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- 5.5. Direct the City Manager to establish a policy requiring the SCLAA Board of Directors to justify the use of SCLAA bond funds when used for projects outside of GAFB parcels. Such a policy should require a detailed justification for how the expenditures directly benefit the redevelopment of the former GAFB before the issuance and expenditure of future tax increment bonds.
- 5.6. Review current contracts for potential conflicts of interest. This would help ensure that the SCLAA Board of Directors makes decisions in the interest of the SCLAA.

Based on these findings, the VVEDA Commission should:

- 5.7. Consider a review of the delegated authority provided to the City of Victorville for governance and administration of the SCLAA to ensure representation of each individual jurisdiction's interests in the governance and administration of redevelopment activities.

Introduction

Harvey M. Rose Associates, LLC is pleased to present this *Limited Scope Performance Audit of the Finances of the City of Victorville* conducted for the 2011-12 San Bernardino County Grand Jury pursuant to its authorities defined in California Penal Code Section 925, et seq.¹. This report is a continuation of work initiated by *Kessler International, LLC (Kessler)*, which had been retained by the 2009-10 and 2010-11 San Bernardino County grand juries to conduct a forensic audit of the City. This report builds upon the work of *Kessler* by conducting data validation steps and developing findings, conclusions and recommendations for those areas where *Kessler* compiled sufficient information and evidence to suggest areas where there may be opportunities for improvement.

Study Purpose and Scope

This performance audit was conducted to evaluate certain concerns originally identified by the 2009-10 San Bernardino County Grand Jury and pursued by subsequent grand juries for further investigation. After conducting data validation steps from the forensic audit, the 2011-12 San Bernardino County Grand Jury requested that the following areas be analyzed to determine identify areas for potential improvement:

1. The City's government-wide financial statements, as well as separate financial statements for the City's component units, for reporting consistency and appropriateness.
2. The use of restricted funds for general government and other purposes, including the use of money restricted for George Air Force Base redevelopment activities under the Victor Valley Economic Development Authority (VVEDA). The use of inter-fund borrowing and other inter-fund financial transactions made by the City between the General Fund, proprietary funds, special revenue funds and fiduciary funds.
3. The amount and status of loans made by the City to CBS Aviation Development, LLC and other contractors, including decisions that may have been made to substantially modify or forgive balances due.
4. Bond funding protocol and disbursements, including inter fund transactions subsequently reclassified as loans.

¹ California Penal Code Section 925 states, "The grand jury shall investigate and report on the operations, accounts, and records of the officers, departments, or functions of the county including those operations, accounts, and records of any special legislative district or other district in the county created pursuant to state law for which the officers of the county are serving in their ex officio capacity as officers of the districts."

Methodology

The data validation and performance audit tasks for the limited scope performance audit were conducted in accordance with *Government Auditing Standards, December 2011 Revision*, by the U.S. Government Accountability Office, Comptroller General of the United States, as modified by directives from the Grand Jury to ensure investigative integrity. In accordance with these modified standards, the following key activities and tasks were conducted:

- An entrance conference was held with the executive staff from the City of Victorville to introduce HMR staff, describe the performance audit process and protocol, and request general information on the organization and the issues included in the scope.
- Documentation that had been compiled by *Kessler* during the forensic audit was catalogued and assessed. The *Kessler* documentation and finding summaries were then aligned with the San Bernardino County Grand Jury scope statements, including subsequent revisions.
- An initial assessment of the identified issues was conducted, in accordance with project goals defined in the work plan approved by the 2011-12 San Bernardino County Grand Jury and subsequent communications with the assigned Grand Jury committee. During this initial assessment phase, City management was interviewed, including the City Manager, the Assistant Director of Finance, the City Attorney, and the Assistant City Manager/Executive Director of the VVEDA. Seven formal information requests were submitted to City management and documentation was provided through CD-ROMs or email transmission.
- Field work tasks were conducted to further refine an understanding of the topics under review. The field work involved additional interviews of City management staff and the collection and analysis of additional information and documentation. In addition, a tour of the Southern California Logistics Airport and the Foxborough Industrial Park was conducted to gain perspective on certain projects and developments. At the conclusion of field work activities, preliminary findings, conclusions, and recommendations were developed.
- A draft report was produced and internally reviewed for quality assurance purposes. At the direction of the Grand Jury, an exit conference was held with City management prior to the release of the final report.

Background

The City of Victorville was incorporated in 1962 with a population of 8,110 and an area of 9.7 square miles in the Victor Valley region of San Bernardino County. The City experienced dramatic economic and population growth from about 2002 to 2006. During that period the City had an annual population growth over seven percent each year. Since 2008 annual population growth has slowed to less than one percent as the economy, particularly in the housing industry, has slumped. As of 2010, the City had a population of approximately 116,000 residing in an area of approximately 75 square miles.

Victorville was established as a general law city, meaning that when the City incorporated, City leaders chose to use the existing State codes as they relate to laws, functions, and powers of the Mayor and City Council, rather than write a charter. In July 2008 Victorville became a charter city, which articulates aspects of City affairs including the form of government; the method of election of Council members; contracting, public financing, franchises, and revenue; and revenue retention. The charter also states that the City retains general law powers and authority. The recent change to a charter city does not materially affect any findings in this report

The City operates with a council-manager form of government, whereby the Council appoints a City Manager who administers the daily operations of city government. The City Council also appoints a City Attorney who is responsible for advising the Council on legal issues affecting the City. The Mayor is a member of the City Council and is selected by a vote of the Council.

Organization and Staffing

The City of Victorville operates nine departments including:

- Administrative Services, which includes the City's Finance, Human Resources, and Information Services divisions. Since July 2011, the City Manager has assumed the responsibilities of managing the Administrative Services Department. In February 2012, the Assistant Director of Administrative Services-Finance was assigned City Treasurer responsibilities. Previous to this action, the City had not had a dedicated director for Finance since August 2009. The City Manager will continue to oversee Human Resources and Information Technology.
- The City Manager's Office, which includes the City Clerk and Risk Management. The Risk Management function is managed by the City Manager, but is contracted out to a third party.
- Community Services, which includes the Park, Library, Recreation and Community Services, Parks and City Facilities, and Golf divisions. The operation of the City's golf course is contracted out to a third party.
- The Development Department, which includes the Building and Safety, Code Enforcement, and Planning divisions.
- The Economic Development Department, which includes the Airport, Business Development, and Housing divisions. In addition, the Victorville Redevelopment Agency was managed under this Department until its dissolution in February 2012.²
- The Engineering Department, which includes the Engineering, Signal Maintenance, Street Lighting, and Traffic Control divisions.
- The Fire Department, which includes the Emergency Services, Fire Protection, Hazardous Materials and Hazardous Waste divisions. All Fire Department operations are provided, by contract, by the San Bernardino County Fire Department.

² Assembly Bill 26 (AB 26) dissolved local redevelopment agencies in 2012.

- The Police Department, which includes the Police Administration, Investigation, and Patrol/Traffic divisions. All Police Department services are provided, by contract, by the San Bernardino County Sheriff's Department.
- The Public Works Department, which includes the Animal Control/Graffiti Abatement, Solid Waste/Recycling, Storm Drain/Wastewater, Street Maintenance/Sweeping, Open Space and Municipal Utilities divisions. The Victorville Municipal Utility Services (VMUS) does not currently generate electricity. However, it provides electrical, cogeneration, and natural gas services for commercial and industrial customers at the Foxborough Industrial Park and the Southern California Logistics Airport through power purchase agreements with energy suppliers. The electricity is distributed through Southern California Edison transmission lines. VMUS and does not provide electric utility services to residential areas. Additionally, this Department provides all Water District functions.

In addition to the Departments listed above, the City contracts with Green, de Bortnowsky, and Quintanilla, LLP for City Attorney services. The City has contracted with this firm for general counsel since 2002. The firm has also provided legal counsel to the Victorville Redevelopment Agency and Southern California Logistics Airport Authority for approximately 15 years. According to the City Attorney, the firm retains 10 attorneys to provide services for the City, VVRDA and SCLAA for a pre-determined minimum number of hours and then on an as-needed basis.

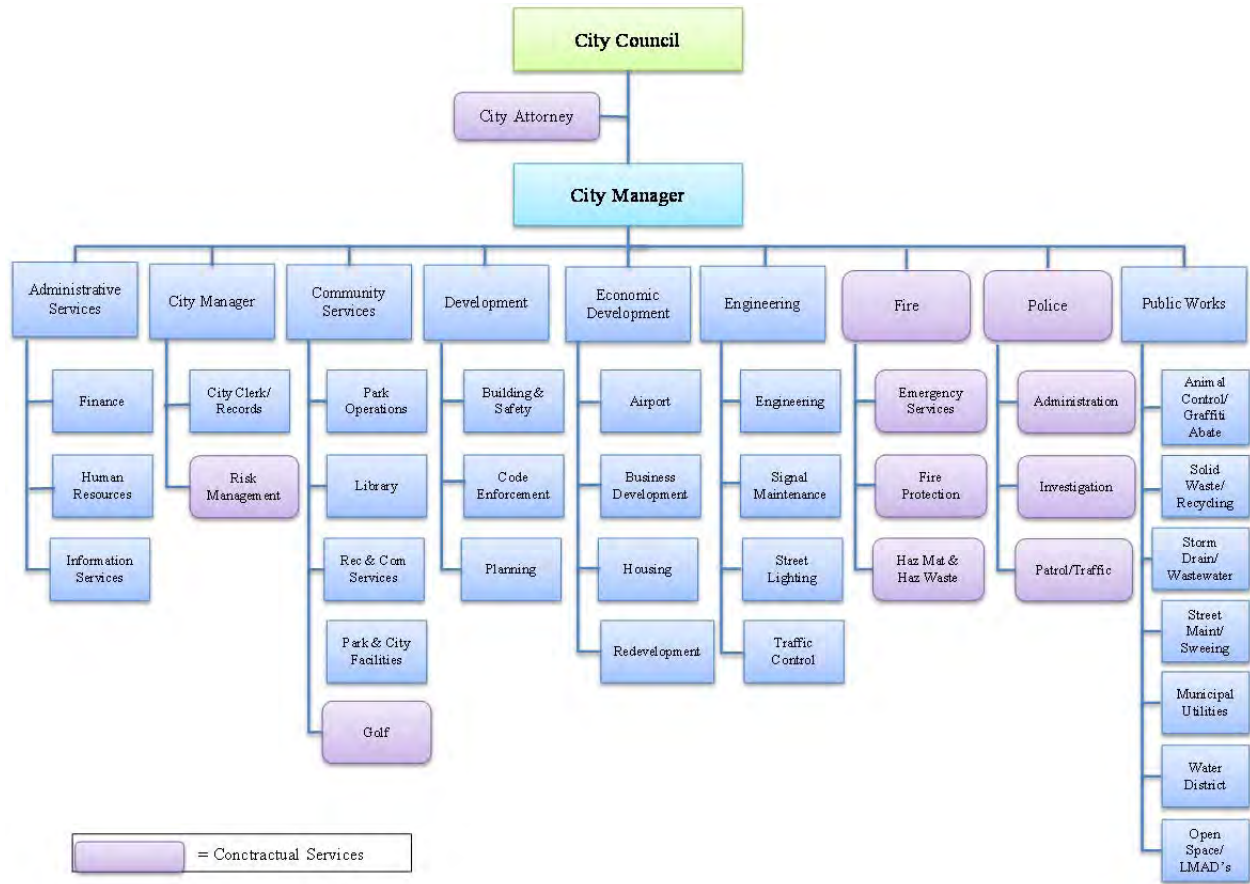
In FY 2011-12, the City Council authorized a total of 315 budgeted full time positions. In addition, the City has budgeted funds for risk management services, City Attorney services, operation of the City's golf courses, operation of the Fire Department, and operation of the Police Department through contracts with third parties. An organization chart for the City of Victorville is provided on the next page.

