



# CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

January 22, 2013

The Honorable City Council  
Palo Alto, California

## Finance Committee Recommendation to Accept the Utilities Reserves Audit

The Office of the City Auditor recommends acceptance of the Utilities Reserves Audit. At its meeting on December 4, 2012, the Finance Committee approved and unanimously recommended the City Council accept the report. The Finance Committee minutes are included in this packet.

**Recommended Action:** Accept the Utilities Reserves Audit.

Respectfully submitted,

Jim Pelletier  
City Auditor

### ATTACHMENTS:

- Attachment A: Utilities Reserves Audit (PDF)
- Attachment B: Finance Committee Meeting Minutes Excerpt (December 4, 2012) (PDF)

Department Head: Jim Pelletier, City Auditor





## CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

December 4, 2012

**The Honorable City Council**  
**Attention: Finance Committee**  
**Palo Alto, California**

### **Utilities Reserves Audit**

In accordance with the Fiscal Year (FY) 2012 Annual Audit Work Plan, the Office of the City Auditor has completed the Utilities Reserves Audit. The audit contains two findings with a total of five recommendations. The Office of the City Auditor recommends the Finance Committee review and recommend to the City Council acceptance of the Utilities Reserves Audit.

We thank the staff of the Utilities Department and Administrative Services Department for their time, information, and cooperation during the audit process.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "JPelletier".

Jim Pelletier  
City Auditor

#### **ATTACHMENTS:**

- Attachment A - Utilities Reserves Audit (PDF)

Department Head: Jim Pelletier, City Auditor

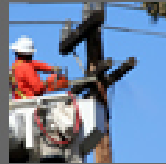




CITY OF  
**PALO  
ALTO**

# UTILITIES RESERVES AUDIT

DECEMBER 2012



Office of the City Auditor

Jim Pelletier, City Auditor  
Mimi Nguyen, Senior Performance Auditor



CITY OF  
**PALO  
ALTO**

## Office of the City Auditor

### EXECUTIVE SUMMARY—UTILITIES RESERVES AUDIT

Summary of Audit Objectives: To assess the appropriateness and adequacy of utilities reserves, reserve policies, reserve guidelines, and usage of reserves.

#### SUMMARY OF RESULTS

##### REPORT HIGHLIGHTS

Opportunities for improving and strengthening of internal controls are provided in the following findings:

**FINDING 1:** Rate Stabilization Reserves are not consistently maintained within Council-approved guidelines. The City does not currently have a formal, comprehensive reserve policy for its utility funds. Key City documents show inconsistency in communication of the City's reserve policy decisions. Rate Stabilization Reserve balances were often outside of Council-approved guideline ranges. Reserve balances are inconsistently reported and do not always reconcile, primarily due to the exclusion of Capital Improvement Program (CIP) carryforward reserves.

Establishing a more comprehensive reserve policy, with effective supporting procedures, the City Council and the Utilities Department could benefit from having clear criteria to communicate, manage, and monitor utility reserves.

**FINDING 2:** Capital Improvement Program reserves are not consistently and clearly reported to Council. The reports issued regarding CIP are not sufficient to adequately support effective financial and project planning. Improvements to the consistency and completeness of reporting CIP carryforward reserve balances could better support the City Council's operating budget, capital budget, and reserves processes.

##### RECOMMENDATIONS

The Office of the City Auditor (OCA) recommends the following actions:

- The Utilities Department should establish formal and comprehensive policies and procedures for its Utility Reserves.
- The Utilities Department should re-evaluate and determine the use of reserve balance guidelines, updating the City's resolution and the language in key City documents accordingly.
- The Utilities Department should revisit its annual risk assessment model to determine, establish, and document appropriate levels of utility fund working capital held in unrestricted reserves.
- The Utilities Department should revisit and update the 5-year financial projection rate making worksheets to completely state all reserve balances consistent with the City's key financial documents and improve visibility over all unrestricted reserves.
- The Utilities Department should develop a mechanism to consistently and clearly report Capital Improvement Program carryforward reserves to the oversight bodies.

*This document represents a limited summary of the audit report and does not include all of the information available in the full report. The full report can be found on the Office of the City Auditor website at: [http://www.cityofpaloalto.org/depts/aud/audit\\_reports.asp](http://www.cityofpaloalto.org/depts/aud/audit_reports.asp)*

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In accordance with the Fiscal Year 2012 Annual Audit Work Plan, the Office of the City Auditor has completed this Audit of Utilities Reserves. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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We would like to thank the staff of the Utilities Department and Administrative Services Department for their time, information, and cooperation during the audit process.

## INTRODUCTION

### Audit Objectives

The objectives of this audit were to assess the adequacy and appropriateness of the utility financial reserves, which included:

- 1) Determining if established utilities reserves policies are reasonable and appropriate for all Utilities Funds, including Electric, Gas, Water, Wastewater Collection (WWC), and Fiber Optics.
- 2) Determining if the City maintains adequate reserves within the Utilities Funds.
- 3) Determining if the City's utilities reserve balances conform to City Council-approved utilities reserve guidelines.
- 4) Determining if reserve funds maintained in utilities reserves are used appropriately in accordance with established policy.

### Background

Palo Alto is the only city in California that offers a full array of utility services to its citizens and businesses. The utility services are managed by the Palo Alto Utilities Department with a mission to provide safe, reliable, environmentally sustainable and cost effective services. The department is comprised of the following five divisions:

- 1) **Administration** - responsible for the overall management of the Utilities Department, including communication, regulatory compliance, budget coordination, and personnel and administrative support.
- 2) **Customer Support Services** - responsible for customer services of the electric, fiber, water, gas, and wastewater systems, including the Utilities Department's call center, meter reading, utility billing, credit and collections, energy efficiency and renewable energy programs, and liaison with key accounts.
- 3) **Engineering** - responsible for managing all phases of the Utilities Department's capital improvement projects, including replacement and rehabilitation of the City's electric, fiber, water, gas, and wastewater distribution systems.
- 4) **Operations** - responsible for operations, maintenance, and emergency response for the electric, fiber, water, gas and wastewater distribution systems.
- 5) **Resource Management** - responsible for the long-term acquisition plan of resources, including electricity, natural gas, and water; contract negotiations to acquire renewable resources; rate development; and legislation and regulatory policy analysis.

The Utilities Department controls an operating budget of \$222.8 million and a capital budget of \$25.7 million summarized by fund in Exhibit 1:

**Exhibit 1: Utilities Department Operating Budget (FY 2012) and Reserve Actuals (FY 2011)**

| (in millions)         | Budget FY 2012    |                   |                 | Actual FY 2011 |
|-----------------------|-------------------|-------------------|-----------------|----------------|
| Fund                  | Operating Revenue | Operating Expense | Capital Expense | Reserve        |
| Electric              | \$125.2           | \$132.0           | \$8.7           | \$142.7        |
| Gas                   | \$44.8            | \$49.5            | \$7.8           | \$34.4         |
| Water                 | \$33.2            | \$36.6            | \$4.4           | \$25.5         |
| Wastewater Collection | \$15.9            | \$17.2            | \$4.3           | \$17.1         |
| Fiber Optic           | \$3.7             | \$2.1             | \$0.5           | \$11.9         |
| <b>TOTAL</b>          | <b>\$222.8</b>    | <b>\$237.4</b>    | <b>\$25.7</b>   | <b>\$231.6</b> |

Source: FY 2012 Adopted Operating Budget and FY 2011 Comprehensive Annual Financial Report (CAFR)



The charter of the City of Palo Alto, Article VII, Section 2: Public utilities revenue states, “The revenue of each public utility shall be kept in a separate fund from all other receipts and shall be used for the purposes and in the order as follows...:

- a) The payment of the operating and maintenance expenses of such utility...
- b) The payment of interest on the bonded debt incurred for the construction or acquisition of such utility.
- c) The payment of the principal of said debt, as it may become due.
- d) The capital expenditures of such utility.
- e) The replacements or emergency repairs and after special appropriation by the council.
- f) The remainder shall be paid into the general fund by quarterly allotments.”

Specific to the utilities funds and by resolution, the City Council set aside unrestricted net assets (in the form of reserves) and established reserve guidelines for:

- General contingencies
- Future capital and debt service expenditures
- Operating and capital contingencies for unusual or emergency expenditures.

Listed below are current utility fund reserves, including rate stabilization reserves (which have Council-approved minimum and maximum balance guidelines) and other reserves.

#### Exhibit 2: List of Utilities Department Reserves

| Reserve Name  | Minimum Guideline Methodology | Maximum Guideline Methodology |
|---|-------------------------------|-------------------------------|
| <b>Reserves with Council-approved balance guidelines:</b>   |                               |                               |
| 1. Rate Stabilization Reserves (RSR)                        |                               |                               |
| a) Electric Distribution Rate Stabilization Reserve (D-RSR) | 15% sales revenue             | 30% sales revenue             |
| b) Electric Supply Rate Stabilization Reserve (S-RSR)       | 50% purchase cost             | 100% purchase                 |
| c) Gas Distribution Rate Stabilization Reserve (D-RSR)      | 15% sales revenue             | 30% sales revenue             |
| d) Gas Supply Rate Stabilization Reserve (S-RSR)            | 25% purchase cost             | 50% purchase cost             |
| e) Water Rate Stabilization Reserve (RSR)                   | 15% sales revenue             | 30% sales revenue             |
| f) Wastewater Rate Stabilization Reserve (RSR)              | 15% sales revenue             | 30% sales revenue             |
| g) Fiber Optics Stabilization Reserve (RSR)                 | 20% sales revenue             | 50% sales revenue             |
| 2. Emergency Plant Replacement Reserves (EPR)               |                               |                               |
|   | Insurance Deductible          |                               |

#### Other Reserves:

3. Reappropriations
4. Commitments
5. Electric Special Projects (formerly Calaveras)
6. Public Benefit Program
7. Central Valley Project
8. Underground Loan

#### Audit Scope and Limitations

We reviewed and evaluated Council-approved resolutions and policies addressing Utilities operating and capital reserves. We reviewed the City’s utility reserve balances and considered guidance on the establishment and maintenance of municipal reserves. We reviewed other related City documents including Adopted Operating and Capital Budgets, Comprehensive Annual Financial Reports, Rate Making Financial Forecasts, Energy Risk Management Policy and Procedures, and the Debt Policy. We also reviewed and analyzed activity pertaining to the sources and uses of utility reserves, reserve levels, and appropriate levels of reserve over an 8-year period.

