



THE CITY OF SAN DIEGO  
**REPORT TO THE CITY COUNCIL**

DATE ISSUED: June 10, 2014 REPORT NO: 14-035

ATTENTION: City Council Meeting

SUBJECT: Revision to City of San Diego Reserve Policy #100-20 – Water Enterprise Fund Reserve Policy, Sewer Enterprise Fund Reserve Policy, Refuse Disposal & Recycling Enterprise Fund Reserve Policies, Development Services Enterprise Fund Reserve Policy, and adding the Golf Course Enterprise Fund Reserve Policy. Amending the General Fund Reserve Policy to include a discussion of “Excess Equity”.

REFERENCE: City Council Reserve Policy #100-20 – Revised February 10, 2014

REQUESTED ACTION: Council Policy #100-20 entitled “Reserve Policy” is amended and superseded for sections titled “Water Enterprise Fund Reserve Policy”, “Sewer Enterprise Fund Reserve Policy”, “Refuse Disposal & Recycling Enterprise Funds Reserve Policy”, and the revision of “Development Services Enterprise Fund Reserve Policy”, and addition of “Golf Enterprise Fund Reserve Policy.” Amend the “General Fund Reserve Policy” to include a discussion of maintaining additional Excess Equity.

STAFF RECOMMENDATION: Approve the requested item.

SUMMARY:

The City Council Reserve Policy (Policy) #100-20 was amended by Resolution R-308740 on February 10, 2014 for the General Fund Reserves, Public Liability, Workers’ Compensation and Long-Term Liability Reserves. This report is a subsequent action to revise the Enterprise Fund Reserve Policies and to further amend the General Fund Reserve Policy regarding the budgeting of Excess Equity.

Enterprise Funds are used to account for “business-type” activities, similar to those in the private sector. Accounting Standards require local governments to use Enterprise funds to account for operations (a) that are financed and operated in a manner similar to private business enterprises, where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.

Enterprise Funds, like Governmental Funds, require strong financial policies to ensure financial stability and the long-term viability of the business. Each fund is viewed independently according to its specific operational needs, business risks and vulnerabilities. Risk factors include revenue volatility, rate predictability, regulatory compliance, extreme events, business continuity and community development.

The proposed updates to the Enterprise Funds Reserve Policies are also based on the best practices recommended by the Government Finance Officers Association (GFOA) recommending operating reserves for Enterprise Funds of no less than 45 days and no more than 90 days of working capital. The Rating Agencies recognize formal reserve policies as good management practice for enterprise funds; however, they do not provide specific guidelines on reserve levels. The overall liquidity, which includes reserves and fund balance is a significant measure in evaluating the credit quality of an enterprise. Fitch Ratings has cited the City's strong reserve policies, long-term financial planning and prudent financial management practices all as positive factors which support our credit ratings.

Financial Reserve Policies can provide reasonable boundaries for rate analysis and cost allocations; provide management guidance on budgeting and long-range planning; and reduce cost of capital by supporting continued strong credit ratings which improve an agencies financial health and lower the cost to ratepayers. The following Enterprise Fund Reserve Policies are discussed in detail in the following pages.

### **Water and Wastewater Reserve Policies**

The Water Enterprise Fund is used to account for operating and maintenance costs, capital replacements and improvements, expansion of facilities, and payments necessary to obtain water from the Colorado River, the State Water Project and local sources and supply to customers. The Sewer Enterprise Fund is used to account for the operation, maintenance and development of the City's sewer system.

Appropriated Reserve – It is recommended that the Appropriated Reserve be removed from the formal Water and Wastewater reserve policies. This reserve is in fact an annual appropriation and separate from the reserve policy funds. Since it is budgeted, and not a general ledger reserve, the Appropriated Reserve will be amended to be a new commitment item in the budget which will be created in Fiscal Year 2015 by Financial Management to ensure greater transparency. This new commitment item will be budgeted annually for unanticipated operating contingencies. It is recommended that the budget for this commitment item be maintained at the current \$3.5 million for each fund based on historical levels. In Fiscal Year 2014, the Appropriated Reserve for both Water and Wastewater was budgeted at \$3.5 million.

Emergency Operating Reserve – The GFOA Best Practices report from 2011 recommends that enterprise funds have a working capital target of no less than forty-five (45) days of annual operating expenses, and that policy targets should start with a baseline of ninety (90) days of working capital and be adjusted based on particular factors of each enterprise fund. The current target for the Water and Wastewater Operating Reserves is 70 days of annual operating expenses. No change is recommended to the target. As of June 30, 2013, the Water Operating Reserve was at \$29.5 million and the Wastewater Operating Reserve was at \$43.7 million.

