COUNTY of NAPA

NANCY WATT
County Executive Officer

BRITT FERGUSON
Assistant County Executive Officer

To: Board of Supervisors

From: Nancy Watt, County Executive Officer

Date: April 1, 2008

Subject: **GENERAL FUND FIVE-YEAR FORECAST**

Introduction

As your Board will recall, on March 11th, we provided you with a mid-year review of the County's fiscal status. That review included an estimate of what the General Fund's fiscal condition will be at the end of the current (2007-08) fiscal year. As the next step in the budget process, we are providing you with a forecast of what the General Fund's fiscal condition could be like over the next five years.

As you know, in making budget decisions for the next year, it is important to look at future years as well. This is because revenue/expenditure decisions made in one year can have a significant impact on the resources that will be available to fund General Fund programs in future years.

Forecasting Methodology

Given all the uncertainties, forecasting revenues and expenditures a number of years into the future is a problematic undertaking at best. We base our future years' projections in part on estimates of current year revenues and expenditures and actual current year revenues and expenditures may differ from those estimates. In addition, we make a number of assumptions about what will happen over the next four years in terms of such things as inflation rates, state budgets, state law changes, union contract negotiations and local economic conditions.

Given our inability to predict the future, in many cases our assumptions may well 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 you with three different forecast scenarios:

Baseline Scenario: 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 very likely changes in revenues/expenditures. The following are some of the key assumptions used in this scenario:

COUNTY EXECUTIVE OFFICE
1195 Third Street • Suite 310 • Napa, CA 94559 • (707) 253-4421
www.co.napa.ca.us FAX (707) 253-4176

- Our projected Net County Cost for FY2007-08, as reflected in the Mid-Year fiscal report to your Board, adjusted to reflect the historical difference between the Mid-Year projection and year-end actuals, is considered the "base year" for future projections.

- Generally, the projections assume no General Fund supported staff increases after the current (2007-08) fiscal year.

- The projections assume that $500,000 will be spent on General Plan update implementation and the Housing Element update in FY2008-09 and that $250,000 will be spent for these purposes each of the succeeding fiscal years. The projections assume that the County will continue to incur approximately $200,000 a year in General Fund costs related to operating the Napa County Housing Authority. The projections do not assume any loss of property tax revenue from the City of Napa's new Soscol Avenue Redevelopment Project.

- The projections assume that inflation rates will be in the area of 3 to 4% annually, and that the "cost of doing business" will increase by that amount for most contracts and purchases. The projections assume that salary and retirement costs will increase by approximately 6% annually (including annual cost of living increases, step increases for eligible employees and a limited amount of equity increases for positions that are significantly below the market). The projections do not assume significant increases related to classification and compensation/equity studies or labor negotiations. This is based on the fact that the County conducted equity studies annually for three years (through FY2006-07) for most County positions and just completed negotiations on new memoranda of understanding with the unions representing County employees and thus salaries should be close to the market average. The projections assume that employee medical insurance costs will increase at a declining rate starting at 10% in FY2008-09, based on projections provided by the County's actuarial consultant.

- The projections assume the County will begin pre-funding our Other Post Employment Benefits (OPEB) unfunded liability in FY2007-08 based on a 14-year amortization.

- The projections assume that, in FY2008-09, a $1.9 million General Fund designation for the Road Fund will be cancelled and the money transferred to the Road Fund, but that no additional General Fund resources will be transferred to the Road Fund during this five-year period. The projections also assume that the $723,000 loaned by the General Fund to the Road Fund in FY2005-06 will not be repaid during this period.

- The projections assume that most revenues will grow or decline based on past trends or known 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). For the Health & Human Services Agency, the projections assume that the FY2007-08 Net County Cost will be held constant throughout the five-year period (except for an adjustment to account for the decision to allocate OPEB costs to the various operating departments).

- In terms of major discretionary revenues, the projections assume that the rate of property tax revenue growth will decline to 2% in FY2009-10 (from a projected FY2007-08 growth rate of 8%) and then gradually increase, for an average annual growth rate during this five-year period of 4%. This reflects the downturn in the housing market and constrictions in the credit market being felt nationally and in California, but assumes that the impact will not be as severe in Napa County as it will be in some other counties in the State. The projections assume that sales tax revenue will increase by an average of 4% a year and transient occupancy tax revenue will increase by an average of 2.6% per year. These assumptions reflect the general slowing of national economic growth that appears to be occurring, but, again, with the expectation that the impact will not be as severe in Napa County as was the case with certain previous economic downturns, such as the period following the dot.com bust and 9/11.

