City of Pleasant Hill

MEMORANDUM

TO: Budget Committee Chairman Tim Flaherty
Budget Committee Member Jack Weir

FROM: Andrew Murray, Assistant City Manager
Mary McCarthy, Finance Manager

DATE: February 24, 2014

SUBJECT: Revised General Fund Reserve Policy Proposal

## Introduction

The City of Pleasant Hill (City) Budget Committee (Committee) requested in summer 2013 that staff review the City's existing General Fund reserve policy and recommend updates. Staff proposed a number of potential changes to the Committee at its August 29, 2013 meeting. The Committee discussed the proposed changes and directed staff to conduct additional analysis. Staff is now presenting a revised proposal that simplifies and distinguishes the different reserves.

## Background

The City Council first created a General Fund reserve when it passed Resolution #44-02 on June 17, 2002. This resolution directed that a portion of unreserved General Fund balance be designated for contingencies. The resolution noted that designating fund balance for contingency purposes would mitigate current and future risks associated with cash flow, revenue shortfalls, natural or manmade calamities, and unanticipated expenditures. The designation for contingencies was set at $5.0 million on July 1, 2002, and set to increase by 5.5% on July 1, 2003 and by 3.5% every July 1 thereafter.

Council Resolution #54-03, passed on June 16, 2003, increased the designation for contingencies to $8.0 million on July 1, 2003, and directed that it shall increase by 2% every July 1 thereafter. Although not directed through a specific resolution on reserves, the designation for contingencies has been held constant in the budget at $8,323,200 since July 1, 2005. Council Resolution #35-06, which designated $8.3 million for contingencies, specified that $6.0 million was intended for cash flow (working capital), and $2.3 million for unforeseen emergencies.

## Analysis

In order to recommend updates to the General Fund reserve policy, staff reviewed the City's historical practice regarding reserves and the associated justification. As noted in the background section above, staff identified that since July 1, 2005, the City has set a reserve requirement of $8.3 million, of which $6.0 million was envisioned for working capital and $2.3 million for other purposes.

To evaluate whether the historic practice continues to be appropriate, staff researched current best practices within the public finance field regarding reserve types and levels. In addition, staff took a fresh, zero-based look at the City's financial risks and liabilities and identified which of the risks and liabilities already have a funding plan in place (e.g., pension obligations), and therefore do not require a General Fund reserve. Staff also identified which of the risks and liabilities are recurring and predictable (e.g., capital expenditures or accrued paid leave), and therefore are more appropriately funded through the regular budget process in a mechanism such as an internal service fund or capital accumulation fund rather than a reserve.

Staff ultimately determined that the following four risks/needs are best addressed through a General Fund reserve:

- Working capital;
- Economic/budgetary uncertainty;
- Catastrophic/extreme event; and
- Umpqua debt covenant.

These are the most common segmentations of reserves among municipalities. A more detailed description of these reserves, as well as specific proposed amounts, are included below, as is a discussion of the appropriate mechanisms through which to fund some other key liabilities of the City's.

## Proposed General Fund Reserves

As noted above, the City has a number of risks and liabilities. However, not all are best addressed through a General Fund reserve. In general, reserves are well suited to addressing working capital requirements as well as non-recurring, unpredictable fiscal events. Most other risks and liabilities are better addressed through other mechanisms.

Regarding working capital, the City's General Fund revenue sources are fairly concentrated and uneven in their timing. For example, the City receives 75% of the sales tax allocation monthly and the remaining 25% is received twice a year during the months of February and May. Property taxes are remitted in December, May and June and business license revenue is primarily received during January. As such, the City needs to maintain a substantial fund balance in order to provide adequate liquidity throughout the year to meet cash flow obligations. Although it is a common practice among municipalities, particularly through tax and revenue anticipation notes (TRANs), the City has historically made the policy decision not to borrow funds to satisfy recurring annual cash flow needs. It has decided to fund short-term needs with reserves rather than debt. In theory, this saves the City money, as it does not need to pay market rates to borrow cash. Staff recommends that the City continue this conservative financial practice of holding significant working capital in reserve, $5 million specifically, unless the Council determines that there are investment opportunities for this capital that would provide returns on investment that exceed the cost of borrowing the cash.

Staff identified $5 million as the preferred amount by reviewing General Fund monthly revenue versus expenditure activity for the past three fiscal years. Based on this review, it was determined that General Fund expenditures maximally exceeded revenues during the month of November for each of these years. Total City fund expenditures also exceeded revenues during the same period.

During fiscal year (FY) 2012/2013 the City successfully negotiated a loan with Umpqua Bank and used the proceeds to pay off the City's CalPERS Public Safety side fund obligation. One of the covenants requires that the City maintain a General Fund reserve balance of a minimum of $3.2 million. Additionally, $890,000 held in a separate fiscal agent account by Umpqua Bank is considered a reserved portion of the General Funds' total fund balance.

The concentration of the City's General Fund revenue sources also impacts the desirability of having a reserve for economic/budgetary uncertainty. If one of the few large sources of revenue decreases, it can have a significant impact on the General Fund at large. Dramatic changes in revenue, which require associated changes in expenditures, often through staffing or key service reductions, can have disproportionately large and long-lasting disruptive effects on organizations. As such, it is usually wise and efficient in the long run, when possible, to smooth expenditures and the ramping down and up of staffing and services. The main mechanism through which municipalities smooth expenditures is by retaining reserves, which can be deployed as one-time revenues during challenging economic times. Staff recommends that the City reserve $2 million for economic uncertainty, which would be used to limit General Fund budget reductions to no more than 2.5% per year total over four years of an economic downturn similar in profile to the recent Great Recession. Staff believes that the General Fund could temporarily absorb a reduction in revenue of this level without a decline in services.