It is recommended that the Operating Reserve be renamed to the Emergency Operating Reserve. The reserve is intended to be used in the event of a catastrophe that prevents the utility from operating in its normal course of business. City Council approval will be required to appropriate funds from the Emergency Operating Reserve by a simple majority vote. This is a change from the original policy which delegated to the Chief Operating Officer/Chief Financial Officer due to the more severe restrictions placed on use of Reserve funds for a catastrophic event.

The Reserve Policy has also been revised to clarify how the Emergency Operating Reserve target is to be calculated. The reserve level will be calculated based on the annual operating budget for the fiscal year, less the budgeted operating contingency and the budget for water purchases and debt service (including State Revolving Fund loan repayments). Any request to use the reserve will include a plan and timeframe for replenishment. Previously, the Policy required that the target reserve balance be replenished by the next fiscal year; however, depending on the specific circumstances, full replenishment of the Operating Reserve may not be feasible in the next fiscal year without adverse impacts to operations or debt coverage ratios. Finally, the Policy for the Wastewater Emergency Operating Reserve has been revised to clarify that any reserves funded by the Participating Agencies for their share of the Metropolitan Sewer System would count toward the 70-day reserve target.

Capital Reserve – It is recommended that this reserve be renamed to the Emergency Capital Reserve. The Reserve Policy has been revised to clarify that this reserve is intended to be used for Emergency Capital Needs. The reserve is budgeted at \$5.0 million annually in the CIP Budget for both Water and Wastewater, and no change is recommended to the target reserve levels. Approval of the Chief Operating Officer or Chief Financial Officer is required to use this reserve and is not a policy change. The only revision to this Capital Reserve Policy is the name change.

Rate Stabilization Fund (RSF) – The recommended revision to this fund is a change from the current fixed amount to establish a baseline target balance of 5% of the prior fiscal year total system operating revenue as reported in the Comprehensive Annual Financial Report (CAFR) – Proprietary Funds Statement of Revenues, Expenses, and Changes in Fund Net Assets. This fund was established and is maintained pursuant to the legal bond documents for the outstanding water and wastewater system revenue bonds. Changing this reserve to a baseline percentage of prior year system operating revenue would amount to small changes to the current RSF target reserves for both enterprises. This reserve would be used as a management tool by the Public Utilities Department to provide stability for budgetary purposes and maintaining debt service coverage levels. As of June 30, 2013, the amount in the Water RSF was at \$38.5 million and the Wastewater RSF was at \$21.3 million. Based upon the recommendation of the Department, approval of the Chief Operating Officer or Chief Financial Officer is required to use this reserve.

Dedicated Reserve from Efficiency and Savings (DRES) – It is recommended that the DRES be eliminated as a policy reserve. This reserve was established in 2008 to protect and preserve savings from efficiencies, changing priorities or other actions related to reducing costs of the Capital Improvement Program (CIP) or operations and maintenance of the Water and Wastewater systems. The DRES balances for both Water and Wastewater will be fully drawn down in Fiscal Year 2014 to cash fund the Capital Improvement Program for both systems. As of June 30, 2013, the Water DRES was at \$29.9 million and Wastewater DRES was at \$27.2

million. The DRES has served its purpose for which it was created, to provide a transparent mechanism to deposit efficiency savings that would be used for capital projects.

Municipal Code Section 26.2003 specifies that one of the duties and functions of the Independent Rates Oversight Committee (IROC) shall be to oversee deposits to and withdrawals from the DRES. If the recommendation to eliminate the DRES is approved, the Public Utilities Department will work with IROC to propose an amendment to the Municipal Code with respect to IROC's duties and functions. The Public Utilities Department will continue to update IROC on CIP project schedules, costs and execution, as well as any other actions or initiatives that result in departmental savings or efficiencies.

Secondary Purchase Reserve (Water Only) – No changes are recommended for the Secondary Purchase Reserve. This reserve was established to purchase additional water supply in case of a major drought or unforeseen emergency that diminishes the City's normal supply. The reserve target is equal to 6% of the annual water purchase budget, including both commodity charges and fixed costs. City Council action is required in order to appropriate these reserves. As of June 30, 2013, the Secondary Purchase Reserve was at \$12.3 million.

#### **Refuse Disposal & Recycling Enterprise Funds Reserve Policy**

The Refuse Disposal Enterprise Fund was established to separate tipping fee revenues from the General Fund. The tipping fees support active and inactive landfill operations, solid waste code enforcement, commercial and industrial recycling programs, community cleanups and abatements, and collection and maintenance of street litter containers in business districts, these fees are levied on landfill users including the City of San Diego.

