Agenda Report

Date: March 26, 2013

To Mayor Newcomer and Members of the City Council

From: Jeffrey W. Collier, City Manager

Subject: Mineral Extraction Financial Plan Subcommittee Report

RECOMMENDATION

It is recommended that the City Council receive and file this second report from the Mineral Extraction Financial Plan Subcommittee consisting of Mayor Pro Tem Henderson and Councilmember Vinatieri.

BACKGROUND

On September 11, 2012, the City Council voted to form a Subcommittee to work with staff to draft recommendations for the best practices to manage any revenues that may be forthcoming from the lease/royalty payments generated as a result of the 2008 Mineral Extraction Lease, as amended.

The Subcommittee members have met several times to set out the basic tenets of a Financial Plan and met with the City Attorney along with expert Special Counsel and City staff to start the process of creating the outline of a Plan to safeguard the revenue generated by this important City asset.

On November 13, 2012 the Subcommittee made their first report to the City Council and they are returning to provide an update on their progress through March 25, 2013.

DISCUSSION

The Subcommittee will be prepared to expand on their progress up to this point and have attached a "White Paper" created as a by-product of their efforts that discusses the issues associated with the management of non-recurring municipal revenues as might be experienced by the City with the receipt of revenue generated from the Mineral Lease. Again, many of the key issues brought forward at their November 13th report continue to be the foundation of their work thus far. They include the following tenets:

- The conversion of the City-owned minerals to a revenue stream is perhaps the most important asset management discussion that the City Council will face for decades.

- It is paramount that the management of this revenue is a process that allows the public full access to the decisions regarding the allocation of funds. Transparency is critical to the public's understanding and acceptance of the fact that their assets are being appropriately used.

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- The oil and natural gas produced under the terms of the Lease are both expected to produce revenue to the City for a limited period of time. The exact duration cannot be determined at this point in the process.

- The funds must be allocated so that a portion can be used today to benefit the current residents of Whittier and a significant portion be preserved in a Trust/Endowment Fund. The Trust Fund is intended to insure that future generations can be afforded both a continuing revenue stream from the investment of the Fund's corpus that can be available to meet the needs of the City and its residents as well as to provide a "safety net" to the City in the case of catastrophic disaster losses.

- This Trust/Endowment must be professionally managed. The Subcommittee foresees the need for the engagement of an expert Fund Manager(s) (not a City employee) that would be solicited and contracted through a public process. In addition, the Subcommittee and the City Attorney agree that Special Counsel should be identified and engaged to insure that all aspects of the Fund are legally binding to insure that its life continues into the future.

- The Trust/Endowment must be subject to the on-going and consistent scrutiny of Whittier residents expert in the area of investments, financial accountability, and long-term decision-making. This "Oversight Committee" would meet in public (pursuant to Brown Act provisions) and be the body appointed by the City Council to work directly with the Fund Manager(s). Their recommendations would be made to the Council and they would meet publicly on a regular basis with the Council to deliberate on matters concerning the management of the fund.

FISCAL IMPACT

The Subcommittee has previously recommended that all expenses incurred in the creation of this plan and Trust/Endowment be paid by revenues generated from the Mineral Extraction lease revenue and not be a burden upon existing General Fund operations. This continues to be their suggested course of action.

Submitted by:

Jeffrey W. Collier
City Manager

Attachment: Management of Non-Recurring Municipal Revenues

Management of Non-Recurring Municipal Revenues

March 26, 2013

Background

California municipalities normally sustain municipal operations by collecting recurring revenues in the form of taxes, fees, and charges. These revenues are allocated by the City Council through the budget process to pay for the services of municipal employees, contractors, along with the associated materials and supplies to perform the tasks associated with the usual and customary responsibilities of City government.

There are situations when cities collect fees and charges for specific one time capital improvements and these can be Aid in Construction charges that pay for expansion of capital assets (i.e. water mains or water storage capacity) along with development charges that can include calculated impacts on streets-traffic, utilities, or other infrastructure needs brought on by a specific development or construction activity. Often, grants from the Federal and State government are restricted to the creation of assets (water treatment facilities, libraries, parks) that are deemed by the grantor to be needed by their constituents to maintain or improve the standard of living in the grantee's jurisdiction. All of these situations dictate that this money received by the City government cannot be used for the financial support of ongoing public services.

