A Tradition of Stewardship
A Commitment to Service

County Executive Office

FISCAL STATUS REPORT

Year-End FY2008-09; FY2009-10 through FY2013-14

September 29, 2009

1 – INTRODUCTION AND BACKGROUND

The County's annual budget includes beginning fund balance (which is the same as the prior year's ending fund balance) information based on revenue and expenditure estimates made more than three months before the June 30th end of the prior fiscal year. The Auditor-Controller's Office normally closes the prior fiscal year's books in August and establishes the prior year's preliminary actual ending fund balances for the various County funds, including the General Fund. Then, staff typically comes to the Board of Supervisors in September and asks for approval to revise the budget to reflect the preliminary actual fund balances and to make other budget adjustments needed to reflect changes that have occurred since the adoption of the County's Final Budget. This report provides information on the FY2008-09 preliminary actual ending fund balances for various County funds, with a focus on the General Fund and other major operating funds.

In April 2008, staff provided the Board with the annual General Fund Five Year Forecast. That Forecast concluded that, assuming no major changes in capital or operating programs, practices or staffing levels, the General Fund would likely not be in structural balance over the 5-year period ending in FY2012-13. Specifically, the Forecast projected that, if nothing were done, annual operating deficits would reduce the General Fund's unrestricted ending balance from $52.5 million in FY2006-07 to between $8 and $28 million by FY2012-13, depending on assumptions about inflation, discretionary revenue, etc. In light of this, in August of 2008, the Board approved a Fiscal Contingency Plan designed to provide appropriate guidance as to how the County would address any structural imbalance (copy attached).

In December of 2008, staff provided the Board with an updated General Fund Five Year Forecast that continued to project that the General Fund would be in structural imbalance through FY2012-13, but that the structural imbalance would be somewhat less severe than the April projection indicated. According to the revised Forecast, the General Fund would end FY2012-13 with an unrestricted fund balance of between $29 million and $39 million, but it was noted that, due do a change in methodology, this Forecast was probably over-optimistic. Given that Forecast and recognizing that there were signs of national economic difficulties and that the State was experiencing significant cash flow problems that could impact counties, the Board voted to implement the first six Longer-term actions and first four Short-term actions contained in the Fiscal Contingency Plan. The Longer-term Actions were included in the FY2009-10 Budget Policies approved by the Board and are reflected in the adopted FY2009-10 Budget.

By April of 2009, when the Board held its FY2009-10 Budget Study Session, it was clear that the national and California economies were in recession, that the bottom had fallen out of the housing market and that the State was facing its most sever fiscal crisis since the great depression of the 1930s. Not only was there a concern about the loss of State funding for certain programs, but the County was looking at potential reductions in a number of discretionary and semi-discretionary revenues and the potential that the State would take a portion of County property taxes. The General Fund Five Year Forecast presented to the Board at that time continued to show a structural imbalance, with a projected FY2013-14 unrestricted ending balance of between $3 million and $23 million, down from an actual FY2007-08 unrestricted ending balance of $47.8 million. Given this, the Board voted to implement Fiscal Contingency Plan Longer-term Action 7 and directed staff to return in the first quarter of FY2009-10 with recommendations concerning any further budget actions that might be necessary, with the expectation that by that time there would be a better understanding of:

- How the General Fund actually ended the FY2008-09 fiscal year;
- What is happening with our major discretionary and semi-discretionary revenues, particularly property taxes;
- The impact on the County of the State's fiscal situation;
- The outcome of negotiations with the County's employee unions; and
- What the general state of the economy is, including the outlook for inflation.

Much, though not all, of that information is available and is included in this report along with an updated General Fund Forecast and certain budget adjustment recommendations.

2 – FY2009-10 BEGINNING BALANCE

On June 23, 2009, the Board of Supervisors adopted the Fiscal Year 2009-10 Final Budget. That Budget included an estimated beginning fund balance (which is the same as the FY2008-09 ending fund balance) for each of the County's 79 funds. The Auditor-Controller's Office has now closed the County's books for FY2008-09 and established preliminary ending balances for each County fund. This section reviews the FY2008-09 preliminary actual ending FY2009-10 beginning fund balance status for the County's five major operating funds.

The General Fund

The Fiscal Year 2009-10 Final Budget reflected an estimated FY2009-10 General Fund beginning balance of $41,793,012. The FY2009-10 Final Budget for the General fund was balanced using an estimated undesignated/unreserved beginning balance of $9 million and by the cancellation of approximately $3,982,000 in designations for Fiscal Uncertainties. The Auditor-Controller's Office has now determined that the preliminary actual General Fund ending balance was $48,184,388 and that the undesignated/unreserved balance was approximately $13.4 million. A comparison of the General Fund's budgeted FY2009-10 beginning balance and preliminary actual FY2008/09 ending (FY2009-10 beginning) balance is provided below:

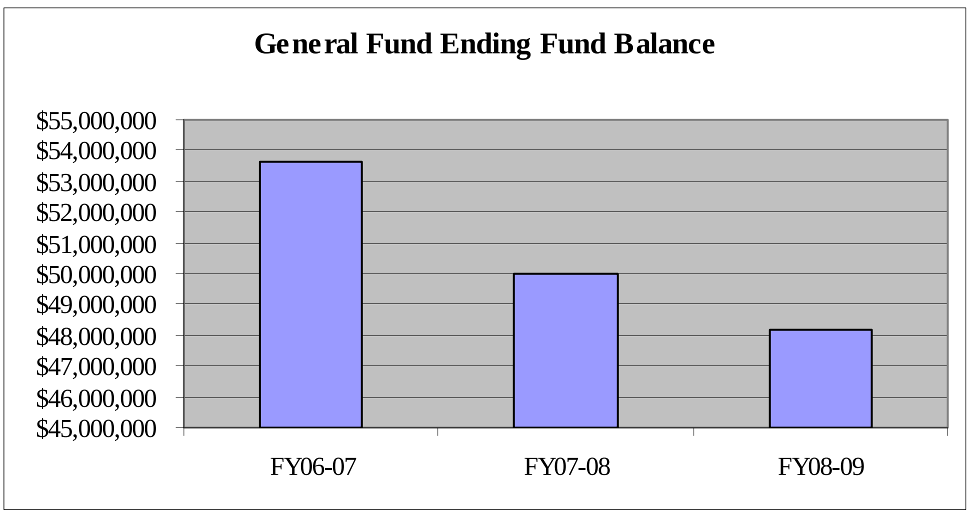
	FY09-10 Budgeted	FY09-10 Actual	Difference Actual - Budget
Beg. Balance:	$41,793,012	$48,184,388	$ 6,391,376
Encumbrances	300,000	289,598	(10,402)
Reserves	9,586,435	9,445,238	(141,197)
Designations	22,906,577	24,932,848	2,026,261
Undesig./Unrevrd.	9,000,000	13,375,517	4,473,517

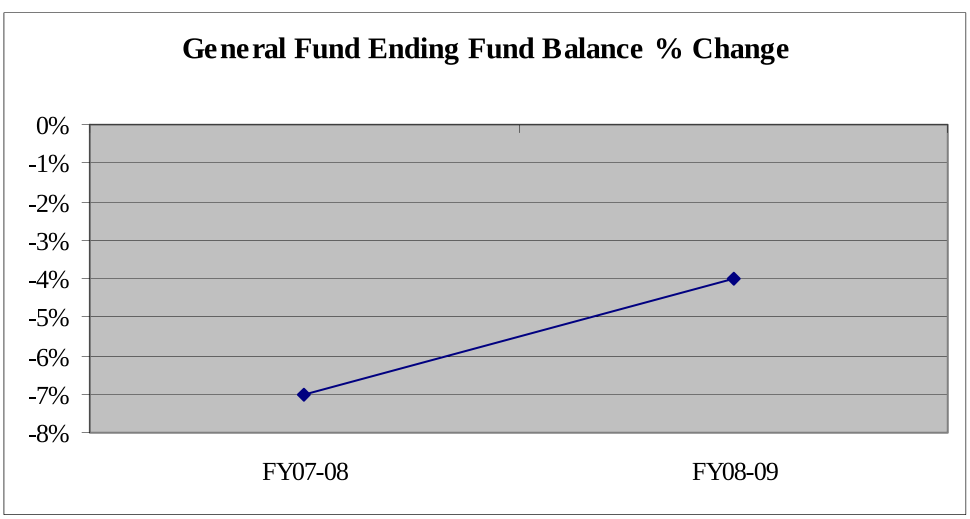
As can be seen, the preliminary actual FY2009-10 beginning balance is $6.4 million higher than the budgeted beginning balance for this fiscal year. This increase is due to a number of factors, most significantly the fact that the County received approximately $6.6 million in "excess excess" ERAF payments in FY2008-09 that were not anticipated when the FY2009-10 budget was being prepared. If these "excess excess" ERAF payments are factored out, the General Fund's actual FY2009-10 beginning balance would have been essentially the same as the budgeted fund balance. The unanticipated "excess excess" ERAF payments received by the County in FY2008-09, and reduced expenditures due in part to the impact of the selective hiring freeze and efforts to conserve cash, were partially offset by lower than anticipated collections of other discretionary revenue (such as sales tax and transient occupancy tax), semi-discretionary revenue (Realignment and Proposition 172), and other departmental revenues.

Of the $6.4 million in additional FY2008-09 beginning fund balance, approximately $2 million will be used to augment various General Fund designations. These augmentations are in part due to year-end adjustments related to things like the need to set additional revenue aside to address audit-required paybacks in Health and Human Services and in part due to an accounting adjustment to correct for an error in recording Board-approved designations in FY2008-09. The $4.5 million increase in the unreserved/undesignated fund balance is money that, had it been available when the budget was prepared, would have eliminated the need to reduce the designation for Fiscal Uncertainties in order to balance the General Fund budget. For that reason, staff is recommending that the money be included in the designation for Fiscal Uncertainties. If that were to be done, the Fiscal Uncertainties designation would stand at approximately $25.3 million.

To put this in perspective, the following tables show what has happened to the General Fund's ending fund balance over the last three fiscal years.

	FY06-07	FY07-08	FY08-09
Ending Fund Balance	$53,644,271	$49,971,307	$48,184,388
Percent Change		(7%)	(4%)
Balance as % of Expenditures	30%	27%	25%



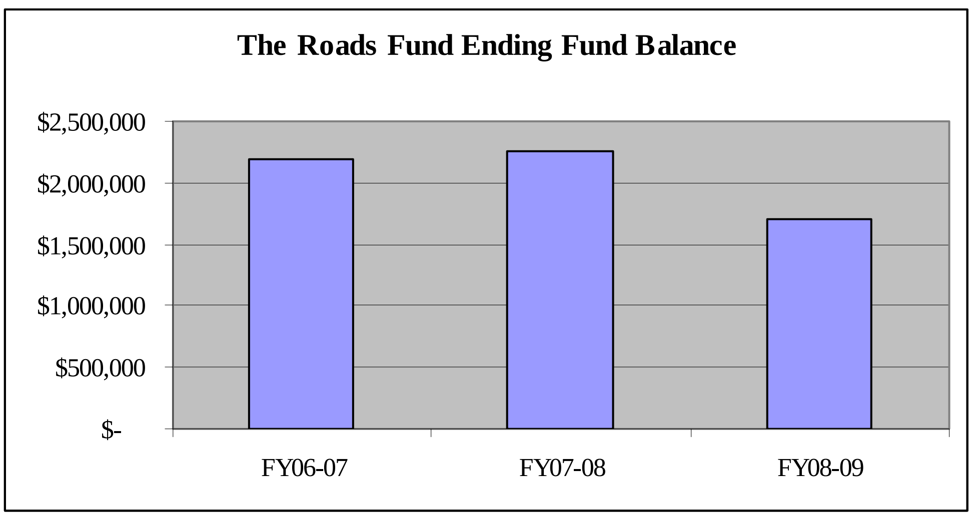


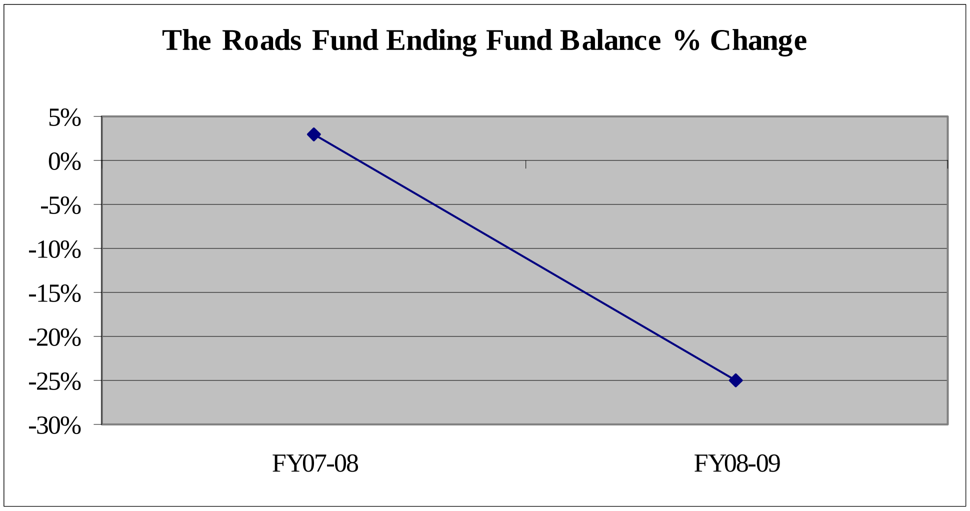
As can be seen, over the last three years the General Fund's ending balance has decreased by approximately 10%, and that increase would have been more significant had the County not received the "excess excess" ERAF mentioned above. The future implications of this for the General Fund's fiscal condition are discussed more fully below in the sections of this report dealing with discretionary revenues and the updated Five Year Forecast.

