



## **CITY OF KIRKLAND**

**Department of Finance & Administration**

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### **MEMORANDUM**

**To:** David Ramsay, City Manager

**From:** Tracey Dunlap, P.E., Director of Finance & Administration

**Date:** September 22, 2006

**Subject:** Development Services Reserve Policies and Procedures

#### **Background**

In late 2005, the City Council established the Development Services Reserve, using available year-end resources to fund a revenue stabilization (or staffing stabilization) component and a “work in progress” component, for a total reserve balance of \$920,000. The detailed discussion supporting this decision, the “Development Services Reserve and Staffing” memorandum dated October 28, 2005, is provided as Attachment A to this issue paper.

As part of that decision, the City Council also approved making six temporary development services positions permanent, which essentially establishes a baseline staffing level, recognizing the level of development activity over the last few years. The purpose of this discussion is to assess changes to the reserve needs based on current development activity and establish reserve management guidelines.

#### **Recap of Reserve Elements and Sizing**

##### *Work-in-Progress Component*

The objective of establishing a “work in progress” reserve component is to provide a mechanism for setting aside current revenue to fund the workload backlog in a future time period when it is not accompanied by revenue. This component recognizes that revenue collection precedes the costs of providing service (for example, inspections can occur in the year or two following the permit fee payment), which can put revenues out of balance with authorized spending during the normal business cycles of the building and development industry.

To determine whether an adjustment should be made to this reserve component at year-end 2006, the Building Division reviewed the current inventory of permit/review fees collected to estimate that portion that still required review and inspection. The estimate was developed separately for single family residences and large non-residential projects, recognizing that the different types of development follow different completion timetables.

To establish the reserve requirement for new single family houses, an evaluation of the annual activity was conducted that resulted in the following estimate:

1. Calculate the average permit fee for a new house (including trade permits) = \$3,694
2. Determine the number of single family permits applied for in the last 12 months = 230
3. Calculate the average time to build (from time of issuance to final) = 279 days
4. Based on these statistics, the equivalent value of 77 houses is expected to carry forward into a future budget period:
  - 77 houses times average permit/house of \$3,694 = \$284,438, rounded to \$290,000.

To estimate the non-residential work in progress, all non-residential permits for large projects (those having a valuation greater than \$3 million) were reviewed and Building Division staff estimated the percentage of work that remains to be done on each project. For non-residential projects, two elements were identified: (1) the inspection liability and (2) the plan review liability. Each element was calculated based on the following steps:

1. Identify non-residential permits having a valuation of greater than \$3 million dollars (11 projects) and the actual building permit fee revenue collected for each project.
2. Estimate the percentage of inspection-related work remaining for each project.
3. Multiply the actual revenue collected by the estimated percentage of work remaining to produce an estimated inspection liability of approximately \$585,000.
4. Calculate the plan review fee revenues collected for each project by multiplying the building permit revenue in Step 1 by 65% (the plan review fee is 65% of the building permit fee).
5. Since plan review occurs in advance of inspections, Building staff estimated that approximately half of these plan review revenues would carry forward into a subsequent period, resulting in a weighted average plan review liability of approximately \$175,000.

The table below summarizes the estimated Building Division work in progress.

|                             |           |
|-----------------------------|-----------|
| Building Work in Progress   |           |
| Single Family               | 290,000   |
| Non-Residential Inspection  | 585,000   |
| Non-Residential Plan Review | 175,000   |
| Total Work in Progress      | 1,050,000 |

Note that this reserve element represents the average amount expected to carry forward between years. If the level of permit activity were to remain exactly the same from year to year, changes to the balance would not be expected if it is at the target level. In reality, the level of activity will fluctuate from year to year, resulting in additions to or uses of the reserve balance.

At this time, no explicit work in progress component is recommended for Land Use Permits (Planning) and Public Works permits based on the following:

- The processing time for Land Use permits averages 120 days and, in general terms, the level of activity has been reasonably stable from year to year.
- Public Works permits are based on a percentage of public improvements, which makes sizing of a reserve component difficult.
- Both Planning and Public Works permits receive an explicit General Fund subsidy, whereas Building is primarily fee-supported.

- For very large projects that would likely result in revenue and expenditure timing differences, such as Totem Lake, the current recommendation is to track revenues and expenditures separately to manage the workflow, as discussed later in this memo.

Once the City gains more experience managing the Development Services reserve, the decision of whether to establish separate elements for Planning and Public Works could be revisited.

#### *Revenue (Staffing) Stability Component*

The revenue or staffing stabilization component is intended to recognize that permit revenues can fluctuate during declines in development activity, but that there is a need to provide services “on demand”, even during slow development periods. This reserve component provides the resources to maintain skills/staffing for a set period of time while the severity and duration of the downturn is assessed and specific cost containment actions can be identified. When the Development Services Reserve was established in 2005, \$400,000 was set aside for revenue stability. This figure was based on a review of the development services revenue over a ten year period, which showed that revenue had not fallen by more than 10% of the prior year’s revenue during that time.

