



THE CITY OF SAN DIEGO
REPORT TO THE CITY COUNCIL

DATE ISSUED: January 27, 2014 REPORT NO: 14-012

ATTENTION: Budget and Government Efficiency Committee

SUBJECT: Revision to City of San Diego Reserve Policy - General Fund Reserve Policy and Risk Management Reserve Policy: Workers' Compensation, Public Liability and Long-Term Disability

REFERENCE: City Council Reserve Policy – Revised December 15, 2011

REQUESTED ACTION: Council Policy #100-20 entitled "Reserve Policy" is amended and superseded for sections titled "General Fund Reserve Policy" and "Risk Management Reserve Policy" which include the sub-sections for "Public Liability Fund Reserve", "Workers' Compensation Fund Reserve" and "Long-Term Disability Fund Reserve."

STAFF RECOMMENDATION: Approve the requested item.

SUMMARY:

The City Council Reserve Policy (Policy) #100-20, effective December 15, 2011, is revised to update and strengthen the City's reserves, clarify the reserve structure and provide additional transparency for the General Fund reserve calculation.

The revisions to the Policy include the General Fund, Public Liability, Workers' Compensation and Long-Term Liability Reserves. A subsequent action will be presented to the Budget and Government Efficiency Committee for the Development Services, Water, Sewer, Refuse Disposal and Recycling Reserve Funds.

The revised Policy describes the General Fund Reserves as the Emergency Reserve and Stability Reserve, which in total shall not be less than 14% of General Fund operating revenues. The General Fund Reserve target is adjusted to 14% of the most recent three year average of annual audited General Fund revenue (excluding revenue from other financing sources or uses.) The revision to the Policy will change the funds held in the General Fund Reserves from approximately \$86 million to \$150 million. The reserve amounts above the Policy reserve level of 14% are determined to be Excess Equity, (currently estimated at approximately \$27 million). These are primarily one-time funds available for budgeting and appropriation through the budgetary process. The former designations of Committed, Assigned and Unassigned fund balance in the current policy are simplified and equate to the Stability and Excess Equity Reserves in the new Policy.

No change is proposed to the Public Liability Reserve target of 50%. The revised Policy updates the annual reserve contributions based on the most recent valuation. The target remains to achieve 50% funding of the liability for the Public Liability Reserve in FY 2019.

The Workers' Compensation Reserve target has been reduced from 50% to 25% of the liability after assessing the risk for large claims payments from this fund. The Workers' Compensation Reserve is projected to be funded at the policy reserve amount at the end of this fiscal year.

The revised Policy updates the Long-Term Disability (LTD) annual reserve contributions based on the most recent valuation. The target remains at 100% funding for the LTD Reserve in FY 2016 in anticipation of a possible conversion to a fully insured program for LTD.

General Fund Reserves

The revision to the General Fund Reserve Policy adds greater clarity and transparency to the reserve calculation and reconciles the basis for the determination of General Fund revenue to the City's Comprehensive Annual Financial Report (CAFR). It also incorporates the budgetary and fiscal principles and policies adopted by the City Council, including "Structural Budget Deficit Elimination Guiding Principles" (R-305615), "City Council Budget Policy 000-02" and the "Mid-Year Budget Authority Ordinance" (O-20084).

The recommended General Fund Reserve Policy target is 14% of the most recent three year average of annual audited General Fund operating revenues, comprised of the Emergency Reserve targeted at 8% plus the Stability Reserve at 6%.

The Emergency Reserve is recommended at 8% of the most recent three year average of annual audited General Fund operating revenues. This reserve level will be maintained for the purpose of sustaining General Fund operations in the event of a public emergency such as a natural disaster or other unforeseen catastrophic occurrence. This reserve may be expended only if an event is determined to be a public emergency by a two-thirds vote of the City Council, when such expenditures are necessary to ensure the safety of the City's residents and their property. The target Emergency Reserve percentage is consistent with City Charter Section 91 requiring financial reserves and with the City Attorney's opinion letter concerning Charter Section 91 dated September 27, 2007.

