Atascadero City Council
Staff Report – Administrative Services Department

Financial Reserve Policy

(This report has been compiled, in preparation for the upcoming budget cycle, to assist in evaluating the City’s fiscal position and the level of appropriate reserves.)

RECOMMENDATION:

Council provide direction to staff regarding the financial reserve policy.

REPORT-IN-BRIEF:

The mark of fiscal stability is a city’s undesignated General Fund balance, or reserve. In the early 1990’s, the City had a negative reserve. Since that time, Atascadero has improved its financial condition. In preparation for the upcoming budget cycle, this information has been compiled to assist in evaluating the City’s fiscal position and the level of appropriate reserves.

DISCUSSION:

City finances are comprised of various funds, which for legal purposes have to be separated. For example, sewer charges are to be spent on maintaining and operating the wastewater system and may not be used to hire police officers or firefighters. One fund over which the Council may exercise considerable discretion is the General Fund. General taxes and receipts are deposited into this fund and the Council decides on how to spend these general revenues, whether it’s for police, fire, parks maintenance, recreation services or other public services. (Of course restricted revenues such as grants or fees for services are also deposited into the General Fund and the City must
ensure that these receipts are spent appropriately.) The City must cautiously guard its General Fund to ensure that there are always adequate resources to provide critical services to the public.

An indication of fiscal stability is a city’s undesignated and officially “reserved” General Fund balance. In the early 1990’s, the City of Atascadero had a negative General Fund balance, forcing layoffs and service reductions in order to weather the storm. In fiscal year 1995, the collapse of the Orange County Investment Pool hit the City and the General Fund reserves fell to an all time low of $ - 790,360 (or -11.1% of General Fund expenditures). The City’s audit carried a going concern note and the General Fund stayed afloat by borrowing from the Wastewater Fund and issuing tax revenue anticipation notes. By the late 1990’s, the economy was starting to turn around, and wounds to the organization from the fiscal rollercoaster were just starting to scab over. In order to avoid this devastating turn of events in the future, Council adopted a fiscally conservative reserve policy and began to aggressively go about building reserves.

The City first adopted a Financial Strategy in 1998 and the results of having a plan have become clear. The City has focused its resources and its financial condition has improved dramatically. The overall strategy has consistently been to maintain a conservative outlook by putting aside reserves in good times and then using those reserves during down periods to achieve stable operations. By employing this cautious strategy, the City can avoid the undesirable peaks and valleys in services due to revenue fluctuations and can better maintain its long-term financial viability.

As of June 30, 2006, there is $7.2 million in the undesignated and officially “reserved” General Fund balance. This represents 44% of expenditures. When we add amounts reserved for loans to other funds, this figure goes up to $10.2 million or 63% of general fund expenditures.

As the City’s financial condition has improved, the focus has shifted from accumulating reserves to managing reserves. When the City was in financial difficulties, we knew that the reserves on hand were not adequate to meet the needs of the City, but in recent years, it has been necessary to ask ourselves whether we are accumulating too much in reserves. After all, a City’s purpose is not to accumulate money, but instead to provide services for its constituents. Each dollar in reserves is money that could have been spent on fixing roads, storm drains, parks or other infrastructure.
The Adoption of Reserve Policies in California Cities by Anita Lawrence asked “What is the amount of fiscally prudent reserve? How much would be enough to cover certain events and develop a sense of security for the organization and the community? At what level would the constituency begin to question it as too much? What is the risk tolerance of the organization and the community? What criteria should be used to make that decision?” There is no easy answer to these questions. Anita’s research showed that “…if you asked 100 city finance professionals these questions, very few would provide the same mix of answers. The elements that are right for one city are entirely wrong for another.”

The real question is: What is the right amount of reserves for the City of Atascadero, both at this point in time and for the foreseeable future? In order to formulate a reserve policy, it is important to answer the following:

1. How broad is the City’s revenue base?
2. How stable is the tax base?
3. How vulnerable is our revenue base to State or Federal political action?
4. What are the cash flow needs of the City?
5. How susceptible is the City to natural disasters or emergencies?
6. What is the City’s policy on equipment and infrastructure replacement?
7. How important is it to our organization and constituents that we maintain consistent service levels?
8. How important is it that the City has the ability to capitalize quickly on opportunities that arise?
9. What future commitments has the City made that are not currently funded?