- In accordance with your Board's Budget Policies, the projections assume that all discretionary revenues that your Board has not previously earmarked for a particular purpose will be available to fund any General Fund programs as needed.

- In accordance with the policy adopted by your Board, the projections assume that in FY2008-09 the General Fund contribution to the Special Projects Fund will be 12.5% of the actual calendar year 2007 Transient Occupancy Tax (TOT) collections. In later years, the General Fund contribution to the Special Projects Fund is projected to grow at the same rate as TOT revenue.

- The projections assume no major increase 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 supported positions or new General Fund supported programs beyond those already in existence in FY2007-08.

- As indicated above, the projections assume that Napa County's discretionary revenues will be negatively impacted by the slowdown in the national economy and the collapse of the housing bubble, that that slowdown will not be severe and will last for roughly a year and then the economy will gradually begin to recover and that the impact will be less severe in Napa County than in certain other parts of the State. This is based on various economic forecasts and on the most recent information available on sales tax and transient occupancy tax revenues (however, some of this data is a number of months old).

The projections also assume that the overall rate of inflation will increase moderately over the next few years, compared to the recent past, and then decline to roughly the level experience this last year or so. This is based on the most recent economic data available to staff. However, in some cases, this includes forecasts that are a number of months old and the economy is in a state of significant flux at the moment, making these sorts of estimates difficult. As the Board is aware, some economists have suggested that the nation may be at risk of moving into a period of "stagflation" as was experienced in the in the late 1970s. This does not appear to be the consensus view among economists and our projections do not assume that will occur.

- The projections assume no major changes in state or federal funding sources and methodologies. The projections also assume that the County will not have to make significant "paybacks" to the state or federal government based on audits or reviews of Health & Human Services programs. The General Fund's fund balance currently includes approximately $900,000 in designations to cover certain potential "paybacks," but that might or might not be enough to cover the cost, and any paybacks would reduce the fund balance further than indicated in the baseline projection.

<u>Revenue Reduction/Expenditure Increase Scenario:</u> This scenario is designed to provide a measure of what the impact on the General Fund might be of a reduction 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 $2 million, or 2%, increase in Net County Cost starting in FY2008-09.

A 2% Net County Cost increase or discretionary revenue decrease is well within the realm of possibility and could result from a variety of factors or combination of factors. For example:

- The current contracts between the County and the two unions representing most County employees calls for providing cost of living adjustments (COLA's) to those employees based on the annual increase in the Bay Area Consumer Price Index (CPI) and, if inflation were to increase significantly, that CPI could increase at a higher rate than assumed in the Baseline projection. In addition, the current union contracts will expire in June of 2009 and new contracts will need to be negotiated at that time. Those new contracts could provide for a higher COLA level or equity adjustments that are higher than the level assumed in the Baseline projection.

- As part of the FY2008-09 budget process, Departments have presented the County Executive Office with requests for a variety of new positions or programs. If the Board were to agree to fund those requests, annual Net County Cost would increase.

- The Board could commit to General Fund investment in facilities beyond the $1 million a year included in the Baseline projection for capital projects. The Board has already agreed to move forward on planning for the construction of replacement and/or new jail beds, although the exact number and cost of those beds has not yet been determined. In addition, the County is currently completing a comprehensive space study that will identify our longer-term needs for office and clinic space, but we already know that there are significant space deficiencies, particularly on the Health & Human Services campus. The Board has prudently set aside approximately $15 million on the Accumulated Capital Outlay (ACO) Fund to help finance future capital projects, but the cost of needed improvements could easily exceed that amount.

- In December of 2007, your Board approved the Adult Correctional System Master Plan Phase I recommendations, which included the construction of new/replacement jail beds, the development of a Community Corrections Service Center and the implementation of new and enhanced programs in a number of areas. In addition to the capital cost, many of these recommendations will involve a significant increase in operating costs. This will likely result in increased Net County Cost.

- The preparation of the County's General Plan update could take longer than expected, and the County's additional cost could continue beyond FY2007-08. Although, as indicated above, the projections include funding in future years for implementation and Housing Element update costs, if the General Plan process itself continues, annual costs could be higher.