Another approach to validate this target level is to consider that the six temporary positions that were made permanent in 2005 presume that this is a new baseline staffing level based on the level of development activity in the recent past. If, in fact, the level of development activity were to decline to earlier levels, the assumed funding for these positions would decline. However, before adjusting staffing levels, it would be important to evaluate whether the down turn was short-term in nature or was expected to continue. The cost of these positions was estimated at approximately \$500,000 for 2006. In the event of a downturn, it might take several months to determine whether the downturn will be sustained, and potentially several additional months to adjust staffing levels. The current revenue stability balance would provide approximately nine months of funding for these positions in the event of a downturn, which appears reasonable and is consistent with the practices of other jurisdictions.

#### *Other Potential Reserve Components*

Some jurisdictions that maintain a development services reserve include components for use in funding process improvement efforts, new technology, and/or facilities reconfigurations. The funding for these components is often generated by building a surcharge or cost element into the fees to ensure that the cost of improvements that benefit all customers are paid for over time (which improves equity), rather than only being funded in periods of high development activity when revenues are strong. This approach also provides for a more level accumulation of funding toward periodic costs. The City’s current reserve does not include this component at present, but an update of the cost of service study is anticipated for 2007 and adding this element could be considered at that time.

#### *Adequacy of Current Reserve Balance*

Based on these estimates, the target reserve balance compares to the current balance as follows:

|                                  |                  |
|----------------------------------|------------------|
| Total Work in Progress           | 1,050,000        |
| Revenue Stabilization            | 400,000          |
| <b>Total Reserve Requirement</b> | <b>1,450,000</b> |
| Current Reserve Balance          | 920,000          |
| Estimated Addition to Reserve    | 530,000          |

Based on the estimated year end 2006 cash balances, we recommend that an additional \$530,000 be transferred to the Development Services Reserve. Note that the level of reserve requirement is intended to fluctuate over time based on the building cycle, as discussed later in the memorandum, so that the required additions or use will vary from year to year.

## **Reserve Management**

### *Basic Concepts*

There are several basic reserve management concepts that apply to the Development Service Reserve:

- One of the primary purposes of establishing this reserve is to provide a means for reacting to changes in conditions in a planned manner. As a result, reserve levels are expected to fluctuate over time, recognizing that the City cannot directly control the level of development activity.
- The reserve is a tool to manage cash flow and maintain relatively stable fees, as well as provide a means for better matching fee revenues with related expenditures.
- The reserve provides a mechanism for maintaining service levels during changes in the building cycle and provide for measured responses to changes in activity level.
- If reserve balances fall below target levels, balances should be recovered over time through fee revenues. When reserve balances exceed target levels, surplus amounts should be considered for funding resources to maintain service levels.
- On-going reserve management requires:
  - Work-in-progress – routine monitoring of backlog and adjustments in staffing levels and/or fees to maintain reserve balances at targeted levels.
  - Revenue (Staffing) Stability – management of staffing levels to maintain essential skills and functions during downturns in workload.

### *Reserve Management Discussion Items*

There are several aspects of reserve management that need to integrate with overall development services operations and decision-making.

*Hiring decisions/contracting authority* – When revenues and service needs exceed planned levels, there should be a degree of flexibility provided to obtain resources to meet these needs. Defining a process to modify the budget for purposes of responding to changes from assumptions is a key element. One approach to address this need is to provide for contingent budget authority to contract for additional resources or bring in limited term employees to meet anticipated needs. This approach may take the form of providing a mechanism for spending revenue collected in excess of planned levels by some margin (10-20%) to obtain additional resources. Another option would be to bring requests to Council when needed and to provide a process for action to be taken quickly to meet the need. The type of resource should be determined by the expected duration of the increased activity level and care should be taken to ensure that revenues for work in future periods are not used to meet current needs.

*Importance of activity/revenue tracking within the year* – Reserve management reinforces the need to track permit activity, revenue collections, and workload consistently throughout the year. Such monitoring should provide cues for potential requirements to adjust resource levels (up or down) and are a necessary part of the reserve strategy.

