



CITY OF SANTA BARBARA

CITY COUNCIL AGENDA REPORT

AGENDA DATE: July 17, 2012

TO: Mayor and Councilmembers

FROM: Administration Division, Finance Department

SUBJECT: General Fund Reserve Policies

RECOMMENDATION:

That Council consider newly proposed policies governing the establishment and use of General Fund reserves recommended by the Finance Committee.

DISCUSSION:

In connection with their 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. At that meeting, the Finance Committee expressed their 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. As a result, in July 2011, after receiving feedback from the City Council, the Finance Committee was directed to work with City staff to develop recommended changes to existing policies.

Accordingly, the Finance Committee met on April 10, May 22 and June 12, 2012; and, working with staff, has crafted newly proposed reserve policies for the General Fund, which will be presented to Council for consideration.

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

The policies contained in Resolution No. 95-157 were presented and discussed at a Council work session on October 17, 1995 and adopted on November 14, 1995 by Council.

Resolution No. 95-157 establishes policies for the City's General Fund and Enterprise Funds. 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 5% of net fixed assets or the average of capital funded in the previous three years.
2. Reserve for Emergencies – As the name implies, this reserves provides funds in the case of an emergency, such as natural disaster, during which the City would be facing increased costs immediately to respond to the emergency and potentially see a decline in revenues. It should be funded at an amount equal to 25% of the operating budget.
3. Reserve for Future Years' Budgets – This reserve is intended to provide funding for ongoing costs and avoiding a disruption of services during periods of naturally occurring declines in operating revenues typically associated with economic downturns. It should be funded at an amount equal to 10% of the operating budget.
4. Appropriated Reserve – The reserve establishes an appropriation 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 resolution also requires Council approval any time the use of these policy reserves is proposed and 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. In practice, this is done when the proposed use of reserves is presented to Council during the year or in connection with the adoption of the annual budget.

Finance Committee Recommendations

The recommendations of the Finance Committee include items suggested by staff as well as those initiated by Committee members. The recommendations also reflect the feedback received by Council in July 2011. Please refer to the attached Proposed General Fund Reserve Policies for details of the policy recommendations.

General Policy Recommendations

1. Retain Current 25% Reserve Requirement – The Finance Committee concurred with staff's recommendation that the methodology, which establishes reserves as a percentage of the operating budget, remain unchanged.

2. Eliminate the General Fund \$1 Million Capital Reserve – The effect of this recommended change would be to lower the overall reserve requirements by \$1 million in the General Fund. The existing balance in the Capital Reserve would go to the Contingency Reserve, thereby reducing the current overall shortfall by the amount.
3. Allocate Future Year-End Surpluses 50% to Capital and 50% to Restore and/Maintain Reserves as Necessary – 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 and maintain reserves to a fully-funded status. Therefore, the Committee concurred with staff’s recommendation that, in any year where there is surplus (measured at year-end as revenues over expenditures), the surplus be allocated as follows:
 - 50% would be transferred into a capital sinking fund, with the remaining 50% left in the General Fund to help rebuild and/or maintain reserves.
 - If and when reserves are fully funded pursuant to City policy, transfer 100% of any year-end surplus to the capital sinking fund.

Note that this recommendation does not mean that the annual capital program would be supplanted by any transfer of funds to a capital sinking fund. Each year, the General Fund would continue to fund the annual capital program from current revenues. The purpose of building capital reserves is to accumulate funds for larger capital projects, including those previously funded by the Redevelopment Agency.