Although it is certainly not the main purpose, reserves also generate interest income. Investment earnings is a General Fund revenue that is spent on ongoing operating items such as police and fire. As we reduce reserves, we consequently reduce our general fund income and this should be considered as part of the equation when determining the correct reserve level for the City of Atascadero.

Measurement #1 – General Fund Revenue

One measurement to quantify an appropriate level of reserves concerns how broad a range of General Fund revenues the City 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, Pismo Beach and Morro Bay enjoy a large amount of transient occupancy taxes (hotel tax). Other cities, such as Grover Beach and San Luis Obispo, have a utility user tax. This is a percentage of the cost of all utilities used by citizens of those cities, including gas, electric, phone, cable TV, and even the city’s own utilities of water, sewer, and garbage. Yet other cities have a gross receipts business license tax that provides a large General Fund revenue.
Cities with fewer sources of General Fund Revenue will require a greater amount in reserves in order to successfully weather a downturn in one revenue area. This is true for the City of Atascadero. Transient occupancy tax netted only $480,000 in fiscal year 2005-2006, which is only 5% of what the City receives from property and sales taxes.* The City’s modest business license tax resulted in only $162,470 in 2005-2006. Again, this is about 2% of what property and sales tax will produce.* Now that a portion of VLF is tied to property tax, property tax is an even larger piece of the pie, while VLF is smaller, exacerbating the issue. In short, the City has a very narrow base of General Fund tax revenue. Well over half of the General Fund depends on property and sales taxes alone.

One reserve methodology dictates that that reserve levels should be tied to the breadth of General Fund tax revenues sources. The greater number of revenue sources require fewer layers of reserves. Conversely, the fewer number of revenue sources require higher levels of reserves. As Atascadero’s property tax and sales tax revenues comprise $11.7 million of the $17.3 million in General Fund taxes, the City is defined as having a narrow base of revenue-just two significant categories.

* Includes property tax in lieu of vehicle license fees.
Measurement #2 – Tax Base Stability

As discussed above, General Fund revenues for fiscal year 2005-2006 were $17.3 million. Sixty-eight percent of this was from taxes, with the balance coming from fees, grants, and other sources. The fees and grants pay for specific services or projects. While it is important to analyze the General Fund revenues as a whole, it is also critical to examine the General Fund tax base. These taxes are used to support services for which there are no fees, such as public safety and parks, and they are really the bulk of the City’s discretionary funds.

To examine the tax base more closely, it is helpful to break it down further. Property tax comprises 52% of the tax base, sales tax 34%, and all other taxes make up the remaining 14%. Property tax is considered to be one of the more stable sources of revenue; however, the growth in this revenue varies with the strength of the housing market. With the relative affordability of housing in the City in comparison to other markets, property tax revenues have shown slight growth during the past few years. New housing developments and sales have benefited the City’s revenues. When looked at on a per capita, constant dollar basis, however, the true character of the revenue becomes transparent. As shown in the graph below, property tax revenue reflects the ebbs and flows of the market, but its trajectory is relatively flat. In other words, there is relatively no growth in over half of the City’s tax revenue base. Moreover, because property tax comprises a full 52% of the tax base, even small percentage fluctuations can have a major impact in terms of dollars of revenues. Even a 5% decrease could potentially take two police officers off the street.

* Includes property tax in lieu of vehicle license fees.
Another way to view the strength of property tax as a revenue is to compare Atascadero with other cities in the county. The chart below shows that our community has the lowest per capita property tax in the county. It is true that in this county, each city has its own unique characteristics which often make it hard to do comparisons. Even with that in mind, however, this chart does make one thing painfully clear. Atascadero has less money per person to spend on essential functions such as public safety and parks that are critical to citizens of the community. In other words, the relative strength of our dollars per capita is not as good as that of our neighbors.

Sales tax is much more susceptible than property tax to fluctuations in the economy. Thirty-four percent of the City’s General Fund taxes comes from sales tax and 43% of
that stems from automobile sales and sales of building and construction materials, segments of the economy that are vulnerable to recession. In fact, Atascadero is highly reliant on two major retailers, Home Depot and Atascadero Ford Outlet. Twenty percent of the City’s total sales tax revenue is generated between these two companies. If either one of these retailers decided to relocate out of the City; sales tax revenue would drop significantly. A sluggish economy could potentially have a negative effect on the vulnerable sales tax base. A two-year economic recession, which had the effect of sustaining only a 10% reduction in retail sales in the City, would result in an $800,000 loss to the General Fund over the period.