Victorville Water District

The Victorville Water District provides over 7.4 billion gallons of water each year to a population of over 100,000 people within the boundaries of the City of Victorville. Although operationally managed under the Department of Public Works, the Victorville Water District is technically an independent legal entity and an enterprise³ district of the City. In 2007 the Victorville Water District was established as a subsidiary district of the City from the consolidation of the Baldy Mesa Water District and the Victor Valley Water District. The Victorville City Council serves as the Victorville Water District Board.

³ Under Generally Accepted Accounting Standards (GAAS) enterprise funds are used to account for business-type activities. Business-type activities typically provide goods of services that are funded through user charges.

Exhibit 1 City of Victorville Organization Chart



Victorville Redevelopment Agency

The City of Victorville created the Victorville Redevelopment Agency in 1981 under the California Community Redevelopment Act with a mission to eliminate conditions of blight in the community by promoting and providing affordable housing to households with low to moderate incomes and encouraging opportunities for new and expanding commercial and industrial businesses. The Agency operated until February 1, 2012 when it was dissolved as the result of a December 2011 California Supreme Court decision upholding the passage of Assembly Bill 26, which dissolved all redevelopment agencies in the state.

At the time of its dissolution the Victorville Redevelopment Agency had three adopted redevelopment project areas including the: (1) Bear Valley Project Area; (2) Hook Project Area; and, (3) Old Town/Midtown Project Area.

Bear Valley and Hook Project Areas

The Bear Valley Project Area, located in the southeastern region of the City, was created in 1981 with an original goal of developing commercial, industrial and residential growth. In recent years the project area has experienced significant commercial and industrial growth, including the development of facilities for large industrial firms including ConAgra, Nutro, Goodyear Tire and Rubber Company, and M&M/Mars, among others. The project area includes the Victorville Medical Campus, the Foxborough Industrial Park, the Desert Valley Medical Hospital, and an apartment community that has a total of 285 affordable housing units.

The Hook Project Area, located in the central area of the City just north of City Hall, was adopted as an amendment to the Bear Valley Project Area in 1985. The area, which is not contiguous with the Bear Valley Project Area, has been zoned for commercial and residential development. Significant commercial developments in the project area include the Auto Park at Valley Center and the Desert Plazas retail center.

Old Town/Midtown Project Area

The Old Town/Midtown Project Area, located in the northeastern region of the City, was adopted in 1998. The Old Town/Midtown Project Area was adopted with the goal of redeveloping the Old Town area, which has experienced a significant amount of business vacancies and substandard housing, to a mixed-use downtown hub with specialty restaurants and retail. The actions taken by the Redevelopment Agency in this project area have primarily consisted of the purchase of certain sites and subsequent demolition to allow for redevelopment.

Victor Valley Economic Development Authority

The VVEDA was created in 1989 through a Joint Exercise of Powers Agreement (JPA) with Hesperia, Apple Valley, and the County.⁴ In 1993 the VVEDA members established the original

⁴ The County of San Bernardino Redevelopment Agency was the authorized recipient of tax increment accrued within unincorporated areas of the Victor Valley Project Area.

boundaries of the Victor Valley Project Area consisting of portions of each member's jurisdictional boundary within an eight mile radius of the former George Air Force Base. The VVEDA currently operates under the Fourth Amended and Restated JPA, which provided for the inclusion of the City of Adelanto in 2000. The current JPA also enables each member entity to enter into transactions and execute agreements within their respective portions of the VVEDA project area without approval of the full VVEDA Board, provided that any financial obligations would be backed by pledged tax increment revenue allocable solely to that member.

The purposes of the JPA, as stated on page eight of the agreement, are to provide for:

- The coordination of long range planning of the territory of George Air Force Base and surrounding areas;
- The interaction with the Federal Government;
- The acquisition, through public benefit transfer and economic development conveyance, and administration and management of an airport or other public facilities at George Air Force Base;
- The redevelopment of George Air Force Base and surrounding areas; and,
- The financing needed to effectuate such planning, interaction, airport, public facilities and redevelopment activities.

Importantly, the JPA sets out how the tax increments are to be divided and allocated between the redevelopment of the former George Air Force Base and the surrounding project area. This allocation, as defined by the JPA, is described in detail in Section Five of this report.

Victor Valley Amended Redevelopment Plan

The VVEDA established and amended a redevelopment plan to institute a framework for implementation of the VVEDA Project Area. The most recent and current plan (including Amendments one through eight) was established in December 2006. The primary purposes of the Redevelopment Plan are to provide the mechanism and funding to:

- Acquire the Air Base and facilitate the successful reuse of the property;
- Ensure that adequate access exists to and from the major transportation systems and the Air Base;
- Promote economic development within the area surrounding the Air Base; and,
- Cause the replacement of jobs which resulted from the closure of the Air Base and provide for affordable housing opportunities in accordance with participating jurisdictions' Housing Elements.

The VVEDA Redevelopment Plan: (1) defines the 22 redevelopment plan goals of the Authority; (2) lists the actions that member jurisdictions may take, such as the demolition and rehabilitation of buildings; (3) lists the major categories of land uses permitted in the Project Area; (4) provides a description of methods available for financing the project; (5) lists allowable actions by VVEDA's participating jurisdictions; and, (6) describes administration, enforcement, duration, and procedure for amendment of the plan.

The VVEDA may be dissolved under AB 26 and a subsequent California Supreme Court decision, which dissolved all redevelopment agencies as of February 1, 2012. The Executive Director of VVEDA currently maintains that the VVEDA, along with the Inland Valley Development Agency (IVDA), should not be subject to the provisions of AB 26. Both the IVDA and VVEDA have filed suit against the State in order to prevent dissolution.

Southern California Logistics Airport Authority

The VVEDA JPA provides for the delegation and assignment of the member jurisdictions' voting rights, with respect to all issues directly affecting the operation and redevelopment of the former George Air Force Base, to the Victorville City Council acting as the Southern California Logistics Airport Authority (SCLAA). The responsibilities delegated to the SCLAA include: (1) all budgeting authority; (2) all redevelopment authority; and, (3) all operational and management authority affecting the George Air Force Base parcels. Essentially, the Victorville City Council, acting as the SCLAA, has the authority to redevelop, operate, and manage all aspects of the former George Air Force Base, now known as the Southern California Logistics Airport.

In 1999, the Southern California International Airport, the predecessor agency to SCLAA, entered into a master agreement with Stirling Airports International, LLC (Stirling) "for the marketing, acquisition, operation, and development" of the airport. The primary purpose of this agreement was to allow Stirling to acquire portions of the airport property in phases and construct buildings for a variety of uses in order to develop the airport as a cargo and aircraft maintenance facility as well as a business and industrial center. Under this master agreement and subsequently under a separate Airport Management Agreement, a Disposition and Development Agreement, and other arrangements, SCLAA successfully developed several "on airport" and "off airport"⁵ parcels occupied by FedEx, GE, Boeing, Pratt and Whitney, Dr. Pepper/Snapple, and Newell Rubbermaid, among others, generating local job opportunities for the community and property tax increment for SCLAA. In addition, the SCLAA arranged for the development, construction, and operation of an 840 megawatt natural gas power plant, known as the High Desert Power Plant, through a third party. The power plant, which went online in 2003, has provided additional tax increment revenue to SCLAA. Despite these developments, the Southern California Logistics Airport has, through FY 2010-11, consistently had an annual operating deficit. However, despite the airport's recent accomplishment of generating an annual operating surplus for airport operations, a heavy debt load continues to keep SCLAA in an overall deficit position.

⁵ "On-airport" refers to former George Air Force Base parcels located within the security perimeter of the functioning airport while "off-airport" refers to former George Air Force Base parcels outside the security perimeter.

The SCLAA operated under a separate JPA between the City and the Victorville Redevelopment Agency until January 2012. On January 17, 2012 the Victorville Water District became a member of the SCLAA in order to avoid the dissolution of the SCLAA given the mandates of AB26 and the California Supreme Court decision upholding it. According to a staff report submitted by the City Attorney to the Water Board, if the Victorville Water District had not become a member of the SCLAA, the JPA would have been dissolved when the Redevelopment Agency was dissolved on February 1, 2012. The SCLAA now operates under a JPA between the City and the Victorville Water District. According to the agreement, the Water District shall not be responsible for the assets or liabilities of the SCLAA.

Audit Period

The Grand Jury requested the audit team to review the current financial condition and financial transactions that have occurred since 2005. The reader should note that City management has changed incrementally during this period. However, according to interviews with current City management the firm of Green, de Bortnowsky, and Quintanilla, LLP has served as the City Attorney since 2002. In addition, the current City Manager, who has been in that position since July 2011, previously served in other positions within the City Manager's Office starting in August 2002 as a Senior Management Analyst. Beginning in 2008, he was appointed to Deputy City Manager and assigned responsibilities to address a number of the topics in this report, including stabilization of the City's finances. Finally, the current Assistant City Manager has served in various roles in the City since 1996 including as an Administrative Intern, Deputy Director of Redevelopment, and Director of Economic Development.

Acknowledgements

Harvey M. Rose Associates, LLC would like to thank the Grand Jury for their participation and counsel during this performance audit. In addition, we would like to thank personnel from the City of Victorville and others for their insight into the finances and operations of the City and the SCLAA. In particular, we would like to thank the City Manager and his staff for their efforts in compiling and indexing the many documents required for this review.