Policy Recommendations Applicable to the Disaster Reserve

The Disaster Reserve (previously named the “Reserve for Economic Contingencies”) will remain largely unchanged as proposed, but language is being recommended to provide added clarification. As proposed, the policy establishes the following requirements for the Disaster Reserve:

- It will be calculated as 15% of the operating budget (unchanged)
- It will be restricted to use in cases of natural disasters, such as floods, fires, tsunamis, earthquakes, and any other events that cause significant damage to City facilities and infrastructure.
- It will be primarily intended for state or federal declared disasters; however, can be used for other local disasters
- It can only be used after other available funds, including Contingency Reserves, are fully exhausted.
- The use of Disaster Reserves requires simple majority approval of City Council

Policy Recommendations Applicable to the Contingency Reserve

Most of the proposed changes to existing policies are in the Contingency Reserve (previously named the “Budgetary Reserve”).

The policy recommendations are summarized below:

- It will be calculated as 10% of the operating budget.
- Its purpose is to allow for the orderly implementation of a plan to address the fiscal impacts of unexpected events to minimize disruption to city.
- It should be used only for *unexpected and unplanned events* that have significant negative fiscal impact (including natural disasters) on the City’s finances.
- It should not be used for planned or anticipated events, such as negotiated increases to salaries & benefits, increases to retirement costs, or increases to health insurance premiums
- The use of Contingency Reserves will require approval by a supermajority of City Council at least 5 votes). An exception is in the case of natural disasters, wherein only a simple majority is required.

Additional policy recommendations associated with the use of Contingency Reserves are as follows:

- Assessment of Fiscal Condition – The proposed use of Contingency Reserves should be accompanied by an objective assessment of the General Fund’s fiscal condition. The purpose of the assessment is to measure and define the scope and estimated duration of the fiscal impacts. The assessment should be based on available and relevant financial and non-financial data, such as:
 - The City’s Comprehensive Annual Financial Report
 - Revenue and expenditure trends
 - Economic indexes and trends (population growth, CPI, etc.)
 - Local forecasts prepared by financial and academic institutions and paid consultants
- Development of a Balancing Strategy – The proposed use of Contingency Reserves should be accompanied by a comprehensive plan for addressing the scope and duration of the impacts, and should consider other measures to minimize use of Contingency Reserves, including:
 - Expenditure reductions achieved through efficiency measures, cuts to programs, services and staffing
 - Revenue enhancement measures that generate new or increased revenues
 - Use of available one-time funds and reserves in other funds, as allowable and appropriate

- Plan for Replenishment – The use of Contingency Reserves should be accompanied with a plan for replenishment. A one-time (1 year) use of reserves should include a specific plan for how and when reserves will be restored. If the use of Contingency Reserves is proposed for more than one year, the long-term plan can be more general.

Other Recommendations Applicable to Internal Service Funds

The Committee concurred with staff's recommendation to 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.

The funds that this reserve requirement would apply include the following:

1. The Information Systems Fund
2. The Vehicle Maintenance Fund
3. Facilities Management Fund

The 10% reserve requirement would not apply to 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. The policy would also not apply to the Self-Insurance Fund since its primary purpose is to accumulate reserves for payment of claims and insurance funded from charges to other funds and departments; and its operating component (staffing and supplies) is relatively small.

ATTACHMENT: Proposed General Fund Reserve Policies

PREPARED BY: Robert Samario, Finance Director

APPROVED BY: City Administrator's Office

**CITY OF SANTA BARBARA
Proposed Reserves Policies
GENERAL FUND**

GENERAL POLICY REQUIREMENTS

The reserves established pursuant to this policy are designed to provide the City with a degree of funds to address unexpected, unplanned and unbudgeted events that have a detrimental impact on the City's financial condition. The use of reserves should be considered in the context of other sources of funds that may be available, such as property and business interruption insurance reimbursements and disaster relief funds in the case of federal and/or state declared emergencies.

Calculation of the final reserve balances will be calculated at end of each year after the final closing of the accounting records and will be accounted for in each fund, as applicable, as a designation of fund balance for each type of reserve established by this policy.

As soon as practical after the close of a fiscal year, staff will provide City Council a report showing the status of reserves as of June 30. In addition, at any time the use of reserves in excess of reserves established pursuant to this policy, staff will provide a similar report on reserves and projected fiscal impact from the proposed use of reserves.

