ATTACHMENT B

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A Tradition of Stewardship
A Commitment to Service

TO: Board of Supervisors

FROM: Nancy Watt, County Executive Officer

DATE: March 26, 2010

SUBJECT: **GENERAL FUND FIVE YEAR FORECAST**

Introduction

As your Board will recall, on March 23, 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 would be at the end of the current (FY2009-10) 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 revenue 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 five 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 not come to pass. In addition, with all of 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 reasonably likely changes in revenues/expenditures. The following are some of the key assumptions used in this scenario:

- Our projected Net County Cost for FY2009-10, as reflected in the Mid-Year Fiscal report to your Board, adjusted to reflect known changes since that report was prepared and 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 (2009-10) fiscal year. Exceptions include known adjustments, such as the addition of a Sergeant and two Sheriff's Deputies to the Sheriff's Department, consistent with the agreement with the Sheriff to fund replacement positions for Deputies assigned to provide Jail security starting in FY2009-10.

- The projections assume that approximately $200,000 per year will be spent on implementation costs related to the General Plan and Housing Element Updates, but that the General Fund will no longer contribute approximately $200,000 a year to the Napa County Housing Authority. Consistent with the Board's decision, County funding for the Housing Authority will now come from the Affordable Housing Fund.

- The projections assume that inflation rates will be in the area of 2% annually, and that the "cost of doing business" will increase by that amount for most contracts and purchases. The projections assume that there will be no cost of living increase for employees in FY2010-11 and that salary and retirement costs (including annual cost of living increases, step increases for eligible employees and any equity increases) will increase by approximately 3% to 4% per year over the rest of this period, except in FY2013-14, when retirement costs will increase by an additional 7% to reflect the impact of PERS investment losses. The projections assume that employee medical insurance costs will increase at a declining rate, starting at 9.9% in FY2010-11, based on projections provided by the County's actuarial consultant. It should be noted that retirement cost increase projections assume that the current provisions in the employee labor agreements regarding County/employee sharing in retirement cost increases will be retained.

- The projections assume the County will continue to fund our Other Post-Employment Benefits (OPEB) unfunded liability on a 20-year amortization schedule and that we will begin pre-paying our annual employee pension contribution (as opposed to the current practice of paying it bi-weekly), which will save approximately $200,000 a year in Net County Cost.

- The projections assume that the $480,000 previously loaned to the Napa-Berryessa Resort Improvement District will not be repaid during this period, that approximately $580,000 will be loaned to the Lake Berryessa Resort Improvement District in FY2009-10 and not repaid during this period and that an additional $100,000 a year will be loaned to the Napa-Berryessa Resort Improvement District over the next five years (for a total of $500,000) and not repaid within the projection period.

- In addition to typical annual capital improvement costs of about $1 million per year, the projections assume that approximately $1 million will be spent to replace the current Jail Control System, which has reached the end of its useful life and represents a potential safety and security issue in the Jail. Other than that, the projections do not assume any costs related to the construction of a new jail or new or renovated County buildings on the Downtown Campus or Health and Human Services Campus.

- The projections assume that the County will move forward on updating our financial management software and replacing our Criminal Justice Information System (CJIMS) and budget system software.

- The projections assume that the County will no longer make a $167,000 General Fund Contribution to the Library Fund to pay for extended hours at the Downtown Napa Main Library.

- The projections assume that the FY2010-11 Net County Cost for the Health and Human Services Agency (HHSA) will be held essentially constant throughout the five-year period. This means that if HHSA revenues (such as Realignment revenue) decline, HHSA will reduce expenditures to remain within the set Net County Cost.

- 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). In general, based on various economic forecasts, we are assuming that the recent economic downturn has bottomed out; that economic growth will remain flat for the rest of this calendar year and then begin a very gradual increase; and that neither retail sales nor property values will rebound to pre-recession levels or growth rates during the five-year forecast period

- In terms of major discretionary revenues, the projections assume that property tax revenue (except for Excess Excess ERAF) will decline by approximately 1% in FY2010-11, remain flat in FY2011-12 and then gradually increase, for an average annual increase of about 1.5% during this five-year period. This assumption is based on discussions concerning assessed value trends with the County Assessor. The projections assume that sales and use tax and transient occupancy tax revenue will increase by 2% in FY2010-11, with the year-over-year growth rate gradually increasing to 4% by FY2013-14. This assumption is consistent with our general views on current and future economic conditions as described above.

