A Tradition of Stewardship
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Nancy Watt
County Executive Officer

TO: Board of Supervisors

FROM: Nancy Watt, County Executive Officer

DATE: April 5, 2011

SUBJECT: **GENERAL FUND FIVE YEAR FORECAST**

Introduction

As your Board will recall, on March 15th, 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 (2010-11) 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 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 FY2010-11, 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 actual, is considered the "base year" for future projections.

- Generally, the projections assume no General Fund supported staff increases after the current (2010-11) fiscal year. Exceptions include known adjustments, such as the addition of a Sheriff's Deputy 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.

- The projections assume that inflation rates will be in the area of 2% to 2.5% annually, and that the "cost of doing business" will increase by that amount for most contracts and purchases. The projections assume a total 3% cost of living increases for employees over the 2011-12 and 2012-13 fiscal years and that salary 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.

- The projections assume that retirement costs will increase by approximately 4% to 12% a year, reflecting both the increase in salary costs described above, and an increase in the employer's share of California Public Employee Retirement System (PERS) rates of approximately 1% to 9% annually. The projected increase in PERS rates is based on rate estimates provided by the County's actuarial consultant. It should be noted that retirement cost increase projections assume the new PERS Safety rates resulting from the implementation of a second tier retirement formula for new Safety employees and the payoff of the two Safety Side Funds, as called for in the recent Memorandum of Understanding (MOU) with the Deputy Sheriff's Association. The retirement cost increase projections also assume that the current provisions in the employee labor agreements regarding County/employee sharing in retirement cost increases will be retained and that we will continue to pre-pay our annual pension contributions.

- The projections assume that employee medical insurance costs will increase at a declining rate, starting at 9.5% in FY2011-12 and decreasing to 7.5% by FY2015-16, based on projections provided by the County's actuarial consultant.

- The projections assume that the County will continue to fund our Other Post-Employment Benefits (OPEB) unfunded liability on a 20-year amortization schedule. For FY2011-12, the projections include an additional $1.3 million in OPEB costs, reflecting the impact of the June 30, 2010 Actuarial Valuation recently completed by the County's actuarial consultant. This increase is the result of a variety of factors, including investment losses, increases in health care costs and changes in the age at which County employees are retiring. The entire FY2011-12 cost of the OPEB cost increase is assumed to be paid out of Net County Cost, due to the timing of the receipt of the actuarial evaluation. In future years, the higher cost will be allocated to non-Net County Cost programs. The permanent increase in Net County Cost due to the June 30, 2010 Actuarial Valuation is projected to be 26%.

- The projections assume that the $1.6 million previously loaned to the Napa-Berryessa Resort Improvement District (NBRID) and Lake Beryessa Resort Improvement District (LBRID) will not be repaid during this period and that an additional $100,000 a year will be loaned to the Districts over the next five years (for a total of $500,000) and not repaid within the projection period.

- In addition to the carry-forward of uncompleted FY2010-11 projects, the projections assume typical annual capital improvement costs of about $1 million per year. 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 replacing our Criminal Justice Information System (CJIMS) and budget system software (with the latter costing approximately $500,000).

- 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, the projections assume that HHSA will reduce expenditures to remain within the set Net County Cost.

- The projections assume that all Proposition 172 revenue will be used to fund General Fund public safety departments.

- 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 and recovery has begun; that economic growth will start out slow this year (FY2010-11) and gradually increase; that retail sales will rebound to pre-recession levels (though not pre-recession growth rates) toward the end of the five-year forecast period; and that property values will remain essentially flat for the next two years and property value growth rates will not rebound to pre-recession levels during the forecast period.

- In terms of major discretionary revenues, the projections assume that secured property tax revenue will remain flat for the next two years (through FY2012-13) and then gradually increase, for an average annual increase of about 1.6% 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 approximately 4% a year during the forecast period. 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 (which we are now going to refer to as "Excess ERAF") revenue in each fiscal year. This is less than we currently expect to receive in FY2010-11 (approximately $19 million, including approximately $9 million in prior year's revenue) and FY2011-12 (approximately $10 million), but is consistent with the Board's policy 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. According to Board policy, any Excess ERAF revenue above this amount is to be used to build reserves or transferred to the Accumulated Capital Outlay (ACO) Fund to help finance the cost of needed capital improvements.

