THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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City of San Diego General Fund Reserve Benchmark and Review

OVERVIEW

Year	Reserve Balance at Beginning of FY	% Of General Fund Revenue *
FY 2007	$ 39.9	3.8%
FY 2008	$ 72.5	6.6%
FY 2009	$ 71.5	6.3%
FY 2010	$ 78.3	7.0%
FY 2011	$ 105.0	9.7%
FY 2012	$ 115.5	9.7%
FY 2013	$ 153.4	13.3%

** FY 07-11 are based on percentage of actual audited revenue, FY 12 is a percent of Charter 39 unaudited actual revenue, and FY 13 is a percent of Adopted Budget*

The City of San Diego's General Fund reserve level has increased significantly as a result of several factors: the City's commitment to achieving the stated policy goal of an 8.0 percent General Fund reserve by FY 2012; implementation of a new policy to eliminate carry-over of funds from fiscal year-to-year; and more recently, dramatic increases in reserves as the affects of the recession that persisted from 2007 to 2010 have begun to gradually recede from the region. However, the affects of the recession, natural disasters, and other unforeseen negative impacts on the City's fiscal condition over the past years have continued to underscore the need to continue to maintain a General Fund reserve level that provides a sufficient hedge against these and other circumstances.

Based on the report titled “Fiscal Year 2012 General Fund Ending Balance and Public Liability Fund” (Report #12-115, issued on September 17, 2012), the City of San Diego’s current un-audited General Fund reserve is $153.4 million or 13.3 percent of budgeted revenue for FY 2013. Based on the City’s established reserve policy of maintaining a minimum of 8.0 percent of General Fund revenues, this is $61.3 million or 5.3 percent above policy levels. However, five percent of this total amount is for the City’s emergency reserve, which was established solely for the purpose of securing City life and property during a catastrophe, and is specifically forbidden to be utilized to mitigate an operating shortfall. Excluding the emergency reserve, the City has approximately $95.8 million in unassigned fund balance which is available to mitigate any potential General Fund deficit, fund one-time expenditures, and maintain reserve policy goals. Additionally, $23.6 million of this amount has been specifically set aside to address the potential impacts from the dissolution of the City’s redevelopment agency.

While the City’s total reserve balance is significantly greater than policy levels, it is important for fiscal planning to determine the following two questions:

- How does the City’s reserve policy compare to similar municipalities and other available guidelines, and should any potential changes be made based on these comparisons?

- What are the potential benefits (credit and otherwise) of increasing, maintaining, or utilizing portions of the current General Fund reserve level?

The following report details information garnered from various sources to illustrate answers to these questions.

COMPARABLE RESERVE POLICY & LEVELS

Establishing Comparable Municipalities & Reserve Levels

To provide additional insight into the City of San Diego’s reserve policy and to determine the relative strength of the City of San Diego’s current reserve level, it is beneficial to create a comparison with similar cities. However, proper comparison of similar level of reserves between cities can be a difficult task due to the different classifications of available financial resources throughout budget monitoring and Comprehensive Annual Financial Reports (CAFR), and due to the implementation of the Governmental Accounting Standards Board (GASB) statement number 54 in FY 2011.

GASB 54 requires the classification of reserves into five separate categories: 1.) non-spendable; 2.) restricted; 3.) committed; 4.) assigned; and 5.) unassigned. Categorization of reserves into each of these five categories among different cities can be based on reserve policy, Mayoral / City Manager action, city charter, and other city council established polices. Depending on what, if any, action has been taken by charter or other city authority to segment a city’s reserves, comparisons between two municipalities GASB based reserve levels is very difficult.

Adding to the difficulty of comparing reserve levels, cities may be required to maintain additional reserves based on services provided to citizens, while cities with a smaller population and General Fund revenue / expenditure size typically also have a higher General Fund reserve balance (as a percentage of General Fund revenues / expenditures) than larger cities. Based on these criteria, an appropriate comparison would be based on cities that are comparable in population, General Fund revenue / appropriation size, and services provided.

