



Council Meeting: August 9, 2011

SUBJECT: 2011 Study Issue FIN 11-02 – Update Fiscal Sub-element Policy Related to Budget Stabilization Fund

BACKGROUND

At the January 28, 2011, Study/Budget Issues Workshop, Council prioritized a Department of Finance study of the City's current policy related to its Budget Stabilization Fund (formerly known as the 20-Year RAP Reserve). Specifically, the policy currently requires that the Budget Stabilization Fund be drawn to zero in the twentieth year of the plan. The City had moved away from this policy beginning in FY 2007/2008, as the logic of drawing this reserve down to zero was the subject of significant discussion amongst staff and Council. The purpose of the study was to develop and recommend an updated policy related to the Budget Stabilization Fund that addresses the appropriate balance to maintain in that reserve.

On June 2, 2011, at the Budget Workshop to review the FY 2011/2012 Recommended Budget, Council requested that a review and potential update of the policy related to the General Fund's Contingency Reserve be incorporated into this study. Because both of these reserves are in the General Fund, policy changes to one can affect the other, and therefore, it made sense to review both policies at the same time.

On July 19, 2011, a Council Study Session was held to review the results of the study and the recommendations for changes to the policies. At that session, Council provided additional direction to staff regarding modifications to the recommendations that had been made. This Report to Council addresses this direction and presents for Council's review and approval updated policies for the Budget Stabilization Fund and the Contingency Reserve.

EXISTING POLICY

General Plan

Fiscal Sub-element 7.1.E.1.1 – The City shall maintain a General Fund Contingency Reserve of at least 20% of operating expenditures to cover emergencies or disasters.

Fiscal Sub-element 7.1.E.1.4 – The Twenty-Year RAP Reserve should be balanced to zero in the twentieth year of the Long-Term Financial Plan.

DISCUSSION

Budget Stabilization Fund

The General Fund's Budget Stabilization Fund serves several purposes. In addition to being utilized to stabilize services through economic cycles, the Budget Stabilization Fund also serves as an early warning system for future fiscal issues and to inform decision making and budgetary assumptions. Utilizing the Budget Stabilization Fund as an early warning system and to inform decision making are unique to Sunnyvale's long-term financial planning process.

With respect to stabilizing services through economic cycles, the Budget Stabilization Fund's purpose is to have enough funds set aside to allow the City to mitigate the short-term impact of significant and unplanned revenue declines. Twice in the past 11 years, the General Fund has faced a 15% year-over-year revenue decline due to the volatile nature of many of our major revenue sources, most notably Sales Tax. Having sufficient funds available in the Budget Stabilization Fund allowed the City to take a measured and reasoned response to these drastic revenue declines as opposed to immediately reducing spending to balance the budget in the short term. Going forward, the City's policy related to the utilization of the Budget Stabilization Fund needs to ensure that this fund maintains sufficient reserves in the short-term to continue to be able address severe and unanticipated revenue fluctuations.

In developing a utilization policy for the Budget Stabilization Fund, however, it is also important that its other functions are also considered. Utilizing the Budget Stabilization Fund to serve as an early warning system and to inform decision making and budgetary assumptions is driven by the City's 20-year financial planning model. Each year as the General Fund's 20-year plan is developed, the impact of budgetary assumptions on the Budget Stabilization Fund is the key benchmark in determining the sustainability of the plan and the policy decisions that are required by Council to execute the plan. Because of the way the Budget Stabilization Fund is utilized to inform budgetary assumptions and policy decisions, it is essential that a policy related to its utilization be flexible to accommodate this. Setting a ceiling or a floor on the Budget Stabilization Fund beyond two years limits its usefulness, as it can require unrealistic assumptions to meet the parameters of the floor and/or ceiling.

To capitalize on both the short- and long-term purposes of the Budget Stabilization Fund, staff recommends a policy that sets enough funds aside in the first two years of the plan to cover significant and unplanned revenue declines while providing the flexibility to use the Budget Stabilization Fund to drive budgetary assumptions and policy decisions. Specifically, staff recommends the policy for the Budget Stabilization fund be as follows:

- The Budget Stabilization Fund will be a minimum of 15% of projected revenues for the first two years of the 20-year planning period.
- Beyond year two, there will be no set maximum or minimum for the Budget Stabilization Fund.