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

<u>Revenue Reduction/Net County Cost 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 roughly 2%, increase in Net County Cost starting in FY2011-12.

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 September 30, 2011, and it is unknown what the final impacts of new contracts will be. For point of reference, every 1% increase in salaries results in a roughly $1 million increase in total cost to the County and a $450,000 increase in Net County Cost.

- An increase in inflation above the relatively low level assumed in the Baseline Forecast could result in a higher cost of doing business generally. While most economists appear to be projecting inflation in the 2% range over the near future, some economists are now suggesting that various factors could push inflation to substantially higher levels. 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 increase. 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 $600,000). This year there is a particular concern about certain revenues from the state that are at risk due to the state's budget problems. For example, various public safety departments have historically received about $1.4 million in Vehicle License Fee (VLF) funding through programs like RASCLEAP and COPS, and that funding is included in the Baseline Forecast. The VLF rate that provided this funding will expire at the end of this fiscal year. The Governor had proposed to ask the voters to extend this VLF rate, but the Legislature failed to approve placing the constitutional amendment that would have included that extension on the ballot. At this point it is not clear whether the state will continue to provide funding for the programs previously funded from this source.

- 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 necessary to augment that Net County Cost rather than see the Agency make significant reductions in staffing and/or services. Here, too, the state budget is a particular concern. For example the budget provisions recently signed by the Governor could involve a reduction of as much as $600,000 in social services revenue to the County that currently funds staffing and other costs associated with administering the CalWORKS program.

- The Board could authorize loans to the resort improvement districts beyond the level included in the Baseline Forecast. As noted above, the Baseline Scenario assumes that a total of $500,000 in new loans will be made to NBRID and/or LBRID during the five-year projection period and that those loans will not be repaid during this period. A recent, preliminary, analysis by Public Works suggests that the cost of needed improvements that the districts would be not be able to cover with district revenues could be as high as $1 million.

- 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.

- The State could proceed with the realignment of various health and human services and public safety programs to the counties as proposed by the Governor. Although the Governor's Realignment proposal included additional revenue to counties, it does not appear that the revenue would be sufficient to fully cover the cost of the programs. Although the Legislature's failure to place the proposed constitutional amendment on the ballot that would have provided the funding for Realignment makes it less likely the Realignment proposal will be implemented, it is still possible that a future funding measure could revive the proposal. In addition, the Legislature has passed and the Governor has signed AB 109, which realigns certain offenders from state prison/parole to county jails/probation without providing funding to the counties. The Governor has indicated in a "signing statement" that this Realignment will not take place until a funding source is found, but the signing statement is not legally binding and it is not clear if and when such a non-funded Realignment will take place.

<u>Revenue Increase/Net County Cost 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 FY2011-12. 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; inflation could be lower than projected; salary savings could be greater than projected due to higher employee turnover rates; fee revenue could be higher than expected; negotiations with the unions could result in lower salary and benefit costs than projected; and/or the FY2010-11 actual revenue/expenditure gap could be less than the level estimated in the adjusted Mid-Year Fiscal Review.

<u>Forecasts and Analysis</u>

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 other factors (except for known or reasonably expected changes), that the General Fund will receive at least $5 million a year in 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 FY2015-16 should be in the area of $51 million.[1] This represents a decrease of approximately $6.4 million, or 11%, from the FY2010-11 beginning unrestricted fund balance level. This forecast is somewhat more optimistic than the Five Year Forecast provided to your Board in April of 2010, reflecting, in part, more optimistic discretionary revenue projections and, in part, the impact of the various cost-containment measures the Board has adopted under the auspices of the County's Fiscal Contingency Plan.

Under the Revenue Reduction/Net County Cost Increase Scenario, the projected unrestricted fund balance at the end of FY2015-16 would be approximately $41 million. Under the Revenue Increase/Net County Cost Decrease Scenario the unrestricted fund balance would increase to approximately $61 million by the end of the 2015-16 fiscal year.