- The projections assume that the General Fund will receive $5 million a year in Excess Excess ERAF in each fiscal year, starting in FY2009-10. This is more than we currently expect to actually receive in FY2009-10 and FY2010-11 (approximately $11.1 million and $10 million, respectively), but is consistent with the premise that the County should not rely on the General Fund receiving more than $5 million a year from this source to fund on-going operations. Staff will be recommending this policy due to the volatility and uncertain future of Excess Excess ERAF as a General Fund revenue source. As part of this policy, staff will be recommending that any Excess Excess ERAF received in each year above the $5 million level be transferred to the Accumulated Capital Outlay Fund or used to address other critical one-time-only (non-ongoing) needs.

- The projections assume no major changes in state or federal funding sources and methodologies.

<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 FY2010-11.

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 County employees expire on June 30th and in October of 2010. As indicated above, the Baseline Forecast projections assume that new contracts will provide for no cost of living adjustments, equity increases or other cost impacts in FY2010-11, and that salary costs will increase by no more than 3% to 4% (including COLAs, equity increases and step increases) per year in future years. The Baseline Forecast also assumes that the current contract provisions that require the County and employees to share equally any PERS pension premium cost increases will also continue during the forecast period. If new contracts were to be negotiated that included additional salary and/or benefit cost increases, Net County Cost would be higher than projected. For point of reference, every 1% increase in salaries results in a roughly $450,000 increase in Net County Cost.

- The County's employee pension costs could increase at a greater rate than assumed in the Baseline Forecast due to higher-than-anticipated investment losses at CalPERS.

- The Board could commit to General Fund investments in facilities beyond the $1 million a year (plus the cost of the Jail control panel replacement) included in the Baseline projection for capital projects. The Board has already approved moving forward with planning for the replacement of the County Jail, which will cost an estimated $80 million. In addition, the recent facility study prepared for the County identified over $100 million in additional facility needs and the Board has prioritized addressing significant deficiencies at the Health & Human Services campus. The Board has prudently set aside $19 million in the Accumulated Capital Outlay

(ACO) Fund to help finance future capital projects, but the cost of needed improvements will easily exceed that amount.

- An increase in inflation, above the relatively low level assumed in the Baseline Forecast, could result in a higher cost of doing business generally. In addition to salaries and benefits, many of the County's contracts for services include provisions for increases based on the rate of inflation and many of the commodities the County purchases (such as fuel, for example) are subject to inflationary cost increases. Overall, a 1% increase in inflation results in an approximately $900,000 increase in Net County Cost.

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

- Property tax, sales tax or other discretionary or departmental revenues (such as Proposition 172 revenue) could decrease or grow at a rate that is less than the level assumed in the Baseline projections (every 1% change in property tax revenue, for example, equates to about $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/labor negotiations and/or 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.

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

- Excess Excess ERAF revenue could come in below the $5 million a year figure used in the Baseline Scenario. Staff does not think this is likely, but it is a possibility, particularly in the out-years of the forecast period.

<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 million decrease in Net County Cost, starting in FY2010-11.
A discretionary revenue increase or Net County Cost decrease such as this is also within the realm of possibility. For example, Proposition 172 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 five years; inflation could be lower than projected; salary savings could be greater than projected due to higher employee turnover rates; fee revenues could be higher than expected; negotiations with the unions could result in lower salary and benefit costs than projected;

Excess Excess ERAF revenue could come in at a higher level than predicted and/or the Board could choose to utilize more of that revenue to fund on-going operational costs; and/or the FY2009-10 actual revenue/expenditure gap could be less than the level estimated in the adjusted Mid-Year Fiscal Review.

Forecasts and Analysis

The results of the three forecasts are shown in 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), that the General Fund receives at least $5 million a year in Excess Excess ERAF but no more than that amount is used each year to fund on-going operations, and based on our best understanding of what is happening in terms of the economy, the General Fund's projected unrestricted, or available, fund balance at the end of FY2014-15 should be in the area of $30 million.[1] This represents a decrease of $17 million, or 37%, from the FY2009-10 beginning unrestricted fund balance level. Although slightly more pessimistic, this forecast is generally consistent with the Five Year Forecast provided to your Board in September of 2009.