Grants that are given to municipalities for services are normally viewed as "seed money" to get the City Council to embark on a program or service area that they may not have seen the need for in the past or just simply didn't have the funding to support what may be viewed as a luxury in the community. In the City of Whittier these programs have historically taken several forms: from the temporary addition of Traffic Safety Officers, creation and staffing of a Homework Center, operation of a Federally constructed water treatment facility, School Resource Officers, and many others too numerous to list here. Again, in these situations, the ability of the City Council to use the funding for anything other than the specific program dictated by the Grantor is eliminated.

The dilemma faced by most governing bodies is how to balance the demand from their constituency to provide current services (public safety services, recreation, library service) with current dollars against their perceived (as opposed to legally required) fiduciary responsibility to provide for capital assets. These assets are necessary to meet the long-term infrastructure needs of the community that range from roadways, underground utilities (water, sewer, flood control) and public use buildings such as parks, libraries, and municipal buildings (such as Police Department operational support assets, public works yards, and

city halls). With most governing bodies elected for four-year terms there is often the perception that they are put into office to "make things better" today by providing immediate solutions to the public's needs rather than saving up to provide for long-term needs that may actually be used by a future City Council and not by them during their term of office.

The issue of providing capital assets to a community has been made even more complicated for cities in the State of California with the lack of ability to issue general obligation debt to fund capital improvements without two-thirds voter approval and the recent elimination of redevelopment agencies and their ability to provide infrastructure support to municipalities.

So the question that all municipalities have to deal with is how to pay for the current services and assets to serve their constituents while "saving" for the unexpected demands that they may face in the future (i.e. claims, lawsuits, emergencies and catastrophes) and the known need to be able to replace and modernize their asset base as it is made obsolete from use and wear combined with advances in technology or design into the future.

Given These Competing Priorities, How Should a Governing Body deal with Non-Recurring Revenues?

Municipal and State governments often deal with revenues as a "forever" source of funding for operations. That being said, it is often the case that revenue generators are likely to run their economic life and the next use of the property may not produce revenue of the same magnitude. Many of us remember stores like White Front, Fedco, or Gemco that looked like they were stable and reliable sources of goods and would generate revenue for the City in which they resided into the foreseeable future. In Whittier we saw the decline of the Whittwood Mall that was thankfully redeveloped and the disappearance of the majority of our "forever" automobile dealerships. The City was developed with the California Youth Authority Fred C. Nelles School as a cornerstone of our economy and now it sits as a blighted property with the challenge of appropriate redevelopment before the City Council.

Understanding the temporary nature of many revenue generators and the depletion of most assets over time, how should the City deal with any revenue that may come from the use of its ownership of minerals? Specifically, any revenues generated from the Mineral Lease for the oil, natural gas, and water in the Whittier Hills.

Unlike most assets, the water assets from the aquifer in the Upper Basin that the City has owned for over a century continue to be regenerated from rainwater and surface uses and allow the City to extract and sell the water over and over again over time. This model for asset ownership, extraction and sales is unique and does not apply to most minerals. The City's minerals subject to the mineral

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extraction lease may or may not generate significant income to the City of Whittler. But it is certain that the mineral assets, once extracted, will not be replenished over the foreseeable future.

So, the question in the case of the mineral revenue becomes whether the City Council should simply use it for the needs of today in the time and manner in which it is received by the City treasury or whether the City Council should plan and structure a method to balance the use (and the benefits to the residents) over time.

Certainly, the City Council could treat it as a windfall and just spend it for the myriad of things that are constantly in need of financial resources: more public safety staffing; new facilities (Central Library); higher levels of general services (better streets, repair or replacement of aging infrastructure in our sewer and water systems); additional staff and higher staff salaries; more parks; support for and additional facilities to provide for expanded senior citizen and youth recreation programs, etc.

But what happens when the minerals are gone and the revenues that the City has become dependent upon are no longer there?

We've heard a lot of reference recently to the "fiscal cliff" that the Federal Government faced in 2013 but the depletion of a potentially significant revenue stream and the loss of a myriad of services and assets it supported for the City could have dire consequences for which a resolution would be virtually impossible and the impact on our residents would be very unpleasant. And would it be prudent and wise for the current Council to "front load" this problem for future Councils?

The question facing the City Council and the residents of the City of Whittier is:
Do we leave the management and expenditure of this revenue stream to chance or is it more prudent to manage the preservation and use of the revenue more aggressively to insure that future generations of Whittier residents can benefit from the assets that we all own?