DISASTER RESERVE

The Disaster Reserve will be calculated as 15% of the adopted operating budget of the immediately following fiscal year.

The Disaster Reserve is restricted to use in addressing the financial impacts of natural disasters, such as floods, fires, tsunamis, earthquakes and any other event that results in significant damage to City facilities and infrastructure.

The use of Disaster Reserves should generally be limited to disasters that are associated with a federal and/or state declared disaster. However, the use of Disaster Reserves is allowable in cases where the natural disaster is less severe, such as a major fire to a City building that requires temporary facilities to be leased. Disaster reserves may be used only after other available funds are exhausted, including the Economic Contingency Reserve.

Examples of financial impacts that would justify the use of Disaster Reserves include:

- Extraordinary costs incurred in connection with the immediate emergency response to address public safety matters.
- Revenue losses resulting from a significant decline or temporary halt in visitors to the City due to major damage to facilities, infrastructure and local businesses.
- Additional costs necessary to maintain City operations.
- Long term costs incurred to rebuild City facilities and infrastructure.

A simple majority approval of City Council is required for any use of Disaster Reserves.

CONTINGENCY RESERVE

The Contingency Reserve is calculated based on 10% of the adopted operating budget of the immediately following fiscal year.

The main purpose of the Contingency Reserve is to allow for the orderly implementation of a balancing strategy to address the fiscal impacts of unexpected events in a manner that minimizes the impacts to the organization and community, balanced against the goal of preserving reserves.

The Contingency Reserve is restricted to addressing the impacts of unplanned and unexpected events negatively affecting General Fund revenues or expenses. Because the primary revenues in the General Fund can be volatile and fluctuate with economic cycles, an economic recession is the more typical unexpected event that negatively affects local revenues. However, unexpected events that have a financial impact on the General Fund, and the City as a whole, can also include the following:

- Natural disasters, as described above for Disaster Reserves
- Revenue impacts resulting from State of California action and unfunded State mandates
- Unexpected loss of external funding (grants, entitlements, etc.)
- An unplanned loss of, or damage to, a City facility (e.g., loss of a building due to fire)
- Mitigation of an emergency that poses a threat to public health and safety
- Adverse judicial action that requires large cash payments to third parties

The general intent of the of the Contingency Reserve is not to fund known and/or anticipated financial impacts, such as negotiated salary and benefit increases or increases to health insurance premiums or retirement costs.

The following provides specific requirements applicable to the use of Contingency Reserves.

Council Approval

Any use of Contingency Reserves, except in cases of natural disasters, requires a supermajority approval (at least 5 votes) of City Council

Assessing the Fiscal Condition and Outlook of the General Fund:

The use of Contingency Reserves should be accompanied by an objective evaluation of the General Fund's fiscal condition and an evaluation of the fiscal impacts of the event that triggered the use of reserves. The purpose of this evaluation is to measure and define the scope and duration of the problem to assist in developing an appropriate balancing strategy.

The assessment of fiscal condition should include the use of available and relevant financial and non-financial data, including but not limited to: economic and demographic indexes and trends; historical revenue and expenditures results; and local economic forecasts developed by recognized academic and financial institutions and paid consultants.

Developing a Balancing Strategy

Whenever Contingency Reserves are proposed to be used, the City Council should also approve a balancing strategy. The balancing strategy should include, as appropriate and feasible, other measures that minimize the use of Contingency Reserves, such as:

- Expenditure reductions achieved through efficiency measures, cuts to programs, services and staffing
- Revenue enhancement measures that generate new or increased revenues
- Use of existing one-time funds
- Use of available reserves in other funds, as allowable and appropriate

The balancing strategy should also be consistent with the nature of the fiscal impact. For example, a one-time impact may be resolved fully with the use of reserves, depending on its severity. However, an event that has an ongoing financial impact, such as decline in revenues due to a major recession, will require a balancing strategy that includes ongoing budget adjustments to minimize the use of reserves.

