Fiscal Issues Related to General Fund Reserves

by:

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INTRODUCTION

City finances are comprised of various funds, which for legal purposes have to be separated. For example, gas taxes have to be spent on street maintenance and cannot be used to hire police officers. One fund over which the City Council may exercise considerable discretion is the General Fund. It is also the fund used to account for the receipt of general taxes such as property taxes and sales taxes. Most public safety services are also paid for from the General Fund. Proposition 218 dictates that taxes can only be raised by a vote of the electorate. As such, the City must cautiously guard its General Fund to insure that expenses do not eclipse revenues.

The mark of fiscal stability is a city’s undesignated General Fund balance or an officially designated General Fund reserve or one derived from General Fund revenues. The City had $433,307 as a General Fund undesignated reserve as of June 30, 1991. The General Fund operating budget for FY 91-92 was $14.3 million. As such the City had 3% in reserves as compared to its annual operating budget. In 1991 there was a recession and when revenues fell there were not sufficient financial resources to weather the storm and 22 City positions had to be eliminated.

The City of Tracy has improved its fiscal condition since 1991. As of June 30, 2005 (the most recent available audited figure) the City had a General Fund undesignated fund balance of $19,800,007. In addition, the City had $10,069,879 in a special reserve fund known as the “Reserve for Economic Uncertainties”. Therefore, the City had a total of $29.9 million in reserves. The General Fund operating budget for FY 05-06 was $43.1 million. As such, the City has 70% in reserves as compared to its annual General Fund operating budget. The unaudited fund balances as of 6/30/06 for these two funds as projected in the FY 06-07 budget document is $19.8 million for the General Fund and $13.9 in the Reserve for Economic Uncertainty Fund. This is a total of $33.7 million compared to a General Fund operating budget of $47.6 million or 71% in reserves. So while the raw dollar amount of reserves from June 30, 2005 to June 30, 2006 may increase, as a percentage of General Fund expenses, it remains constant. Since FY 90-91 it is clear there has been a marked improvement in the fiscal condition and stability of the City of Tracy’s financial position.

With this improved financial condition, questions have been asked as to whether the City has too much in its reserves. It has further been suggested that the City could spend most of its reserves on capital projects such as a new sports field complex. This report addresses these questions and presents other information that may be useful in examining the City’s fiscal position and the level of appropriate reserves.
WHAT IS THE AMOUNT OF A FISCALLY PRUDENT RESERVE?

There is no easy answer to this question. What is okay to one city may not be okay to another. In a published 2000 survey of General Fund reserves of 205 California cities, the author notes that, "If you asked 100 finance professionals this question, very few would provide the same answer. The elements that are right for one city are entirely wrong for another." Data from this survey indicated the respondent cities had anywhere from 2% to 150% in General Fund reserves. Within this range, Tracy would be in the middle. Note this is not a random sampling but only the results from the 205 cities that responded to the survey.

MEASUREMENTS TO DETERMINE PRUDENT RESERVES

Although finance professionals may not have the same answer as to what is a prudent reserve, most agree on a set of parameters by which such a question could be examined for a specific city. The need for reserves is determined primarily by the degree of risk associated with revenues and revenue sources, and by the likelihood of major contingencies and the amount of funds required to respond to them. Here are some important questions to consider:

1. How stable is the tax base in the face of adverse economic conditions?
2. How broad is the City’s General Fund revenue base?
3. Is any City revenue source at risk due to State or Federal political action?
4. What are the cash flow needs of the city?
5. What future contractual obligations does the City have that dictate required expenditure levels?
6. What new program areas in the future will be required and how will the City pay for these?
7. How has the City increased its reserves in the past and how likely would these circumstances be repeated?
8. Is the City susceptible to natural disasters? What is the level of insurance?
9. Does the City have any unfunded liabilities?