*Action during downturns* – As described earlier, one of the roles of the reserve is to help provide a mechanism to maintain service levels during times of changing activity levels. Several questions arise: When and how do you know when you are entering a downturn? Is there any trend in planning permits that might indicate a coming decline in building permits? There is no formula for determining when action is required, but monitoring activity levels throughout the process is the first step. A mechanism is already in place within Development Services to track permit revenues and activity levels, although a greater degree of consistency among the three departments may be required for reserve management purposes. Once the number of permits or revenues collected (or both) begin to decline from historical patterns, close attention should be paid to determine if it is a one-time occurrence or a change in trend. In addition, a more consistent reporting of activity levels to the City Council, perhaps on a quarterly basis, could provide early warning of changes in activity levels. In the experience of other jurisdictions, it is often difficult to determine a decline is occurring until at least 3-4 months of lower than anticipated activity occurs. At that juncture, cost containment measures and implementation timelines should be identified and reserve usage should be balanced against cost reductions. If a downturn lasts for longer than 6 months, cost reductions may need to be implemented more aggressively to ensure that reserve balances are not depleted before expenditures are brought back into balance with revenues.

*Extraordinary projects* – In order to keep reserve levels reasonable and provide the capacity to respond to projects that are extraordinarily large, it can be good practice to separate the resource needs and funding sources similar to the current plan for the Totem Lake Redevelopment. However, cash flow still becomes an issue because resources may need to be in place before fees have been collected. The Development Service Reserve can be a useful tool in these circumstances. If expenditures precede the collection of related revenues, short-term funding can be provided from the reserve so long as it is repaid once revenue is collected. In these circumstances, a formal process for this action should be put in place to ensure that the reserve is reimbursed.

Finally, it is important to note that, as the City gains additional experience in managing the Development Services Reserve, that there may be further refinements in estimating techniques and management guidelines. This reserve will be revisited periodically as part of the budget process to ensure that it is serving its intended purpose and determine if adjustments are required.

### **Summary of Recommendations**

- Based on the reserve sizing methods summarized earlier, add \$530,000 to the Development Services Reserve at the end of 2006 from year end cash balances.
- Establish consistent monthly activity reporting and quarterly reporting provided to the Council on development activity levels (permit volumes/revenues).
- Work to refine reserve management guidelines based on experience, including an evaluation of mechanisms for adjusting resource levels quickly in times of higher than anticipated activity and identification of actions to be taken in the event of a downturn in workload.
- Evaluate establishing additional reserve components for process improvement efforts, new technology, and/or facilities reconfigurations as part of the 2007 building fee update.
- Consider accounting for extraordinarily large projects separately, similar to the current plan for the Totem Lake Redevelopment.



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MEMORANDUM

To: Dave Ramsay, City Manager  
From: Marilynne Beard, Director of Administration and Finance  
Date: October 28, 2005  
Subject: Development Services Reserve and Staffing

During last year's budget process, the City Council asked staff to prepare a recommendation for establishing a development services reserve or special fund. The purpose of this memo is to provide background on the options available to provide stable funding for development services and to address staffing requests from the development departments.

**Background and Options**

Development fees can fluctuate from year to year as economic conditions change and the development cycle responds. Development fees may also be collected before all of the associated work of a permit is completed (e.g. inspection). As a result, permit fees collected in one year may represent workload in the following year. At a base level, there will always be a "carryover" of workload for some permitting and development review activities for permits that were issued towards the end of the year. However, some larger projects can span multiple years (e.g. Evergreen Hospital and Juanita Village). Since revenue may not always appear in the same year as the workload, cities often manage their development revenue receipts so that they can be applied to work over multiple periods. Development revenue management can also provide a hedge against economic fluctuations and provide bridge funding when revenue declines during a lull in construction activity. If it appears as though the revenue decline will be a longer term phenomenon, it is generally an indicator that less work is in the queue and fewer staff may be needed.

As part of the last development services cost of service study, FCS Group provided a report on how other jurisdictions have approached development revenue management (see attachment A). Their report discussed the following three approaches commonly used by cities:

1. **Incorporate All Development Services Revenue and Expenditures in the General Fund.**

This is the current practice in Kirkland where development services are tax-subsidized by Council policy. Any gap between expenses and income in any given year does not necessarily require any action on the Council's part to account for cyclical fluctuations. If development revenue falls below the previous year's level (or the budgeted amount), it is covered by other General Fund

revenue (i.e. taxes) or backfilled from General Fund reserves (such as the Revenue Stabilization reserve). When revenues are higher than budget, they remain in the General Fund.

