May 14, 2018

Honorable Al Muratsuchi, Chair
Joint Legislative Audit Committee
1020 N Street, Room 107
Sacramento, CA 95814

**RE: City of Lincoln Legislative Audit Request**

Dear Assemblymember Muratsuchi:

As members of the City Council of the City of Lincoln (City), we are providing this letter in response to the April 11, 2018, letter submitted by Senator Ted Gaines requesting that the Joint Legislative Audit Committee (JLAC) conduct a complete audit and review of the administration of public funds and assets by the City. The City Council and the City's administration are committed to being the best possible stewards of the City's public funds and assets and to ensuring that those funds and assets are handled in the most transparent and ethical manner possible.

The primary concern expressed in the audit request is that *"This pattern could point to the potential for a 'high-risk' City which, should it fail, the state may have to use its funds to bolster the City's budget."* High-risk cities are identified by the California State Auditor and, according to the California State Auditor's website, usually exhibit negative characteristics in the following financial indicators: ability to pay short-term obligations, capacity to respond to emergencies, revenue growth rate, ability to pay retiree obligations, and projected fiscal outlook. **As illustrated below, the City does not exhibit any of the high-risk city financial indicators:**

- **Ability to pay short-term obligations:** The City prepares an Annual Budget that is available for public review, prior to final adoption by City Council. The City's budget is based on a fiscal year that spans the 12 month period from July 1 through June 30. The City's budget includes four main fund classifications; General Fund, Special Revenue Funds, Internals Services Funds and Proprietary Funds. The Proprietary Funds include Water, Wastewater, Solid Waste, Airport and Transit. The 17/18 Annual Budget includes 47 funds and total expenditures of **$93,700,000**. The City's cash and investment portfolio totaled **$159,336,758** as of March 31, 2018.

  Prior to establishment of a budget for any one of the City's funds, its annual revenues and projected expenditures are taken into consideration. If revenues received are lower than projections used to develop the Annual Budget, a mid-year adjustment is made to ensure the City has the ability to pay short-term obligations. In addition, the City Council and the Fiscal Investment and Oversight Committee (FIOC) conducts annual budget reviews in a public process and makes its budgets available to the public upon request and via the City's website.

- **Capacity to respond to financial emergencies**: The City has a General Fund reserve policy that establishes a number of reserves that enable the City to respond to financial emergencies, such as:
    - Operating Reserve
        - This fund enables the City to manage cash flow
        - It is equal to 25% of annual General Fund outflows
        - The projected Fiscal Year 17/18 End Balance is **$4,420,968**
        - The Fiscal Year 18/19 reserve has a projected funding of **$4,674,039** (an increase of **$253,071** to meet reserve target)
        - It is fully funded
    - Catastrophic Reserve
        - This fund is intended to maintain the ability of the City to meet operational expenses during times of declared emergency or major catastrophe
        - The target is set at **$2,000,000**
        - It is fully funded
    - Economic Downturn Reserve
        - This fund is intended to maintain the City's economic viability during the cyclical effects of the economy
        - The target is set at 15% of the annual General Fund operating expenditures
        - The projected Fiscal Year 17/18 End Balance is **$2,199,243**
        - The Fiscal Year 18/19 projected funding is **$2,350,063** (an increase of **$150,820** to meet reserve target)
        - It is fully funded
    - Capital Replacement Reserve
        - This fund allows the City to acquire and replace equipment, vehicles, and facilities that serve General Fund purposes
        - It has a committed annual contribution of **$300,000**
        - It is funded as intended
    - Other Post Employee Benefits (OPEB) Reserve
        - This fund is intended to allow the City to fulfill its obligation to employees for health insurance coverage after retirement from the City
        - The annual contribution amounts are calculated in accordance with annual financial statement reporting, applying data from bi-annual actuarial reports
        - The projected Fiscal Year 17/18 End Balance is **$2,512,000**

- The fiscal Year 18/19 projected funding is **$2,094,818**
- It is funded as intended

The City's total General Fund Balance was $2,880,860 as of June 30, 2009 and increased to $13,241,999 as of June 30, 2017.

- Enterprise Fund Reserves:
  - Each of the three main enterprise funds (Water, Wastewater, and Solid Waste) also has reserve accounts. The reserve targets are established for each fund in the associated rate study in accordance with Government Finance Officers Association (GFOA) recommended best industry practices. There are two reserves (operational and capital replacement) for each of the funds.