The Roads Fund

The FY2009-10 Final Budget reflected an estimated FY2009-10 Roads Fund beginning balance of $1,827,053. The Roads Fund's preliminary actual FY2008-09 ending balance (the same as the FY2009-10 beginning balance) has now been determined by the Auditor-Controller to be $1,696,764, which is $130,000 (7%) lower than the FY2009-10 budgeted beginning balance. The following tables show what has happened to the Roads Fund's ending fund balance over the last three fiscal years.

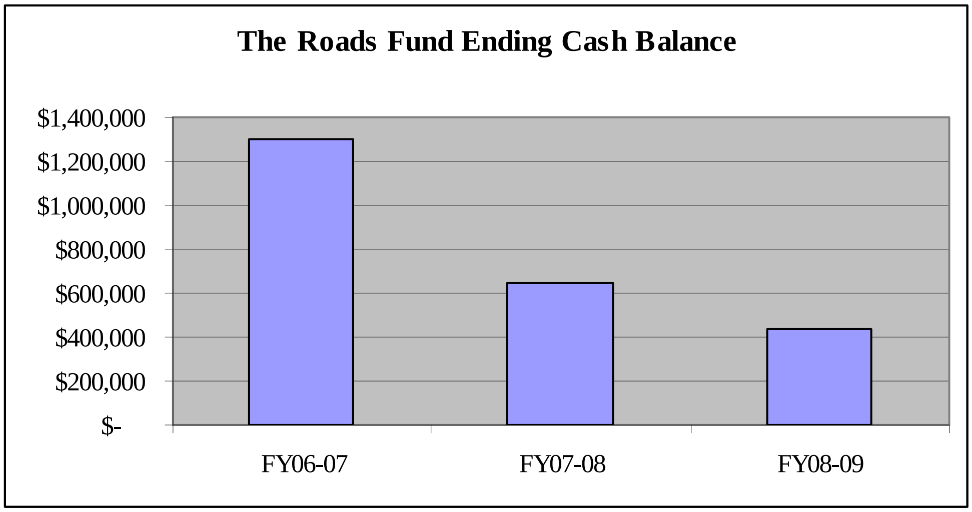
	FY06-07	FY07-08	FY08-09
Ending Fund Balance	$2,197,894	$2,256,961	$1,696,764
Percent Change		3%	(25%)
Balance as % of Expenditures	28%	30%	15%

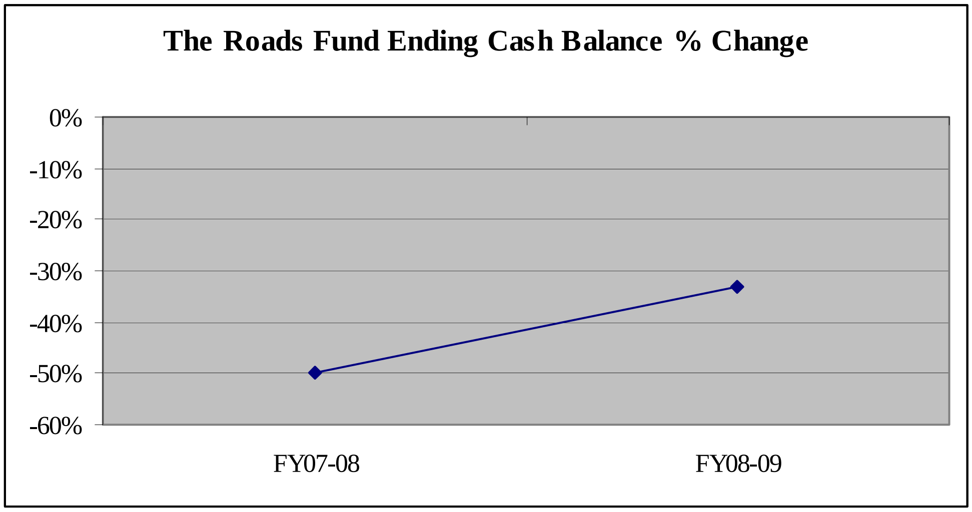




As the Board is aware, in recent years the Roads Fund, though not overly robust, has been in balance from a budget and accrual accounting standpoint. However, the Fund has faced significant cash flow problems, due in part to the impact of the December 2005/January 2006 flood and the delay in receiving reimbursements for flood repairs from the federal and state governments. The Fund's cash flow status was so severe in FY2005-06 that the Board authorized a $723,000 General Fund loan so that the Road Funds did not end that fiscal year with a negative cash balance. The Board subsequently turned the "loan" into a contribution and, in FY2007-08 made an additional $1.9 million General Fund contribution to the Roads Fund above the regular annual $932,000 General Fund contribution. Despite these actions, the Roads Fund's cash flow situation has continued to be somewhat precarious. This is illustrated by the following tables which show the ending cash balance of the Roads Fund over the last three fiscal years.

	FY06-07	FY07-08	FY08-09
Ending Cash Balance	$1,300,000	$644,586	$435,310
Percent Change		(50%)	(33%)
Balance as % of Expenditures	17%	8%	4%





More recently, projections of the Roads Fund's short term cash situation have become somewhat more optimistic for a variety of reasons, including:

- The actual/projected receipt of almost $5 million in Proposition 1B funds from the State in FY2008-09 and FY2009-10;
- The projected receipt of almost $2 million in American Recovery and Reinvestment Act (ARRA) funds in FY2009-10;
- The receipt, at long last, of Federal Emergency Management Agency (FEMA) funds to reimburse the Roads Fund for certain expenditures related to the December 2005/January 2006 flood;[1]
- A decision by the Department of Public Works to use road crews to perform certain projects previously contracted out.

[1] Though the County still has about $2 million in as-yet unpaid flood related claims outstanding. The Public Works Department is relatively confident these claims will be paid.

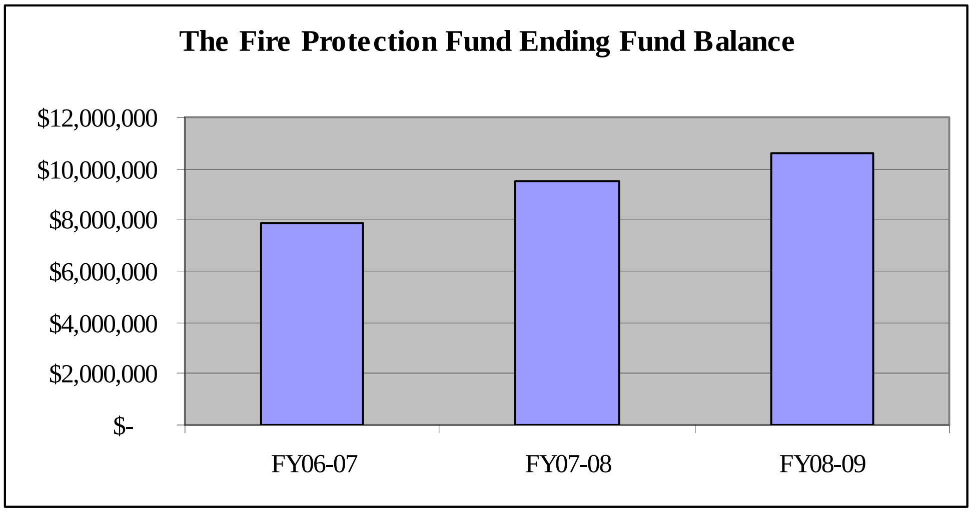
These positive factors are counterbalanced to some extent by potential fiscal threats, most significantly the Governor's proposal to take county gas tax revenues (Napa County's Roads Fund receives approximately $2.5 million a year from this source). Although the Legislature ultimately did not agree to the Governor's proposal and there are questions concerning its legality, the threat remains, as the State continues to face daunting fiscal problems.

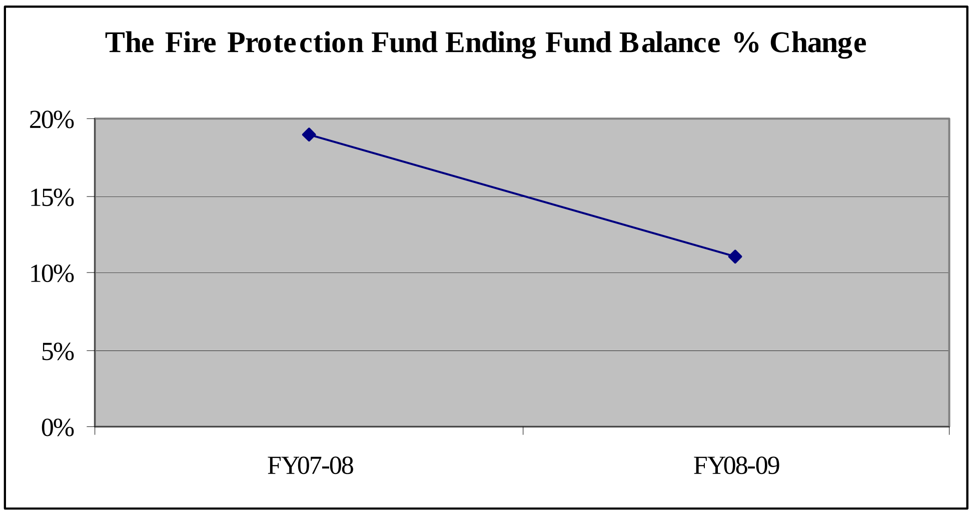
At this point, assuming the State does not take counties' gas tax or Proposition 42 revenue, Public Works staff estimate that the Roads Fund will end this fiscal year with a cash balance of approximately $2.7 million and that balance will decline to approximately $2 million by FY2011-12. However, even under the most optimistic assumptions, the longer-term outlook for this Fund remains problematic unless an alternative revenue source is identified.

The Fire Protection Fund

The FY2009-10 Final Budget reflected an estimated FY2009-10 Fire Protection Fund beginning balance of $9,813,171. The Fire Protection Fund's preliminary actual FY2008-09 ending balance (the same as the FY2009-10 beginning balance) has now been determined by the Auditor-Controller to be $10,579,384, which is $776,000 (8%) higher than the FY2009-10 budgeted beginning balance. The following tables show what has happened to the Fire Protection Fund's ending fund balance over the last three fiscal years.

	FY06-07	FY07-08	FY08-09
Ending Fund Balance	$7,892,101	$9,505,749	$10,579,384
Percent Change		19%	11%
Balance as % of Expenditures	90%	103%	102%





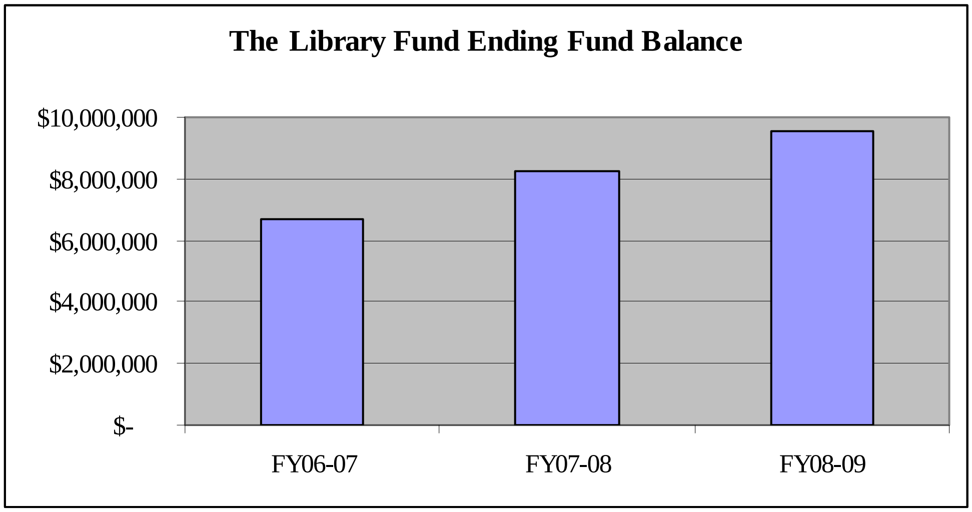
In addition to paying for on-going operating costs, the Fire Protection Fund accumulates resources to periodically make major capital purchases (like fire trucks). In addition, like the General and Library Funds, the Fire Protection Fund receives property tax revenue and is facing a likely decline in the growth rate of that revenue sources and the potential "loan" to the State of approximately $641,000 in property tax revenue in FY2009-10 due to the State's borrowing local property taxes under the emergency suspension provisions of Proposition 1A. Nevertheless, even taking those factors into account, the Fire Protection Fund is, by any measure, in a very good position to deal with the impact of the economic downturn.

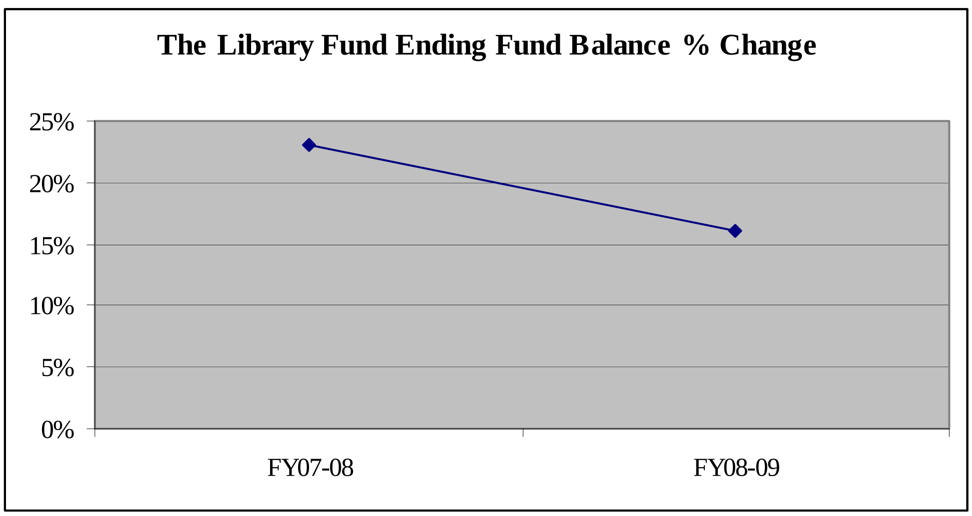
The Library Fund

The FY 2009-10 Final Budget reflected an estimated FY2009-10 Library Fund beginning balance of $8,621,385. The Library Fund's preliminary actual FY2008-09 ending balance (the same as the FY2009-10 beginning balance) has now been determined by the

Auditor-Controller to be $9,519,581, which is $898,000 (10%) higher than the FY2009-10 budgeted beginning balance. The following tables show what has happened to the Library Fund's ending fund balance over the last three fiscal years.

