2014 Strategic Financial Plan

Executive Summary

Introduction

The County of Orange is committed to financial sustainability through long-term planning which enhances the ability to respond to financial uncertainty in a manner that minimizes the impact to the quality and range of services provided to the community. The year leading up to the 2014 Strategic Financial Plan process presented challenges, including continued moderate economic growth, set-aside of $150 million for repayment of the VLFAA to the State, and provision of programs and services under the AB109 implementation that have not been fully funded by State revenue streams. While the County has experienced slow economic growth since the Great Recession, it was navigating to recovery prior to the loss of the VLF revenue. This loss of revenue and the subsequent planning for repayment to the State reemphasizes the need for long-term strategic planning including building a reserve balance that allows the County to weather downturns with minimal impact on the community it serves.

Looking toward the future, continued growth in the demand for services and related costs will affect the County's ability to sustain service levels and emphasizes the need to ensure that resources and programs are aligned to countywide strategic priorities and values. Planning for the future must continue to include budget stabilization, preparation for contingencies, and funding of infrastructure needs deferred during the economic downturn.

In light of the challenges since the Great Recession, the County maintained key services and programs and implemented new award-winning programs including:

- Election Operations Improvements – The County of Orange Registrar of Voters received a 2014 award from the National Association of Counties (NACo) for the use of technology and consultation with logistics experts to improve the time it takes to process ballots.
- "Healthier Living" Collaborative – The partnership between OC Community Services' Office on Aging and the Health Care Agency to bring community programs helping disenfranchised, disabled, and elderly communities deal with chronic disease and other problems, received a 2014 NACo Health award.
- Theo Lacy Facility Sustainability Project – The Sheriff's Department received a Merit Award from the California State Association of Counties (CSAC) for this project, which is moving toward eliminating waste at the Theo Lacy Jail Facility, and is using recycled resources to benefit the community. For example, linens and clothing are recycled into pet beds and donated to the OC Animal Care shelter.

The Process

The Strategic Financial Plan (the Plan or SFP) is a financial component of the County's Strategic Plan that provides short and long-term operational linkage between the County's Strategic Plan and the annual budget process. It offers a means to focus on Departments' needs and resources to ensure the County's financial position is adequate to support ongoing services and long-term needs while ensuring realistic sustainability within projected future economies. The Plan provides policy makers with a tool for gauging the potential financial impact of policy decisions related to General Fund operations, capital requirements, and strategic priorities.

The Plan establishes the framework for a five-year operating budget and prepares for development of the next fiscal year budget with the caveat that assumptions used in developing the plan may change over time. The Plan is developed with a goal of identifying significant issues that must be addressed to achieve the County's mission, goals and long-term plan for financial sustainability. Key fiscal goals continuing to warrant attention include:

- Budget stabilization and planning for contingencies
- Planning for and funding agency infrastructure

The primary focus of the SFP is the portion of the General Fund often referred to as discretionary funding or Net County Cost (NCC). This is the funding source allocated to departments and approved by the Board for programs and activities which are not funded by specific revenue sources. The non-discretionary portion of the budget contains mandated activities such as benefit payments to clients, which the County provides on behalf of the State and Federal governments. Such activities are primarily funded with State and Federal revenues.

This year's plan continues to focus on General Fund gap analysis in an effort to highlight the significant impacts of State budget actions, the continuing impact of subdued General Fund revenue growth, and the rising cost of doing business. The plan focuses on identification of General Fund fiscal gaps (comprised of Departmental planned expenditures net of Departmental revenues and NCC) and imbalances that will need to be addressed during the FY 2015-16 Annual Budget Process. A summary analysis of capital needs was also conducted. This year's SFP lays the groundwork for establishing budget priorities and funding solutions for FY 2015-16 prior to the normal timeframe of the annual budget process, allowing more time for collaboration and creative solutions.

The SFP also provides an opportunity to review the General Fund Reserves Policy, which is developed to provide flexibility in the maintenance and use of reserves and to reflect the County's continued commitment to sound fiscal policy. There are no recommended changes to reserve policies proposed in this year's SFP.