- The County could have to pay back funds to the state or federal governments as a result of audits of various Health & Human Services programs.

- Property tax or other discretionary or departmental revenues could grow at a rate that is less than the level assumed in the Baseline projections (every 1% change in property tax revenues equates to almost approximately $500,000). As indicated above, the Baseline scenario assumes that the Health & Human Services Agency's Net County Cost will not increase during the five-year projection period (which means, for example, that any cost-of –doing business increases would need to be absorbed within the Agency's revenues). Depending on what happens with inflation and/or with state and federal funding, the Board may feel it is necessary to augment that Net County Cost rather than see the Agency make significant reductions in staffing and/or services.

- An increase in inflation could result in a higher cost of doing business generally.

<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 revenues 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 $2,000,000 decrease in Net County Cost, starting in FY2008-09.

A discretionary revenue increase or Net County Cost decrease such as this is also within the realm of possibility. For example, Realignment, Proposition 172 revenue and/or certain discretionary revenues could grow at a higher rate than assumed in the Baseline scenario; costs for capital improvements could be lower than $1 million in one or all of the next four years; inflation could be lower than projected; or salary savings could be greater than expected due to higher employee turnover rates.

<u>Forecasts and Analysis</u>

The results of the three forecasts are shown on the attached exhibits. In summary, the Baseline Scenario shows that, assuming things generally stay the way they are in terms of staffing and capital costs (except for known or reasonably expected changes) and based on our best understanding of what is happening in terms of the economy, the projected General Fund fund balance at the end of FY2012-13 should be in the area of $18 million – a decrease of approximately $34 million from the FY2007-08 beginning fund balance level. For budget purposes, by FY2012-13 it will likely be necessary to use approximately $13 million in fund balance to balance the budget and that would leave approximately $9 million in fund balance to cover General Reserves and designations (it is typically necessary to budget for a higher level of expenditures than actually occurs, since the budget includes a contingency and typically does not reflect all of the salary savings that occur during the year).

Under the Revenue Reduction/Expenditure Increase Scenario, the projected fund balance at the end of FY2012-13 would be approximately $8 million. For budget purposes, by FY2012-13 it would likely be necessary to use approximately $15 million in fund balance to balance the budget, which would essentially utilize all of that year’s beginning fund balance, totally depleting the General Fund’s reserves.

Under the Revenue Increase/Expenditure Decrease Scenario, it should be possible to make it through FY2012-13 and end the year with a fund balance of approximately $28 million.

This year’s General Fund Five Year Forecast is significantly more pessimistic than last year’s forecast. As the Board may recall, last year the Baseline Scenario projected that the General Fund’s ending balance in FY2011-12 would be approximately $48 million. This year’s Baseline forecast is that the FY2011-12 ending balance will be approximately $23 million – a $25 million, or 52%, reduction – and, as noted, this year’s forecast projects that the FY2012-13 ending balance will decline to $18 million. This rather large shift in the Fund's fiscal prospects is the result of a number of factors, including:

- Discretionary Revenue Decreases: As discussed above, due to the housing market problems and the general downturn in the economy, we have revised downward the growth estimates for a number of the County's discretionary revenue sources, such as property and transient occupancy taxes. If growth in these revenue sources in this years' Five Year Forecast had been projected at the same level as in last year's Five Year Forecast, total discretionary revenue received over the five-year period would have been approximately $10 million higher.

- New Positions: As part of the FY2007-08 Budget, the Board approved the addition of 10 new General Fund-supported positions. The total cost of these positions (salary and benefits) over five years is approximately $5 million.

- OPEB Costs: Last year's Five Year Forecast projected the County's OPEB costs based on a 20-year amortization. Based on the Board's final pre-funding decision, this year's Forecast projects those costs based on a 14-year amortization. The total cost impact of this change over five years is approximately $3 million.

- Transfer to Road Fund: As part of the FY2007-08 Budget, the Board established a designation of approximately $1.9 million to be transferred to the Road Fund once the Public Works Department develops a spending plan. As mentioned above, this year's Five Year Forecast assumes that money is transferred out of the General Fund and into the Road Fund in FY2008-09.