	FY06-07	FY07-08	FY08-09
Ending Fund Balance	$6,689,231	$8,242,279	$9,519,581
Percent Change		23%	16%
Balance as % of Expenditures	124%	146%	150%



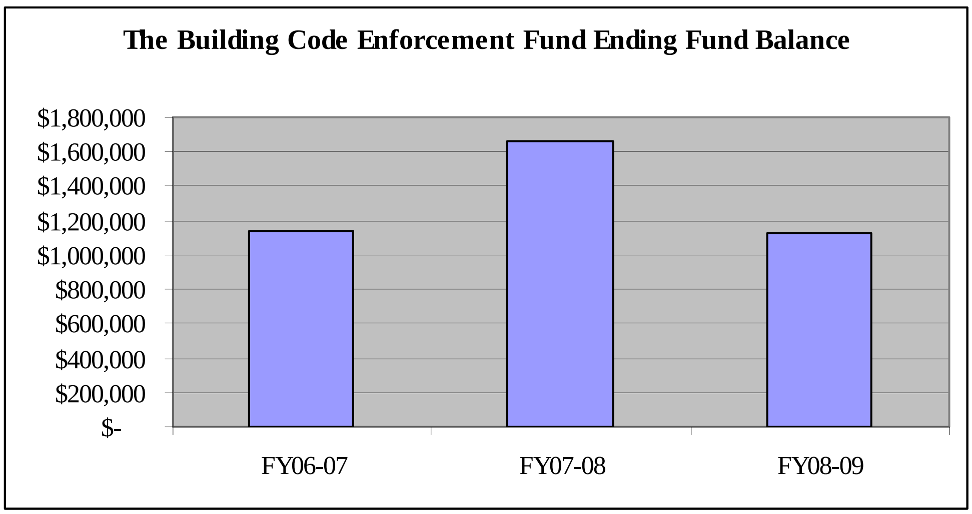


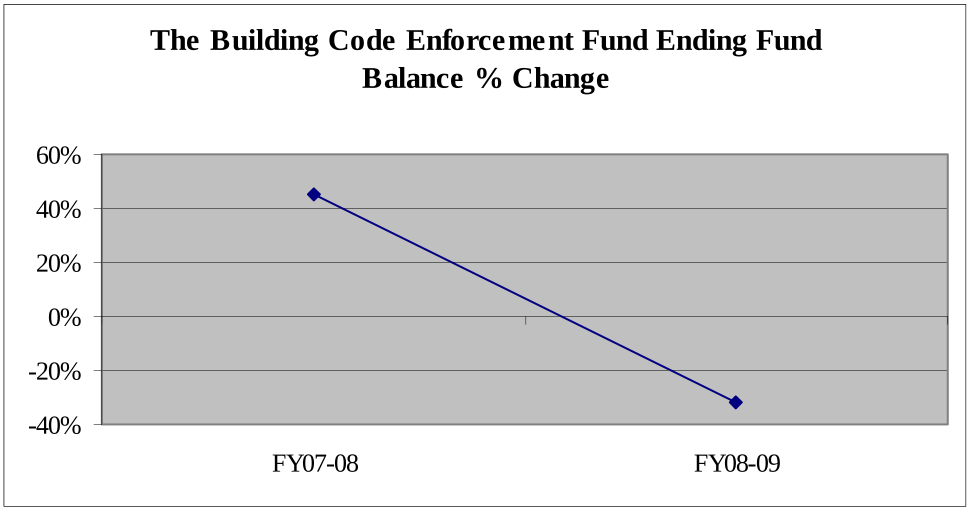
As with the Fire Protection Fund, the Library Fund is accumulating resources for future capital investments, though no specific plan for those capital investments has been developed. The Library Fund is also facing a reduction in the rate of growth of property taxes and the potential "loan" to the State of approximately $456,000 in property tax revenue in FY2009-10 due to the State's invoking the emergency provisions of Proposition 1A. Even taking that into account, though, it is clear that the Library Fund is in solid financial shape and, barring a catastrophic event, should be able to weather the continuing economic downturn without major difficulties.

The Building Code Enforcement Fund

The FY2009-10 Final Budget reflected an estimated FY2009-10 Building Code Enforcement Fund beginning balance of $1,125,488. The Building Code Enforcement Fund's preliminary actual FY2008-09 ending balance (the same as the FY2009-10 beginning balance) has now been determined by the Auditor-Controller to be $1,125,414, essentially the same as the FY2009-10 budgeted beginning balance. The following tables show what has happened to the Building Code Enforcement Fund's ending fund balance over the last three years.

	FY06-07	FY07-08	FY08-09
Ending Fund Balance	$1,140,368	$1,656,775	$1,125,414
Percent Change		45%	(32%)
Balance as % of Expenditures	50%	65%	43%





The Building Code Enforcement Fund has built a substantial balance, due, in part, to the significant amount of building activity that occurred in recent years. The 32% decline in fund balance in FY2008-09 reflects the impact of the recession on building activity in the unincorporated County. In FY2008-09, the County issued 1,187 building permits, a reduction of 297, or 20%, from the number of building permits issued in FY2007-08. FY2008-09 revenue decreased by $973,000, or 32%, compared to FY2007-08 and expenditures exceeded revenues by $531,000. The Building Code Enforcement Fund's FY2009-10 Adopted Budget included $2,384,000 in revenue, approximately $300,000 more than the amount of revenue actually received in FY2008-09. If the FY2008-09 trend were to continue, expenditure reductions in the Building Code Enforcement Fund will be required before the Fund spends down its fund balance.

To address this situation, the Conservation, Development and Planning Department is holding positions vacant and making other expenditure reductions, for a total reduction in FY2009-10 expenditures of approximately $142,000 compared to the Adopted Budget. The Department is also closely monitoring permit activity to see if additional budget adjustments will be needed.

3 – DISCRETIONARY AND SEMI-DISCRETIONARY REVENUES

According to the Auditor's Office, the County ended FY2008-09 with approximately $92,114,000 in discretionary revenue, an increase of approximately $7.7 million, or 9%, compared to the FY2008-09 Third Quarter estimate and amount included in the April, 2009 General Fund Five Year Forecast. This increase is due primarily to the receipt of approximately $6.6 million in unanticipated "excess excess" ERAF as mentioned above and further discussed below. The following table shows the actual collections compared to previous estimates for each of the County's major discretionary revenue sources as well as two "semi-discretionary" revenue sources: Realignment (that funds a variety of

Health and Human Services programs) and Proposition 172 (that funds a variety of public safety programs).

Tax	FY08-09 Budget	FY08-09 3rd Quarter Est.	FY08-09 Actual	Difference Actual vs. Est.	Percent Diff.
Property	$62,241,868	$63,601,000	$71,586,069	$7,985,069	12.5%
Transient Occ.	9,213,660	9,200,000	8,452,117	(747,883)	(8.1%)
Sales & Use	5,617,637	5,039,223	4,900,885	(138,338)	(2.7%)
Realignment	18,207,669	16,255,000	15,622,929	(632,071)	(3.9%)
Prop. 172	11,600,000	10,655,000	10,395,178	(259,882)	(2.4%)
TOTAL:	$106,880,834	104,750,223	110,305,838	5,555,615	5.3%

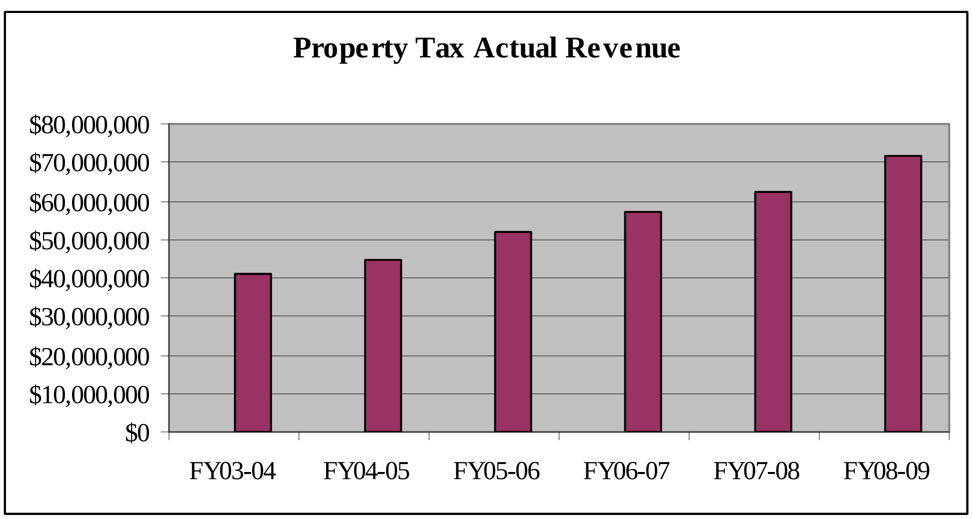
As can be seen, with the exception of property taxes, all of the County's major discretionary and semi-discretionary revenues declined in FY2008-09 compared to the FY2008-09 Budget and the FY2008-09 Third Quarter estimate. These declines were due primarily to general economic conditions, which deteriorated significantly over the last year or so as the nation and state grappled with the impacts of the recession.

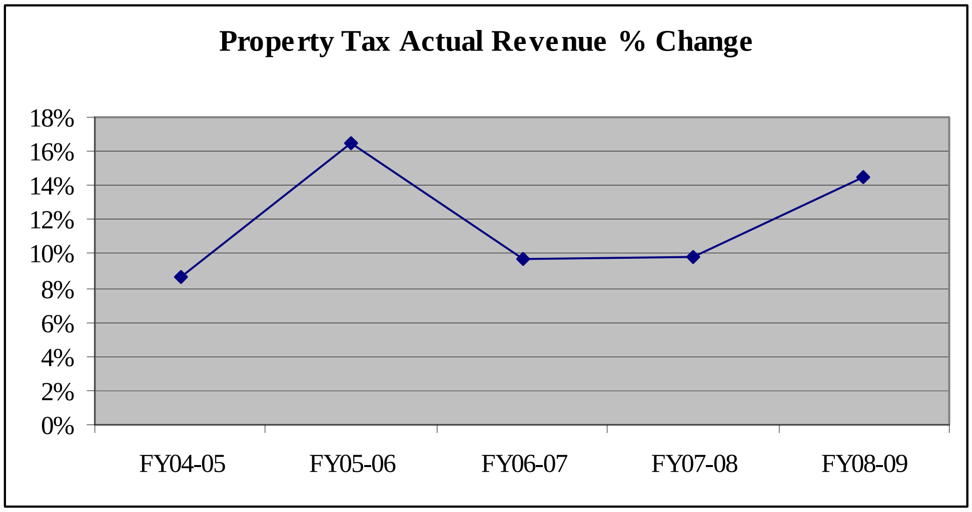
As noted above, the significant increase in property tax revenue was due in part to the receipt of $6.6 million in "excess excess" ERAF payments.

The key issue now with regard to discretionary and semi-discretionary revenue is what is going to happen in the future; will these revenues decline or increase and, in either case, at what rate?

Property Tax Revenue

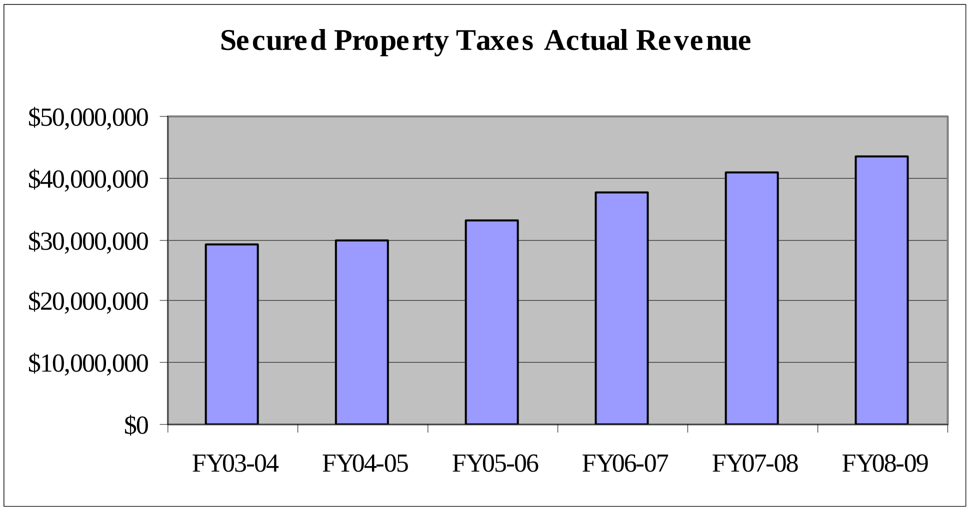
The following tables show actual property tax revenue from all sources (secured, VLF Swap, Triple Flip, unsecured, prior year, supplemental, penalties, etc.) for each year since F2003-04 and the annual change in property tax revenue over the last five years.