EXAMINATION OF THE CITY’S FISCAL POSITION AGAINST THE MEASUREMENT TOOLS

Measurement #1 – Tax Stability

In FY 05-06 it is estimated the City will have received $43.8 million in General Fund revenue. Of this amount $31.5 is from taxes with the balance from fees, grants or fines. Keep in mind that fees and grants are paying for a specific service such as building permit fees or funds from Tracy Rural to fund its share of fire operations (classified as a grant). General Fund taxes are used to support community services for which there is no fee. This is primarily police and fire protection (public safety). Of this $31.5 million in taxes, $16 million (51%) is from property taxes and $13 million (42%) is from sales tax.

In judging stability of the tax base, property tax is considered to be a stable source of revenue. Sales tax however, is considered to be less stable. An excellent example of this is the California recession in the early 2000s. Cities in the Bay Area were especially hard hit by this recession. Why? Because many of these cities relied heavily on sales taxes that were especially prone to the effects of the recession whereas their property tax base
remained steady. During this same time, the City of Tracy was able to weather the effects of this economic downturn on sales tax because due to relative housing affordability, the City was in the midst of a population and growth boom. With little or no population growth between now and 2013 due to Measure A, the City cannot expect growth to be its savior in any future sales tax downturn.

Furthermore, an analysis of the City's sales tax reveals that 23% comes from new auto sales, 29% from purchases at retail stores (department, clothing, furniture), and 15% from building materials. These areas of sales are vulnerable to effects of recession and they constitute 67% of the City's sales tax. In addition rising gas prices in the recent year have had an effect on sales of certain types of vehicles (i.e. SUVs) that typically are more expensive (and hence more sales tax paid). Also within sales tax, one must be concerned with the growing number of Internet transactions that escape taxation and replace those transactions for which the City would otherwise receive sales tax. This trend has steadily grown and will continue to do so, impacting future sales tax revenue.

With 67% percent of the City's sales tax from segments vulnerable to recession and with 42% of the City's General Fund taxes coming from sales tax, it is prudent to reserve funds. In other words, the City has an exposure of a less stable tax base in the face of adverse economic conditions. Because of higher global risks, a housing slowdown, and high energy prices, some are predicting a recession beginning in 2007. A two-year economic recession, which had the effect of a sustained 10% reduction in sales tax over the two years, would result in a possibility of a $2.6 million dollar reduction in sales tax.

**AS SUCH, A MODEST VULNERABILITY RESERVE FOR SALES TAX WOULD BE $2.6 MILLION.**

**Measurement #2 – Broadness of Revenue Base**

Another measurement to quantify an appropriate level of reserves concerns how broad a range of General Fund revenue the City of Tracy receives and what the future holds for such revenue. Some cities have a very broad range of General Fund revenues not associated with fees. For example, a resort city enjoys a large amount of transient occupancy taxes (hotel/motel tax). Often this exceeds the amount the city receives from property tax or sales tax. Some cities with parking limitations receive large amounts of revenue from the sale of parking passes, parking meters, parking garages and even parking tickets! Many cities have a utilities users tax. It is often 5% on the cost of all utilities citizens of that city use, including gas, electric, phone, cable TV, and even the city's own utilities of water, sewer and garbage. Utility user tax is sometimes is the largest General Fund source of revenue for a city. Many cities have a gross receipts business license tax that provides a large General Fund amount. Finally, a few cities even have a payroll tax.

Cities with a less broad base of General Fund Revenue will require a greater amount in reserves in order to weather a downturn in just one revenue area. This is true for Tracy. Transient occupancy tax will net only $780,000 in FY 05-06, which is but 3% of what the City will receive from property and sales taxes. Tracy does not have a utility users tax or a gross receipts business license tax. The City's modest business license tax ($20 per employee, cap of $2,000) will result in $840,000 for FY 05-06. Again, this is about 3% of what property and sales tax will produce. Tracy has no parking fees or parking meters. In short, the City has a very narrow base of General Fund tax revenue. Tracy is almost totally dependent upon property tax and sales tax.
The following illustrates differing reserve methodologies given the broadness of General Fund tax revenue sources. Logic would dictate that the fewer number of revenue sources would require additional layers of reserves. Conversely, the greater number of revenue sources would require fewer layers of reserves.

