THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Proposed Reserve Policy Revisions

BACKGROUND

In April 2016 the City Council voted to update the City Reserve Policy, increasing the required General Fund (GF) Reserve from 14% to 16.7% of the previous three-year average of audited General Fund operating revenues. As outlined in the City Reserve Policy, the components of the 16.7% GF Reserve include an 8% Emergency Reserve and an 8.7% Stability Reserve – a 2.7% increase to the 6% Stability Reserve from the previous Reserve Policy. Per the Reserve Policy, the new 16.7% Reserve level is to be phased in over six years (beginning in FY 2016 and ending in FY 2021). The FY 2017 Reserve target is 14.75%.

Information Used in Vetting the Current Reserve Policy

The 16.7% policy goal for the General Fund Reserve was decided based upon a vetting of best practices, as well as comments from rating agencies. The Government Finance Officers Association (GFOA) best practice regarding cities' reserve levels calls for maintaining a minimum reserve equal to two months of operating expenditures or operating revenue, which equates to an approximate 16.7% reserve. Other information was also considered at the time of the Reserve Policy change. For example, in their criteria for credit rating assessments of cities (dated September 2013), S&P considered reserves of 8-15% to be "strong" and any amount over 15% to be "very strong."

Additionally, in a November 12, 2014 report "Anatomy of Successful US Cities," Moody's found that 34 of the largest US cities (including San Diego) have either "improved or maintained their credit quality…since the onset of the Great Recession." Of the factors contributing to this credit status, Moody's identified that successful cities had strong financial management which supported revenue growth and improved reserve positions. According to this report, by 2013 the 34 successful cities' average median reserves had grown to 18.6% of operating revenues, up from the 14.5% in 2008.

Moody's also cited a reserve-related Credit Challenge for the City in a rating update at that time: "While reserves have improved, overall reserve position falls below the median for the current rating category." One factor Moody's identified that could cause the City's rating to go up was "[s]ignificant growth in city reserve position." Note that this factor was again identified as one that could lead to an upgrade in Moody's February 12, 2016 Credit Opinion for the City. In October 2016 Moody's indicated that it "expects the city will continue to operate with strong fiscal discipline resulting in a stable financial position and reserves."

Events Subsequent to the April 2016 Reserve Policy Changes

When the Reserve Policy was modified in 2016 (increasing the General Fund Reserve Policy goal to 16.7% of operating revenues), the City was looking at an over $30 million estimate for FY 2016 ending Excess Equity; and projected revenues and expenditures were balanced. Since the execution of the current Reserve Policy, the Five-Year Outlook has been released, showing projected deficits for FY 2018 and FY 2019.

These deficits are due to a number of factors that have caused a structural imbalance to the budget which include: an increase in the City's pension payment, increasing costs associated with employee organization agreements, and slowing revenue growth. Additionally, these deficits only include expenditures for existing service levels, which are designated as "Baseline Expenditures." Expenditures for upcoming critical strategic programs and services that are not part of the FY 2017 Baseline Expenditures, are not included in the Outlook's FY 2018 and FY 2019 projected deficits. In the IBA's review of the Five-Year Outlook (IBA Report #16-43), we incorporate upcoming critical strategic programs that have been planned by the City. After totaling such additional expenditures, the projected deficits increase significantly and extend into FY 2020 and FY 2021.

The City is in the process of considering strategies for dealing with the upcoming budget deficits – including analyzing City departments' 3.5% budget reduction proposals for FY 2018, as well as evaluating whether/how to utilize excess reserves and modification of the City's Reserve Policy. Proposed modifications to the City's Reserve Policy (Report to the City Council #17-011) were presented by the Chief Financial Officer (CFO) and Financial Management Department to the Budget & Government Efficiency Committee (B&GE) on February 2, 2017. The Committee discussed the proposed modifications and moved them forward to the full City Council with a recommendation for Council to approve them (the anticipated Council meeting date is February 13, 2017). The next section addresses specifics of the proposed changes to the Reserve Policy.

DISCUSSION

In Report to Council #17-011, the CFO proposed changes to two components of the Reserve Policy: reserve requirements for the General Fund Reserve and the Workers' Compensation Reserve.

Workers' Compensation Reserve

Report #17-011 discusses the recommendation to reduce the Workers' Compensation (WC) target reserve from 25% of the outstanding actuarial liability[1], to 12%. At this time, the 12% –

[1] The WC outstanding actuarial liability is based on the most recent three-year average of outstanding liabilities.

approximately $28 million – is equivalent to about one year's worth of WC operating expenses. Note that the General Fund portion of the $28 million would be approximately $22.8 million.