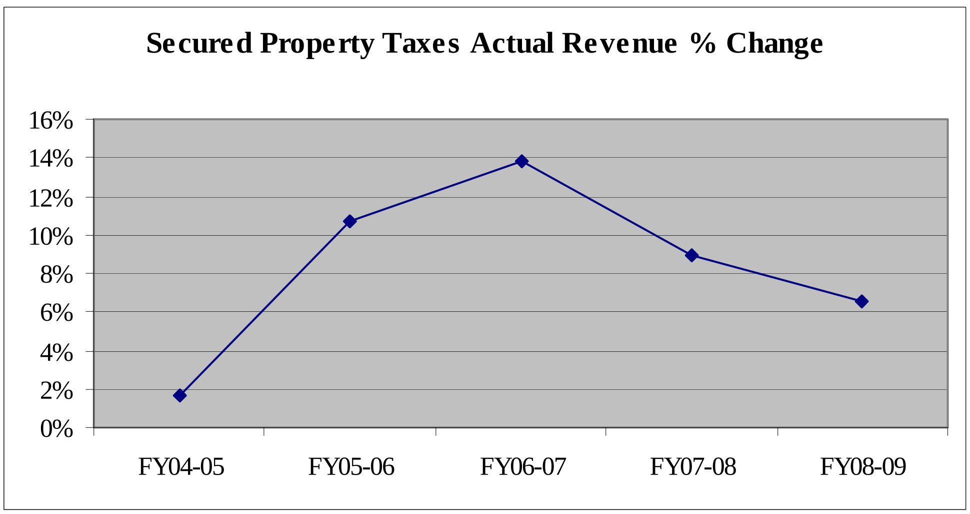




As can be seen, during this period, property taxes increased between 9% and 15% a year, for an average annual increase of 12%. In FY2008-09, property tax revenue grew by 15%, but, as noted above, that increase was due in part to the receipt of "excess excess" ERAF. If that "excess excess" ERAF was factored out, the County would have received approximately $65 million in property tax revenue in FY2008-09, an increase of 9% compared to the prior year, a rate of increase consistent with the last two fiscal years. Excluding FY2008-09, property tax revenues increased during this period at an average annual rate of 11%.

For purposes of projecting property tax revenues in the future, it is also useful to look specifically at Secured Property Tax revenue, which is the revenue historically generated by the County's assessed value and excludes less predictable property tax components like prior year taxes and excess excess ERAF. The following table shows Secured Property Tax revenue for each year since FY2003-04 and the annual change in Secured Property Tax revenue over the last five years.





As can be seen, over this period Secured Property Tax revenue grew at a rate of between 2% and 14% each year, for an average annual increase of 8%. Even last year (FY2008-09), when many counties were experiencing significant reductions in assessed value and property tax revenue, Napa County's Secured Property Tax revenue grew by 7%, the result of a 5.95% increase in overall County assessed value (revenue increased by a greater rate than assessed value in part because the County does not receive the same proportionate share of property taxes in all taxing districts). It is clear, however, that since FY2006-07, the rate of increase has been trending down, driven in part by the recent bursting of the housing bubble.

The Assessor has now completed the process of compiling the FY2009-10 assessment roll and that roll reflects a .7% increase over FY2008-09. Based on this, staff believes that, without any adjustments due to the State's borrowing 8% of our property taxes under the emergency provisions of Proposition 1A, it is reasonable to assume the County would receive at least a 1.7% increase in Secured Property tax revenue compared to the

Secured Property Tax revenue level for FY2008-09 million (the reason for the 1.7% increase in secured property tax revenue when values are only increasing by .7% has to do with the fact that the County receives different proportions of property tax revenue from different parts of the County).

There are three key questions that will drive what happens with property tax revenue over the next five years:

1. Will property assessed value increase or decrease and at what rate?
2. Will the County continue to receive "excess excess" ERAF funds and if so, at what level?
3. How will the State's invocation of the fiscal emergency provisions of Proposition 1A, which allows them to take 8% of our property tax revenue in FY2009-10, impact the General Fund?

Changes in assessed value drive the two largest components of property tax revenue - Secured Property Taxes and the VLF swap (totaling approximately $57.7 million in FY2008-09) - as well as some of the smaller components. According to the Assessor, we are continuing to see declines in assessed value throughout the County, though the decline in residential values is leveling off somewhat. However, we are now seeing a decline in commercial property values. In addition, one of the critical factors influencing assessed value growth, particularly when property values are falling or not increasing, is the rate of inflation. Along with adjustments to property values if there is new construction or a change in ownership, Proposition 13 provides that a property's assessed value will change by the same rate as the October to October California Consumer Price Index (CPI), or 2%, whichever is less. As of June, 2009, the California CPI was .7% **lower** than its October 2008 level. Some economists are projecting that inflation will be back on the positive side by October, but it is not a sure thing. At the least, it does not appear that there will be significant inflationary adjustments upward in FY2010-11 and perhaps in subsequent years.

The County Assessor is currently estimating that countywide assessed value will decline slightly in FY2010-11, and then start to increase slowly in succeeding years, though certain areas of the County will continue to be more severely impacted by the decline in values. Based on that, and not factoring in the State's borrowing 8% of our property tax revenues, staff is projecting growth in Secured and VLF Swap-related property tax revenue as follows:

	FY09-10	FY10-11	FY11-12	FY12-13	FY13-14
Percent Change	1.7%	0	1%	2%	5%

The question of whether the County will continue to receive "excess excess" ERAF revenues and, if so, at what levels, is in part related to the issue of assessed value growth since that is part of the ERAF formula. Other factors include Average Daily Attendance

(ADA) and state subvention levels, which, together, are used to calculate the school district's revenue limit.

The ERAF (Educational Revenue Augmentation Fund) program was enacted by the Legislature in 1992. Then, as now, the State found itself in a serious deficit situation. To meet its obligation to fund education at specified levels under Proposition 98, the Legislature passed a law that shifted partial financial responsibility for funding education to local governments (cities, counties and special districts). This was accomplished by requiring county auditors to shift a portion of local property tax revenues from local governments to Educational Revenue Augmentation Funds, and directing that money in these funds be used to support non-basic aid schools. In the early 2000's, also in response to State fiscal difficulties, the Legislature enacted the so-called "triple flip" and "VLF swap." Under these programs, certain sales tax and vehicle license fee (VLF) revenue were taken from counties and cities and replaced with property taxes taken from ERAF funds.

Each year, then, county auditors' identify how much ERAF money is available and perform a calculation to determine how much of that money needs to be distributed to the non-basic aid school districts (in Napa County, that is only the Napa Valley Unified School District and the Napa Community College District). That calculation includes the districts' average daily attendance and related state subventions, and property tax revenue generated in the district. If there is money left over after the school districts have been paid, that money is designated "excess ERAF," and is used to fund certain special needs programs and services. If there is money left over after those special needs programs and services are funded, that money is called "excess excess ERAF," and is returned to the cities, counties and special districts.

Because of the unexpected receipt of $6.6 million in excess excess ERAF funds in FY2008-09, staff has spent some time analyzing the ERAF methodology and data. The goal was to determine what caused the significant increase in excess excess ERAF funding in FY2008-09 and, thus, whether we can expect to continue to receive excess excess ERAF funding in the future. Although the issue is complicated and uncertainty remains, our preliminary conclusion is that the County received less excess excess ERAF than it was entitled to in prior years because, in prior years the Office of Education used conservative estimates of district property tax revenue rather than actual district revenues or more realistic estimates. Thus, staff believes that the FY2008-09 excess excess ERAF revenue figure is closer to accurate and the County can expect to receive between $3 million and $5 million a year from this source annually. It should be noted, however, that various factors could result in the County not receiving this revenue, including significant declines in assessed value in the Napa Valley Unified School District or changes in the state funding formula for schools. The latter, in particular, is a matter of some concern. In FY2008-09, the State reduced its deficit factor from 1.0 to .946, which partially contributed to the higher amount of excess excess ERAF received for that year. A relatively small future reduction would likely result in additional excess excess ERAF to the County. A significantly larger reduction, however, could have the effect of making the Napa Valley Unified School District basic aid which, depending on what happens with regard to the Community College District, could mean the County will no longer receive VLF Swap and Triple Flip funds. This, in turn, could result in net positive or net negative revenue to the County depending on how much additional Secured Property Tax revenue the County would then receive. If, on the other hand, the State were to increase its deficit factor in future years, then the amount of excess excess ERAF the County receives would be reduced.

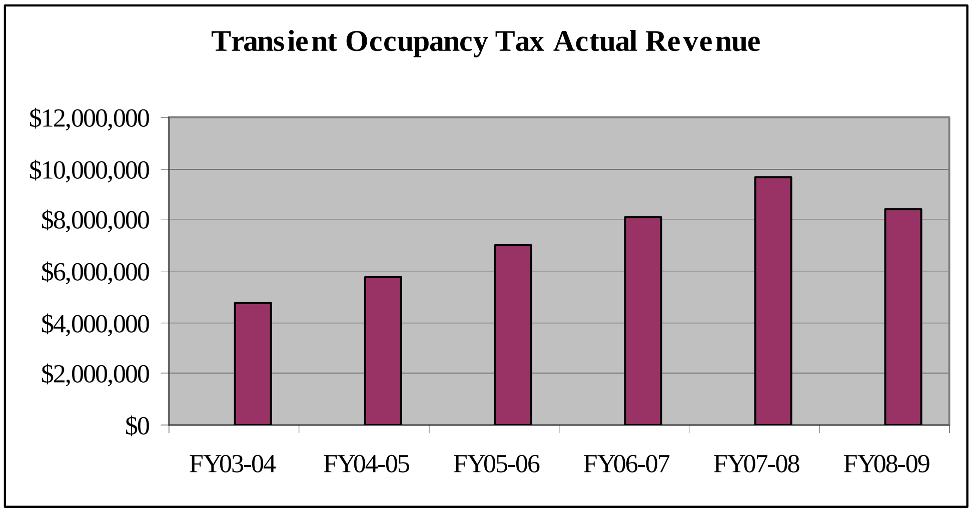
As indicated, the above secured property tax estimates do not factor in the "borrowing" by the State of 8% of the County's FY2008-09 property tax revenues in FY2009-10 resulting from the State's invocation of the emergency provisions of Proposition 1A. Under the 1A emergency provisions, the General Fund would lose approximately $5 million in property tax revenues in FY2009-10 and will, in theory at least, be repaid that amount, plus interest, by June 30, 2013. However, in invoking Proposition 1A, the Legislature also provided a mechanism for local governments to essentially sell our property tax "loan" to the California Statewide Community Development Authority, which in turn will issue bonds to pay local governments for the purchase of those "loans." Principal and interest on the bonds will be paid directly by the State. For reasons outlined more fully in a later section of this report, staff is recommending that the County participate in the securitization program. If this is done, the General Fund will see no loss of property tax revenue as a result of the State's action.

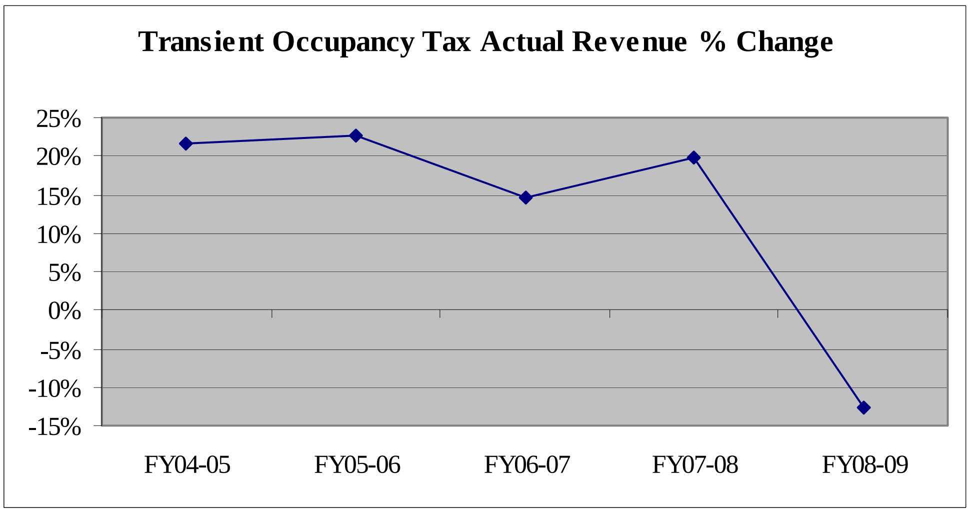
Taking this all together, and assuming the County will receive approximately $4 million in excess excess ERAF, staff is projecting that the County will receive approximately $69.2 million in property tax revenue from all sources in FY2009-10, a $2.4 million (9%) reduction compared to the FY2008-09 property tax revenue level and a $5.6 million (3%) increase compared to the FY2009-10 budgeted level. Staff further believes that a reasonable, though conservative, assumption is that property tax revenues will grow at a rate of 0% to 5% per year over the succeeding four years.

Transient Occupancy Tax Revenue

Over the 5-year period FY2003-2004 through FY2008-09, Transient Occupancy Tax (TOT) revenues grew at between a negative 13% and a positive 23% each year, for an average annual increase of 13%.[2] The following tables illustrate what has happened to this revenue source during this period.

[2] Effective January 1, 2005, the TOT rate was increased from 10.5% to 12%, which contributed to the higher revenue growth rates in 2004-05 and 2005-06. If the impact of that increase is factored out, the average annual increase over the five years was 11% and the average annual increase for the first four years was 15%.