As in prior years' plans, the County Executive Office compiled relevant economic data for use in preparing the County's 2014 SFP including:

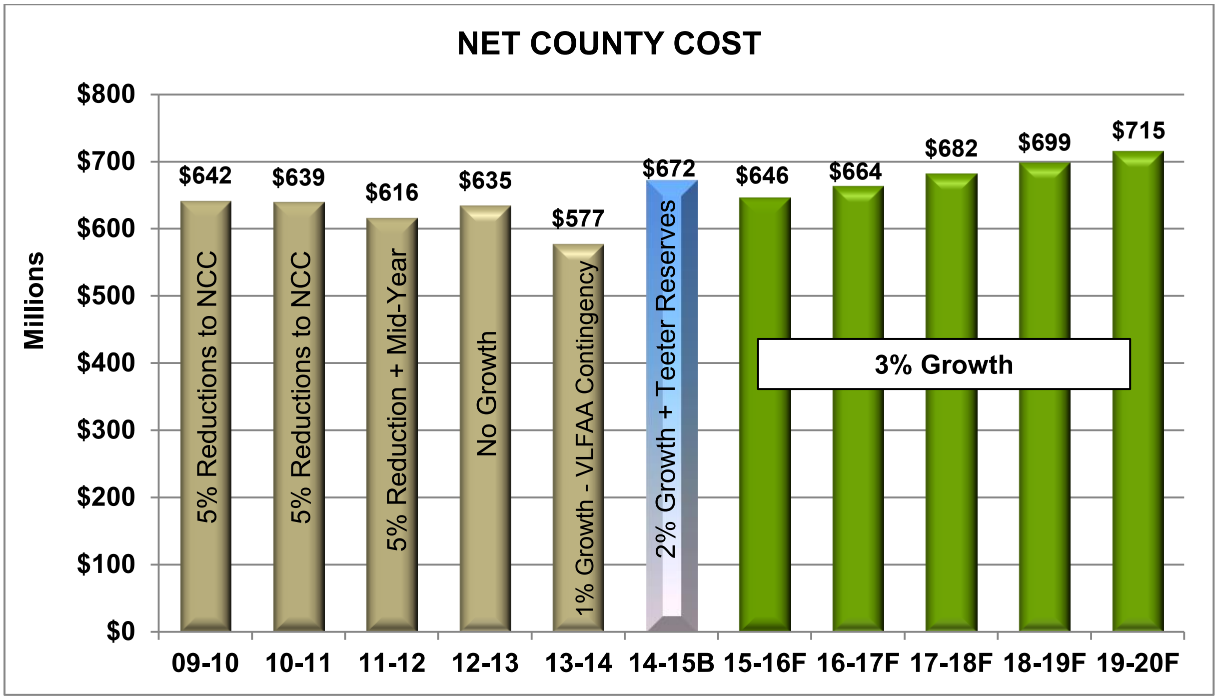
- General Purpose Revenue forecast developed in conjunction with forecasts by the Auditor-Controller, the 2014-15 Local Assessment Roll of Values, and revenue receipt trends.
- Various projections for capital and operating inflationary factors, as developed by governmental or industry experts in the related field.
- Continued monitoring of economic forecasts published by Chapman University, University of California, Los Angeles, the State Legislative Analyst Office and other various sources.

Economic data compiled in August 2014 was included as part of the 2014 SFP instructions. As changes occur in the economy, some projections may be updated during the FY 2015-16 annual budget process.

<u>Key Assumptions</u>:

- The total cost of salaries and benefits is expected to increase by 13% over the five plan years and includes the following assumptions:
  - Salaries (growth projection developed independently and not in consultation with Human Resource Services or the Board, and does not represent a commitment for bargaining purposes)
    - Year 1: 1.0%
    - Years 2 through 5: 2.0%
  - Retirement Rate Assumptions (Tier II)
    - Safety Rate from 60% to 58% (3@50; excludes retiree medical)
    - Non-Safety Rate from 30% to 29% (2.7@55; excludes retiree medical)
    - Retiree Medical for AOCDS at 3.80% (4.80% for Law Enforcement Managers)
    - Retiree Medical for General at 3.50%
  - Health Benefit Cost Assumptions
    - 5-Year Growth from $181M to $267M (47%)
- Consumer Price Index (CPI) Assumptions for Services & Supplies: 2.1% to 2.5%
- Departmental NCC limits were set for ongoing baseline operations (current levels of service). FY 2015-16 NCC limits were projected using the adopted FY 2014-15 limits ($672.0 million) as a starting point, with amendments for technical adjustments and removal of one-time items resulting in proposed baseline limits for FY 2015-16 of $646.1 million (3% growth is included in the FY 2015-16 limits). Departments

have identified $42 million in reductions that would be required to meet the FY 2015-16 NCC limits. After factoring in NCC limit growth of 3% in each year of the five-year Plan, Departments still identified a 5-year cumulative budget gap of $334.5 million. The following table summarizes historical and forecasted NCC. The FY 2015-16 amount includes removal of $18 million no longer required for the bankruptcy debt payment.