Sustained increases in development activity will generate requests for additional staff. The following chart shows the regular and temporary funding provided for development services compared to revenue over the past eight years.

|                         | 1999        | 2000        | 2001        | 2002           | 2003           | 2004           | 2005           | 2006           |
|-------------------------|-------------|-------------|-------------|----------------|----------------|----------------|----------------|----------------|
| <b>FTE's Added</b>      |             |             |             |                |                |                |                |                |
| Building                | 1.85        | 1.00        | 1.00        | 0.12           |                |                |                |                |
| Planning                | 2.00        |             | 1.00        |                |                |                |                |                |
| Public Works            |             |             |             |                |                |                |                |                |
| <b>Total</b>            | <b>3.85</b> | <b>1.00</b> | <b>2.00</b> | <b>0.12</b>    | -              | -              | -              | -              |
| <b>One-Time Funding</b> |             |             |             |                |                |                |                |                |
| Building                |             |             |             | 128,749        | 40,657         | 160,493        | 323,477        | 391,737        |
| Planning                |             |             |             |                |                | 46,000         | 117,768        | 121,794        |
| Public Works            |             |             |             | 62,713         | 79,982         | 82,328         | 74,533         | 78,111         |
| <b>Total</b>            | -           | -           | -           | <b>191,462</b> | <b>120,639</b> | <b>288,821</b> | <b>515,778</b> | <b>591,642</b> |

|                |                  |                  |                  |                  |                  |                  |                  |                  |
|----------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| <b>Revenue</b> | <b>2,271,532</b> | <b>2,783,848</b> | <b>2,773,833</b> | <b>2,500,833</b> | <b>3,352,080</b> | <b>3,807,854</b> | <b>4,887,359</b> | <b>4,341,895</b> |
|----------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|

Beginning in 2002, there was a shift from adding positions to approving temporary staffing, partially because we were unsure how long additional development staff would be needed but also because resources became scarcer. Although development departments have requested ongoing staffing, only temporary staffing was approved.

Temporary staffing is funded from resources carried forward from the previous year, usually from revenue in excess of the budgeted amount (from development fees and other sources of revenue). The advantage of this approach is that temporary staff can more easily be reduced at the end of an "up" cycle because they are generally only hired for one year at a time. The disadvantage is that it is more difficult to attract and retain qualified staff in one-year temporary positions. All of the departments involved in development services believe that the temporary staff that has been funded over the past five years is more representative of a new "base" and that the temporary positions should be converted to ongoing FTE's.

Since development services overall are tax-subsidized by Council policy, development fees are being applied to development services and not to other General Fund services. Total development

revenue does not cover total development costs (as demonstrated in our cost of service studies completed every three years). However, since all development revenue and expenditures are in the General Fund, we do not attempt to match them on an annual basis. The disadvantage of not matching revenues and expenditures on an annual basis is that we cannot accurately apply excess development fees towards workload in the following year.

2. **Maintain Development Services Revenues and Expenses in the General Fund and Create a Development Services Reserve.**

This approach retains development services within the General Fund but establishes a reserve composed of development revenues collected in one year over and above that amount needed to fund current services. The reserve would be tapped when development revenue fell below the amount needed to fund ongoing services. If a sustained downturn in development activity takes place, then staff would be downsized.

The original report from FCS Group suggested that the amount of reserve contributions each year would require that departments track activities closely and that we compare actual costs with actual revenue. Any marginal revenue over and above the costs would be placed in reserve. In order to accomplish this level of analysis on an annual basis, staff would essentially replicate the cost of service analysis each year. Given the workload requirements related to this method, we asked the consultant to identify other approaches that would be acceptable but not as labor-intensive.

The consultant identified an alternative approach that focuses on large projects to determine the amount of workload that is anticipated to span multiple years (and the amount of revenue that should be placed in reserve to fund the future need). For example, the City issued a permit to Evergreen Hospital for the bed tower – a project that produced \$322,000 in permit revenues in 2005. Building Services staff estimates that the bed tower project will continue through next year and will require one full-time inspector for most of the year. Based on this situation, the City Council approved the hiring of one full-time temporary building inspector to address the Evergreen project. Additional development fee revenues were budgeted as the source of funding in 2005 and 2006. In this case, the temporary staff was approved in the same year as the revenue was received. We simply acknowledged the additional cost and revenue within the biennial budget. If this situation spanned budget years, a portion of the permit revenue from the Evergreen project would be transferred to the reserve in order to provide sufficient funding for staff work in the next budget year.

In order to identify the amount needed to transfer into the reserve at year end, development staff would be asked to identify large outstanding projects that will generate workload beyond the "base" in the coming year. This exercise would involve both objective and subjective data. For instance, in 2005 year-to-date building permit revenue is \$1.54 million. Of that total, nine permits with fees greater than \$20,000 constituted nearly fifty percent of the revenue. For objective data, we would analyze projects with permit fees above a certain level since these are the projects that contain "unearned revenue" because we have collected fees for work that will partially be performed in future years (referred to in the consultant report as "work in progress revenue"). The subjective analysis would be applied to these projects by development staff to



determine what percentage of the project work that will be performed in the following year. This analysis would form the basis for the transfer from the General Fund to the development services reserve.

A secondary element to a development services reserve would consist of a revenue stabilization component. In years when revenue decreases below the base level, the reserve would be tapped on a temporary basis to backfill funding. In the interim, staff would determine whether the downturn was longer term in nature and whether permanent staffing reductions were in order.