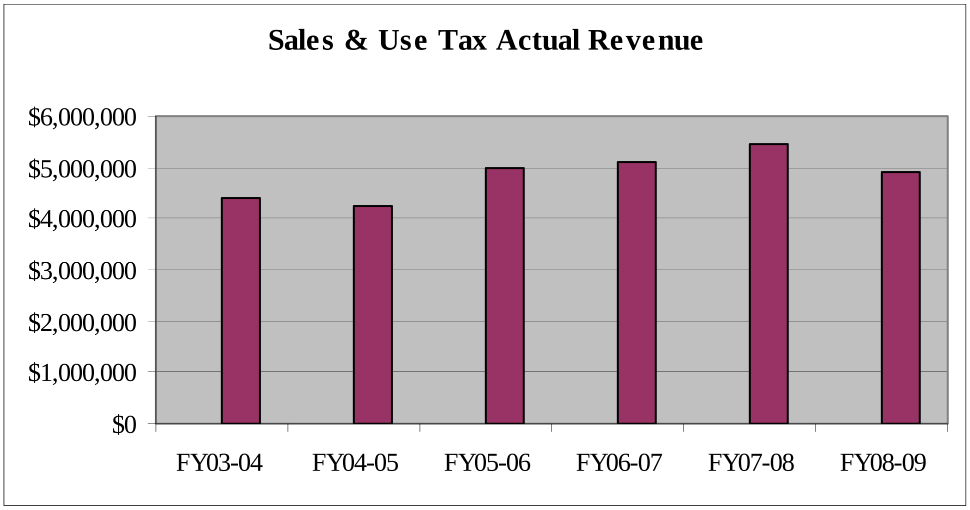


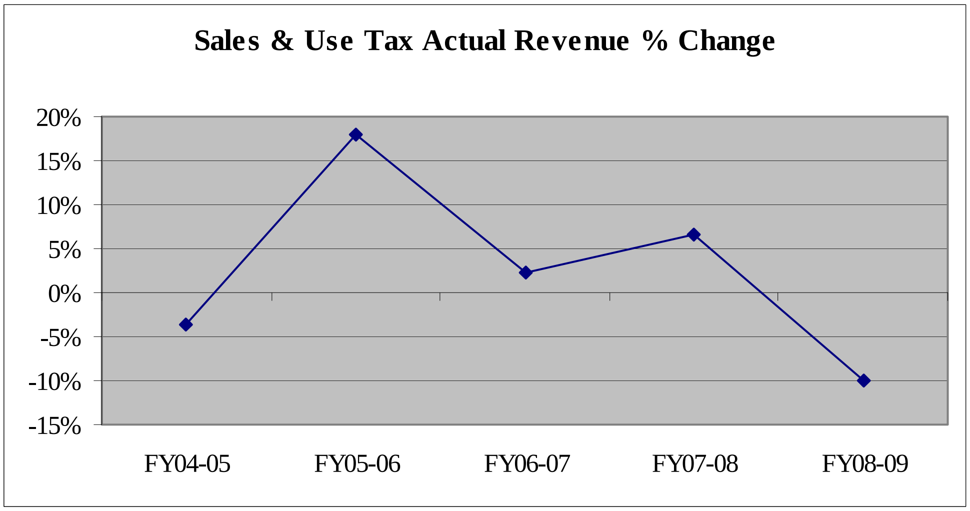


As can be seen, through FY2007-08 TOT revenues showed consistent increases - an average annual rate of 20% - and then dropped by 13% in FY2008-09, reflecting the impact of the national and state recessions. Most economists appear to have concluded that the recession is bottoming out now and that the economy will begin a very gradual recovery over the next 3 to 5 years. The general view is that California's economic recovery will lag the nation, though the Bay Area appears to be doing better than the State as a whole. Based on this, staff is projecting that the County will receive approximately $8.5 million in TOT revenue in FY2009-10, essentially the same as the amount received in FY2008-09, but a $700,000 (8%) decrease from the FY2009-10 adopted budget level. Staff further believes that a reasonable, but prudent, assumption is that TOT revenue will begin a gradual increase of between 2% and 4% a year through FY2013-14.

Sales and Use Tax Revenue

Over the 5-year period FY2003-04 through FY2008-09, Sales and Use Tax revenues grew at between a negative 10% and positive 18% per year, for an average annual increase of 3%. The following tables illustrate what has happened to this revenue source during this period.



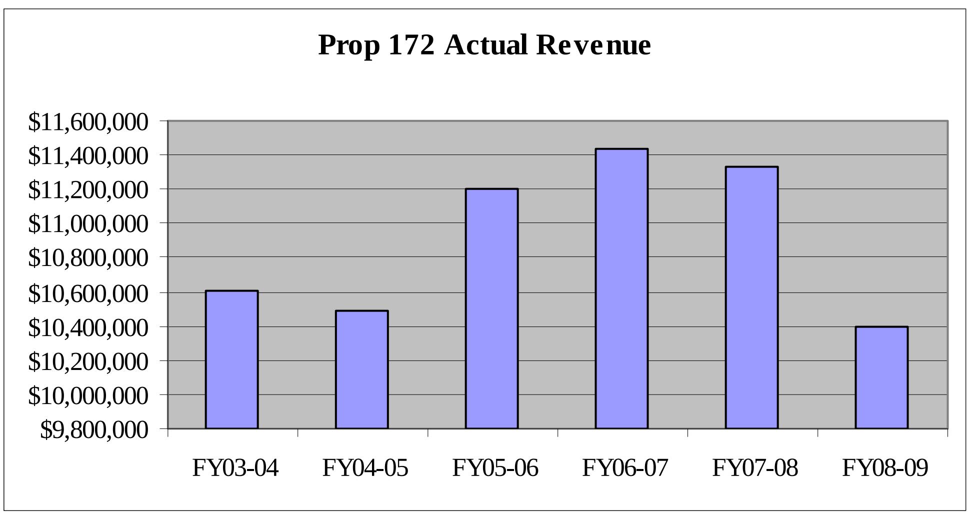


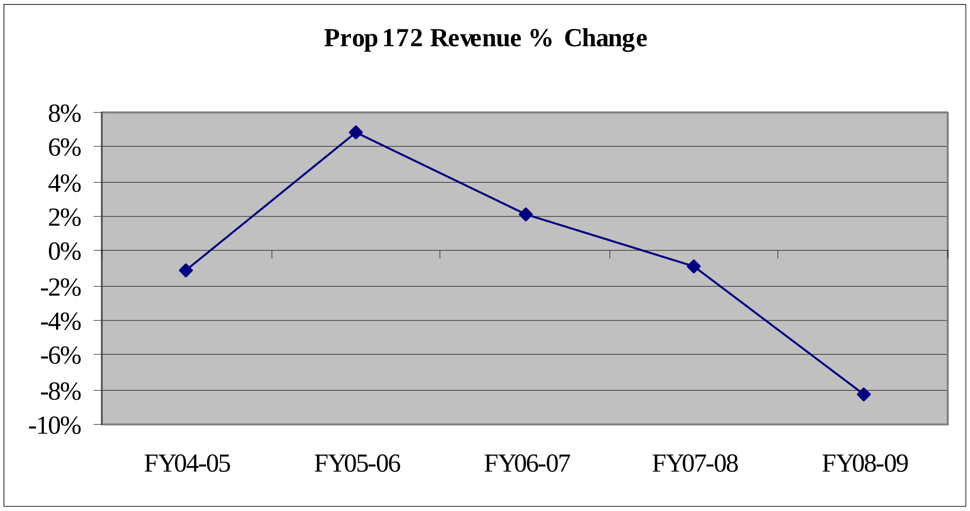
As can be seen, between FY2003-04 and FY2007-08, Sales and Use Tax revenue grew at an average annual rate of 6%, and then dropped by 10% in FY2008-09, again, reflecting the impact of the recession. One of the difficulties in projecting sales tax revenue – particularly for a specific year or small group of years as opposed to a more long-term period- is its extreme volatility – with fairly routine fluctuations of as much as 20% per year. Nevertheless, based on the premise that the recession will bottom out this year and then begin a gradual recovery over the ensuing four years, staff is projecting sales and use tax revenue of $4.9 million in FY2009-10, the same amount received in FY2008-09, but an $83,000 (2%) increase compared to the FY2009-10 adopted budget level. Staff further believes that a reasonable, but prudent assumption, is that sales and use tax revenue will then begin a gradual increase at a rate of between 2% and 4% a year through FY2013-14.

Proposition 172 Revenue

Proposition 172 revenue is generated by a half-cent statewide public safety sales tax levy that is allocated to counties and some cities based on a formula that includes each jurisdiction's proportionate share of statewide taxable sales. Thus, the County's Proposition 172 revenue fluctuates each year depending on the growth or decline in total statewide sales and on the growth or decline in Napa County's taxable sales relative to the rest of the state. In Napa County, Proposition 172 revenue is considered departmental revenue for the various law, justice and public safety departments to which it is allocated. It is designated semi-discretionary because, though it must be spent on public safety programs, the Board has considerable discretion about which programs to fund, the level of funding and what to fund within the eligible programs.

Over the 5-year period FY2003-04 through FY2008-09, Proposition 172 revenue grew between a negative 8% and positive 7% per year, for an average annual increase of 0%. The following tables illustrate what has happened to this revenue source during this period.



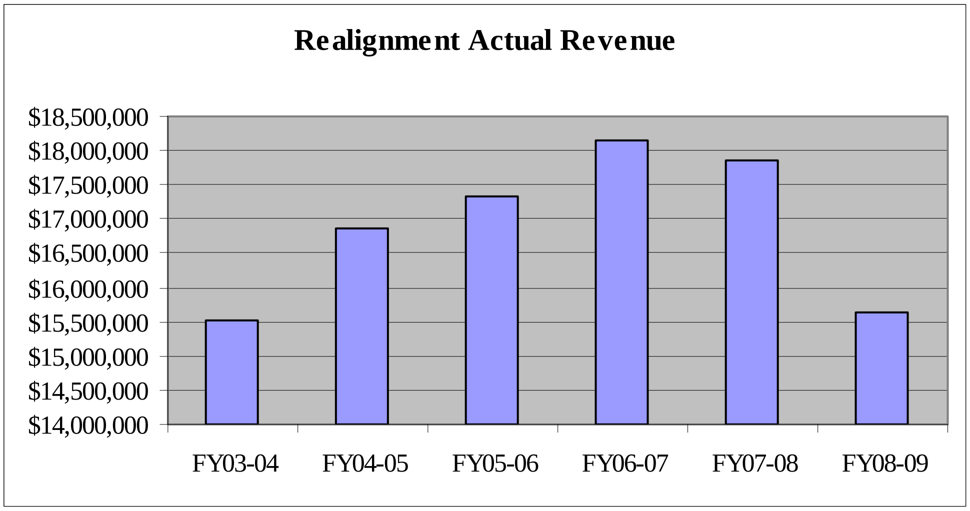


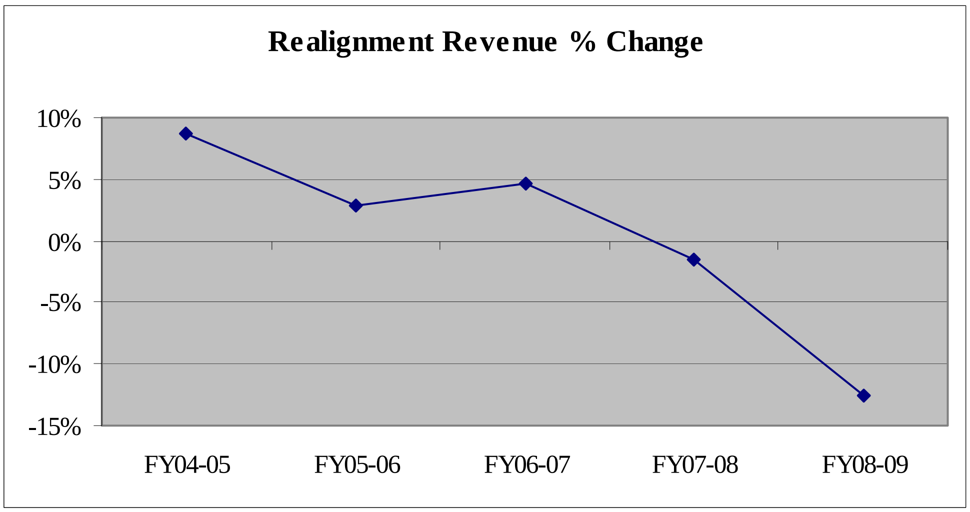
As can be seen, between FY2003-04 and FY2007-08, Proposition 172 revenue grew at an average annual rate of 2%, and then dropped by 8% in FY2008-09, once again reflecting the impact of the recession, but partially offset by the fact that taxable sales in Napa County have not declined as steeply as the state as whole, thus increasing Napa County's share of Proposition 172 revenue. Even before FY2008-09, however, the County was seeing a significant decline in the rate of Proposition 172 revenue growth. As with most discretionary revenue, staff's Proposition 172 revenue projections reflect the assumption that we will experience a gradual economic recovery starting in FY2010-11, with growth rates rising to historic levels by FY2015-16.

Realignment Revenue

Realignment revenue is allocated to counties based a complex formula that involves statewide growth in sales tax and Vehicle License Fee (VLF) revenues and caseload growth in certain realigned health, mental health and social services programs. Realignment revenue can only be spent on certain health, mental health and social services programs, but it is designated as semi-discretionary because it can be spent pretty much as the Board wants within a fairly broad array of programs in those areas and can be used to offset General Fund support, as long as certain maintenance of effort requirements are met. In Napa County, Realignment revenue is considered departmental revenue to the Health & Human Services Agency and, in accordance with Board policy, the County does not typically backfill reductions in Realignment funding.

Over the 5-year period FY2003-04 through FY2008-09, the County's Realignment revenue grew or declined at a rate of between negative 16% and positive 9% in each year, for an average annual change of 0%. The following tables illustrate what has happened to this revenue source during this period.





