



THE CITY OF SAN DIEGO

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**OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT**

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# **Consideration of General Fund Reserve Excess Equity Proposal and Enterprise Funds Reserve Policies**

## **OVERVIEW**

At the Budget and Government Efficiency Committee meeting of May 22, 2014, Financial Management Department staff presented new proposed language for the General Fund Reserve Policy to clarify the use of excess equity and revisions to Enterprise Fund reserves (Water, Wastewater, Refuse Disposal and Recycling, and Development Services) and a new reserve policy for the Golf Enterprise Fund. The Committee approved the motion to forward the revised Reserve Policy to City Council without a recommendation and requesting staff to:

1. Revise the General Fund Reserve Policy to require the Mayor to identify the amount of excess equity as part of the Quarterly Budget Monitoring Reports;  
and
2. Bring forward clarification on the replenishment language and consider additional explanatory language on the Enterprise Fund Reserve Policies as discussed by the IBA.

Additionally, the Committee requested that the Mayor's Office return as quickly as possible with any recommended revisions to the City of San Diego Municipal Code based on these proposed changes to the Reserve Policy (specifically in relation to any changes to the Municipal Code based on the removal of language in the Reserve Policy in regards to the Dedicated Reserve for Efficiency and Savings, or DRES, from the Water and Wastewater Departments).

Our Office's review of the proposed Reserve Policy prior to the Budget and Government Efficiency Committee meeting is included below. The topics outlined by our Office in this report were discussed at Committee and served as the basis for the requests listed above. In reviewing the changes made to the proposed Reserve Policy in response to Committee's request,

we believe the Reserve Policy appropriately addresses our Office's key recommendations and the Budget and Government Efficiency Committee's requests.

## FISCAL/POLICY DISCUSSION

### General Fund Reserve Excess Equity Proposal

Excess fund balance remaining at year-end, after accounting for all proposed expenditures, any re-budgeted items for the upcoming fiscal year, and the required reserve of 14% of General Fund revenues, is defined as excess equity. Excess equity is available for appropriation but is considered a one-time resource. The City's current Reserve Policy does not address how, when or if excess equity can be expended. Absent a policy, the use of an estimated \$14.1 million in excess equity became a focus during the Mid-Year Budget Monitoring Report review when it was recommended the full \$14.1 million be used as a buffer to protect against potential fluctuations in revenues. Our office noted at that time that further Council discussion was warranted and a policy needed to be established regarding future uses of excess equity.

In consideration of our healthy 14% General Fund reserve requirement and the City's typically conservative major revenue estimates, we noted that Council may want to consider alternative one-time uses for excess equity such as increasing funding for the Public Liability or Long-Term Disability reserves (Risk Management Reserves) or committing additional funding to infrastructure needs. During Council's review of the Mid-Year Budget Report on March 4, 2014, Council approved a motion stating that excess equity remaining at FY 2014 year-end is to be used to fund City Risk Management Reserves.

In our recent review of the Mayor's FY 2015 Proposed Budget, we proposed the following language be added to the General Fund Reserve Policy to address this issue:

*"As part of the May revisions, the Mayor will identify the amount of excess equity projected to be available at year-end based on the most recent revenue and expenditure projections and full funding of the 14% General Fund Reserves; and will recommend to the Council one-time uses for the excess equity based on the following priorities: 1) Allocating funding to meet General Fund reserve goal; 2) Allocating funding to the City's infrastructure needs based on project prioritization."*

The Mayor has proposed the following alternative language in the updated Reserve Policy for your consideration, which we support:

*"The Quarterly Budget Monitoring Reports provide an estimate of excess equity based on the projected activity from operations during the fiscal year; however, unrestricted fund balance is not determined until the City closes its books as of June 30. In the May Revision of the annual budget, the Mayor may propose to budget any projected excess equity as a contingency to fund the General Fund Reserves, Risk Management Reserves or for a priority one-time capital need. The transfer would occur after the fiscal year close is completed and the budgeted excess equity amount is determined to be available in fund balance above the 14% General Fund reserves."*

The Mayor's proposed language mirrors the intent of our proposal, however, we recommend one small edification - to add the section as underlined in our proposal above. Similar to how the Mid-Year Budget Authority Ordinance works, the Mayor would be **required** to report the amount of excess equity and **may** make a recommendation for its use but is not required to. If the Mayor makes no recommendation for use of the excess equity, the Council could choose to appropriate none, a portion, or all excess equity in their final budget decisions, regardless of the Mayor's recommendation. Council has full discretion to modify the Mayor's proposal during the budget process, subject to his veto. If the budget including the appropriation of the excess equity were to be vetoed by the Mayor, as provided in the Charter, the Council could override the Mayor's veto with a 2/3 vote.

We recommend approval of the Mayor's addition to the City's General Fund Reserve Policy with our amendment as discussed above.