Contingency Reserve

The General Fund's Contingency Reserve was established in FY 1980/1981 as a 10% set aside to plan for situations such as emergencies or unanticipated revenue declines. Over the years, the purpose of the Contingency Reserve began to change, as by FY 1992/1993, the reserve balance was increased to 20% of operations expenditures, and it was no longer utilized to cover unanticipated revenue declines. By this time, the 20-Year RAP Reserve, which is now the Budget Stabilization Fund, had been established for the purpose of covering unanticipated revenue declines. As such, the Contingency Reserve has become a set aside of 20% of the General Fund's operating expenditures to cover non-fiscal emergencies, such as a natural disaster. To date, the Contingency Reserve has never been utilized.

There are several examples of circumstances that would trigger utilization of the Contingency Reserve. The clearest example would be a disaster such as a fire, an earthquake, or something along the lines of the recent incident in San Bruno. If something like this were to occur in Sunnyvale and it resulted in severely damaged or destroyed infrastructure, utilization of the Contingency Reserve would be appropriate. It is important to note, however, that in the San Bruno example, the city has utilized other sources of funding, including federal, state, and PG&E monies, to cover the cost of the incident. While San Bruno has had to cover some of the initial cash outlay, it expects that it will be reimbursed for all costs related to the pipeline failure. Another example of when the Contingency Reserve could be utilized is to provide cash flows to keep operations running if revenues were delayed in being remitted to the City or until insurance reimbursements were paid. For example, if billing or permitting systems went down due to damage and the City were significantly delayed in billing and receiving revenues, the Contingency Reserve could be utilized to cover the cash flow issues that this would cause. In this case, the Contingency Reserve would be replenished when the systems became operational again and billing resumed.

With the intended usage clarified, the next consideration in this study was the appropriate amount to set aside in the Contingency Reserve and how should this amount grow, if at all, over the 20-year plan. Currently, the Contingency Reserve is set at 20% of operations annually. The 20% requirement was set back in FY 1992/1993 and was an increase from the 10% requirement that had been in place since the inception of the Contingency Reserve in FY 1980/1981. The 20% value was not tied to anything specific, and instead, as described in that year's transmittal letter, was set at the higher amount to remain conservative in uncertain times. Given the fact that the Contingency

Reserve has never been drawn upon and because the General Fund also maintains the Budget Stabilization Fund, staff recommends that the Contingency Reserve amount for year one of the 20-year plan be reduced to 15% of operations expenditures. This will maintain sufficient funds in this reserve (\$18.7 million in FY 2011/2012) without setting aside more than should be necessary. The 15% value also represents the upper threshold of Government Accounting Standards Board (GASB) recommended reserve set asides, which will be discussed in more detail later in this report.

With respect to the rate of growth in the Contingency Reserve over the 20-year plan, the reserve currently grows at the rate of operational cost growth. However, since the City's operational costs are predominantly internal labor, over half of which is Public Safety, relating the growth in the Contingency Reserve to growth in operating expenditures does not align with the rate at which future set asides need to increase and ties up more funds than necessary. Instead, because this reserve's primary intent is to be used for non-fiscal emergencies, such as if an earthquake were to damage or destroy City infrastructure, the inflator for future years should be tied to the estimated cost increases for projects, which includes materials and private-sector labor. As such, the recommended inflator for the Contingency Reserve is the projected increase in the Consumer Price Index.

It is also important to note that since the most likely scenario that would trigger the utilization of the Contingency Reserve would be a disaster that severely damaged City infrastructure, this reserve would only be necessary if it were General Fund-related infrastructure such as roads and streets or administrative facilities. In the event of a disaster, infrastructure funded by the utilities would be covered by the utilities funds, which also maintain contingency reserves for a similar purpose. The Water and Wastewater Funds maintain 25% contingency reserves, and the Solid Waste Fund maintains a 10% contingency reserve. It is also important to note that the City carries insurance that, under certain circumstances, would partially offset the amount the City would need to expend from its General Fund Contingency Reserve in the event of a disaster. For example, if there were a fire that destroyed City infrastructure, the City is covered for up to \$10 million per incident. And while the City does not carry earthquake insurance, staff believes that if an earthquake were to damage or destroy City infrastructure, there would be federal funds available to offset the City's costs to rebuild.