## **Audit Methodology**

To conduct this audit, we analyzed reports from the City's SAP Enterprise Resource Planning system on reserve balances, operating and capital budgets, and capital project financial information. We interviewed Utilities Department staff and Administrative Services Department (ASD) staff to assess the City's overall reserve and financial policies and procedures, to determine roles and responsibilities, and to assess the adequacy and reasonableness of established policies and procedures related to reserves. We reviewed applicable federal, state, and local laws and regulations, and consulted with the City Attorney's Office. We also reviewed financial documents from other jurisdictions for benchmarking.

## **City Auditor's Conclusion**

Government auditing standards require us to report our conclusion based on the sufficiency and appropriateness of the evidence supporting the findings in this report. Based on our assessment of Utilities Reserves, we found that the City generally maintains adequate reserves within the utility funds. We also found that reserves are generally used appropriately in accordance with established policy. However, we found that by establishing a more comprehensive reserve policy, with effective supporting procedures, the City Council and the Utilities Department could benefit from having clear criteria to communicate, manage, and monitor utility reserves. Additionally, improvements to the consistency and completeness of reporting reserve balances could better support the City Council's operating budget, capital budget, and reserves processes.

In this report, the Office of the City Auditor provides five recommendations to improve the management and monitoring of utility reserves. The audit recommendations in the report are addressed to the Utilities Department; however, to effectively implement the recommendations, the Utilities Department should work with the Administrative Services Department to ensure City policies are in alignment.

## AUDIT RESULTS

### FINDING 1:

### Rate Stabilization Reserves are not consistently maintained within Council-approved guidelines

Reserve level guidelines for utility reserve balances were introduced in 1993 with the establishment of the Rate Stabilization Reserves. The following are guidelines and objectives for the Rate Stabilization Reserves:

1. To finance extraordinary one-time contingencies and to finance increased operating cost in the short-term.
2. Not to be used to solve long-term financial problems or to cover major catastrophic disasters.
3. Reserve guidelines to be set to allow reserves to float up or down, with target reserves set based on assessment of uncertainties and financial risk facing the utilities.
4. Adequacy and prudence of the guidelines to be reviewed internally each year, and if appropriate, revisions be recommended.

A 1993 Council-approved resolution states, "The levels of the Rate Stabilization Reserves shall conform to the reserve level guidelines and other criteria set forth in the Utilities Reserve Policy, as such may be amended from time to time, and shall be accounted for or disposed of by action of the Council during the fiscal year in which revenues are placed therein or in the budget of the next succeeding fiscal year."

Since 1993, some reserve accounts, the methodology for calculating reserve levels, and reserve level guidelines have changed; however, the requirement to maintain reserve levels within Council-approved guidelines has remained unchanged.

#### Establishing a comprehensive reserve policy could clarify reserve requirements.

The City does not currently have a formal, comprehensive reserve policy. However, we saw elements of policy language within City staff reports, strategic and operational plans, and other financial documents.

Financial policies are fundamental financial management tools that serve as guidelines for operational and strategic decision making. Financial policies focus primarily on a government's general fund; however, the same emphasis should be placed on other funds, such as utility enterprise funds, where service is provided which requires a stable rate and revenue structure, orderly provision of services to ratepayers, adherence to legislation and regulatory requirements, and sound management of fiscal financial processes. Due to the close relationships between rate making, operational and capital budgeting, and debt financing, it is important that these related policies and procedures are in alignment and support each other.

**Recommendation 1:** The Utilities Department should establish formal and comprehensive policies and procedures for its Utility Reserves.

Exhibit 3 includes portions of reserve guideline language in various City documents that communicate reserve information.

**Exhibit 3: Communication of reserve information in various City documents**

| City Document   | Reserve statement   |
|---|---|
| City of Palo Alto, Council Resolution Numbers 7207, 7769, and 8386  | <p>The levels of the Rate Stabilization Reserves shall conform to the reserve level guidelines and other criteria set forth in the Utilities Reserve Policy, as such may be amended from time to time, and shall be accounted for or disposed of by action of the Council during the fiscal year in which revenues are placed therein or in the budget of the next succeeding fiscal year.</p> <p>... the City conformed the levels of the rate stabilization reserves to the reserve level guidelines, as amended from time to time.</p>   |
| FY 2012 Adopted Operating Budget, under electric fund narrative   | Reserves may be above the maximum guideline level or below the minimum guideline level for a particular year as long as the levels are projected to move back to between the minimum and maximum over the five-year financial forecast planning horizon.  |
| FY 2012 Adopted Operating Budget, under enterprise fund overview section  | Reserve levels that are above guidelines are returned to customers in the form of lower future rates, or used to pay for expenses, which also result in lower future rates.   |
| FY 2013 Adopted Operating Budget, under City overview section and under enterprise funds overview, respectively | <p>Council has adopted a policy specifying the appropriate levels of reserves in each Enterprise Fund. Typically, the budget will reflect either increasing or decreasing the reserves to within Council-approved ranges.</p> <p>...Reserve levels that are above guidelines are returned to customers in the form of lower future rates, or used to pay for expenses, which also result in lower future rates.</p>   |
| Utilities Strategic Plan FY 2011  | Maintaining adequate cash reserves contributes to maintaining our overall financial health and retaining our current favorable bond rating. We will maintain Rate Stabilization Reserves levels within Council-approved guidelines and sufficient to provide rate stability as desired by ratepayers. During the annual budget and rate setting process, the risks that each Utilities fund is exposed to will be identified along with the trajectory of costs and revenues to allow Council to determine appropriate reserve levels and rate adjustments.   |
| Electric Utility 5-year Financial Projections report to Council (4/19/11)                                       | <p>The projected rate adjustments achieve the goals of ensuring that the balances of the Electric Supply and Distribution Rate Stabilization Reserves (E-SRSR and E-DRSR, respectively) are adequate and within the Council-approved reserve guideline levels for the long-term forecast horizon.</p> <p>...These minimum and maximum guidelines represent long term assessments of reserve level requirements based on long term expected changes in commodity costs, hydro risk and credit risk. In addition to the long term reserve guidelines, staff performs an annual assessment of short term uncertainties and risks for each of the supply and distribution funds.</p> <p>...Rate Stabilization Reserve Adequacy<br/>Table 4 summarizes electric supply and distribution reserve requirement guidelines, short term assessment of risks and estimated end of year reserve balances for E-SRSR and E-DRSR for the current plus next two fiscal years.</p> <p>...With no rate increase for the next two years, it is estimated that the end of year balance for both E-SRSR and E-DRSR are expected to be within the long term reserve guideline levels as well as above the short term risk assessment levels for the current and next two fiscal years.</p> |
| Energy Risk Management Policy   | Maintaining the adequacy of these reserve funds in accordance with Council approved reserve policies and guidelines is a matter of the highest priority for City of Palo Alto Utilities and the City.   |

|   |  |
|---|--|
| <p>Water Revenue Bond<br/>Official Bond Statement - City of<br/>Palo Alto, Utility Revenue<br/>Refunding Bonds, 2011 Series A</p> | <p>The projected adjustments achieve the goals of ensuring that the balance of the water rate stabilization reserves is adequate and within the Council-approved reserve guidelines in the long-term horizon.</p> <p>...Based upon a City Council-approved methodology, reserve level guidelines (minimum and maximum) are set annually to allow reserves to adjust up or down without unduly falling below the minimum or above the maximum. On occasion, reserves have exceeded the maximum level for a short time. Reserve levels are then adjusted in subsequent years, usually through rate changes. The decision to set aside more or less than the minimum or maximum is based upon an assessment of the uncertainties and financial risk facing the utilities. The City notes that reserve levels in excess of "maximum" levels are considered to be consistent with its reserve guidelines.</p> |
|---|--|

The various documents show inconsistency in communication of the City's reserve policy decisions. By establishing a comprehensive reserve policy, the Utilities Department will be able to more effectively monitor, manage, and report reserves within the defined parameters.

Upon testing Rate Stabilization Reserve balances for compliance with reserve guidelines<sup>1</sup> approved by Council, we found the balances were often outside of these Council-approved guideline ranges, as illustrated in Exhibit 4. These minimum and maximum ranges for each of the Rate Stabilization Reserves can be found in the Adopted Operating Budgets.

**Recommendation 2:** The Utilities Department should re-evaluate and determine the use of reserve balance guidelines, updating the City's resolution and the language in key City documents accordingly.

**Exhibit 4: Rate Stabilization Reserves balance to Council-approved guideline ranges (FY 2008 – FY 2012)**

|                           | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012         |
|---------------------------|---------|---------|---------|---------|-----------------|
|                           | Q4      | Q4      | Q4      | Q4      | Q4 <sup>2</sup> |
| Electric Supply RSR       | ⊙       | ⊙       | ⊙       | ⊙       | +6%             |
| Electric Distribution RSR | ⊙       | -13%    | ⊙       | ⊙       | ⊙               |
| Gas Supply RSR            | -19%    | -11%    | ⊙       | ⊙       | ⊙               |
| Gas Distribution RSR      | ⊙       | ⊙       | +16%    | +15%    | +56%            |
| Water RSR                 | +9%     | ⊙       | +97%    | +24%    | ⊙               |
| WWC RSR                   | ⊙       | ⊙       | +57%    | +37%    | +10%            |
| Fiber Optics RSR          | n/a     | +380%   | +505%   | +366%   | +166%           |

Legend: ⊙ within range of Council-approved guidelines  
% above maximum range or % below minimum range

Source: Comprehensive Annual Financial Report (FY 2008-FY 2011), Administrative Services Department-Enterprise Account (FY 2012), and Adopted Operating Budget (FY 2008-FY 2012)

According to the Utilities Department, the Council-approved rate stabilization guideline ranges are used for long-term financial planning purposes, and the reserve balances may be above the maximum or below the minimum guidelines. In addition, the Utilities Department states November 2001 was the first report in which Rate Stabilization Reserve (RSR) levels and guidelines were issued to the Utilities Advisory Commission (UAC) in quarterly staff reports. The Utilities Department also issues a 5-year financial projection report showing changes in RSR balances as a result of changes in rate adjustments for the next five years. This report is issued to the UAC, Finance Committee, and City Council.

