



CITY OF SANTA BARBARA

FINANCE COMMITTEE AGENDA REPORT

JUL 19 2012
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AGENDA DATE: March 27, 2012
TO: Finance Committee
FROM: Administration Division, Finance Department
SUBJECT: City Reserve Policies

RECOMMENDATION:

That the Finance Committee hear a report from staff on possible changes to existing policies governing reserve amounts as contained in City Council adopted Resolution No. 95-157.

DISCUSSION:

Background

In connection with its review of the Fiscal Year 2012 Recommended Budget, the Finance Committee received a report on May 17, 2011 from staff regarding the current policies guiding the establishment of reserves in all City operating funds. These policies were adopted in Fiscal Year 1995 through Resolution No. 95-157 (see attachment).

At the meeting of May 17th, the Finance Committee expressed interest in reevaluating and potentially modifying the current policies to address certain specific limitations and shortcomings identified by Committee members, as well as any other concerns of the Council as a whole. The Committee unanimously voted that this matter be heard by the City Council and that Council provide general direction to staff and the Finance Committee for improving the existing policies. The recommendation contemplated that, based on Council's direction, the Committee would meet as necessary to develop recommendations that would then be forwarded back to City Council for consideration.

On July 19, 2011, staff presented the Finance Committee's recommendation to the City Council and, after providing some ideas and suggestions, the Council referred a more detailed discussion back to the Committee.

At this meeting of the Finance Committee, staff will provide the Committee with a recap of Resolution 95-157, which establishes reserve policies, and with recommended changes to existing reserve policies based on the general direction received by Council.

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Overview of Existing Policies (Resolution No. 95-157)

Resolution No. 95-157, adopted on October 17, 1995, establishes policies for the City's General Fund and Enterprise Funds. In essence, it requires the establishment of four reserve "buckets" as follows:

1. Reserve for Capital – This reserve is established to cover unexpected capital needs and/or capital cost overruns. In the General Fund, the reserve should equal a fixed amount of \$1 million. In Enterprise Funds, it should either be 5% of net fixed assets or the average of capital funded from operating revenues in the previous three years.
2. Reserve for Emergencies – As the name implies, this reserve provides to respond to emergencies, such as natural disasters, during which the City would face increased costs immediately to respond to the emergency and also potentially see a decline in revenues. The reserve requirement is equal to 15% of the adopted operating budget.
3. Reserve for Future Years' Budgets – This reserve is intended to provide funds for meeting ongoing costs and minimizing any disruption of services during periods of declines in operating revenues typically associated with economic downturns. The reserve requirement is equal to 10% of the adopted operating budget.
4. Appropriated Reserve – This in an e reserve establishes an appropriated (i.e., budgeted) item that serves as a cushion for unexpected costs. The policy requires that this be established for the General Fund and each of the Enterprise Funds in an amount equal to ½ of 1 percent of the operating budget.

The rationale behind the 15% and 10% requirements for items 2 and 3 above was that this represented, on a combined basis, 25% of operating expenditures. As such, the funds would enable to City to potentially operate for a 3-month period (3 out of 12 months in a year equals 25%) before running out of cash. Because these two reserves are established as a percentage of the operating budget, each year that the budget grows, the reserve requirements grow proportionately.

The resolution also indicates that any use of policy reserves be accompanied, when feasible, with a plan for replenishment within a reasonable period of time.

Lastly, the policy requires that the use of reserves must be approved by a simple majority of Council. This policy has always been adhered to, whether it was done as an amendment to the budget during the year or in connection with the adoption of the annual budget.

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History of Reserve Balances and Their Use

From the time Resolution No. 95-157 was adopted through fiscal year 2004, General Fund reserves were fully funded. In fact, throughout that time, reserves exceeded the required amount by as much as \$10 million. During this time period, excess reserves created from budgetary surpluses were used to fund General Fund capital projects, including replacement and improvements to City facilities such as public restrooms, recreation facilities, playground equipment and public buildings.