3. **Create a Development Review Services (DRS) Fund.**

A development services fund could be set up as a special revenue fund (such as the Street Operating Fund) or an enterprise fund (such as the Water/Sewer Utility Fund). The following excerpt from the FCS Report explains how a dedicated fund would work.

- *Costs: The programmatic costs incurred to provide development review services would be segregated from their existing departments and budgeted in the new DRS Fund. For each existing department, allocations of department management and administration might need to be made. Citywide overhead costs could also be imposed as an interfund charge and transfer.*
- *Fee Revenues: Revenues collected from development review fees would be dedicated entirely to the new DRS Fund. General Fund subsidies, if any, could be made as explicit transfers into the special revenue fund.*
- *Reserves: The special DRS Fund could maintain a cash reserve/set-aside for sustaining itself during downturns in the development cycle.*

Unlike the utilities, development services are not fully fee supported. By Council policy, some services such as Planning are subsidized by taxes due to the general community benefits attributed to these regulatory activities. This makes the use of an enterprise fund which contemplates a self-supporting, business-type activity less appropriate. Enterprise funds also have specific financial reporting requirements that are staff-intensive. Since the same objective is achieved using a special revenue fund, staff recommends this approach if the Council wants to consider a separate fund. The General Fund subsidy could be acknowledged by an annual transfer from the General Fund or by budgeting some costs directly in the General Fund. The amount of the annual subsidy would be based on budgeted expenditures applying the cost recovery policies established by Council. This again would require closer data tracking by departments.

**Recommendation**

Staff recommends that Council adopt option 2 (establish a development services reserve). If a development services reserve is established, then current temporary staff that operating departments consider "base" staffing should be converted to regular FTE's (see attached service package requests from Fire and Building, Planning and Public Works). It is further recommended that we use the estimate of "work in progress revenue" as the basis for annual transfers to the reserve.

The current development cycle is yielding revenue over and above budgeted amounts and includes several large projects that are likely to continue into 2005. An upswing in the development cycle is the ideal time to initiate a reserve because resources are available to provide seed funding. The following table summarizes development revenue estimates compared to budget for 2005 and 2006.

Development Services Revenues\*

|             | <b>Budget</b> | <b>Estimate</b> | <b>Difference</b> |
|-------------|---------------|-----------------|-------------------|
| <b>2005</b> | 3,944,027     | 4,887,359       | 943,332           |
| <b>2006</b> | 4,073,078     | 4,341,895       | 268,817           |

\*Excludes Express Review

A portion of the excess revenue in 2005 is being dedicated to a temporary building inspector (for the Evergreen Hospital project) in the amount of \$94,521 (represents a portion of 2005 and all of 2006). The net amount of revenue anticipated over and above the budgeted amount is \$848,811 (not all of which represents work to be performed next year). Based on staff's estimate of "work in progress revenue" for 2005, funds should be transferred into the development services reserve for work to be performed in the future (amount to be determined at year-end). As a practical matter, the City Council has already funded the development services temporary staff by approving funding for 2005 and 2006 and by approving the new temporary building inspector. The reserve would not need to be tapped in 2006. In subsequent years, adequate ongoing revenue should be budgeted to match ongoing expenditures but may be supplemented by the development services reserve if needed.

In addition to the "work in progress" set-aside, it is recommended that the Council transfer an additional amount as a revenue stabilization reserve. Over the past ten years, development services revenue has fluctuated but never fell more than 10% of the previous year's revenue. A revenue stabilization reserve equivalent to 10% of budgeted development revenue would equal about \$400,000.

**Summary of Recommendations**

1. Establish a Development Services Reserve using 2005 year-end available resources in an amount to fund a revenue stabilization component and a "work in progress" component. The amount of the transfer would be determined at year-end, however, it is estimated that about \$800,000 should be available to transfer.
2. Convert temporary development staff approved for 2005 and 2006 to regular employees, with the exception of the temporary building inspector approved specifically for the Evergreen Hospital project (a total of 6.0 FTE's).

It should be noted that none of the revenue or staffing projections assume that the Totem Lake Mall project will be permitted in the coming year. A special report is included as Attachment C that provides a recommended approach to staffing the project if it is approved.

# ISSUE PAPER

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## Development Review Services Revenue Management

How should the City of Kirkland account for and manage development review services revenues, which fluctuate according to development cycles, in order to satisfy long-term program funding needs? What are the issues, policies, and practices related to various approaches? What is the experience of other cities who actively manage their development review functions as special funds separate from the General Fund?