<sup>1</sup> Guidelines used for testing were based on the methodologies in Exhibit 2 as approved by Council in various City Manager's Reports (CMR).

During the course of this audit, the Utilities Department reported that the FY 2012, Q4 report to the UAC included a summary table that shows all Utilities Reserves. Additionally, for the last two quarters, the Department has specifically included the UAC Quarterly reports as part of the informational reports provided to the Council.

We were not able to adequately assess the reasonableness of the City's other utility reserves in relation to Council-approved guidelines since a comprehensive reserve policy does not exist to provide the criteria required.

**On average, the City maintains between 13 and 18 months of total unrestricted reserves.**

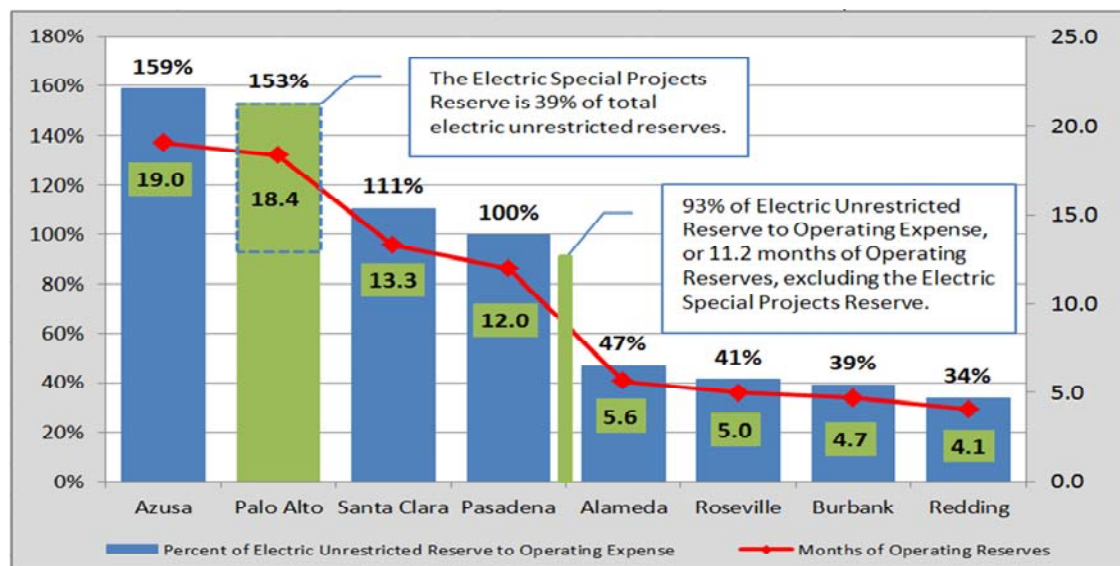
From a broader perspective, we reviewed the City's total unrestricted reserve balances, in addition to the Rate Stabilization Reserves as discussed previously. The City's FY 2011 Comprehensive Annual Financial Report indicates the level of working capital, within the Utilities reserve funds listed below, could cover between 13 and 18 months of operating expenses:

- Electric - 18.4 months
- Gas – 13.0 months
- Water - 13.2 months
- Wastewater Collection - 16.7 months

The Government Finance Officers Association (GFOA) recommends a reserve baseline of three months of working capital as a starting point and states that the appropriate level depends on the particular characteristics of each enterprise fund. While the level of unrestricted reserves for the City may be appropriate, the Utilities Department could not provide documentation to support the current level of working capital currently held in reserves.

We selected seven local jurisdictions to benchmark the City's Electric Fund unrestricted reserve balance. We found the average number of months of operating capital to be 10.3 months, with the City of Palo Alto currently at 18.4 months, as shown in Exhibit 5. Exhibit 5 compares the City of Palo Alto's FY 2011 Electric Fund unrestricted reserve balance, including the Electric Special Projects reserve, to other local jurisdictions providing similar services. The City of Palo Alto's Electric Fund reserve represents approximately 62 percent, or \$142.7 million, of total reserves in FY 2011.

**Exhibit 5: Comparison of FY 2011 Electric Fund Unrestricted Reserve Balances for selected jurisdictions**



Source: Comprehensive Annual Financial Reports

The level of unrestricted fund balance may differ from one jurisdiction to another based on each jurisdiction's particular financial and economic characteristics, and local conditions. According to the Utilities Department, the higher reserve requirement is a result of a higher share of hydro resources in the City's Electric portfolio, which could result in unexpected shortfalls in generation as well as higher exposure to market price risk.

The GFOA's guidance states that local governments should adopt a target amount of working capital to maintain in each of their enterprise funds that best fits local conditions for each fund. Ideally, targets would be formally described in a financial policy and/or financial plan. The guidance recommends consideration of the following areas while customizing a working capital target:

- Support from general government
- Cash cycles
- Demand for services
- Asset age and condition
- Control over expenses
- Separate targets for operating and capital needs
- Transfers out
- Customer concentration
- Control over rates and revenues
- Volatility of expenses
- Management plans for working capital
- Debt position

Currently, the Utilities Department performs an annual risk assessment to determine the adequacy of Rate Stabilization Reserves; however there is no explicit criteria or a specified target to indicate appropriate levels of working capital.

**Recommendation 3:** The Utilities Department should revisit its annual risk assessment model to determine, establish, and document appropriate levels of utility fund working capital held in unrestricted reserves.

### Reserve balances are inconsistently reported and do not always reconcile.

In reviewing the various reports related to reserve levels and guidelines, we found that the Utilities Department's financial forecasting reports have underreported reserve balances, as shown in Exhibit 6. The reports include some utility reserves, and specifically exclude CIP reserves (known as reappropriation and commitments). As a result, the financial forecasting understated actuals of all utility reserves by \$51 million, \$72 million, and \$54 million in FY 2009, FY 2010, and FY 2011, respectively.

The projections include balances for reserves that are attributed to the City's audited Comprehensive Annual Financial Report (CAFR); however, the reserve balances in the financial projection do not reconcile in total to the CAFR or to quarterly reports of actual

**Exhibit 6: 3-year historical understatement of financials**

| Fund/Year       | Actual Reported by Utls in Financial Projections (in 000's) | Actual reported by ASD in CAFR, restricted and unrestricted (in 000's) | Understated (in 000's) |        |
|-----------------|---|--|------------------------|--------|
|                 |   |  | Amt                    | %      |
| <b>Electric</b> |   |  |                        |        |
| FY2009          | 117,599   | 129,368  | (11,769)               | -9.1%  |
| FY2010          | 118,955   | 133,384  | (14,429)               | -10.8% |
| FY2011          | 126,028   | 142,653  | (16,625)               | -11.7% |
| <b>Gas</b>      |   |  |                        |        |
| FY2009          | 15,134  | 27,330   | (12,196)               | -44.6% |
| FY2010          | 20,499  | 30,610   | (10,111)               | -33.0% |
| FY2011          | * 18,140  | 34,362   | (16,222)               | -47.2% |
| <b>Water</b>    |   |  |                        |        |
| FY2009          | 7,180   | 27,399   | (20,219)               | -73.8% |
| FY2010          | 21,383  | 59,884   | (38,501)               | -64.3% |
| FY2011          | * 14,986  | 25,513   | (10,527)               | -41.3% |
| <b>WWC</b>      |   |  |                        |        |
| FY2009          | 7,022   | 14,123   | (7,101)                | -50.3% |
| FY2010          | 7,771   | 16,561   | (8,790)                | -53.1% |
| FY2011          | * 6,896   | 17,147   | (10,251)               | -59.8% |

\* Reappropriation and Commitment balances were shown in the report; however, the balances were not included in the total reserve balance.

|                           |          |
|---------------------------|----------|
| FY 2009 Total understated | (51,285) |
| FY 2010 Total understated | (71,831) |
| FY 2011 Total understated | (53,625) |

reserve balances provided by the Administrative Services Department. This is primarily due to the exclusion of CIP reserves (reappropriations and commitments).

Our review showed the following causes for inconsistencies in the “Actual” column of the Utilities Department’s financial forecasting report:

- All funds excluded the CIP reserves (reappropriation and commitment).
- Water and Gas Funds, in addition to excluding the CIP reserves (reappropriation and commitment), included debt service reserves. Debt service reserves are unique when compared to other reserves included in this report as they are considered restricted. In the CAFR, Debt Service reserves are segregated from other reserves because of their restricted status. Additionally, other restricted reserves that are included in the CAFR are not included in this report.
- Electric Fund, in addition to excluding the CIP reserves (reappropriation and commitment), also excluded two other reserves (Underground Loan and Central Valley Project).
- FY 2010 Gas Fund stated the Rate Stabilization reserve figure twice, once each for pre-transfer and post-transfer; however the total reserve balance is correct in that it does not reflect the duplicate figures.

**Recommendation 4:**

The Utilities Department should revisit and update the 5-year financial projection rate making worksheets to consistently state reserve balances consistent with the City’s key financial documents and improve visibility over all unrestricted reserves.

We also found instances where the Utilities Department financial forecast figures do not reconcile to the City’s key documents, such as the Adopted Budgets.

According to the Utilities Department, the financial forecasting report is adequate for the purpose of its intended use in rate planning, not reserves management. The Department explains that the report only shows a reserve if the balance is expected to change during the forecast horizon as a result of policy change or Council action. However, we found this report to be the Departments’ primary mechanism for reporting reserves from a financial planning

perspective. Based on our assessment, the report alone does not provide a complete view of the City’s utility reserves.