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As the property tax and sales tax comprise $29 million of the $31.5 million in General Fund taxes, the City has a narrow base of revenue – just 2 significant categories. As such, a reserve of 20% of $31.5 million would be reasonable to account for the narrow band of tax revenue sources as opposed to cities that enjoy a wider or broader range of tax revenue sources.

A RESERVE FOR THIS PURPOSE WOULD THEREFORE BE $6.3 MILLION

Measurement #3 – Revenues at Risk Due to State or Federal Action

When the State faced fiscal challenges in the early 1990s it simply transferred more property tax and reduced the amount of property tax previously going to local government. This shift in taxes (known as the ERAF shift) necessitated that many local governments during this time had to reduce services, cut expenditures and dig into reserves. Proposition 1A (which passed in November 2004 with an unprecedented 84% approval) established strong new constitutional protections for the City’s largest sources of general fund revenues including property tax and sales tax. Note however, that although Proposition 1A protects local government from increased State raids, the ERAF shift already in place continues to this day and will do so in the future even with Proposition 1A. While Proposition 1A has substantially reduced the political risk to California city finances, recent events attest to the fact that risks remain.

Proposition 90 on the upcoming November ballot is another example of either legislation or ballot initiative that at any time can come along that can dramatically affect either a city’s revenue or cost of doing business. A recent independent report on Proposition 90 concluded it would cost local state and local government in California billions of dollars.

State and federal legislative developments related to video franchising should also be considered. For example, the recently enacted Digital Infrastructure and Video Competition Act of 2006 (AB2987) may ultimately impact the amount of franchise fees the City is able to collect from its existing cable operator. The City receives approximately $664,000 per year in cable TV franchise revenue (payment for use of the City’s right-of-way as the franchised cable operator). Reserving two years of this revenue as potential offset to possible State or Federal action in this arena is recommended.

RECOMMENDED TWO YEARS IS $1.2 MILLION.
Measurement #4 – Cash Flow Requirements

Cash flow needs of a city also have a direct bearing on the amount of reserve needed. Since about 80% of all city expenditures are for labor costs, the City has a fairly even outgoing cash flow demand. While cash is going out at a fairly even monthly rate, cash is not received in a like manner. The first receipt of property taxes is not paid to the City until usually the last day of December. Even then, it is only 40% of the total for the fiscal year. This means from July 1st to December 31st, the City has had about half of its cash flow for the fiscal year going out, but has yet to receive any cash from property taxes. Keep in mind property taxes are half the total of all General Fund tax revenues.

Compounding the cash flow problem is that the City used to receive its sales tax allocation monthly but now receives only 75% of this allocation with the other 25% coming in two times a year. This is the result of the budget deficit bonds issued two years ago by the State of California. One quarter of the local sales tax (.25 cents of the 1 cent local) was technically used as a pledge for the bonds. The State does make up this .25 cents but does so only two times a year and does so after the fact.

The City of Tracy needs to have reserves to cover this cash flow demand until cash catches up to expenses in the last half of the fiscal year. If there were not sufficient reserves, then the City would have to borrow funds to cover the cash needed for the first half of the fiscal year. This borrowing is called Tax and Revenue Anticipation Notes (TRANs). In the early 1990s when the City had few reserves, there were several years when the City had to issue TRANs. To avoid borrowing the City would need to have in reserve 60% of its Property tax revenue plus 25% of 50% of its sales tax revenue.

This amounts to about $13 million.

Measurement #5 – Contractual or Other Legal Obligations

It is also very important to look at what future General Fund obligations the City has in order to determine an appropriate level of reserves. Such obligations can come from two sources, contracts with city employee labor unions or other employee obligations and debt payments on city debt.

The City of Tracy has minimal General Fund debt. Annual payments on General Fund supported debt is about $1.2 million per year or about 3% of the General Fund operating budget. The ability to pay this $1.2 million each year is long standing and already included in the City’s base budget. Final year payments on this debt are already reserved as required by the debt issuance. There is no need in Tracy’s situation to reserve more for debt.