Four cities were selected based on similar population size (2010 census information, City of San Diego population of, 1,307,402), services provided, General Fund size, and the requirement that they have established a formal reserve policy. Based on these qualifications, the municipalities that were selected for comparison to the City of San Diego are:

1.) Phoenix, Arizona - population 1,445,632
2.) San Antonio, Texas - population 1,327,407
3.) Dallas, Texas - population 1,197,816
4.) San Jose, California - population 945,942

Comparable Municipalities

($ in millions)

Municipality [1]	General Fund Size [2]	FY 2013 Comparable Reserve Level	% of General Fund Revenue	Reserve Policy Goal	Surplus or (Deficit) from Policy Goal
San Diego	$ 1,151.2	$ 153.4	13.3%	8.0%	$ 61.3
Phoenix, Arizona	$ 1,109.3	$ 35.8	3.2%	5.0%	$ (19.6)
San Antonio, Texas	$ 918.1	$ 109.9	12.0%	9.0%	$ 27.3
Dallas, Texas	$ 1,041.0	$ 83.9	8.1%	5.0%	$ 31.9
San Jose, California	$ 882.4	$ 55.2	6.3%	3.0%	$ 28.7

1 - Read individual municipality descriptions in this section for additional information on each calculation
2 - San Diego FY 13 Adotped Budget, Dallas FY 13 Proposed Budget, Phoenix FY 13 Adopted Budget, San Antonio FY 13 Proposed Budget, San Jose FY 13 Proposed Budget

City of Phoenix

The City of Phoenix's Financial Excellence Strategic Plan, developed in 2012, dictates that the city strive to achieve 5.0 percent of total General Fund expenditures in fund balance within a five year timeframe. The city defines their fund balance as one that "provides for revenue shortfalls and unanticipated costs…. possibility of natural disasters, public or employee safety emergencies or up-front costs for productivity opportunities." Their contingency amount at the end of FY 2012 is $35.8 million (un-audited) or approximately 3.2 percent of FY 2013 projected General Fund revenue. The city has budgeted a contribution in FY 2013 to achieve a 3.7 percent General Fund reserve level based on the same projected General Fund revenue.

The unassigned fund balance for the City of Phoenix is significantly higher than the amount of contingency reserves reflected in their financial statements. Their FY 2011 CAFR reflects approximately $195.0 million in total unassigned fund balance, which is $159.2 million above their contingency reserve level. In discussions with the City of Phoenix Finance Department, they indicated that the overwhelming majority of this additional unassigned fund balance is due to their General Fund inclusion of their self insured public liability and worker's compensation activities, which have significant reserves to ensure sufficient funds to fund their claims experience. We did not include these reserves in our comparison calculations due to the City of San Diego's exclusion of self insured public liability and worker's compensation funds from the General Fund.

City of San Antonio

The City of San Antonio's reserve policy specifies that the city's financial reserve is to be reviewed annually by City Council during their budget adoption process. San Antonio treats their reserves differently than the City of San Diego by budgeting only a portion of their total unassigned fund balance for unforeseen circumstances during the upcoming fiscal year. The city has proposed a reserve policy of 9.0 percent of projected expenditures for FY 2013 (which begins October 1, 2012), equaling $82.6 million. That additional amount of unassigned fund balance above the budgeted amount for FY 2013 is being utilized to balance their FY 2012 projected budget deficit in addition to aiding in mitigating a portion of the projected FY 2013 deficit.

San Antonio's total unassigned fund balance (that is comparable to the City of San Diego's reserve policy) was $170.7 million prior to the beginning of FY 2012. However, based on updated financial projections for the current fiscal year, San Antonio projects a $39.0 million deficit in their General Fund, reducing projected available fund balance to approximately $131.7 million. Based on San Antonio's updated five-year financial outlook (as of May 2012), FY 2013 General Fund operations are projected to end in a $65.8 million deficit. San Antonio has set aside $20.8 million to aid in reducing this projected deficit and $1.0 million for additional set-asides, which in turn reduces total projected available fund balance to $109.9 million ($82.6 million of which is budgeted as reserves for the upcoming fiscal year) or 12.0 percent of proposed General Fund revenues for FY 2013.[1]

City of Dallas

The City of Dallas' Financial Management Performance Criteria requires the unassigned fund balance (including the city's emergency and contingency reserves) be maintained at no less than 5.0 percent of General Fund expenditures. Their unassigned fund balance projected for the end of FY 2012 (which ends September 30, 2012) is $83.9 million or 8.1 percent of proposed General Fund revenues for FY 2013.