**FINDING 2:****Capital Improvement Program reserves are not consistently and clearly reported to Council**

The Utilities Department does not consistently and clearly report Capital Improvement Program (CIP) carryforward appropriations, a reserve which holds unexpended CIP funds from prior fiscal years. Utility carryforward reserve balances are significant, totaling a high of \$82.8 million in FY 2012 and an estimated \$75.9 million in FY 2013. The reporting of this information may assist with financial and project planning.

Carryforwards are unexpended appropriations at the end of a fiscal year which are automatically carried over to the following year for open projects. Exhibit 7 shows each of the utility CIP carryforward balances from the prior fiscal year, over an 8-year period, including both reappropriations and commitments.

**Exhibit 7: CIP Carryforward Balances of all Utility Funds (FY 2005 – FY 2013)**

| (in 000's)  | 2005            | 2006            | 2007            | 2008            | 2009            | 2010            | 2011            | 2012            | Estimated<br>2013 |
|---|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-------------------|
| ELECTRIC  | \$14,945        | \$17,425        | \$8,825         | \$8,872         | \$5,311         | \$10,017        | \$10,536        | \$13,791        | \$15,892          |
| GAS   | \$4,514         | \$3,522         | \$3,967         | \$7,097         | \$9,197         | \$12,066        | \$9,467         | \$15,887        | \$17,023          |
| WATER   | \$15,694        | \$16,121        | \$13,277        | \$4,470         | \$11,537        | \$20,014        | \$40,903        | \$42,207        | \$31,054          |
| WASTEWATER COLLECTION   | \$10,152        | \$10,451        | \$9,233         | \$6,060         | \$6,445         | \$7,492         | \$8,751         | \$10,338        | \$11,246          |
| FIBER OPTICS  | \$0             | \$0             | \$0             | \$0             | \$0             | \$0             | \$642           | \$616           | \$692             |
| <b>TOTAL OF ALL FUNDS</b>   | <b>\$45,306</b> | <b>\$47,519</b> | <b>\$35,302</b> | <b>\$26,499</b> | <b>\$32,490</b> | <b>\$49,589</b> | <b>\$70,299</b> | <b>\$82,838</b> | <b>\$75,907</b>   |
| Total percentage of carryforward<br>increase/(decrease) from prior year |                 | 5%              | (26%)           | (25%)           | 23%             | 53%             | 42%             | 18%             | (8%)              |

There are four key reports used for communicating CIP reserves: the Comprehensive Annual Financial Report (CAFR), the Adopted Budget (Budget), the Financial Forecast (Forecast), and the CIP Status report. The CAFR represents the most formal reporting of carryforward balances, reflected as a consolidated number and reported at the end of the calendar year for the fiscal year ending June 30. The Forecast and the Budget exclude prior year carryforward and report only on projects with planned appropriations looking forward five years. Lastly, the CIP Status Report does include carryforward information; however, carryforward balances are not reported separately, and the report is not available until three to six months after the close of the mid-year and year-end periods.

**Recommendation 5:** The Utilities Department should develop a mechanism to consistently and clearly report Capital Improvement Program (CIP) carryforward reserves to the oversight bodies.

The Government Finance Officers Association (GFOA) guidance on Capital Project Monitoring and Reporting states, "Producing project status reports will help officials make informed decisions regarding scheduling and cost. It is important to be consistent and use plain language when compiling information from various sources and reporting it to multiple stakeholders. Meaningful reports should provide straightforward project information for executive leadership and internal staff as well as citizens and the media, and, at minimum:

1. Provide a comparison of actual results to the project plan, including:
  - Percent of project completed
  - Percent of project budget expended
  - Progress on key project milestones
  - Contract status information
  - Revenue and expenditure activity
  - Cash flow and investment maturities

- Funding commitments
- Available appropriation
- Comparison of results in relation to established performance measures

2. Highlight significant changes to project scope or costs.”

As an example, Exhibit 8 details the CIP projects for Electric Fund Capital projects for FY 2012. The table includes columns for the FY 2012 Budget, Carryforwards from the prior year, and Net Additional Appropriations>Returns. The last four columns indicate which projects are included or excluded from each of the key reports. Detailed CIP projects in FY 2012 for all utility funds are provided in Appendix 1.

In this example, 25 of 39 projects, which represent \$6,672,273 or 30% of the total Electric Fund CIP budget, are not included in the Forecast or the Budget. Additionally, the carryforward total of \$13,790,931 is not reported in detail.

**Exhibit 8: Electric Fund Capital projects available appropriations detail (FY 2012)**

**ELECTRIC FUND - Capital Projects Appropriation Detail**

Legend: - not reported • reported

| Project Number | Project Description | FY 2012 Budget                           | Carryforward (from FY 2011) | Net (Suppl, Return, Tfr) | Total FY 2012 Budget | CAFR          | Budget | Forecast | Status |
|----------------|---------------------|--|-----------------------------|--------------------------|----------------------|---------------|--------|----------|--------|
| 1              | EL-89028            | Electric Customer Connections            | \$ 2,000,000                | \$ 1,303,710             | \$ (284,782)         | \$ 3,018,928  | -      | •        | •      |
| 2              | EL-89031            | Communications System Improvements       | \$ 120,000                  | \$ 288,112               | \$ (200,000)         | \$ 208,112    | -      | •        | •      |
| 3              | EL-89038            | Substation Protection Improvements       | \$ 250,000                  | \$ 465,238               | \$ (290,672)         | \$ 424,566    | -      | •        | •      |
| 4              | EL-89044            | Substation Facility Improvements         | \$ 165,000                  | \$ 224,800               | \$ (190,670)         | \$ 199,130    | -      | •        | •      |
| 5              | EL-98003            | Electric System Improvements             | \$ 1,200,000                | \$ 2,109,842             | \$ 97,718            | \$ 3,407,560  | -      | •        | •      |
| 6              | EL-02010            | SCADA System Upgrades                    | \$ 200,000                  | \$ 43,023                | \$ -                 | \$ 243,023    | -      | •        | •      |
| 7              | EL-02011            | Electric Utility GIS                     | \$ 100,000                  | \$ 284,185               | \$ -                 | \$ 384,185    | -      | •        | •      |
| 8              | EL-04010            | Foothills System Rebuild                 | \$ -                        | \$ 102,802               | \$ -                 | \$ 102,802    | -      | -        | •      |
| 9              | EL-04012            | Utility Site Security Improvements       | \$ -                        | \$ 518,614               | \$ 8,842             | \$ 527,456    | -      | -        | •      |
| 10             | EL-04014            | Automated Meter Reading System           | \$ -                        | \$ 296,157               | \$ (296,157)         | \$ -          | -      | -        | •      |
| 11             | EL-05000            | El Camino Underground Rebuild            | \$ -                        | \$ 185,671               | \$ 3,856             | \$ 189,527    | -      | -        | •      |
| 12             | EL-06000            | Park Blvd. 4/12 kV Conversion            | \$ -                        | \$ 9,973                 | \$ (9,973)           | \$ -          | -      | -        | •      |
| 13             | EL-06001            | 230 kV Electric Interconnection          | \$ -                        | \$ 95,955                | \$ 2,328             | \$ 98,283     | -      | -        | •      |
| 14             | EL-06002            | UG District 45                           | \$ -                        | \$ 309,393               | \$ 9,730             | \$ 319,123    | -      | -        | •      |
| 15             | EL-06003            | Utility Control Center Upgrade           | \$ -                        | \$ 7,989                 | \$ (7,989)           | \$ -          | -      | -        | •      |
| 16             | EL-08000            | E. Charleston 4/12 kV Conversion         | \$ -                        | \$ 592,650               | \$ 12,069            | \$ 604,719    | -      | -        | •      |
| 17             | EL-08002            | E. Meadow/Alma/Loma 4/12kV Conversion    | \$ -                        | \$ 414,014               | \$ (414,014)         | \$ -          | -      | -        | •      |
| 18             | EL-09000            | Middlefield Underground Rebuild          | \$ -                        | \$ 625,786               | \$ 1,932             | \$ 627,718    | -      | -        | •      |
| 19             | EL-09002            | Middlefield / Colorado 4/12 kV Conv.     | \$ 150,000                  | \$ -                     | \$ (90,175)          | \$ 59,825     | -      | •        | •      |
| 20             | EL-09003            | Rebuild UG Dist 17                       | \$ -                        | \$ 756,457               | \$ 4,605             | \$ 761,062    | -      | -        | •      |
| 21             | EL-09004            | W. Charleston/Wilkie to S. 4/12kV        | \$ -                        | \$ 96,324                | \$ 4,910             | \$ 101,234    | -      | -        | •      |
| 22             | EL-10006            | Rebuild UG Dist 24                       | \$ -                        | \$ 1,017,856             | \$ 4,418             | \$ 1,022,274  | -      | -        | •      |
| 23             | EL-10008            | AMR/AMI - Feasibility Study              | \$ -                        | \$ 255,545               | \$ 32                | \$ 255,577    | -      | -        | •      |
| 24             | EL-10009            | Street Light System Conversion Project   | \$ 800,000                  | \$ 935,240               | \$ 2,401             | \$ 1,737,641  | -      | •        | •      |
| 25             | EL-11000            | Seale/Waverley 4/12kV                    | \$ -                        | \$ 40,000                | \$ (40,000)          | \$ -          | -      | •        | •      |
| 26             | EL-11001            | Torrey Court Rebuild                     | \$ -                        | \$ 96,025                | \$ 1,286             | \$ 97,311     | -      | -        | •      |
| 27             | EL-11002            | St. Francis Oregon 4/12kV                | \$ -                        | \$ 50,000                | \$ (50,000)          | \$ -          | -      | •        | •      |
| 28             | EL-11003            | Rebuild UG Dist 15                       | \$ -                        | \$ 76,522                | \$ 706               | \$ 77,228     | -      | •        | •      |
| 29             | EL-11004            | Hewlett Subdivision Rebuild              | \$ -                        | \$ 390,297               | \$ 402,796           | \$ 793,093    | -      | -        | •      |
| 30             | EL-11006            | Rebuild UG Dist 18                       | \$ -                        | \$ 348,531               | \$ 2,699             | \$ 351,230    | -      | -        | •      |
| 31             | EL-11007            | Rebuild Greenhouse Condo Area            | \$ 350,000                  | \$ 136,665               | \$ 6,956             | \$ 493,621    | -      | •        | •      |
| 32             | EL-11008            | Rebuild UG Dist 19                       | \$ -                        | \$ 507,130               | \$ (399,905)         | \$ 107,225    | -      | -        | •      |
| 33             | EL-11010            | UG District 47                           | \$ 1,500,000                | \$ 136,686               | \$ 1,417             | \$ 1,638,103  | -      | •        | •      |
| 34             | EL-11014            | Smart Grid Technology Installation       | \$ -                        | \$ 500,000               | \$ 1,328             | \$ 501,328    | -      | •        | •      |
| 35             | EL-11015            | Reconductor 60kV OH Transmission System  | \$ 700,000                  | \$ 434,655               | \$ 1,671,408         | \$ 2,806,063  | -      | •        | •      |
| 36             | EL-11016            | Electric Vehicle Charging Infrastructure | \$ -                        | \$ 135,083               | \$ -                 | \$ 135,083    | -      | -        | •      |
| 37             | EL-12001            | UG District 46                           | \$ 150,000                  | \$ -                     | \$ 3,954             | \$ 153,954    | -      | •        | •      |
| 38             | EL-12002            | Hanover 22 - Tfmr Replacement            | \$ 1,000,000                | \$ -                     | \$ -                 | \$ 1,000,000  | -      | •        | •      |
|                |                     |  | \$ 8,685,000                | \$ 13,790,931            | \$ (28,946)          | \$ 22,446,985 |        |          |        |

