Solano County
General Fund Reserve & Other Designations Policy
February 13, 2007

GFOA RECOMMENDATION

The appropriate level for the General Fund Reserve is a policy decision that must be set by the Board of Supervisors. There is no nationally uniform standard regarding the appropriate level of "general fund reserve" local governments should maintain. However, the Government Finance Officers Association (GFOA) recommends a prudent reserve policy be in place to protect the County from risks associated from various factors such as economic uncertainties, natural disasters, changes in funding from the State and Federal government, etc.

The GFOA recommends general-purpose governments maintain a "General Fund Reserve" level of **no less than five to fifteen percent of general fund operating revenues or of no less than one to two months of regular general fund operating expenditures.** In addition, the financial resources in the other funds should also be considered in evaluating the adequacy of "reserve" in the general fund.

CURRENT "GENERAL FUND RESERVE POLICY"

On February 6, 2001 the Board adopted a policy to establish a general fund reserve equal to 5% of the County's total budget, excluding inter-fund transfers. The Board reaffirmed its policy on October 31, 2005. This is equal to $36.2 million using the Final Budget for fiscal year 2006-2007. The County's "General Fund Reserve" balance as of January 16, 2007 was $39.1 million.

The 5% goal was subjectively determined without conducting any formal analysis of the County's specific risks or vulnerabilities. Furthermore, the 5% goal is coincidentally the lowest percentage recommended by the GFOA. As stated above, the GFOA recommends a 5% - 15% level of the general fund operating revenues plus the resources needed in other funds.

The County's general fund reserve has increased from $8 million as of July 1, 1999 to $39.1 million as of July 1, 2006. This is due to the increase in the County's total budget excluding inter-fund transfers from $394 million to $724.1 million respectively.

The current Board policy directs "General Fund Reserve to be used as the last resort in balancing the County budget. Must maintain a minimum balance of $10 million at all times and can spend-down a maximum of $4 million per fiscal year."

The General Fund Reserve will be maintained to provide the County with sufficient working capital and a comfortable margin of safety to support one-time costs for the following purposes:

- When the County faces economic recession/depression and the County must take budget actions.

- When the County is impacted by a natural disaster or any other emergency.

- When the County experiences unexpected declines in revenues and /or when unpredicted large one-time expenditures arise.

- Should **not** be used to support recurring operating expenditures.

In addition, the General Fund Reserve is subject to additional restrictions imposed by Government Code Section 29086, which states "the General Fund Reserve, except in cases of a legally declared emergency, may only be established, cancelled, increased or decreased at the time of adopting the budget as provided in section 29088." This means that the Board can only open discussions of the use of these moneys during the annual budget hearing process and requires a **four-fifths** vote by the Board of Supervisors.

CURRENT OTHER GENERAL FUND "DESIGNATIONS"

Employee Leave Payoffs

The Board established a "designation" for Employee Leave Payoffs in the amount of $6.1 million to be used for employee leave payoffs upon retirement or termination from county employment. The purpose for this designation was to minimize the financial hardship placed on management's ability to operate their respective programs when large amounts of employee leave payoffs are made to retiring or terminating employees. The Auditor-Controller calculated the projected leave payout requirements for the subsequent 5 years to be $7.7 million as of December 17, 2005. This number was calculated net of Federal & State reimbursements.

Departments may access the Employee Leave Payoff funds in one of two ways:

1) During the annual budget process. Department staff will project employee retirements based upon employee notices and historical experience. This financial impact will be reviewed and verified with CAO analysts for inclusion in the Proposed Budget.

2) During the fiscal year, departments may experience unanticipated retirements or terminations requiring payoffs in excess of the amounts budgeted. In such cases, the department will first seek to absorb the cost through unspent appropriations. If current year appropriations are not sufficient, the department, in consultation with CAO staff, will present to the Board of Supervisors a request to transfer monies from the Employee Leave Payoff designation. This Board action will require a **four-fifths** vote.

Deferred Capital/Maintenance Projects

The Board established a designation for deferred capital/maintenance projects in the amount of $10.7 million to be used to fund deferred capital maintenance for the County's public facilities. This designation was established primarily as a mechanism to accumulate funding for the infrastructure rehabilitation program to repair or renovate existing buildings.

