Staff Report

DATE: May 9, 2006
TO: City Council
FROM: Paul Navazio, Finance Director
SUBJECT: Proposed General Fund Reserve Policy

**Recommendation**

It is recommended that the City Council adopt the enclosed General Fund Reserve Policy to be implemented in conjunction with the FY2006/07 Annual Budget. The policy seeks to formally establish a) appropriate level of reserve, b) criteria for draw-down of reserve funds and c) guidelines for use of available funds in excess of reserve requirements.

**Background**

Current City practice is to maintain a General Fund reserve level equal to 15% of General Fund revenues. While this policy “statement” guides development and management of the annual budget, the City lacks a formal reserve policy document as well as any documented analytical or policy basis for this level of reserve.

Staff has developed a formal General Fund Reserve Policy setting the appropriate level of reserve funds, establishing formal criteria for draw-down of reserves, and provide guidelines for use of funds that may be available in excess of the reserve policy. Staff requests City Council adoption of the enclosed Reserve Policy to be implemented with the development of the City’s FY2006/07 Annual Budget.

**Discussion**

In an effort to evaluate and formalize the City’s General Fund Reserve Policy, staff undertook a review of policies adopted by other cities. In addition, recommendations from the Government Finance Officers’ Association (GFOA) “best practices in budgeting” were considered in the development of the enclosed draft policy.

While specific reserve policy “targets” vary greatly across cities, several elements appear in numerous adopted policies, consistent with best practices and prudent fiscal management. Individual community circumstances and characteristics greatly influence actual reserve level targets, however the following are some of the common themes found in many well-written reserve policies:

- Reserve acts as a “risk management” tool
Reserves provides a “buffer” against revenue fluctuations inherent in economic cycles
- Prohibition of use of reserve funds for ongoing operating expenditures
- Guidelines for use of reserve funds
- Guidelines for replenishment of reserve funds, as needed
- Regular review of reserve policy and reserve levels

The following summarizes the recommendation for the General Fund reserve policy

1) Maintain General Fund reserve policy level of 15% of discretionary General Fund Revenues; however, the reserve level should be subject to periodic review.

Staff has performed an analysis of historical revenue trends and forecasts in an effort to establish appropriate reserve levels to mitigate potential impacts of “normal” revenue fluctuations. Based upon this analysis, staff has concluded that a reserve level of 6%-8% is likely sufficient to address annual variations in General Fund revenues. The City’s “risk” stemming from potential revenue fluctuations is largely mitigated by a relatively stable economic base, as well as recent passage of Proposition 1A which significantly protects local governments from future “raids” of local tax revenues by the State.

Staff has not undertaken an analysis of potential risks that arise from unforeseen emergencies, such as natural disasters. However, staff notes that many jurisdictions base their “emergency” reserve levels to either a specific dollar amount, or a specified period of operating costs. In other words, a reserve equal to one-month’s operating costs (or two pay-periods) equates to approximately 8%. Actual reserve levels vary greatly across cities, with some policies based on an analytical assessment of risk, while others appear to be based on establishment of an arbitrary dollar amount or percentage reserve level.

While an argument could be made that the City’s economic base and other risk factors may warrant a less conservative reserve level, staff is recommending maintaining the current 15% reserve level at this time. Staff would recommend that the level of reserve be revisited in two years, following a more comprehensive analysis of “risk” factors as well as progress made addressing the projected structural budget deficit and achieving the Council’s goal of fiscal stability. The reserve level established by City policy should not be viewed as a means of addressing our budget shortfalls, and evaluating the appropriate reserve level is best undertaken outside the discussion of an overall budget-balancing framework.

2) Establish Guidelines for Use of Reserve Funds for the following purposes:
   - Reserve for economic uncertainty
   - Emergency Reserve

3) Establish Guidelines for Use of Funds in Excess of established reserve levels.
   - Transfer to other funds, as appropriate, to offset year-end deficits within those funds,
   - Transfer to the Capital Program Fund (Fund TBD) for appropriation within the Capital Improvement Program Budget and/or Deferred Maintenance for non-recurring needs,
- Re-appropriation within the subsequent year’s operating budget to provide for one-time, non-recurring needs.
- It is the intent of the City Council to limit use of General Fund Reserves to address unanticipated one-time needs.
- Reserves shall not be applied to recurring annual operating expenditures.

**Finance and Budget Commission**

The Finance and Budget Commission has discussed establishment of a formal General Fund reserve policy over the past year and has reviewed and commented on earlier draft policies presented by staff. Many of the comments provided by the commission have been incorporated into the policy now being presented to the Council.

At their meeting of April 3rd, the Finance and Budget Commission voted unanimously to recommend that the City Council adopt the enclosed policy. Among the issues discussed by the commission is the appropriate level of reserve. While some commissioners felt comfortable recommending a reduction in the reserve level, the final recommendation of the commission was to retain the current reserve policy level, and review it within two years time.

**Conclusion**

Staff recommends adoption of the General Fund Reserve Policy. Staff would concur that additional analysis and discussion is warranted with respect to the appropriate reserve level, however, staff would recommend adoption of the current reserve level and related policy guidelines at this time.