The chart below depicts sales tax per capita, constant dollar, over the last 20 years. Like property tax, it too shows evidence of the ebbs and flows of the market, but to a greater extent. Atascadero started experiencing an increase in this revenue after Home Depot came on line in fiscal year 2000-2001. The good news is that the City is holding its own. The bad news is that the City is holding its own. Being familiar with the fluctuations in the market, a decrease in revenues in future periods is all but guaranteed and should be anticipated. Without sufficient reserves, critical services could suffer.

The strength of sales tax can also be compared to the other cities, as shown below in the per capita comparison. Atascadero ranks 5th of the 7 cities, with approximately $144 in sales tax revenue per person. As with property tax, the City falls far behind the county leaders in revenue per capita, and therefore our community experiences less strength in each sales tax dollar than our neighbors.
One silent thief comes in the form of internet transactions. These transactions, when done via the internet, replace retail sales that the City would otherwise have earned sales tax revenue for. This trend has steadily grown and will continue to do so, further impacting future sales tax revenue.

Measurement #3 – State and Federal Action

When the State faced fiscal challenges in the early 1990’s it simply transferred property tax revenues from cities and counties in effect to itself (known as the ERAF I & II shifts). In addition, the State reduced funding for counties, and in turn allowed counties to recoup these lost revenues by charging cities for services such as collection of property taxes and booking people into county jail. In the late 1990s, the State was in very good financial position and desired to give constituents a tax break. The State did this by reducing one City revenue (VLF) and promising to backfill it with a different one. As the State’s financial good fortune deteriorated, so did the State’s promise to backfill revenues.

Proposition 1A established new strong 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 annually to this day and will remain in the future even with Proposition 1A.

While Proposition 1A has reduced the political risk to City finances, the State may still delay payments and “borrow” from cities in times of State need. In addition to this, Proposition 1A has not been tested yet, and as all entities are when facing financial crisis, the State has been very creative in the past when its financial back was against
the wall. Current rumblings from the State have put us on notice that the State may be looking to cities once again in the near future to help bail them out.

Cities are also at risk from ballot measures and other political actions. One example of this would be Proposition 90, which was defeated in the November election. Had this ballot measure passed, the cost to state and local governments in California would have been in the billions of dollars.

Although in a better position than in years past, the City’s financial well-being continues to be vulnerable to political action.

**Measurement #4 – Cash Flows**

The cash flow needs of the City have a direct bearing on the amount of reserve needed. Unlike many private organizations and businesses with a steady cash stream, the City receives large portions of its annual revenues in chunks, twice a year. The fiscal year begins in July and ends in June. During the summer months, the City incurs more expenses for fire reserves, recreation programs, and capital projects than during other months of the year. However, the City does not receive its first fiscal year injection of property tax until late December, and then waits to receive the rest in late April. In other words, the City’s receipts go down from April through November while the City’s disbursements go up during the same period.

Recent changes in state legislation have exacerbated the City’s cash flow situation. The exchange of monthly sales tax revenue and monthly motor vehicle in-lieu fees for the semi-annual sales tax in lieu and property tax in-lieu of VLF, has increased the cash flow gap. Over 40% of the City’s General Fund revenues now come in late December and in late April. For example, at June 30, 2006 the General Fund had a cash balance of $7.8 million, but at November 30, 2006 the cash balance had dropped to only $4.0 million. This is an annual $3.8 million cash flow gap.

<table>
<thead>
<tr>
<th>Date</th>
<th>Balance</th>
<th>General Fund</th>
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<tbody>
<tr>
<td>June 30, 2006</td>
<td>$7,828,000</td>
<td></td>
</tr>
<tr>
<td>November 30, 2006</td>
<td>4,045,000</td>
<td></td>
</tr>
<tr>
<td>Cash Flow Fluctuation</td>
<td>$3,783,000</td>
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Another element that affects cash flow is the amount of projects being undertaken. The construction of Lewis Avenue Bridge, the Youth/Community Center, and the renovation of the Historic City Hall are just three of the many projects to which the City is financially committed. These projects require significant cash flow. Grants fund many of these projects, which is a terrific source of funding. However, these are reimbursable grants, meaning that the City must first expend the funds and then request reimbursement. Depending on circumstances of the grant and the lead agency, it could be anywhere from one month to 18 months before the City has recouped its funds.

