CITY COUNCIL AGENDA REPORT

MEETING DATE: March 3, 2015 **ITEM NUMBER:** **NB-2**

SUBJECT: General Fund Reserves Study

DATE: February 20, 2015

FROM: FINANCE DEPARTMENT

PRESENTATION BY: STEPHEN DUNIVENT, INTERIM FINANCE DIRECTOR 714.754.5243

FOR FURTHER INFORMATION CONTACT: STEPHEN DUNIVENT 714.754.5243

RECOMMENDATIONS:

1. Approve a recommended reserves goal of $63,671,535.
2. Approve a plan to add up to $2,000,000 per year to reserves until the City reaches the reserves goal of $63,671,535 in about ten years.

BACKGROUND:

Current General Fund reserves consist of committed and assigned fund balance are part of the total General Fund balance. As of June 30, 2014 reserves total $26,141,092 and consisted of the following:

- $14,125,000 Committed for declared disasters
- 2,000,000 Committed for self-insurance
- 4,443,799 Assigned for compensated absences
- 2,262,032 Assigned for Police Retirement 1% Supplemental
- 3,310,261 Assigned for Optional Post-Employment Benefits (OPEB)

In addition, there is $20,629,130 in unassigned General Fund balance. Of this amount, $4,000,000 is recommended in the mid-year budget report to be allocated to future capital facilities projects.

ANALYSIS:

The $14,125,000 committed for declared disasters was established by the City Council as an emergency reserve. As set forth by Council Resolution 11-27 (June 21, 2011) and Municipal Code Sections 2-206 and 2-207, use of this reserve is limited to the following purposes:

1. To provide required emergency funding as a result of a declared emergency.
2. To provide required funding for an unanticipated but urgent event threatening the public health, safety and welfare of the City such as earthquakes, major unanticipated infrastructure failures and terrorist events.

At the time this reserve was established, it represented about 15% of the next year's general fund revenues. Paired with this reserve is a policy to maintain a minimum monthly cash balance (throughout the fiscal year) in the General Fund of at least $14,000,000. This keeps the reserve funds liquid (readily available) rather than having them tied up on longer-term investments. The monthly Treasurer's Report tracks actual monthly ending cash balances.

The $2,000,000 self-insurance reserve is set by Resolution 11-27 and Municipal Code Section 2-154. The City will maintain a minimum $2,000,000 Committed General Fund Balance to be used to pay actual losses not covered by other insurance policies or insurance pools. If used, this reserve shall be replenished with funds each fiscal year from the General Fund operating reserve.

The other three categories of reserves (compensated absences, Police retirement 1% supplemental and OPEB) are based on specific studies or calculations of what is needed for those programs. The amounts are updated at least every two years and recommended to continue as long as required.

A common practice in local government is for general reserves or reserve goals to be established as a percentage of General Fund revenues. For example, if the city desired to be able to operate for three to six months in the absence of the inflow of new revenues, it might establish a reserve target or goal of 25 to 50% of general fund revenues. This approach establishes reserves based on desired elapsed survival time rather using past experience or an analysis of potential future risks.

The October 2013 edition of Government Finance Review included an article titled "Sizing Your Reserves – A Risk-Based Approach" by Shayne Kavanagh and Kara Skinner. The methodology in this report is largely based on the principles in that article. The risks that the City faces, and which should be accounted for in the process of establishing reserves, include economic volatility, major infrastructure failure, natural disasters and other emergencies. The approach to analyzing these uncertainties is called the triple-A approach:

> Accept that the City is subject to future uncertainties and risks.
> Assess the potential impact based on historical baselines.
> Augment historical data by a factor of 1.5 to recognize the range of uncertainty.

With respect to economic conditions, City revenues are highly dependent on sales tax and sales tax can be quite volatile. Sales tax, as well as Transient Occupancy Tax (TOT), can vary much more quickly than property tax. Staff analyzed the past fifteen year history of these three revenue sources to determine a recommended amount of reserves for economic volatility.

Sales Tax (Attachment A): Sales tax represents 46% of the City General Fund revenues. The average annual growth rate of sales tax was a fairly constant 4.3% from 2000 to 2008. During 2008, sales tax declined rapidly for two consecutive years and took three years to recover to the previous level. During that time, the revenue loss was $27,757,606. A shorter recovery time would have reduced the loss to $24,156,484. A longer recession and recovery time would have increased the loss to $34,933,779. In assessing the risk of this happening again, we can assume that either a) 100% of the loss would be covered by reserves, b) one-half would be offset by using reserves and one-half would be offset by cutting expenses, or c) one third would be offset using reserves with larger spending cuts. Using option b applied to the City's actual experience yields an initial reserve amount of $13,878,803. Augmenting this amount by 50% to recognize the range of uncertainty yields a recommended sales tax economic uncertainty reserve of $20,818,204. This type of reserve would also serve to cover a failure, disaster or other event that might take a revenue-producing facility off-line for an extended period of time.