Plan of Replenishment

The use of Contingency Reserves should be accompanied by a plan for their restoration.

- A one-time (one-year) use of reserves should be accompanied by a specific plan for how and when the reserves will be restored.
- An extended use of reserves for more than one year should be accompanied by a long-term strategy that includes a more general plan for how the reserves will be restored.



Reserve Policies



City Council Meeting
July 17, 2012

RESERVE POLICIES

Background

◆ May 2011

- Finance Committee received a report from staff on reserve policies
- FC expressed an interest in evaluating and potentially modifying current policies
- FC recommended that Council:
 - Provide general direction to staff
 - Refer item back to FC for detailed discussion and recommended changes

RESERVE POLICIES

Background

◆ July 2011

- Staff presented the Finance Committee's recommendation to the City Council
- Staff received comments and suggested changes
- Referred item to Finance Committee



SUMMARY OF CURRENT POLICIES

Resolution No. 95-156

Budget Policies

RESERVE POLICIES

Summary of Resolution No. 95-156

- ◆ Budgetary emphasis on high quality municipal services – added emphasis on public safety and well maintained infrastructure
- ◆ Budget will provide sufficient funding for maintenance and replacement of capital assets
- ◆ Budget will reflect higher priority for maintenance of existing facilities over acquisition of new facilities

RESERVE POLICIES

Summary of Resolution No. 95-156

- ◆ A diversified and stable revenue system will be maintained to shelter against short-term fluctuations to a single revenue
- ◆ Revenues will be conservatively estimated
- ◆ One-time revenues will be used for operating programs only as a short-term solution
- ◆ In general, one-time revenues will be used to support capital or other one-time costs



SUMMARY OF CURRENT POLICIES

Resolution No. 95-157

Reserve Policies

RESERVE POLICIES

Summary of Resolution No. 95-157

◆ Applicability of Resolution

- Reserve requirements are applicable to all operating funds
 - General Fund
 - Enterprise Funds
- Policies do not apply to internal service funds

RESERVE POLICIES

Summary of Resolution No. 95-157

◆ Reserve for Capital

- Intended to fund major capital costs
- General Fund
 - Fixed amount of \$1 million
- Enterprise Funds
 - Either 5% of net book value of fixed assets, or
 - Average of previous 3 years of capital funding (from operating fund)

RESERVE POLICIES

Summary of Resolution No. 95-157

◆ Reserve for Emergencies (Disasters)

- Equal to 15% of the annually adopted operating budget
- Intended to provide funds in cases of emergencies, including natural disasters
- Impacts would likely include loss of revenue streams (i.e., sales tax, bed tax) and substantial emergency costs in addition to normal costs
- Would provide some funds before any FEMA or CalEMA disaster relief funds were received
- Would be available to cover ineligible cost and/or uninsured costs

RESERVE POLICIES

Summary of Resolution No. 95-157

◆ Reserve for Future Years' Budgets

- Equal to 10% of the annually adopted operating budget
- Intended to provide for "...unique one-time costs and for the maintenance of City services and permit orderly budget adjustments during periods of reductions"
- Suggests that any use of these reserves should be accompanied by a plan for replenishment within a reasonable period of time
- When combined with Disaster Reserve, would provide 3 months (25%) of operating costs if necessary

RESERVE POLICIES

Summary of Resolution No. 95-157

◆ Appropriated Reserves

- Equal to 0.5% of operating budget
- No longer applied to General Fund – set at \$150,000
- Generally applied as prescribed to Enterprise Funds



Finance Committee Recommendations

RESERVE POLICIES

Recommendations

- ◆ Recommendations approved on a 3-0 vote
- ◆ Difference of opinion on a few areas

RESERVE POLICIES

Broad Recommendations

- ◆ Enterprise Funds
 - Wait for feedback from affected departments, boards and commissions
- ◆ Internal Service Funds
 - Establish a 10% Operating Reserve requirement for Internal Service Funds