- **Revenue growth rate:** The City carefully monitors its revenue growth rate to ensure projected future expenses can be covered by projected future revenues. The City's General Fund receives revenues from a variety of sources including property taxes, sales and other taxes, intergovernmental, recreation services, fees and permits, services charges, and interest earned on investments. For the Fiscal Year 18/19 it is anticipated that total General Fund revenues will increase by 3.3%.

  The City's *General Plan 2050* serves as a long-term policy guide for growth in the City. The City's population is currently 48,000. The 2050 General Plan projects a build-out population of 132,000 and the City is currently experiencing a growth rate of approximately 1.5% per year. This growth will not only result in increased property tax revenues but also sales tax revenues as commercial properties are constructed. Additionally, all new development parcels are required to annex into a Community Facilities District (CFD). A CFD is a long-term financing mechanism that will be used to fund maintenance of infrastructure and to supplement the financing of public safety services.

  Based on current revenue growth projections, expected increases in tax revenues, the establishment of long term funding mechanisms, and implementation of sound budget management, the City anticipates that future revenues will be sufficient to address anticipated future expenditures. The City Council insists on prudent and conservative fiscal management. In the past, when expenses were projected to exceed revenues received, cost-cutting measures were swiftly implemented to minimize any potential impacts. As a result, the City is even better prepared today to handle any future economic downturns due to the current reserve funds the City holds.

- **Ability to Pay Retiree Obligations:** There are three separate obligations that the City has in relation to its retirees:
  - The City currently fully funds the PERS Normal Cost Rate associated with current

employees. CalPERS defines the Normal Cost rate as the annual cost of service accrual for the upcoming fiscal year for active employees.

- The City currently pays the PERS required Unfunded Accrued Liability (UAL) payment at the beginning of each fiscal year.

- The City currently pays into the OPEB Trust to ensure payment of future retiree health care obligations. The OPEB Trust balance at March 31, 2018 was $3,757,390, which represents a 25% funding of the City's current OPEB obligation.

In addition to the obligations listed above, the City is also developing and implementing strategies through employee contracts to address some of the long-term costs and risks associated with retiree cost obligations. In the past 5 years, the City has successfully negotiated higher employee retirement contributions in all employment contracts and continues to monitor short-term and long-term trends related to retiree cost increases. Like other well managed cities and other local agencies in California, the City is proactively reviewing and managing the costs of its retiree obligations. As a result, the City is able to pay retiree obligations and has established the means to continue doing so annually.

- **Projected Fiscal Outlook:** A review of the City's financial outlook is completed on an annual basis through the annual budgeting process and on a quarterly basis by the City's Fiscal and Investment Oversight Committee (FIOC). The FIOC is composed of two council members, the City Treasurer, two citizens at large, and two staff members (the City Manager and the Support Services Director) who combined have over 140 years of finance and investment experience. The purpose of the FIOC is to review quarterly investment reports, manage investments, provide oversight to the City's ability to meet its stated investment goal (**$2,500,000 per month**), provide input on other financial matters, and review the Comprehensive Annual Financial Report (CAFR). Based on the last Retirement/Investment/Fiscal Update Report provided to the FIOC on May 1, 2018, current revenue and spending projections, with incoming maturities, redemptions, investment returns and available cash have been determined to support the monthly investment goal.

  Additionally, the City is required to conduct an annual audit of all financial statements to ensure they are presented fairly, in all material respects, and in accordance with applicable general and governmental accounting standards. The City goes even further than the general audit requirement and has a Comprehensive Annual Financial Report (CAFR) prepared annually. The CAFR is prepared annually by the City's independent auditor and is presented to the City Council, the FIOC, and the public. In the past two years, the City's independent audits were performed by two different firms. Each auditor provided a clean audit report to the City. In addition to presenting CAFRs to the public as part of the City Council and FIOC review process, as a matter of transparency, the City makes copies of its CAFRs available to the public upon request and also posts the several years' worth of CAFRs on the City's website.

When the CAFR identifies a deficiency or weakness in any accounting practice or financial statement, the City responds by developing a plan to address the identified issue. The most recent CAFR completed did identify areas that could be improved. Staff has developed plans to address all findings and is implementing changes to address all of them. The Council invests in the cost of a CAFR each year because it believes that the CAFR serves as a valuable tool to further improve the financial management of the City. The City is committed to sound financial management and was the recipient of the Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association (GFOA) in both 2015 and 2016.