Due a combination of factors, both intended and unintended, General Fund reserves fell below policy beginning in Fiscal Year 2005. One of the factors leading to the consumption of reserves relates to the natural growth in reserve requirements as the operating budget grows. For example, if the operating budget grows \$2 million in a year, the reserve requirements grow by \$500,000 (25%), which means the General Fund would need to generate a surplus of \$500,000 in this example just to stay fully funded in its policy reserves.

As of June 30, 2011, the General Fund reserves totaled almost \$19 million, short of the policy requirements by \$5.2 million. Still, the General Fund today is in very good financial condition and its reserves are much higher in dollar terms and as a percentage compared to many other agencies. This is due in large part to the quick and decisive action taken by Council to significantly cut General Fund costs over the last few years to avoid the use of reserves.

What is an Appropriate Level of Reserves?

There have been many surveys performed by statewide finance professional organizations and by national bond rating agencies to determine reserve levels among local agencies, with the focus usually on General Funds. Unfortunately, the results of the surveys, which are only as good as the level of participation among local agencies, do not provide much information that could be used to ascertain a definitive answer to the question of appropriate reserves policies and levels. The only conclusion one could draw is that no one size fits all.

Some of the factors that should be considered in determining appropriate reserve levels for a particular agency are discussed below.

Nature and Volatility of Revenues

In a city such as Santa Barbara, where the General Fund's key revenues are tied to consumer spending and particularly tourism and, therefore, are susceptible to economic impacts, reserves should provide for these swings in revenues. However, in a bedroom community that relies primarily on property taxes and fees, which historically are much more stable, reserves to address economic impacts may not need to be as high.

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Susceptibility to Natural Disasters

In Santa Barbara, we are vulnerable to floods, earthquakes, fires and tsunamis. As such, we are more likely at some point to need reserves to not only fund extraordinary costs to address threats to life and property, but also to cover the potential loss of revenues. For example, if the City sustained a major earthquake, businesses may shut down and tourists may stop visiting the City for some extended period of time.

While virtually all cities are subject to some type of natural disaster, some are more susceptible than others. In any case, this should certainly play a factor in developing reserve policies.

Reserves in other Funds

An important consideration in developing reserve policies is the degree of availability of reserves in other funds to respond to either emergencies or economic downturns. Some agencies, including the City of Santa Barbara, accumulate funds in internal service funds and capital funds for capital replacement. These funds, although not part of the General Fund, are still funds that can be used at the discretion of Council for General Fund purposes, so long as they were funded originally from General Fund sources.

In the early 2000s, the City began charging departments for vehicles in a manner designed to fully capture the future cost of replacements. Previously, these vehicles, including large fire apparatus such as ladder trucks and pumper trucks, were replaced on a "pay-as-you-go" basis. The result of this internal change in funding policy led to the accumulation of reserves applicable to General Fund departments totaling \$2.5 million as of June 30, 2011.

Although restricted to their respective funds, the City's reserves policies also apply to Enterprise Funds, which means that each fund has its own reserves for disasters, future years' budgets and capital. Moreover, the capital reserve requirements in Enterprise Funds are considerably higher than for the General Fund because their operations are more capital intensive. If a natural disaster were to hit the City of Santa Barbara, the reserves in the Enterprise Funds would be available to fund emergency response activities and repairs to the extent these costs relate to water, wastewater, airport, golf, waterfront and downtown parking facilities.

Council Suggestions for Discussion

At the July 19, 2011 City Council meeting, Council members provided some ideas and suggestions as to what they would like to see included a new or revised reserve policies. They are summarized into the following themes.

- The policies should include guidelines or "findings" for when policy reserves can be used.

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- The use of policy reserves should be accompanied by a plan for restoring reserves.
- The policy should require regular reports to Council on the status of reserves.
- Reserves should continue to be used for responding to the impacts of economic recessions; however, such use should be better defined.
- Consider the recommendations of the Infrastructure Financing Task Force in the reserve policy discussion.
- Consider reserves in other funds.
- Eliminate the \$1 million capital reserves.

Staff Recommendations

1. Retain Current 25% Reserve Requirement – Staff believes there is no compelling reason to change the methodology or percentages for calculating reserve requirements. The City is clearly vulnerable to natural disasters, as evidenced by the major fires that have occurred nearby in just the last few years. While it's hard to imagine, we also have considerable exposure to tsunamis, which could cause considerable damage to the City similar to the damage sustained in coastal cities in Japan recently.