Under the Revenue Reduction/Expenditure Increase Scenario, the projected unrestricted fund balance at the end of FY2014-15 would be approximately $20 million. Under the Revenue Increase/Expenditure Reduction Scenario the unrestricted fund balance will be reduced to approximately $40 million by the end of the 2014-15 fiscal year.

A projected FY2014-15 ending fund balance that ranges from $20 million to $40 million 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. Notwithstanding this, staff believes it is possible to draw a number of conclusions from these projections:

- First, it appears that, given the assumptions described above and absent corrective action, the General Fund will likely not be in structural balance over the upcoming five-year period. The Baseline Scenario projects an average annual Discretionary Revenue/Net County Cost deficit of about $3.4 million, or 3.5% of Net County Cost. Even the Revenue Increase/Expenditure Decrease Scenario projects an average annual deficit of approximately $1.4 million, or 1.4% of Net County Cost. Put another way, for the General Fund to be in structural balance, discretionary revenues would have to increase or Net County Cost decrease by a net average of approximately 3.5% from the Baseline Scenario level. This is not a huge deficit, but, unless

[1] 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.

economic conditions improve significantly, it will not be easily bridged, particularly since most departments have already tightened their budget belts over the last few years (to put this in perspective, if County employees did not receive any salary increases during this period – no COLAs, equity or step increases- it would still not be enough to cover that 3.5% gap). And, under the more pessimistic Revenue Reduction/Net County Cost Increase Scenario, the average annual deficit that would need to be bridged would be even larger - closer to $5.3 million, or 5.5% of Net County Cost.

- Second, the fact that the fund balance is as robust as it is means that we are not facing a crisis situation. Though our longer-term prospects are problematic, even if we do nothing in FY2010-11 the Baseline projection shows the General Fund ending that fiscal year with an unrestricted fund balance of about $44 million. Further, under the Baseline Scenario, the General Fund could, theoretically, make it through the 2012-13 fiscal year before major expenditure reductions would be necessary to ensure compliance with the Board's policy that calls for maintaining an unrestricted fund balance that is a least 10% of General Fund appropriations. [2] This gives us time to implement the Board-approved Fiscal Contingency Plan in a careful and thoughtful way.

- Third, despite uncertainties concerning the exact magnitude of the General Fund's structural imbalance, it would not be prudent to wait to take action to attempt to address this situation. Not only is there considerable uncertainty concerning the timing and rate of economic recovery and how that will impact the County's discretionary and semi-discretionary revenues, but the State is continuing to face a fiscal crisis that could impact the County's budget situation. At the same time, staff believes that it would be a mistake to implement drastic service level reductions until truly necessary. Thus the challenge is to carefully calibrate our budget actions to minimize the potential structural deficit but not make unnecessary expenditure reductions, and to do this with imperfect knowledge about a number of key factors – such as future economic conditions and the state budget decisions.