If the need arises to access these funds during the fiscal year, the request will be presented to the Board of Supervisors and will require a **four-fifths** vote. Otherwise, the request will be incorporated as part of the annual budgetary process.

APPROPRIATIONS FOR CONTINGENCIES

Appropriations for Contingencies are legal authorizations granted by the Board of Supervisors to be used for one-time unexpected needs that arise outside of the regular budget planning process. Any unspent appropriations at the end of the fiscal year lapse and are returned to fund balance. The Board has adopted appropriations for contingencies for State uncertainties and for other general fund uncertainties.

In addition, Pursuant to Government Code Section 29130, access to either of the appropriations for contingencies requires a **four-fifths** vote by the Board of Supervisors.

State Uncertainty

The Board approved an appropriation for contingency for state uncertainty in the amount of $10 million to mitigate against any potential loss of revenues that would impact the county's ability to continue county operations for fiscal year 2006-2007. Recent events have made it very clear that actions of the State Legislature and the Governor in Sacramento can completely negate any prudent budget planning.

Other General Fund Contingency

The General Fund Contingency was established to mitigate the impact of potential risks to the General Fund from various funding problems and threats that may occur within the General Fund and threats to other funds related to the priorities of the Board.

Board policy calls for a General Fund Contingency target of 5% of the General Fund total budget. This equates to $11.2 million for fiscal year 2006-2007. The General Fund Appropriations for Contingencies had an unused balance of $23.6 as of January 23, 2007.

General Fund Reserve & Other Designations
July 1, 2006

General Reserve	**$39,098,925**
Designations:	
Employee Leave Payoff	**6,118,630**
Deferred Capital/Maintenance Projects	**10,725,922**
SUB-TOTAL	**16,844,552**
Contingencies:	
Other General Fund Contingency	**23,620,910**
State Uncertainty	**10,000,000**
SUB-TOTAL	**33,620,910**
TOTAL	**$89,564,387**

DETERMINING THE APPROPRIATE SIZE FOR THE GENERAL FUND RESERVE & OTHER DESIGNATIONS

Funding of reserves and other designations will generally come from one-time revenues, excess fund balance and projected revenues in excess of projected expenditures.

Justification for desired levels of reserves and designations

The CAO management analysts, Assistant CAO, Auditor-Controller, and the Treasurer-Tax Collector met several times to identify the risk factors specific to Solano County.

The types of risk factors recognized were categorized in three separate groups based on the specific risks or vulnerabilities common to each group. The category risks below are **not in any order of priority**. The order of priority will be determined by the Board of Supervisors when deciding the desired levels of reserves and designations.

Category 1 Risks— Natural Disasters: Includes natural disaster costs for a period of three months. This includes costs for relocations and homeland security. The three month time frame was estimated based on the recent Katrina disaster and the time it took to get the disaster under control. The total costs for this risk category is estimated at $37.5 million. This estimate was based on serving 100,000 people for 3 months @ $125 per person per month. Solano County's Office of Emergency Services assisted in the calculation for this risk.

Disaster costs including Relocations and Homeland Security	**$ 37,500,000**

Category 2 Risks —Infrastructure: Includes primarily infrastructure costs to maintain and repair the County's facilities and roads. It also includes a risk factor for an unforeseen increase in energy costs, temporary lease costs for damaged buildings and emergency repairs to county roads. The amount for facilities was estimated by using 20% of the facilities condition assessment need of $127.2 million as determined by the 5 year Capital Facilities Improvement Plan. The total costs for this risk category is estimated at $29 million.

Temporary Lease for damaged buildings	$ 1,000,000
Repairs to Building/Jails/Facilities	25,500,000
Roads	1,500,000
Energy	1,000,000
Total	**$ 29,000,000**

Category 3 Risks—Prudent Reserves: Includes the costs and losses of revenues for the continuance of essential mandated programs for a six month period, six months of payroll costs excluding a portion of Health and Social Services, one year of debt service payments, property tax risks and extraordinary legal costs in the event of a major criminal prosecution.

The six month timeline was based on the minimum time it would take the County to off ramp programs in the event a significant turn in the economy occurred or the County lost a significant amount of Federal or State dollars that would severely impact the ability to continue to provide the existing program service level. The total estimated cost for this risk category is $164.6 million.

