A Tradition of Stewardship
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To: Board of Supervisors

From: Nancy Watt, County Executive Officer

Date: April 6, 2012

Subject: **GENERAL FUND FIVE YEAR FORECAST**

Introduction

As your Board will recall, on March 20th, 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 status would be at the end of the current 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 look 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. For example, 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 FY2011-12, 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 (2011-12) fiscal year. Exceptions include known adjustments.

- 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 3% 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 a 1.5% cost of living adjustment (COLA) for most employees in FY2012-13 and FY2013-14 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 most retirement costs will increase by approximately 2% to 6% a year, reflecting both the increase in salary costs described above, and annual changes in the employer's share of California Public Employee Retirement System (PERS) rates that range from a decrease of approximately.5% to a 2.2% increase. The projected changes in PERS rates are based on rate estimates provided by the County's actuarial consultant. These estimates assume the new PERS Safety and Miscellaneous rates resulting from the implementation of a second tier retirement formula for new employees, as called for in the recent Memoranda of Understanding (MOU) with the Deputy Sheriff's Association and SEIU[1]. The retirement cost increase projections also takes into account that PERS has reduced its assumed average annual rate of return from 7.75% to 7.5% 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 8% by FY2016-17, based on projections provided by the County's actuarial consultant and reflecting the agreement with our two unions that employees will pick up a greater share of cost.

- 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 Mid-year 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 OPEB cost increase will 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 24% over the FY2010-11 level.

- The projections assume that the $2 million previously loaned to the Napa-Berryessa Resort Improvement District (NBRID) and Lake Berryessa Resort Improvement District (LBRID) will not be repaid during this period. In addition, the projections assume an on-going "loan" of $150,000 a year to LBRID to help cover an expected annual operating shortfall. The projections do not assume any additional loans to LBRID or NBRID, including any loans related to the approximately $927,000 in fines recently imposed by the Regional Water Quality Control Board.

[1] The new, lower cost, retirement tiers apply to all new employees, both management and represented.

- For FY2012-13, the projections include $3.2 million in carry-forward capital and major maintenance projects from the prior year and $2.2 million in new projects, including the remodel of the second floor of the Administration Building to create a one-stop permitting center. The projections assume typical annual capital improvement and major maintenance costs of about $1 million per year in FY2013-14 and beyond. The projections do not assume any General Fund 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 General Fund will contribute approximately $200,000 annually to fund Homeless Services starting in FY2012-13. Prior to FY2008-09 the General Fund spent approximately $400,000 a year on various homeless services, such as the Winter Shelter program, the South Napa Shelter and the Hope Center. In FY2008-08, these costs were transferred to the Affordable Housing Fund, and now total approximately $552,000 a year. At the time the Affordable Housing Fund assumed responsibility for covering the County's homeless services costs, the Fund's revenues and fund balance were significantly higher than they are now and staff is concerned that the current level of homeless services funding, as a percent of fund balance and revenues, cannot be justified. Staff is evaluating the level of homeless services funding that would be appropriate for the Affordable Housing Fund and other alternatives to funding these services besides the General Fund. The final General Fund amount may end up being more or less than $200,000.

- The projections assume that the "fixed" Net County Cost for the Health and Human Services Agency (HHSA) will be held essentially constant throughout the five-year period at $10.8 million. 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. $10.8 million reflects the FY2011-12 projected actual Net County Cost for HHSA, but it is approximately $200,000 higher than HHSA's FY2011-12 budgeted Net County Cost and the HHSA Net County Cost assumed in the last (January 2012) Five Year Forecast. This increase in Net County Cost is due to increase In-Home Supportive Services (IHSS) provider costs. Typically, increases in IHSS provider costs result in an adjustment in HHSA's fixed Net County Cost.

- The projections assume that all Proposition 172 revenue will be used to fund General Fund public safety departments and that the only General Fund Contribution to the Library will be to cover the salary of the Library Director as required by State law.

- The projections assume the General Fund will contribute $932,000 annually to the Roads Fund.

- 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 that a slow recovery has begun and the rate of grow will very gradually increase; that retail sales will rebound to pre-recession levels (though not pre-recession growth rates) within the next three to four years; and that property values will grow at roughly the rate of the assumed rate of inflation (2% to 3%) during the forecast period.

