Response to Questions on the FY 2014 Budget

Request By: Supervisor Foust

Question: Review reserves and verify that the annual contributions are necessary and are funded at the proper levels.

Response: The County has defined policies for reserves including policies to govern their use and formulas to identify how they are funded. The attached memo from October 2011 lays out the importance of the reserves and the uses for them. As indicated in the memo, staff is continuing to work on improving the transparency of the reserves by making the uses and methods of calculation clearer in budget and financial reporting documents.

Many of the reserves are not funded with General Fund resources but rather with the revenue streams supporting the operation of the programs, such as sewer fees. Those that are supported by the General Fund include the Managed Reserve, the Revenue Stabilization Fund, the Accrued Liability Reserve in the Self Insurance fund, the Other Post-Employment Benefits (OPEB) and Retirement reserves, and replacement reserves for vehicles and technology infrastructure.

The annual contributions for the Managed Reserve and the Revenue Stabilization Reserve are directed by long standing Board policy and equate to, respectively, 2 percent and 3 percent of General Fund disbursements. These reserves are funded concurrently with any changes in appropriation.

The Accrued Liability, OPEB and Retirement reserves are funded annually in accordance with actuarial valuations performed by external actuaries. The Accrued Liability Reserve represents the County's current and projected requirements as a result of Worker's Compensation and other self-insured liabilities of the County. The $1.1 million in funding required to meet the June 2012 valuation is included in the *FY 2013 Third Quarter Review* as it adjusts the FY 2013 required funding level. The OPEB reserve is a relatively new requirement by the Governmental Accounting Standards Board to ensure that the long term impact of County health benefits are accounted for. There is no increase to the General Fund OPEB contribution in FY 2014 based on the actuarial valuation for June 2012. The retirement contributions are also funded as a result of annual actuarial valuations to address long term funding requirements of the obligations of the County's retirement systems. The net impact of Retirement funding requirements in FY 2014 is an increase of $0.8 million.

The replacement reserves for vehicles and technology infrastructure are sized to accommodate the inventory of vehicles, including Police cars and Fire and Rescue apparatus and ambulances, and computer equipment such as PCs and laptops, the costs of replacement equipment and the age and usage criteria established for each type of equipment.

The levels of most vehicle reserves did not require adjustments in FY 2014. However, Fire and Rescue apparatus and ambulance reserves are not sufficient and an increase of $1.0 million is required to support the first year of a multi-year process to gradually increase the annual contributions to the Large Apparatus Replacement Fund and Ambulance Replacement Fund. This funding is in addition to the department dedicating additional grant funds, additional baseline funds and one-time contributions in support of this effort. Additional contributions are required due to increasing cost of vehicles, some fleet growth, and a contribution level that has remained flat since FY 2007. Without additional funding, the replacement reserves will be depleted in FY 2016. It should be noted that given the current inventory and replacement cycle, the annual contribution should be in the $5-6 million range for the Large Apparatus Replacement Reserve and approximately $1 million for the Ambulance Replacement Reserve. The current annual contributions are $3.1 million and $0.2 million, respectively. It is also anticipated in the FY 2015 Plan that additional funding of $1 million will be required and that the County will need to start funding a portion of the estimated $0.8 million in annual requirements for apparatus and ambulances currently owned by volunteer companies due to the concern that exists that many of the volunteer companies will be unable to replace these vehicles when necessary.

As a result of the annual review of the requirements for these reserves, a balance of $1.5 million was identified in the PC Replacement Reserve and was transferred to the General Fund as part of the FY 2014 Advertised Budget Plan. Under the current proposal, the PC Replacement Program will permanently move from a 4 year to a 5 year PC refresh cycle as part of a long term PC replacement strategy that is in development. A one-time transfer to the General Fund of $1.5 million in FY 2014 can be accommodated within this proposal based on a lower number of hardware replacements in FY 2014, and is consistent with the ongoing requirements that have been preliminarily identified as a result of a review of inventory, replacement costs and the useful life of this equipment.