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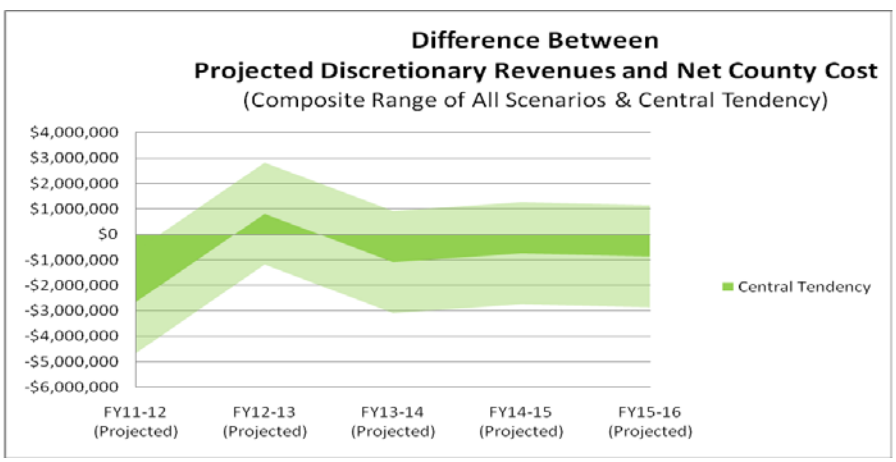
[1] The "unrestricted" fund balance includes the undesignated/unreserved fund balance, General Reserves and designations that are not legally earmarked or restricted. It does not include designations legally restricted for a particular purpose. The unrestricted fund balance is the portion of fund balance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

A projected FY2015-16 ending fund balance that ranges from $41 million to $61 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 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, it appears that, given the assumptions and conditions described above and absent corrective action, the General Fund will likely not be in structural balance over the upcoming five-year period, though this structural imbalance may not be great. The Baseline Scenario projects an average annual Discretionary Revenue/Net County Cost deficit of about $900,000, or 0.9% of Net County Cost, which, if it came to pass, would indicate that the General Fund is fairly close to being in structural balance, though it would be a precarious balance. However, taking into account all of the factors that may tip the County's fiscal condition one way or the other – economic uncertainties, the state's budget situation, etc – we believe that there is a greater likelihood that the General Fund's fiscal condition will be worse than the Baseline Projection rather than better. This is not to suggest that the General Fund's fiscal condition will be as described in Revenue Reduction/Net County Cost Increase Scenario, only that it is more likely to move in that direction than toward the Revenue Increase/Net County Cost Decrease Scenario. The following table illustrates this situation by showing the composite Discretionary Revenue/Net County Cost surplus/deficit range of the three Scenarios and the central tendency, which is the Baseline Scenario.



Taken together the three Scenarios suggest that the average annual difference between Net County Cost and discretionary revenues could range from a $2.9 million deficit (3% of Net County Cost) to a $1.1 million surplus (1.2%). Again, we believe that the most likely outcome is somewhere close to, though perhaps less positive than, the Central Tendency (an average annual defecit of $900,000, or 0.9% of Net County Cost).[2]