The City has just entered into new labor contracts with both the police and fire unions. The police contract goes to June 30, 2011 and with the Fire union to March 31, 2009. The current contracts and labor agreements with all other city employees will expire on March 31, 2007 and June 30, 2007. With expected increases to health insurance costs as well as the wage increases called for in the contracts, labor costs for police and fire will increase an average of 5% per year. Such a range could be estimated for the increase in future labor costs for other employee groups once their current agreements expire.
Approximately 80% of the City’s General Fund is spent on personnel expenses. The General Fund budget for FY 06-07 is $47.6 million. As such General Fund personnel expenses can be expected to cost $38 million in FY 06-07. If these expenses increased by 5%, that would require additional revenues to cover the increased expenses of nearly $2 million per year. That equates into needing an annual growth in sales tax of 16% or an annual growth rate in property taxes of 13%.

Although 80% of the City’s General Fund can be viewed to be contractually obligated each year in employment agreements, the reality is the remaining 20% of the budget will likely be hit with cost increases. These are likely to average 5%. In the past 18 months the City has been hit especially hard with fuel expenses rising dramatically. As such, it should also be estimated that non-personnel General Fund expenses could likely increase by 5% per year. While not legally obligated in employment MOUs, these expenses would have to be reduced and hence services reduced if there were not sufficient revenues.

With the recent downturn in real estate prices, the very limited ability to construct new residential building in Tracy under Measure A until 2013, and the susceptibility of sales tax to economic cycles, let’s assume that property tax and sale tax only grow at 5% annually. Let’s then quantify the obligation of the labor cost increases for the next 4 years. The increased obligated labor cost amount to $3.95 million and the revenue amounts to only $6.25 million. As such, under conservative revenue growth of just 5% a year, the obligated labor costs will outpace revenues by $2.7 million based upon the size of the current City work force. If the work force were increased in the next 4 years, (i.e. additional police or fire positions) then this figure would be greater.

$3 MILLION WOULD THEREFORE BE A REASONABLE ESTIMATE.

Measurement #6 – Expenses for New Operating Programs

Appropriate reserves are also necessary to meet the expense of new operating programs not currently in the City budget. The City currently maintains the Tracy Sports Complex and other sports fields (35 acres total) at a cost of about $400,000 per year. This cost is in the current base budget and can be projected into the future. But what about the cost to maintain future facilities not yet constructed? The City is planning both a new sports field facility (Schulte Road) and a new aquatics center. The consultants working on these projects have estimated annual net operating expenses (expenses over any revenues) for these facilities at $665,000 to $1.3 million depending on the nature and extent of the improvements (August 1, 2006 City Council agenda). These expenses are not currently in the base budget and therefore are not in any current budget extrapolation of future revenues vs. expenses for the General Fund. Since the current budget is balanced (revenues equal expenditures) with no forecasted revenues beyond expenses, funds would have to be reserved for the future operating expenses of these facilities. A mid-point of $1 million from the range supplied by the consultants, the City would have to reserve approximately $3.3 million (allowing for 5% annual cost increases) now in order to have funds to pay for the facilities during their first 3 years of operations. This estimate does not address the costs for operations after this point. What is hoped is that over a period of years, General Fund revenues would grow to be able to absorb the cost of the annual operating subsidies for these facilities and the City would no longer have to dip into its reserves. This is an aggressive assumption of only a 3-year transition period and therefore this reserve estimate is not conservative. If it took 5 years another 2.5 million would be needed.

THE THEREFORE AN APPROPRIATE RESERVE (REPRESENTING 5 YEARS) FOR THIS ITEM WOULD BE $5.8 MILLION.
Measurement #7 – Likelihood of Continuation of Present Fund Balances

As stated, the City has improved its financial condition since FY 90-91 going from about $433,000 (3% in reserves) to $33.7 million (71%) today. How did the City improve its savings during this time and how likely are these circumstances to be repeated in the future? The City has long maintained that growth must pay for itself and the above referenced financial numbers certainly point to the achievement of this goal. There are three main reasons behind the City’s ability to add to its savings during the past 15 years; revenue increases due to growth, controlling of expenditures (including favorable PERS rates), and structural budget savings.