RESERVE POLICIES

Broad Recommendations

- ◆ Retain 25% reserve requirement
- ◆ Eliminate General Fund \$1 Million Capital Reserve
- ◆ Allocate Future General Fund Surpluses As Follows:
 - 50% remaining surplus to a Capital Sinking Fund
 - 50% of remaining surplus to maintaining and/or restoring reserves
 - The surplus would be calculated after funding of annual capital program

RESERVE POLICIES

General Fund Recommendations

◆ General Comments

- Added more language applicable to Disaster Reserve
 - Examples of types of disasters
 - Examples of potential financial impacts
- Most of the clarity needed in the Contingency Reserves
 - Avoided being too restrictive or formulaic
 - Provides for judgment, while still imposing stricter requirements
- Use of reserves above policy not specifically covered in proposed policy

RESERVE POLICIES

General Fund Recommendations

- ◆ Disaster Reserves (Renamed)
 - Set as 15% of the operating budget
 - Restricted to use in cases of natural disasters
 - Allows primarily for state or federal declared disasters; allows for other local disasters
 - Use only after other available funds, including Contingency Reserves, are exhausted
 - Require simple majority approval of City Council

RESERVE POLICIES

General Fund Recommendations

- ◆ Contingency Reserves (Renamed)
 - Set as 10% of the operating budget
 - Purpose: To allow for the orderly implementation of a plan to address the fiscal impacts of unexpected events to minimize disruption to city
 - Allowable Uses: Unexpected and unplanned events that have significant negative fiscal impact (including natural disasters)
 - Unallowable Uses: Planned or anticipated events, i.e.,
 - Negotiated increases to salaries & benefits
 - Increases to retirement costs or health insurance premiums

RESERVE POLICIES

General Fund Recommendations

- ◆ Contingency Reserves (Cont'd)
 - Additional Requirements
 - Approval by Council
 - Supermajority approval (at least 5 votes)
 - Exception: Natural disasters, simple majority
 - Objective Assessment of the fiscal condition of the General Fund
 - Balancing Strategy
 - Plan of Replenishment

RESERVE POLICIES

General Fund Recommendations

- ◆ Contingency Reserves (Cont'd)
 - Objective Assessment of Fiscal Condition
 - Purpose: To measure and define the scope and duration of the fiscal problem
 - Should be based on available and relevant financial and non-financial data
 - Annual Financial Report
 - Revenue and expenditure trends
 - Economic indexes and trends (population growth, CPI, etc.)
 - Local forecasts prepared by financial and academic institutions and paid consultants
 - Multi-Year forecast model could be vehicle to present fiscal condition and scope of problem

RESERVE POLICIES

General Fund Recommendations

- ◆ Contingency Reserves (Cont'd)
 - Development of a Balancing Strategy
 - Strategy should include a comprehensive plan for addressing the scope of the impacts as defined
 - Should consider other measures to minimize use of Contingency Reserves
 - Expenditure reductions achieved through efficiency measures, cuts to programs, services and staffing
 - Revenue enhancement measures that generate new or increased revenues
 - Use of available one-time funds and reserves in other funds, as allowable and appropriate

RESERVE POLICIES

General Fund Recommendations

- ◆ Contingency Reserves (Cont'd)
 - Plan for Replenishment
 - Use of Contingency Reserves should be accompanied with a plan for replenishment
 - One-time (1 year) use of reserves should include a specific plan for how and when reserves will be restored
 - Extended (more than 1 year) use of reserves should include a long-term plan for replenishment



NEXT STEPS

RESERVE POLICIES

NEXT STEPS

- ◆ Provide staff with final direction on proposed policies
- ◆ Staff will return with resolution for adoption (consent calendar) incorporating any requested changes by Council
- ◆ Return at a later date to discuss possible changes to reserve policies governing enterprise funds

GENERAL FUND

Reserve Balances vs. Tax Revenues