CAFR shows total only, includes operational reappropriations, and does not display the project specific details.

BUDGET shows project specific details only for future projects with planned appropriations.

FORECAST shows budgeted totals only for projects with planned appropriations in the fiscal year. Recent forecast reports show future projects with planned appropriations listed in detail.

STATUS shows project specific details for projects with activity.

Overall, we found the reports issued to Council regarding CIP are not sufficient to adequately support effective financial and project planning. The Utilities Department should have a reporting mechanism that provides transparency of CIP reserves, specifically carryforward balances, to the oversight bodies.

## Glossary of Acronyms and Terms

- **Adopted Budget:** The annual City budget approved by the City Council on or before June 30.
- **Administrative Services Department (ASD):** City department that strives to provide proactive administrative support to City departments and decision makers, and to safeguard and facilitate the optimal use of City resources. ASD is comprised of six divisions, including Administration, Accounting, Purchasing and Contracts, Office of Management and Budget, Property Management and Acquisition, and Treasury.
- **Appropriation:** The allocation of an expense budget for a particular project or program usually for a specific period of time.
- **Capital Budget:** A plan of proposed capital outlays and the means of financing them for the current fiscal period. In a two-year budget, the second year of the Capital Improvement Program is adopted-in-concept.
- **Capital Improvement Program (CIP):** The Capital Improvement Fund accounts for projects related to the acquisition, expansion, or rehabilitation of the City's infrastructure.
- **Carryforward:** Unexpended appropriations at the end of the fiscal year that are automatically carried over to the following year for open projects.
- **Committed Fund Balance:** Amounts that can only be used for the specific purposes determined by a formal action of the City's highest level of decision-making authority, the City Council. Commitments may be changed or lifted only by the City taking the same formal action that imposed the constraint originally (for example: resolution and ordinance).
- **Comprehensive Annual Financial Report (CAFR):** The CAFR is presented annually to provide City Council, citizens, representatives of financial institutions and others with detailed information concerning the financial condition and performance of the City of Palo Alto.
- **Electric Services Fund:** This fund accounts for all financial transactions relating to the City's Electric service. Services are on a user charge basis to residents and business owners located in Palo Alto.
- **Enterprise Funds:** These funds account for City operations that are financed and operated in a manner similar to private enterprise. Costs of providing service to the public are covered by user charges, grant funds, and impact fees. The City of Palo Alto owns and operates its own utilities, comprised of the Electric, Fiber Optics, Gas, Water, and Wastewater Collection Funds.
- **Fiber Optics Fund:** This fund accounts for all financial transactions relating to the City's Fiber Optics service. Services are on a user charge basis to licensees located in Palo Alto.
- **Fiscal Year:** A 12-month period of time to which the annual budget applies and at the end of which a governmental unit determines its financial position and the results of operations.
- **Funds:** Local government budgets are made up of funds, which help to organize and account for restricted resources. Each fund is considered a separate accounting entity.
- **Gas Services Fund:** This fund accounts for all financial transactions relating to the City's Gas service. Services are on a user charge basis to residents and business owners located in Palo Alto.

- **Government Finance Officers Association (GFOA):** Organization with the purpose to enhance and promote the professional management of governments for the public benefit by identifying and developing financial policies and best practices and promoting their use through education, training, facilitation of member networking, and leadership.
- **Invested in Capital Assets, Net of Related Debt:** The portion of net assets, which is represented by the current net book value of the City's capital assets, less the outstanding balance of any debt issued to finance these assets.
- **Net Assets:** The excess of all the City's assets over all its liabilities, regardless of fund. Net assets are divided into three categories, 1) Invested in Capital Assets, Net of Related Debt, 2) Restricted, and 3) Unrestricted.
- **Reappropriations and Commitments:** Listed in the City of Palo Alto's Comprehensive Annual Financial Report (CAFR) as Unrestricted Reserves in the notes to the basic financial statements.
- **Reserve:** The portion of fund balance set aside for financing future capital improvements or the outlay of capital projects in any given year, and addressing one-time emergency needs.
- **Restricted:** The portion of net assets, which is restricted as to use by the terms and conditions of agreements with outside parties, governmental regulations, laws, or other restrictions which the City cannot unilaterally alter. These principally include bond proceeds received for use on capital projects, debt service requirements, and special revenue programs subject to limitations, defined regulations, and laws underlying such programs.
- **Restricted Fund Balance:** Comprised of amounts that can be spent only for the specific purposes stipulated by external resource providers, constitutionally or through enabling legislation. Restrictions may effectively be changed or lifted only with the consent of resource providers.
- **Unrestricted:** Describes the portion of net assets which is not restricted as to use.
- **Unrestricted Net Assets (for Enterprise Funds):** The City Council has set aside unrestricted net assets for general contingencies, future capital and debt service expenditures including operating and capital contingencies for unusual or emergency expenditures.
- **Wastewater Collection Fund:** This fund accounts for all financial transactions relating to the City's Wastewater Collection service. Collections are on a user charge basis to residents and business owners located in Palo Alto.
- **Water Services Fund:** This fund accounts for all financial transactions relating to the City's Water service. Services are on a user charge basis to residents and business owners located in Palo Alto.