The potential cash sources for these grant-funded projects are severely limited by legislative and other restrictions that are placed on the City’s funding sources. This means that the General Fund will be tapped once again to front the cash for these projects. If the City were to complete all of its current year budgeted projects by June 30, 2007 and reimbursement time frames are similar to those experienced by the City in the past, the General Fund would have to spend $7.2 million of its cash reserves, advancing the money to other funds. (We believe that the number will be less than this, as construction time frames for the Youth Center will take longer than June 30, 2007.) The General Fund would recoup these funds as soon as the State reimburses the City, however the General Fund would be out the cash until that time. The City is at a critical point in time as far as future commitments are concerned.

The General Fund reserve is largely the focus of this analysis since this is the fund over which the Council may exercise considerable discretion. However, the City has over 40 funds in total. As stated before, many of these funds carry legal restrictions on how they can be spent. For example, Gas Tax Fund money must be spent on street maintenance and cannot be used to hire additional police officers. It is permissible, in some funds, to loan money to other funds. If the Wastewater Fund had excess cash for example, and the General Fund needed cash, the Wastewater Fund could loan the General Fund money. This may be one possible option to reduce City reserves overall. The reserve strategy could be built to view fund reserves globally, in essence reducing individual fund stability, but increasing overall reserve efficiency. This option does not come without concern, however. Levels must be constantly monitored for current stability and forecasted for future stability. Using the above Wastewater Fund example, if the Wastewater Fund loaned most of its excess cash to the General Fund, the Wastewater Fund may find itself unable to fulfill its own capital project obligations. While following this path is the leaner strategy, it would require more frequent and accurate financial predictions, and thus, carries more risk.
Measurement #5 - Natural Disasters or Emergencies

As defined by the City’s Hazard Mitigation Plan, Atascadero is subject to some potentially devastating disasters. The San Simeon Earthquake was enough to shake us into reality regarding the costs of natural disasters. The quake severely damaged the Historic City Hall Administration building and the Printery, and caused thousands of dollars in damages to Fire Station #1, the Police Station, the Wastewater Treatment Plant, and numerous roads and infrastructure around the City. Fortunately, FEMA and OES have paid for a large portion of the repairs thus far. However, as discussed above, the City must pay for the costs of repair before requesting reimbursement from these agencies. At a cost of over $30 million to the City, recovery from the earthquake means that the City must be financially prepared to pay the majority of this cost before being reimbursed. Additionally, a significant portion of these costs are not reimbursable under FEMA/OES policy, and the City is required to absorb them.

The City’s natural rural beauty and mountainous terrain unfortunately also make it a target for devastating wildfire. In fact, the threat of a wildland fire is so great that the federal Department of Homeland Security will be funding a cooperative exercise this Spring, using nearly all local jurisdictions in a simulation training for a fire that starts in Atascadero at Highway 41. The financial threat to the City of such a fire is of astronomical proportion. Although the City is a party to mutual aid fire response agreements, this only covers the first twelve hours of firefighting time for the use of trucks, bulldozers and hand crews from neighboring jurisdictions. If the firefighting goes on beyond that first twelve hours, the City foots the bill for everything from the first moment outside help arrives until they leave. Those costs can add up very quickly: A strike team, which includes five engines with 14 to 28 firefighters per engine, can cost $10,000 to $15,000 per day plus the cost of feeding the crews and any reimbursed expenses for damaged equipment. To give some perspective, the recent 7-acre fire at north El Camino Real used the equivalent of five strike teams. In addition, if a fire was in terrain that necessitated the use of firefighting aircraft, the cost could range from $1,000 per hour for a helicopter with no crew to $9,000 per hour for a forest service helicopter with a crew of 22 to 24 firefighters. This hourly rate does not include the cost of fuel for the aircraft. Clearly, even a mid-size wildfire of 300 acres would put a huge financial burden on the City. Additionally, if any city structures were damaged, it would be the City’s responsibility to provide an alternate location to conduct City activities.

Other potential emergencies have been identified, such as flooding, multiple casualty accidents, acts of terrorism, and major hazardous materials spills associated with cargo coming through town on either Highway 101 or on the railroad.