County of Fairfax, Virginia

MEMORANDUM

DATE: OCT 25 2011

TO: Board of Supervisors

FROM: Anthony H. Griffin
County Executive
AHG

SUBJECT: County Reserve Policies

Fairfax County has established a number of long term financial policies and practices which provide for strong and consistent fiscal performance. These policies, and the fact that the Board adheres to them even during difficult budget periods, are instrumental in maintaining the County's reputation for strong financial management that is repeatedly cited as one of the most important elements of our credit rating and the favorable impression the County has in the financial markets among investors.

Chief among those policies which have effectively guided financial decision-making over the last several decades is the County's Ten Principles of Sound Financial Management which were first adopted by the Board of Supervisors in 1975. These principles provide a set of policies that govern the development and monitoring of County budgets, identify debt standards and procedures, detail County internal controls, cash management practices and efficiency efforts and distinguish the County reserve polices particularly as they relate to the County's General Fund reserves.

To further strengthen our published financial policies staff has compiled the existing reserve policy language into a comprehensive overview of the definitions of and uses for a wide array of reserves. As the Board is aware, identification of reserves have always been included in the budget's financial statements by fund that are reaffirmed and adopted annually as part of the budget process. This overview of reserves seeks to clarify the purpose of each reserve, to provide greater transparency and to coordinate the budget presentation with the Comprehensive Annual Financial Report (CAFR) which has been impacted by new GASB 54 requirements as it relates to fund balance reporting.

Beginning in FY 2013 budget, the reserves overview summarized below will be incorporated into the "Long Term Financial Policies and Tools" section of the budget. Staff will then continue to refine the specific criteria for the calculation of reserves over the course of the next year. These very specific statements will then be incorporated into the budget narratives in future years to supplement the reserve information currently contained in the County's fund statements. For example, definitions of the number of vehicles and the age and usage criteria adopted by the County and the resulting annual contribution to reserves for vehicle replacement will provide County decision makers and the public reviewing the budget documents the information they need to evaluate if current contributions are sufficient or should be discussed for modification. The description of these methodologies and updates to them as they are refined over time as new standards are applied will make this process more transparent. This more clear

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statement of our Reserve Policies will also be used as we continue to communicate our message of strong financial management to the rating agencies.

Reserve Policies Statement

There are two primary General Fund reserves:

A Managed Reserve (MR) shall be maintained in the General Fund at a level sufficient to provide for temporary financing of critical unforeseen disbursements of a catastrophic emergency nature. The reserve will be maintained at a level of not less than two percent of total Combined General Fund disbursements in any given fiscal year. The MR has been maintained since 1983 and a withdrawal has never been made from it. The current balance of the fully funded Managed Reserve is $69.2 million.

A Revenue Stabilization Fund (RSF) shall be maintained in addition to the managed reserve at a level sufficient to permit orderly adjustment to changes resulting from curtailment of revenue. The ultimate target level for the RSF will be three percent of total General Fund Disbursements in any given fiscal year. The RSF was created in FY 2000 and fully funded in FY 2006. The Revenue Stabilization Fund will not be used as a method of addressing the demand for new or expanded services; it is solely to be used as a financial tool in the event of an economic downturn. Three specific criteria that must be met in order to make a withdrawal from the Fund :

- Projected revenues must reflect a decrease greater than 1.5 percent from the current year estimate;
- Withdrawals must not exceed one-half of the fund balance in any fiscal year; and
- Withdrawals must be used in combination with spending cuts or other measures.

The Revenue Stabilization Fund was used for the first/only time in FY 2009. A withdrawal of $18.7 million was a small part of the total plan approved by the Board with included significant reductions, a furlough for employees and application of other balances to address a $64.7 million shortfall at the *FY 2009 Third Quarter Review*. As a result of available balances at FY 2009 year end, the full reserve has been replenished. .