## Attachment 1: Utility Fund Capital Projects - FY 2012 Appropriation Detail

### ELECTRIC FUND - Capital Projects Appropriation Detail

Legend: - not reported • reported

| Project Number | Project Description | FY 2012 Budget                           | Carryforward (from FY 2011) | Net (Suppl, Return, Tfr) | Total FY 2012 Budget | CAFR          | Budget | Forecast | Status |
|----------------|---------------------|--|-----------------------------|--------------------------|----------------------|---------------|--------|----------|--------|
| 1              | EL-89028            | Electric Customer Connections            | \$ 2,000,000                | \$ 1,303,710             | \$ (284,782)         | \$ 3,018,928  | -      | •        | •      |
| 2              | EL-89031            | Communications System Improvements       | \$ 120,000                  | \$ 288,112               | \$ (200,000)         | \$ 208,112    | -      | •        | •      |
| 3              | EL-89038            | Substation Protection Improvements       | \$ 250,000                  | \$ 465,238               | \$ (290,672)         | \$ 424,566    | -      | •        | •      |
| 4              | EL-89044            | Substation Facility Improvements         | \$ 165,000                  | \$ 224,800               | \$ (190,670)         | \$ 199,130    | -      | •        | •      |
| 5              | EL-98003            | Electric System Improvements             | \$ 1,200,000                | \$ 2,109,842             | \$ 97,718            | \$ 3,407,560  | -      | •        | •      |
| 6              | EL-02010            | SCADA System Upgrades                    | \$ 200,000                  | \$ 43,023                | \$ -                 | \$ 243,023    | -      | •        | •      |
| 7              | EL-02011            | Electric Utility GIS                     | \$ 100,000                  | \$ 284,185               | \$ -                 | \$ 384,185    | -      | •        | •      |
| 8              | EL-04010            | Foothills System Rebuild                 | \$ -                        | \$ 102,802               | \$ -                 | \$ 102,802    | -      | -        | •      |
| 9              | EL-04012            | Utility Site Security Improvements       | \$ -                        | \$ 518,614               | \$ 8,842             | \$ 527,456    | -      | -        | •      |
| 10             | EL-04014            | Automated Meter Reading System           | \$ -                        | \$ 296,157               | \$ (296,157)         | \$ -          | -      | -        | •      |
| 11             | EL-05000            | El Camino Underground Rebuild            | \$ -                        | \$ 185,671               | \$ 3,856             | \$ 189,527    | -      | -        | •      |
| 12             | EL-06000            | Park Blvd. 4/12 kV Conversion            | \$ -                        | \$ 9,973                 | \$ (9,973)           | \$ -          | -      | -        | •      |
| 13             | EL-06001            | 230 kV Electric Interconnection          | \$ -                        | \$ 95,955                | \$ 2,328             | \$ 98,283     | -      | -        | •      |
| 14             | EL-06002            | UG District 45                           | \$ -                        | \$ 309,393               | \$ 9,730             | \$ 319,123    | -      | -        | •      |
| 15             | EL-06003            | Utility Control Center Upgrade           | \$ -                        | \$ 7,989                 | \$ (7,989)           | \$ -          | -      | -        | •      |
| 16             | EL-08000            | E. Charleston 4/12 kV Conversion         | \$ -                        | \$ 592,650               | \$ 12,069            | \$ 604,719    | -      | -        | •      |
| 17             | EL-08002            | E. Meadow/Alma/Loma 4/12kV Conversion    | \$ -                        | \$ 414,014               | \$ (414,014)         | \$ -          | -      | -        | •      |
| 18             | EL-09000            | Middlefield Underground Rebuild          | \$ -                        | \$ 625,786               | \$ 1,932             | \$ 627,718    | -      | -        | •      |
| 19             | EL-09002            | Middlefield / Colorado 4/12 kV Conv.     | \$ 150,000                  | \$ -                     | \$ (90,175)          | \$ 59,825     | -      | •        | •      |
| 20             | EL-09003            | Rebuild UG Dist 17                       | \$ -                        | \$ 756,457               | \$ 4,605             | \$ 761,062    | -      | -        | •      |
| 21             | EL-09004            | W. Charleston/Wilkie to S. 4/12kV        | \$ -                        | \$ 96,324                | \$ 4,910             | \$ 101,234    | -      | -        | •      |
| 22             | EL-10006            | Rebuild UG Dist 24                       | \$ -                        | \$ 1,017,856             | \$ 4,418             | \$ 1,022,274  | -      | -        | •      |
| 23             | EL-10008            | AMR/AMI - Feasibility Study              | \$ -                        | \$ 255,545               | \$ 32                | \$ 255,577    | -      | -        | •      |
| 24             | EL-10009            | Street Light System Conversion Project   | \$ 800,000                  | \$ 935,240               | \$ 2,401             | \$ 1,737,641  | -      | •        | •      |
| 25             | EL-11000            | Seale/Waverley 4/12kV                    | \$ -                        | \$ 40,000                | \$ (40,000)          | \$ -          | -      | -        | •      |
| 26             | EL-11001            | Torrey Court Rebuild                     | \$ -                        | \$ 96,025                | \$ 1,286             | \$ 97,311     | -      | -        | •      |
| 27             | EL-11002            | St. Francis Oregon 4/12kV                | \$ -                        | \$ 50,000                | \$ (50,000)          | \$ -          | -      | -        | •      |
| 28             | EL-11003            | Rebuild UG Dist 15                       | \$ -                        | \$ 76,522                | \$ 706               | \$ 77,228     | -      | -        | •      |
| 29             | EL-11004            | Hewlett Subdivision Rebuild              | \$ -                        | \$ 390,297               | \$ 402,796           | \$ 793,093    | -      | -        | •      |
| 30             | EL-11006            | Rebuild UG Dist 18                       | \$ -                        | \$ 348,531               | \$ 2,699             | \$ 351,230    | -      | -        | •      |
| 31             | EL-11007            | Rebuild Greenhouse Condo Area            | \$ 350,000                  | \$ 136,665               | \$ 6,956             | \$ 493,621    | -      | •        | •      |
| 32             | EL-11008            | Rebuild UG Dist 19                       | \$ -                        | \$ 507,130               | \$ (399,905)         | \$ 107,225    | -      | -        | •      |
| 33             | EL-11010            | UG District 47                           | \$ 1,500,000                | \$ 136,686               | \$ 1,417             | \$ 1,638,103  | -      | •        | •      |
| 34             | EL-11014            | Smart Grid Technology Installation       | \$ -                        | \$ 500,000               | \$ 1,328             | \$ 501,328    | -      | -        | •      |
| 35             | EL-11015            | Reconductor 60kV OH Transmission System  | \$ 700,000                  | \$ 434,655               | \$ 1,671,408         | \$ 2,806,063  | -      | •        | •      |
| 36             | EL-11016            | Electric Vehicle Charging Infrastructure | \$ -                        | \$ 135,083               | \$ -                 | \$ 135,083    | -      | -        | •      |
| 37             | EL-12001            | UG District 46                           | \$ 150,000                  | \$ -                     | \$ 3,954             | \$ 153,954    | -      | •        | •      |
| 38             | EL-12002            | Hanover 22 - Tfmr Replacement            | \$ 1,000,000                | \$ -                     | \$ -                 | \$ 1,000,000  | -      | •        | •      |
|                |                     |  | \$ 8,685,000                | \$ 13,790,931            | \$ (28,946)          | \$ 22,446,985 |        |          |        |

CAFR shows total only, includes operational reappropriations, and does not display the project specific details.

BUDGET shows project specific details only for future projects with planned appropriations.

FORECAST shows budgeted totals only for projects with planned appropriations in the fiscal year. Recent forecast reports show future projects with planned appropriations listed in detail.

STATUS shows project specific details for projects with activity.

### FIBER OPTICS FUND - Capital Projects Appropriation Detail

Legend: - not reported • reported

| Project Number | Project Description | FY 2012 Budget                           | Carryforward (from FY 2011) | Net (Suppl, Return, Tfr) | Total FY 2012 Budget | CAFR*        | Budget | Forecast | Status |
|----------------|---------------------|--|-----------------------------|--------------------------|----------------------|--------------|--------|----------|--------|
| 1              | FO-10000            | Fiber Optic Customer Connections         | \$ 200,000                  | \$ 253,869               | \$ 89,490            | \$ 543,359   | -      | •        | •      |
| 2              | FO-10001            | Fiber Optic Network System Improvements. | \$ 300,000                  | \$ 361,830               | \$ 53,846            | \$ 715,676   | -      | •        | •      |
|                |                     |  | \$ 500,000                  | \$ 615,699               | \$ 143,336           | \$ 1,259,035 |        |          |        |

CAFR shows total only, includes operational reappropriations, and does not display the project specific details.

BUDGET shows project specific details only for future projects with planned appropriations.

FORECAST shows budgeted totals only for projects with planned appropriations in the fiscal year. Recent forecast reports show future projects with planned appropriations listed in detail.

STATUS shows project specific details for projects with activity.

## GAS FUND - Capital Projects Appropriation Detail

Legend: - not reported • reported

| Project Number | Project Description | FY 2012 Budget                | Carryforward (from FY 2011) | Net (Suppl, Return, Tfr) | Total FY 2012 Budget | CAFR          | Budget | Forecast | Status |
|----------------|---------------------|-------------------------------|-----------------------------|--------------------------|----------------------|---------------|--------|----------|--------|
| 1              | GS-01019            | GPS                           | \$ -                        | \$ 118,242               | \$ 6                 | \$ 118,248    | -      | -        | •      |
| 2              | GS-02013            | Direct. Boring Machine        | \$ -                        | \$ 475,771               | \$ (7)               | \$ 475,764    | -      | •        | •      |
| 3              | GS-03007            | Directional Boring Equipment  | \$ -                        | \$ 155,419               | \$ (7)               | \$ 155,412    | -      | •        | •      |
| 4              | GS-03008            | Polyethylene Fusion Equipment | \$ -                        | \$ 43,794                | \$ (40)              | \$ 43,754     | -      | •        | •      |
| 5              | GS-03009            | Sys Ext Ops - Unreimbursed    | \$ 167,000                  | \$ 489,344               | \$ (480,703)         | \$ 175,641    | -      | •        | •      |
| 6              | GS-05002            | GMR Project 15                | \$ -                        | \$ 141,749               | \$ (87,592)          | \$ 54,157     | -      | -        | •      |
| 7              | GS-06001            | GMR - Project 16              | \$ -                        | \$ 61,221                | \$ (61,221)          | \$ -          | -      | -        | •      |
| 8              | GS-07002            | GMR - Project 17              | \$ -                        | \$ 128,570               | \$ 30,351            | \$ 158,921    | -      | -        | •      |
| 9              | GS-08000            | Gas Station 2 Rebuild         | \$ -                        | \$ 203,511               | \$ 73                | \$ 203,584    | -      | -        | •      |
| 10             | GS-08011            | GMR - Project 18              | \$ -                        | \$ 4,803,623             | \$ 63,163            | \$ 4,866,786  | -      | -        | •      |
| 11             | GS-09000            | Gas Station 1 Rebuild         | \$ -                        | \$ 200,485               | \$ -                 | \$ 200,485    | -      | -        | •      |
| 12             | GS-09002            | GMR Project 19                | \$ -                        | \$ 5,669,197             | \$ 68,635            | \$ 5,737,832  | -      | -        | •      |
| 13             | GS-10000            | Gas Station 3 Rebuild         | \$ -                        | \$ 206,931               | \$ -                 | \$ 206,931    | -      | -        | •      |
| 14             | GS-10001            | GMR - Project 20              | \$ 5,970,000                | \$ 643,863               | \$ 2,735             | \$ 6,616,598  | -      | •        | •      |
| 15             | GS-10002            | Gen Shop Equip                | \$ -                        | \$ 15,325                | \$ (5,349)           | \$ 9,976      | -      | •        | •      |
| 16             | GS-10003            | Cathodic Current Interrupters | \$ -                        | \$ 299,931               | \$ (12,866)          | \$ 287,065    | -      | -        | •      |
| 17             | GS-10004            | Automating Test Stations      | \$ -                        | \$ 100,000               | \$ (81,823)          | \$ 18,177     | -      | -        | •      |
| 18             | GS-11000            | GMR - Project 21              | \$ -                        | \$ 457,000               | \$ 951               | \$ 457,951    | -      | •        | •      |
| 19             | GS-11001            | Gas Station 4 Rebuild         | \$ -                        | \$ 337,000               | \$ -                 | \$ 337,000    | -      | •        | •      |
| 20             | GS-11002            | Gas System Improvements       | \$ 200,000                  | \$ 178,500               | \$ (91,630)          | \$ 286,870    | -      | •        | •      |
| 21             | GS-12001            | GMR - Project 22              | \$ 468,000                  | \$ -                     | \$ -                 | \$ 468,000    | -      | •        | •      |
| 22             | GS-80017            | Gas System Extensions         | \$ 710,000                  | \$ 964,960               | \$ (826,666)         | \$ 848,294    | -      | •        | •      |
| 23             | GS-80019            | Gas Meters and Regulators     | \$ 306,000                  | \$ 192,282               | \$ (97,959)          | \$ 400,323    | -      | •        | •      |
|                |                     |                               | \$ 7,821,000                | \$ 15,886,718            | \$ (1,579,949)       | \$ 22,127,769 |        |          |        |

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BUDGET shows project specific details only for future projects with planned appropriations.

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STATUS shows project specific details for projects with activity.