As can be seen, from FY2003-04 through FY2007-08, Realignment revenue grew at an average rate of 4% a year, and then declined by 12% in FY2008-09 due to the recession. As with Proposition 172 revenue, however, it is clear that even before FY2008-09 the rate of growth in Realignment revenue was trending downward. Projecting Realignment revenue into the future is difficult, in part because of the current uncertainty regarding statewide sales tax and VLF revenue growth and, in part, because of similar uncertainty regarding caseload growth. At this point, Health & Human Services Agency staff are projecting Realignment revenue will come in approximately $1.3 million, or 8%, lower than the amount included in the FY2009-10 adopted Budget. Staff is uncomfortable making any Realignment revenue projections beyond this fiscal year. However, because the County's policy is to hold the Health & Human Services Agency's Net County Cost steady, any reduction or increase in Realignment revenue would impact the Agency's ability to provide services, but have no impact on the fiscal condition of the General Fund.

4 – STATE BUDGET IMPACTS

Shortly after the Legislature approved the State's FY2009-10 budget, the Legislative Analyst issued a report indicating that the State was still facing a $24.3 billion budget deficit in FY2008-09 and FY2009-10. In addition, the Analyst indicated that the State was facing a severe cash-flow problem and might not be able to pay many of its bills (including funds owed to counties) for "much of the 2009-10 fiscal year." In response to this and other reports concerning the State's ongoing fiscal difficulties, the Governor and Legislature began a three-month long effort to bring the State's FY2009-10 budget into balance. That effort culminated (more or less) on July 28, 2009, when the Governor signed the budget package approved by the Legislature, after vetoing $489 million in General Fund appropriations.

In terms of its impact on counties, the final budget package, though it significantly reduces funding for certain County health and human services programs, is not as bad as it could have been, given some of the proposals that were floated during budget discussions. Among the ideas suggested at one point or another in the budget process, but ultimately not agreed to, were:

- Eliminating most or all of gas tax funding to cities and counties and "borrowing" a portion of the Proposition 42 money allocated to counties for transportation projects.

- Eliminating the CalWORKS and Healthy Family programs entirely.

- Eliminating funding for the COPS and RASCLEAP programs.

The following are some of the key components of the approved budget package that will impact counties:

- As authorized by the fiscal emergency provisions of Proposition 1A, the State will borrow an amount equal to 8% of county, city and special district FY2008-09 property tax revenues. According to Proposition 1A, borrowed property tax revenue must be repaid within 3 years (by June 30, 2013), with interest. The budget package authorizes the Director of Finance to set the interest rate, not to exceed 6%. The Legislature also authorized the California Statewide Community Development Authority to issue bonds to generate funds to purchase the State's debt from those local governments willing to sell it. All costs of issuance and debt service would be borne by the State. In Napa County's case, the State will be borrowing $6,125,000 - $5,025,000 from the General Fund, $456,000 from the Library Fund and $641,000 from the Fire Protection Fund.

- The budget package reduces California Work Opportunity and Responsibility to Kids (CalWORKS) funding by $510 million, primarily by reducing County block grant allocations for welfare-to-work services and child care. In addition, effective July 1, 2011, the budget legislation reduces from 60 to 48 the number of consecutive months an adult may receive a cash grant and requires adults to meet with county workers every six months regarding work requirements.

- The budget package assumes savings of $264 million in the In Home Supportive Services (IHSS) program primarily from eliminating domestic and related services for all but the most severely disabled IHSS recipients, making the least disabled ineligible for all services, eliminating the share of cost buy-out program, and implementing several anti-fraud activities. Unless the County backfills these reductions, this will actually save the County money.

- The budget package reduces county Child Welfare Services funding by $124 million statewide, but keeps all State requirements related to counties' responsibilities in place. Health & Human Services preliminary estimate is that this will cost Napa County approximately $100,000 in revenue.

- The budget package assumes $323 million in General Fund savings from Medi-Cal, though it is not entirely clear how those savings will be achieved. It appears that approximately $120 million will come from reductions in funding for county administration of Medi-Cal, essentially eliminating funding to account for the increased workload due to the uptick in Medi-Cal applications related to the recession.

- The budget package, including the Governor's vetoes, reduced funding for the Healthy Families program by a total of $172.6 million. This program currently provides health insurance to 900,000 children statewide. These cuts would result in waiting lists and possibly even result in some current recipients losing service. However, recently, the Legislature passed a bill imposing a 2.35% tax on the gross premiums of companies that manage Medi-Cal insurance plans, that, along with other sources, will provide enough funding to cover the reduced funding in the budget package. The Governor has indicated he supports the bill, though he has not yet signed it.

- The budget package cuts in half (from $225 million to $113 million) the allocation to counties for the Medi-Cal Managed Care program. Staff estimates that this reduction will cost Napa County approximately $350,000, plus another $350,000 in federal matching funds.

- The budget package defers $52 million in AB3632 mandate reimbursement to counties for past claims and $300 million in Proposition 63 funding to counties.

- The budget package also reduces funding for other health programs, including the elimination of certain HIV/AIDS local assistance funding.

- The budget package eliminates all of the $90 million in General Fund support for Proposition 36 programs that provide drug treatment in lieu of jail. The package maintains $18 million in General Fund support for the Offender Treatment

Program and includes $45 million of Edward Byrne Memorial Assistance Grant program funding provided through ARRA for the offender treatment program. All-together, $63 million is provided for Proposition 36 programs.

- The budget package, including the Governor's vetoes, eliminates funding for the Williamson Act for FY2009-10. Napa County receives approximately $90,000 annually in Williamson Act subventions, but forgoes approximately $1 million in property tax revenue.

- The budget package suspends 51 State mandates, decreasing funding for mandates from approximately $142 million to about $76.4 million.

- The budget package, including the Governor's vetoes, reflects a reduction of $1.2 billion in State General Fund support for the State Department of Corrections and Rehabilitation. However, in order to get the votes to pass the budget package, the details of these cuts were left unspecified with the understanding they would need to be worked out later. Subsequently, the State Senate passed a package, supported by the Governor, that would reduce the State's prison population by approximately 27,000 inmates. This would be accomplished through a number of measures, including: having the Governor commute the sentences of felons who are not citizens and then turning them over to federal authorities for deportation; allowing certain inmates to earn credits on the their sentences by completing certain education programs; changing the way parolees are monitored, with low-level offenders not subject to active supervision; providing for the release to house arrest with electronic monitoring of certain inmates who are at least 60 years old or mentally incapacitated or are in the last year of their sentence; and making certain changes to sentencing laws, such as increasing the dollar threshold for charging felony grand theft from $400 to $2,500. Later still, the Assembly passed a different bill, eventually agreed to by the Senate that included the provisions related to reducing supervision of low level offenders, providing credits for completing education programs and turning over certain non-citizen felons to federal immigration authorities. The final package also provides that some felony probation violators would be housed in county jails or local treatment programs rather than prisons. The final package approved by both houses would reduce prison crowding by only about 17,000 inmates and save the State approximately $200 million a year less than the Senate version and the savings included in the budget package. County staff are currently trying to determine what the impact of these changes will be on the County's criminal justice and health and human services systems.

In terms of impact on counties, perhaps as significant as the specifics of the approved budget package is the potential for future reductions in State funding. According to the State Finance Department, the State is currently looking at a FY2010-11 General Fund deficit of over $7 billion and FY2011-12 and 2012-13 deficits of over $15 billion, due in part to the fact that certain temporary tax hikes are scheduled to end in 2011 and ARRA funding will go away. And the situation could be worse if State tax revenues fail to meet projections. If the State experiences budget shortfalls of this magnitude and is unable to increase revenues significantly, it is likely the Governor and Legislature will once again look to local governments –and counties in particular – to help them balance the State's budget. In particular, we would expect to see additional cuts to Health and Human Services funding and, potentially, another attempt to raid city and county gas tax funds.

5 – HEALTH & HUMAN SERVICES

As indicated above, the County's Health & Human Services Agency (HHSA) will bear the brunt of reductions in categorical State funding to the County. In addition, as also mentioned above, HHSA has seen a significant decline in Realignment revenues over the last two years. Unfortunately, as of the time this report is being written, HHSA still has not received all notices due from the State for its FY2009-10 program funding allocations. The FY2009-10 State budget package signed by the Governor on July 28th was based on deals negotiated by the "Big Five" (the Governor and legislative leaders). Because relevant legislative committees and State departments were not consulted by the Big Five on the deals made, the budget package is short on logical implementation processes. State departments have been scrambling since then to make the deals operationally implementable. The State has indicated that the allocation notices will be sent out by the end of this month.

In the meantime, it is clear that the projected $1.3 million reduction in Realignment revenue compared to the FY2009-10 budgeted level will have a significant impact on HHSA's Mental Health and Public Health Divisions and, to a lesser degree, on the Self Sufficiency and Child Welfare Services Divisions. In addition, state funding reductions and changes in funding practices known to-date will require an additional $1.5 million reduction in HHSA expenditures. These known reductions mainly involve the Mental Health and Alcohol and Drug Divisions and, here too, some of the reductions will be signifcant. However, because not all allocation notices have been received, and because HHSA's budget is set based on a fixed Agency-wide Net County Cost, HHSA expects to be able to present a clearer picture of the State's impact by the latter part of October. For now, HHSA management is currently working on alternatives to managing the anticipated funding reduction by considering:

- The deletion of certain positions intentionally held vacant since July 1, 2009. Over the last two years, HHSA has compensated for reductions in funding, in part by eliminating a total of 17.65 FTE. The Agency is currently holding an additional 16.75 FTE positions vacant, pending the finalization of plans to address the additional budget reductions.

- The reduction or elimination of contracts for professional services.

- Shifting available funding sources to offset appropriated Realignment funding.

- Making greater use of funding available from non-operating special revenue funds.

- Re-allocation among the various HHSA budget units of the $11 million in General Fund support the Agency receives.

- Restructuring service delivery, including service level cuts.

- As a last resort, a reduction of the existing Agency workforce.

6 – STATE MANDATES

As noted above, the budget package approved by the State Legislature eliminates 51 State mandates, decreasing funding for mandate reimbursement by approximately $66 million (copy of list attached). For FY2007-08, Napa County claimed approximately $1.3 million in mandate reimbursements, of which approximately $871,000 was for AB 3632 services (mental health services for children). The value of Napa County's suspended mandates was approximately $118,000, with the Animal Adoption mandate representing approximately $108,000 of the total.

The Animal Adoption mandate requires that animal shelters hold animals for 6 days rather than 3 days. Over the past three years the County's Animal Adoption claim has averaged $114,000 a year, though the County has only received an average of $62,000 a year. In FY2008-09 the County did not receive any reimbursement for this mandate. The Department of Environmental Management has indicated that they believe it is appropriate to continue to adhere to the 6-day holding period. In addition, the Department has negotiated agreements with the cities designed to ensure that the cities pay an appropriate share of Animal Shelter costs, which will result in reducing the County's share of costs by roughly 75% over three years. Given this, staff recommends not changing the animal holding policy from 6 to 3 days as long a no increase in Net County Cost is required.

The other suspended county mandates Napa County has claimed in the past – e.g., the Not Guilty by Reason of Insanity Mandate – have totaled less than $10,000 a year. Staff is recommending that the decision as to whether to continue providing these services be left to the relevant departments, with the understanding the General Fund will not backfill the reduction in revenues.

7 - REVISED GENERAL FUND FIVE YEAR FORECAST

This General fund Five Year Forecast updates the General Fund Forecast provided to the Board in April of 2009.

<u>Forecasting Methodology</u>

Given all the uncertainties, forecasting revenues and expenditures a number of years into the future is a problematic undertaking at best. In this Forecast we base our future years' projections on preliminary actual FY2008-09 expenditures and revenues, adjusted for known or likely changes in FY2009-10. In addition, we make a number of assumptions about what will likely happen over the next five years in terms of such things as inflation rates, State budgets, State law changes, union contract negotiations and national, state and local economic conditions.

Given our inability to predict the future, in many cases our assumptions may not come to pass. In addition, with all the complexities involved, it is likely there will be differences between what we project and the actual numbers, even assuming most of our key assumptions are correct. In light of the problematic nature of our revenue/expenditure projections, we are providing three different forecast scenarios.

<u>Baseline Scenario:</u> This scenario is based on a continuation of the status quo in terms of budget policies, state laws and funding levels and general economic conditions, with adjustments made only for known or reasonably likely changes in revenues/expenditures. The following are some of the key assumptions used in this scenario:

- Preliminary actual Net County Cost for FY2008-09 is considered the “base year” for future projections.

- Generally, the projections assume no General Fund supported staff increases after FY2008-09.

- The projections assume $250,000 a year will be spent on the General Plan update and Housing Element update implementation. The projections assume that the County will continue to incur approximately $200,000 a year in General Fund costs to operate the Napa County Housing Authority. The projections also assume that approximately $1.2 million a year will be spent to operate the new Community Corrections Services Center.

- The projections assume that inflation will be in the area of 1% to 2% annually, and that the “cost of doing business” will increase by that amount for most contracts and purchases. The projections assume that employees will not receive a cost of living adjustment in FY2009-10 and FY2010-11 and that salaries will increase by 2% a year in the remaining years of the projection period. The projections also assume that the RASCLEAP monies will continue to be used to cover the ongoing cost of the cost of living adjustment awarded to Sheriff’s Deputies in FY2008-09.

- The projections assume that retirement costs will increase at the same rate as salaries, except in FY2011-12, when retirement costs will increase by approximately 20% to reflect the impact of recent PERS investment losses. These projections also reflect the assumption that the current provisions in the employee labor agreement regarding County/employee sharing in retirement costs will be retained.