The funding concept is that by establishing a reserve level close to the total identified in Category 3, the Board would have sufficient funds to draw from to meet any risks arising from Category 1 or 2, if necessary. This is based on the premise that not all risks and exposures would occur at the same time. By stacking all the risks the amount of money necessary in reserves and designations is minimized. Therefore, the total necessary to meet the risks and exposures identified is $164.6 million instead of the full $231.1 million (sum of all category risks). This represents funding at a 71.2% of all the identified risks and exposures to Solano County.

	Salaries & Benefits	Services & Supplies	Other	Total
Mandated Programs – (6 months) –				
Sheriff Operations/Coroner Services	19,230,000	10,250,000	0	29,480,000
General Assistance – GA	0	0	1,220,000	1,220,000
CMSP (Indigent Care)	0	4,500,000	0	4,500,000
Public Health	6,500,000	5,500,000	0	12,000,000
Child Welfare Services	6,100,000	3,500,000	0	9,600,000
Animal Services	409,000	198,000	139,000	746,000
Environmental Health	1,155,700	107,000	0	1,262,700
Probations Services/Juvenile Hall	8,250,000	1,100,000	0	9,350,000
Court MOE	0	0	0	0
Sub-total	**41,644,700**	**25,155,000**	**1,359,000**	**68,158,700**
County Payroll (6 months) – 60 – 70%				
Salaries/Benefits	72,792,000	0	0	72,792,000
Salaries/Benefits - H&SS	5,000,000	0	0	5,000,000
Sub-total	**77,792,000**	**0**	**0**	**77,792,000**
Debt Services Obligations (1 year) -	0	0	11,000,000	11,000,000
Sub-total	**0**	**0**	**11,000,000**	**11,000,000**
Extraordinary Events -				
Legal Costs/Criminal Activity/Prosecution	0	4,600,000	0	4,600,000
Sub-total	**0**	**4,600,000**	**0**	**4,600,000**
Property Tax Risks -				
Appeals/Reduced Property Tax Revenue	0	0	3,000,000	3,000,000
Sub-total	**0**	**0**	**3,000,000**	**3,000,000**
CATEGORY 3 – TOTALS	**119,436,700**	**29,755,000**	**15,359,000**	**164,550,700**

RECOMMENDATIONS:

As a result of the risks and uncertainties discussed above, the minimum general reserve & other designations levels recommended for Solano County are as follows:

General Fund Reserve

Increase the General Fund Reserve to 10% of the County's total budget, excluding inter- fund transfers. This equates to $72.4 million. This amount represents 53.4% of the total or "stacked" risk of $164.6 less $29 million (separate infrastructure / designation established by BOS). In addition, this 10% reserve level is between the GFOA recommendations of maintaining a prudent reserve level of 5% to 15%. If the Board chooses to fund at the recommended level, this reserve would have to be funded /increased over time.

In addition, due to the recommended increase to the general fund reserve level, a corresponding increase of $10 million to the minimum balance to be maintained and a maximum spend-down of $6 million per fiscal year are warranted to be consistent with the risks identified. This will increase the minimum balance to be maintained at all times to $20 million. The goal is to raise this floor over time to the $29 million to be consistent with the exposure for the category 2 risks.

OTHER GENERAL FUND "DESIGNATIONS"

Employee Leave Payoff

Increase the Employee Leave Payoff designation to $8.5 million. The $8.5 million recommended is the projected leave pay out calculated as of December 16, 2006. This amount represents the estimated leave payoffs for employee vacation and sick leave balances for vested employees likely to retire over the next five years. This estimate was based on the age and years of service of the current employee pool.

Deferred Capital/Maintenance Projects

Increase the designation level by $10 million for Deferred Capital/Maintenance Projects. Based on the 5 year Capital Facilities Improvement Plan, the current unmet and unfunded needs for the county facilities is estimated at $127.2 million. Category 2 above only includes 20% of the total unmet needs for facilities as the target designation or $25.4 million. Increasing this designation by $10 million will provide funds for both the needs of deferred maintenance and seed money for new capital projects. Therefore, the recommended $10 million would increase this designation to a total of $20.7 million or 16.3% of the total unmet facilities need.

This designation would have to be increased over time, if the Board chooses to fund at the recommended designation level.

APPROPRIATIONS FOR CONTINGENCIES

State Uncertainty

Maintain at the current level of $10 million. No increase is recommended at this time.