## WATER FUND - Capital Projects Appropriation Detail

Legend: - not reported • reported

| Project Number | Project Description | FY 2012 Budget                          | Carryforward (from FY 2011) | Net (Suppl, Return, Tfr) | Total FY 2012 Budget | CAFR          | Budget | Forecast | Status |
|----------------|---------------------|---|-----------------------------|--------------------------|----------------------|---------------|--------|----------|--------|
| 1              | WS-02014            | W-G-W Utility GIS Data                  | \$ 100,000                  | \$ 338,675               | \$ -                 | \$ 438,675    | -      | •        | •      |
| 2              | WS-06002            | WMR - Project 20                        | \$ -                        | \$ 10,780                | \$ (10,780)          | \$ -          | -      | -        | •      |
| 3              | WS-07000            | Turnouts Regulator Station Improvements | \$ -                        | \$ 959,579               | \$ (600,000)         | \$ 359,579    | -      | -        | •      |
| 4              | WS-07001            | Water Recycling Facilities              | \$ -                        | \$ 704,583               | \$ 390               | \$ 704,973    | -      | •        | •      |
| 5              | WS-07003            | WMR - Project 21                        | \$ -                        | \$ 188,967               | \$ (188,438)         | \$ 529        | -      | -        | •      |
| 6              | WS-07004            | Water Sys Portable Emergency Generators | \$ -                        | \$ 208,833               | \$ (208,833)         | \$ -          | -      | -        | •      |
| 7              | WS-08001            | Water Reservoir Coating Improvements    | \$ -                        | \$ 1,871,089             | \$ -                 | \$ 1,871,089  | -      | •        | •      |
| 8              | WS-08002            | Emergency Water Supply Project          | \$ -                        | \$ 29,114,787            | \$ (3,169,525)       | \$ 25,945,262 | -      | -        | •      |
| 9              | WS-08017            | WMR - Project 22                        | \$ -                        | \$ 154,770               | \$ 1,313             | \$ 156,083    | -      | -        | •      |
| 10             | WS-09000            | Seismic Water System Upgrades           | \$ 2,700,000                | \$ 778,715               | \$ -                 | \$ 3,478,715  | -      | •        | •      |
| 11             | WS-09001            | WMR - Project 23                        | \$ -                        | \$ 2,136,145             | \$ 13,627            | \$ 2,149,772  | -      | -        | •      |
| 12             | WS-10001            | WMR-Project 24 (WS-10001)               | \$ -                        | \$ 3,127,551             | \$ 6,063             | \$ 3,133,614  | -      | -        | •      |
| 13             | WS-11000            | WMR-Project 25 (WS-10000)               | \$ -                        | \$ 292,000               | \$ 709               | \$ 292,709    | -      | •        | •      |
| 14             | WS-11001            | Vacuum Excavation Equipment             | \$ -                        | \$ 275,000               | \$ -                 | \$ 275,000    | -      | •        | •      |
| 15             | WS-11003            | Water Distribution Sys Improvements     | \$ 206,000                  | \$ 153,771               | \$ (128,612)         | \$ 231,159    | -      | •        | •      |
| 16             | WS-11004            | Water Supply Sys Improvements           | \$ 206,000                  | \$ 190,069               | \$ (124,998)         | \$ 271,071    | -      | •        | •      |
| 17             | WS-12001            | WMR-Project 26 (WS-12001)               | \$ 305,000                  | \$ -                     | \$ -                 | \$ 305,000    | -      | •        | •      |
| 18             | WS-80013            | Water System Extensions                 | \$ 420,000                  | \$ 444,315               | \$ (250,996)         | \$ 613,319    | -      | •        | •      |
| 19             | WS-80014            | Water Service Hydrant Replacement       | \$ 217,000                  | \$ 583,214               | \$ (500,000)         | \$ 300,214    | -      | •        | •      |
| 20             | WS-80015            | Water Meters                            | \$ 215,000                  | \$ 674,445               | \$ (640,000)         | \$ 249,445    | -      | •        | •      |
|                |                     |   | \$ 4,369,000                | \$ 42,207,288            | \$ (5,800,080)       | \$ 40,776,208 |        |          |        |

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STATUS shows project specific details for projects with activity.

## WASTEWATER COLLECTION FUND - Capital Projects Appropriation Detail

Legend: - not reported • reported

| Project Number | Project Description                            | FY 2012 Budget | Carryforward (from FY 2011) | Net (Suppl, Return, Tfr) | Total FY 2012 Budget | CAFR | Budget | Forecast | Status |
|----------------|--|----------------|-----------------------------|--------------------------|----------------------|------|--------|----------|--------|
| 1              | WC-02002 WC Rehab/Aug. Project 15              | \$ -           | \$ 55,760                   | \$ (55,760)              | \$ -                 | -    | -      | -        | •      |
| 2              | WC-04002 WC Sys. Rehab/Aug. Project 17         | \$ -           | \$ 185,364                  | \$ (127,649)             | \$ 57,715            | -    | -      | -        | •      |
| 3              | WC-05003 WC Reh/Aug. Prj 18                    | \$ -           | \$ 248,894                  | \$ (225,526)             | \$ 23,368            | -    | -      | -        | •      |
| 4              | WC-06003 WC Reh/Aug. Prj 19                    | \$ -           | \$ 137,637                  | \$ (137,637)             | \$ -                 | -    | -      | -        | •      |
| 5              | WC-07004 WC Reh/Aug. Prj 20                    | \$ -           | \$ 598,015                  | \$ 37,966                | \$ 635,981           | -    | -      | -        | •      |
| 6              | WC-08012 WC Reh/Aug. Prj 21                    | \$ -           | \$ 984,182                  | \$ 12,010                | \$ 996,192           | -    | -      | -        | •      |
| 7              | WC-09001 WC Reh/Aug. Prj 22                    | \$ -           | \$ 2,542,182                | \$ 126,333               | \$ 2,668,515         | -    | -      | -        | •      |
| 8              | WC-09002 Root , Sediment, Dewatering Container | \$ -           | \$ 59,358                   | \$ (59,358)              | \$ -                 | -    | -      | -        | •      |
| 9              | WC-10002 WC Reh/Aug. Prj 23                    | \$ -           | \$ 3,029,144                | \$ 157                   | \$ 3,029,301         | -    | -      | -        | •      |
| 10             | WC-11000 WC Reh/Aug. Prj 24                    | \$ 2,829,500   | \$ 290,000                  | \$ -                     | \$ 3,119,500         | -    | •      | •        | •      |
| 11             | WC-12001 WC Reh/Aug. Prj 25                    | \$ 300,000     | \$ -                        | \$ -                     | \$ 300,000           | -    | •      | •        | -      |
| 12             | WC-12002 Pipe Bursting Machine                 | \$ 33,000      | \$ -                        | \$ (33,000)              | \$ -                 | -    | •      | •        | -      |
| 13             | WC-15002 Wastewater System Improvements        | \$ 206,000     | \$ 176,853                  | \$ (271,567)             | \$ 111,286           | -    | •      | •        | •      |
| 14             | WC-80020 Sewer System Extensions               | \$ 340,000     | \$ 611,116                  | \$ (546,037)             | \$ 405,079           | -    | •      | •        | •      |
| 15             | WC-99013 Sewer Manhole Rehab/Replacement       | \$ 565,000     | \$ 1,419,111                | \$ (433,648)             | \$ 1,550,463         | -    | •      | •        | •      |
|                |  | \$ 4,273,500   | \$ 10,337,616               | \$ (1,713,716)           | \$ 12,897,400        |      |        |          |        |

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## ATTACHMENT 2: City Manager's Action Summary

In response to the Audit Recommendations in this report, the City Manager has agreed to take the following actions.

| Finding # | Summary of Finding   | Recommendation   | City Manager's Action Plan   | Target Date |
|-----------|--|--|--|-------------|
| 1         | The City does not currently have a formal, comprehensive reserve policy for its utility funds.   | 1. The Utilities Department should establish formal and comprehensive policies and procedures for its Utility Reserves.  | <ul style="list-style-type: none"> <li>Utilities Department will establish formal and comprehensive policies and procedures for its Utility reserves</li> </ul>  | June 2013   |
| 1         | Key City documents show inconsistency in communication of the City's reserve policy decisions. Rate Stabilization Reserve balances were often outside of Council-approved guideline ranges.  | 2. The Utilities Department should re-evaluate and determine the use of reserve balance guidelines, updating the City's resolution and the language in key City documents accordingly.                   | <ul style="list-style-type: none"> <li>Utilities Department will re-evaluate and determine the use of reserve balance guidelines, updating the City's resolution and the language to key City documents accordingly.</li> </ul>  | June 2013   |
| 1         | Although the Utilities Department performs an annual risk assessment to determine the adequacy of Rate Stabilization Reserves; however there are no explicit criteria or a specified target to indicate appropriate levels of working capital. | 3. The Utilities Department should revisit its annual risk assessment model to determine, establish, and document appropriate levels of utility fund working capital held in unrestricted reserves.      | <ul style="list-style-type: none"> <li>The Utilities Department will revisit its annual risk assessment model to determine, establish and document appropriate levels of utility fund working capital held in unrestricted reserves.</li> </ul>  | June 2013   |
| 1         | Reserve balances are inconsistently reported and do not always reconcile, specifically excluding Capital Improvement Program (CIP) carryforward reserves.  | 4. The Utilities Department should revisit and update the 5-year financial projection rate making worksheets to completely state all reserve balances consistent with the City's key financial documents | <ul style="list-style-type: none"> <li>The Utilities Department will revisit and update the 5-year financial projection rate making worksheets to completely state all reserve balances consistent with the City's key financial documents and improve visibility over all unrestricted reserves.</li> </ul> | June 2013   |



| Finding # | Summary of Finding   | Recommendation   | City Manager's Action Plan  | Target Date |
|-----------|--|--|---|-------------|
|           |  | and improve visibility over all unrestricted reserves.   |   |             |
| 2         | The reports issued regarding CIP are not sufficient to adequately support effective financial and project planning. Improvements to the consistency and completeness of reporting CIP carryforward reserve balances could better support the City Council's operating budget, capital budget, and reserves processes | 5. The Utilities Department should develop a mechanism to consistently and clearly report Capital Improvement Program (CIP) carryforward reserves to the oversight bodies. | <ul style="list-style-type: none"> <li>The Utilities Department will develop a mechanism to consistently and clearly report Capital Improvement Program (CIP) carryforward reserves to the oversight bodies.</li> </ul> | June 2013   |



## **FINANCE COMMITTEE EXCERPT**

Special Meeting  
December 4, 2012

### Utilities Reserves Audit

Jim Pelletier, City Auditor said the objective of the Utilities Reserves Audit was to review the Utilities Reserves, reserve policies, reserve guidelines and the usage of those reserves. There were two main findings, five recommendations, and the City Manager's Action Summary in response to the findings of the report. The conclusion was that the City maintained adequate reserves in the Utility Fund and that reserves were used appropriately within the established policy. Council and the Utilities Department can benefit from establishing a more comprehensive reserve policy to manage and monitor their reserves. Staff recommended improvements towards the consistency of reporting reserves and said it would better support the Council's Operating Budget, Capital Budget, and reserve processes.