As discussed previously, General Fund revenues will always be affected by economic swings. The likelihood of facing another recession like the one we just experienced is low, but the economy clearly runs in cycles, and we will inevitably experience other economic downturns.

2. Eliminate General Fund Capital Reserve – The \$1 million capital reserve in the General Fund has never been used. In the past, any cost overruns or unplanned capital expenditures were funded from either current revenues or the reserve for Future Years' Budgets.

The effect of this recommended change would be to lower the overall reserve requirement by \$1 million in the General Fund. The existing balance in the Capital Reserve would go to the Future Years' Budget, thereby reducing the current overall shortfall in that reserve account.

3. Allocate Future Budgetary Surpluses 50% to Capital and 50% to Restore Reserves – There are two immediate funding priorities: one is to accumulate funds for future General Fund capital improvements and replacements, and the other is to restore reserves to a fully-funded status. Staff recommends that, in any year where there is budgetary surplus, the surplus be allocated as follows:
 - Provide for whatever additional reserves may be needed based on the growth of the operating budget.
 - Of the remaining surplus, if any, transfer 50% to a capital sinking fund, with the remaining 50% left in the General Fund to help rebuild reserves.

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- Once the reserves have been fully funded pursuant to City policy, transfer 100% of any remaining surplus to the capital sinking fund.

Note that this recommendation does not mean that the annual capital program would be replaced with this recommendation. Each year, the General Fund would continue to fund the annual capital program from current revenues. In the last several years, the capital program has been less than \$1 million. The purpose of building reserves is to accumulate funds for larger capital projects, including the types that had been historically funded by the Redevelopment Agency.

4. For Any Recommended Use of Policy Reserves, Require the Following:

- A status of reserve balances
- Approval by a "super" majority (at least 5 votes) of Council
- A plan for the replenishment of reserves

5. Establish a 10% Operating Reserve Requirement for Internal Service Funds –

The current reserve policies do not include Internal Service Funds (ISF's). As a reminder, ISF's are designed to provide services to other departments, such as vehicle maintenance and replacement, building maintenance, information systems, etc.

We recommend that a 10% operating reserve requirement be established for internal service funds. The only fund where such a requirement would not be needed or warranted is in the Vehicle Replacement Fund. Since this fund's sole purpose is to accumulate funds for the replacement of all rolling stock and does not have an operating component to it, an operating reserve is not needed.

Long-Term Capital Funding

Although not included in the main discussion of reserve requirements, developing a long-term plan and specific policies for funding major capital projects is an important discussion that needs to take place in the near future.

As previously noted, several years ago the City implemented a new funding approach for the replacement of vehicles and other rolling stock. This has resulted in the accumulation of reserves in the Vehicle Replacement Fund with a current balance of approximately \$6 million, including funds for Enterprise Funds. Since the fund still is underfunded with respect to longer-lived vehicles, such as fire trucks, the reserve balances will ultimately grow in the future. However, these funds are not currently covered by any Council adopted reserve policy.

Beyond vehicles, there are many other capital needs that may require or lend themselves to accumulating reserves over time rather than being funded through debt. This will, thus, result in the accumulation of a large amount of reserves over time.

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Within the next few years, as the economy improves and General Fund revenues further recover, the City will hopefully be in a position to begin setting aside monies for capital. At that time, staff will return to Council to discuss alternative strategies and policies to address these unfunded capital needs, including those identified by the Infrastructure Capital Financing Task Group.

Waterfront Capital Reserve Policies

A number of years ago, the City created by ordinance (Municipal Code Section 17.40) a Harbor Preservation Fund (HPF) whose purpose is to accumulate funds for the preservation and enhancement of the harbor and other Waterfront properties. The ordinance required that funds be deposited into the HPF as available from operating surpluses, up to a total of \$5 million.

In June of 1999, the City Council adopted Resolution No. 99-066, amending Resolution No. 95-157, in order to designate the funds accumulated in the HPF as the Waterfront's capital reserve. It further established a \$2 million minimum balance in the HPF. Thus, the Waterfront Department does not have a separate capital reserve as required for other enterprise funds, but instead maintains between \$2 and \$5 million in the HPF.