<u>TOT</u> (Attachment B): TOT represents 7% of the City General Fund revenues. The average annual growth rate of TOT over the past 15 years has been 4.6% including two recession periods. From 2008 to 2010, TOT declined for three consecutive years and took two years to recover to the previous level. During that time, the revenue loss was $4,775,445. The previous downturn and slower recovery resulted in a slightly lower loss of $4,143,501. A longer recession and recovery time would have increased the loss to $6,763,741. Using the same methodology described above for sales tax including the additional 50% to recognize the range of uncertainty, yields a recommended TOT economic uncertainty reserve of $3,581,583.

<u>Property Tax</u> (Attachment C): Property Tax represents 22% of the City General Fund revenues. The average annual growth rate of Property Tax from 2000 to 2008 was 7.9%. Since 2008, the average annual growth rate has slowed to 2.6%. Property tax is less volatile and slower to change than sales tax and TOT. During 2011 and 2012, Property Tax declined for two consecutive years and took one year to recover to the previous level. During that time, the revenue loss was $3,371,980. The previous one-year downturn and two-year recovery resulted is a lower loss of $1,974,366. A longer recession and recovery time would have increased the loss to $5,488,639. Using the same methodology as for sales tax described above including the additional 50% to recognize the range of uncertainty, yields a recommended Property Tax economic uncertainty reserve of $2,528,985.

<u>Infrastructure</u>: With respect to the risk of major infrastructure failure, the City does not have an extensive inventory of bridges or storm channels. A discussion with the City Public Services Director resulted in two potential scenarios for consideration—a catastrophic event requiring the rebuild of:

1. Fire Station 1 or 2: $7,100,000 including equipment
2. Communications Facility including equipment: $18,000,000

Staff recommends the using both of the above; $25,100,000 reduced by insurance coverage of $4,200,000 leaving a need for $20,900,000. Increasing this by a 50% uncertainty factor yields an infrastructure reserve of $31,350,000.

<u>Natural disasters or other events</u>: With respect to natural disasters and other emergencies, a discussion with the City Fire Chief resulted in three potential scenarios that could apply to a major fire or earthquake or other natural disaster for which Strike Teams would respond into the City and for which the City might be financially responsible. Costs are based on a recent Cal E-M-A survey:

1. Three strike teams for 24 hours: $102,594
2. Three strike teams for 48 hours: $208,187
3. Three strike teams for 72 hours: $307,781

Staff recommends number 3 above ($307,781) with a 50% uncertainty factor for a natural disaster reserve of $461,671. This amount would also serve as a reserve for the Police Department in the event of a terrorist threat or other emergency threatening the public safety.

Budgeted Capital Projects: In developing a target for recommended reserves, we can also account for the impact of our budget goal of 5% (currently $5,450,000) of general fund revenues being dedicated to Capital Projects with an additional 1.5% ($1,635,000) for Capital Facility Improvements as a goal for next fiscal year. This means that the budget would contain up to $7,085,000 in appropriations that could be diverted for emergency purposes if needed.

Summary: The following chart summarizes the existing resources and recommended reserves:

	Existing Resources	Recommended Reserves	Gap
Self-Insurance	2,000,000	2,000,000	-
Compensated Absences	4,443,799	4,443,799	-
Police 1% Supp. Retirement	2,262,032	2,262,032	-
Opt. Post-Employment Benefits	3,310,261	3,310,261	-
Economic Reserves			-
Sales Tax		20,818,204	20,818,204
TOT		3,581,583	3,581,583
Property Tax		2,528,985	2,528,985
Res. 11-27 Declared Disasters/Infrastructure	14,125,000	31,350,000	17,225,000
Natural Disasters/Other		461,671	461,671
Unassigned Fund Balance	20,629,130		(20,629,130)
Subtotal	46,770,222	70,756,535	23,986,313
Adjustment for Capital Appropriations	(4,000,000)	(7,085,000)	(3,085,000)
Total	$ 42,770,222	$ 63,671,535	$ 20,901,313

Recommended reserves total $63,671,535. There currently is a $20,901,313 gap between existing resources and recommended reserves if we include the unassigned fund balance. This gap could be closed over future years by either budgeting annual contributions to reserves or by allocating a portion of any fiscal year-end surplus to reserves until the $63,671,535 goal is met in about 10 years.

ALTERNATIVES CONSIDERED:

More optimistic assumptions about economic, infrastructure, natural disaster and other risks could be used thereby lowering the goal and reducing or eliminating the gap. More pessimistic assumptions could also be used thereby increasing the goal and the gap. Sensitivity analysis on the various risk factors is included in the analysis section above and in the attachments.

CONCLUSION:

The City is fortunate to have existing reserves and unassigned fund balance. Existing reserves are lower than recommended. Having categories of reserves such as those recommended above makes the purpose and need for reserves more transparent. Having a goal for reserves and plan to meet that goal strengthens the City's financial position.

Stephen Dunivent
Interim Finance Director

Thomas Hatch
CEO

Attachments: Attachment A Sales Tax Volatility
Attachment B Transient Occupancy Tax Volatility
Attachment C Property Tax Volatility