- The projections assume the County will implement the first six Fiscal Contingency Plan Longer-term actions approved by the Board, including pre-funding our Other Post Employment Benefits (OPEB) unfunded liability on a 20-year amortization schedule.

- The projections assume the $480,000 previously loaned to the Napa-Berryessa Resort Improvement District will not be repaid during this period.

- The projections assume that most revenues will grow or decline based on past trends or know adjustments and that, with certain exceptions, departmental revenue increases will generally keep pace with cost increases (or, in certain cases, that the County will not backfill reductions in State or federal funding). The exceptions include Proposition 172 and certain fee revenues that are adjusted based on recent trends or decisions. The projections assume that cities will pay a proportionate share of cost for the Animal Shelter on a three-year phase in basis. For the Health & Human Services Agency, the projections assume that the FY2009-10 budgeted Net County Cost will be held constant throughout the five-year period.

- In terms of major discretionary revenues, the projections assume that the County will securitize our property tax loan to the State under Proposition 1A and property tax revenue will decline by approximately 9% in FY2009-10 compared to the FY2008-09 actual level and the gradually increase by between 0% and 5% over the next four years and that the County will receive approximately $4 million in excess excess ERAF in each of those years. The projections assume that transient occupancy and sales and use tax revenue will stay essentially flat in FY2009-10 and then gradually increase at rates of between 2 and 4% over the succeeding four years.

- The projections assume that the General Fund contribution to the Special Projects Fund (by Board policy, 12.5% of the prior calendar year's Transient Occupancy Tax collections) will grow or decline at the same rate as TOT revenue.

- The projections assume no major increases in General Fund supported program costs, beyond the normal increases in the cost of doing business, except as described above. For example, the projections do not include any new General fund loans to the resort improvement districts.

Revenue Reduction/Expenditure Increase Scenario: This scenario is designed to provide a measure of what the impact on the General Fund might be of a reduction of in discretionary revenues and/or increase in Net County Cost (the bottom line impact of a discretionary revenue decrease is the same as a Net County Cost increase). To illustrate this impact, this scenario utilizes all of the assumptions described above, except that it assumes a $3 million, or 3%, increase in Net County Cost, starting in FY2009-10[3].

A 3% Net County Cost increase or discretionary revenue decrease is well within the realm of possibility and could result from a variety of factors. For example:

- New contracts with the labor unions representing County employees could result in a COLA in FY2010-11 or a COLA higher then the projected inflation rate in succeeding years. Or, inflation could be higher than the 2% rate assumed in the out-years of these projections. Every 1% increase in salary and benefits results in a roughly $500,000 annual increase in Net County Cost.

- The County's employee pension costs could increase due to greater-than-anticipated investment losses at CalPERS.

- The Board could commit to General investments in facilities beyond the $1 million a year included in the Baseline projection for capital projects. Future projects already identified include a new jail and County Administration Building and replacement of buildings on the Health & Human Services campus.

- The Board could authorize additional loans to the resort improvement districts that are facing continuing fiscal problems.

- Property tax, sales tax or other discretionary or departmental revenues could grow at a rate that is less than the level assumed in the Baseline projections. In particular, significant uncertainty remains regarding how much excess excess ERAF the County may receive.

- As indicated above, the Baseline Scenario assumes that the Health and Human Services Agency's Net County Cost will not increase during the five-year projection period. Given the magnitude of State funding reductions HHSA is facing, the Board may feel it is necessary to augment the Agency's Net County Cost rather than see additional reductions in Agency staffing or services.

<u>Revenue Increase/Expenditure Decrease Scenario:</u> This scenario is designed to provide a measure of what the impact on the General Fund might be of an increase in discretionary revenue and/or decrease in Net County Cost. To illustrate this impact, this scenario utilizes all of the assumptions in the Baseline Scenario, except that it assumes a $2 million decrease in Net County Cost, starting in FY2009-10.

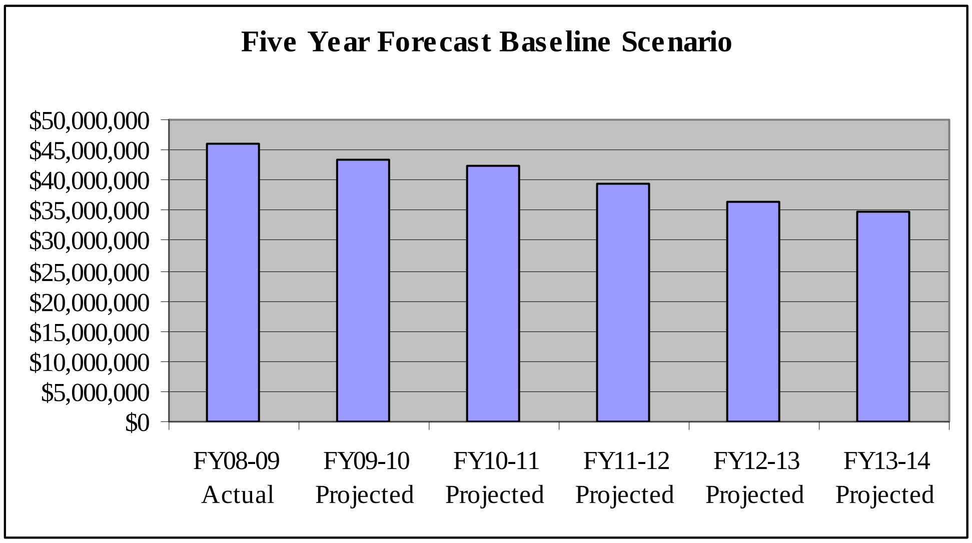
---

[3] Past Five Year Forecasts have typically used a $2 million increase in Net County Cost in the Revenue Reduction/Expenditure Increase Scenario. Because this year the downside risks seem significantly higher than the upside risks, a $3 million Net County Cost increase is being used for the Revenue Reduction/Expenditure Increase Scenario. A $2 million reduction in Net County Cost is still used for the Revenue Increase/Expenditure Decrease Scenario.

A discretionary revenue increase or Net County Cost decrease such as this is well within the realm of possibility. For example, the County might receive more than $4 million in excess excess ERAF in each year of the forecast period, or other discretionary revenue might increase at a higher than projected rate.

Forecasts and Analysis

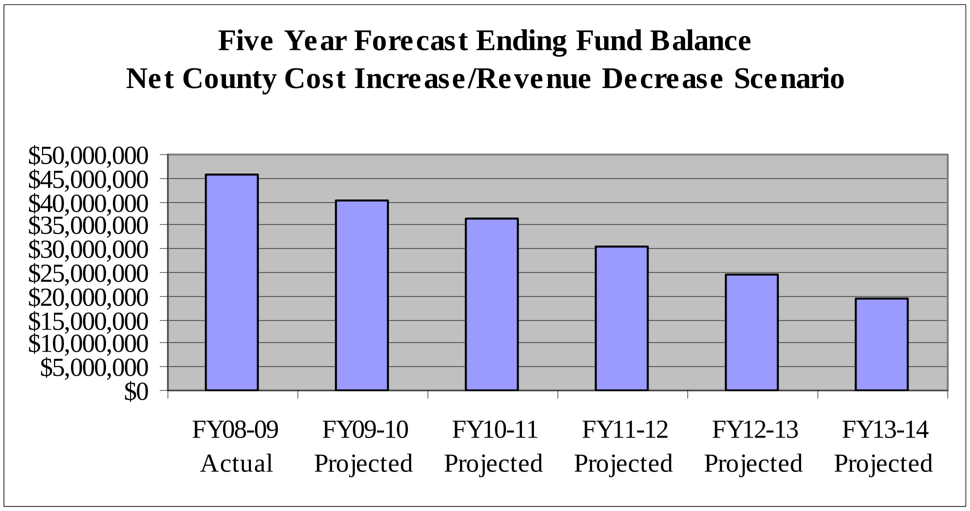
The following table shows the results of the Baseline Scenario Forecast:



In summary, the Baseline Scenario shows that the projected General Fund unrestricted fund balance at the end of FY2013-14 will be in the area of $35 million.[4] This represents a decrease of $13 million, or 27%, from the FY2008-09 actual unrestricted beginning fund balance level. For budget purposes, by FY2013-14 it will likely be necessary to use approximately $11 million in fund balance to balance the General Fund budget and that would leave approximately $26 million available to cover General reserves and designations). Since Board policy calls for maintaining at least 10% of General Fund appropriations in General Reserves or unrestricted designations, this means that, under this scenario (which, again, assumes no new positions or programs or service level increases), the General Fund could likely make it to FY2013-14 without significant reductions in spending (except possibly in Health & Human Services), but would then be required to look at additional budget reductions.

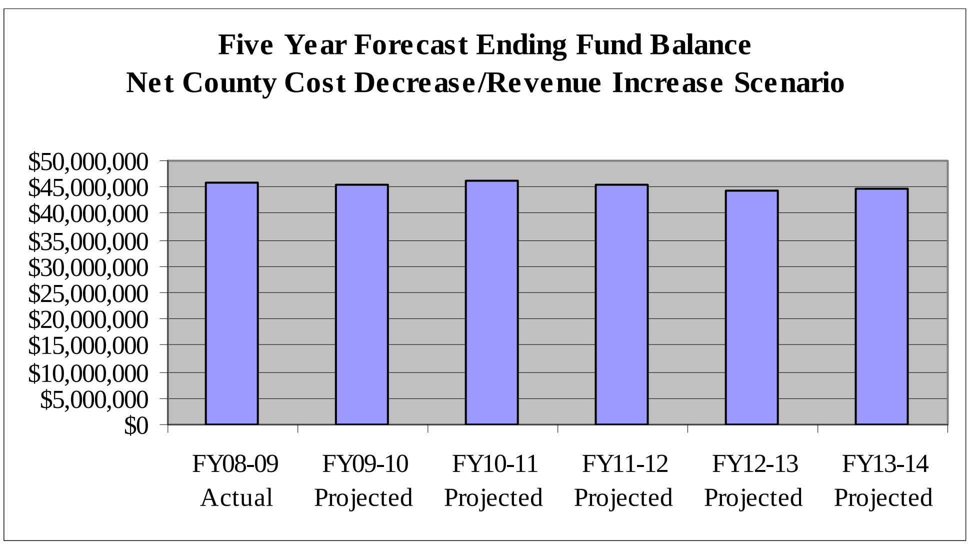
[4] The unrestricted fund balance includes the undesignated/unreserved fund balance, General Reserves and designations that are not legally earmarked or restricted. It does not include designations legally restricted for a particular purpose. The unrestricted fund balance is the fund balance that the Board could spend down in order to balance the General Fund budget.

The following table shows the results of the Revenue Reduction/Expenditure Increase Scenario:



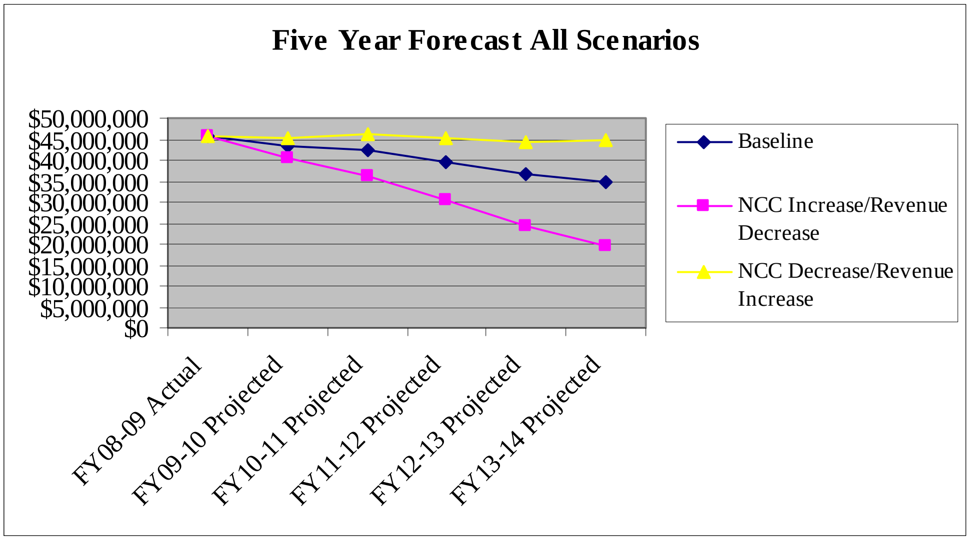
Under this Scenario, the projected unrestricted fund balance at the end of FY2013-14 would be approximately $20 million. This means that in FY2013-14 it would not be possible to balance the General Fund budget and still adhere to the Board's policy of maintaining at least 10% of General Fund appropriations in General Reserves and unrestricted designations.

The following table shows the results of the Revenue Increase/Expenditure Decrease Scenario:



Under this Scenario it would be possible to make it through FY2013-14 with essentially no decrease in Fund Balance.

The results of the three Forecast Scenarios are shown on the following table:



As can be seen, this Forecast is significantly more positive than the April 2009 General Fund Forecast. Staff believes that there are a number of factors contributing to this, but most significantly, this Forecast includes between $6 million and $4 million a year in excess excess ERAF revenue that was not included in the April Forecast, inflation assumptions are lower than in the April Forecast and, unlike the April Forecast, this Forecast assumes no cost of living increases for employees in FY2009-10 and FY2010-11. These factors are partly offset by lower discretionary revenue increase assumptions than in the April Forecast. In addition, for reasons that are not entirely clear, it appears that Forecasts based on the prior fiscal years' actual expenditure and revenue numbers are somewhat more optimistic then Forecasts based on the current year's Mid-Year revenue and expenditure projections.