1. Financial Condition

- Analysis of the financial statements for the City of Victorville and the agencies for which it has fiduciary responsibility, reveal that the City's solvency, capacity to continue operations at current service levels, and ability to repay large debt obligations is a growing concern. As of June 30, 2011, the General Fund balance was \$3.1 million, which was 6.4 percent of General Fund annual operating expenses of \$48.5 million. This General Fund balance was \$5.0 million, or 61.6 percent less than the Government Finance Officers Association (GFOA) recommended target of \$8.1 million, or two months reserve based on annual expenditures. Such reserves are needed for cash flow requirements, economic uncertainties, and other financial hardships.
- The General Fund balance has been depleted as the result of several fiscal years when expenditures have exceeded revenues, leading to an operating deficit and a need to use reserves to meet expenditure obligations. Additionally, the General Fund has loaned or transferred money to other City funds, in the form of subsidies, to support the operations of functions that receive the majority of funding from restricted sources.
- Similarly, the financial condition of Victorville Municipal Utility Services (VMUS) and the City Golf Course are concerning. Annual operating deficits, in which expenditures routinely exceed revenues; negative fund balances, because long-term liabilities exceed assets; and, the inability to meet debt service payments using VMUS resources, have required subsidies in the form of transfers from the General Fund, or inter-fund loans from other City funds. Further, VMUS' inability to repay significant debt obligations is of serious concern, increasing General Fund risk exposure due to the potential need to absorb VMUS liabilities and obligations. Similarly, the financial condition of the Southern California Logistics Airport Authority (SCLAA) is weak. SCLAA defaulted on a principal payment due on December 1, 2011, which was not cured until March 2012. Though the General Fund is not liable for SCLAA's bond indebtedness, the General Fund has loaned funds to SCLAA for other expenditures and the City Manager had indicated that it may do so again this fiscal year.
- As the Successor Agency for the Victorville Redevelopment Agency (VVRDA), which was dissolved this year pursuant to State law, the City is responsible for repaying VVRDA's recognized obligations, including bond indebtedness; payments due to third party contractors or other entities as a result of legally binding agreements; inter-fund loans; and administrative costs associated with operating as the Successor Agency. Although the City will receive some amount of tax increment funds to meet these obligations, analysis of previous fiscal year tax increment trends suggest ongoing risk exposure, since the General Fund will likely be required to absorb obligations not being met by the tax increment.

In the financial statements for the fiscal year that ended on June 30, 2007, the independent auditor for the City of Victorville stated that the City “has continued to suffer significant reductions in net assets from operations, which raises uncertainties regarding future operations.” Subsequent financial statements audited by a different independent auditor have concluded that, there is “a substantial doubt of the City’s ability to continue as a going concern.” Analysis of the financial statements for the City of Victorville and its component¹ agencies conducted for this audit reveal similar conclusions—that the City’s solvency, ability to repay large debt, and continue funding some operations is of concern.

The General Fund is in Poor Financial Condition

The ability of the General Fund to continue to support general City government operations, support the operations of enterprise funds, and meet debt obligations is questionable, based on various indicators, including: (1) a decreasing General Fund balance; (2) multiple years of operating at a deficit; (3) various inter-fund transfers from the General Fund to other City funds over the past few years; and, (4) a low cash balance.

Fund Balance is Very Low

As shown in Table 1.1 below, the City’s General Fund balance has steadily decreased over the past four fiscal years. As of June 30, 2011, the General Fund balance was \$3,103,630, which was 6.4 percent of the General Fund operating expenses of \$48,495,022 in Fiscal Year (FY) 2010-11. The General Fund balance as of June 30, 2011 was \$4,445,923 less than the General Fund balance of \$7,549,553 as of June 30, 2010, representing a 58.9 percent decrease in General Fund balance from the previous fiscal year.

Table 1.1
Four-Year Comparison of General Fund Balance and Annual Expenditures

Fiscal Year	Fund Balance (FB)	Unrestricted Portion	Annual Expenditures	FB as a % of Expenditures
FY 2007-08	\$2,455,670	\$12,132,307	\$42,632,770	29.2%
FY 2008-09	10,645,865	10,398,067	61,595,837	17.3%
FY 2009-10	7,549,553	2,229,649	51,141,804	14.8%
FY 2010-11	3,103,630	781,523	48,495,022	6.4%

Source: City of Victorville Financial Statements

On June 1, 2010, the City Council for the City of Victorville adopted a General Fund Reserve Policy (CP-10-04) that established a target reserve of 15 percent of the General Fund annual appropriations and transfers out. Further the policy states that:

¹ A unit that is legally separate from the City but financially accountable to the City; or, a unit which has a financial relationship with the City that would cause the City’s financial statements to be misleading or incomplete if excluded.

During times of fiscal hardship, a minimum of five percent (5%) of the General Fund annual appropriations and transfers out shall be maintained to provide provision for cash flow requirements, economic uncertainties, uninsured losses, local emergencies/disasters, or other unknown financial hardships.

As shown in Table 1.1 above, the City was close to meeting its target of 15 percent for reserves as of June 30, 2010, with a General Fund balance of \$7,549,553, or 14.8 percent of its annual expenditures of \$51,141,804 in FY 2009-10. However, within one year, the City's General Fund balance as a percent of annual expenditures decreased by more than half, from 14.8 percent to 6.4. Though the General Fund balance as a percent of expenditures in FY 2010-11 was above the City's established minimum of five percent, the rate of decrease in General Fund balance is significant. On April 19, 2011 the City Council suspended the minimum five percent reserve threshold so that the City may use General Fund reserves to close the gap between revenues and expenditures for FY 2011-12 without a commensurate cut in services

The Government Finance Officers Association (GFOA) currently recommends that governments establish a formal policy on the level of unrestricted fund balance that should be maintained in the general fund. The current policy is vague in stating that the "adequacy of unrestricted fund balance in the general fund should be assessed based upon a government's own specific circumstances." Though the existing GFOA policy is not specific, it recommends that regardless of size, general-purpose governments should maintain unrestricted fund balance in their general fund of "no less than two months of regular general fund operating revenues or expenditures." The City's General Fund balance is well below this threshold. The City's General Fund balance of \$3,103,630 is \$4,978,874, or 61.6 percent less than the target reserve of \$8,082,504, or two months reserve based on annual expenditures of \$48,495,022 in FY 2010-11.

It should be noted that \$2,322,107 of the General Fund balance is restricted, and therefore, unavailable to meet unforeseen expenditure obligations. A majority of the restricted portion of the General Fund Balance is due from other funds, as a result of General Fund advances and inter-fund loans² to other City funds. A small portion of the restricted funds, or \$7,256, is reserved for prepaid expenses. Therefore, only \$781,523 of the General Fund balance is actually available for immediate expenditures.

Three Consecutive Years of Operating Deficits

Over the past three fiscal years, actual General Fund expenditures have exceeded actual revenues, resulting in General Fund operating deficits for those three fiscal years. When there is an operating deficit, the General Fund balance is used to balance the operating budget, thus, partially explaining the depletion of the General Fund balance over the last few years. As shown in Table 1.2 and Chart 1.1 below, the General Fund had an operating *surplus* of \$8,972,198 in FY 2007-08, but in the following fiscal year, FY 2008-09, had an operating *deficit* of \$14,037,653. If the trend of operating deficits continues, the General Fund Balance will continue to decrease, very possibly leading to the City's insolvency, as well as an inability to pay for day-to-day operating expenses and outstanding debt.

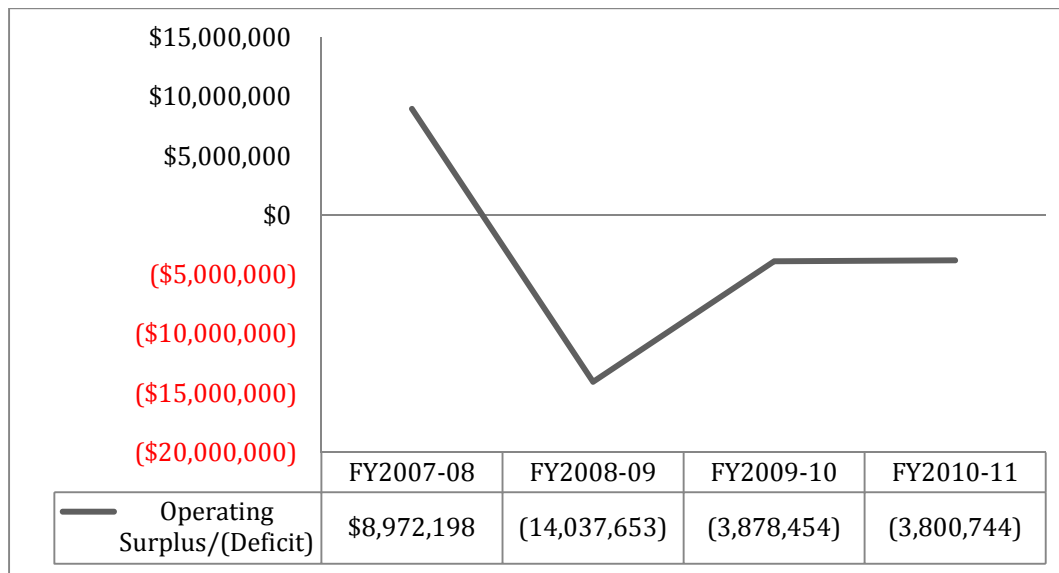
² The City Manager has asserted that an advance of approximately \$2.3 million from the General Fund to SCLAA to cover negative cash balances is not a long term loan and has been repaid since it was on the City's June 30, 2011 financial statements. However, the City Manager has also stated that another "short term" loan to SCLAA from the General Fund may be necessary at the end of the current fiscal year.

Table 1.2
Four-Year Comparison of General Fund Actual Revenues and Expenditures

Fiscal Year	Revenues	Expenditures	Operating Surplus/(Deficit)
FY 2007-08	\$51,604,968	\$42,632,770	\$8,972,198
FY 2008-09	47,558,184	61,595,837	(14,037,653)
FY 2009-10	47,263,350	51,141,804	(3,878,454)
FY 2010-11	44,694,278	48,495,022	(3,800,744)
4-Year Average	\$47,780,195	\$50,966,358	(\$3,186,163)

Source: City of Victorville Financial Statements

Chart 1.1
Four-Year Comparison of General Fund Operating Surplus/(Deficit)



Source: City of Victorville Financial Statements

Inter-fund Loan and Transfers from the General Fund

In addition to using the General Fund balance to support General Fund operations when there is an operating deficit, the City has used the General Fund balance to support other funds when there is a negative cash balance. As shown in Table 1.3 below, from FY 2007-08 through FY 2010-11, the General Fund has provided support to seven other funds in the form of:

- Short-term loans that are due within a year;
- Inter-fund loans that are due within more than a year; and,

- Transfers that are not to be repaid. These are otherwise known as subsidies if they are used to support operations, as opposed to payment for the exchange of services (i.e. utility services).