The following table summarizes NCC by program:

Program	11-12	12-13	13-14	14-15B	15-16F	16-17F	17-18F	18-19F	19-20F
Public Protection	$311.20	$337.50	$328.27	$358.50	$347.85	$357.07	$366.57	$376.35	$386.28
Community Services	136.20	137.30	108.36	132.34	140.63	144.72	148.94	153.29	157.77
Infrastructure	30.70	32.10	31.54	32.35	37.89	38.89	39.92	36.77	37.86
General Government	98.60	97.30	101.60	105.80	104.81	107.88	111.15	114.18	117.65
Capital Improvements	39.70	6.00	17.54	23.97	17.94	18.27	18.62	20.99	19.75
Debt Service	23.10	19.30	19.00	19.29	0.87	0.87	0.87	0.87	-
Insurance, Reserves & Misc.	(23.30)	5.20	(28.88)	(0.23)	(3.86)	(3.85)	(3.85)	(3.83)	(3.82)
GRAND TOTAL NCC	**$616.20**	**$634.70**	**$577.43**	**$672.03**	**$646.14**	**$663.86**	**$682.22**	**$698.63**	**$715.48**

Note: FY 14-15B NCC is the adopted budget. SFP years are forecasted (F).

Outlook and Challenges

In general, trends in key economic indicators reflect continued modest economic growth now and into the near future. Although economic growth is predicted to be better than in the past several years, it is not sufficient to offset the Great Recession as far as income and employment are concerned. Please see further discussion of economic impacts in the *Economic Forecast* section of this document.

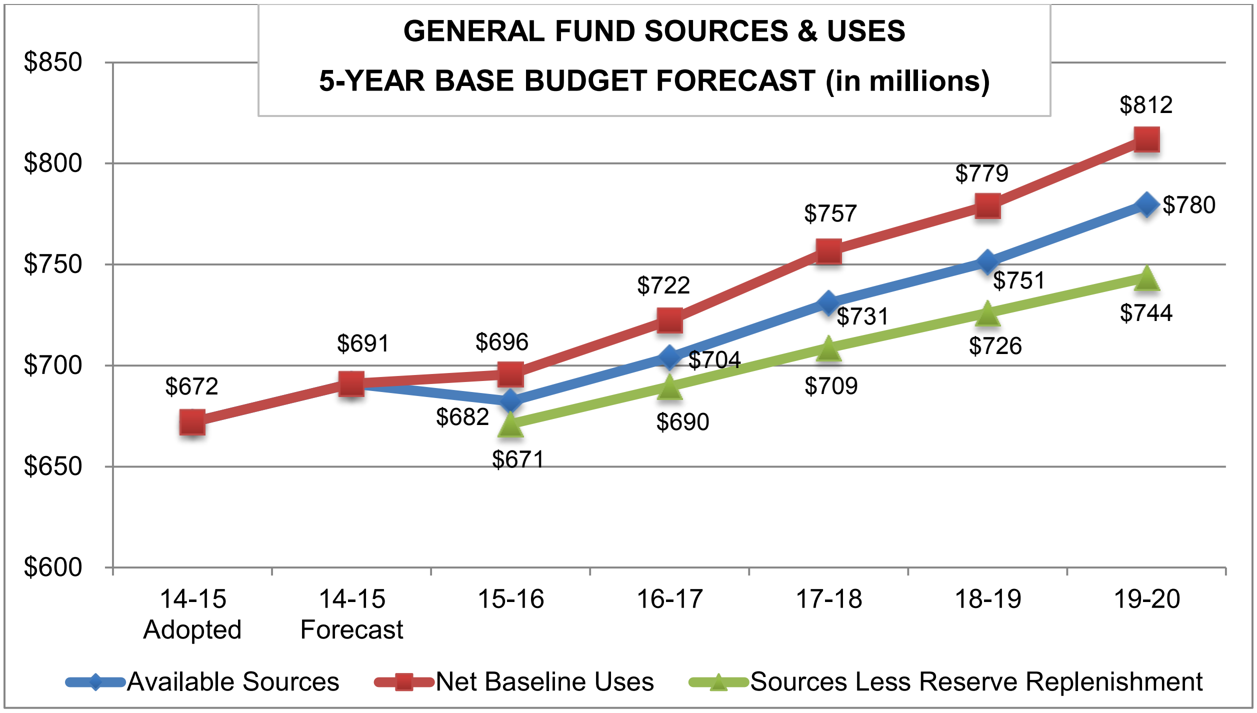
This SFP has been conservatively developed and includes modest growth consistent with current economic conditions. The County continues to follow fiscal policies that will stabilize department budgets, prepare for contingencies, and address and fund agency infrastructure.