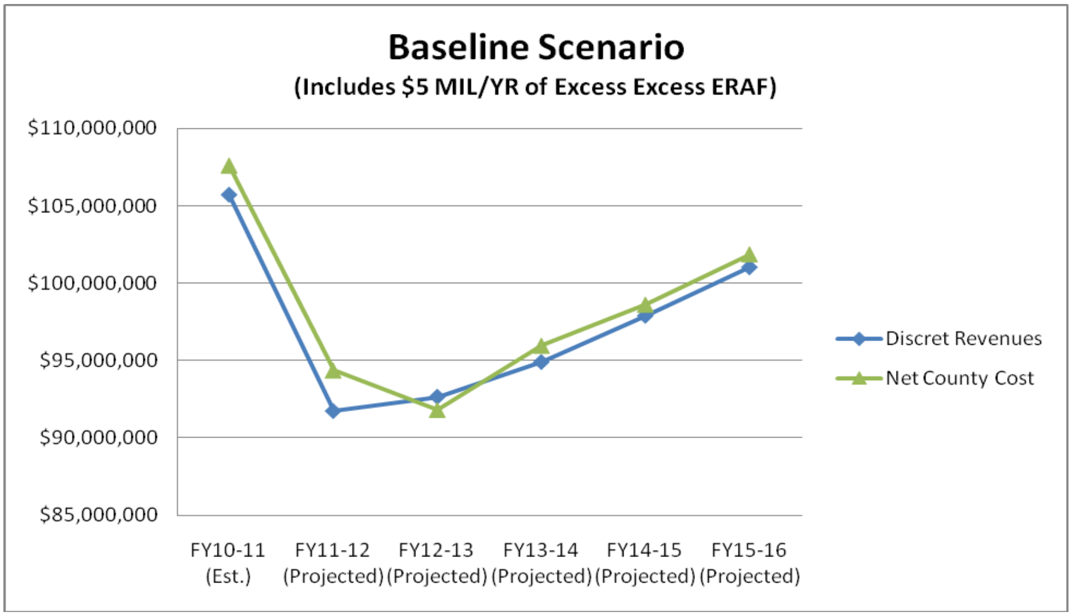
- Second, we are not facing a crisis situation. We have time to continue to implement the Board-approved Fiscal Contingency Plan in a careful and thoughtful manner.

[2] This assumes that counties are not saddled with the full cost of the corrections/probation Realignment approved by the Legislature and the Governor. If that were to occur, the General Fund's structural deficit could be significantly higher.

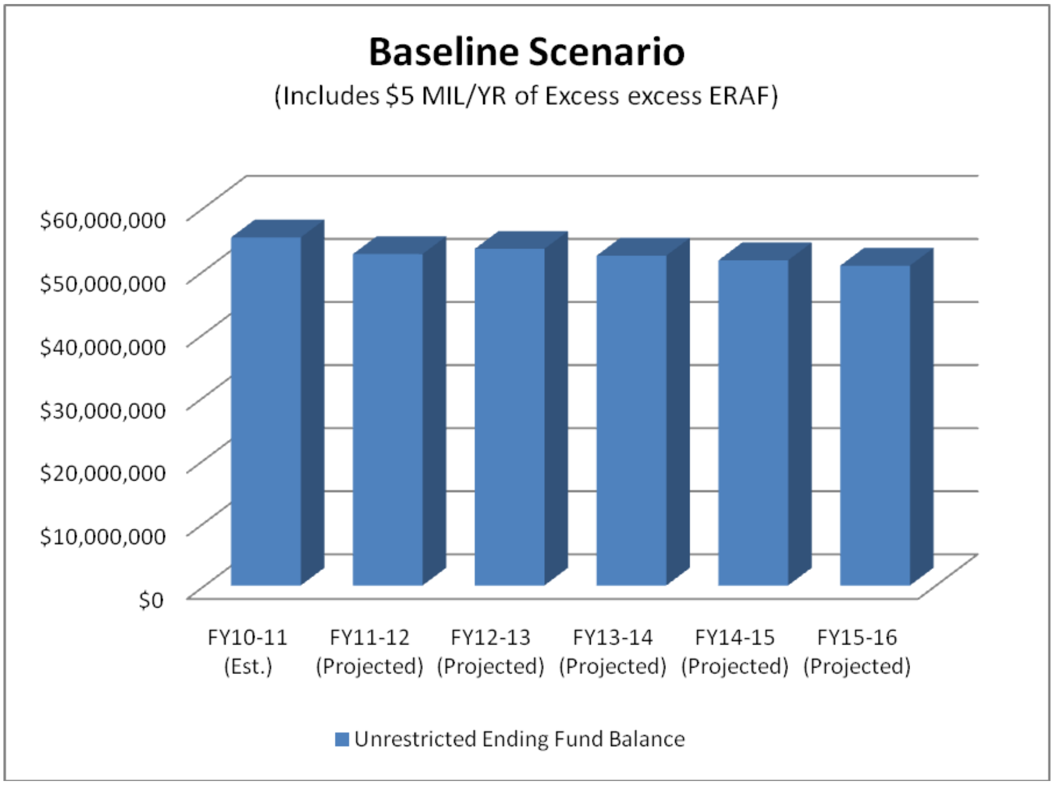
- Third, despite uncertainties concerning the exact magnitude of the General Fund's structural imbalance, it would not be prudent to back-off our efforts to aggressively control Net County Cost. The potential impact on the County of the state's budget situation, in particular, suggests that we are entering a period of significant potential risk. Controlling Net County Cost, as we have been, will put us in a better position to carefully calibrate our budget actions once the situation becomes more clear, hopefully without the need for draconian action.

