

RESERVE POLICY – FUNDING

Confidential to SCA homeowners

[Note to readers: *This is a modification of a document that I intended to present to the 2010 Reserve Study Advisory Group after the Reserve Study was completed. It was in our charter to address this issue, but it has now been “sunsetting” by the Board. This matter is not new, however. In my first year as a member of the Finance Committee, I observed that SCA had a Reserve Fund that was much larger than we needed and it was growing larger each year. I presented this observation to Don Manning and Joe DeMeo, but neither of them seemed much concerned. I thought that when I became Chairman, I would be able to get some attention from the Board. I must now take this matter to the public because I think our money is being taken for no practical use.*

Richard Pendleton, 2010 Chairman, Finance Committee]

After our Reserve Study meeting of Aug 6, 2010, we will return to work on our policy recommendations. A main concern is what the funding policy should be. At present, the Board is insisting that we maintain funding at 90% of the “Ideally” funded amount. One reason is that the association is claiming that P/DW owes our Reserve Fund about \$700,000 or possibly up to \$1,000,000 and our claim is based on our 90% policy. If we back off of 90%, we will weaken our case. A second reason for maintaining 90%, according to one Board member, is because it is “prudent”.

I have a serious concern that the 90% policy costs the homeowners a lot of money for which they will see **no** benefit! Secondly, the \$700,000 is not likely to be fully realized, if at all, but it is a subject of negotiation at this time. Be aware that the claim, at most, will result in a one time contribution of about \$100 per household and probably more like \$50 or even less. Given that the Reserve fund already has more funding than it really needs, the benefit to current homeowners is several years out (even if we stop assessing for Reserve funds altogether)!

In order to provide a solid basis for my concern, I have prepared an Excel workbook based on data from the 2010 Reserve Study. That study provided two funding models, Component Funding and Threshold Funding. The Component Funding Model is what SCA has been using since transition. ARC states that this is the most conservative model and it includes a 3% contingency for expenses each year.

The Threshold Funding Model is used by some associations and has been recommended to me by one of the Reserve Study bidders. It allows the association to set minimum reserve assessments while maintaining a positive balance in the fund for a specified number of years. The minimum balance and the number of years are both selected by the association.

For your information, the per unit Reserve assessments for the following years were:

- 2008 \$194
- 2009 \$118 (including a transfer from operating to accommodate the dues holiday)
- 2010 \$ 94
- 2011 \$127 (Board approved - \$97 bldgs 1 & 2 plus \$30 for Liberty Center)
- 2011 \$218 (ARC recommended - \$185 bldgs 1 & 2 plus \$33 for Liberty Center)

RESERVE POLICY – FUNDING

Confidential to SCA homeowners

The following figure shows the growth of the fund as currently recommended by ARC.

