

DATE ISSUED: August 5, 2002 **REPORT NO.** 02-186

ATTENTION: The Committee on Rules, Finance and Intergovernmental Relations
Agenda of August 7, 2002

SUBJECT: City Manager's Proposal Regarding General Reserves (Revised)

REFERENCE: Blue Ribbon Committee Report on City of San Diego Finances –
February 2002
Blue Ribbon Recommendations/Rules Committee Actions – Memo April 2002
City Manager's Proposal Regarding General Reserves – Report No. 02-170

SUMMARY

Issue – Should the City Council adopt the City Manager's recommendations to establish a goal of 5 – 7% of General Fund revenues for General Reserves including a goal of 3 - 5% of General Fund revenues for the General Fund Reserve?

Manager's Recommendation– Adopt the proposal to increase General Reserves to a goal of 5 - 7% of General Fund revenues and the General Fund Reserves to a goal of 3 - 5% of General Fund revenues.

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

Fiscal Impact– To achieve a goal of approximately 3 – 5% of General Fund revenues for the General Fund Reserve in Fiscal Year 2003, would require an increase of approximately \$.5 - \$15.1 million. This increase would bring the General Fund Reserve to an estimated \$21.9 - \$36.5 million and bring total General Reserves to an estimated \$38.7 - \$53.3 million.

BACKGROUND

On April 15, 2002 the City Council adopted the Blue Ribbon Committee Report. The first recommendation of the Committee is:

Recommendation #1; Evaluate and determine what an adequate reserve level is for the City. At this time, the Committee recommends increasing the reserves to be between 7 to 10% of General Fund revenues. (See Attachment A)

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.

On July 24, 2002, the City Manager presented to the Committee on Rules, Finance and Intergovernmental Relations a proposal to increase General Reserves to a goal of 5 - 7% of General Fund revenues. A representative of the San Diego County Taxpayers' Association recommended that the 5 - 7% goal be focused on increasing the General Fund Reserves rather than General Reserves as a whole. The Committee on Rules, Finance and Intergovernmental Relations agreed that efforts to increase General Reserves should focus on the General Fund Reserve component and that the other general reserves serve as an added advantage. Accordingly, the Mayor directed the City Manager to return to a subsequent Rules Committee meeting to continue the discussion on adequate general reserve as well as General Fund reserve goals. The City Manager was also directed to provide additional information on the City's outstanding debt obligations including Certificates of Participation (COPs).

DISCUSSION

The City of San Diego is guided by six principles of budgeting in the development of its annual budget. The second principle states that *the General Fund should maintain a 3% reserve of General Fund revenue*. The Blue Ribbon Committee recommended that the principle be changed to reflect a requirement of 7 – 10% in total General Reserves. (The current principle reflects only the General Fund portion of General Reserves).

The City's General Reserves are comprised of the General Fund Reserve and several other pre-established reserves. It is important to distinguish between General Reserves and the General Fund Reserve, which is only one component of total General Reserves. The General Fund Reserve is an unappropriated reserve established for purposes such as funding General Fund emergencies and assisting in maintaining a favorable bond rating. As of June 30, 2002, the General Fund Reserve is \$21.4 million, which is 2.9% of General Fund revenues. Approximately \$5.7 million of the General Fund Reserve is designated for the library system.

In the Blue Ribbon Committee Report, which was issued in February 2002, the City's total General Reserves were \$30.5 million (approximately 4% of General Fund revenues) as of June 30, 2001. Subsequent to the Blue Ribbon Committee Report, total General Reserves have increased to \$38.2 million (approximately 5.2% of Fiscal Year 2003 estimated General Fund revenues). The \$7.7 million increase included items such as monies returned to the Balboa Park/Mission Bay Park Reserve, the establishment of the Ballpark Reserve, and \$1.7 million for the current year allocation for the library system.

Following is a summary of the City's total General Reserves as of June 30, 2002 (in millions):

General Fund Reserve	\$21.4
GASB 31 Reserve	2.0
Convention Center Reserve	6.9
MTDB/Trolley Reserve	2.1
Balboa Park/Mission Bay Reserve	3.5
Ballpark Reserve	<u>2.3</u>
Total General Reserves	\$38.2

In accordance with Government Accounting Standards Board Statement 31, the GASB 31 Reserve is established to fund impacts to the General Fund due to fluctuations in the market value of pooled investments. The GASB 31 Reserve is not established as a matter of law, but rather sound management practices. If General Fund investments are less than fair market value at the end of each fiscal year, then GASB 31 requires that the City fund the difference between fair market value and book value. This reserve is available and could be used to offset any market valuations not resolved by other means.

The Convention Center, MTDB/Trolley, Balboa Park/Mission Bay Park, and Ballpark projects are funded with bond issuances supported by Transient Occupancy Tax (TOT) allocations. The reserves for each project are funded by TOT revenue and are used as revenue stabilization reserves to protect against fluctuations in TOT revenue allocations during adverse economic conditions. Each reserve is established at 50% of one year's debt service for the bonds issued. These reserves are in addition to the traditional debt service reserves required by bond indentures.

Currently the Ballpark Reserve is \$2.3 million. In Fiscal Year 2004 it is projected to increase by \$5.2 million to reach the half-year's debt service amount. See Attachment B for a summary of debt commitments for which the General Fund is obligated.