Table 1.3
Four-Year Comparison of General Fund Short-Term Loans,
Inter-fund Loans, and Transfers to Other Funds

Fund	Year	Short-Term	Inter-fund Loan	Transfer/Subsidy	Amount
City Golf	FY 2007-08			\$1,133,238	\$6,878,884
	FY 2008-09	\$5,745,646		1,253,552	1,253,552
	FY 2009-10		5,073,220		5,073,220
	FY 2010-11			1,400,322	1,400,322
Total City Golf					14,605,978
SCLAA	FY 2007-08			1,353,898	1,353,898
	FY 2008-09			1,755,396	1,755,396
	FY 2010-11		2,314,851		2,314,851
Total SCLAA					5,424,145
Municipal Utility	FY 2007-08			9,990,448	9,990,448
	FY 2008-09	818,427			818,427
Total Municipal Utility					10,808,875
Fire Protection	FY 2007-08	131,198		5,465,894	5,597,092
CDBG Grants	FY 2007-08	718,895			718,895
Other Federal Grants	FY 2007-08	4,624,051			4,624,051
Park and Recreation	FY 2007-08			1,115,412	1,115,412

Source: City of Victorville Financial Statements

Short-term loans to meet negative cash balances at the end of the year are typical of most jurisdictions. Because the short-term loans are intended to be repaid within a year, it is assumed that the loans listed in Table 1.3 above were repaid. However, inter-fund loans where repayment is expected beyond one year, without a clear repayment plan, are a sign of financial distress. Inter-fund loans are further discussed in Section 2 of this report.

Cash Balance

As of June 30, 2011, the City's cash and investments were \$88,306. While there is no specific standard for how much a City should have in cash and investments, the amount is very low when compared to the City's rate of expenditures of approximately \$4,000,000 per month, resulting in a cash flow risk for the City.

There are three ways in which cities typically address cash flow issues. The first is to resolve low cash balances through inter-fund loans. However, as previously discussed, the City's ability for the General Fund to engage in inter-fund borrowing has diminished because of long-term lending and the poor financial condition of other funds. Secondly, cities can borrow from Internal Service Funds on a temporary basis, yet the City of Victorville does not have any Internal Service Funds. Finally, through the California Statewide Communities Development Authority (CCDA or California Communities),³ cities can finance short-term cash flow deficits through Tax and Revenue Anticipation Notes (TRANs). However, the maximum maturity of TRANs issued by CCDA is 13 months and State law requires that funds be set aside for the repayment of TRANs from current fiscal year revenues, or the fiscal year in which the TRANs was actually issued. Based on the City's track record of setting aside cash, applying for TRANs may not be a viable option for the City either.

The City should develop a plan to replenish the General Fund reserves to the recommended level of two months annual revenue or expenditures. By doing so, the City would be eligible for TRANs should the City have major cash flow risks in the future. Such a plan should include further reducing expenditures and identifying additional sources of revenue while the economy improves and major sources of revenue—sales tax, property tax, and franchise tax—increase. Additionally, the City should avoid inter-fund loans and transfers from the General Fund to other City funds.

Other Entities are in Poor Financial Condition

Three entities for which the City has fiduciary responsibility have been operating at a deficit over the past four fiscal years (operating expenditures exceeded operating revenues). These entities are the Southern California Logistics Airport Authority (SCLAA), Victorville Municipal Utility Services (VMUS), and the City Golf Course. Additional factors, such as significant debt for SCLAA and VMUS, contribute to these entities' poor financial condition. As previously noted, the General Fund has had to transfer funds to support some of these operations.

³ The California Statewide Communities Development Authority is a joint powers authority sponsored by the California State Association of Counties and the League of California Cities. Its mission is to provide local governments and private entities access to low-cost, tax-exempt financing for projects.

Southern California Logistics Airport Authority

The Southern California Logistics Airport Authority is a joint powers agency that secures funding, oversees development and redevelopment in a joint project area, and manages and operates the former George Air Force Base under a base conversion agreement with the federal government. From FY 2007-08 through FY 2010-11, SCLAA has had negative net assets. In FY 2010-11, negative net assets grew to \$100,116,522 and is a result of (a) multi-year operating deficits; (b) long-term liabilities that exceed assets, including excessive debt; and (c) insufficient pledged revenue to meet debt payments, year after year. The SCLAA's solvency and ability to repay debt is another area of concern.

Operating Deficit

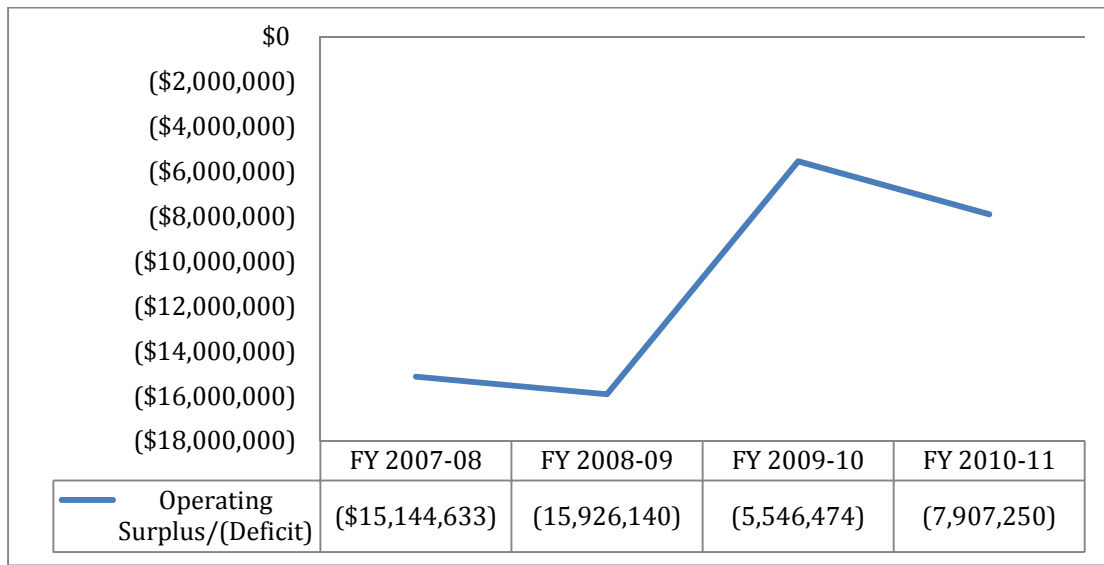
Similar to the General Fund, operating expenditures at SCLAA has exceeded operating revenues. In other words, SCLAA has not collected enough rent revenue from tenants at the airport to support its own operation. As a result, the General Fund, as well as other funds, has had to transfer funds to SCLAA to support airport operations. Table 1.4 below provides details of SCLAA's expenditures and revenues over the past four fiscal years. Chart 1.2 also illustrates SCLAA's on-going operating deficit.

Table 1.4
Four Year Comparison of SCLAA Actual Revenues and Expenditures

Fiscal Year	Revenues	Expenditures	Operating Surplus/(Deficit)
FY 2007-08	\$8,842,868	\$23,987,501	\$(15,144,633)
FY 2008-09	7,465,482	23,391,622	(15,926,140)
FY 2009-10	8,254,815	13,801,289	(5,546,474)
FY 2010-11	9,295,069	17,202,319	(7,907,250)
4-Year Average	\$8,464,559	\$19,595,683	\$(11,131,124)

Source: Southern California Airport Authority Financial Statements

Chart 1.2
Four-Year Comparison of SCLAA Operating Surplus/(Deficit)



Source: Southern California Airport Authority Financial Statements

City management has reported that SCLAA's airport operations⁴ is expected to break even this fiscal year, meaning that operating revenues will equal operating expenditures. However, long term debt, including bond indebtedness and inter-fund loans, is not considered part of the operating budget.

Insolvency

Over the past four fiscal years, SCLAA's liabilities have exceeded its assets, resulting in negative net assets. As shown in Table 1.5 below, SCLAA's net assets were negative \$100,116,522 as of June 30, 2011.

Table 1.5
Four-Year Comparison of SCLAA Assets and Liabilities

Fiscal Year	Assets	Liabilities	Net Assets
FY 2007-08	\$334,570,562	\$389,179,948	\$(54,609,386)
FY 2008-09	292,558,832	345,089,580	(52,530,748)
FY 2009-10	254,627,190	355,966,415	(101,339,225)
FY 2010-11	250,708,960	350,825,481	(100,116,521)
4-Year Average	\$283,116,386	\$360,265,356	\$(77,148,970)

Source: Southern California Airport Authority Financial Statements

⁴ "Airport operations" refers only to those operations directly related to the management and administration of the airport. Airport operations does not include development activities that are not directly related to the airport.

SCLAA’s liabilities are primarily due to long-term liabilities, which totaled \$329,562,038 as of June 30, 2011 and consisted of bond indebtedness from various Tax Allocation Bonds, a liability for compensated absences, and loan payables from the defunct EB-5 program.⁵ The decrease in net assets from FY 2008-09 to FY 2009-10 was caused by a \$50,020,000 write off of a deposit to General Electric for equipment for the proposed second power plant for SCLAA, or Victorville #2. Plans for the power plant, the General Electric contract, and the subsequent settlement litigation with General Electric are further discussed in Section 3 of this report.

In addition to bond indebtedness, SCLAA has borrowed funds from several City sources due to its negative cash balances and other purposes. Table 1.6 below details the source of funds for SCLAA’s \$15,965,603 in inter-fund loans as of June 30, 2011.

Table 1.6
SCLAA Inter-fund Loans, Since FY 2007-08⁶

Source of Loan	Original Amount	Date of Loan	Balance as of 6/30/11	Term	Interest Rate	Purpose
Redevelopment Agency - Project Area Bear Valley	\$10,000,000	9/5/2009	\$10,114,922	5	LAIF ⁷	Redevelopment activities on SCLA, such as the fuel farm
Redevelopment Agency - Low and Moderate Housing	1,700,000	10/12/2009	1,715,210	5	LAIF	Redevelopment activities on SCLA, prior years capital improvements, and project expenses
General Fund	2,314,851	6/30/2011	2,314,851	N/A	N/A	Inter-fund loan due to negative cash balances
Victorville Municipal Utility Services	1,230,671	6/30/2011	1,230,671	N/A	N/A	Inter-fund loan due to negative cash balances
Wastewater Enterprise Fund	589,949	6/30/2011	589,949	N/A	N/A	Inter-fund loan due to negative cash balances
Total	15,835,471		\$15,965,603			

Source: City of Victorville and Southern California Airport Authority Financial Statements

According to the Finance Department, the three loans made to SCLAA in FY 2010-11 due to negative cash balances were never formalized. These loans were made at the end of the fiscal year without documentation of loan terms or interest rates. The Finance Department noted that it

⁵ The EB-5 program was a part of a United States Customs and Immigration Services (USCIS) program. The SCLAA was supposed to obtain loans from foreign investors for development projects in exchange for eligibility for an immigration visa into the country. However, on October 20, 2010, the USCIS terminated the City’s participation in the program.