Staff also notes that implementation of this policy is likely to occur over a period of time, likely 1-2 years. Given the City’s historical practice of relying on General Fund fund balance to balance the annual operating budget ($2.6 million in one-time funds were used in the current-year budget), it may be realistic to gradually decrease City’s reliance on one-time funds. A formal recommendation on how this policy is being implemented in the short-term will be included in the City Manager’s FY2006/07 Proposed Budget.

**Attachments:**

A) Resolution Adopting General Fund Reserve Policy
B) Proposed General Fund Reserve Policy Document
C) California Society of Municipal Finance Officers - Survey: Reserve Levels (selected cities)
D) Calculation of Reserve Requirement based on review of “discretionary” revenues
RESOLUTION NO.______, SERIES 2006

RESOLUTION ADOPTING A GENERAL FUND RESERVE POLICY

WHEREAS, the City Council of the City of Davis wishes to adopt a formal General Fund reserve policy to establish appropriate levels of reserves as well as guidelines for uses of funds in excess of said reserve levels; and

WHEREAS, a draft General Fund Reserve Policy was presented to the City Council in March, 2006 and the City Council directed staff to present the policy for consideration and adoption in conjunction with development of the FY2006/07 Annual; and

WHEREAS, the draft General Fund Reserve Policy was reviewed by the Finance Budget Commission, which voted unanimously at its meeting of April 3, 2006 to support adoption of the policy;

NOW, THEREFORE, BE IT RESOLVED by the City Council of the City of Davis that the General Fund Reserve Policy is hereby adopted.

PASSED AND ADOPTED by the City Council of the City of Davis on this ____ day of May, 2006, by the following vote:

AYES:

NOES:

ABSTAIN:

Ruth Uy Asmundson, Mayor

ATTEST:

Margaret Roberts
City Clerk
General Fund Reserve Policy

Purpose

The City of Davis establishes its General Fund Reserve policy as additional insurance against disasters, emergencies and unforeseen expenditures.

Reserve Level

The City Council hereby establishes the following minimum General Fund reserve targets:

- The City shall strive to maintain a General Fund reserve equal to 15% of discretionary General Fund revenues. These funds are set-aside to address potential needs in the following areas:
  - A Reserve for Economic Uncertainty - funds designated to mitigate periodic revenue shortfalls due to downturn in economic cycles, thereby avoiding the need for service-level reductions within the fiscal year.
  - An Emergency Reserve - funds designated to mitigate costs of unforeseeable emergencies and natural disasters.
- The appropriate level of General Fund reserves shall be reviewed every two years.

For the purpose of this section, discretionary General Fund revenues include all taxes, assessments, fee and miscellaneous revenues that are not restricted as to use.

Use of Reserve Funds

Reserve for Economic Uncertainty – Funds reserved under this category shall be used to mitigate annual revenue shortfalls (actual revenues less than projected revenues) due to slowdown in general economic conditions as well as reductions in revenues caused by actions by State/Federal governments. Should any unanticipated reductions in revenues be deemed to be recurring, adjustments will be made in the following budget so as to reflect revised revenue expectations.

Any reserve funds expended within this category that result in year-end reserves below the established policy level shall be restored in the subsequent budget year. However, if the reserve level falls to below 10%, the Council may restore funds over a multi-year period.

Emergency Reserve - Funds reserved under this category shall be used to mitigate costs associated with unforeseen emergencies, including natural disasters. Should unforeseen and unavoidable events occur that require expenditure of City resources beyond those provided
for in the annual budget, the City Manager shall have the authority to approve appropriation of Emergency Reserve Funds. The City Manager shall then present to the City Council – no later than its first regularly scheduled meeting - a resolution confirming the nature of the emergency and formally authorizing the appropriation of reserve funds.

**Excess Fund Balance**

At the end of each fiscal year, the Finance Department will report on the audited year-end budgetary fiscal results. Should actual General Fund revenues exceed expenditures and encumbrances, a year-end operating surplus shall be reported. Any year-end operating surplus which results in the General Fund fund balance exceeding the level required by the reserve policy shall be deemed available for allocation for the following, subject to Council approval:

- Transfer to other funds, as appropriate, to offset year-end deficits within those funds,
- Transfer to the Capital Program Fund (Fund TBD) for appropriation within the Capital Improvement Program Budget and/or Deferred Maintenance for non-recurring needs,
- Re-appropriation within the subsequent year’s operating budget to provide for one-time, non-recurring needs.

It is the intent of the City Council to limit use of fund balances in the General Fund to address unanticipated one-time needs. Fund Balances shall not be applied to recurring annual operating expenditures.

**Other Funds**

In conjunction with approving the General Fund Reserve Policy, the City Council expresses its intent to evaluate other Special Revenue, Enterprise and Internal Service funds to establish appropriateness of developing formal fund-specific reserve policies.
### Calculation of Reserve Levels

Re-classification of Discretionary Revenues

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<th>Baseline Budget</th>
<th>Proposed Budget</th>
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<td>General Fund Revenues</td>
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<td>$ 36,212,777</td>
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<td><strong>Adjustments:</strong></td>
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<tr>
<td>Building Fund Revenues</td>
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<td>Transportation Fund Revenues</td>
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<td>Reserve Target (15%)</td>
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