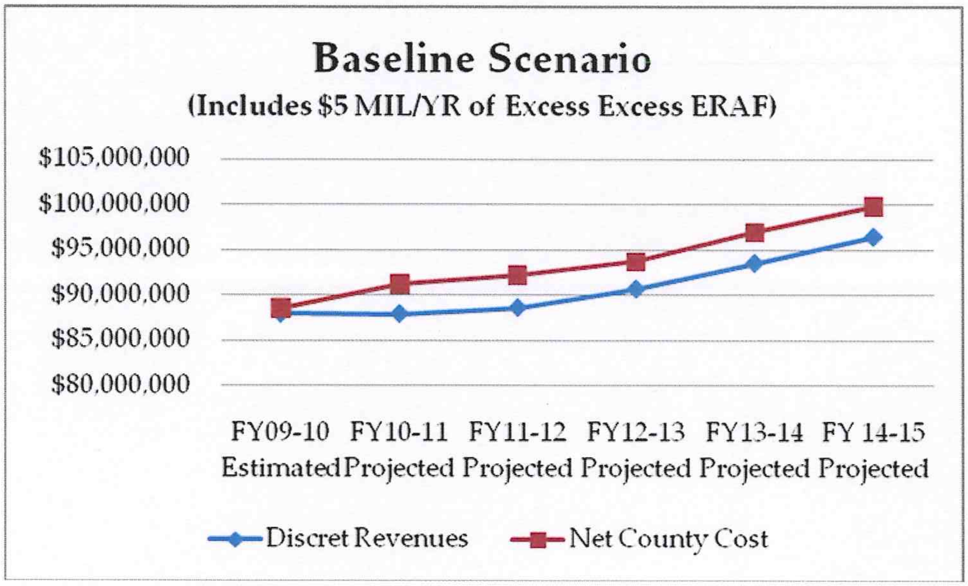
[2] Again, the projection scenarios all assume that the General Fund will have $5 million available in Excess Excess ERAF each year to fund on-going operational costs and that any Excess Excess ERAF received beyond that amount will be transferred to the Accumulated Capital Outlay Fund or spent on other one-time needs. Staff believes that the General Fund will likely receive substantially more Excess Excess ERAF than that in FY209-10 and FY2010-11. If that amount were added to the General Fund's unrestricted balance (rather than set aside for capital or other one-time needs) the period of time before major expenditure reductions would be needed to comply with the Board's unrestricted fund balance policy under the Baseline Scenario would increase. On the other hand, if the General Fund were to receive less than $5 million in Excess Excess ERAF in any year (which is potentially possible in the latter part of the projection period), then the deficit could be larger in those years.

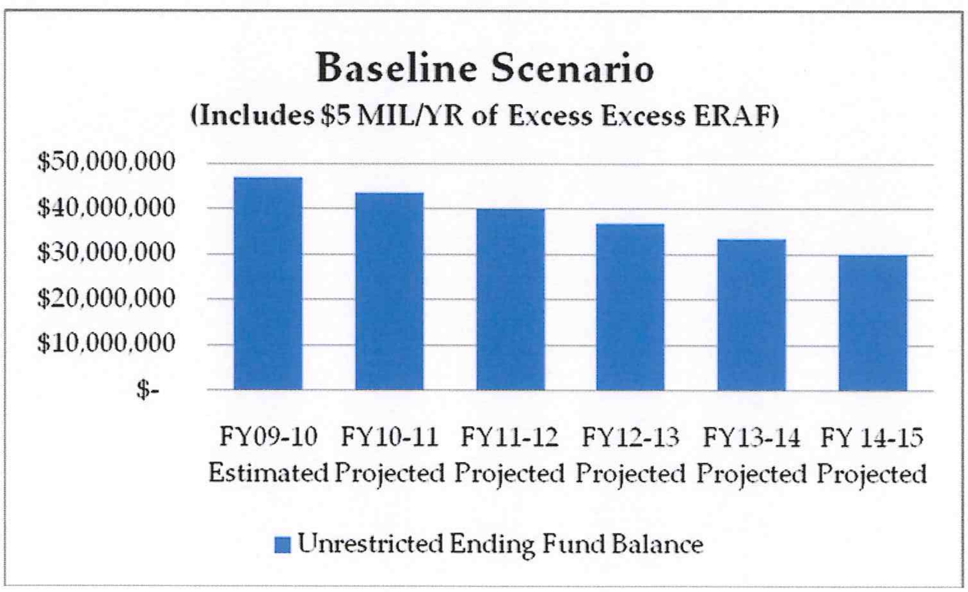
As you know, your Board has previously approved implementing all of the Short-term Actions contained in your Fiscal Contingency Plan (copy attached) and seven of the 13 Longer-term Actions. At this point, staff is recommending that your Board continue to authorize implementation of Short-term