Other General Fund Contingency

Increase the General Fund Contingency to 10% of the General Fund Budget. This equates to $22.3 million. The General Fund Contingency currently has a balance of $23.6 million. This change will bring the policy in line with the Contingency level approved by the Board.

ACCOUNTING DESIGNATIONS AND LEGAL RESERVES

In addition to the designations noted above, fund balance levels shall be sufficient to meet debt service requirements, reserves for encumbrances, and other reserves required by legal obligations, state law, or generally accepted accounting principles. As of July 1, 2006 the additional reserves in the general fund for this category totaled $3.6 million. The majority of these reserves were for the long term loan to the Airport and outstanding encumbrances.

Recommended General Reserve & Other Designations

	Risk Exposure	Current	Recommended
General Reserve	**$135,550,700***	**$39,098,925**	**$ 72,400,000**
Designations:			
Employee Leave Payoff	**8,500,000**	**6,118,630**	**8,500,000**
Deferred Capital/ Maintenance Projects	**127,247,000**	**10,725,922**	**20,725,922**
SUB-TOTAL	**135,747,000**	**16,844,552**	**29,225,922**
Contingencies:			
General Fund	*	**23,620,910**	**22,300,000**
State Uncertainty	*	**10,000,000**	**10,000,000**
SUB-TOTAL		**33,620,910**	**32,300,000**
TOTAL	**$271,297,700**	**$89,564,387**	**$133,925,922**

*Dollar Risk exposure included in General Reserve.

ALTERNATIVES:

1. The Board could choose to do nothing at this time and leave the general fund reserve & other designations at their current level.
2. The Board could approve the recommendations as contained in this report.
3. The Board could choose a different general fund reserve level and a different level for other general fund designations.
4. The Board could provide staff with additional direction and ask to bring the item back before the Board.

CONCLUSION

While it is a very difficult task to predict all of the vulnerabilities and uncertainties facing Solano County, it is important to note that maintaining a sufficient level of unreserved fund balance will ensure the continued operation and provision of critical services to the residents of the County, the primary mission of county government.

In addition, the level of unreserved fund balance implies financial stability which is an important factor considered by rating agencies in evaluating the credit worthiness of the County. This was demonstrated on January 8, 2007 when Standard and Poor's Rating Services raised its ratings on Solano County from "A+" to "AA-" due to the strong financial management and their confidence in Solano County's ability to maintain solid operations and reserve levels. Conversely, the lack of financial stability may lead to a credit downgrade resulting in increased borrowing costs on bond insurance and interest payments.

Furthermore, the current dollars maintained in the General Fund Reserve and other General Fund Designations are invested by the County Treasurer. Currently the Treasury pool is earning approximately 5% on an annual basis. This generates an estimated $4.5 million in interest earnings to the general fund annually. These earnings are used to fund the operating budget.

Appendix A

GFOA RECOMMENDATION

Determination of the appropriate level of General Fund Designations (reserves) is a policy decision. There is no nationally uniform standard regarding the appropriate level of unreserved fund balance that local governments should maintain. The Government Finance Officers Association (GFOA) recommends reserve levels be directly related to the degree of uncertainty the local government faces.

The GFOA produced a research bulletin titled *Unreserved Fund Balance and Local Government Finance* in September 1990 which set the stage for many of the reserve policies that are in place today.

What is Fund Balance?

Prior to discussing the issues related to the establishment of an adequate level of unreserved fund balance for contingencies, it is important to define "fund balance".

Fund Balance is the cumulative difference of all revenues and expenditures since the government's creation.

For accounting purposes, a distinction is made between reserved and unreserved fund balance.

Reserved Fund Balance consists of portions of fund balance legally restricted to a specific use or not available for appropriation or expenditure. Examples include "fund balance-reserved for encumbrances" and "fund balance-reserved for debt service."

Unreserved Fund Balance is often subdivided into designated and undesignated portions. *Designated* portions reflect tentative management plans for future use, such as equipment replacement and designations for contingencies. Undesignated portions of unreserved fund balance represent expendable available financial resources that can be used to meet working capital requirements.

Generally discussions of fund balance will focus on the government's general fund. However, financial resources available in other funds should also be considered in evaluating the adequacy of unreserved fund balance in the general fund.