Any natural disaster or emergency could also have the compounding effect of slowing the local economy, thus potentially reducing General Fund revenues and exacerbating the situation even further.
The City is fully insured against property damage and liability claims. Additionally, Atascadero is very aggressive in applying for all applicable grants, when available, particularly to pay for the cost of responding to emergency situations. Unfortunately, grants are not always available, and at times, the City will need to foot the bill when emergencies arise. Even when grants are available to defray costs, as is the case for the earthquake recovery effort, the City must have reserves to cover the costs until the City can be reimbursed.

Measurement #6 – Asset Replacement

The repair and replacement of existing assets is a large commitment that is not reflected in traditional governmental budgeting and reporting, yet is a critical part of any reserve or funding strategy. The City of Atascadero owns large amounts of assets that have lives longer than a year: streets, storm drains, computers, playground equipment, fire hoses, ball field lights, street signs, fire stations, radar equipment, vehicles, wastewater treatment plant, zoo exhibits, City Hall, and others. Replacing these items takes large influxes of cash at irregular intervals. For example, a storm drain culvert typically lasts about 75 years. The City may have to clean out the culvert on occasion, but in general for the 75 years of the culvert’s life, the City has to spend very little cash on that culvert. Now in year 75, when that culvert fails, the City will have to expend a very large amount of cash to replace that culvert.

The use and replacement of capital assets becomes a very easy item to ignore especially in times of economic hardship. The necessity of waiting until an asset completely fails before replacing it becomes the rule rather than the exception. The City of Atascadero is not immune to this budget balancing strategy.

This strategy works in the short term, but of course does not work in the long term. As long as the assets are still functioning, the City is in good shape; however when the assets fail, the City has three choices:

1. Reduce Service Levels – For some items, the City may elect to not replace assets, but instead to just do without, as has been the case with items such as the playground equipment at Paloma Park. This typically results in a service level reduction for the community but may be the most prudent solution at the time. This solution typically does not work for life safety assets where there is minimal community tolerance for reduced service levels. (One cannot imagine a situation in which the community would say that it is okay for the police department not to have running vehicles.)

2. Debt Finance Replacement of the Asset – Financing replacement of an asset either through bonds, leases or some other type of loan is always a viable solution once an asset fails (assuming that the City has good credit). The downside of purchasing/constructing assets using loans is, of course, that the City would then have to find money within its annual operating budget to pay
back not only the principal amount, but interest as well. Assuming no change in City revenues, this would also result in a reduction of service levels as programs were cut in order to make payments on the debt.

3. Replace the Assets Using Current Reserves – The City may also accumulate reserves in order to replace certain assets, certain groups of assets, or have a general emergency replacement fund for those items which become critical at any given time. The City also earns interest on these reserves, helping defray the cost of replacing the asset when necessary. The downside of this strategy is that the public sees this as money that can be spent now on new assets. (Worry about tomorrow, tomorrow.)

Because the City had deferred the replacement of even the simplest fixed assets in order to balance its budget, by the mid 1990s, things had reached critical mass. The City was suffering the embarrassment of having police cars routinely break down while responding to a call, departments trying to complete tasks with only one working computer in the department, and of course a failing road and infrastructure system. As part of the 1998 Financial Plan, Council adopted a strategy to go about establishing replacement reserves for the most critical day to day assets.

Today an annual amount is charged to each department for replacement of its computers and vehicles. These reserves are fully funded as part of the Technology Maintenance & Replacement Fund and the Vehicle & Equipment Replacement Fund.

The Council also set strategies to begin funding equipment replacement; however due to budget constraints, the City has not been able to include a full year’s equipment replacement amount in the budget and the deficit from years of not funding this reserve still exists. The City has, however, been very successful in obtaining public safety grants in recent years, which have helped to replace items such as breathing apparatuses for the fire department and emergency communications equipment for the police department. As other agencies are also looking for alternate means of funding, and state and federal agencies run up against tighter budgets, the availability of grant funds is reduced and the competition for them has increased.

Council’s strategy for the building replacement reserve has been to attempt to fund an estimated full year’s annual replacement each year and look for opportunities to reduce the accumulated reserve deficit from previous years. Since instituting the annual transfer to the Building Maintenance & Replacement Fund, the City has spent the majority of this on much needed repairs of deferred maintenance items, leaving very little in building replacement reserves.