In addition to the Managed Reserve and the Revenue Stabilization Fund, the County has many reserves maintained within various funds. Among these reserves are those designated for replacement of equipment and facilities, identified for long term liabilities, to meet debt service requirements and as operating / rate stabilization reserves. As part of the annual budget process staff identifies potential changes to funding levels and brings to the Board policy decisions which need to be made in relation to Reserve Policies. In addition, at yearend, during the Carryover process, reserve balances are often reset as a result of actual fund balances and/or actuarial analyses. More detail about the size of reserves and the specific use for them is available in each agency narrative but the Board policies, as included in the annual budget process, concerning reserves are summarized below.

Replacement Reserve Policies: The Board of Supervisors has repeatedly reaffirmed the policy that the County budget shall include funds for cyclic and scheduled replacement or rehabilitation of equipment and other property in order to minimize disruption of budgetary planning from irregularly scheduled monetary demands. These reserves are necessary to provide a source of funding for planned replacement of major equipment or infrastructure over several years. For example, the County maintains a vehicle replacement reserve within the Department of Vehicle Services to plan for vehicle replacement once age; mileage and condition criteria have been met. Funding is set aside each year over the life of the existing vehicle in order to pay for its replacement. Helicopter, ambulance and large apparatus replacement funds are also maintained for the Police and Fire and Rescue Departments. Fixed payments to these reserves are made annually to ensure funding is available at such time that the equipment must be replaced. Defined Replacement Reserves exist in the following funds:

Solid Waste: Funds 108 Leaf Collection, Fund 109 Refuse Collection and Recycling Operations, Fund 114, I-95 Refuse Disposal

Facility based programs: Fund 111, Reston Community Center, Fund 141, Elderly Housing Programs

Internal Service Funds: Fund 503, Department of Vehicle Services, Fund 504, Document Services Division, Fund 505, Technology Infrastructure Services

Replacement Reserves specifically designed to meet construction requirements have also been established to accrue funds for larger projects thereby reducing financing costs. Construction related reserves are identified in the following funds: 110, Refuse Disposal, 111 Reston Community Center, 113 McLean Community Center, 114 I-95 Refuse Disposal, 121, Dulles Rail Phase I Transportation Improvement District, 122 Dulles Rail Phase II Transportation Improvement District, and 340, Housing Assistance Program.

It should be noted that there are also Replacement Reserves in a number of the Non-Appropriated Housing and Park Authority Funds.

Outstanding Liability Policies: The Board of Supervisors has also consistently funded reserve requirements for outstanding liabilities as they are identified and in conformance with accounting standards and practices. It is important to note that contributions to these liability reserves have been sustained even as reductions in services have been made demonstrating the commitment of the Board to meet its fiduciary responsibilities. An example of a liability reserve is the County's Self Insurance program which is evaluated each year by an actuary and the liability for all self-insured programs is identified. The accrued liability reserve identified as of year-end each year is funded during the Carryover Review. An additional reserve is also currently identified by County policy for catastrophic loss above and beyond the identified accrued liability. Beginning in FY 2008 the County's financial statements were required to implement Governmental Accounting Standards Board (GASB) Statement No. 45 for post-employment benefits including health care, life insurance, and other non-retirement benefits offered to retirees . This new standard addresses how local governments should account for and report their costs related to post-employment healthcare and other non-pension benefits. As a result an annual required contribution (ARC) to meet the long term liability is funded by both the County and Schools.

The liability reserves held by the County include Funds 501 and 590 for County Insurance and School Insurance, Funds 603 and 692 for County OPEB and School OPEB Trust Funds and Funds 600, 601, 691 and 691 for the County and School Retirement Funds. The size of the reserves in all of the above cases is consistent with the annual actuarial valuations performed to ensure that the County is meeting its funding responsibilities relative to these long term liabilities. One of the hallmarks of the County's bond rating has been the consistent commitment by the County to meeting these requirements even during the most difficult of budgets.