The Stability Reserve is recommended at 6% and will be maintained to mitigate extraordinary financial and service delivery risk due to unexpected revenue shortfalls in an economic downturn or from unanticipated one-time expenditures, such as a spike in the actuarially determined contribution to the pension system, or payment for a large claim or claims that cannot be met by other City reserve funds such as the Public Liability Fund. The purpose of this reserve is to provide budgetary stabilization for critical needs during a period of significant economic hardship, and is not intended to serve as an alternative funding source for new programs, or needs identified in the ordinary course of City operations. Recommendations to appropriate from the Stability Reserve will be brought forward by the Mayor and will require approval by a majority of the City Council.

Excess Equity is defined as the potentially spendable and unrestricted fund balance that is not otherwise assigned to reserves and is available for budgeting and appropriation for one-time

expenditures. Recommendations for the use of Excess Equity may be brought forward by the Mayor and will require approval by a majority of the City Council. The budgeting and appropriation of Excess Equity follows the policy guidance in the City Council budget policies and principles referenced in the Summary to this report.

Calculation of General Fund Reserves

The target General Fund Reserve balances are calculated based on the most recent three year average of the operating revenues as presented in the General Fund Budgetary Schedule of Revenues, Expenditures and Changes in Fund Balance in the Required Supplementary Information section of the City's CAFR. These revenues are from recurring revenue sources that support operations and exclude other financing sources. The exclusion of other financing sources reduces the variability introduced by one-time transfers into and out of the General Fund. This revised basis for determining General Fund revenue provides a clear, audited foundation for calculating the reserve percentage and is an important change to the policy to create transparency and consistency in calculating the General Fund Reserve.

Government Finance Officers Association (GFOA)

The total General Fund reserve policy target of 14% of operating revenues is consistent with GFOA best practices guidance which recommends *"at a minimum, that general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures."*

Two months of regular General Fund operating equates to 16.6% of the City's operating revenues based on the CAFR definition established in the Policy (an average of three years of General Fund operating revenue). It is important to note that the GFOA guidance is a broad recommendation that covers the breath of public agencies from small townships to large cities and counties. GFOA guidance recommends that a city evaluate its particular circumstances to develop a policy that takes into account its strengths and risks.

The City has mitigating strengths to support a General Fund Reserve percentage at 14%, including the strong fiscal policies and historical discipline during the past several years to fund the General Fund, Public Liability, Long-Term Disability and Workers' Compensation Reserves. Additional strengths include the City's strong access to capital markets, a track record to adhere to budget policies and principles in the budgeting of one-time funds for one-time expenditures, and the history of consistent, regular budget monitoring, financial forecasting and mid-year budget adjustments to maintain a balanced budget.

The City's current bond ratings are bolstered by our current General Fund Reserve funding level. As recently as June 2013, both Standard & Poor's and Fitch Ratings opined on the City's strong reserve levels and linked strong reserves to the bond ratings for the City.

As of June 30, 2013 the total amount of General Fund Reserves was \$179.5 million. Using the updated calculation method, General Fund Reserve policy percentage at June 30, 2013 was 16.8%. Based on the FY 2014 First Quarter Report, the City is projected to end FY 2014 with approximately \$27 million in Excess Equity. Financial Management is currently revising the FY

2014 expenditure and revenue projections for the FY 2014 Mid-Year Report, and this projection of reserve levels and excess equity may be revised.

Public Liability Reserve

The revision updates the annual Public Liability Reserve contributions based on the most recent valuation results. The target is to achieve 50% funding for the Public Liability Reserve in FY 2019 through annual contributions of \$3.2 million.