Creation of a Long-Term Asset Management Program

Long-term asset management programs can take many forms, but for purposes of this discussion we will use the term "Trust". Trusts are a common form of long-term asset management used by non-profit institutions to preserve capital and donations for the future benefit of the institution and mission. There are many examples of other non-profits that use this aggressive, but prudent, management strategy and governments who preserve capital to meet long-term needs in a similar manner. One such example is the Alaska Permanent Fund. This is a constitutionally established fund managed by a state-owned corporation, the Alaska Permanent Fund Corporation. The fund was established

in Alaska in 1976 as an amendment to the Alaska State Constitution. It was designed to be an investment where at least 25% of the oil money would be put into a dedicated fund for future generations who would no longer have oil as a resource. Similarly, North Dakota's voters approved a legislatively-referred ballot measure to amend their State constitution establishing the North Dakota State Legacy Fund. The Legacy Fund sets aside 30% of oil revenues received from oil extraction activities in their state and places them into the Fund to benefit their residents.

Internationally, there are similar management techniques in Australia (where they deposit budget surpluses into a special fund) as well as Alberta, Canada's Heritage Savings Trust Fund where funds are also set aside to benefit future generations.

Were it the desire of the City of Whittier to use such a long-term planning and management model to preserve a portion of the mineral (oil) income for future generations, how would such a structure be established?

Can the City Council create this 'Trust'?

Yes, by Council action all or any portion of the mineral (oil and natural gas) income received from the Mineral Lease could be set aside in a separate fund for future use. It should be disclosed, however, that anything established by Council action can also be changed by Council action. To strengthen the promise of long-term management of the funds, a Trust could be established and, to further insure the preservation of the assets, such a Trust or pledge could be put to a vote of the electorate of the City. If approved, any changes to the pledge would require that the voters of the City approve of the change.

Can you use some of the money to meet current needs and preserve the remainder to generate income to meet future needs?

Yes, either the City Council action, the Trust Document, or a voter approved initiative can detail the amount of oil revenue to be allocated to the City Council to be used through the normal appropriations process or put into the Trust to be invested in support of future allocations to the City at some point in time. As an example, at current price levels the production from the test wells (up to 450 barrels a day) would generate about $4.5-5.0 million per year to the City in lease revenues from the oil and natural gas. It may be practical to use those funds to get the City back up to the budget levels prior to the decrease in revenue from sales and property tax before funding the Trust.

Logically, the Trust would begin at some point to collect and preserve funds so that it could step in at some point in the future to continue to provide funding to the City at a sustainable level as the oil revenue declines to a level that can no longer sustain the ongoing allocation of all or a portion of the revenue for current

appropriation by the City Council. The key in this regard is to determine how much money to allocate to the City initially if the long-term desire is to maintain this level in perpetuity. Obviously, this determination is going to be based on expected investment earnings and the amount of oil/mineral revenue deposited into the fund.

How can the City create a Trust and hold funds for operations in the instance where the City is struck by a catastrophic event?

It would be reasonable, even advisable, for the Trust to provide for the ability of the City Council to remove funds to allow for recovery from a natural disaster or act of war. To insure that the situation is bonafide there should be language referring to a Federal or State declared emergency in the City of Whittier.

Who would invest the funds in the Trust?

It goes without saying that a very high level of expertise is required to invest and safeguard the funds in any endowment or trust designed to preserve and grow capital into the future. The City Council and City staff are not equipped to provide such expertise. It would be normal and customary practice for a professional Fund Manager(s) to be hired by the City to oversee investments and have an Investment Committee or Oversight Committee selected to oversee the performance of the Fund Manager(s) and to make recommendations to the City Council on matters related to the Trust. Specific to the City of Whittier is a practice of selecting and assigning Boards and Commissions that would be suitable to fill this Committee but there should be requirements for the appointees to have demonstrated expertise in the area of investments, banking and/or financial management. As with other Boards and Commission appointments, City staff would not be eligible to serve as a member but would act in a staff support capacity. The Oversight Committee would report on a regular basis to the City Council and would not be empowered to allocate or expend the funds in the Trust. The professional Fund Manager(s) would be paid for his/her work, but the Oversight Commission members, City staff and City Council would not receive any compensation from the Trust.

Timing

With the test wells expected to begin test extraction up to their capped production levels (prior to issuance of SCAQMD permits the field can produce only 450 barrels per day) during 2013 it would be appropriate with the Trust concept to have Trust documents drafted for review and action by the City Council in 2013. This would require not only action on the Trust documents but selection of an Oversight Committee and a Fund Manager(s). It would also be advisable to provide for an educational campaign to inform the citizens of Whittier as to how this Trust would work and how it might help them to reach the goal of a long-term asset management plan. Any expenses incurred in this effort would be paid

solely from current and future revenue generated by the Mineral Extraction Lease.

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