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### BACKGROUND

The City of Kirkland provides development review services (inspection and plan review) across three of its departments: Building and Fire, Planning, and Public Works (Engineering Division), each of which is budgeted in the General Fund. These functions collect fees that are linked to the cost of providing service and are intended to recover a portion of those costs, according to recovery targets set by the City Council. In all cases, the targeted cost recovery from fees is less than 100%, which means that, by design, the General Fund bears responsibility for funding the remaining share of development review activities.

Revenues from these fees are not currently accounted for directly to these three departments. Rather, they are recorded as revenues of the General Fund. The City does not currently maintain a dedicated reserve (or set-aside) for development review; as departments in the General Fund, they rely on the common reserves and/or contingencies of the General Fund.

In 2004, during its third cost-of-service based update of development review fees, the City raised the question of whether or not Development Review Services, as a comprehensive function, should be managed as a special revenue fund separate from the General Fund. Among other implications, this means that revenues collected and costs incurred specifically for development inspection and plan review activity in each of these disciplines would be accounted for explicitly. In essence, fee revenues become the formally recognized, primary source of funding for development review activities at the City. The level of spending to provide service from these functions would be dependant on development fee revenues and whatever General Fund appropriation was available and consistent with the City Council's cost recovery targets.

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### ALTERNATIVES

There are three primary approaches to account for and manage Development Review Services funding:

- A. The current General Fund practice, described above.
- B. The General Fund with a dedicated cash set-aside account.



C. A special revenue fund and reserve for development review services.

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## **ANALYSIS OF ALTERNATIVES**

### **A. Current General Fund Practice**

Under this approach, the City would continue its existing practice as described above. Specifically:

- **Costs:** Expenses incurred to provide development review services would continue to be budgeted in their respective departments, subject to the appropriation of General Fund resources each fiscal year.
- **Fee Revenues:** Revenues from development review fees would be recorded within the General Fund.
- **Reserves:** Development review services would rely on the common reserves and/or contingencies of the General Fund and be subject to budgeting decisions (i.e., both increases and cuts) with other General Fund programs.

The primary benefit of this approach is simplicity; it requires no change from existing practice. For development review programs, it also provides funding stability during downturns in the development cycle when fee revenues subside, to the extent that General Fund resources are available. The chief implication of this approach is the inability to regularly track development fee revenues against the costs of service and according to outstanding workload liability.

### **B. Revised General Fund Practice**

Under this approach, the City would continue its existing practice, but augment it to establish a dedicated cash reserve, or set-aside, for development review services. Under this approach:

- **Costs:** Expenses for these programs would continue to be budgeted in the General Fund according to current practice.
- **Fee Revenues:** Fee revenues, while still recorded as undedicated General Fund resources, would be tracked periodically against the costs incurred to provide service. Surpluses in any given fiscal year would be reserved in a set-aside account for the future use of development review services only. Deficiencies in a given fiscal year could be funded, in whole or in part, using the set-aside balance.
- **Reserves:** A special reserve/set-aside account would be established for development review services. This reserve would be funded by fee revenues collected in excess of the current costs of services, which is caused by the collection of permit revenue in advance of



performing the work. Some or all of the cash set aside could be transferred to the General Fund in years during a development downturn, as needed, to sustain the programs while work obligations on existing pre-paid projects remained.

The benefits of this approach are similar to Alternative A in that it remains relatively simple to manage. While current budgeting practices remain the same, a special set-aside account would be established, providing development review services a dedicated source of funding to manage workload cycles. Proper maintenance of that reserve would require increased analytical efforts, as the costs of development review services would need to be tracked on a regular basis and compared to collected fee revenues. Furthermore, the departments providing those services would be tasked with a higher level of data-tracking (e.g., staff time) than is currently conducted, so reserves could be accurately sized, built, and used.

### C. Special Development Review Services Fund

Under this approach, the City would establish a new fund, apart from the General Fund for Development Review Services (DRS). The following would take place:

- **Costs:** The programmatic costs incurred to provide development review service would be segregated from their existing departments and budgeted in the new DRS Fund. For each existing department, allocations of department management and administration might need to be made. Citywide overhead costs could also be imposed as an interfund charge and transfer.
- **Fee Revenues:** Revenues collected from development review fees would be dedicated entirely to the new DRS Fund. General Fund subsidies, if any, could be made as explicit transfers into the special revenue fund.
- **Reserves:** The special DRS Fund could maintain a cash reserve/set-aside for sustaining itself during downturns in the development cycle.