Based on the review of the Contingency Reserve discussed above, staff recommends the following policy for this particular reserve:

- The General Fund Contingency Reserve will be maintained at 15% of operations costs in year one of the long-term plan, with annual increases based on projected increases in the Consumer Price Index.

- The General Fund Contingency Reserve will only be utilized for non-fiscal emergencies or disasters as determined by Council.

FISCAL IMPACT

There is no fiscal impact to implementing staff's recommendation on the policy for the Budget Stabilization Fund. The recommended minimum balance of 15% in year one and year two of the long-term plan has been met in the FY 2011/2012 Adopted Budget. In FY 2011/2012, the Budget Stabilization Fund is 23% of revenues and in FY 2012/2013 it is 22%.

Implementing staff's recommendation on the policy for the Contingency Reserve will not impact overall reserve levels, but it will redistribute funds from the Contingency Reserve to the Budget Stabilization Fund. In the FY 2011/2012 Adopted Budget, the 20% Contingency Reserve is \$24.9 million. If the reserve requirement were reduced to 15%, the Contingency Reserve would drop to \$18.7 million, with the \$6.2 million difference shifting into the Budget Stabilization Fund.

In total, the City has approximately \$200 million currently in reserves. While many of these funds are in legally restricted special revenue funds that cannot be used for general purposes, the City does have significant funds set aside in the General Fund and in the utilities to cover emergencies or disasters. Below is a table that includes the current amounts available in the Budget Stabilization Fund as well as in the City's contingency reserves.

<u>Fund</u>	<u>Reserve Type</u>	<u>Current Balance</u>
General Fund	Budget Stabilization Fund	\$35.0M
General Fund	20% Contingency	\$23.4M
Water Fund	25% Contingency	\$5.4M
Wastewater Fund	25% Contingency	\$3.4M
Solid Waste Fund	10% Contingency	\$1.2M
Total		\$68.4M

Further, maintaining a General Fund long-term plan that ensures in year one that 15% of revenues (Budget Stabilization Fund) and 15% of operating expenditures (Contingency Reserve) are maintained in reserve provides the City with appropriate funding to withstand both a severe unanticipated decline in revenues and a non-fiscal emergency or disaster. As a point of comparison, the GASB recommends total reserves of either no less than 5 to 15% of operating revenues or no less than one to two months of operating expenditures. The recommended policy changes leave the City with two reserves that meet the maximum reserve thresholds recommended by GASB.

PUBLIC CONTACT

Public contact was made by posting the Council agenda on the City's official-notice bulletin boards outside City Hall, in the Council Chambers lobby, the City Clerk's office, at the Library, Senior Center, Community Center, and Department of Public Safety; posting the agenda and report on the City's Web site; and making the report available at the Library and Office of the City Clerk.

ALTERNATIVES

1. Approve staff recommendation to update the Budget Stabilization Fund fiscal policy to read:
 - The Budget Stabilization Fund will be a minimum of 15% of projected revenues for the first two years of the 20-year planning period.
 - Beyond year two, there will be no set maximum or minimum for the Budget Stabilization Fund.
2. Approve staff recommendation to update the Contingency Reserve fiscal policy to read:
 - The General Fund Contingency Reserve will be maintained at 15% of operations costs in year one of the long-term plan, with annual increases based on projected increases in the Consumer Price Index.
 - The General Fund Contingency Reserve will only be utilized for non-fiscal emergencies or disasters as determined by Council.
3. Approve staff recommendations to update Budget Stabilization Fund and Contingency Reserve fiscal policies with modifications.
4. Do not approve updates to Budget Stabilization Fund and Contingency Reserve fiscal policies.

RECOMMENDATION

Staff recommends alternatives 1 and 2:

#1: Update the Budget Stabilization Fund fiscal policy to read:

- The Budget Stabilization Fund will be a minimum of 15% of projected revenues for the first two years of the 20-year planning period.
- Beyond year two, there will be no set maximum or minimum for the Budget Stabilization Fund.

#2: Update the Contingency Reserve fiscal policy to read:

- The General Fund Contingency Reserve will be maintained at 15% of operations costs in year one of the long-term plan, with annual increases based on projected increases in the Consumer Price Index.
- The General Fund Contingency Reserve will only be utilized for non-fiscal emergencies or disasters as determined by Council.

Reviewed by:

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