- In terms of major discretionary revenues, the projections assume that secured property tax revenue will grow in the 2% to 3% range during this five-year period. This assumption is based on discussions concerning assessed value trends with the County Assessor. The projections also assume that, in FY2013-14, the General Fund will start receiving approximately $600,000 a year in additional property taxes as a result of the dissolution of the Napa Redevelopment Agency. 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 ERAF revenue in each fiscal year starting in FY2013-14. This is less than we received in FY2010-11 (approximately $20 million, including approximately $9 million in prior year's revenue) and what we expect to receive in FY2011-12 (approximately $10.5 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. For FY2011-12 the projections assume the General Fund will receive $10.5 million in Excess ERAF and in FY2012-13 the projections assume the General Fund will receive $8.6 million (the $5 million base, plus Excess ERAF revenue to cover the cost of General fund Capital projects). In the latter two years, we are more confident that the General Fund will actually receive the higher amount of Excess ERAF.

- 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 FY2012-13.

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 expire on September 30, 2013 and June 30, 2014, and it is unknown what the cost impacts of new contracts will be. For point of reference, every 1% increase in salaries results in a roughly $500,000 increase in Net County Cost.

- Employee health insurance costs could increase at a greater rate than assumed in the Baseline Forecast due to the implementation of national health insurance reform through the Affordable Care Act (the Act), which is scheduled to be substantially implemented by 2014 and fully implemented by 2018. There is considerable uncertainty about what the cost impact of the Act on employers will be, what changes to the act Congress may make and whether the Act will be upheld by the Supreme Court, but some experts believe that if the Act goes into effect as written, employer costs could increase significantly.

- 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). One area of possible vulnerability here is 2011 Public Safety Realignment funding from the State. This funding has been provided to cover the cost of dealing with prison inmates realigned to the counties as well as for to fund certain public safety and health and human services programs and no on-going funding source for this funding has been approved.

- 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.

- The Board could authorize loans to the resort improvement districts beyond the level included in the Baseline Forecast.

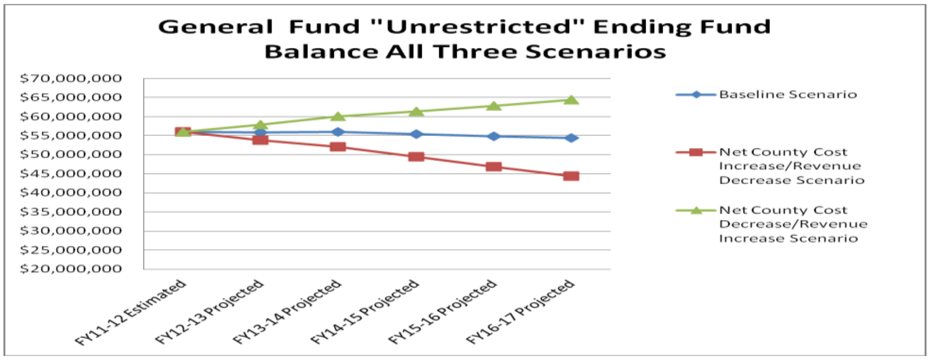
- The Board could authorize additional General Fund contributions to the Roads Fund, beyond the historic $932,000 annual amount included in the Baseline Forecast.

- 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/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 FY2011-12 actual revenue/expenditure gap could be less than the level estimated in the adjusted Mid-Year Fiscal Review.

Forecasts and Analysis

The impact of the three forecasts on the General Fund's unrestricted (available) ending fund balance is shown in the following table.



As can be seen, the Baseline Scenario projects that the General Fund's unrestricted or available fund balance at the end of FY2016-17 should be in the area of $54.5 million.[2] This represents a decrease of approximately $850,000, or 1.4%, from the FY2011-12 beginning unrestricted balance level of approximately $55.3 million. This forecast is somewhat less optimistic than the Five Year Forecast presented to your Board in January, where the Baseline Forecast projected an 11% increase in fund balance by the end of FY2016-17. The reasons for this change include a downward revision in estimates for Secured Property Tax and Sales Tax revenue in FY2011-12 based on updated information, a change in methodology for allocating ITS charges that is being implemented in FY2012-13, which increases the General Fund's share of those charges, the assumption that the General Fund will need to assume responsibility for at least $200,000 in homeless services costs, the assumption that the General Fund will need to make an on-going $150,000 a year loan to LBRID to cover that District's annual operating shortfall and a $200,000 increase in the HHSA fixed Net County Cost assumption, due to increased IHSS provider costs.