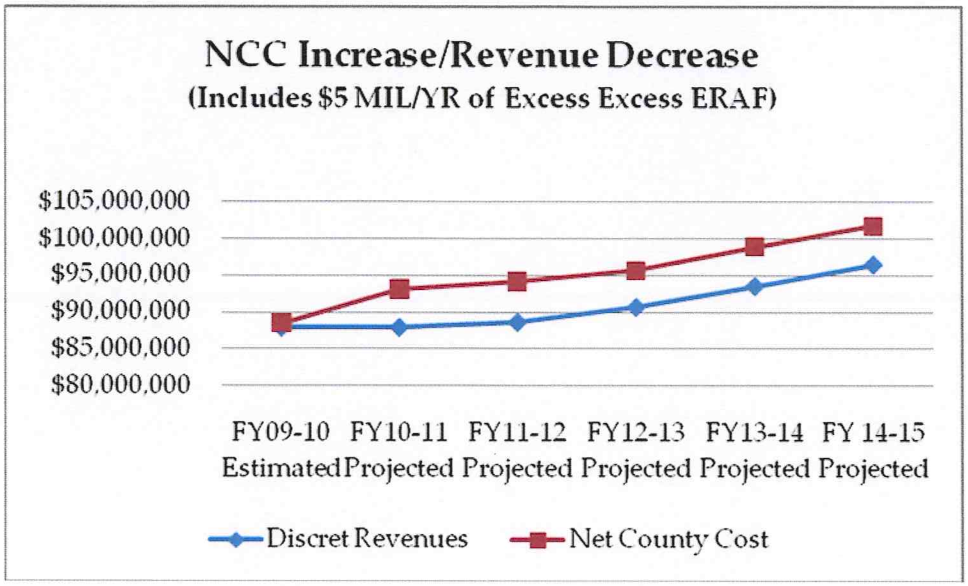
Action 1: a selective hiring freeze. The other Short-term actions are more focused on mitigating cash-flow problems, which are not a major concern, given the County's substantial cash reserves.

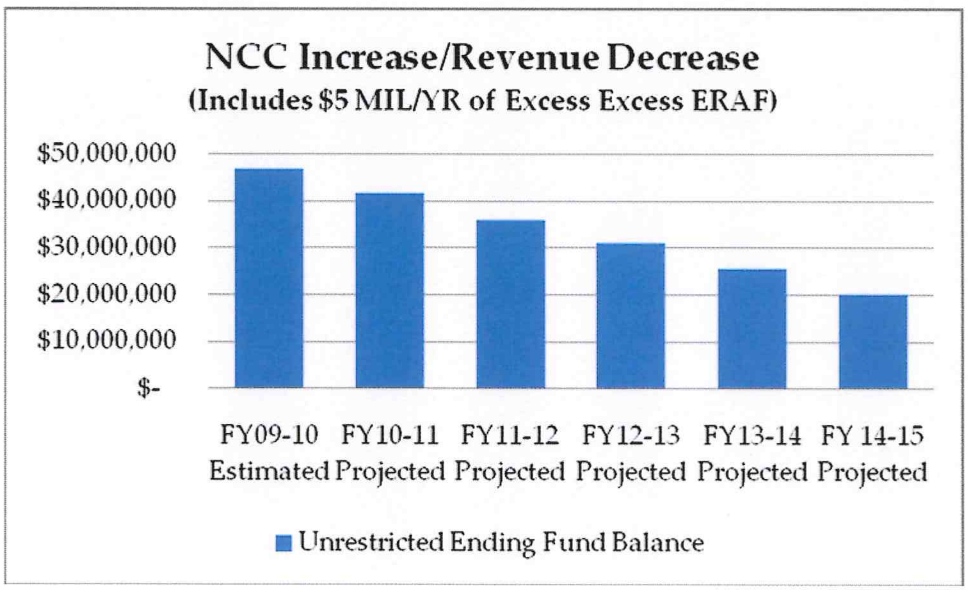
Fiscal Contingency Plan Longer-term Actions 1 through 6 are effectively included in the Board's approved FY2010-11 Budget Policies, and no additional Board action is required. Staff is recommending that the Board authorize continuation of Longer-term Action 7:

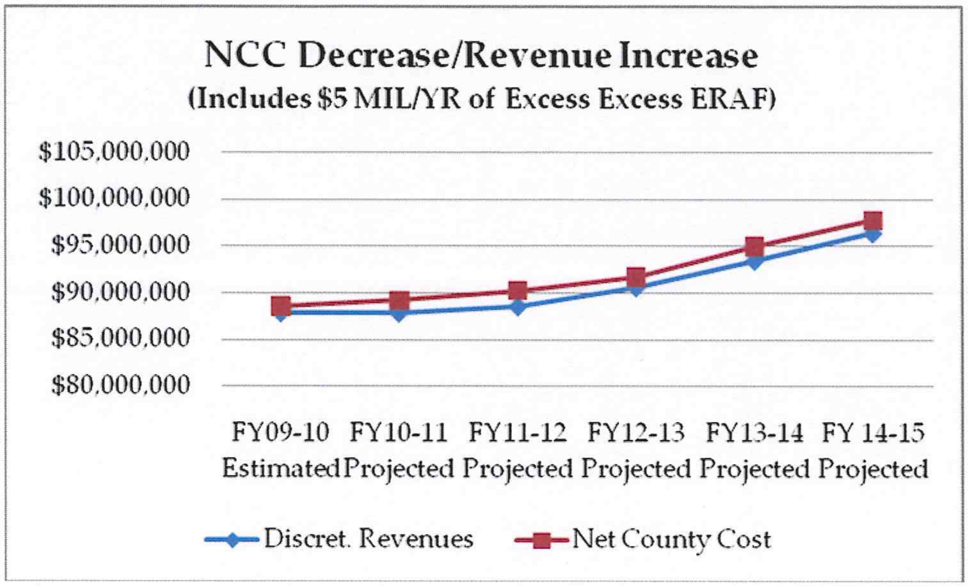
> Moderate reductions in discretionary support will be made on a case-by-case basis. These reductions will focus on programs appropriately funded by dedicated resources (such as fee-supported programs or state or federal programs where there is an over-match. Reductions made at this point will generally have only a limited impact on service levels and may, in some cases, be offset by increased fees.

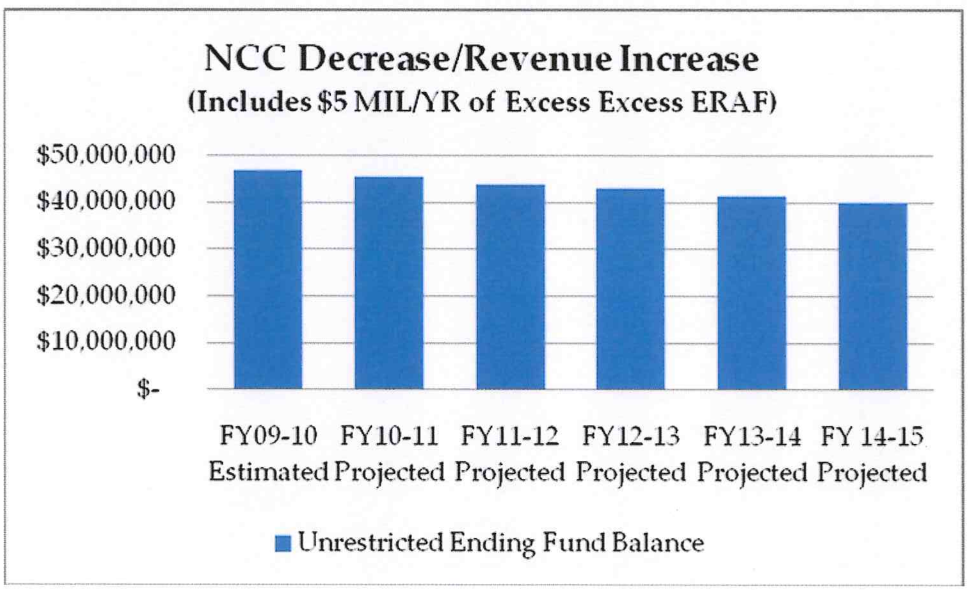

Baseline Scenario
(Includes $5 MIL/YR of Excess Excess ERAF)
$105,000,000
$100,000,000
$95,000,000
$90,000,000
$85,000,000
$80,000,000
FY09-10 Estimated
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
FY13-14 Projected
FY 14-15 Projected
Discret Revenues
Net County Cost