The Recycling Enterprise Fund and Assembly Bill (AB) 939 Fee were established as a result of the Integrated Waste Management Act of 1989. AB 939 authorized local jurisdictions to impose fees based on the types or amounts of solid waste generated to be used to pay actual costs incurred in preparing, adopting, and implementing integrated waste management plans.

#### **Operating Reserve**

The Operating Reserve is intended to be used in the event that the Enterprise Fund has a funding shortfall and continuity of business is jeopardized. This reserve may be drawn upon to fund unanticipated emergency expenditures, one-time high priority programs, or revenue shortfalls due to an unexpected economic slowdown or recession. The Chief Operating Officer and/or Chief Financial Officer will have authority to approve expenditures for unanticipated funding shortfalls for operational needs, and the reserve must be replenished no later than the subsequent fiscal year. This is a change from a current policy to ensure consistency among enterprise funds and make use more restrictive as it delegates this authority to the Department Director.

The Operating Reserve target level is 15% of operating revenues which is in keeping with GFOA best practices of a minimum of 45 days of working capital. This level equates to reserve balances of approximately \$4.6 million for the Refuse Disposal Fund and \$2.4 million for the Recycling Fund. The Environmental Services Department (ESD) has been allocating \$920,000 annually to the Refuse Disposal Fund Operating Reserve and \$480,000 annually to the Recycling Fund Operating Reserve since fiscal year 2011 with the intent to achieve the target levels by

Fiscal Year 2015. An annual review of this level will be conducted by the Department to determine adequate funding levels.

In Fiscal Year 2013, the balance was \$2,760,000 for the Refuse Disposal Fund Operating Reserve and \$1,440,000 for the Recycling Fund Operating Reserve. The targeted reserve levels are projected to be achieved by Fiscal Year 2015 based on the following schedules:

**Refuse Disposal Fund Reserve Targets**

<i>Target Date</i>	<i>Refuse Disposal Fund Target Contribution</i>	<i>Projected Reserve Balance</i>	<i>Target (% of Operating Revenues)</i>
June 30, 2014	\$920,000	\$3,680,000	12.00%
June 30, 2015	\$920,000	\$4,600,000	15.00%

**Recycling Fund Reserve Targets**

<i>Target Date</i>	<i>Recycling Fund Target Contribution</i>	<i>Projected Reserve Balance</i>	<i>Target (% of Operating Revenues)</i>
June 30, 2014	\$480,000	\$1,920,000	12.00%
June 30, 2015	\$480,000	\$2,400,000	15.00%

**Development Services Enterprise Fund Reserve Policy**

The Development Services Fund accounts for the City’s development review and inspection services, which are funded directly by fees and charges paid by Development Services’ customers. The fund is intended to be self-supporting.

**Operating Reserve**

The Operating Reserve is intended to provide financial stability during economic cycles and provide business continuity when significant natural or manmade disasters occur. The reserve may be used to meet current expenditures following an unanticipated decline in workload resulting in decreased revenues.

The use of funds is for unanticipated emergency situations resulting from loss of revenue and would include major incidents such as an earthquake or wild fires. Revenue generating work, such as permitting or land use may be interrupted; however, downsizing staff may not be prudent as construction will commence or increase once damage assessments are completed. The reserve is not intended to maintain staffing levels during lengthy economic recession; and based on forecasted activity it may be used to maintain core services during relatively short downturn periods. The reserve will be replenished to previous levels at the earliest opportunity after revenues have improved and stabilized to cover on-going operating expenses. The Chief Financial Officer/Chief Operating Officer will be responsible for approving the use of the reserve for unanticipated operating expenses. This is a change from the current policy that delegates this authority to the Department Director.

The reserve is based on annual expenditures operating budget for the fiscal year. The target reserve level for the operating reserve is 7%-15% of operating expenses, or a target of 60 days of operating reserves once the 15% is obtained. The 7% target reserve is expected to be reached by Fiscal Year 2016 and the maximum reserve level of 15% by Fiscal Year 2022. The target reserve amount will be assessed on an annual basis using the most recent three years of audited actual expenditures.