- General Plan Implementation/Housing Element Update Costs: As described above, last year's Five Year Forecast assumed that there would be no additional General Plan-related costs over the five-year period in question. This year's Forecast assumes that $500,000 will be spent in FY2008-09 and $250,000 in each of the subsequent years to cover costs associated with implementing the General Plan update and preparing the statutorily required Housing Element update. The total cost of these expenditures over five years is $1.5 million.

- Higher Inflation: This year's Five Year Forecast assumes a slightly higher rate of inflation than last year's Forecast, with a total, cumulative, cost impact of approximately $1 million.

A projected FY2012-13 ending fund balance that ranges from $8 million to $28 million and that is significantly different from last years' projection, illustrates the sensitivity of such projections to the 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 these numbers suggest, since circumstances over the next five years will likely differ from all of the estimates. Notwithstanding this, staff believes it is possible to draw a number of conclusions from these projections:

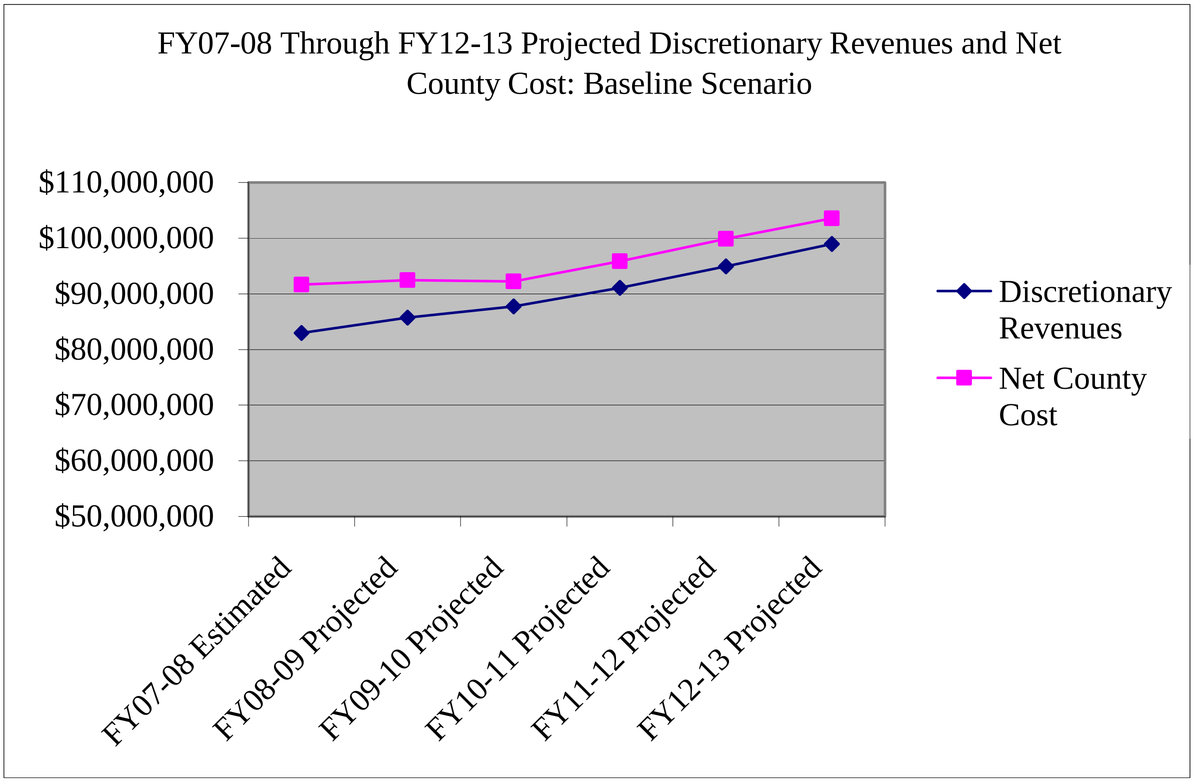
- First, as the Board will recall, last year's Five Year Forecast suggested that the General Fund was in structural balance, though a precarious one. This year's forecast suggests that the General Fund is likely not in structural balance, at least over this five-year period. Based on the information available, it is not clear whether the fund will come naturally back into balance as the economy improves – nor is it clear when and at what rate that improvement will occur. It is clear to staff, however, that it would not be prudent to wait five years to see what happens. The sooner we act to start addressing our projected fiscal difficulties, the less severe any actions will need to be in a particular year.

