THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: February 6, 2014 **IBA Report Number:** 14-05

City Council Docket Date: February 10, 2014

Item Number: 200

Revision to the City of San Diego Reserve Policy

OVERVIEW

The current City of San Diego Reserve Policy (Council Policy 100-20, "Policy") establishes reserve requirements for the City's General Fund, Development Services Fund, Risk Management Reserves (worker's compensation, long-term disability, and public liability), Water Enterprise Fund, Wastewater Enterprise Fund, and the Refuse Disposal and Recycling Enterprise Funds. The Policy has undergone a number of revisions since its establishment, however, no major revision to the Policy has occurred since FY 2008 when the General Fund Emergency Reserve requirement and funding targets for future fiscal years were established, among other changes.

In recent fiscal years, a number of significant events have occurred that have warranted reevaluation of the Policy. They include a substantial increase in General Fund reserves above Policy levels due to the recovery in major revenue sources since the end of the recession in 2010 and large unanticipated one-time revenue distributions received by the City. Additionally, updating Risk Management Reserves to reflect the most recent claims experience is prudent. On January 29, 2014, the City's Chief Financial Officer (CFO) presented proposed changes to the Policy to the Committee on Budget and Government Efficiency for revised General Fund reserve requirements in addition to Risk Management Reserves. Additional revisions to Enterprise Fund Policy requirements are anticipated to be brought forward in the coming months.

The proposed changes to the Policy as presented by the City's CFO are discussed in detail in their staff report; however, in this report we offer some additional clarification and information for Council's review prior to deliberations on the Policy revisions.

FISCAL/POLICY DISCUSSION

The proposed Policy revisions include: 1) eliminating language for the Appropriated Reserve; 2) increasing the General Fund reserve requirement; 3) specifically defining how the required reserve is calculated and new terms for component portions of the calculated reserve; and 4) changing the funding target for the worker's compensation reserve from 50 percent to 25 percent of outstanding actuarial liability[1]. In the following sections, we provide clarification on the elimination of the Appropriated Reserve, define "excess equity", and explain how the new reserve requirement is calculated. Based on the information presented by staff for changes to the Risk Management Reserves, we do not believe that it is necessary to provide additional clarification or detail on these items.

Elimination of Appropriated Reserve

The current Policy provided the Council with an opportunity to address budget issues not known or anticipated at the time of budget adoption through the establishment of a small Appropriated Reserve. For several years this reserve was funded during the annual budget process, and the Policy provided the authority to the Mayor or the City Council to initiate expenditures from this reserve during the course of the year; however, City Council approval was required in both cases.

Per subsequent City Attorney clarifications, the Council has a very limited role with regard to budgetary changes outside the course of the annual budget process, and must first receive recommendations from the Mayor for any such changes and use of any reserves, including the Appropriated Reserve. Based on this clarification by the City Attorney, the language with respect to the Appropriated Reserve is considered obsolete and unnecessary and has been eliminated in the proposed Policy revisions.

"Excess Equity" in Revised Policy

Proposed Policy revisions include increasing the required minimum reserve balance from 8.0 percent to 14.0 percent and to define any excess reserves above the 14.0 percent minimum reserve as "excess equity". These revisions define the minimum reserve to be 14.0 percent of "the most recent three year average of annual audited General Fund operating revenues". Currently, based on these proposed Policy revisions, there is $26.7 million in "excess equity" as shown below:

Projected FY 2014 YE Reserve Balance	$ 176.5
FY13,12,11 Average Actual Revenue	$ 1,070.3
Minimum Reserve % Of Actual Revenue	14.0%
Required Minimum Reserve Amount	$ 149.8
"Excess Equity"	$ 26.7

[1] In addition to updating the target dollar amount for all Risk Management Reserves based on the most recent actuarial information.

The Council may want to begin discussions on potential uses for the "excess equity" of $26.7 million if these Policy revisions were to be approved. As discussed at the Committee on Budget and Government Efficiency on January 29, 2014, these funds could be utilized to accelerate funding goals for the Risk Management Reserves ahead of Policy targets; be utilized for important one-time expenditures; invested in infrastructure; retained as "excess equity"; or a combination of these items. All proposals for utilization of this "excess equity" would require a recommendation by the Mayor and approval by a majority of City Council.

These options would all be appropriate uses of these funds now and in future fiscal years when "excess equity" becomes available, however, further discussion is needed to determine the most prudent course of action at this time. We would also note that utilizing the "excess equity" may necessitate contributions to the General Fund reserve to maintain minimum Policy reserve levels in the upcoming fiscal year(s).

Calculation of Reserves

The current Policy stipulates that the minimum balance is to be 8.0 percent of "annual General Fund revenues". The minimum balance has been calculated and illustrated in past fiscal years as 8.0 percent of the latest General Fund revenue forecast, whether that be the Proposed or Adopted Budget, or projected year-end revenue from the most recent General Fund Budget Monitoring Report. As outlined previously, the Policy revisions change this definition of minimum reserves to 14.0 percent of "the most recent three year average of annual audited General Fund operating revenues", and does not include transfers from proprietary, special revenue, and debt service funds (among others)[2]. In addition to not including transfer, this new definition also does not incorporate any current fiscal year General Fund revenue projections, which impacts the total required reserve.

Comparing the Office of the IBA's preliminary proposal of a 12.0 percent reserve, based on the current definition of revenue as "annual General Fund revenue", to the proposed Policy revision of 14.0 percent of "the most recent three year average of annual audited General Fund operating revenues" illustrates the effect of this change in definition.

In the Office of the IBA's review of the FY 2015-2019 Five-Year Financial Outlook, we contemplated maintaining a 12.0 percent reserve based on the current definition of revenue, which would have required $151.4 million to be maintained as a current reserve, as shown below[3]:

IBA Proposed Reserve Level

Fiscal Year	Budget Monitoring Revenue	Reserve	% Reserve
FY 2014	$ 1,261.4	$ 151.4	12.0%

$ in million

The 14.0 percent reserve that would be required to be maintained based on the proposed Policy revision would be equal to $149.8 million, as previously outlined. Despite the reserve

[2] Transfers totaled approximately $92 million in FY 2013.
[3] Based on the FY 2014 First Quarter Budget Monitoring Report total projected year-end General Fund .

requirement increasing 2.0 percent above the IBA proposal of 12.0 percent, the new reserve amount is approximately equal to the IBA proposal due to this change in the definition of revenue from "annual General Fund revenues" to "the most recent three year average of annual audited General Fund operating revenues".

CONCLUSION

The City of San Diego has exercised good fiscal discipline and adherence to policy to generate the current General Fund reserve. An increase in the General Fund Reserve Policy enables the City to help address any significant fiscal impact to City operations based on a public safety emergency, weather financial impacts from an economic downturn, as well as to maintain or potentially improve the City's credit rating. Our office agrees with the proposed revisions and believe that these revisions to the Policy are an excellent way to ensure that the City is able to continue to benefit from these positive impacts now and in the future. However, to properly address all potential Policy impacts these changes would have, we would recommend the following:

1. Council begin discussions of the most prudent uses, if any, of "excess equity";
2. CFO re-evaluate the Reserve Policy in the future to determine a) if changes should be made including updating Risk Management Reserves based on latest actuarial estimates and b) determine whether the revised definition of revenue continues to be appropriate.

Seth Gates
Fiscal & Policy Analyst

APPROVED: Andrea Tevlin
Independent Budget Analyst