City of San Jose

The City of San Jose's General Fund reserve policy is split into four separate categories: 1.) contingency reserve; 2.) cash reserve fund / earmarked reserve; 3.) emergency reserve fund; and 4.) the economic uncertainty reserve. The contingency reserve is set by policy at a minimum of 3.0 percent of the General Fund operating budget, and is established to "meet unexpected circumstances such as a General Fund revenue shortfall." The cash reserve fund / earmarked reserve is established for a "known but unspecified expense", which is not comparable to the

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[1] It should be noted that FY 2013 operating figures for San Antonio are based on projections, but are only a small portion of the projected $65.8 million deficit and therefore projected to be utilized as a resource in their budget proposal for FY 2013. Should this amount be included in reserve calculations, their total reserves as a percent of General Fund revenues would increase to 14.2 percent.

City of San Diego's reserve policy and is excluded from this analysis. The emergency reserve fund directly parallels our emergency reserve, in that it can only be utilized for meeting any public emergency threatening city lives, property, or welfare; however, no minimum percentage or reserve dollar amount is established in the policy. Finally, an economic uncertainty reserve to be utilized in General Fund revenue shortfalls is required to be maintained, but at no specific dollar amount or percentage.

In our analysis of the City of San Jose's reserves, we combined the contingency, economic uncertainty, emergency reserve, and cash reserve funds. With the exception of one, we did not include earmarked funds in the comparison.. San Jose's contingency reserve has a current balance of $29.3 million, which is 3.3 percent of proposed General Fund operating expenditures for FY 2013. This is $2.8 million in excess of their policy established minimum level. The emergency reserve currently has a balance of $3.4 million, while the cash reserve fund has a negligible balance currently. Finally, just as in the City of San Antonio's case, the City of San Jose currently projects a General Fund operating deficit for FY 2014 and has set aside funds specifically for the purpose of aiding in mitigating the entire projected deficit. The total amount of reserves earmarked by the City of San Jose for this purpose is $22.5 million. In combining these four reserves, the total amount of fund balance available to the City of San Jose that is comparable to our General Fund reserves is $55.2 million or 6.3 percent of proposed General Fund revenues for FY 2013.[2]

City of San Diego

As can be seen from the information presented, the City of San Diego's actual available reserve position is higher than the four jurisdictions reviewed and exceeds the City's minimum policy level of 8.0 percent by $61.7 million. Based on comparable jurisdictions' reserve policies, the City of San Diego's 8.0 percent minimum reserve goal is higher than three cities and slightly lower than one. The majority of other cities have also established their reserves to be utilized in a similar manner; where emergency funds are set-aside for specific purposes, but excess funds are for other unanticipated expenditures and to mitigate any operating deficit in the General Fund.

Other Reserve Policy Guidelines

A generally accepted reserve guideline for a municipal General Fund is to continually maintain one to two months of expenditures as fund balance to utilize for any potential purpose. A single month of reserves equals approximately 8.0 percent of General Fund appropriations, which equals the City's current policy (though augmented to be a percent of revenues). The Government Finance Officers Association's (GFOA) best practice recommendation moves to the upper end of this guideline with a recommended two months or approximately 16.7 percent of General Fund appropriations. Two months, or 16.7 percent, would be equal to $191.9 million in General Fund reserves for the City of San Diego. It is further stressed by GFOA that any decision on reserves be made in combination with long-range financial planning. A five-year

[2] The reserve to mitigate the projected FY 2014 deficit is included in San Jose's reserve calculation unlike San Antonio's set aside reserve due to the fact that San Jose's set aside is based on forecasts two fiscal years out, which may change dramatically with revenue and expenditure projections and may not be required to be utilized.

forecast may reflect continued General Fund deficit, which may require a city to maintain reserves beyond recommended levels to aid in mitigating this General Fund imbalance.