Waterfront staff intends to evaluate its current capital policy to determine if any changes are warranted given it has been 13 years since its adoption. Staff will bring any recommendations to the Harbor Commission for discussion and, if necessary, bring recommended changes to City Council.

ATTACHMENT: Resolution No. 95-157 (Reserve Policies)

PREPARED BY: Robert Samario, Finance Director

APPROVED BY: City Administrator's Office

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RESOLUTION NO. 95-157

**A RESOLUTION OF THE COUNCIL OF
THE CITY OF SANTA BARBARA
ESTABLISHING POLICIES FOR RESERVES
FOR THE CITY'S GENERAL FUND AND
ENTERPRISE FUNDS**

WHEREAS, the City desires to establish policies regarding reserves for the various City funds for the purpose of providing consistent designations for different categories of reserves, ensuring fiscal security for the funds, defining standards for minimum and maximum amounts to be maintained in reserves, and providing flexibility to recognize differences among funds; and

WHEREAS, such reserves policies will be most readily communicated and understood if they are consolidated and formally adopted in a single document; and

WHEREAS, staff has presented and Council has reviewed the proposed reserves policies in a Council Work session on October 17, 1995; and

WHEREAS, the Council has considered the proposed reserves policies at a regular Council meeting on November 14, 1995;

NOW, THEREFORE BE IT RESOLVED, by the Council of the City of Santa Barbara that the following reserves policies are adopted:

1. In combination, the Reserves for Economic Contingency/Emergency and Reserves for Future Year Budgets/Fund Balance (by fund) will be funded to a goal level of 25% of the annual operating budget of the respective fund.

2. APPROPRIATED RESERVES

An Appropriated Reserve will be included in each operating fund's adopted budget to provide for unanticipated expenditures or to meet unexpected small increases in service delivery costs within the fiscal year. This reserve will be budgeted up to one-half of one percent of the operating budget and any unused portion will be returned to fund balance at the end of the fiscal year.

3. RESERVE FOR CAPITAL

Each operating fund will establish a Capital Reserve funded to at least 5% of the value of its capital assets. In the alternative, the amount may be established at an amount equal to the average of the adopted capital program budgets for the

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previous three years. The goal for the General Fund Capital Reserve shall be set at least \$1 million. Appropriations from these reserves will be to fund major capital costs.

4. RESERVE FOR ECONOMIC CONTINGENCY/EMERGENCIES

For each operating fund there will a reserve equal to 15% of its annual operating budget for the purpose of coping with emergencies. It may take more than one year to meet the 15% goal if these emergency reserves do not presently meet the 15% goal.

5. RESERVE FOR FUTURE YEAR BUDGETS/FUND BALANCE

Each operating fund will establish and maintain a reserve equal to 10% of its annual operating budget for the purpose of providing for unique one-time costs and for maintenance of City services and permit orderly budget adjustments during periods of reductions. Appropriation of these reserves to operating budgets should, when feasible, be accompanied by a plan for replenishment within a reasonable period of time.

6. FUNDING OF RESERVES

Funding will come generally from one-time revenues, excess fund balance and projected revenues in excess of projected expenditures. They will generally be reserved in the following priority order:

- Reserve for Economic Contingency/Emergencies
- Reserve for Capital
- Reserve for Future Years Budgets

However, flexibility will be retained to allocate available funds among the reserves based on the current circumstances and needs of the City's various operating funds.

7. Appropriation or use of funds from any of these reserves will require Council action.

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Waterfront Department
Reserve Balances
June 30, 2011

Reserve for Emergencies	\$	1,386,076	<i>15% of operating budget</i>
Reserve for Future Years' Budgets	\$	924,051	<i>10% of operating budget</i>
Reserve for Capital / HPF	\$	3,694,957	<i>\$2 million minimum</i>
Appropriated Reserve	\$	100,000	<i>\$57,000 minimum</i>
Reserve for COP /Debt Service	\$	1,393,260	<i>contract amount</i>
Total Reserves	\$	7,498,344	