Road maintenance is another area with a reserve deficit. It is estimated that the City of Atascadero needs to spend approximately $2,750,000 annually to maintain it's over 140 miles of road. (This annual expenditure would not improve the roads, but only keep them in the shape they are in today.) At Council’s direction, the Atascadero Roads
Program was developed to focus the City's efforts on maintaining and protecting the roads of Atascadero in an organized, efficient and cost-effective manner. Since the inception of the Atascadero Roads program, the City has used a variety of funding sources including LTF Funds, Street Impact Fee Funds, Traffic Congestion Relief Funds and competitive grant funds, along with an annual General Fund contribution of $250,000 to make considerable progress toward the backlog of City road maintenance issues. However, there still remains a large accumulation (over $30 million) of road maintenance issues that need to be addressed.

<table>
<thead>
<tr>
<th></th>
<th>Annual Reserve Fund Requirement</th>
<th>2005-2006 Reserve Fund Strategy</th>
<th>Reserve (Deficit) Balance 6-30-06</th>
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</thead>
<tbody>
<tr>
<td>Street Maintenance</td>
<td>$2,750,000</td>
<td>$1,193,000</td>
<td>$(30,700,000)</td>
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<tr>
<td>Building Replacement</td>
<td>606,000</td>
<td>313,300</td>
<td>$13,741,000</td>
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<tr>
<td>Technology Replacement</td>
<td>89,930</td>
<td>89,930</td>
<td>-</td>
</tr>
<tr>
<td>Vehicle Replacement</td>
<td>231,080</td>
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<td>-</td>
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<tr>
<td>Equipment Replacement</td>
<td>310,000</td>
<td>35,000</td>
<td>$(1,397,000)</td>
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<tr>
<td>Parks Infrastructure Replacement</td>
<td>200,000</td>
<td>-</td>
<td>$(3,793,000)</td>
</tr>
</tbody>
</table>

| Unknown Items: Storm Drain Replacement | estimated at several million dollars |
| Unknown Items: Other Infrastructure Replacement | estimated at several million dollars |

The City’s assets include more than just buildings, equipment, vehicles, roads, and computers. Also included are storm drains, catch basins, manholes, bridges, sidewalks, curbs, gutters, medians, traffic signals, park infrastructure and parking lots. Because of funding limitations, there is no current funding of reserves for these items. The reserve deficit for these items is estimated to be over $34 million. The City has been able to address failure of these items as they arise, either by not funding replacement, or by using reserves; however as the storm drains increasingly begin to fail and the park infrastructure continues to deteriorate, this strategy will not work in the long run.

Measurement # 7 – Service Level Consistency

Another issue to consider is how important it is to the organization and constituents that services levels are consistently maintained. Looking back a decade and a half ago, this was a key concern. A less fiscally conservative policy was in effect during that time, and when the economy became sluggish, reserves were insufficient to carry the City through the tight times. Services were cut. Many families had to seek alternate sources for youth recreational activities. Parks and Public Safety services were at a bare minimum. Employees were laid off. The few employees that remained to run the City
were overworked and frustrated. Morale was at an all time low. Recruitment during the recovery period was difficult at best. That fear of instability and layoffs is still alive today in the minds of many employees and employee associations. The fiscal sustainability policy that is currently in effect is that of putting aside reserves in good times and then using those reserves during down periods to achieve stable operations. This was a critical step in 1992 on the path to recovery. The important question to ask now is, is this policy still relevant? Staff believes it is. The constituency and employees are expecting stability in the organization more than ever. It builds confidence in the people to know they can depend on their government (and their employer) for their needs and services, regardless of the state of the economy.

Measurement 8 – Opportunities

Previous Councils have wanted the flexibility to take advantage of opportunities as they arose. Reserves have been a tool to achieve such goals. The purchase of the Hay and Feed property and Paloma Park were opportunities that came up quickly. Council was able to maximize those opportunities and purchased both properties. Financing can be another option to use in this type of situation, but at times procuring financing can take longer than expected, and opportunities may dissolve. Staff firmly believes that it continues to be important to have reserves that give the Council flexibility with such opportunities.

Measurement 9 – Future Commitments

The City has made financial obligations that will affect future budget cycles. For example, when construction is complete on the Youth/Community Center, the Center will require an operating budget that is estimated to be at least $500,000 annually. In an effort to address some of the reserve deficits in buildings and streets, the Pavilion is scheduled to receive much needed improvements of approximately $150,000, the Police station will receive repairs to the lobby and a new roof for $50,000, and one additional mile of road will be paved annually. Maintenance on new assets such as the downtown streetscape, creek trails, and neighborhood parks (in the communities of Apple Valley, De Anza, and Las Lomas) will also be required. The City continues its commitment to public safety through additional expenditures in Police Department recruiting, and expands resources for the community with the addition of an affordable housing management assistant. All of these commitments are valuable to the community, and it is the City’s responsibility to ensure that there are sufficient resources to fulfill these obligations.