In establishing a separate DRS Fund, a number of decisions must be made:

- **Scope:** Will all development services functions across the three departments, including Building/Fire, Planning, and Engineering, be accounted for in the new fund or just a subset of those, such as Building? If all functions are included, it reinforces the perception of "one stop" permitting and allows for separate decision-making, however, the extent of the centralization may be limited when development services activities, such as Engineering, are subsets of much larger functions (Public Works).
- **Accounting Structure:** Should the DRS Fund be a special revenue fund or an enterprise fund? Both options allow for segregation of revenues and maintenance of reserves/set-asides. An enterprise fund would require separate reporting in the City's financial statements. In either case, Citywide overhead costs could be budgeted directly in the fund.
- **General Fund Appropriation:** Will a separate General Fund appropriation be transferred into a separate DRS Fund for subsidized activities or will those activities be budgeted outside



the fund? For example, there are substantial components of the Planning Department which, by cost recovery policy, remain obligations of the General Fund, such as long-range/comprehensive planning. Will the entire Planning Department be folded into the DRS Special Fund, or will an attempt be made to split out the functions?

- **Reserves or “Set Asides:”** As the primary development services function, Building is most impacted by variations in the development cycle and therefore most in need of reserves and related policies to maintain service despite revenue fluctuation. Within a special DRS Fund, reserves or “set asides” become a requirement to effectively manage the fund. This important component is discussed in more detail below.

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## CONSIDERATIONS FOR CASH RESERVES/SET-ASIDES

### Purpose of Reserves

The purpose of a reserve (or set-aside) is to allow agencies to better manage their cash flow from year to year and to improve the financial stability for services that are subject to economic cycles related to the construction industry. Because revenue collection precedes the costs of providing service, the cyclical nature of the development and building industry routinely puts revenues out of balance with authorized spending. In an expansion phase of the development cycle, application and permitting of large projects generate significant revenues that support inspection services required over multiple fiscal periods. Fund balances may accumulate faster than the development services functions are called upon to provide service. In a contraction phase, current period revenues are insufficient to meet current period costs. If work-in-progress funds are inadequate, the City may be unable to meet its obligation to provide services without funding from other revenue sources.

While set-asides can be made toward one-time needs, special projects, or technology advancements, the reserves addressed in this document are primarily designated for the deferred liability associated with pre-paid work-in-progress (WIP) and staffing stabilization.

The objective in establishing a WIP reserve is to provide a mechanism for setting aside current revenue to fund the workload backlog in a future time period when it is not accompanied by revenue. Interest earnings on a reserve fund also provide an offset to the impact of inflation on workload liability. The work-in-progress liability should be funded by revenues paid in advance and is not a reserve component that needs a new funding source, provided fees are adequate to recover the costs of services. The unspent funds needed to complete plan/technical reviews or to conduct inspections in subsequent periods should be recognized as such to assure that they are available to offset the liability and not used for other purposes. The WIP reserve should be expected to vary over time with the size and composition of the workload backlog. Since the needed reserve is linked to the expected workload, it should not be considered a static requirement and should be reviewed annually as part of the budget process.

The staffing stabilization reserve is intended to recognize that there is the need to provide services “on demand”, even during slow development periods. To meet this requirement, a core

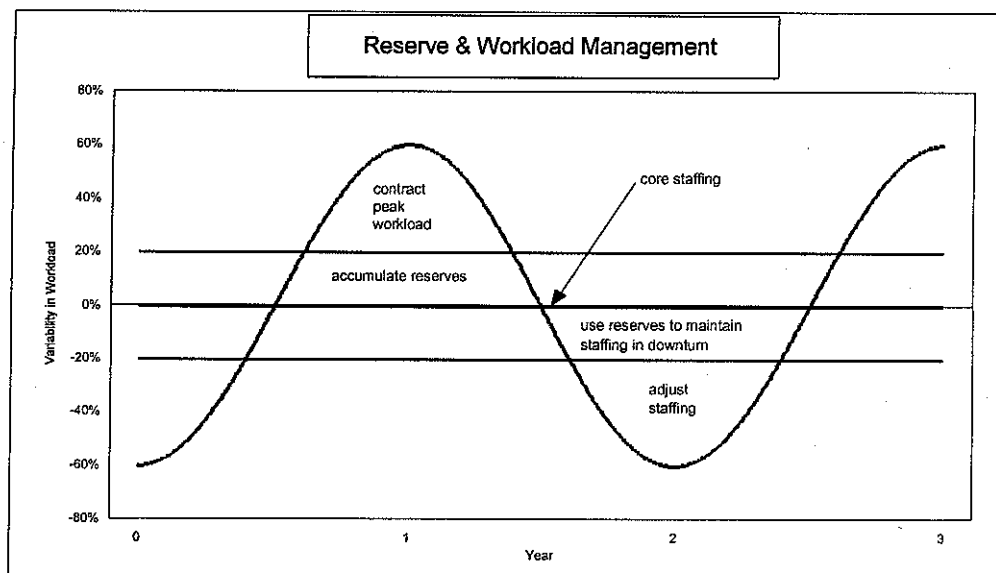


level of staffing is required to maintain critical skills and service levels. Such a reserve provides the resources to maintain skills/staff for a set period of time while the severity and duration of the downturn is assessed and specific cost containment actions are identified. A staffing stabilization reserve ensures that minimum basic staffing levels and essential skills are maintained for each function during the times of depressed workload. Such basic staffing levels would allow the City to maintain essential levels of expertise and service. Such a reserve can also be used to stabilize fees that would otherwise be increased to offset significant revenue fluctuations. The reserve provides a temporary revenue source until workload intake increases, cost containment measures can be put into effect, or the duration of the downturn can be assessed. Funding for such a reserve becomes a cost of providing service, and fees should be sufficient to maintain a reserve, if necessary.