Although total General Reserves include a variety of pre-designated stabilization reserves, these reserves are not restricted and may be used for general purposes. These reserves are discretionary funds set aside for unanticipated circumstances including revenue fluctuations. As the General Fund is ultimately responsible for these debt obligations, these reserves also help protect the General Fund against any potential liabilities as a result of these debt obligations. On a few occasions, the City has advanced these reserves for short-term cash management purposes and then replaced the monies.

Maintaining these reserves has contributed to the City's positive credit rating even in the environment of declining revenues during a weakened economy. If the City were to no longer maintain these reserves, it could negatively impact the City's credit rating as well as the cost of debt financing for future projects.

As the economy expands or slows, revenues are expected to increase or decrease accordingly. Since Fiscal Year 1993, General Fund revenues have increased annually by an average of 4.5% per year. Table 1 illustrates the trend in General Fund revenue and the General Fund Reserve over the past ten years.

Table 1. General Fund Revenues and General Fund Reserve by Fiscal Year

Fiscal Year	General Fund Revenues	General Fund Reserve ¹
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	(Actual in Millions)	(Millions)
2003	\$729.3 ²	\$21.4 ²
2002	\$727.4 ²	\$21.4
2001	\$709.9	\$19.5
2000	\$652.5	\$13.8
1999	\$583.9	\$6.2
1998	\$558.3	\$6.1
1997	\$513.8	\$6.0
1996	\$498.3	\$5.7
1995	\$783.7	\$5.5
1994	\$472.1	\$4.0
1993	\$462.7	\$4.0

¹Fiscal Year 1993 was the first year in which an unappropriated unallocated reserve was established

²Budgeted

In a recent survey conducted by the Financial Management Department, the City of San Diego was found to be among the California cities with the highest bond ratings from Moody's Investor Service, Fitch Ratings and Standard & Poor's (see Table 2 below). An adequate reserve has contributed to these favorable ratings. 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. In addition, staff found that large California cities with similar economic environments maintain general fund reserves or rainy day funds that range between 3 – 6% of general fund revenues.

Table 2. Survey Results

City	Population in Millions (2002)	Moody's Rating ¹ (2002)	Fitch Rating ¹ (2002)	Standard & Poor's Rating ¹ (2002)	General Fund Reserves ² (% of General Fund Revenue)
Los Angeles	3.8	Aa2	AA	AA	3.1%
San Diego	1.3	Aa1	AAA	AA	2.7%
San Jose	.9	Aa1	AA+	AA+	3.0%
San Francisco ³	.8	Aa3	AA	AA	1.2%
Long Beach	.5	N/A	A+	AA-	10.0% ⁴
Fresno	.4	N/A	N/A	N/A	5.68%
Sacramento	.4	Aa2	N/A	AA	6.0%
Oakland	.4	A1	A+	A+	7.5% ⁴
Santa Ana	.3	N/A	N/A	N/A	0%
Anaheim	.3	Aa2	N/A	AA	7.0%-8.0% ⁴

(July 2002)

¹General Obligation Bond Rating

²Level at which the General Fund unappropriated and unreserved fund balance is maintained, (Unaudited)

³San Francisco is a City/County form of Government

⁴Expressed as a percentage of operating expenditures

In order to progress from the current General Fund Reserve level of 2.9% of General Fund revenues to the proposed goal of 3 - 5% of General Fund revenues over the next five years, it is recommended that the following sources be considered to contribute to the General Fund reserves:

- (1) net budget surplus resulting from increased revenues and/or budget expenditure savings at year-end
- (2) remaining Tobacco Settlement funds after all pre-established priorities have been met

Any contributions to General Fund Reserves will be considered after ensuring adequate funding is obtained for City operations. Deposits to the General Fund Reserve would continue until the recommended goal of 3 - 5% of General Fund revenues is achieved. It is understood that in balancing resources with critical needs, conflicting priorities may arise which may impact the plan for funding the General Reserves. For instance, it may be difficult to accumulate reserves given the General Fund's low revenue base as well as the need to fund important City priorities such as the backlog of deferred maintenance, retirement system contributions, workers' compensation and liability fund requirements in conjunction with significant General Fund operational needs. 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.

Table 3 below shows a variety of general reserve levels expressed as a percentage of Fiscal Year 2003 estimated General Fund revenues.

Table 3. General Fund Reserves as a Percentage of Estimated General Fund Revenues

Fiscal Year 2003 Estimated General Fund Reserves \$729.3 Million	
General Fund Reserves as a % of Estimated General Fund Revenues	
2.7%	\$19.5M
3.0%	\$21.9M
3.5%	\$25.5M
4.0%	\$29.1M
4.5%	\$32.8M
5.0%	\$36.5M

CONCLUSION

Reserves are an integral part of the City's fiscal health. Strong economic performance, sound financial operations, low debt burden, and sufficient reserves contribute to the City's favorable bond rating and its ability to be flexible during uncertain economic times.

In addition to maintaining the various pre-established reserves, it is prudent for the City to increase its General Fund Reserve to a goal of 3 - 5% of General Fund revenues and the total General Reserves to 5 – 7% of General Fund revenues. An increase in the General Fund Reserve component to a goal of 3 - 5% of General Fund revenues would enable the City to better address unforeseen events.

Respectfully submitted,

Lisa Irvine
Financial Management Director

Approved: Michael T. Uberuaga
City Manager

IRVINE/CMC

[Attachment A – Blue Ribbon Recommendation #1](#)
[Attachment B – Summary of Debt Obligation](#)