POTENTIAL EFFECT OF CHANGES IN RESERVES

Credit Rating Review and Impacts

A city's credit rating can create significant financial benefit and can be influenced by their level of unassigned reserves that are available to provide a hedge against any potential financial impact that may jeopardize a bond holder's security. However, a city's credit rating is based on a compilation of factors that are reviewed to determine the overall confidence and perceived aptitude in management's ability to continue fiscal stability and cash flow. Factors that influence a credit rating include the strength and diversity of the local economy, the average income level of citizens, the city's overall debt load, financial management, and management culture, among others. The following table compares the City of San Diego and the four municipalities previously reviewed and their current issuer credit rating from each of the three largest rating agencies.

Municipality	Moody's Rating	S&P Rating	Fitch Rating [1]
San Diego	Aa3 / Stable	AA- / Stable	AA- / Stable
Phoenix, Arizona	Aa1 / Stable	AAA / Stable	-
San Antonio, Texas	Aaa / Negative	AAA / Stable	AAA / Stable
Dallas, Texas	Aa1 / Stable	AA+ / Stable	-
San Jose, California	Aa1 / Stable	AA+ / Negative	AA+ / Stable

1 - Fitch does not cover Phoenix and Dallas

As detailed in the table above, the City of San Diego has a "high grade" credit rating from each rating agency, but is still the lowest credit rating of each municipality reviewed. However, San Diego's credit rating has gradually risen in recent years after significant downgrades during the mid-2000's due to the financial investigations the City was subject to and subsequent delay in financial reporting. In reviewing the rationale associated with each rating review, each agency details very similar rationale for each positive and negative attribute associated with the City of San Diego's current position. The City is consistently lauded for its closely monitored budget, diverse economy, strong management practices, and appropriate debt load; while each agency cautiously points out required pension contributions and State of California budget effects on local revenues as an offsetting weighted factor.

While all three agencies agree that a reduction in reserves could potentially warrant a downgrade of the city's rating, they have different reviews of the comparable adequacy of reserves with other municipalities and our maintenance of a sufficient balance[3]. Fitch Ratings notes in their rationale that the City "continues to demonstrate a commitment to …. General Fund balance and reserves preservation." Standard & Poor's elaborates that San Diego's credit rating is also based

[3] Rating agency information utilized in review would have been FY 2011 CAFR and monitoring information available as of April / May 2012.

on "Reserves that meet the city's reserve policies and that the city projects will remain at strong levels in fiscal years 2012 and 2013, particularly after the recent stabilization of General Fund revenue." However, Moody's Investors Service notes "below average reserves" as a credit challenge for the City and a "significantly stronger reserve position" could be a factor in the credit issuer increasing the credit rating in the future.

Based on Moody's review of the City's reserve position, our office contacted the primary analyst for the City's credit rating review, Kevork Khrimian. Mr. Khrimian's review of Moody's database showed that the average unrestricted reserves for cities with the same rating as San Diego (regardless of size) equaled 12.6 percent of General Fund appropriations; while an increase of one incremental credit rating, to Aa2, the average unrestricted reserve increases to 22.4 percent of General Fund appropriations. Our office also discussed the potential negative perception from citizens of keeping over 20 percent of General Fund appropriations in reserves without restoring services that were cut during the recession from 2007 to 2010. Moody's focus is solely on investor interests and bondholder security and they do not weigh the potential negative perception from citizens regarding service levels. However, he continued to impress upon us the significant negative impact the State of California and certain state laws have had on the City of San Diego's credit rating.

Four key factors have been noted by both Moody's and Fitch as impacting credit ratings in the state of California.

1.) Proposition 13 (which controls assessed property tax levels to California citizens, and thusly City revenue) hinders a municipality's ability to raise tax levels during periods of depressed revenue in addition to not being able to experience greater revenue growth during times of economic expansion due to the cap on a citizen's tax bill increase per year. Moody's commented in August 2012[4] that "….Proposition 13, the state's constitutional property tax limitation, restricts the ability of municipalities to adjust tax rates, thereby capping property tax revenues at a time when flexibility is most needed.