As you know, your Budget Policies call for implementing seven of the 13 Longer-term actions contained in your Fiscal Contingency Plan. As alluded to above, staff is recommending that you continue those policies in place.

EXHIBIT A

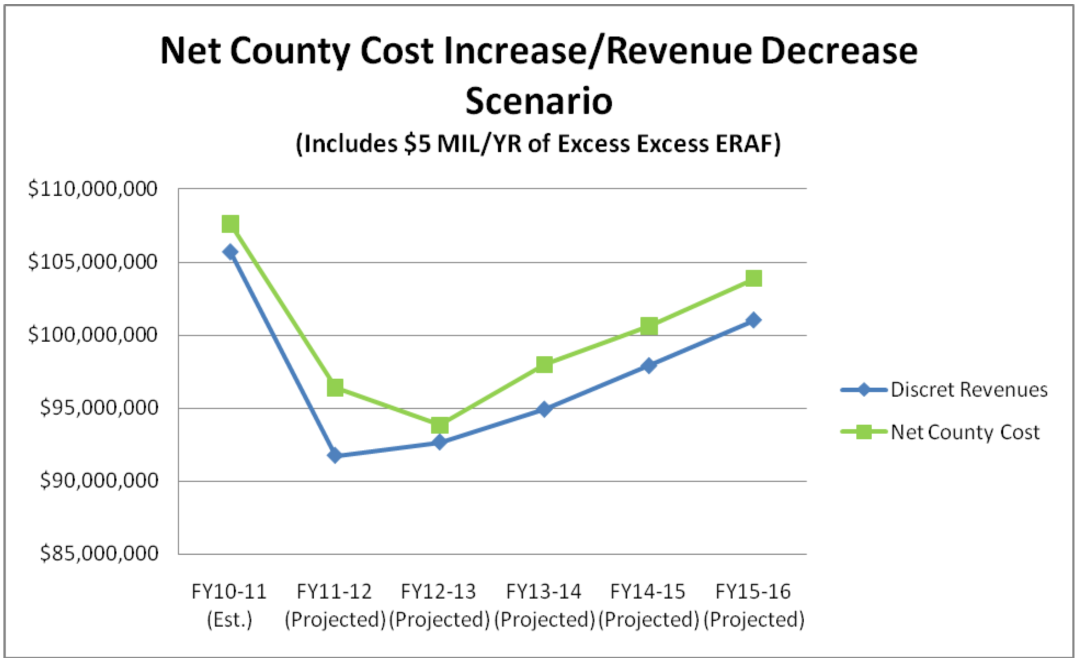


Baseline Scenario
(Includes $5 MIL/YR of Excess Excess ERAF)
$110,000,000
$105,000,000
$100,000,000
$95,000,000
$90,000,000
$85,000,000
FY10-11 (Est.)
FY11-12 (Projected)
FY12-13 (Projected)
FY13-14 (Projected)
FY14-15 (Projected)
FY15-16 (Projected)
Discret Revenues
Net County Cost



Baseline Scenario
(Includes $5 MIL/YR of Excess excess ERAF)
$60,000,000
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$0
FY10-11 (Est.)
FY11-12 (Projected)
FY12-13 (Projected)
FY13-14 (Projected)
FY14-15 (Projected)
FY15-16 (Projected)
Unrestricted Ending Fund Balance