In addition, credit rating agencies carefully monitor levels of fund balance and unreserved fund balance within the general fund to evaluate the continued credit worthiness of the agency. A prudent reserve policy will safeguard the County's credit rating and reduce the interest costs when additional long term borrowing is required.

Establishing a Fund Balance Policy

The GFOA advises that all governments should have comprehensive financial policies that accurately reflect their financial objectives. These objectives include a wide range of activities from raising revenues to accounting for assets and liabilities and investing public funds. Such policies should be in written form, and subject to review on a regular basis. Such policies should also include a formal policy for the level of unreserved fund balance the local government wishes to maintain.

As part of the comprehensive financial policy, local governments should also have a formal policy regarding the level of unreserved fund balance they wish to establish and maintain for contingencies and other purposes. An important reason for developing such a policy is to provide the taxpayers with an explanation of why financial resources have been set aside and the conditions under which such resources will be expended.

The GFOA recommends that sufficient levels of unreserved fund balance can ensure the continued orderly operation of government with the ability to continue to provide services to residents. Local governments that have established sufficient levels of unreserved fund balance can avoid or reduce the impact of budget cutbacks during periods of sluggish or negative economic growth.

The adequacy of unreserved fund balance in the general fund should be assessed based upon a government's own specific circumstances. Nevertheless, GFOA recommends that general-purpose governments maintain an unreserved fund balance in their general fund of ***no less than five to fifteen percent of regular general fund operating revenues or of no less than one to two months of regular general fund operating expenditures***. The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a government's particular circumstances.

A government's fund balance policy should include:

- Setting aside financial resources for contingencies
- Allocating financial resources to unreserved fund balance (or a budget stabilization fund);
- Utilizing unreserved fund balance resources; and
- Determining the appropriate size of unreserved fund balance

Variations in Reserve Levels

Certain situations may require levels of unreserved fund balance in the general fund significantly in excess of these recommended minimum levels. In addition, the adequacy of reserve levels should be determined based on a long term forecasting perspective, thereby avoiding the risk of placing too much emphasis upon the level of unreserved fund balance in the general fund at any one time.

In establishing a policy governing the level of unreserved fund balance in the general fund, the GFOA recommends a government should consider a variety of factors, including:

- The predictability of its revenues and the volatility of its expenditures (i.e., higher levels of unreserved fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile).

- The availability of resources in other funds as well as the potential drain upon general fund resources from other funds (i.e., the availability of resources in other funds may reduce the amount of unreserved fund balance needed in the general fund, just as deficits in other funds may require a higher level of unreserved fund balance be maintained in the general fund).

- Liquidity (i.e., a disparity between when financial resources actually become available to make payments and the average maturity of related liabilities may require a higher level of resources be maintained).

- Designations (i.e., governments may wish to maintain higher levels of unreserved fund balance to compensate for any portion of unreserved fund balance already designated for a specific purpose).

Economic Uncertainty

The finances of governments that are dependent on economically sensitive revenues, such as general sales tax, will be more affected by a downturn in the economy than governments that are dependent on more stable tax sources, such as property taxes. The former are generally more likely to benefit from the maintenance of a higher level of unreserved fund balance. However, governments that are dependent on property taxes may also be affected by an economic slowdown, particularly if the market value of real estate and assessed values decline. In addition, economic downturns may also contribute to the loss of major taxpayers in some jurisdictions, further depressing local revenue collections.

Other Forms of Uncertainty

While the health of the economy often has a major effect on local government finances, other forms of uncertainty must also be taken into consideration, such as:

- Unanticipated changes in the tax and spending policies of federal and state governments.

- The imposition of mandates by federal and state governments, which often have uncertain economic and financial impacts on local governments.

- Limitations on a government's taxing and spending powers as the result of the passage of voter referendums.

- Financial impacts of labor agreements, particularly those stemming from binding arbitration.

- Unanticipated expenditures resulting from natural disasters.

- Unforeseen increases in energy costs.

- Unexpected capital expenditures resulting from water main breaks, bridge collapses, etc.
- Extraordinary employee overtime costs.
- Errors in revenue and expenditure estimation due to the difficulty in identifying the turning point in the business cycle.
- Unexpected variations in a government's cash flow that necessitates the use of short-term borrowing if sufficient monies are not available to cover shortfalls.

The bottom line is that there is no nationally uniform standard regarding the appropriate level of unreserved fund balance that local governments should maintain.