- Second, the fact that the fund balance is as robust as it is, means that we are not facing any sort of a crisis situation. Though our longer-term prospects are problematic, even we do nothing in FY2008-09 the projections show the General Fund ending that year with a healthy fund balance in the $35 million to $40 million range. Thus, staff does not believe that draconian actions are required at this time. Rather, we have time to craft and implement a thoughtful Fiscal Contingency Plan that will include policies and strategies to help us carefully calibrate our expenditures to maintain a minimally acceptable fund balance and move the General Fund toward structural balance.

- Third, with the possible exception of certain costs related to the on-going Adult Correctional Master Plan development process, staff does not believe that FY2008-09 is a year in which the investment of General Fund resources in new staff or programs would be appropriate.

- Fourth, in order to make the most prudent financial decisions in the long run, staff believes it is important to complete work on the Capital Improvement Plan (CIP) and Strategic Financial Plan. The latter, in particular, will help move the County beyond the exigent need to deal with more immediate fiscal difficulties to a strategy for insuring longer-term structural balance in the General Fund.

EXHIBIT A


FY07-08 Through FY12-13 Projected Discretionary Revenues and Net County Cost: Baseline Scenario
$110,000,000
$100,000,000
$90,000,000
$80,000,000
$70,000,000
$60,000,000
$50,000,000
FY07-08 Estimated
FY08-09 Projected
FY09-10 Projected
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
Discretionary Revenues
Net County Cost

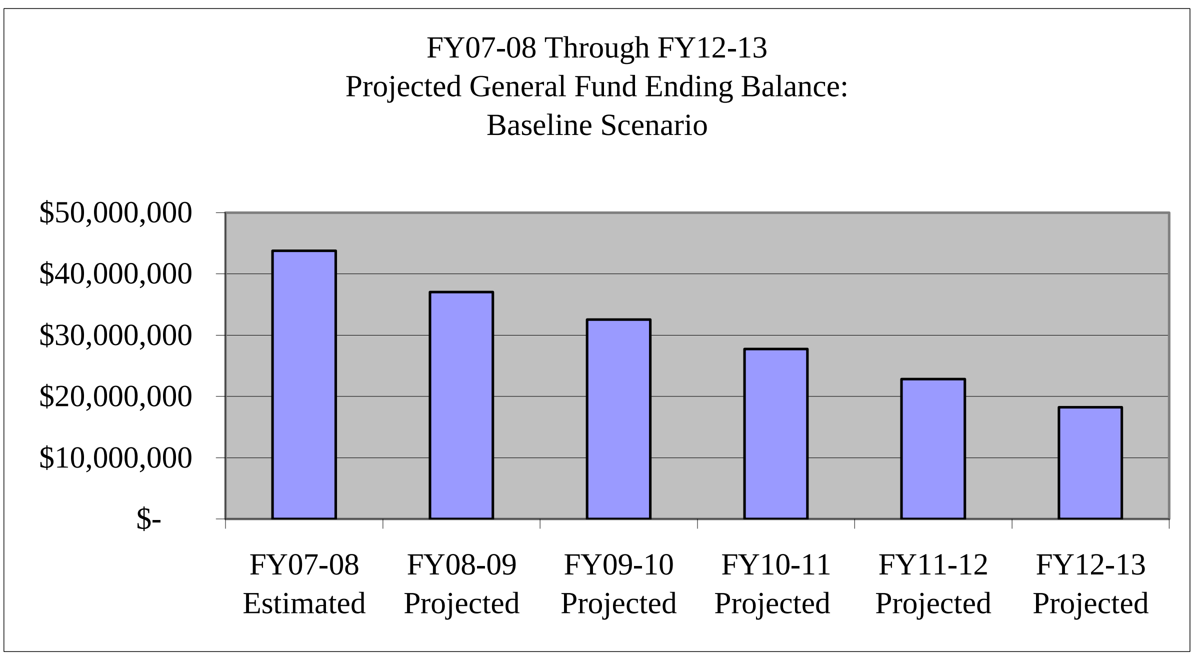
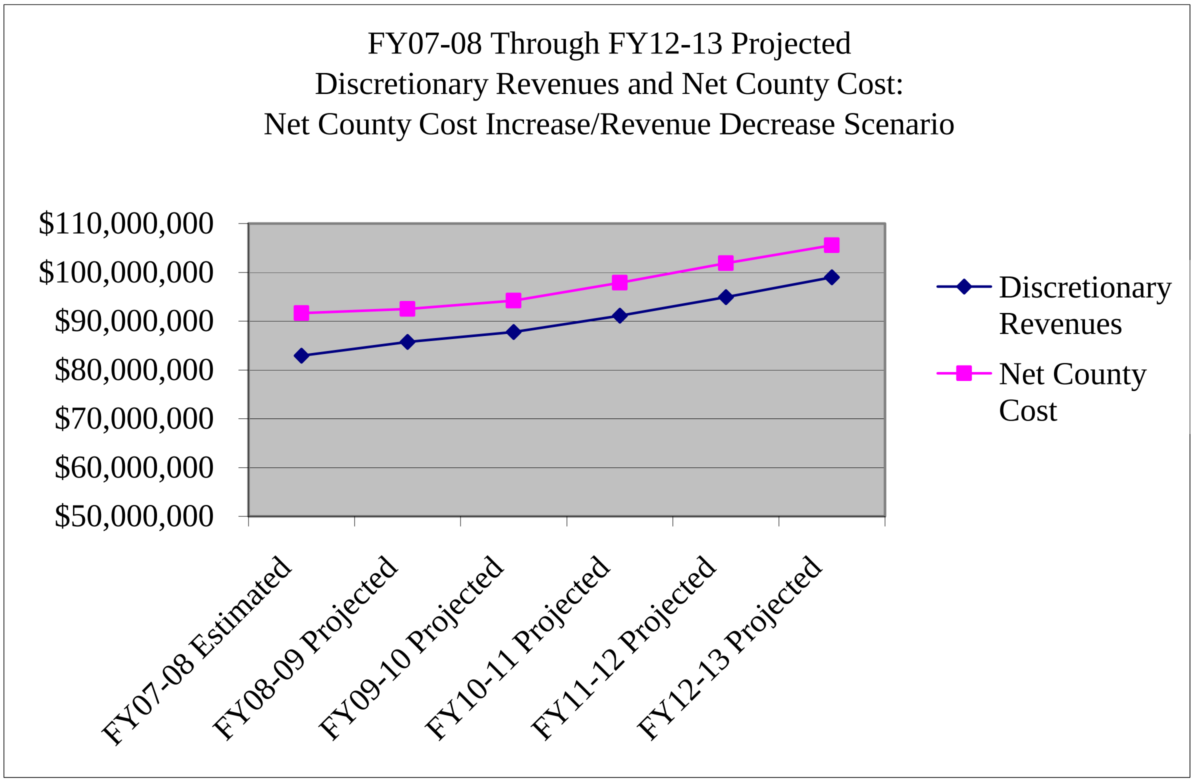