Interest Earnings

The measurements discussed in this document provide guidelines to a thought process that should be undertaken when developing a financial reserve policy. But there is one aspect that is often overlooked when deciding on the appropriate level of reserves. The City’s reserves are invested; therefore, they generate interest revenue. This interest on
reserve funds can be viewed as a kind of ‘endowment’ that provides additional General Fund operating revenues that can fund important services to residents. Conversely, as reserves are spent and not replaced, that ‘endowment’ disappears along with the reserves, further depleting the availability of funding for such things as parks maintenance and public safety.

Look at the Big Picture

Nine criteria have been analyzed in order to ascertain what constitutes a prudent reserve for the City of Atascadero. While each of these is an important measurement, they should not be looked at individually but instead as a whole. They must also be considered within the framework of the financial picture for the entire organization rather than just the General Fund.

If each reserve was to be considered individually, it might be recommended that the City reserve 10% of sales tax in case a major sales tax provider closes its doors, plus three months’ worth of expenditures for natural disasters, plus $3.8 million for annual cash flow needs, plus $2 million on hand just in case an opportunity comes up, etc. Each item listed is an individual event, and, in theory, could all happen at the same time, but the risk of that happening is minimal. It would be very conservative to keep the cumulative amount of what would otherwise be prudent individual reserves. Instead it may be sensible to reserve for a more likely combination of events (such as the need for our annual cash flow obligation and the loss of State revenue at the same time) while having a contingency plan for the more unlikely events (a major natural disaster, a once in a lifetime opportunity and the need for our annual cash flow obligation all at the same time.)

In the event the City’s General Fund could not meet its cash needs because of an unlikely string of events, there may be other places to look within the organization. For example, as the Wastewater Fund has an available cash balance that the General Fund can borrow in an emergency situation, the need for redundant reserves in the General Fund goes down. If the other funds of the City have very few cash reserves, the General Fund loses that “safety valve” and may consider the need to increase its reserves.

Recommendations

General Fund reserves are at an all time high, but this is expected as part of the City’s overall financial strategy of putting money away in the good times to carry us through the bad times. In line with this strategy, the City should have its highest level of reserves just prior to an economic slowing. This way, the City can use those reserves to carry it through the down times and into the next economic boom. Staff believes that an economic slowing is just on the horizon and recommends that the City maintain its policy of accumulating its reserves in periods of abnormal revenue growth and using
those reserves in periods of slow or no growth. This reserve amount should ebb and flow with the City’s normal economic cycle.

It is also recommended that the General Fund maintain at least the prior year’s maximum ongoing cash flow needs in reserves. This would prevent the necessity of the City having to borrow funds to meet its regular operating activities. Staff further recommends that the Council maintain a very conservative project cash flow reserve for the next few years. The restoration of the Historic City Hall building (an estimated $30 million project), and the construction of the Youth Center (over $5 million), are major capital projects that are being funded in large part through reimbursement grants. Staff will be evaluating and analyzing the timing of reimbursement payments throughout the Youth Center Project in order to evaluate cash flow strategies for the much larger Historic City Hall Project.

Staff also believes that it is prudent that the City always maintain an amount equal to three months of General Fund expenditures in reserves in order to insulate the City from the effects of unexpected events such as raids from the State, large economic swings, or natural disasters. However, with the current year’s need for a conservative cash flow reserve and the availability of Wastewater funds in the event of an emergency, staff believes that an overlap of this reserve with the cash flow reserve is appropriate.

Staff further recommends that Council continue fully funding replacement reserves for technology and vehicles, and partially funding reserves for streets, buildings, and equipment. Staff will continue to look for opportunities to decrease these reserve deficits through grants and other funding sources.

**Conclusion**

It is important that the City of Atascadero 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 $7.2 million, or reserves roughly equal to 44% of the City’s present General Fund operating budget is not unreasonable. It has been noted that the reserves of the City of Atascadero serve in an endowment-like fashion that provide General Fund operating income of approximately $325,000 in interest earnings. Any consideration to reduce reserves by allocating funds to a capital project must also consider this negative effect on the City’s operating budget.