⁶ The inter-fund loan to SCLAA from the Redevelopment Agency Project Area Bear Valley for \$10,000,000 first appeared in the FY 2007-08 financial statements. However, the loan was not approved by City Council until September 15, 2009.

⁷ Interest rates for the two Redevelopment Agency loans are based on the annualized Local Agency Investment Fund (LAIF) rate of return. As of December 2011, the LAIF rate of return was .38 percent.

has not yet identified a long term financing entity for the inter-fund loan, because currently, the General Fund and Victorville Municipal Utility Services are not in a proper financial condition for making long term advances to SCLAA. The City Manager subsequently indicated that these three loans have been repaid, but “may exist again at the end of this fiscal year.” The repeated use of advances to cover negative cash balances points to a systemic cash flow problem in the City. Further, a cycle of borrowing and repaying these short-term advances can also be interpreted as a mechanism for creating longer-term debt, while complying with the technical requirements of repaying the advances within the shorter one-year timeframe.

The Southern California Logistic Airport Authority’s ability to repay long term debt and short term advances from other City funds is of serious concern. Though SCLAA is trying to break the cycle of operating at a deficit, there is still insufficient revenue to make debt payments. As shown in Table 1.7 below, from FY 2007-08 through FY 2010-11, SCLAA’s pledged revenues have been insufficient to make debt payments.

Table 1.7
Four-Year Comparison of SCLAA Pledged Revenue and Debt Payments

Fiscal Year	Pledged Revenue	Debt Payments	Surplus/ (Shortfall)
FY 2007-08	\$25,531,786	\$34,907,070	\$(9,375,284)
FY 2008-09	34,123,855	47,687,282	(13,563,427)
FY 2009-10	21,546,180	21,725,516	(179,336)
FY 2010-11	20,115,215	29,082,737	(8,967,522)
4-Year Average	\$25,329,259	\$33,350,651	\$(8,021,392)

Source: Southern California Airport Authority Financial Statements

Beginning with SCLAA’s financial statements for FY 2009-10, City management, with confirmation from independent auditors, noted that if pledged revenues were less than the debt service payments, the City would need to bridge the difference between the debt service payments and pledged revenue. The FY 2010-11 financial statements for SCLAA noted that SCLAA would need to “draw on reserves” held with SCLAA’s fiscal agent to bridge the gap between pledged revenues and debt service payments until the economy rebounds.

However, on December 1, 2011, SCLAA defaulted on the principal payment of two Tax Allocation Revenue Bonds, for a total of \$535,000 in unpaid principal. The Bank of New York Mellon, the Trustee that holds the City’s reserves for bond payments, stated that the reserves could only be used for interest payments, not payments on principal. City management reports that tax increment received in March 2012 has been used to re-pay the unpaid principal balance that was due as of December 2011.

SCLAA should continue to explore ways to decrease operating expenditures and increase operating revenues to begin building its fund reserve. Maintaining a positive cash balance and a healthy cash reserve should reduce the need for inter-fund loans and increase its ability to make debt service payments.

Victorville Municipal Utility Services

The Victorville Municipal Utility Services (VMUS) is a City enterprise that provides electrical, cogeneration, and natural gas services for commercial and industrial customers at the Southern California Logistics Airport and Foxborough Industrial Park. However, the enterprise does not provide utility services in residential areas. Operations, maintenance, and capital expenditures are funded by user charges, other fees, and loans. Similar to SCLAA, VMUS has had insufficient revenues to cover operating expenditures and has incurred significant debt due to failed contracts and projects.

Operating Deficit

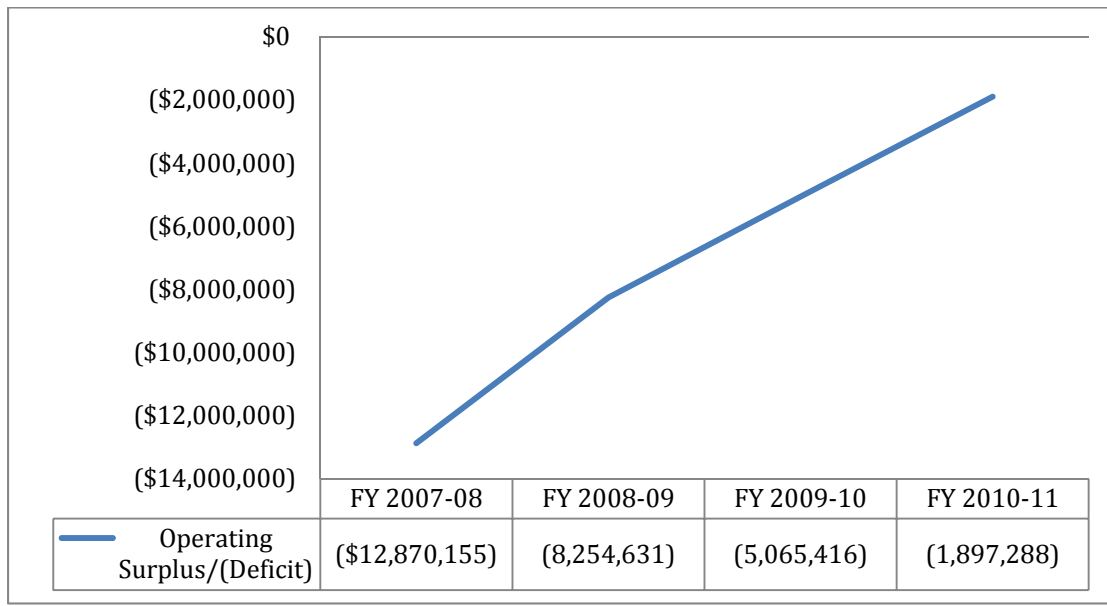
As shown in Table 1.8 and Chart 1.3 below, VMUS has had an operating deficit over the last four fiscal years. However, the deficit has decreased from *negative* \$12,870,155 in FY 2007-08 to *negative* \$1,897,288 in FY 2010-11.

Table 1.8
Four Year Comparison of VMUS Actual Revenues and Expenditures

Fiscal Year	Revenues	Expenditures	Operating Surplus/(Deficit)
FY 2007-08	\$5,660,317	\$18,530,472	\$(12,870,155)
FY 2008-09	6,175,912	14,430,543	(8,254,631)
FY 2009-10	5,963,060	11,028,476	(5,065,416)
FY 2010-11	9,627,295	11,524,583	(1,897,288)
4-Year Average	\$6,856,646	\$13,878,519	\$(7,021,873)

Source: City of Victorville Financial Statements

Chart 1.3
Four-Year Comparison of VMUS Operating Surplus/(Deficit)



Source: City of Victorville Financial Statements

The operating deficits in FY 2007-08 through FY 2009-10 are a result of the City’s attempt to self-generate power through the construction of the Foxborough power plant, as well as the purchase and operation of gas fired generators. However, these attempts to make a profit from self-generated power failed in that the cost to construct and/or maintain the power generation exceeded expected revenues. The Foxborough power plant is further discussed in Section 3 of this report.

The Victorville Municipal Utility Services has since changed its business model and continues to incur expenses and receive revenue by buying power through power purchase agreements and reselling the power to tenants at the airport or industrial customers at the Foxborough Industrial Park. As a result, the operating deficit of VMUS has decreased over several years. Because the City is already providing power to these customers, VMUS should continue to operate, but closely monitor its programs and expenditures to generate an annual surplus and build up reserve funds. At the same time, VMUS should avoid any future plans to self-generate power, given its current debt obligations.

Insolvency

Despite the trend of decreasing operational deficits, VMUS remains insolvent due to significant debt. Table 1.9 below illustrates that as of June 30, 2011, VMUS had assets of \$31,978,746 and liabilities of \$107,966,697, resulting in *negative* net assets of \$75,987,951.

Table 1.9
Four-Year Comparison of VMUS Assets and Liabilities

Fiscal Year	Assets	Liabilities	Fund Balance
FY 2007-08	\$45,156,593	\$109,491,132	\$(64,334,539)
FY 2008-09	33,187,052	108,788,754	(75,601,702)
FY 2009-10	29,648,775	108,153,500	(78,504,725)
FY 2010-11	31,978,746	107,966,697	(75,987,951)
4-Year Average	\$34,992,792	\$108,600,021	\$(73,607,229)

Source: City of Victorville Financial Statements

The majority of debt for VMUS is due to 2007 Variable Rate Lease Revenue Bonds totaling \$83,770,000, the balance of which was \$83,470,000 as of June 30, 2011. The proceeds from the bond were used to liquidate earlier bonds in the amount of \$41 million and \$23 million, which were used to acquire generators and other equipment for installation at the Southern California Logistics Airport and the Foxborough Industrial Park.

The financing agreements for the bonds contain specific conditions that may constitute a default under the agreements, which include:

- Failure to submit annual financial statements;
- Failure to pay debt in excess of \$1 million;
- Deterioration in the financial condition of the City that would have a material adverse impact on the ability of the City to pay the lease amounts; and,
- Failure to obtain an unqualified opinion from the City's external CPA firm on the City's financial statements.

Unless cured or waived by BNP, Paribas (BNP), the institution that the City has the financing agreements with, any of these conditions would constitute a default. BNP would then have an ability to pursue any remedy permitted by law.

Finally, because VMUS has been operating at a deficit, the enterprise has had to execute two inter-fund loans from the Victorville Water District to pay for capital improvements, general administrative and operating expenditures. The balance of these loans was \$22,108,568 as of June 30, 2011 and is further discussed in Section 2 of this report.

Similar to SCLAA, VMUS should further reduce expenditures and increase revenues in order to begin building its fund reserve, reduce the need for inter-fund loans, and have an additional source of revenue to make debt service payments.

City Golf Course

The City once owned two golf courses, Green Tree and Westwinds golf courses. However, in FY 2011-12 the City closed down the Westwinds golf course to increase savings to the City and eliminate the annual General Fund subsidy to support golf course operations. Though the City has made efforts to improve the financial condition of the Golf Course, recent financial statements show little impact.