A projected FY2013-14 ending fund balance that ranges from $45 million to $20 million, and that varies so significantly from the Forecast provided in April, illustrates the sensitivity of such projections to the methodology and assumptions used in making them. And, in fact, it is likely that the General Fund's actual fiscal condition in any future year will be better or worse than those numbers suggest, since circumstances over the next five years will likely differ from all of the estimates. And this is particularly true at this time, when there is significant uncertainty about what will happen with the economy and questions about major revenue sources, such as excess excess ERAF and the magnitude of the State's fiscal problems. Notwithstanding this, staff believes it is possible to draw a number of conclusions from these projections:

- First, it appears that, absent any corrective action, the General Fund will likely not be in structural balance over the upcoming five-year period, though the situation now seems to be less serious than was suggested by the April Forecast. The

Baseline Scenario shows Net County Cost exceeding discretionary revenues by an average of $2.2 million, or 2%, a year. This is a deficit that should be manageable without severe budget adjustments. However, as noted, there is more than the normal amount of uncertainty concerning economic and fiscal conditions, and relatively minor changes could have significant impact. As the Net County Cost Increase/Revenue Decrease Scenario shows, revenue decreases or expenditure increases of just 3% would increase the average annual deficit to over $5 million.

- Second, given the relatively robust nature of the General Fund's fund balance, we are not facing a crisis. We have time to implement the Board's approved Fiscal Contingency Plan in a careful and thoughtful way. The Board has already approved implementing the first seven Longer-term Actions in the Fiscal Contingency Plan and the Five Year Forecast reflects that implementation. It does not, however, fully reflect the result if implementing Longer Term Action 7 – moderate reductions to programs on a case-by-case basis, focusing first on programs appropriately funded by dedicated resources. It would make sense to move to more fully implement Longer-term Action 7, but in a very careful and incremental way, recognizing that the General Fund's actual fiscal situation could be better than the Baseline Scenario Forecast rather than worse.

8 – POLICY ISSUES AND RECOMMENDATIONS

Fiscal Contingency Plan Longer-term Action 7

To address the General Fund's projected structural deficit, the Board approved implementation of Fiscal Contingency Plan Longer-term Action 7. That Action reads as follows:

> Moderate reductions in discretionary support will be made on a case-by-case basis. These reductions will focus first on programs appropriately funded by dedicated resources (such as fee supported programs where fees are not yet at full cost recovery or State or Federal programs where the County provides an over-match). Reductions made at this point will generally have only a limited impact on service levels and may, in some cases, be offset by increases in fees.

Implementation of Longer-term Action 7 was, for the most part, not reflected in the FY2009-10 Adopted Budget and staff indicated we would return to your Board at this time with recommendations in this regard.

In accordance with Longer-term Action 7, staff focused our initial analysis of potential Net County Cost savings on programs appropriately supported by dedicated resources. Most of those programs fall into two functional areas:

- Health & Human Services

- Community Resources

We also focused our efforts on cost savings that would make a significant difference in the General Fund's long-term fiscal condition.

The Health & Human Services Agency receives approximately $60 million a year in funding from the State and Federal governments, primarily to fund various State or Federal programs administered by the County. By Board policy, the Agency's Net County Cost is fixed at $11.01 million. Of that $11.01 million, approximately $4 million represents the County's legal maintenance of effort or match requirements. The remaining $7 million represents discretionary investments by the Board in health and human services programs. This is often referred to as the County's "overmatch."

Unfortunately, as discussed above, the Health & Human Services Agency has experienced some significant revenue reductions in recent years, necessitating program elimination and staffing and service level reductions. Thus, with one exception, staff does not believe it would be possible to reduce the Agency's Net County Cost beyond a nominal amount without having more than a limited impact on service levels. The one exception is approximately $420,000 in Net County Cost the Agency currently receives to fund the County's contribution to the cost operating four homeless shelters. The County's Community and Intergovernmental Affairs (CIA) Division recently received an analysis that confirmed that the cost of funding these shelters can legally be paid for out of the County's Affordable Housing Fund.

In terms of the Community Resources departments, the Board recently approved fee adjustments for property-related programs. The new fee schedule, though it is projected to result in a significant increase in fee revenues to the relevant departments, by design will not fully recover the cost of all of those programs through fees – Board policy calls for recovery of 80% of the cost of certain Planning and Environmental Management program costs through fees. Thus there is an opportunity to reduce the Net County Cost by increasing certain fees to recover 100% of certain program costs. However, since the Board just approved the new fee structure in May of this year, staff believes it may be difficult to increase fees again in the near future. Notwithstanding this, staff's from the various Community Resources departments have, though, identified certain one-time expenditure reductions that can be made (by keeping positions vacant or cutting back on the use of extra help employees) and revised fee revenue projections for an estimated Net County Cost savings in FY2009-10 of approximately $640,000. For the most part, though, these are FY2009-10 reductions only and the impact is already reflected in the updated General Fund Five Year Forecast discussed above.

One Community Resources department where it may be possible to reduce the General Fund Contribution on a longer-term basis is the Library. As indicated above, the Library currently has its own property tax levy that generates most of the funding for Library operations. In addition, the Library receives contributions from the County General Fund and various cities to pay for extended hours of operations. Currently, the County General Fund makes a $167,000 annual contribution to the Library Fund - matched by a similar contribution from the City of Napa - to help pay for the cost of 14 hours of operation at the downtown Napa Library (for a total of 66 hours of operation). This allows the Library to be open 3 hours on two evenings a week and 7 hours on Sundays. If the County's General Fund contribution to the Library is reduced, it is possible that the City of Napa will eliminate its contribution as well.

Staff believes that reducing this General Fund contribution may have merit because:

- Although the loss of this funding could result in the Library reducing the period it is open by 14 hours a week and this is not insignificant, as discussed above, the Library Fund has a substantial fund balance and the Board could, if it chooses, backfill that reduction with Library Fund monies – though this may have implications for the level of service at other libraries as well. The Library is currently working on a Fiscal Analysis Study that will address the appropriate funding level for all County libraries and it would be timely to factor this issue into that Study.

- Some of the hours funded with this money do not appear to be heavy-usage periods.

In addition to possibly funding the County's homeless shelter costs, the legal analysis related to use of Affordable Housing Fund monies suggests that those monies could also be used to cover the County's share of cost for operating the County Housing Authority ($190,000) and a portion of the time of the County staff person who administers the Affordable Housing Fund ($68,000).

Thus, using Affordable Housing Fund monies to fund the County's current contribution to homeless shelters and the County Housing Authority and half the time of the staff person working on Farmworker Center issues, could reduce Net County Cost by approximately $678,000. The Affordable Housing Fund has a current uncommitted fund balance of approximately $12 million and last fiscal year received approximately $3 million more in revenue then it spent. The CIA is currently working on a more aggressive plan to facilitate affordable housing loans, but the Fund certainly has sufficient resources to cover $678,000 in additional costs for the foreseeable future.

At this point, staff is recommending that the Board authorize the use of Affordable Housing Fund monies to cover the cost of the County's contribution to homeless shelters and the County Housing Authority and part of the cost of the staff person who is working on Farmworker Center issues, beginning with the current fiscal year. Staff is also recommending that the Board direct staff to work with the Library Department to work out the implications of discontinuing the County's $167,000 General Fund contribution to the Library, with a goal of implementing that change, if feasible, in FY2010-11.

Finally, staff have identified FY2009-10 expenditure reductions and additional revenues in a variety of non-Community Resources departments that can reduce Net County Cost by approximately $700,000. Examples include a reduction of Information Technology

Services (ITS) charges to departments due to scaling back training and infrastructure enhancements, keeping positions vacant, using more on-line employee training and using ARRA funds to offset General Fund costs. For the most part, these savings are short-term (this fiscal year only) and are already included in the updated Five Year Forecast.

Staff would not recommend any other budget reduction actions at this time. Based on the revised Five Year Forecast it is not clear exactly what the magnitude of required reductions might be and staff does not believe it is prudent to make further reductions until we have a better sense of the General Fund's fiscal status later in the year.

Proposition 1A Property Tax Borrowing Securitization

As discussed above, For Fiscal Year 2009-10 the State has invoked the fiscal emergency provisions of Proposition 1A and will borrow an amount equal to 8% of FY2008-09 property tax revenue from cities, counties and special districts. In the case of Napa County this will amount to $6,124,548: $5,262,492 from the General Fund, $641,427 from the Fire Protection Fund and $456,629 from the Library Fund. As also discussed above, the budget package approved by the Legislature authorizes cities, counties and special districts to essentially sell their loans to the California Statewide Community Development Authority (CSCDA). That Authority, in turn, is authorized to sell bonds to pay the local governments the full value of their loan amounts, with the State being responsible for all costs of issuance and debt service, including interest costs, up to a maximum of 8%. If a local government does not sell its loan to the CSCDA, the budget package requires the State to repay the local governments the full amount borrowed by June 30, 2013 at a rate to be set by the Director of Finance, but not to exceed 6%.

The question the Board must now consider is whether Napa County will sell its loan to CSCDA or take a loss of $6.1 million in property tax revenues in FY2009-10, with the expectation of being repaid in FY2012-13[5]. From staff's perspective, there are three factors to consider in making this decision:

- Does the County have sufficient cash to cover likely expenditures if we decide not to securitize;
- What is the net rate of interest the County will earn on the borrowed funds if we chose not to securitize;
- What are the risks of securitizing vs not securitizing.

With regard to the first factor, as the General Fund Five Year Forecast and the discussion of operating fund balances status provided above suggests, it seems likely the County will have sufficient cash available to cover on-going expenditures under most reasonable

[5] The following discussion assumes that the Legislature passes a clean-up bill making certain technical changes in the law that will make it easier for CSCDA to securitize the Proposition 1A debt and, in particular, ensure that the debt can be tax exempt. That clean-up bill failed at the end of the last Legislative session due to partisan infighting. There is every reason to hope that a similar bill can be passed in the near future. If not, it is still possible that the securitization can take place, depending on interest rates, but it is not certain and will be more difficult.

scenarios. Nevertheless, given the State's continuing fiscal problems, there is some risk that the State will be forced to defer a significant amount of county funding.

With regard to the second factor, it is not possible to determine what that net interest rate will be at this time. Currently, the County is earning approximately 1.4% on its investments, but that rate could change over time. The Director of Finance is expected to set the interest rate the State will pay for the loan on September 28th. Assuming the best case scenario, however, if the State sets a 6% interest rate (which we do not think likely) and the County were to earn, say 2% a year on our investments, the net annual return to the County for loaning $6 million to the State would be approximately 4%, which would equate to approximately $700,000 over 3 years.

The budget package that authorized CSCDA to securitize the local government loans to the state made it clear that this securitization was to be at no cost to the local governments. Staff is reviewing the loan documents to confirm that this is the case, but assuming this is true, in staff's view the main risk to the County of securitization is that there would be some recourse against the County if the State failed to pay debt service on the bonds. At this point, a preliminary review of documents available from CSCDA suggests that there would be no recourse against the County. In addition, the budget package makes payment of the CSCDA loan securitization payment a priority, only exceeded by the State's obligation to pay General Obligation bond debt service and payments to schools under Proposition 98.

Staff believes that the main risk of not securitizing the County's loan to the State is that, given its serious financial problems, the State will find some way not to repay the loan in 2013. In our view, the State will always make every effort to pay bond-holders since not to do so would jeopardize the State's ability to issue any further debt. However, the money "borrowed" from local governments is not the same as bonded debt and, as we have seen with the deferral of payments for SB 90 claims, the State is not adverse to finding ways to evade its obligations to pay local governments money we are owed. Thus, while we think it is very unlikely the State will not meet its debt service obligations for bonds issued by CSCDA, we believe there is a greater likelihood the State will not repay local governments the property tax money borrowed from us, despite the constitutional requirement that they do so (though it is likely that failure by the State to make the repayment would result in legal action).

Taking all of this into account, staff believes that, on balance, the prudent thing to do is to participate in the CSCDA securitization program (assuming relevant legal issues are resolved and securitization is possible at no cost to the County). Although we believe the risk involved in not securitizing is small, it is a real risk and the amount of net interest earnings from not securitizing is not so great as to counterbalance that risk.

<u>Fiscal Contingency Plan Short-term Actions</u>

The Board previously authorized implementation of the five Fiscal Contingency Plan Short-term Actions. Those Actions are:

1. A selective hiring freeze.
2. Halting implementation of new programs that are not revenue offset.
3. Stopping major General Fund supported office remodels, unless required to address critical health or safety needs.
4. Selectively defer contracts for services not fully revenue offset.
5. Selectively defer purchase of equipment.

These Actions were initially implemented, pending the completion of the County's FY2009-10 Budget process, when there was considerable uncertainty about how the State would deal with it's FY2008-09 and FY2009-10 budget shortfalls and what the impact of the economic downturn would be the County's discretionary revenues. At that time, County staff were concerned both about potential actual reductions in funding and proposals by the State to defer the payment of certain funds to counties.

The County now has a FY2009-10 Budget in place that reflects certain cost savings called for by the Board. In addition, as described above, the State has passed budget packages in an attempt to address its fiscal problems and we have a somewhat better idea where the County stands fiscally. Given that, it might seem appropriate to end implementation of the approved Short-term actions. Staff is recommending that these Actions be continued through the end of this fiscal year, however, for the following reasons:

- The updated General Fund Five Year Forecast, though more optimistic then the previous Forecast, still projects a structural imbalance and there are many uncertainties with regard to some of the assumptions contained in the Forecast, such as how much excess excess ERAF the County will receive.

- The economy continues to be volatile. Our projections are based on what seems to be a widely held view among economists, but it is by no means a certainty. Things could be significantly worse than our projections assume.

- Perhaps most importantly, as also discussed above, the State is likely to be facing significant deficits over the next few years. We are once again in the position of not knowing how those deficits may impact counties.