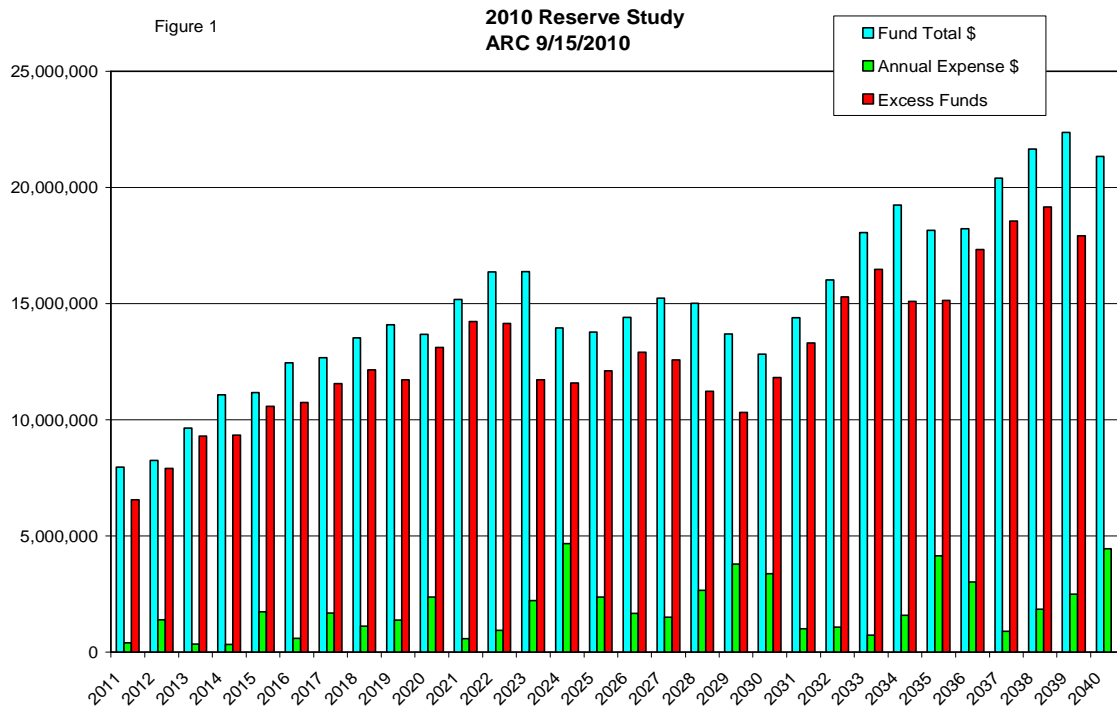


Figure 1 shows the 30 year Component Funding Model. It is not significantly different from the DFS model from the 2008 report, but it does include Liberty Center. It shows the annual reserve expenses and the growth of the fund balance to more than \$22,000,000 in 30 years while annual expenses are about 1/10th of that! Red bars are included to highlight the magnitude of the excess at the end of each year. The short green bars indicate the projected reserve expense for each year.

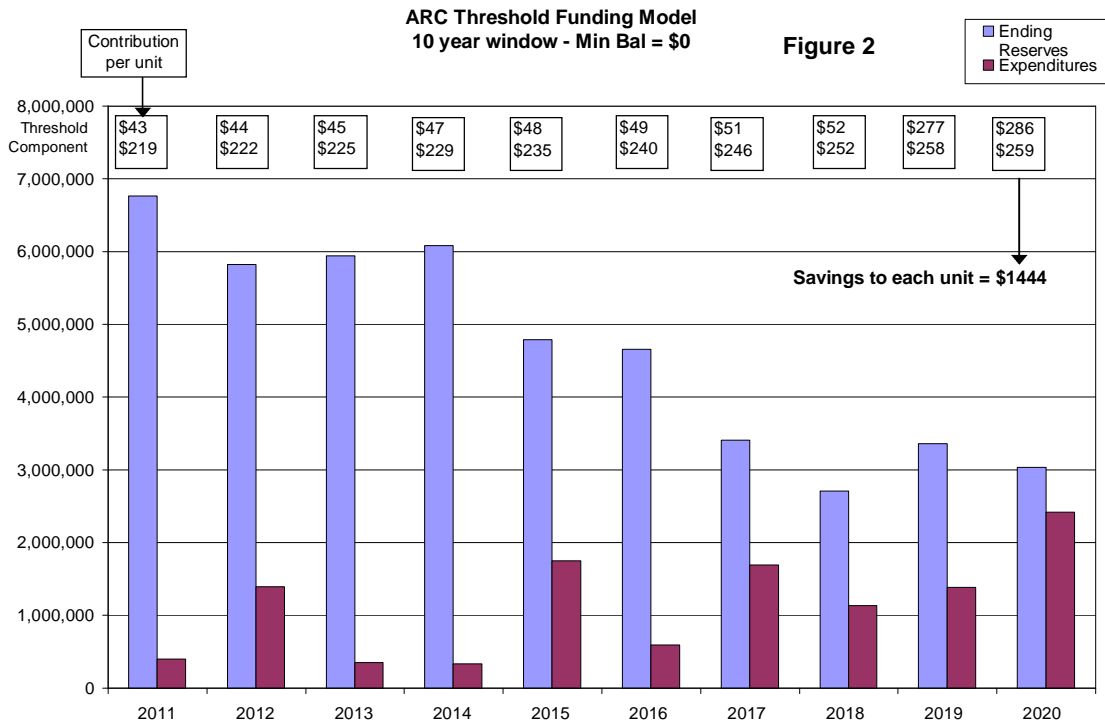
The problem with excess reserve funding, as controlled by NRS116, is that it cannot be used for anything other than Reserve items. If there is more money in the fund than we need to cover Reserve expenses this year and even more next year, it is very much like putting that extra money in a safe and throwing the safe into the deepest part of the ocean!