In addition, a liability reserve was established by the School Board in FY 2010 to address the deferred funding requirements of the Virginia Retirement System VRS. This reserve is held in Fund 090, Public School Operating and is intended to be a short term buffer for the School system as the State gradually resets the contribution rates local school systems pay into VRS.

It is important to note that the largest reserves held by the County are for the County and School employee retirement systems. Each of these systems is funded from employees' contributions based on a fixed percentage of pay, County contributions based on a variable percentage of employee pay as determined by actuarial analysis, and return on investments. In order to assure the continued soundness of each fund, an actuarial valuation is conducted annually and, if appropriate, an adjustment is made to the employer contribution rate.

On March 18, 2002 the Board of Supervisors adopted a corridor approach to employer contributions. The corridor approach adds further stability to the employer contribution rates and continues to adequately fund the retirement systems. In the corridor method of funding, a fixed contribution rate is assigned to each system and the County contributes at the fixed rate unless the system's funding ratio falls outside the pre-selected corridor of 90-120 percent or if benefit enhancements are approved. At the Board of Supervisors' direction, staff conducted a comprehensive examination of the corridor policy in FY 2010 and concluded that the corridor approach should be maintained, as it has cushioned the County from dramatic rate increases in the past and is currently providing insulation from the global financial crisis. However, recognizing the difficult economic environment and the impact on investment returns, it is unlikely that the funding ratios for the three systems will increase significantly over the next few years based on the current corridor parameters. Consequently, the corridor will remain at 90-120 percent, as codified in the Fairfax County Code, but every effort will be made to gradually move towards a narrower corridor of 95-105 percent. This solution will allow the County to maintain the flexibility afforded by the current policy with the understanding that increasing contributions to the retirement systems, when feasible from a budgetary perspective, will improve the systems' financial position. At a future date, when the funding ratios of the systems have risen above 95 percent, consideration will be given to formally revising the corridor to 95-105 percent.

Debt Service Reserve Policies: The majority of debt service reserves are maintained by a trustee as stipulated by the terms of the bond documents for the bonds which are being supported. However, as an Enterprise System of the County, Sewer Bond Debt Reserves were established in Funds 400, Sewer Revenue, 406, Sewer Bond Debt Reserve and 407, Sewer Bond Subordinate Debt Reserve to provide one year of principle and interest for the outstanding bond series as required by the Sewer System's General Bond Resolution.

Operating and Rate Stabilization Reserve Policies: The County has also identified reserves for potential operating adjustments that may be required and/or to help mitigate the need for significant shifts in tax rates or charges for services. The Boards of both the County and Schools have often approved set aside reserves to assist in budget development for the next year. These reserves have been established as the result of balances accumulated through expenditure savings and conservative revenue projections consistent with the policy that positive cash balances are available at year end. Similarly, operating reserves also exist for rate or premium stabilization purposes in Special Revenue funds (Funds 108, Leaf Collection, 109 Refuse Collection and Recycling Operations, and 112 Energy Resource Recover (ERR) Facility) and the County and Schools health insurance funds (Funds 506 and 591). Environmental requirements are also covered in a number of operating reserves in Fund 114, I-95 Refuse Disposal for requirements associated with the landfill. Other County operating reserves are identified within specific County programs like internal service Funds 503, Department of Vehicle Services with a fuel price stabilization reserve which has been maintained over the last several years given the volatility of fuel prices and 504, Document Services Division to address variations in workload. Significant Operating Reserves are maintained within the Sewer System, primarily Fund 400 Sewer Revenue given the age and complexity of the system and the potential environmental and regulatory impacts to which the system must respond.

If you have any questions concerning these policies please let me know. Staff will continue to refine the specific criteria for the calculation of reserves over the course of the next year and we will incorporate this additional detail into the budget narratives in future years to supplement the reserve information currently contained in the County's fund statements.

cc: Senior Management Team

Michael Longhi, Office of the Financial and Program Auditor