EXHIBIT B


Net County Cost Increase/Revenue Decrease Scenario
(Includes $5 MIL/YR of Excess Excess ERAF)
$110,000,000
$105,000,000
$100,000,000
$95,000,000
$90,000,000
$85,000,000
FY10-11 (Est.)
FY11-12 (Projected)
FY12-13 (Projected)
FY13-14 (Projected)
FY14-15 (Projected)
FY15-16 (Projected)
Discret Revenues
Net County Cost

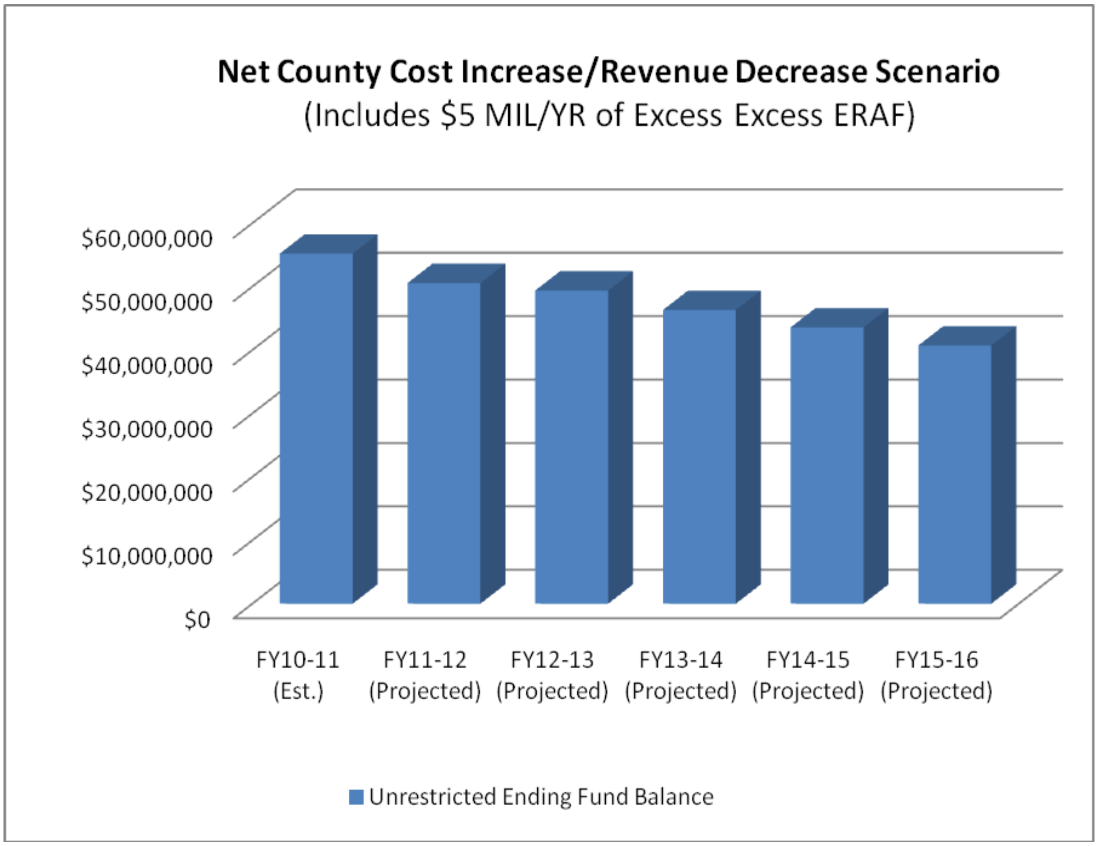
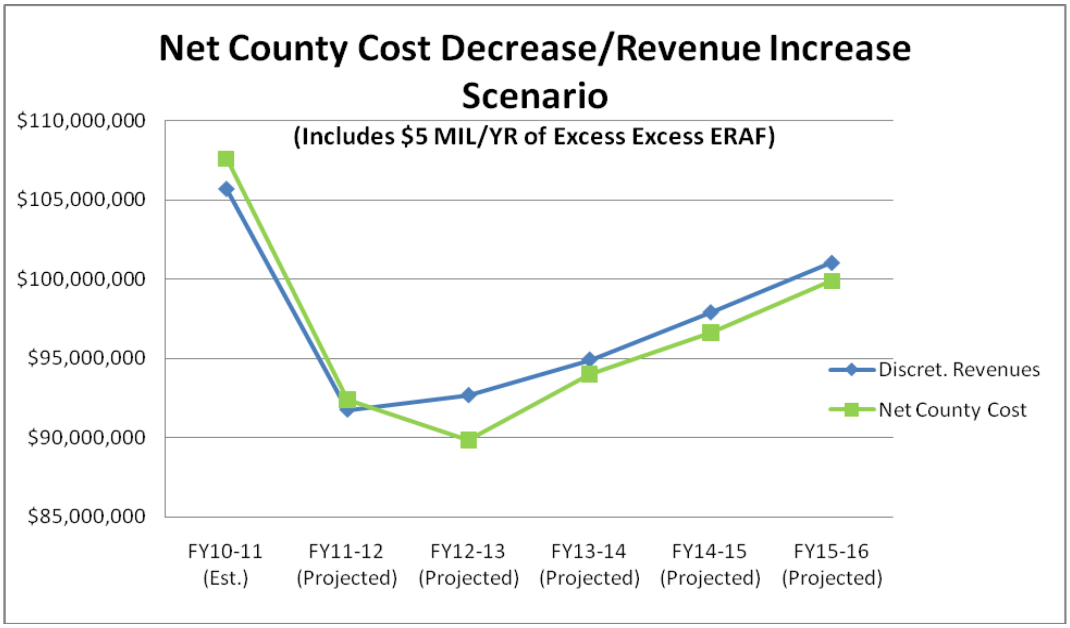