Operating Deficit

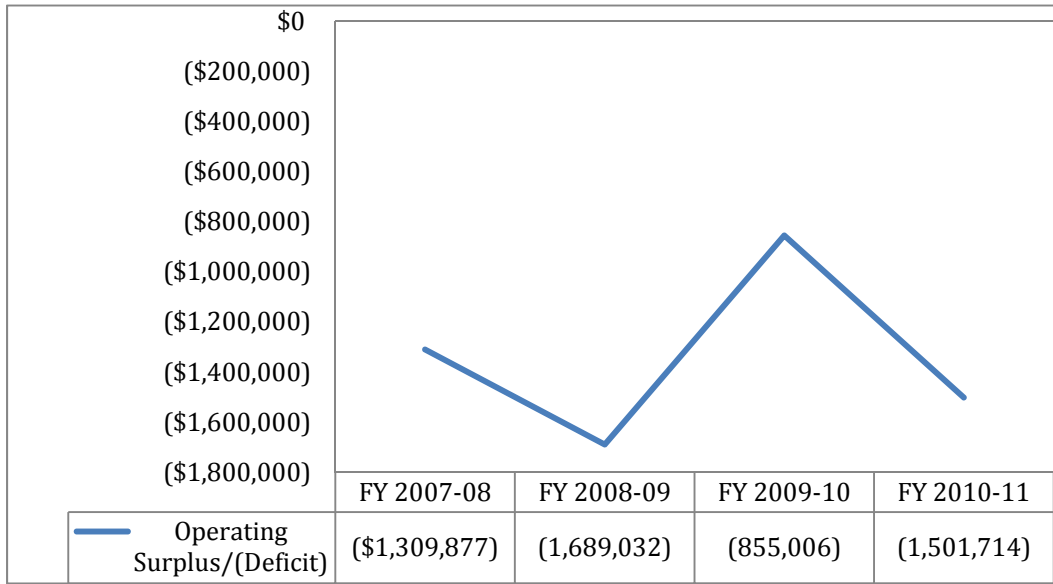
Over the past four fiscal years, the City Golf enterprise has had an average operating deficit of \$1,338,907, as shown in Table 1.10 and Chart 1.4 below.

Table 1.10
Four Year Comparison of City Golf Course
Actual Revenues and Expenditures

Fiscal Year	Revenues	Expenditures	Operating Surplus/(Deficit)
FY 2007-08	\$1,310,864	\$2,620,741	\$(1,309,877)
FY 2008-09	1,193,451	2,882,483	(1,689,032)
FY 2009-10	1,159,914	2,014,920	(855,006)
FY 2010-11	1,022,540	2,524,254	(1,501,714)
4-Year Average	\$1,171,692	\$2,510,600	\$(1,338,907)

Source: City of Victorville Financial Statements

Chart 1.4
Four-Year Comparison of City Golf Course Operating Surplus/(Deficit)



Source: City of Victorville Financial Statements

According to City Management, the golf courses had never been profitable, and for years, the General Fund has had to transfer funds to the golf course enterprise to support operations. These transfers were subsidies to the golf course enterprise, not formal loans, according to City Management. The transfers, shown in Table 1.3 of this report, averaged approximately \$1.3 million per year and are in addition to the inter-fund loans by the golf course enterprise.

In 2010, the City outsourced management of the golf courses, which was estimated to result in a savings of \$658,000 for FY 2010-11, according to the adopted FY 2010-11 budget. However, according to the City’s FY 2010-11 financial statements, there was only a total savings of \$109,479 in personnel services, from \$1,001,325 in personnel services in FY 2009-10 to \$891,846 in FY 2010-11. These savings were \$548,521 less than the estimated savings of \$658,000. Further, expenditures in maintenance and operations in FY 2010-11 increased by \$496,325 from \$565,905 in FY 2009-10 to \$1,062,230 in FY 2010-11. As a result, the operating deficit grew from \$855,006 in FY 2009-10 to \$1,501,714 in FY 2010-11, despite new management

The City should explore further reductions in expenditures in the golf course enterprise and increase revenue to eliminate its operating deficit. Options may include selling the golf course, shutting down the golf course, or finding alternative uses for the land.

Impact of Dissolving the Victorville Redevelopment Agency

With the California Supreme Court upholding the passage of Assembly Bill 26 (AB 26), or the dissolution of redevelopment agencies, the City of Victorville assumed the role of Successor Agency for the now dissolved Victorville Redevelopment Agency (VVRDA). As such, the City of Victorville, in its role as successor agency, is obligated to pay the VVRDA's enforceable obligations,⁸ including outstanding bond debt, as well as assume responsibility of collecting funds from other entities that borrowed money from the VVRDA.

Tax Increment Changes and Role of Successor Agency

Whereas redevelopment agencies' share of tax increment funds used to be deposited directly with the redevelopment agencies prior to AB 26, tax increment is now deposited into a Redevelopment Property Tax Trust Fund (Trust Fund), controlled by the County Auditor. The tax increment funds are then distributed by the County Auditor according to a priority distribution in the following order (the first being the top priority):

- (1) Pass-through payment obligations that existed prior to January 1, 2011, including payment obligations to a county, city, special district, schools, county education offices, and community colleges;
- (2) Payments listed in the Recognized Obligation Payments Schedule (ROPS),⁹ with the priority being for debt service for Tax Allocation Bonds;
- (3) Administrative costs;¹⁰ and,

⁸ Enforceable obligations are defined by the California Health and Safety Code, Section 34171 as (1) bonds, including the required debt service, reserve set-asides, and any other payments required under the indenture or similar documents governing the issuance of the outstanding bonds; (2) loan of moneys borrowed by the redevelopment agency for a lawful purpose, to the extent they are legally required to be repaid pursuant to a repayment schedule or other mandatory loan terms; (3) payments required by the federal government, preexisting obligations to the state or obligations imposed by state law, or legally enforceable payments required in connection with the agencies' employees; (4) judgments or settlements; (5) legally binding and enforceable agreement or contracts; (6) contracts or agreements necessary for the administration or operation of the Successor Agency; and (7) amounts borrowed from or payments owing to the Low and Moderate Income Housing Fund of a redevelopment agency, which had been deferred as of February 1, 2012.

⁹ A Recognized Obligation Payment Schedule is defined by the California Health and Safety Code, Section 34171 as the document setting forth the minimum payment amounts and due dates of payments required by enforceable obligations for each six-month fiscal period (with the first six-month fiscal period being from January 1, 2012 through June 30, 2012).

¹⁰ Per California Health and Safety Code, Section 34171, administrative costs consist of those incurred by (a) the Successor Agency and (b) the State Controller for audit and oversight functions. The administrative costs of the Successor Agency is a minimum of \$250,000 and a maximum of five percent of the property tax allocated to the Successor Agency in FY 2011-12, and three percent of the property tax allocated to the Redevelopment Obligation Retirement Fund money that is allocated to the Successor Agency for each subsequent fiscal year.

- (4) Any residual balance in the Trust Fund is then redistributed to any county, cities, special districts, schools, county education offices, and community colleges that were impacted by the creation, and now dissolution, of the redevelopment agency.

In accordance with AB 26, the City of Victorville now has control of the former VVRDA's assets and liabilities and must now dispose of the assets and meet all of VVRDA's payment obligations. Proceeds from the City's disposal of assets would be deposited into the Trust Fund controlled by the County Auditor and then distributed according to the priority distribution listed above. The City receives allocated tax increment from the County Auditor and makes the actual payments to the obligations listed in the ROPS.

Recognized Obligations

The City was required to submit a draft Recognized Obligation Payment Schedule (ROPS) to the County Auditor by March 1, 2012. There are three main categories of debt and obligations included in the City's ROPS which are eligible for payment through tax increment funds. In order of payment priority, these categories are:

- Debt obligation from Tax Allocation Bonds issued under the former VVRDA;
- Debt obligation from SCLAA issued bonds because tax increment designated for VVRDA were pledged to repay several of the bonds when they were first issued;
- Third party contracts and agreements, including inter-fund loans, and,
- Administrative costs associated with operating the Successor Agency, such as salaries for personnel.

However, if there is insufficient tax increment to meet these payment obligations, the City, as Successor Agency, would be required to meet these obligations through the use of reserve funds or inter-fund loans. This provision of the law has been upheld by the California Supreme Court.

According to the City's financial statements, the principal balance of Tax Allocation Bonds issued under the former VVRDA was \$42,395,000 as of June 30, 2011. Based on an analysis of VVRDA's receipt of tax increment and debt service payments over the last four fiscal years, the City should still be able to receive sufficient tax increment funds to make debt service payments for the VVRDA bonds. As shown in Table 1.11 below, the City had an average surplus of \$4,861,822 in tax increment over the past four fiscal years after debt service payments were made, though tax increment has steadily decreased.

Table 1.11
Four Year Comparison of VVRDA Tax Increment and
Debt Service Payments

Fiscal Year	Tax Increment	Debt Service			Surplus
		Principal	Interest	Total Debt	
FY 2007-08	\$9,635,117	\$780,000	\$2,644,204	\$3,424,204	\$6,210,913
FY 2008-09	8,291,658	815,000	2,545,864	3,360,864	4,930,794
FY 2009-10	8,364,404	850,000	2,435,851	3,285,851	5,078,553
FY 2010-11	6,523,217	885,000	2,411,189	3,296,189	3,227,028
4-Year Average	\$8,203,599	\$832,500	\$2,509,277	\$3,341,777	\$4,861,822

Source: Victorville Redevelopment Agency Financial Statements

According to the City's financial statements outstanding principal debt obligations from SCLAA issued bonds was \$330,173,644 (not including the unamortized discount) as of June 30, 2011. However, City management estimates that total debt for SCLAA bonds is \$829,187,009, which includes estimated principal and interest payments. As previously discussed in this report, there has not been sufficient pledged revenue, or tax increment, to cover SCLAA's debt service payments, and SCLAA has had to rely on its reserves with its fiscal agent and go into temporary default.

If the surplus funds available after payment of the VVRDA's loans, as illustrated in Table 1.11, are *not* sufficient to bridge the gap between pledged revenue and debt service payments for the SCLAA bonds, then the City is at risk for having insufficient tax increment funds to make payments to all other obligations listed on the ROPS. As such, the City's General Fund may have to subsidize the third party obligations listed on the ROPS and administrative costs associated with being the VVRDA's Successor Agency. This provision of the law has also been upheld by the California Supreme Court. As previously illustrated in this section, the Fund Balance and cash reserve for the General Fund is severely depleted and may not be in the condition to make such payments.

Inter-fund Loans

As shown in Table 1.6 above, the SCLAA had a balance of \$11,830,132 in unpaid inter-fund loans from VVRDA funds. Additionally, various VVRDA funds borrowed funds from the Low and Moderate Income Housing (LMIH) Fund of VVRDA. The outstanding balance owed to the LMIH Fund as of June 30, 2011 was \$9,813,531. Should these inter-fund loans be repaid back to the Successor Agency, the repayment of the loans would be considered assets and deposited into the Trust Fund. The funds would then be distributed for obligations in the following priority: (1) bond indebtedness, (2) third party obligations, (3) administrative costs, and (4) residual balance to other entities impacted by tax increment such as the County, cities, special districts, schools, county education offices, and community colleges. However, repayment of these inter-fund loans

prior to the end of the loan term is highly questionable, given the financial condition of SCLAA and the possible shortage of tax increment funding for obligations other than bond indebtedness.