### **Proposed Revisions to Enterprise Fund Reserve Policies and Addition of New Golf Fund Reserve Policy**

The General Fund Reserves, Public Liability, Workers' Compensation and Long-Term Disability Reserves were previously updated and revised by staff, reviewed by the Budget and Government Efficiency Committee, and approved by the City Council on February 10, 2014. Financial Management is now proposing updates and revisions to four existing Enterprise Fund reserve policies - Water, Wastewater, Refuse Disposal and Recycling, and Development Services (DSD) - as well as adoption of a new Reserve Policy for the Golf Enterprise Fund. While the City established a General Fund Reserve Policy several years ago, it is just in the past few years that similar policies have been adopted for the Enterprise Funds. A sound reserve policy that is transparent and consistently adhered to is as critical to Enterprise operations, which are funded through user fees and other charges to recover the cost of services provided, as it is to the General Fund supported by tax dollars.

We strongly support the City having formal reserve policies for all of the Enterprise Funds, and support the proposed amendments to the existing policies as well as the new policy for the Golf Enterprise Fund, but request future clarification on differences in the proposed Reserve Policy noted in this report. The chart included as Attachment One provides information on each of the proposed Enterprise Fund Reserve Policies relative to type of reserve; purpose; recommended funding level; approval required for use; and replenishment language. As noted in the staff report, in developing these policies each fund was considered independently as each has its own business model and unique operational needs. We discuss below some of the key differences in the proposed reserve policies between the funds for your information.

### **Recommended Funding Level**

The Government Finance Officers Association (GFOA) recommends that "under no circumstances should the target for working capital be less than 45 days worth of annual operating expenses and other working capital needs of the enterprise fund." They further note that "a government should start with a baseline of 90 days worth of working capital and then adjust the target based on the particular characteristics of the Enterprise Fund in question (using 45 days as the minimum acceptable level)."

Per the staff proposal, recommended funding levels for Enterprise Fund **operating reserves** range from 70 days of operating costs for Water and Wastewater; 15% of operating revenues for Refuse; 60 days of operating costs for DSD once 15% of operating costs are reached; and 45 days (or 12% of 3-year average of audited revenues) for Golf. The funding levels differ in their basis (operating costs versus revenues); their calculation (number of operating days versus a percentage of funds); and in the percentages utilized (15% versus 12%). When revenues are used as a basis, the Reserve Policy for the Golf Enterprise Fund utilizes a prior 3-year average while Refuse utilizes one year of revenue. The operating reserve for the various funds also differ in name which can be confusing: “Emergency Operating Reserve” for Water and Wastewater and “Operating Reserve” for Refuse, DSD and Golf.

### Approval for Use

The approval process proposed for use of the **operating reserves** also varies. Water, Wastewater and Golf require a recommendation from the Mayor and approval by a majority of the Council. Refuse and DSD require only Chief Operating Officer (COO) or Chief Financial Officer (CFO) approval, although this is an improvement over the existing Reserve Policy, which requires only department head approval.

### Replenishment Policy

Policies for replenishing reserves, including defining potential revenue sources to look to and timeframes for doing so, are as important as establishing the reserve targets themselves. For the Enterprise Funds, replenishment language is proposed for all of the funds with the exception of the Water and Wastewater **Emergency Capital Reserves** which are each targeted at \$5.0 million annually. The timeframes for replenishment vary significantly among the other funds from “no later than the subsequent fiscal year” for Refuse; “at the earliest opportunity” for DSD; “as promptly as current conditions warrant” for Golf; and “may be done in conjunction with a future Cost of Service Study and rate adjustment” for Water and Wastewater. We would also note that for the City’s General Fund Reserve, there is replenishment language for the Stability Reserve (“to be replenished as promptly as current conditions warrant”) but none for the Emergency Reserve.

## Conclusion and Recommendation

The IBA recommended the following actions to the Budget and Government Efficiency Committee:

1. Approval of the Mayor’s revision to the General Fund Reserve Policy to address the issue of excess equity, including the amendment recommended by the IBA requiring the Mayor to identify the amount of excess equity at the time of the May Revise whether or not he recommends it be used.
2. Forward the staff recommendations to Council for revisions to the Enterprise Fund Reserve Policies for Water, Wastewater, Refuse and Recycling, and DSD and adoption of a new Golf Enterprise Fund Reserve Policy. Prior to returning to Council, request staff to consider the differences among the policies identified in the IBA report and determine whether any changes are warranted or explanatory language should be provided.

As stated previously, these recommendations formed the basis of the Committee's requests. In reviewing the changes made to the proposed Reserve Policy in response to the Committee's requests, we believe the Reserve Policy appropriately addresses our Office's key recommendations and the Budget and Government Efficiency Committee's requests.



Andrea Tevlin  
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Attachments: 1. Revised Reserve Policy Summary - Updated