Based on the findings of City Council, the FIOC, and the results of the CAFR, the City's projected fiscal outlook is very strong and demonstrates that the City will be able to easily meet its financial obligations and to continue to be financially stable for the foreseeable future.

Based on the analysis above, it is almost certain that the State would not have any basis to find that the City is a high-risk city and even more unlikely that the State would have to intervene in any way on the City's finances. The City's accounting practices, proposed budgets, and annual audit findings are transparent and consistent with other financially healthy cities in the state.

In addition to the concern expressed related to the City potentially being identified as a high-risk City, the audit request letter included a number of other concerns that are addressed below:

- **Water Rates:** Senator Gaines' audit request letter dated April 11, 2018 states that *"the financials produced failed to meet the requirements imposed by Proposition 218 - there was no correlation between rates and costs."* The City has taken several recent actions to resolve legacy issues regarding its water rates and to ensure that its rates are fair and reasonable and that they will comply with California's Proposition 218 as currently interpreted by the courts. Until recently, up to 80 percent of California water providers employed some form of tiered water rate structures to manage their water resources.[1] Tiered water rates impose progressively higher rates for water service based on consumption and therefore incentivize conservation consistent with state policy. In 2015, a southern California Court of Appeal held that tiered water rate structures violate California's Proposition 218 if the tiered rates do not reflect the proportional cost of providing water at higher tiers.[2] In response, the City took the

[1] "California drought: Court rules tiered water rates violate state constitution." San Jose Mercury News, April 20, 2015. https://www.mercurynews.com/2015/04/20/california-drought-court-rules-tiered-water-rates-violate-state-constitution/

[2] Prior to this 2015 appellate court decision, *Capistrano Taxpayers Assn., Inc. v. City of San Juan Capistrano* [(2015) 235 Cal.App.4th 1493], most public water purveyors' legal counsel agreed that tiered conservation water rates were legal and compliant with Proposition 218.

following actions:

- In February 2017, the City suspended collection of its higher-tiered residential water rates while it developed replacement rates.
- After two residents filed a lawsuit challenging the City's tiered water rate structure, the City reviewed the claims with experts and determined that its rates did not comply with Proposition 218 as currently interpreted and stipulated to an early settlement of the case. That settlement resulted in the City committing to refund all water rate revenue collected in violation of Proposition 218 by single-family residential customers within the City. The City committed to providing these refunds back through January 1, 2014, which was the date when the City's tiered rates took effect.
- The City committed to providing parity refunds to all other customer classes. This means all City customer classes – single-family residential, multi-family residential, and commercial customers – will receive refunds of all water rate charges that were not compliant with Proposition 218 back to January 1, 2014.
- The City and its new consultants have undertaken a new water rate study to develop water rates that comply with Proposition 218. The City expects to adopt these new rates in 2018 for the 2018 through 2022 period.

These actions show that, in response to a significant change in the law that affected most California water providers, the City took corrective actions to issue refunds to all affected customers and correct the City's rates going forward. These actions were reasonable and were calculated to treat City customers fairly and legally without jeopardizing the City's ability to continue operating its water enterprise in the future, including maintaining prudent operational and capital reserve levels.

**Municipal Utility Use:** The audit request letter also states that: *"...late December 2017, the ratepayer group stumbled onto the fact the City was using water for 'free' (approx. $1.0 million/year) for over 20 years through 113 City owned meters."* Until July 1, 2017 (the beginning of the 17/18 fiscal year), the City did not pay for the municipal use of utilities (water, wastewater, and solid waste). Municipal utility use generally includes utilities (water, sewer, and garbage) used by the City at City-owned parks, streetscapes, and facilities. The City was not unique in this former practice. Many other cities within California struggle with the same challenge. Prior to the passage of Proposition 218 in 1996, this practice was permitted. While slow to recognize this change, the City has since recognized the problem and took the appropriate corrective actions to remedy the situation and to ensure compliance with the requirements of Proposition 218 now and into the future. In January 2018, City Council authorized a fact finding investigation into the City's practice of not directly billing itself for its own water use that was completed by an investigative attorney from the law firm Meyers Nave. This direction came after a group of residents raised the issue in later 2017. The results of the Fact Finding Investigations were summarized in a report that was released to the public.

