of a significant drop in revenue
- Minimizing the impact of a significant unknown expenditure
- Minimizing the "rate shock" to the funding agencies in case of significant budgetary increases
- Planning for future known expenses (such as outsourcing studies)

Examples From Across the State

For purposes of providing context, Attachment A contains examples of the LAFCOs that have reserves for legal defense, professional services or both. Two LAFCOs have reserve accounts for other purposes (retiree health benefits). Examples of designated reserves are:

- Although they may have general liability insurance, some LAFCOs established legal defense reserves so that they cover any deductibles, have cash on hand to absorb the costs of litigation themselves or in case their carrier declines to cover their costs.
- There is also the very real possibility that an applicant will sue the LAFCO and decline to cover the costs even if they signed an indemnity agreement.
- Some LAFCOs establish reserves to absorb the regular costs of outsourcing municipal service reviews/sphere of influence studies or any other special studies.

Some LAFCOs have opted to have undesignated reserves for budgetary reasons such as the ones covered above.

On the question of the level or size of the reserve, as it can be seen in Attachment A, the most common practice is to set a dollar limit; however, some LAFCOs set their reserves to be a certain percentage of their total budget.

Some LAFCOs have policies governing how those reserve(s) will be established, funded and utilized (refer to Attachment B). The most practical example for funding a reserve comes from Santa Cruz LAFCO; it allocated funds to build up the reserve slowly over time to the designated amount. One idea floated by last year's budget ad hoc

committee was to set aside a certain percentage of carryover funds into a reserve account.

Finally, in terms of policy, the Commission could tie its reserve to be utilized for specific purposes (for example, legal defense) or classify it as “undesignated,” but require certain procedural restrictions on its use (requiring chair and vice chair signature authority) or designating triggers (revenues must be X% lower than previous year’s budget) before funds can be withdrawn. The example from San Diego LAFCO appears to be a good policy to mirror since it takes into account the recently issued new guidelines (GASB Statement Number 54, *Fund Balance Reporting and Governmental Fund Type Definitions*).

Questions for Discussion and Direction to Budget Ad Hoc Committee

If the Commission is inclined to a reserve, the results of the discussion should provide direction to staff and to the budget ad hoc committee.

- How many reserve funds should the Commission have and what would be their purpose?
- Should a policy be created to govern how and when reserve funds could be utilized?
- What should be the limit for these funds?
- What would be the best method to build up the reserve accounts?

Designation of a Budget Ad Hoc Committee

Staff requests that an ad hoc committee of no more than three Commissioners is appointed to review and provide guidance to staff as a draft budget is created for Fiscal Year 2014-15.

Attachments

Attachment A: Sample Policies on Reserves From LAFCOs Across the State

Attachment B: Size of Reserves From LAFCOs Across the State