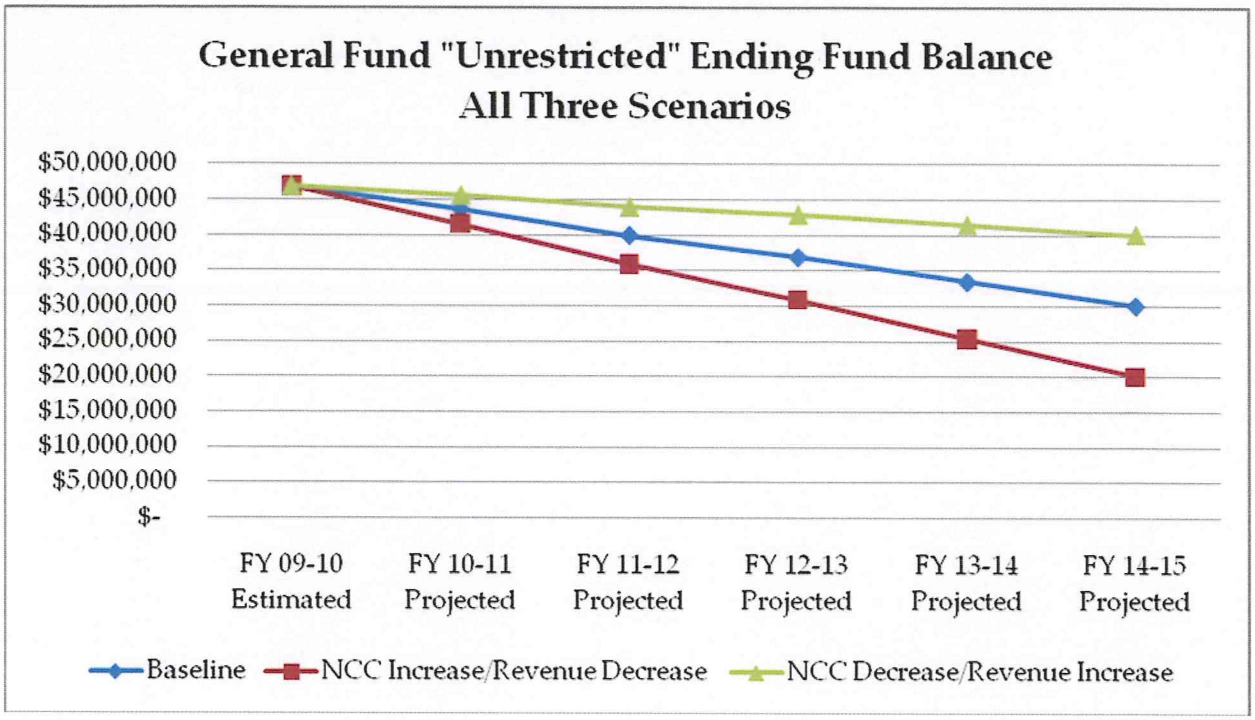

Baseline Scenario
(Includes $5 MIL/YR of Excess Excess ERAF)
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$-
FY09-10 Estimated
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
FY13-14 Projected
FY 14-15 Projected
Unrestricted Ending Fund Balance


NCC Increase/Revenue Decrease
(Includes $5 MIL/YR of Excess Excess ERAF)
$105,000,000
$100,000,000
$95,000,000
$90,000,000
$85,000,000
$80,000,000
FY09-10 Estimated
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
FY13-14 Projected
FY 14-15 Projected
Discret Revenues
Net County Cost


NCC Increase/Revenue Decrease
(Includes $5 MIL/YR of Excess Excess ERAF)
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$-
FY09-10 Estimated
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
FY13-14 Projected
FY 14-15 Projected
Unrestricted Ending Fund Balance


NCC Decrease/Revenue Increase
(Includes $5 MIL/YR of Excess Excess ERAF)
$105,000,000
$100,000,000
$95,000,000
$90,000,000
$85,000,000
$80,000,000
FY09-10 Estimated
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
FY13-14 Projected
FY 14-15 Projected
Discret. Revenues
Net County Cost


NCC Decrease/Revenue Increase
(Includes $5 MIL/YR of Excess Excess ERAF)
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$-
FY09-10 Estimated
FY10-11 Projected
FY11-12 Projected
FY12-13 Projected
FY13-14 Projected
FY 14-15 Projected
Unrestricted Ending Fund Balance


General Fund "Unrestricted" Ending Fund Balance
All Three 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
$-
FY 09-10 Estimated
FY 10-11 Projected
FY 11-12 Projected
FY 12-13 Projected
FY 13-14 Projected
FY 14-15 Projected
Baseline
NCC Increase/Revenue Decrease
NCC Decrease/Revenue Increase