FY07-08 Through FY12-13
Projected General Fund Ending Balance:
Baseline Scenario
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$-
FY07-08 Estimated
FY08-09 Projected
FY09-10 Projected
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected

EXHIBIT B


FY07-08 Through FY12-13 Projected
Discretionary Revenues and Net County Cost:
Net County Cost Increase/Revenue Decrease Scenario
$110,000,000
$100,000,000
$90,000,000
$80,000,000
$70,000,000
$60,000,000
$50,000,000
FY07-08 Estimated
FY08-09 Projected
FY09-10 Projected
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
Discretionary Revenues
Net County Cost

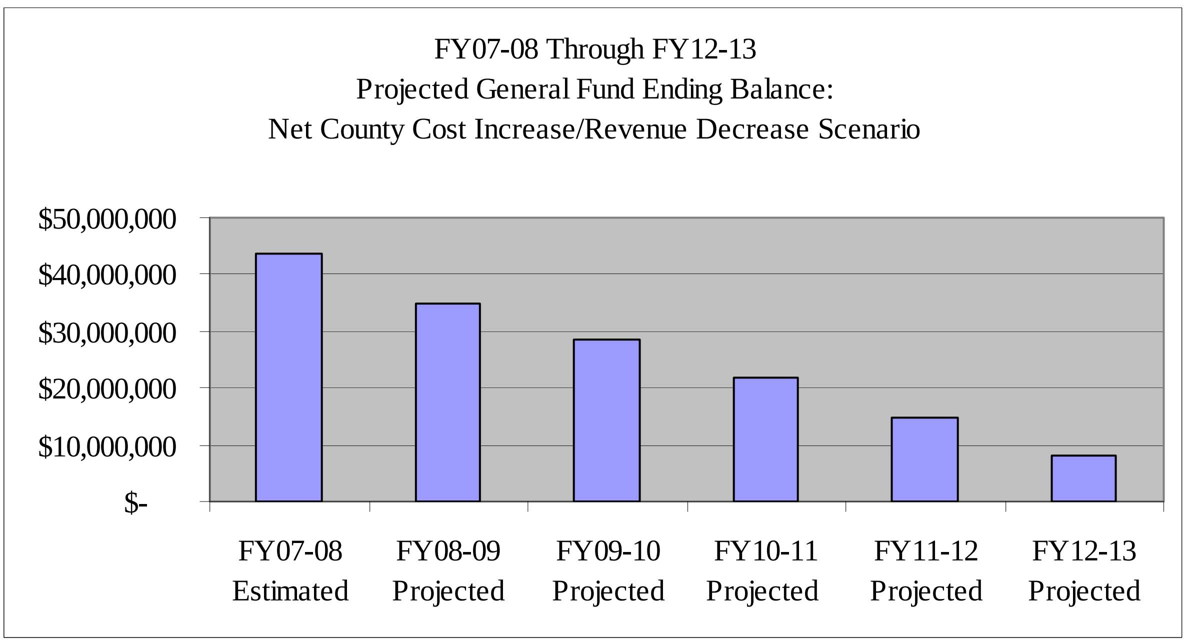
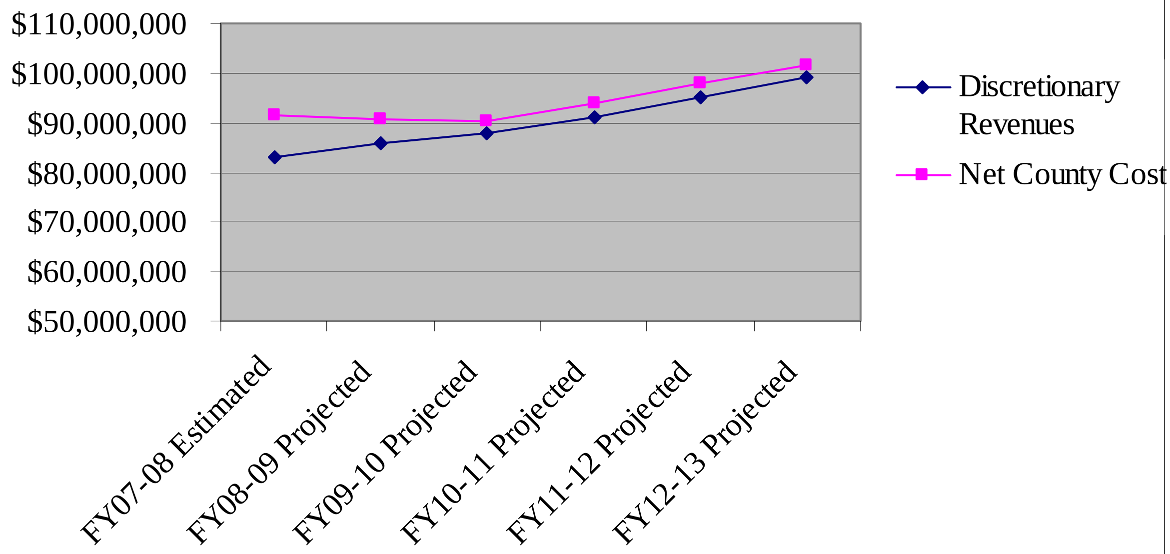

FY07-08 Through FY12-13
Projected General Fund Ending Balance:
Net County Cost Increase/Revenue Decrease Scenario
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$-
FY07-08 Estimated
FY08-09 Projected
FY09-10 Projected
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected

EXHIBIT C

FY07-08 Through FY12-13 Projected Actual Discretionary Revenues and Net County Cost:
Net County Cost Decrease/Revenue Increase Scenario



FY07-08 Through FY12-13
Projected General Fund Ending Balance:
Net County Cost Decrease/Revenue Increase Scenario