Revenues due to growth have come in two forms, an increasing tax base and revenue from fees. Because the City experienced a long and sustained growth period growing from a population of 33,850 in 1991 to 80,461 as of 2006, revenues to the City also increased substantially during this time. Assessed valuation of property in Tracy was about $1.5 billion in 1990 as compared to $7.8 billion in 2005 (a 520% increase or nearly 35% per year). Since property tax received by the City is based on assessed value, it is easy to see that the City has enjoyed a 15 year long increase in property tax. Even though the City receives only about 14 cents of every one dollar paid in property tax (the rest goes to the State, schools and the County), property tax is the foundation revenue for the City’s General Fund.

Because of Proposition 13, new construction is important to insure growth in property tax. A property can only be assessed upon change in ownership to its current market value. Under Proposition 13 a home owned by the same owner for the past 30 years will have a lower assessed value (and hence payment of property tax) than a new home just constructed. This is true even if both homes have the same current market value today. Let’s say the first home was 2,000 square feet and was purchased in 1976 for $50,000. Without change in ownership or any new construction, that home would be assessed at about $67,000 today. That home would pay about $670 in property tax of which the City would receive about $94. The second home is also 2,000 square feet and was just built in 2006 and sold for $525,000. The new homeowners would pay about $5,250 in property tax of which the City would receive about $735. Right or wrong, Proposition 13 has resulted in new growth carrying a far greater share of the tax burden that supports local services. Assessed valuation increase has been one important key to the City’s improved financial condition.

The City has also enjoyed increase to its sales tax revenue as the City has grown. More people living in Tracy naturally means more purchases. The City has made a strong effort to insure it did not lose sales tax dollars to other jurisdictions by encouraging commercial development. Today, the City has many more retail establishments than ever before and residents can find most items locally. The increase in the number and kinds of retail establishments has also benefited the City’s budget through increased sales tax.

Growth also results in a number of fees being paid for services rendered by the City. For example, various building permit fees provide the revenue for which building related services are delivered. While the City does not make money on building fees, they do include a fair share of City overhead. This means, that a good chunk of City overhead over the years has been supported by fee revenue as opposed to tax revenue. Because of Measure A, there will be little if any residential building in the next 5 years. By definition overhead are fixed expenses of the City. As such, in the future, more overhead expenses may need to be supported by taxes because of reduced building related fees.
Another way the City has been able to add to its savings during the past 15 years is by controlling expenses. City management has always kept a mindful eye on the bottom line and Council has supported a commitment to improving the fiscal condition of the City. Also, during the second half of the 1990s there was a tremendous growth in the stock market resulting in much larger gains on investments in the CalPERS retirement system. As a result, the City enjoyed reduced employer rates during this time. Public Safety employer rates dipped below 10% and the employer rate for Miscellaneous Employees went to nearly zero. As such, it was much cheaper for the City to supply the same labor services during this period. In the early 2000s there were three successive years of stock market losses and this resulted in a tremendous increase in rates. Today employer rates are 27% for Public Safety and 13% for Miscellaneous. Even if strong stock market gains return, these rates will remain at near these levels because of newly adopted “smoothing” techniques used by CalPERS. Gains get amortized over a 30-year period instead of the previous 3-year period. In short, the ability to generate savings from reduced CalPERS rates will not be repeated in the future.

Certain budget policies can also add to the bottom line. The City uses a base budgeting model which means budgets are established based upon two years of actual expenditure data plus the current year budget each adjusted for inflation. This means, budgets are very close to actual experience and utilization. However, as noted earlier, about 80% of the City’s General Fund is associated with personnel expenses. There is always a turn over in City employment as employees retire, change jobs or move from the area. Until a replacement is hired, this means there is often budgeted savings from a vacant position. The City budgets for full employment because there is no way to predict how many and in what departments during the year will vacancies occur. Some departments may experience little if any turnover in a year and therefore come very close to 100% expenditure of their budget. If the City only spent 99% of its General Fund budget, this would result in about a half a million in savings. In some years in the past, the City has been between 96% and 98% of its budget.

