

DATE ISSUED: July 22, 2002 **REPORT NO.** 02-170

ATTENTION: The Committee on Rules, Finance and Intergovernmental Relations

SUBJECT: City Manager's Proposal Regarding General Reserves

REFERENCE: Blue Ribbon Committee Report on City of San Diego Finances –
February 2002
Blue Ribbon Recommendations/Rules Committee Actions – Memo April 2002

SUMMARY

Issue - Should the City Council adopt the City Manager's proposal to increase General Reserves to a goal of 5-7% of General Fund revenues and the recommendations for funding the increase?

Manager's Recommendation- Adopt the proposal to increase General Reserves to a goal of 5-7% of General Fund revenues and the recommendations for funding the increase.

Other Recommendations- The Blue Ribbon Committee Report on City of San Diego Finances February 2002 (Blue Ribbon Committee Report) recommended increasing reserves to 7% - 10% of General Fund revenues.

Fiscal Impact - An increase of approximately \$693,000 - \$14.7 million will be required to increase General Reserves to 5-7% of General Fund revenues beginning in Fiscal Year 2004. This increase would bring the General Reserves to an estimated \$36.5 - \$51 million. The amount and percentage of General Reserves will be revisited annually to maintain the level at current year dollars. The proposed increase could be funded by sources including but not limited to net budget surpluses resulting from increased revenues, and/or budget expenditure savings at year-end; and annual Tobacco Settlement monies available after all pre-established priorities have been met.

BACKGROUND

The Blue Ribbon Committee Report recommended that the City's reserve level be evaluated and an appropriate level determined. The Report also recommended that reserves be increased to 7% - 10% of General Fund revenues. In 2002 the Committee on Rules, Finance and Intergovernmental Relations adopted the Blue Ribbon Committee's Recommendation #1, *Evaluate and determine what an adequate reserve level is for the City.*

Subsequently in a memo dated April 4, 2002, the Mayor directed the City Manager to prepare a proposal to the Committee on Rules, Finance and Intergovernmental Relations to evaluate and determine an adequate reserve level for the City. In order to ensure that the level of General Reserves is sufficient to address unforeseen contingencies, the City's revenue sources, its economic environment, budgetary fixed costs, and the debt for which the General Fund is obligated were analyzed. The City was also compared to and positioned among several other major cities in regard to General Reserve levels.

The City's General Reserves have more than doubled since 1997. At the start of Fiscal Year 2002, total General Reserves were \$30.5 million representing 4.0% of General Fund revenues. Recently, General Reserves have increased and are currently \$36.3 million (approximately 4.9% of Fiscal Year 2003 estimated General Fund revenues).

DISCUSSION

General reserves are used as a strategy for maintaining long-term fiscal stability. Monies are set aside during favorable economic times to address unforeseen events such as catastrophes, budget gaps/contingencies, unanticipated cuts in State revenue, and to reduce the need for short-term borrowing.

According to *Public Budgeting and Finance*, an industry publication sponsored by the Association for Budgeting and Financial Management, and the American Society for Public Administration, the most frequently cited guideline for setting an optimal level of reserves is 5 percent of General Fund revenues. Many governmental entities have stabilization funds of some sort. The levels maintained in these types of funds are typically expressed as a percentage of general fund revenues or in some instances, a percentage of operating expenditures or other applicable bases.

In analyzing other municipalities, staff determined population, debt, and the economic environment were among the key factors in determining an appropriate level of reserves for the City. Cities with economies that are heavily dependent on a few industries and those who rely greatly on State funds are more volatile and are expected to maintain higher reserve percentages.

The City of San Diego has a diverse and dynamic economy, which has realized eight years of consecutive growth through 2001. The City's economic base consists of various high tech industry clusters, complemented by tourism and the military, two mainstays of the San Diego economy. Major high tech clusters include telecommunications, bioscience, software, and defense. With a strong emphasis on research and new product development, San Diego's technology industries have been less prone to sharp fluctuations that have adversely impacted other less diverse and more manufacturing oriented high tech centers.

The City's high tech industries have also benefited from the presence of several major research institutions and universities. High tech also plays a key role in San Diego's defense industry, with the

City's major civilian defense contractors concentrated in the non-manufacturing areas of communications and information systems, which account for an increasing share of overall defense spending.

San Diego's tourism is also diverse, serving both pleasure visitors and convention visitors. With pleasure travelers accounting for 70% of the San Diego market, and 70% of those visitors using automobiles as their transportation source, San Diego has been able to consistently out perform other markets negatively impacted by the downturn in air travel. The City's convention visitor component, which accounted for 13% of all hotel guests in 2001, also serves as a stabilizing component to the larger, but more volatile business and pleasure component.

The establishment of adequate general reserves is often factored into an improved government credit profile and used as a measure of liquidity. As economic trends continue to be volatile, reserves from a credit standpoint and the capacity of the City to pay its debt, becomes highly scrutinized. Rating agencies such as Standard & Poor's, Moody's Investors Service, and Fitch Ratings look for an entity's ability to be flexible and react to budget shortfalls in a timely manner.