Additionally, the letter states *"The City had also gone so far as to falsify reports with the Department of Water Resources (DWR) in an attempt to cover up their presumed illegal usages."* Senate Bill 555 requires urban retail water suppliers to conduct and submit validated water loss audit reports to the Department of Water Resources (DWR) on October 1, annually. The first year for which this audit was required was 2016. To prepare the audit, Staff must provide a number of data points that are then verified and inputted into an Excel file. A third-party auditor (approved by DWR) then confirms the data submitted. The issue with the submittal of the 2016 audit was that the water use associated with the municipal use of water was entered into the incorrect cell (which identified water illegally used), and should instead have been entered into the cell that accounts for unbilled metered use. As soon as this issue was brought to Staff's attention, Staff notified DWR to initiate the correction of the 2016 audit. This was simply a mistake related to the fact that this was the first year the water loss audit was required or completed.

- **Redevelopment Act Debt (RDA):** In addition, the audit request letter states: *"While in discovery, citizens discovered apparent misuses of public funds. For instance, the City issued loans for rehabilitation in redevelopment areas, which were never repaid. Following the elimination of redevelopment agencies (RDAs), the City paid the successor fund's debt with monies from the Placer County Water Agency (where there was no nexus between water and rehabilitation). These payments that were not disclosed until a revised report was made to the state, five-years later."*

  The City did not pay RDA debt with monies from Placer County Water Agency (PCWA). In 2004, the City entered into two loan agreements with the RDA, the first in February in the amount of **$411,527.68** and the second in April in the amount of **$2,900,000.00**, to fund redevelopment projects. The funding for both of the loans was from the City's Development Services Fund.

  The Lincoln Public Financing Authority (LPFA) issued RDA bonds in October of 2004. On January 11, 2005, the RDA used **$415,426.58** of the bond proceeds to pay the February 2004 loan from the City. The RDA used the balance of the bond proceeds to fund additional redevelopment projects. In 2010, the City's Development Services Fund was no longer able to carry the loan receivable and the City authorized a new loan agreement with the RDA using the City's PCWA Water Capacity Connection (WCC) Fund as the source of funds.

  The obligation to pay the City's PCWA WCC Fund still exists and the Successor Agency to the Dissolved Redevelopment Agency (Successor Agency) continues to include the obligation on the required Recognized Obligations Payment Schedule (ROPS).

- **Developer Fees:** The audit request letter states: *"A more disturbing event appears to have been when the City 'charged-off ' $11 million in developer fees (a circumstance arising when developers do not build their intended project), though in this case the* *developers were allowed to proceed with their projects. This seems to be a clear gift of public funds."*

The City assumes this comment is in reference to development inspection fees. With the City's rapid growth beginning in the late 1990's there were increased demands for services provided by the City and changes to processes to provide those services in a cost-effective and timely manner. For the period from 2000 to 2006, Lincoln was the fastest growing city in the United States. The development community actively constructed new infrastructure systems for water, wastewater, transportation and drainage to provide necessary services for this growth and to effectively work with the City's existing systems.

For Fiscal Years 2000-01 through 2007-08 the City had reviewed, inspected and approved over 150 miles of new roads, 4,400 street lights, 20 traffic signals, 41 miles of storm drains, 110 miles of potable water lines, 226 miles of sanitary sewer lines and 11,000 new residential lots, totaling approximately $1.2 billion in privately constructed public infrastructure.

In the early stages of projects, the process for collecting inspection fees was effective. However, as the projects progressed into their final phases of construction, disputes arose with the development community pertaining to specific amounts due. The major points of disagreement by developers included the timing of the request for payment, the method of cost allocation for contracted inspection charges and the level of inspection required by the City.

In Fiscal Year 2006-07, the City established an Allowance for Doubtful Accounts (allowance account) to recognize the engineering plan check and inspection amounts due from developers that were in dispute and where collection of the amounts was in question. The purpose of recognizing these amounts was to present the actual funds available to the City. In consultation with the City's auditors, a conservative approach was taken in recognizing the amounts included in the allowance account. While City staff established the allowance account, the authorization to relieve the individual parties of their obligation to the City lay solely with the City Council.

In January of 2011, City staff recommended that the past due balances in the allowance account for services provided from 2000 to 2008 in the amount of $1,638,476.81 be written off as bad debt. For Fiscal Years 2000-01 through 2007-08 the City charged developers approximately $32,326,700 for engineering plan check and inspection services. Based on the amount of the proposed write-off in January 2011 and the $253,590.02 of bad debt recognized by resolution regarding a settlement of fees with a developer in January 2010, the City collected 94% of the amounts invoiced.