So now that we know how the City was able to improve its financial condition during the past 15 years, how likely are these conditions to continue in the future? The City will always have the ability to control expense but keep in mind, that doing so may affect service levels. Employees will also continue to come and go so there is some ability to save some from budget savings. However, what will not continue in the future is the growth related increases to property tax and sales tax. As new homes will not be added until 2013 only the sale of an existing home will result in any new assessed value and this increase will be small since much of the housing stock is relatively new and already assessed at current values. As population growth will also be static, this may affect sales tax growth although the City should have some ability to draw sales from new population growth in areas like Mountain House or Lathrop.

The City Finance Department has previously prepared a multi-year budget forecast taking into account many of the revenue items discussed above. In addition, expense items such as personnel expenses have been estimated at near the 5% level as contained in recent contract renewals. However, there have been no additional positions added in this analysis. The multi-year budget forecast can be found on pages C21 to C28 in the City’s adopted FY 06-07 budget document. The General Fund forecast on page C27 indicates that the City will spend $21.4 million more than it takes in during the next 4 fiscal years through FY 10-11.
This analysis pegs property tax growth at the 3% range and sales tax growth at the 5% range. If these revenue sources outpace these estimates, then the $21.4 million budget gap would be reduced. Also, if the City spends on average 98% of the budgets, then these budget savings would reduce the $21.4 million gap by $4.4 million. The bottom line is that during the next four to five years the revenue circumstances that the City has enjoyed during the past 15 years will not be repeated. As such, it is prudent to reserve funds in accordance with reduced revenue growth rates.

*A RESERVE OF $17 MILLION ($21.4 GAP LESS $4.4 BUDGET SAVINGS) FOR THIS PURPOSE IS PRUDENT.*

**Measurement #8 — Natural Disasters and Insurance**

In terms of natural disasters, the City of Tracy is located in a relatively "safe" area as opposed to other parts of California with respect to earthquakes, and forest fires, or places such as the Gulf or southern states for hurricanes. The City however, is not totally immune to such circumstances as evidenced by the Loma Prieta Earthquake in 1989 that severely damaged fire station #1 and the flood in 1997 that threatened the City's wastewater treatment plant. The City procures insurance through the Central San Joaquin Risk Management Authority. The City would pay the first $25,000 of a City building or City treatment plan damage claim. The City also would pay the first $100,000 of a general liability claim. As these limits are relatively modest and the City is not prone to natural disaster, existing insurance coverage should be sufficient without having to make additional reserves.

**TOTAL OF $0 DOLLARS FOR THIS ITEM.**

**Measurement #9 — Unfunded Liabilities**

There have been several media articles about the new Governmental Accounting Standards Board (GASB) standard #45 relating to accounting for other post employment benefits (OPEB). OPEB benefits are non-pension benefits the largest of which is health insurance. Many governments have provided for paid medical benefits for retired employees. This benefit can be lifetime or until the retired employee reaches Medicare age. Some offer the benefit only after a certain number of years of service to that organization. GASB 45 will require municipalities to account for OPEB liabilities much like they already account for pension liabilities, generally adopting the actuarial methodologies used for pension. Most municipalities have not set aside any funds against this liability, choosing instead to just pay the annual expense for the existing set of retired employees and not accounting for future payments. Keep in mind that roughly about two-thirds of pension costs in the CalPERS system are actually provided through investment earnings on the funds set aside for an employee's pension during their career. Beginning with larger cities (those with total revenue more than $100 million including Tracy), GASB 45 must be followed for fiscal year beginning after December 15, 2006. Cities will first need to do an actuarial valuation in order to determine their OPEB liabilities and then begin to address how such a liability will be funded in the future.

Tracy does not provide for paid retiree medical. The City does offer the ability to convert unused sick leave to a medical insurance bank at time of retirement. But the value of that bank is fixed by the number of unused sick leave hours times an employee's hourly salary.
upon retirement. Because the medical bank is fixed (when the bank is exhausted, there is no more benefit), it does not qualify under GASB 45. The City does however; book such leave annually as “uncompensated absences” in its financial statements.