Note that staff is not specifically recommending a "rainy day"-type reserve for economic uncertainty at this time. Rainy day reserves are characterized by requirements to deposit a certain amount of revenue growth into the reserve, perhaps without regard to the balance, and having specific rules on when reserves can be used, usually tied to threshold reductions in revenues. Staff intends to return to Council with specific recommendations about the sources and uses of the reserves in the near future, at which time such details will be considered.

A catastrophic/extreme event, such as a significant earthquake, flood, or fire, although statistically improbable, could have a severe impact on the City's immediate ability to provide critical services as well as medium and long-term budgetary impacts that could additionally limit services. A reserve for catastrophic events can be conceptualized as having three components. One portion can provide working capital for recovery of infrastructure, even for expenditures that might eventually be reimbursed by the State or federal government. A second portion might be needed to fund non-reimbursable recovery expenditures. A third portion can smooth routine expenditures to cover lost revenue due to an economic downturn related to the catastrophe. Although it is difficult to precisely quantify the likelihood and severity of a catastrophic event, it is nonetheless important that public finance and safety staff to do so in order to create appropriate recovery plans.

City finance staff reviewed the existing City Hazard Mitigation Plan, prepared by Engineering, to gauge the likelihood and severity of different catastrophic events. Based on this information and the City's expectation that it could borrow funds for immediate recovery cash flow and would be reimbursed for approximately 90% of disaster recovery expenditures, staff is recommending a catastrophic/extreme event reserve of $1 million. To provide perspective, although the City does not currently have earthquake insurance, the cost for such would range from $50,000 to $90,000 per year depending upon the coverage selected. The $1 million reserve proposed would be adequate to manage the earthquake risk and other natural disaster risks. Additionally, the City has tax interruption insurance coverage, which mitigates the impact of lost revenue from taxes due to a disaster. As such, the City does not need a large reserve to address that aspect of responding to a disaster.

The proposed reserves are listed in the table below.

| **Proposed General Fund Reserves** | **Amount ($)** |
|---|---:|
| Reserve for Working Capital | 5,000,000 |
| Reserve for Economic Uncertainty | 2,000,000 |
| Reserve for Catastrophic Event | 1,000,000 |
| Reserve for Umpqua Bank Loan (money held by fiscal agent) | 890,000 |
| **Total** | **8,890,000** |
| % of Budgeted FY2013/2014 General Fund Expenditures | 43.6% |

Government Finance Officers Association Assessment Tool

To validate the zero-based, micro scale proposals for reserve types and levels described above, staff calculated the sum total amount of proposed reserves and tested its suitability against industry benchmarks. Perhaps foremost, staff used the Government Finance Officers Association (GFOA) test of General Fund Reserve Risk Factors. Based on staff's qualitative assessment of the City's financial situation, including factors such as revenue stability, expenditure volatility, leverage, availability of resources in other funds, and capital needs, the assessment resulted in a recommended minimum reserve level of 26% - 35% of General Fund expenditures. We are recommending a reserve level of approximately 44%.

Similarly, bond rating agencies evaluate creditworthiness of municipalities based in part on their available fund balance, including reserves. For example, Standard & Poor's considers a municipality to have a "strong" fund balance if it is between 8% - 15% of expenditures and to have a "very strong" balance if it is above 15%.

Other Mechanisms to Fund Liabilities

As noted above, not all of the City's risks and liabilities are best funded or mitigated through reserves. One clear example is the City's general liability risk. Liability cases are so unpredictable and can be sufficiently expensive that it is prudent and cost effective to manage them through risk pooling. In addition, liabilities that are predictable and recurring, such as those related to capital renewal and replacement or accrued paid leave are best funded by internal service or capital accumulation funds. Staff proposes that the City Council authorize the creation of capital accumulation accounts for facilities and infrastructure, vehicles and equipment, information technology, and accrued paid leave.

Reserve for Special Projects

The potential changes that staff recommended to the Committee at its August 29, 2013 meeting included separate discretionary projects and Council contingency reserves. Upon reflection, staff believes that the desire to have funds available for unanticipated special projects can be equally well served through three different mechanisms, of which having a discretionary projects/Council contingency reserve is one. Another option is simply to appropriate funds for unanticipated special projects from undesignated fund balance when the need arises. A third option is to appropriate funds during the regular budget process to a specific Council discretionary account. Staff does not have a recommendation for one approach over another.

Reserves for Non-General Fund Funds

The General Fund is the source of expenditures that contains the most flexibility. Although the General Fund accounts for the majority of the financial activity at the City, the City also maintains special revenue funds, capital project funds, and debt service funds. Due to the legislation and restrictions on how money can be expended in these funds, they are not as significant a target as the General Fund for creating reserves. As such, staff is not recommending that the City Council adopt any reserve policies for non-General Fund funds at this time.

Next Steps

If the Committee approves staff's recommendations, staff envisions the following next steps:

- Staff returns to Committee with a resolution formalizing the reserve types and amounts as well as mechanisms governing the use and replenishment of the reserves;
- Staff returns to Committee with a resolution formalizing the capital accumulation accounts; and
- Regarding unreserved General Fund balance, Committee and Council deliberate and make decision on new appropriations now or as part of the adoption of the fiscal year (FY) 2014/2016 budget.

Staff Recommendation

Staff recommends that the Budget Committee and City Council adopt the recommendations to establish the General Fund reserves and other funds described above, and direct staff to work with the City Attorney to draft appropriate legislation for adoption.

Further, if the City Council adopts revised reserves, staff recommends that these policies be included in the budget document.

Attachments: City Council Resolution #44-02
City Council Resolution #54-03