The City was proactive in addressing the concerns expressed by the development community. On June 27, 2006, it contracted with Sinclair & Associates to complete a review of the City's public facilities improvement processes. The objectives were to analyze the process of reviewing, inspecting and approving infrastructure improvements, and accepting public infrastructure improvements and facilities built by private parties for maintenance and operation by the City of Lincoln. During the review process, interviews were conducted with members of City Council, City staff, City consultants, and development community representatives and their consultants. In total, 55 individuals were interviewed.

The assessment report was completed by Sinclair & Associates on January 5, 2007. A special City Council workshop was held on February 12, 2007 to receive and discuss the report. The purpose of the review is described in the Introduction of the report; *"During our review, we found many sound practices and positive attributes in the current methods of providing services. Individuals who were interviewed offered many positive comments, particularly with regard to the City's response to the rapid pace of development in the City of Lincoln. A report of this nature tends to emphasize the areas where improvements can be made, rather than areas of success. However, this is not to disregard the many strengths, sound practices and committed individuals involved in the current processes. The purpose of this report is to build on those strengths and to provide recommendations where opportunities for improvement have been identified."*

The report discussed a variety of topics and proposed forty-two recommendations for consideration by the City. City staff reviewed, discussed and implemented the recommendations as the opportunities became timely. Some of the recommendations become invalid with the changes in the level of development; however, City staff has relied upon the intent to continually improve the processes.

Although City Council and Staff appreciate the concerns expressed by Senator Gaines, an audit as outlined in the letter would not be a prudent use of taxpayer resources. The City, like all well-managed cities, has lean staffing levels. Requiring the City to use its very limited staff resources to support an audit of the nature requested by Senator Gaines would be extremely time-consuming and resource-intensive. More to the point, as the foregoing discussion establishes, the City's finances are very sound and its administration is responsive, so such an audit would be unwarranted. Additionally, cities in California, including the City of Lincoln, are subjected to more oversight and regulation than most other local agencies in California. Many checks and balances exist that are intended to identify and reduce incidents of mismanagement or fiscal irresponsibility of cities, including:

- The City is subject to oversight by numerous federal, state, and local regulatory agencies.
- The City is required to follow the Ralph M. Brown Act, which guarantees the public's right to attend and participate in meetings of the legislative body.
- The City is required to complete a number of audits not only related to finance, but also to environmental regulations, grant management, water use, stormwater quality, and many other topics.
- The City is required to complete a myriad of monthly, quarterly, and annual reports to a variety of agencies on a variety of topics.
- The City is subject to numerous regulatory permits, which often include reporting, monitoring, documentation, and inspection.
- The City Council has formed a number of committees that include citizens at large. These committees provide oversight of very specific areas of City Management and

include: the Fiscal and Investment Oversight Committee, the Airport Committee, the Economic Development Committee, the Parks and Recreation Committee, the ADA Committee, and the Planning Commission. The intent of all of these bodies is to review and provide input on proposed actions and to provide oversight on the City's activities.

- In 2011, the City Council formed the Fiscal Sustainability Committee (FSC) that was an ad hoc committee created by the City Council to review and analyze the financial condition of the City, make recommendations leading to long-term fiscal stability, and develop appropriate financial policies, procedures, and accountability standards. Many of the deficiencies noted in the final committee report have been addressed and the comprehensive evaluation can in many ways be credited for facilitating the City's current good financial health.
- Due to the issues related to the 2013 tiered water rate structure, the City Council formed an ad hoc committee composed of citizens to provide oversight to the process and input of the development of the new rate structure (anticipated to take effect in October 2018).

In conclusion, although the City experiences challenges similar to those experienced by most California cities and counties, the City proactively practices sound financial management and has exhibited a willingness to modify processes or take corrective actions when required or appropriate. The best thing about the form of government under which the City operates is that the public process guides all major decisions and provides an opportunity to the City Council and the public to engage in a transparent process that results in stronger financial management for the benefit of all citizens. The public process is the best method of oversight; the more involved that citizens become in all City decisions and the more questions that are asked, the better the outcomes and decisions are. Neither City Council nor Staff have all of the right answers all of the time. With increased input and keen scrutiny from the public, the City will only become better and stronger.

The City Council sincerely appreciates the opportunity afforded by the JLAC process to provide a response to Senator Gaines's April 11, 2018 audit request letter. We would also like to thank Senator Gaines for taking the time to inquire about the City's fiscal situation. The City has also reached out to Senator Gaines to discuss his concerns prior to the JLAC hearing.

Respectfully,

Stan Nader

Stan Nader, Mayor
City of Lincoln

cc: JLAC Members