2.) Since June 2012, three different California cities have declared bankruptcy and defaulted on their debt issuances. San Bernardino, Stockton, and Mammoth Lakes have filed for Chapter 9 bankruptcy and have created a significant concern for all rating agencies that other cities in California may follow the same path to attempt to reduce their debt burdens. Moody's has stated that they are currently undertaking a review of all 93 rated cities in California to determine if any rating adjustments are required in this new environment of Chapter 9 filings.

3.) Local jurisdictions in California require a two-third voter approval for new taxes, which continues to constrain a city's ability to have additional options to balance a strained budget during economic difficulties.

4.) The continued financial impact and ambiguity of state legislation on local government finances.

[4] Moody's Investor Services "*Why Some California Cities Are Choosing Bankruptcy"*

The cities of San Antonio and Phoenix are identified by the three rating agencies as having adequate financial reserves in addition to strong management practices[5], which contribute to their "prime" credit ratings. The City of Dallas is noted to have a reserve balance that is not as superior to these two cities by rating agencies and is thusly penalized with a lower credit rating. However, the City of San Jose is also impacted by the four state related issues, but has a credit rating two notches superior to the City of San Diego. Rating agencies credit them with having a strong economic base with "solid resident wealth levels", but have noted an erosion of reserve levels due to four straight years of General Fund deficits. San Jose also has not had the same financial circumstances of San Diego, requiring a hiatus from the public debt market / loss of credit rating and having to rebuild creditworthiness. Based on these factors, Moody's recently downgraded San Jose's rating from AAA and Standard and Poor's currently has San Jose on a negative downgrade watch.

Based on this information, the City of San Diego would have an arduous task of increasing its credit rating in the current state of California fiscal environment. In the current low interest rate environment, an increased credit rating and corresponding decrease in borrowing costs would not be of a large fiscal impact to the General Fund (though savings in borrowing over the long-run as interest rates increase could be significant). However, as evidenced by the recent downgrade of San Jose's credit rating, due to their erosion of reserves based on their General Fund operating losses, any material decline in the City's reserve balance would likely have a negative effect on our credit rating. This would impact our borrowing with an increase in interest rate costs, a potential decrease in the ability to sell debt to investors in the market place, and a loss of overall status.

Potential additional impacts from an increase in the General Fund reserve level (both negative and positive), include:

- An increase of General Fund interest earnings based on greater portfolio earnings for invested assets.

- Maintaining an excessively large fund balance may cause a perception from citizens in that the City is contributing to a pool of assets that has no tangible benefit on their daily lives and has not fully restored services that were previously reduced during the recession.

- Although a five percent emergency reserve fund is set aside for the General Fund through the reserve policy, an increased reserve balance offers the City flexibility to deal with large natural disasters or other unanticipated events that require a significant amount of resources to alleviate.

[5] Due to the City of Phoenix's inclusion of reserves for their self-insured public liability and worker's compensation activities in their unassigned fund balance, rating agencies credit the city with additional reserves that are outside of the scope of their contingency amount.

CONCLUSION

In comparison to the four cities that are similar to San Diego in services and size, the current 8.0 percent reserve policy minimum for the General Fund is in the upper range of required levels, while actual un-audited reserves exceed all four. However, the continued uncertainty associated with the elimination of redevelopment agencies in California, potential declines in consumer spending due to continued global economic pressure, and generally unforeseen circumstances warrant the need to continue to maintain the increased General Fund reserve level. A decline in General Fund reserves could also result in a credit downgrade to the City.

Additionally, the City is currently updating the five-year financial outlook for fiscal years 2014 - 2018. Based on estimated impacts from the implementation of Proposition B, lower than forecasted investment returns for pension funds, potential changes to revenue and expense growth forecasts, and the small General Fund surplus forecasted in FY 2014 and FY 2015[6], it is unknown if deficits may again be forecasted for future fiscal years. As stated in the reserve policy, the amount of funds in excess above the emergency reserve is available to be used for operating shortfalls, which may be required if a deficit is actually incurred and service levels are to be maintained.

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[6] As shown in the updated five year financial outlook during the FY 2013 proposed budget presentation on April 16, 2012. FY 2014 surplus was estimated at $2.0 million, while FY 2015 was estimated at $11.0 million.