Workers' Compensation Reserve

The Workers' Compensation Reserve is revised from a target of 50% to 25%, or \$43 million, which is projected to be achieved at the end of FY 2014. The change is based on a determination that the reserve amount of \$43 million is sufficient to pay claims due to the low probability of large dollar claims requiring immediate payment. The reserves accrued to date accomplish the goal of providing a source of reserve funds for unexpected payment requirements. Workers' compensation liabilities accrue and are paid out differently than other City liabilities. The revised policy to reserve for workers' compensation liabilities recognizes the long-term nature of the liability, in contrast to the immediate requirements for large payments in Public Liability, which involves larger claims and therefore larger reserves.

In civil claims litigation the value of the claim can be determined by either mutual agreement between the parties, by a jury, or by a judge. Once the total value has been determined, the City pays out the total value of the claim at one time, which draws from the Public Liability Reserve. In contrast, all workers' compensation settlements are overseen by the State's Workers' Compensation Appeals Board (WCAB). Upon the WCAB's satisfaction that the level of disability has been appropriately determined, compensation for the disability is not paid out fully at one time with one payment; rather, it is paid out bi-weekly over a period of up to 13 years for cases of partial disability and over a lifetime for cases of total disability, with associated medical expenses paid as they are incurred. There is therefore low risk that the Workers' Compensation fund would be subject to large payouts at any one time as occurs with the Public Liability fund.

Recognizing the long-term nature of workers' compensation claim development and payments, the City's ongoing commitment to fiscal discipline and the need to maintain healthy reserves, the proposed changes to the workers' compensation reserve policy is fiscally prudent. The Workers' Compensation Reserve will be reviewed every other year to ensure that it meets the target based on the average outstanding liability of the three most recent years and if needed, adjusted accordingly.

Long-Term Disability Reserve

The amounts to achieve the 100% LTD Reserve target have been updated based on the smoothing methodology as described for the annual actuarial liability valuations for the most recent three years (FY 2011-2013). The total average outstanding liability is \$17 million and the annual contribution to achieve full funding of this amount in FY 2016 is \$1.6 million. The target reserve balance is needed to support the feasibility of purchasing an insurance policy to cover this benefit as an alternative to the current practice of self-insurance.

FISCAL CONSIDERATIONS: The revision to the Reserve Policy will change the funds held in General Fund Reserves from approximately \$86 million to \$150 million. In addition, the City currently has in fund balance approximately \$27 million in Excess Equity, which represents the portion of the reserves in excess of the 14% recommended General Fund Reserve Policy.

The proposed policy for the Workers' Compensation Reserve reduces the target goal from 50% to 25%. This goal is projected to be met in FY 2014. Future annual contributions of \$8.1 million citywide (\$6.6 million General Fund), projected in the FY 2015-2019 Five Year Outlook will not be required contributions since the policy goal will be met in FY 2014.

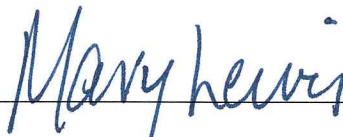
The Public Liability Reserve target goal was updated based on the most recent actuarial valuations. Future annual contributions were reduced from \$3.9 million, as published in the FY 2015-2019 Five Year Outlook, to \$3.2 million, subject to future adjustments upon review of progress to reach the 50% funding target by FY 2019.

The Long-Term Disability target goal was increased from \$12 million to \$17 million based on the most recent valuation. Future annual contributions of \$1.6 million remain the same as published in the FY 2015-2019 Five Year Outlook.


PREVIOUS COUNCIL and/or COMMITTEE ACTION: Council approved the Reserve Policy as Ordinance No. O-19679 on November 20, 2007, and approved revisions as Resolution No. R-303941 on July 29, 2008. The most current revision was approved by City Council on December 15, 2011 (Resolution No. R-307154).

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS: None

KEY STAKEHOLDERS AND PROJECTED IMPACTS: None



Mary Lewis
Chief Financial Officer



Scott Chadwick
Chief Operating Officer