Because the City does not provide paid retiree medical, its OBEB liability is minimal compared to some. The City does have one OBEB liability however, in that retired employees are permitted to purchase health insurance at the City’s group rate either by paying cash or from their medical insurance bank. Because retired employees are in the current mix of those receiving health insurance and because retired employees generally use more health benefits than active employees, health insurance providers charge a larger premium than if retired employees were not part of the mix. Under GASB 45 this “inherent rate subsidy” must have an actuarial valuation in order to determine the City’s future liability. The City has not yet procured this valuation. Such a valuation will take into account many factors including the future number of retired employees procuring health insurance. Currently there are 27 but this number will grow over the years. A quick analysis indicates that if there were 75 employees in the future each receiving an “inherent rate subsidy” of $150 per month and each employee used the subsidy for 25 years after retirement, this would amount to a current liability of $3.3 million.

Although much focus has been on OPEB, many cities also have pension plans that are not 100% funded. The City participates in the CalPERS retirement system but this does not mean the City’s account with PERS is funded at a 100% actuarial level. In fact, the most recent actuarial valuation by CalPERS for the City’s public safety plan indicates it has a $13.1 million unfunded liability (currently funded at 76.7%) and for the miscellaneous employees plan an unfunded liability of $5.5 million (currently funded at 87.4%). The funding status of both plans is fairly typical of cities where there has been an expansion to the work force and where new retirement benefits have been added recently (i.e. Police 3% @ 50 formula). A police officer may have worked 20 years under the old 2% @ 50 formula and hence payments have been made all along under that formula. Then the new 3% @ 50 benefit is implemented and that same officer may only work another 5 years before retirement. When the officer retires all 25 years of their time is credited with 3 @ 50 even though only the last five years had been paid for at the higher benefit level. The other 20 years have to be paid for and are amortized in the new employer rate so that over time, the amount “catches up”. But what this means is that currently, the plan is still catching up in that it has not yet received all the dollars necessary to cover the present value of future benefits. The City’s current employer rate of 27.165% is actually comprised of 18.723% for normal costs and 8.442% as a catch up amortized over 20 years. While CalPERS offers a method to catch up the funding some view this payment over time as passing on the cost of services already rendered (the 25 years the police officer served the City) to the next generation of taxpayers. Some cities pay this catch-up by issuing pension obligation bonds, as they do not have current cash resources to bring their pension plan to 100%. But then they must pay back the bonds over time as well.

To reserve funds for the City’s current unfunded liability for OPEB and CalPERS would take $3.3 million (OPEB), $13.1 million public safety plan, and $5.5 million miscellaneous plan.

**OR A TOTAL OF $21.9 MILLION.**
SUMMARY OF RESERVE LEVELS PER RISK MEASUREMENT

Nine criteria have been analyzed in order to ascertain what constitutes a prudent reserve level for the City of Tracy given its unique set of circumstances. While each of these is an important measurement, a few have overlap with others. For example, as long as there was at least $13 million in reserves as a result of the other measurements, this same $13 million could be used to satisfy cash flow needs. In terms of Measurement #7 the fund balance forecast, contract obligations are already included in this forecast but new programs, tax stability, tax broadness and revenues at political risk are not. As such, there is only the $3.0 million for contract obligations that is already counted in the $17 million for this item.

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<td>$32.9</td>
<td>$16.0</td>
<td>$48.9</td>
</tr>
<tr>
<td>#9 Unfunded Liabilities</td>
<td>$21.9</td>
<td>$21.9</td>
<td></td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td>$54.8</td>
<td>$16.0</td>
<td>$70.8</td>
</tr>
</tbody>
</table>

The above chart illustrates that by using 8 of the 9 criteria to measure what constitutes a “prudent” reserve (without regard to CalPERS and OPEB liabilities) for the City of Tracy, the figure would be $32.9 million as of 6/30/06. As a percentage of General Fund Operating Expenditures for FY 06-07 ($47.6 million) this would be about 70%. It would take an additional $21.9 million to cash out the City’s pension and OPEB liabilities. The pension obligations however are currently being amortized within the City’s PERS employer rate.