The proposed target reduction is based on the conclusion that reserving more than one year's worth of expenses is disproportionate to the operating risks. As explained in Report #17-011, the City's WC claims and costs are paid over a number of years and are not volatile like the City's Public Liability claims. Additionally, the WC reserve has not been accessed since it was established in 2007.

General Fund Reserve

Report #17-011 also discusses modifying the time it takes to achieve the overall General Fund (GF) Reserve goal (again, 16.7% of GF operating revenues). As previously stated, the 16.7% policy goal is to be phased in over six years (beginning in FY 2016 and ending in FY 2021). At FY 2017, the target is 14.75% of operating revenues. Under the current Reserve Policy, increasing each year's target amount by 0.5% of GF operating revenues, the 16.7% policy goal would be reached in FY 2021.

The proposed modification does not alter the 16.7% policy goal, but rather extends the time it would take to achieve it by four years, to FY 2025. This extension of time is accomplished by reducing the annual phase-in for reserve target increases, from 0.5% of operating revenues to 0.25%. It is estimated that the FY 2018 General Fund Reserve contribution will be reduced by $3 million with this policy change.

Report #17-011 states the City has established a strong reserve policy and has consistently funded reserves in an endeavor to meet its reserve targets. We agree that our 16.7% GF Reserve policy goal is prudent; and given the anticipated GF budget deficits over the next few years, extending the time to achieve this goal would be one strategy to help balance competing priorities. Under the proposal, the City would be anticipated to reach the interim reserve target of 15% in FY 2018.

Broader Considerations

There are a few considerations that we would like to highlight with respect to the proposed Reserve Policy changes:

- If the City were to modify the reserve policy as proposed, will there be ratings implications for the City? We believe that these changes are not significant when considered in isolation. However, the ratings agencies consider a combination of various factors in their ratings analysis: reserves, management, economic outlook, structural budget issues, etc.
- Is it envisioned that the General Fund Reserve policy modifications would be revisited if the City experiences future surpluses; and in such a case will the City attempt to achieve the 16.7% goal sooner? Reserve funding has been a priority for the Council in the past; and we believe will continue to be in the future. Achieving the 16.7% policy goal under a more aggressive timetable would be a worthy objective.
- Should there be language in the policy to address potential prepayment of General Fund targets in surplus years? The Council could consider adding such language to the Reserve Policy, which would be in line with its commitment to strong reserves.

- How will the resources made available through these Reserve Policy changes be utilized in the FY 2018 budget process? The following paragraphs discuss resources and potential budget considerations that will need to be addressed during the budget process.

With the proposed Reserve Policy changes, the following resources are estimated to be available:

- After reducing the WC Reserve to the level of one year's worth of WC operating expenses, it is anticipated there will be an excess Reserve balance of approximately $28.5 million ($23.2 million General Fund portion).
- Modifying the annual phase-in approach for reaching the GF Reserve Goal of 16.7% is anticipated to yield approximately $3 million in GF budgetary savings for FY 2018.

Some additional estimated one-time resources that could be utilized to balance FY 2018 budget include:

- $16.0 million from the GF portion of the Pension Payment Stabilization Reserve
- $2.3 million of excess Long-Term Disability Reserves (which is the GF portion)
- Excess Equity projected for the end of FY 2017 (currently estimated at $23.6 million, which includes the recent receipt of the $12.6 million Chargers termination fee)

As the FY 2018 Proposed Budget is developed, consideration will be given to competing priorities and resources available for budget-balancing. The City Council will have the opportunity to contribute their input throughout the budget process (and make the final budget approval). Most imminently, the proposed FY 2018 Council Budget Priorities Resolution, which was heard at the B&GE Committee hearing on February 2, 2017, is anticipated to come forward to the full City Council on February 13, 2017.

CONCLUSION

The IBA's Office agrees that the proposed Reserve Policy changes are reasonable. With respect to the proposed Workers' Compensation target reduction, we concur with staff's conclusion that reserving more than one year's worth of expenses is disproportionate to the operating risks. Additionally, the proposed General Fund Reserve policy change is a reasonable option to consider as a mitigating action for the projected General Fund budget deficit. Consideration should be continually given to the potential for there to be impacts on credit ratings when a combination of factors, including Reserve Policy changes, builds to a pivotal level. Lastly, Council may wish to include language in the Reserve Policy to require potential prepayment of General Fund Reserve targets in budget surplus years, which would be in line with its commitment to strong reserves.

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