<u>Expenditures</u>

Key Issues –

- Cost of doing business continues to grow and outpaces General Purpose Revenue growth.
- Competing needs exist for General Funds, including the need to fund deferred capital and information technology projects and ongoing strategic priority requests.

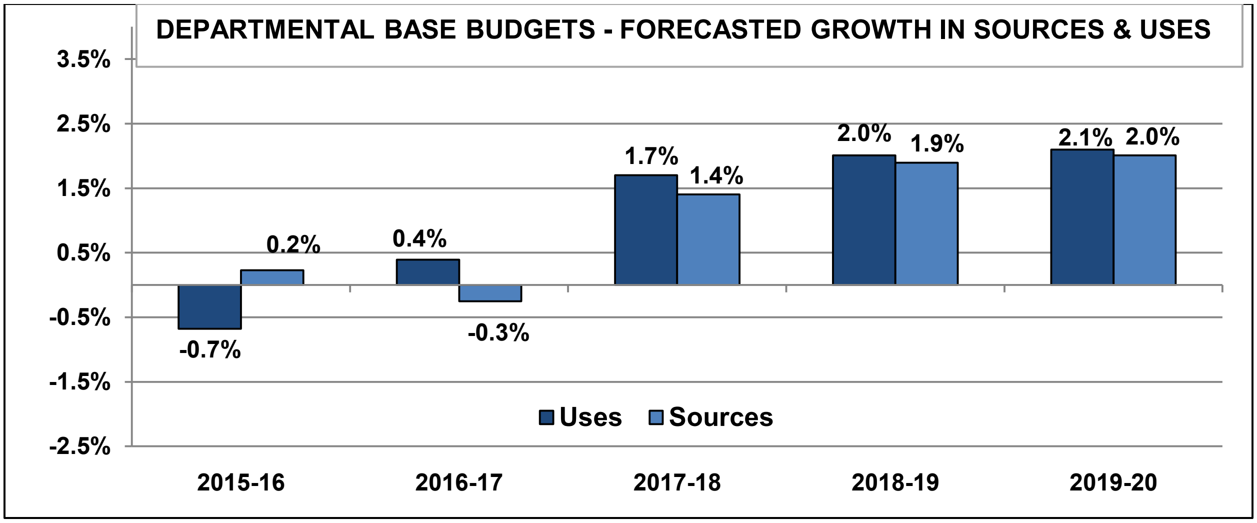
General Fund departments submitted baseline requests plus restoration requests that exceed available sources by $93 million over the five-year Plan period. If partial reserve replenishment is considered, the gap widens to $202 million over the five years. The County will make the final payment of remaining bankruptcy-related debt in FY 2014-15 (annual cost of approximately $18.4 million). The payments, which formerly required NCC allocations, are not included in the calculated NCC limits for FY 2015-16 through FY 2019-20. The following table illustrates the projected General Fund Sources and Uses:



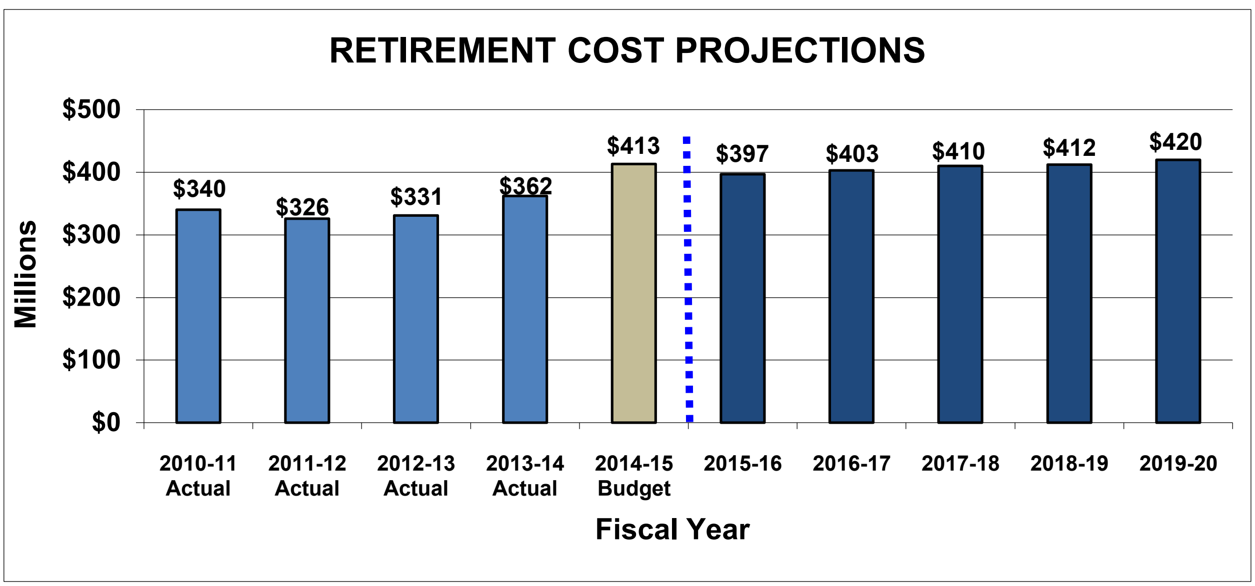
Notes:
[1] Available Sources includes use of one time revenue, but not reserves
[2] Net Baseline Uses is NCC limits plus restore and expand augmentations
[3] Sources Less Reserve Replenishment assumes partial reserve replenishment of State repayment draws