The question, then, is **do we want to put our money into an inaccessible investment?** If it seems as unwise to you as it does to me, then an alternate funding policy must be applied.

The other mode is “Threshold funding”, sometimes referred to as “Cash Flow – min balance”. The antiquated DFS data shows the assessment starting at about \$111 per unit with the fund balance increasing for about 15 years before starting to come down to a more reasonable amount in 30 years. The ARC report includes a valid “Threshold” model analysis capability. An example is shown in Figure 2.

RESERVE POLICY – FUNDING

Confidential to SCA homeowners



In this model, the blue bars show the end of year reserve fund balance, starting with nearly \$7 million at the end of this year. The red bars are the annual reserve expenditures. As can be seen, the balance shows a relatively constant reduction until 9 years out, but there is always enough to cover the next year's expense, including a 3% contingency. At the top of the chart, I have added boxes containing the Threshold and Ideal funding annual contribution for a household. Over this 10 year period, each household would save \$1,444 if we followed the Threshold funding method. *[The 2011 budget allocates \$127 to the Reserve fund and that is pretty close to the first three years of this plan.]* You will notice that the last two years show quite a jump in the annual contribution. That is to start preparing for an expensive year 3 years down the line. The eleventh and twelfth years are quite small, but the model anticipates the demand and minimizes the contribution increase. You might also note that the last two contributions are very close to the Ideal (Component) contributions, so there is no loss of advantage of the Threshold Funding approach.

In my analysis of reserve funding, I think that predicting and planning for expenses 30 years from now is an absurd proposition. For example, in 1980, what would you have predicted the price of a house or car would be today. Even 5 years ago, you could not predict today's price for a house. Considering that we intend to update our Reserve analysis every two years, a ten year cost prediction basis should never surprise us with a sudden, large increase. Our budget guidance has directed us to look at 5 years, but the Finance Committee has looked at 10 years in order to maintain a smooth change in assessment from year to year. Ten years would seem to be a reasonable planning horizon for our Reserve fund.

RESERVE POLICY – FUNDING

Confidential to SCA homeowners

The problem with the 10 year model described above is that the “Ideal Full Funding” percentage runs down to a number below the 90% currently targeted and may be politically undesirable. The answer is that if you are not using the Ideal Funding model, the percent of full funding is a meaningless number. NRS 116 only requires that the funding be on an actuarially sound basis (whatever that is) and Threshold funding is a legitimate candidate. Potential buyers who do their due diligence, would need to know only that our funding plan is to maintain funds at the end of any year that will be greater than the expenses expected for the next year and that the policy always looks 10 years ahead.

By adopting such a policy, we could substantially reduce the overall assessment while accommodating increasing operating expense demands. It appears that the immediate reduction in dues will provide a greater benefit to the homeowners than an unlikely windfall from P/DW which would end up in the safe at the bottom of the ocean anyway.

I recommend that the RSAG give serious consideration to recommending a 10 year planning window with a Reserve Fund balance maintained at some margin above the following year’s projected expense.

Respectfully submitted,
Richard Pendleton, Chairman
(2010) Reserve Study Advisory Group