### Use of Reserves

On-going funding of the WIP reserve is intended to be generated based on an estimation of revenues collected in one fiscal period for which the expenses are not expected to be incurred until a subsequent fiscal period. For the staffing stabilization reserve, when reserve balances need to be augmented, the targeted addition to reserves is included in budgeted expenses. If reserve balances exceed target levels, which may occur during periods of peak workload, the funds in excess of the target should be made available to meet operating needs. It is important that the supplemental resources are temporary in nature, such as contract labor, subcontracting, etc., to ensure that expenditure levels can be reduced once short-term needs are met. If the funds over the target are not required to meet service levels, the surplus could be used to stabilize, or potentially reduce, rates.

The intended management strategy for the reserves is illustrated in the graphic below.



### Calculation of the Accumulation and Consumption of Reserves

Calculation of the accumulation or consumption of balances in a given fiscal period should rely on known and measurable indicators of workload and revenue documented in the City's permit tracking financial management systems. The key metrics involved are new permit fee revenue, the amount of General Fund subsidy, the total cost of development services, and the change in WIP during the fiscal period. The accumulation/consumption of stabilization balance can be calculated from the preceding variables, and ideally would be validated with reference to workload and expenditure data on those activities funded by consumption of the stabilization balance. Tracking staff time data on a formal basis is a critical piece of information in developing an appropriate methodology for using reserves.

If the City chooses to establish reserves for these purposes, an analysis of the work-in-progress and core staffing needs would be required. Such an analysis would establish initial balances and metrics for accumulation and use, as well as identify data tracking needs for future reserve management.

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### COMPARABLE PRACTICES

The following points briefly discuss the practices of other public agencies in managing a special and or enterprise fund for their development review functions:

- **City of Bellevue:** The City manages development services in Planning and Community Development using an enterprise fund, with public benefit activities funded from a General Fund transfer. Reserves are established, maintained, and used to manage workload liability, core staffing, and technology and facilities needs.
- **City of Redmond:** Development services are managed within the General Fund and a reserve of 25% of budgeted expenses has been maintained historically. The City is considering tracking workload liability as the basis for maintaining the reserve in the future.
- **City of Seattle:** The City manages the Department of Planning and Development using an enterprise fund, with public benefit activities funded from a General Fund transfer. Reserves are established, maintained, and used to manage workload liability, core staffing, technology initiatives, and strategic planning projects.
- **City of Vancouver:** The City manages Building Services using a special revenue fund and Land Use services within the General Fund. The special revenue fund maintains a cash balance that is used to fund technology initiatives, staffing stability, and prepaid workload.
- **City of Bellingham:** The City manages Building Services in an enterprise fund, which maintains reserves for deferred liability, economic downturn, and some technology initiatives. Land Use services are managed within the General Fund at present.





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## RECOMMENDATION

Especially in the area of building fees, establishing some sort of reserve/set-aside has been an evolving trend, bordering on becoming standard practice in jurisdictions of larger size. The reason for this has been the increasing need, due to constituent and industry pressure, to justify fee levels, maintain relatively stable fees, and provide service on demand: to demonstrate that revenues are commensurate with the costs incurred to provide service. For building fees, which are a large source of General Fund user fee revenue for most municipalities, the timing differences between fee collection, permit issuance, and subsequent City work makes it difficult to compare real-time costs against real-time revenues in order to judge the status of cost recovery: fees are collected well in advance of the expenditure to perform the work. The accumulation and use of reserves is not only becoming a favored way of funding development review programs, but can also be an integral part of portraying the full cost of service for purposes of setting defensible fees.

The City's development review practices, ongoing workload, and level of fee revenues may warrant the establishment of a reserve or cash set-aside to account for and manage development fee revenue. That said, much can be accomplished through Alternative B, which is to establish this set-aside while retaining current departmental budgeting in the General Fund. This will allow the City and affected departments the time to establish procedures for properly maintaining a reserve and setting associated policies, gain experience in the accounting and use of the structure, and in the future, have greater information with which to determine whether a special DRS Fund is feasible and warranted.