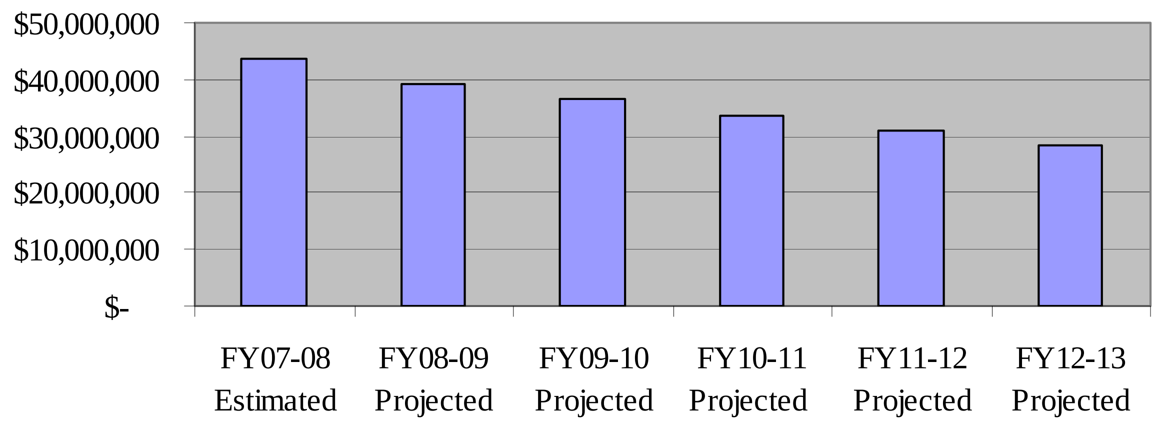
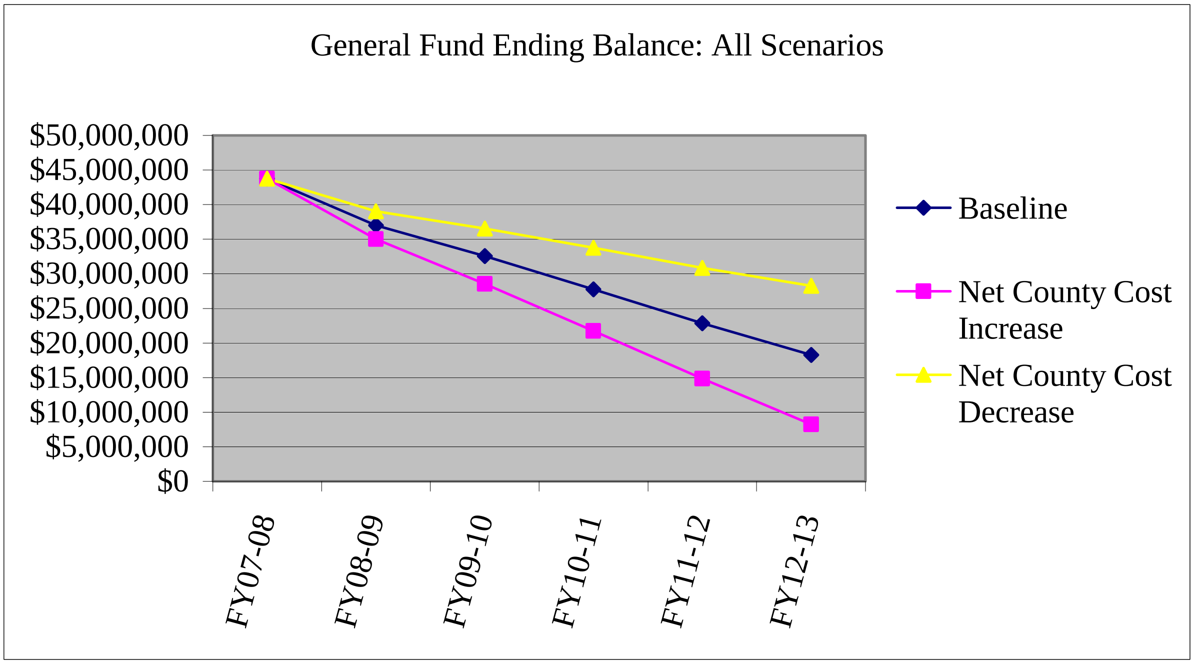


EXHIBIT D


General Fund Ending Balance: All Scenarios
$50,000,000
$45,000,000
$40,000,000
$35,000,000
$30,000,000
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
FY07-08
FY08-09
FY09-10
FY10-11
FY11-12
FY12-13
Baseline
Net County Cost Increase
Net County Cost Decrease