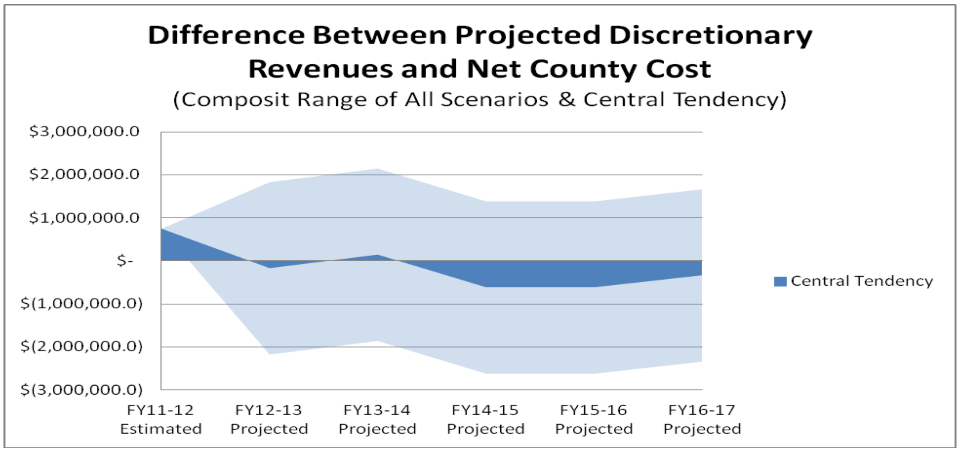
Under the Revenue Reduction/Net County Cost Increase Scenario , the projected unrestricted fund balance at the end of FY2016-17 would be approximately $44.5 million. Under the Revenue Increase/Net County Cost Decrease Scenario the unrestricted balance would increase to approximately $64.5 million by the end of the 2016-17 fiscal year.

A projected FY2016-17 ending fund balance that ranges from $44 million to $64 million illustrates the sensitivity of such projections to the methodology and assumptions used in making them. And, in fact, it is likely the General Fund's actual fiscal condition in any future year will differ from all of the estimates. Notwithstanding this, we believe it is possible to draw a number of conclusions from these projections.

- First, it appears that, given the assumptions and conditions described above, the General Fund is likely close to being in structural balance over the upcoming five year period, with the downside risks being slightly greater than the upside risks. Taken together, the three scenarios suggest that the average annual difference between Net County Cost and discretionary revenues could range from a $2.3 million deficit (2.3% of Net County Cost) to a $1.7 million surplus (1.7% of Net County Cost), with a central

[2] 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.

tendency (the Baseline Scenario) of a $320,000 deficit (0.3% of Net County Cost). The following table illustrates this situation by showing the composite Discretionary Revenue/Net County Cost surplus/deficit range of the three scenarios.



- Second, we continue to be in a period of significant fiscal uncertainty. Although there have been recent positive economic indicators, unemployment remains high and most economists are projecting that the national and state economies will continue to grow slowly at best. In addition, both the federal and state governments are facing serious budget problems in the European economy could impact economic conditions in the United States. In terms of the In terms of the County's discretionary revenues, in the last year we have seen a significant increase in sales tax and Transient Occupancy Tax revenue, but it is not clear whether we can expect those trends to continue. On the other hand, property tax revenue, far and away the County's largest discretionary revenue source, is hardly growing at all and we see little evidence to suggest that that situation will change in the near future. The County is also facing uncertainty with regard to State funding for various programs and, in particular, how 2011 Public Safety Realignment will impact the County including the potential need for a new jail. Given all this, we believe it would be prudent to continue to be cautious and to control costs and avoid major new investments in on-going programs.

- Third, notwithstanding the above concerns, the General Fund has substantial reserves and we are well positioned to respond in a careful and thoughtful way to the impact of a significant deterioration in economic conditions and/or the County's fiscal situation.