Net County Cost Increase/Revenue Decrease Scenario
(Includes $5 MIL/YR of Excess Excess ERAF)
$60,000,000
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$0
FY10-11 (Est.)
FY11-12 (Projected)
FY12-13 (Projected)
FY13-14 (Projected)
FY14-15 (Projected)
FY15-16 (Projected)
Unrestricted Ending Fund Balance

EXHIBIT C


Net County Cost Decrease/Revenue Increase Scenario
(Includes $5 MIL/YR of Excess Excess ERAF)
$110,000,000
$105,000,000
$100,000,000
$95,000,000
$90,000,000
$85,000,000
FY10-11 (Est.)
FY11-12 (Projected)
FY12-13 (Projected)
FY13-14 (Projected)
FY14-15 (Projected)
FY15-16 (Projected)
Discret. Revenues
Net County Cost

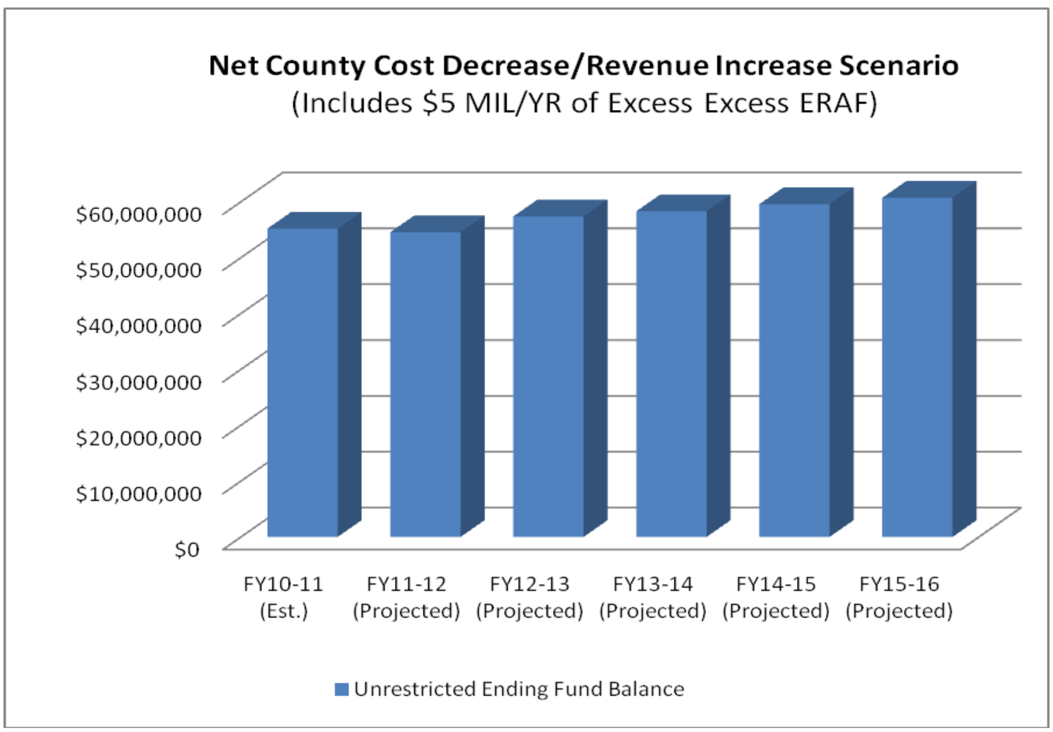
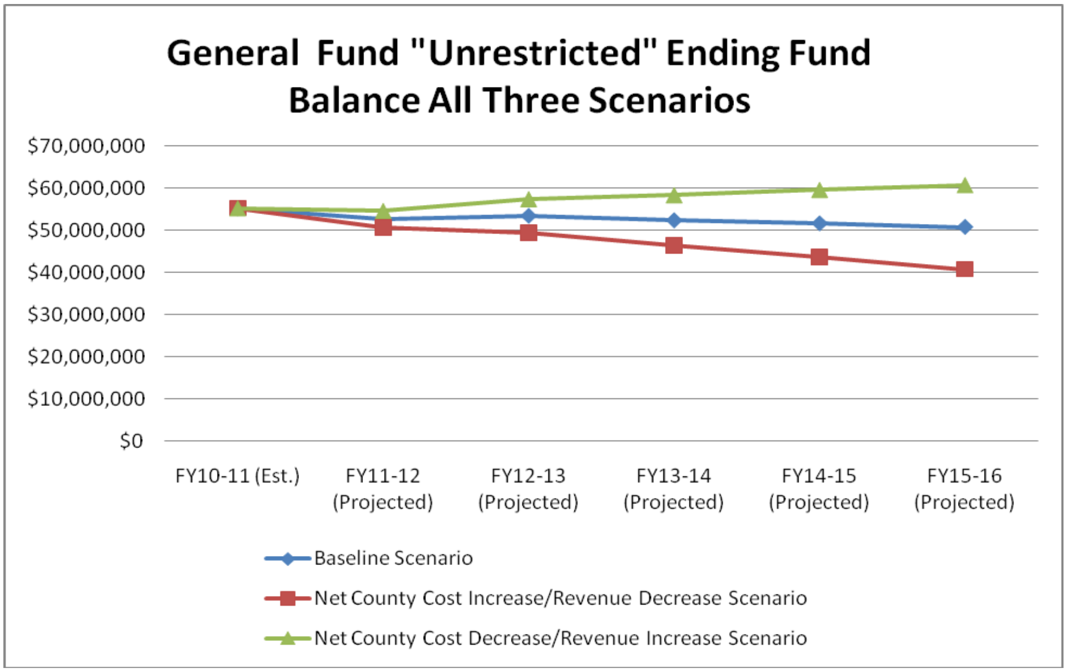

Net County Cost Decrease/Revenue Increase Scenario
(Includes $5 MIL/YR of Excess Excess ERAF)
$60,000,000
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$0
FY10-11 (Est.)
FY11-12 (Projected)
FY12-13 (Projected)
FY13-14 (Projected)
FY14-15 (Projected)
FY15-16 (Projected)
Unrestricted Ending Fund Balance

EXHIBIT D


General Fund "Unrestricted" Ending Fund Balance All Three Scenarios
$70,000,000
$60,000,000
$50,000,000
$40,000,000
$30,000,000
$20,000,000
$10,000,000
$0
FY10-11 (Est.)
FY11-12 (Projected)
FY12-13 (Projected)
FY13-14 (Projected)
FY14-15 (Projected)
FY15-16 (Projected)
Baseline Scenario
Net County Cost Increase/Revenue Decrease Scenario
Net County Cost Decrease/Revenue Increase Scenario