Below is a summary of the City's total General Reserves as of June 30, 2002. This represents 4.9% of the Fiscal Year 2003 budget General Fund revenues. It is important to note that General Fund Reserves are only one component of the total General Reserves. Other listed reserve amounts are pre-established, but not restricted and may be used for general purposes.

| | |
|-------------------------------|---------------|
| General Fund Reserve | \$19.5 |
| Convention Center Reserve | 6.9 |
| MTDB/Trolley Reserve | 2.1 |
| GASB 31 Reserve | 2.0 |
| Balboa Park Reserve | 3.5 |
| Ballpark Reserve | <u>2.3</u> |
| Total General Reserves | \$36.3 |

In a recent survey conducted by the Financial Management Department in June 2002, the staff obtained and compiled data from comparable western and nationwide cities as shown in Table 1 below. In comparison to other major cities, the City of San Diego maintains one of the highest General Reserves, which contributes to a favorable bond rating. Its bond ratings from Moody's Investors Service and Standard & Poor's are among the highest of any large city in California. Recently, Fitch Ratings raised San Diego's General Obligation Bond rating to AAA (best quality credit and a very strong capacity to meet debt obligation commitments). In developing the rating, the agency cited the City's strong economic performance, sound financial operations, and low debt burden.

Table 1. Survey Results

| City | Population in Millions (2001) | Moody's Rating ¹ (2002) | Fitch's Rating ¹ (2002) | Standard & Poor's Rating ¹ (2002) | General Reserves ² (2002 - % of General Fund Revenue) |
|------------------|-------------------------------|------------------------------------|------------------------------------|--|--|
| Los Angeles | 3.7 | Aa2 | AA | AA | 3.1% |
| Chicago | 2.9 | A1 | AA- | A+ | 5.0% ³ |
| Houston | 2.0 | Aa3 | AA | AA- | 5.5% ³ |
| Philadelphia | 1.5 | Baa1 | NR | BBB | None |
| Phoenix | 1.3 | Aa1 | NR | AA+ | 3.0% |
| San Diego | 1.2 | Aa1 | AAA | AA | 4.0% |
| Detroit | .9 | Baa1 | A | A- | None |
| San Jose | .8 | Aa1 | AA+ | AA+ | 3.0% |
| San Francisco | .7 | Aa3 | AA | AA | 1.2% |

¹General Obligation Bond Rating

²Level at which the unreserved fund balance is maintained. Unaudited.

³Expressed as a percentage of operating expenditures.

In response to the adoption of the Blue Ribbon Committee's Recommendation #1, it is proposed that an adequate reserve level for the City is 5-7% of General Fund revenues. An increase is warranted due to anticipated revenue fluctuations, significant drop in revenue raising flexibility due to the passage of Prop 218, and the continued uncertainty of the State budget situation. This reserve level is within the range recommended by public finance experts and bond rating agencies, and would support the City of San Diego's continued fiscal solvency and strong bond ratings.

In order to progress from the current level of 4.9% to the proposed goal of 5-7% over the next five years, it is recommended that the following be considered to contribute to the General Fund reserves:

- (1) net budget surplus
- (2) remaining Tobacco Settlement funds after all pre-established priorities have been met

Any contributions to General Reserves will be considered after ensuring adequate funding is obtained for City operations. Deposits to the General Reserve would continue until the recommended goal of obtaining a reserve level of 5-7% is achieved; upon reaching that level, continued funding would need to be identified in order to maintain the 5-7% reserve level goal. It is understood that in balancing resources with critical needs, conflicting priorities may arise which may impact the plan for funding the General Reserves. Although it is recommended that specific guidelines on accumulating general reserves be developed, it is anticipated that the City Manager will work with the Mayor and City Council to determine the most appropriate course of action when dealing with conflicting priorities, State funding impacts, and other unforeseen occurrences.

ALTERNATIVES

Table 2 below shows a variety of general reserve levels expressed as a percentage of General Fund revenues. Currently, the City’s General Reserves are \$36.3 million, which represents 4.9% of estimated General Fund revenues for Fiscal Year 2003.

Other alternatives include: 1) adopt a different General Reserve amount as a percentage of General Fund revenues, or 2) maintain the current General Reserve amount.

Table 2. General Reserves as a Percentage of Estimated General Fund Revenues

| Fiscal Year 2003 \$729.3M | | | |
|--|---------|-------|---------|
| General Reserves as a % of Estimated General Fund Revenues | | | |
| 4.0% | \$29.1M | 7.5% | \$54.7M |
| 4.5% | \$32.8M | 8.0% | \$58.3M |
| 5.0% | \$36.5M | 8.5% | \$61.9M |
| 5.5% | \$40.1M | 9.0% | \$65.6M |
| 6.0% | \$43.8M | 9.5% | \$69.3M |
| 6.5% | \$47.4M | 10.0% | \$72.9M |
| 7.0% | \$51.0M | 10.5% | \$76.6M |

CONCLUSION

Sound management and financial practices, along with a diverse economy, have served to stabilize San Diego during economic downturns. A realistic General Reserve can contribute to the City’s financial stability.

Although there is no scientific way to predict unforeseen events, a goal to increase general reserve levels to 5-7%, achieved over the next 5 years, will ensure that the level of General Reserves is sufficient and enable the City to better address unforeseen contingencies. In pursuing this goal, it is important to consider other City competing interests including items, such as operating capital needs as well as deferred maintenance requirements.

Respectfully submitted,

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IRVINE/CMC