<b>Target Date</b>	<b>Target (% of Operating Expenses)</b>
June 30, 2014	4.50%
June 30, 2015	5.75%
June 30, 2016	7.00%
June 30, 2017	8.25%
June 30, 2018	9.50%
June 30, 2019	10.75%
June 30, 2020	12.00%
June 30, 2021	13.50%
June 30, 2022	15.00%

**Golf Course Enterprise Fund Reserve Policy**

A new Reserve Policy is being proposed for Golf Course Enterprise Fund. The City has operated a municipal golf program since 1915. Today, the Golf Division operates three City golf complexes: Balboa Park Golf Course 18-hole and 9-hole courses; Mission Bay 18-hole executive golf course; and Torrey Pines 18-hole North Course and 18-hole South Course. The Golf Course Fund was established in 1991 and operates in a manner similar to a private sector enterprise where the cost of providing services is recovered through user charges. A primary goal of the Golf Course Fund is to ensure that the City operated golf courses are financially self-sufficient and that they do not require financial support from the City’s General Fund.

The City will maintain reserves equal to 12% of the most recent three year average of annual audited operating revenues<sup>1</sup>, with the intent to maintain the reserve balance at the same level for future years based on historical requirements. The 12 % reserve level is in alignment with GFOA best practices, which recommend enterprise funds maintain a working capital reserve equivalent to a minimum of 45 days, or 12%. Due to revenue and expenditure stability and rate predictability, the minimum target is deemed adequate for the Golf Fund Reserve. However, an annual review of this policy target will continue to be conducted by the Department to determine sufficient funding levels and alignment with the Golf Business Plan. The Chief Operating Officer/Chief Financial Officer will be responsible for approving the use of the reserve for unanticipated operating expenses.

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<sup>1</sup> Target reserve balances are based on operating revenues as presented in the Budgetary Schedule of Revenues, Expenditures and Changes in Fund Balance in the Required Supplementary Information section of the Comprehensive Annual Financial Report. These revenues are from recurring revenue sources that support operations, and exclude other financing sources.

Based on the Fiscal Years 2010 through 2013, the average fund balance is \$16.4 million or 94% of the most recent three year average of annual audited operating revenues, well above the 12% reserve target. The Golf Course Fund Reserve will be reassessed every two years and incorporated into the budget process in order to ensure that the targeted goal is met in a manner that is balanced with other budget priorities.

**General Fund Reserve: Excess Equity**

The following language has been added to the General Fund Reserve Policy to clarify the timing and the budgeting of any Excess Equity projected in the budget monitoring reports, in particular the year end report.

The Quarterly Budget Monitoring Reports provide an estimate of Excess Equity based on the projected activity from operations during the fiscal year; however, unrestricted fund balance is not determined until the City closes its books as of June 30. In the May Revision of the annual budget, the Mayor may propose to budget any projected excess equity as a contingency to fund the General Fund Reserves, Risk Management Reserves or for a priority one-time capital need. The transfer would occur after the fiscal year close is completed and the budgeted Excess Equity amount is determined to be available in fund balance above the 14% General Fund reserves.

Language was also added to the compliance with reserve policy: “Reporting Use of Reserve Funds” section to require the Mayor to identify the amount of Excess Equity as part of the quarterly budget monitoring reports.

**General Fund Reserve: Emergency Reserve**

The following language has been added to the General Fund Reserve Policy for the Emergency Reserve replenishment: In the event this reserve is reduced below the amount established by this policy, the Mayor shall prepare a plan as promptly as conditions warrant to replenish the Stability Reserve balance to the policy level.

**FISCAL CONSIDERATIONS:**

The recommended revisions to the Enterprise Fund Reserve Policies support the fiscal stability and financial viability of the City’s business activities. The recommended revisions change the methodology upon which the reserve target is based, which may result in minor adjustments to the current balances to better protect the financial operations of the enterprise against unanticipated events.

**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 to the Enterprise Fund Reserves was approved by City Council on December 15, 2011 (Resolution No. R-307154). Council approved the General Fund Reserve Policy amendments on February 10, 2014 by R-308740, including the Public Liability, Workers’ Compensation and Long-Term Disability reserves. On May 22, 2014, the Budget and Government Efficiency Committee forwarded the revision to the City of San Diego Reserve Policy #100-20 to the full City Council without a recommendation and directed staff to: Revise the General Fund Reserve Policy to require the Mayor to identify the amount of Excess Equity as part of the quarterly budget monitoring reports; and bring forward clarification

on the replenishment language and consider additional explanatory language on the Enterprise Fund Reserves Policies.

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:     None

KEY STAKEHOLDERS AND PROJECTED IMPACTS:     None

*Signature on file* \_\_\_\_\_

Mary Lewis  
Chief Financial Officer

*Signature on file* \_\_\_\_\_

Tracy McCraner  
Financial Management Director