Mimi Nguyen, Senior Performance Auditor said the first finding was that Rate Stabilization Reserves were not consistently maintained within Council approved guidelines. There were two parts within this finding: the Rate Stabilization Reserves and all reserves. Staff found that the City did not have a formal comprehensive reserve policy for its Utility Funds and found elements of policy language within strategic and operational plans and Staff reports; however, there were inconsistencies with the communication of reserve policy decisions. One example in a Staff report was that a Council resolution stated that Staff conformed to the reserve level guidelines, but the 2012 Adopted Operating Budget said that it was above the maximum guideline or below the minimum for any particular year. Then a five year financial production report said that it was within the Council approved guidelines, but over a long term period. Based on the Council approved resolution, Staff looked at Rate Stabilization Reserves and tested the balances for compliance. They found that many of the reserves were outside the guideline ranges.

Mr. Pelletier said Staff was not suggesting that Council fall between the minimum and maximum guideline, but wanted to provide Council with the data for them to see and determine what was intended.

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Ms. Nguyen said, regarding reserves in a broader perspective, Staff found that on average, the City maintained between 13 and 18 months of operating expenses in total unrestricted reserves. In reviewing the Fiscal 2011 Comprehensive Annual Financial Report (CAFR), the City's unrestricted reserves covered 18.4 months in the Electric Fund, 13 months in the Gas Fund, 13.2 months in the Water Fund, and 16.7 months in Wastewater Collection Fund. All of the reserves were Council approved for specific spending, including the Electric Special Project Reserve; however, these reserves could be repurposed and returned to Rate Stabilization Reserves if they were not spent the way they were anticipated. She said Staff benchmarked the CAFR with seven other jurisdictions against Palo Alto's reserves and said the levels might be appropriate but they did not find documentation to justify these funds. That did not mean that the justification for these funds were inappropriate; policy and documentation of policy is needs to be established.

Mr. Pelletier said Government Finance Officers Association (GFOA), a government agency that offers general financial criteria suggested starting with two to three months of operating reserves, and building from there. He explained he was emphasizing justification for the City's funds. For example, a hydro project presented a different type of risk and it was good to have enough of a reserve for that type of risk; it was good to see the justification for the level that the City was at.

Vice Mayor Scharff said if Staff did not account for the special projects then Palo Alto was right there with other agencies.

Mr. Pelletier said the problem was not being at a certain level, but to have two to three months of reserves in place, build from there, then justify why the reserves were in place.

Vice Mayor Scharff said that most agencies did not have two to three months of reserves.

Mr. Pelletier said every agency was different, with regard to their risk profile. Some cities set aside more or less funds, depending on their perceived risk. He emphasized the recommended documentation for the justification of the City's reserves and clarifying why the City retained the amount of reserves they had.

Vice Mayor Scharff asked what the justification looked like.

Mr. Pelletier said it was an analysis of the risks that Utilities had; they considered all of the risks, gave Staff examples, and documented in their

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profile as to why they wanted to set aside additional funds. Staff did not want a large sum of money being unaccounted for. He said it was better to see good justification as to why funds might be in a certain account.

James Keene, City Manager confirmed that regardless of what the reserve results were in the Staff report, Staff would have made this request to justify funds.

Mr. Pelletier said this information showed where the City was at today and which cities Palo Alto compared to; the issue was justifying where the City was at today, regardless of the amount of reserves the City was carrying.

Val Fong, Utilities Director said that there was a risk assessment that was done annually that explained what the accounts were at. It quantified what the risks were at, the market price risk, and variability.

Council Member Price asked for explanation of the vertical axis percentages.

Ms. Nguyen said it was the percentage of Electric Unrestricted Reserves to operating expense.

Council Member Burt said the City had a reserve of 153 percent of operating expense.

Chair Shepherd said in the former Calaveras Reserves, now called the Electric Special Projects, there was a three year time period to spend the reserves; the money was being called reserves because an isolation of the reserves was not happening.

Ms. Nguyen said within the CAFR document the reserves listed under "unrestricted" were the types of reserves that are not restricted, including Electric Special Project Reserve.

Chair Shepherd said it was a matter of using a policy to separate the funds out.

Council Member Burt wanted clarification on what Staff was looking for from the City Auditor that was different from what Council received every year regarding the report on Reserve Justification.

Ms. Nguyen said the Risk Analysis was very specific to the Rate Stabilization Reserve. Within the unrestricted reserves, there were more reserves than just the Rate Stabilization Reserves; Staff suggested identifying and justifying the reserves.

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Council Member Burt confirmed that the focus was on reserves other than the Rate Stabilization reserves.

Ms. Nguyen said the risk assessment portion was out of scope.

Council Member Burt clarified whether it was possible to see the reasoning for the non-rate stabilization reserve that was on the General Rate Stabilization.

Ms. Nguyen said the justification was made, but confirmed that she was talking about the General Rate Stabilization.

Mr. Pelletier said Staff wanted to make sure that when the presentation was made that Council had a full understanding and that Rate Stabilization was an important part of the picture.

Vice Mayor Scharff wanted clarification on why Staff chose this portion of the Audit because it did not seem to be a big risk.

Mr. Pelletier said the Audit was requested a few years ago and Staff wanted to answer the request. It was important for Staff to present Council with the correct information and for them to be able to support their decisions. Additionally the Audit revealed other items that needed to be addressed.

Council Member Burt said the reason the Audit was requested was Staff wanted Council to have good policy making tools. If the reserves were too big or small, it affected the City's money and Council wanted to have the information to be able to make informed decisions.

Ms. Nguyen said reserve balances were not always reported and did not always reconcile with the City's CAFR due to the exclusion of the Capital Improvement Program (CIP), carry forward Reserves, and the Utility Funds; there were understated reserves. Staff found that CIP reserves were not consistently or clearly reported to Council and the reports submitted to Council regarding Utility CIP were not adequately supporting financial project planning. Of the four key financial reporting projects, there were problems with the oversight reporting.

Ms. Fong said there were certain things that could be clearer and more consistent.

Chair Shepherd said looking at all CIP's and going forward, there were projects that were finished and some of the funds did not zero out; the funds

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needed to be accounted for in order to move forward. If there were items that were finished then discussion could take place about those funds, taking them out of being held, and making the funds available for something else.

Mr. Pelletier said when the City Auditor's Office reviewed all of the reports, there was a gap in the projects that were carried forward from year to year.

Ms. Nguyen said the CIP Status Report was meant to accompany the CAFR report, it was not meant to give Council a project status up-date, and it did not lay out the details of all the projects. The only reporting document that captured all of the details of all of the reports was the Matrix report. For example, fiscal year 2011, for the Electric Fund, there was a carry forward of funds. The Utilities Department reported out projects, it was still not all encompassing. This other report showed Council a different perspective on the budget.

Council Member Price asked how the Rate Stabilization Reserves, outside Council approved guidelines, with regard to Fiber Optics was at 50 percent for fiscal year 2011 and wanted to know why these numbers were so extreme.

Ms. Fong said there were set rates that were increased by the CPI and making significant profits annually. The City did not spend the monies that were collected because they were still debating how to extend the network right now.

Council Member Burt said there was a lot of discussion on what the best utilization of these extra funds should be.

Chair Shepherd said the Utilities Department just looked at the report.

Mr. Keene said part of the challenge was that the reserve amount was growing. The ultimate objective was so large was that incremental spending did not go too far.

Molly Stump, City Attorney said the Fiber Fund was not a municipal monopoly and the people of Palo Alto were not required to use that service. That put the fund in a different category and gave Council greater flexibility to be able to use the funds.

Council Member Burt said the fund was banking the dollars for a future major project. There was not a decision on what the money would be allocated for.

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Chair Shepherd Palo Alto Unified School District (PAUSD) was getting connected to the funds.

Council Member Burt asked if it was permissible to bank funds for a future major capital need, to have a reserve that was defined differently, and did these extra dollars help explain the Wastewater Connection Fund.

Lalo Perez, Director of Administrative Services said it was permissible to have a Replacement Fund but the key was to outline and document funds. The funds that the City were legally required to have were the ones that had binding obligations with restrictions.

Council Member Burt said there were two categories: projects below budget and projects completed at a slower rate than projected. He asked if that was the reason that funds were not expended, budgeted, or part of the understated reserves.

Mr. Pelletier said one of the concerns the City Auditor's Office had was project management, budgeting for projects, and the use of funds. He said they did not go to that level of detail in this Audit.

Council Member Burt said there had been a general discussion around the CIP rollovers, what the numbers were and how to see the difference. He asked if, through the City Auditor's report, there was a clearer frame work and better policies and procedures that applied to the General Fund.

Mr. Perez said in terms of the reserves, not as much, but the reasoning was sound.

Council Member Burt said the reasoning for the reserves was as well as the explanation for Understated Reserves, how Staff might make them more visible, and how they might be stated in a timelier manner.

Mr. Perez said it could be incorporated in both but there may be different views and needs.

**MOTION:** Chair Shepherd moved, seconded by Vice Mayor Scharff to recommend City Council accept the Utilities Reserve Audit.

**MOTION PASSED:** 4-0