Conclusions

An analysis of the City of Victorville financial statements, as well as those of the agencies for which the City has fiduciary responsibility, reveal that the City's solvency, capacity to provide current services, and ability to repay large debt obligations is a growing concern. As of June 30, 2011, the General Fund balance was \$3,103,630, which was \$4,978,874 or 61.6 percent less than the Government Finance Officers Association's target reserve level of \$8,082,504, or two months reserve based on annual expenditures in FY 2010-11. A General Fund balance of that level exposes the General Fund to the risk of not being able to meet cash flow requirements, economic uncertainties, or other financial hardships.

The General Fund balance has been depleted over the years as the result of several fiscal years when expenditures have exceeded revenues, leading to an operating deficit and a need to use reserves to meet expenditure obligations. Additionally, the General Fund has loaned or transferred money to other City funds, in the form of subsidies, to support the operations of other entities that receive the majority of funding from restricted sources.

The financial conditions of the Southern California Logistics Airport Authority, Victorville Municipal Utility Services, and City Golf Course are similarly weakened by operating deficits. More importantly, the financial conditions of SCLAA and VMUS are threatened by excessive debt and an inability to make debt service payments due to insufficient revenue and fund balance reserves. The General Fund's risk exposure is increased due to a potential need to absorb VMUS liabilities and obligations. Additionally, SCLAA, has already defaulted on a debt payment. While the General Fund is not obligated to pay SCLAA's bond indebtedness, the General Fund has supported SCLAA through advances to cover year-end negative cash balances. The City Manager has indicated that additional short term borrowing may be necessary at the end of the current fiscal year to again cover negative cash balances. The repeated use of advances on annual financial statements points to a serious cash flow problem. Further, a cycle of borrowing and repaying these short-term advances can also be interpreted as a mechanism for creating longer-term debt, while complying with the technical requirements of repaying the advances within the shorter one-year timeframe.

With the dissolution of the Victorville Redevelopment Agency and the City's assumption of VVRDA's assets and liabilities as the Successor Agency, the City's General Fund is further exposed to additional risk of having to absorb, but not being able to meet VVRDA's financial obligations. These obligations include bond indebtedness, payments to third party contractors, inter-fund loans and administrative costs associated with operating as the Successor Agency. Although the City will receive some amount of tax increment funds to meet these obligations, historical analysis suggest ongoing risk exposure, since the General Fund will likely be required to absorb obligations not being met by the tax increment.

Recommendations

The Victorville City Council should:

- 1.1. Develop a plan to replenish the General Fund reserves to the Government Finance Officers Association's recommended level of two months annual revenue or expenditures. This plan should include further reductions in expenditures, identification of additional sources of revenue, earmarking income from major sources of revenues as the economy improves, and avoiding additional inter-fund loans and transfers from the General Fund to other City funds.
- 1.2. Direct the Southern California Logistics Airport Authority and Victorville Municipal Utility Services to further reduce expenditures and increase revenues in order to begin building its fund reserve, reduce the need for inter-fund loans, and have an additional source of revenue to make debt service payments.
- 1.3. Direct the Victorville Municipal Utility Services to closely monitor its programs for utility services and avoid any further attempts to self-generate power.
- 1.4. Direct the City Manager to further reduce expenditures and increase revenues for the golf course enterprise to reverse its operating deficit and eliminate its need for inter-fund loans and transfers. The City Council should also consider various alternatives to the continued operation or disposition of the Green Tree golf course.

Costs and Benefits

Identifying further reductions in City expenditures and identifying other ways to replenish the fund balances and reserves of various City funds, including the General Fund, could result in a reduction in staffing and services while improving the City's financial condition and ability to repay large debt could reduce the risk of costly bankruptcy proceedings.

2. Inter-fund Loans and Use of Restricted Funds

- **Despite repeated recommendations from independent auditors and members of City management as early as February of 2009, the City of Victorville did not adopt a formal Inter-fund Loan policy until May 3, 2011. The adopted policy contains significant weaknesses, including the lack of guidelines and required analysis to determine: (1) the borrowing and lending funds' solvency; (2) timeframes for analysis and approval prior to June 30 of each fiscal year to prevent backdating of loans; and, (3) financial planning and monitoring of the repayment of the loans. Without such guidelines, approval of inter-fund loans could weaken the financial condition of lending funds, result in permanent contributions from the lending fund to the borrowing funds, and complicate or misrepresent the financial condition of all funds involved.**
- **As of June 30, 2011, the City had at least \$69.7 million in outstanding inter-fund loans. A review of these loans demonstrates that a majority of the borrowing funds have not made any repayment toward the loans, and internal controls are not formalized to ensure repayment. Additionally, \$38.1 million, or 54.7 percent of the borrowed funds were provided to the Southern California Logistics Airport Authority (SCLAA) or the Victorville Municipal Utility Services (VMUS), two entities with significant debt obligations, structural cash flow difficulties, and revenue concerns. The ability of these two entities to repay the inter-fund loans is highly questionable.**
- **The California Constitution imposes restrictions on the use of fees imposed for water delivery, sewer services, and garbage collection. Specifically, revenue from property related fees or charges should not exceed the amount required to provide such services, or be used for any purpose other than what the fee or charge is intended. The Constitution does not prohibit investments or short-term loans from restricted funds. However, given that the financial condition of VMUS makes it likely that the \$22.1 million in outstanding inter-fund loans from the Victorville Water District (VWD) could go unpaid, making it a permanent contribution to VMUS operations, then the City is at risk of violating the Constitution. Notably, the City Manager asserts that the City will use approximately \$45 million of \$52 million in judgment proceeds from a suit against a prior engineering contractor to repay the loans.**
- **In September 2008, the Local Agency Formation Commission (LAFCO) adopted a resolution to dissolve the Sanitary District and designate the City of Victorville as the Successor Agency. Subsequent to the dissolution, the City transferred \$15 million in property tax revenue from the Sanitary District to the General Fund. To date, the City has not provided sufficient documentation for the reason why only \$15.0 million of the \$17.8 million in property tax revenue was transferred to the General Fund. More importantly, however, the transfer of such funds violates the conditions set forth in the LAFCO resolution, which states that all Sanitary District funds shall be maintained in a separate enterprise account. Additionally, use of the property tax revenue for purposes other than for Sanitary District services would also be in direct violation of the California Constitution.**

Inter-fund Loan Policy Adopted, but Contains Weaknesses

According to City management, the City has been engaging in inter-fund loans when various funds draw a negative cash balance, or expenditures exceed cash on hand, for several years. Despite recommendations from several parties to formalize these inter-fund loans through loan documents, the City has inconsistently formalized loan documents for inter-fund loans. Additionally, it is not clear what standards and criteria the City has used to guide its inter-fund loans until a policy was adopted by the City Council on May 3, 2011. Improvements should be made to the Inter-fund Loan Policy to ensure that inter-fund loans do not: (a) significantly weaken the financial condition of a lending fund and its ability to pay obligations; (b) become a permanent contribution to the borrowing fund; or, (c) misrepresent the financial condition of all funds involved.

City was Slow to Adopt Inter-fund Loan Policy

In February 2009, Caporicci and Larson, the independent auditors for the 2007 financial statements, recommended that formal agreements should be obtained between funds providing and borrowing cash. In May and June of 2009, the former Director of Finance submitted a draft and a revised draft of an Inter-fund Loan Policy to City management. The former Director of Finance recommended approval by the City Council prior to June 30, 2009, in anticipation of inter-fund loans that were proposed to be a part of Fiscal Year (FY) 2008-09. Current City management reports that they do not know why the Inter-fund Loan Policy was never adopted in 2009 under the former City Manager, though several members of the existing City management were recipients of the draft Inter-fund Loan Policy.

In its audit of the 2008 financial statements, Mayer Hoffman McCann P.C. also recommended that the City formally approve and document inter-fund loans that were approved as long-term advances between funds. As a result, the City approved formal loan documentation for two inter-fund loans on September 15, 2009: loans between (1) the Victorville Water District and VMUS, and (2) the Victorville Redevelopment Agency and SCLAA, which are discussed later in this Section of the report. Subsequent to the auditors' recommendations, several inter-fund loans have been formalized, while others have not. This is also further discussed later in this Section.

Since the draft Inter-fund Loan Policy submitted to City management in 2009 was never adopted, it is not clear what criteria and guidelines were used to identify lending agencies and repayment terms of the loans approved prior to May 3, 2011, when the City Council adopted its current Inter-fund Loan Policy.

Vague Inter-fund Loan Policy

The Inter-fund Policy states that loan documents in the form of a Promissory Note must be prepared by the City Attorney and approved by the City Council when the following conditions are met:

- A fund has insufficient cash in the bank to pay for incurred expenditures, or has a cash shortfall;
- Temporary borrowing of funds from another fund is needed to meet expenditure requirements prior to the close of the fiscal year; and,
- The loan or advance of funds cannot be repaid in the current fiscal year, but will be repaid within five years.

Financial Analysis Prior to Loan Documentation

The existing policy only vaguely states that a periodic analysis is done to identify a fund that has significant expenditures that cause the borrowing need and that a proposed lending fund is identified. According to City management, the periodic analysis is currently a quarterly report on cash balances prepared by the Finance Department and presented to the City Council, though the goal is to make the reports monthly.

However, the Inter-fund Loan Policy does not provide guidelines nor require an analysis of the borrowing and lending funds' solvency, or ability to pay obligations. For example, if the lending fund is in a poor financial condition, then the lending fund may not have sufficient funds to pay for salaries, operations, or debt service after providing funds to the borrowing fund. Similarly, if the borrowing fund is in a poor financial condition and is unable to repay the debt within the terms set for the inter-fund loan, the inter-fund loan could become a permanent contribution to the borrowing fund. In certain circumstances, as discussed in more detail later in this section, this would be a violation of the California Constitution.