OTHER FACTORS TO CONSIDER – RESERVES GENERATE INVESTMENT EARNINGS TO FUND OPERATIONS

An important, yet often overlooked consideration, when deciding on the level of reserves is to also examine what impact on operating revenue and programs would there be if reserves were reduced or eliminated. Keep in mind that the reserve funds of the City are invested. The estimated General Fund balance and balance of the Reserve for Economic Uncertainty Fund as of 6/30/06 is $33.7 million. If invested at 5% for a year, this generates approximately $1.7 million in investment earnings available for General Fund programs. The Kirchhoff report recommendations cited the need to add 10 officers or officer equivalents. It was estimated these would cost $1.3 million in the first year. It was possible for the City to add to police services because investment earnings on reserve funds have provided a stable and consistent revenue source for which to pay for increased police services. Taken in another light, at $1.7 million, investment earnings are three times the amount of money the City receives from the Vehicle License Fee (VLF), two and half times the revenue received from business licenses and two times the amount of transient occupancy taxes. The reserve funds are serving in an
endowment-like fashion to provide additional General Fund operating revenues in which to fund important services such as public safety.

DOES THE CITY HAVE $200 MILLION “IN THE BANK” AND IF SO, CAN IT BE USED TO BUILD SPORTS FIELDS OR AN AQUATICS CENTER? DOES THE CITY HAVE $87 MILLION IN “UNRESTRICTED FUNDS” THAT COULD BE USED TO CONSTRUCT A SPORTS PARK?

There have been several citizen statements at previous council meetings or in newspaper letters to the editor, that the City has $200 million in the bank and therefore could fund new sports facilities or an aquatics center. Other references have been made that the City has $87 million in unrestricted funds that could be used for this purpose.

As of August 31, 2006 the City Treasurer's investment pool totaled $189 million. In previous months the investment pool has been around $200 million. This represents the cash balances of every City fund as of that date. As stated in the introduction to this report, the City maintains a variety of funds most of which are legally restricted for a specific purpose. If the gas tax fund had $1 million in cash, it would be part of the Treasurer’s investment pool but this does not mean this $1 million could be spent on sports fields. Gas tax can only be spent on street maintenance and street improvements. Most City funds have similar restrictions. The statement that the City has $200 million in the bank that it could use to construct sports fields or an aquatics center is not an accurate statement.

As reported in the June 30, 2005 Comprehensive Annual Financial Report (CAFR) the City’s total assets (all funds) exceeded its liabilities by $838 million dollars (net assets). Of this amount, 10% or $84.7 million is unrestricted net assets. City assets are diverse and include such things as fire stations, equipment, treatment plants, pumping stations, parks, etc. These are typically considered restricted assets. The $84.7 million unrestricted figure is a combination of all functions of the City including governmental activities and business-type activities (water, wastewater, solid waste, etc.) Unrestricted funds do not mean that they are legally available to spend on the construction of a sports park. For example, the unrestricted funds of the sewer enterprise can only be spent on operations, maintenance and capital items for the sewer enterprise. The statement that the City has $87 million in net unrestricted funds that could be used to construct a sports field park is not an accurate statement.

CONCLUSION

It is important that the City of Tracy maintain a prudent level of reserves. The City has exposure to certain risk factors when looking at future revenues. What constitutes a prudent level of reserves is different for each city. There is however a series of measuring tools by which the City can examine its financial base and determine an appropriate level of reserves for the City. Using these tools it has been suggested that the amount of $32.9 million or roughly reserves equal to 70% of the City’s current General Fund operating budget is not unreasonable. It has been noted that the current reserves of the City of Tracy currently serve in an endowment-like fashion that provide General Fund operating income of approximately $1.7 million in interest earnings, which has been used to increase Police services to the community. Any consideration to reduce reserves by allocating funds to a capital project must also consider this negative effect on the City’s operating budget for public safety.