The Inter-fund Loan Policy should be revised to include an analysis of the financial condition of each fund involved in the inter-fund loan. To the extent possible, only funds in a relatively stable financial condition should be included in the inter-fund loan. Key factors to review for determining each fund's ability to continue to pay obligations such as the cost of ongoing operations; principal and interest payments for long-term debt, whether it's commercial debt or inter-fund loans; and other legal obligations specified in agreements or contracts with third parties, include:

- **Annual revenues and expenditures:** do revenues match or exceed annual expenditures, or is the fund consistently spending more money than it receives, resulting in the use of reserve funds or reliance of inter-fund loans to address cash shortfalls;
- **Annual assets and liabilities:** does the fund have so much debt that its total liabilities annually exceed its assets, indicating that the fund may have obligations with a higher priority of repayment than an inter-fund loan, such as bonded indebtedness; and,
- **Potential sources of revenue:** will the fund see a predictable increase in revenue, such as an increase in property, sales and franchise taxes with a rebounding economy; additional rent revenue from existing and/or new airport tenants; increases in user fees and charges; or significant proceeds from the sale of property or other assets?

Clear and Reasonable Timeframe for Analysis and Approval

According to the staff report to the City Council when the Inter-fund Loan Policy was approved, a promissory note will be submitted for approval to the City Council prior to the close of the books for any given fiscal year. Therefore, the promissory note could be submitted for approval two to three months after the end of the fiscal year because revenue collection still occurs after June 30, the last day of the previous fiscal year. In other words, the existing Inter-fund Policy permits the backdating of inter-fund loans.

The backdating of inter-fund loans, generally, is not fiscally prudent and should be avoided except in unique circumstances. Approving an inter-fund loan months after determining a need to enter into one to close cash shortfalls identified on June 30 of the fiscal year, and then backdating that loan, is like taking a car home from a dealership, then waiting to receive additional commission or a raise in the next couple of months before returning to get approval for a loan to pay for the car. With adequate tools such as financial reports on cash balances, expected revenue and projected expenditures, the City should be able to determine an appropriate amount for a loan and approve the loan prior to June 30 of the fiscal year. Should revenues collected after June 30 be more than expected, then the borrowing fund could repay the inter-fund loan more quickly.

Financial Planning and Monitoring of Repayment

Although the Inter-fund Loan Policy makes some reference to repayment terms, City management has reported that it currently does not have any internal controls to ensure that the borrowing fund meets the repayment terms specified in the loan documents. The policy only states that the loan documents should include: (a) the maturity date on which all principal together with all accrued and unpaid interest will be due and payable; (b) an applicable interest rate; and, (c) that the borrowing fund has a right to make full prepayment at any time without penalty. However, according to the Government Finance Officers Association (GFOA), prudent measures should include documentation of a financial plan reflecting a repayment schedule.

To prevent inter-fund loans from becoming permanent contributions or transfers to the borrowing fund, the City should include financial plans in its loan documentation for approval by the City Council. The financial plans could include specific amounts in the repayment schedule, starting with low payment amounts and then increasing throughout the term of the inter-fund loan. Alternatively, financial plans could specify that a percentage of surplus revenue at the end of every year in the term of the loan should be made toward the payment of the loan, with the total balance due by the maturity date. The financial plan could also document any anticipated increases in revenue, such as the completion of revenue generating projects, or the sale of assets.

At a minimum, City management should be monitoring a borrowing fund's ability to make payments throughout the term of the loan. City management reports that during the budget process, the Finance Department conducts an informal analysis of surplus funds that could be used to pay off some of the inter-fund loan. This process should be formalized and tied to any financial plans included in loan documentation.

Outstanding Inter-fund Loans Exceed \$69 Million

As shown in Table 2.1 below, the City had at least \$69,666,316 in outstanding inter-fund loans as of June 30, 2011, including original loan amounts and accrued interest. The inter-fund loans included in Table 2.1 are those transactions included in the City's FY 2010-11 financial statements as "Advances to/other funds," which should have had loan documentation executed by June 30, 2011. Note that all of the loans below were executed on or after June 30, 2009 because, according to City management, this is when the City began to formalize inter-fund loans from one entity to another in response to independent auditors' feedback.

Table 2.1
Inter-fund Loans for the City of Victorville as of June 30, 2011

Borrowing Fund¹	Lending Fund	Original Amount	Date of Loan	Balance as of 6/30/11	Purpose
SCLAA	RDA - Project Area Bear Valley	\$10,000,000	9/15/2009	\$10,114,922	Redevelopment activities on SCLA, ² such as the fuel farm
SCLAA	RDA - Low and Moderate Housing	1,700,000	10/20/2009	1,715,210	Redevelopment activities on SCLA, prior years' capital improvements, and project expenses
SCLAA	General Fund	2,314,851 ³	6/30/2011	2,314,851	Inter-fund borrowing due to negative cash balances
SCLAA	VMUS	1,230,671	6/30/2011	1,230,671	Inter-fund borrowing due to negative cash balances
SCLAA	Wastewater Enterprise Fund	589,949	6/30/2011	589,949	Inter-fund borrowing due to negative cash balances
Subtotal for SCLAA		15,835,471		15,965,603	
VMUS	VWD	20,000,000	6/30/2009	20,229,844	Capital improvements, general administrative and operating expenditures from prior years
VMUS	VWD	2,700,000	11/09/2009	1,878,724	Capital improvements, general administrative and operating expenditures from prior years
Subtotal for VMUS		22,700,000		22,108,568	
RDA - Low and Moderate Housing	SCLAA	6,906,148	7/21/2009	6,978,386	Land acquisitions associated with the Old Town Project Area
VWD	SCLAA	20,000,000	7/23/2009	22,711,781	Wastewater Treatment Facility on SCLA
General Fund /Development Impact Fund	SCLAA	1,895,090	9/21/2010	1,901,978	Land acquisitions associated with the public library
Total		\$67,336,709		\$69,666,316	

Source: City of Victorville Financial Statements

¹ Borrowing/lending funds include: Southern California Logistics Airport Authority (SCLAA), Victorville Redevelopment Agency (RDA), Municipal Utility Services (VMUS), and Victorville Water District (VWD).

² Southern California Logistics Airport (SCLA) is the physical airport property.

³ The City Manager had stated that these funds were provided to SCLAA as "a short term advance" and have since been repaid. The City Manager has further stated that this amount "may exist again at the end of this fiscal year."

Table 2.1 does not include inter-fund loans made between the Low and Moderate Income Housing Fund and other Victorville Redevelopment Agency (RDA) funds. The balance of inter-fund loans within the RDA was an additional \$9,813,531 as of June 30, 2011.

Terms and Repayment

With a few exceptions, the inter-fund loans listed in Table 2.1 have a term of five years and have an interest rate equivalent to the Local Agency Investment Fund (LAIF) rate of return. As of December 2011, the LAIF rate of return was 0.38 percent. These terms and interest rates appear to be consistent with the City's inter-fund loan policy, which requires repayment within five years and at an appropriate interest rate.

Unlike the other inter-fund loans, the inter-fund loan between the Victorville Water District (VWD) and SCLAA for \$20,000,000 was originally for a two year term with a seven percent interest rate. According to City management, the loan was originally set for two years because the City anticipated funds from the EB-5 program, which would have secured foreign investor money for planned development projects. However, after the EB-5 program was terminated, the City requested an extension of the inter-fund loan between VWD and SCLAA to five years. Additionally, the interest rate for this loan is seven percent, because the source of funds for the loan is unencumbered funds from SCLAA Housing bonds, which, according to the indenture, must be set at a market rate interest rate.

Based on internal work papers provided by City management, most of the borrowing funds have yet to make a single payment toward the repayment of the inter-fund loans. However, there was a payment made from VMUS to the VWD and the outstanding balance is now \$1,878,724, as of June 30, 2011. It is not clear why payment installments were not made on both outstanding inter-fund loans between VMUS and VWD. As previously mentioned, City management does not have any formal internal controls to ensure that the inter-fund loans are repaid within five years.

Financial Condition of Borrowing and Lending Funds

As previously discussed, an adequate inter-fund loan policy should include an analysis of the financial condition of the borrowing and lending funds. A review of the annual revenues, expenditures, assets, liabilities, and potential sources of revenue for the borrowing funds listed in Table 2.1 suggest that SCLAA, VMUS, and the General Fund may have insufficient financial capacity to repay the inter-fund loans within the terms of the loans. Additionally, SCLAA and VMUS have significant bonded indebtedness, which have a higher priority of repayment based on conditions established in the bond indentures, including penalties if the borrowing entities miss scheduled payments or default on other debt obligations. The financial condition of SCLAA, VMUS, and the General Fund are further discussed in Section 1 of this report.

Three of the inter-fund loans listed above, between SCLAA and other funds, do not have any formal loan documentation. According to City management, appropriate lending funds still need to be identified prior to requesting approval from City Council, because the current funds listed in the financial statements—the General Fund, VMUS, and Wastewater Enterprise Fund – are in a weak financial state.

Backdating of Loans

The inter-fund loans made to SCLAA from VMUS and the Wastewater Enterprise Fund⁴ in 2011, which have still not received City Council approval as of the date of this report, are examples of inter-fund loans that will be backdated, or approved, after they first appear in the City’s accounting records or audited financial statements. As previously noted, the Inter-fund Loan Policy allows City management to submit loan documentation two to three months after the end of the fiscal year because revenue collection still occurs past June 30, otherwise known as backdating loans. However, the suggested timeframe for backdating loans has significantly passed. As discussed in Section 1 of this report, the City should identify lending funds and formalize loan documentation as soon as possible.

As shown in Table 2.2, there have been other instances where inter-fund loans are first mentioned in the financial statements, but are not presented to City Council for consideration until months after the date of the loan.

Table 2.2
Backdated Inter-fund Loans for the City of Victorville

Borrowing Fund	Lending Fund	Original Amount	Date First Appeared, or Referenced in Financial Statement	Date on Promissory Note, or City Council Approval
SCLAA	RDA	\$10,000,000	6/30/2009	9/15/2009
VMUS	VWD	20,000,000	6/30/2009	9/15/2009
VMUS	VWD	2,700,000	4/13/2009	11/9/2009

Source: City of Victorville Financial Statements

In addition, the City has noted one lending fund and amount in its financial statements, but then approved a different lending fund or amount in backdated loans. For instance, the FY 2009-10 financial statement notes that \$5,073,220 was loaned from the General Fund to the Golf Course fund. However, when documentation of the inter-fund loan was requested, City management provided documentation of the approval of \$6,335,780 in total funds loaned to the Golf Course fund from the Solid Waste Management Fund (\$2,300,000), Source Reduction and Recycling Fund (\$2,935,780), and Landfill Mitigation Fund and (\$1,100,000).

According to City management, the amount included in the loan document for the inter-fund loans to the Golf Course fund will not reconcile with the figures in the financial statement because the advances were “simply used to document positive balance coverage of negative balances.” In other words, the amount documented in the audited financial statements represents the amount needed at the close of the fiscal year. However, as time passes between June 30 of a

⁴ As previously mentioned, the City Manager has stated that the \$2.3 million advance from the General Fund has been repaid, but may appear again at the end of the current fiscal year.