It is important to note that the gap between available sources and net baseline uses is primarily attributable to loss of the property tax in lieu of vehicle license fee revenue of $73.5 million annually.

The following chart summarizes variances in General Fund Departments' forecasted base sources and uses, inclusive of technical and reduction augmentations, and before application of any General Fund contribution (NCC).

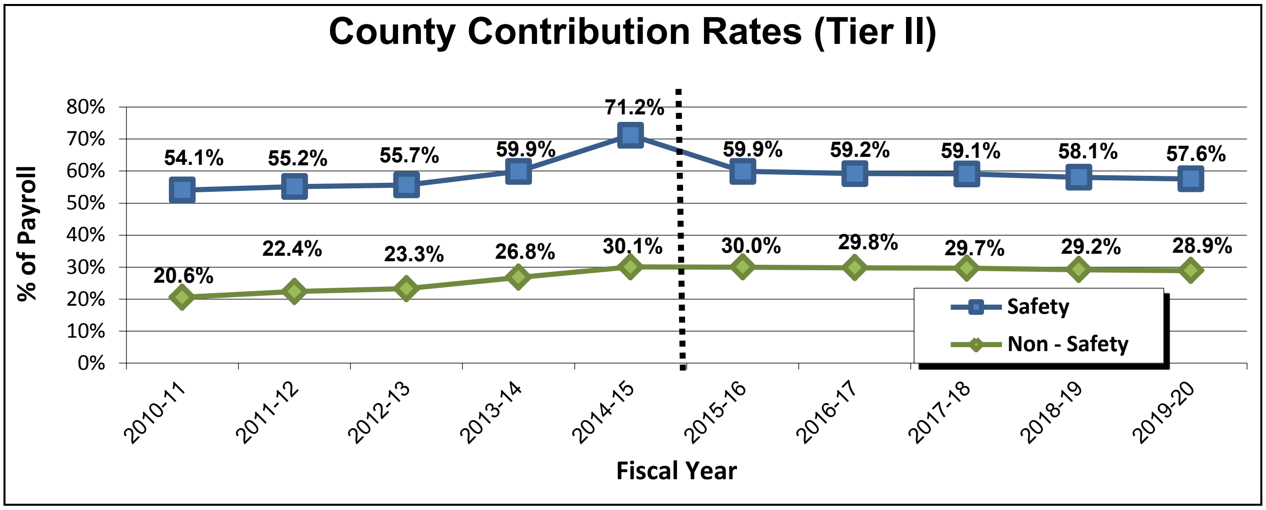


The County's cost of retirement has slowed since the 2013 SFP. As illustrated in the following chart, preliminary forecasts for retirement reflect annual costs growing from $413 million budgeted in FY 2014-15 to a forecast of $420 million in FY 2019-20, an average annual increase of 0.4%.



Note: All years exclude Pension Prepayment. FY 2011-12 forward excludes Retiree Medical.

The following summary of estimated County Contribution Rates for Tier II employees reflects reduced retirement rates for Safety employees beginning in FY 2015-16 as a result of employees picking up their full share of retirement costs, and reduced rates for Safety and Non-Safety employees due to the conclusion of the five year smoothing of the 2008 investment losses, in addition to other various actuarial assumption changes.



Excludes Retiree Medical

Revenues

Key Issues –

- Reimbursements – Timing and matching to costs (e.g., AB109 costs exceed revenue)
- User fees are not always at full cost recovery
- Loss of the vehicle license fee revenue continues to impact the County's ability to fund critical needs

As previously illustrated, departmental base revenues (sources) are growing slowly, and in all but one year are projected to be below growth in departmental base expenditures (uses). The Plan forecasts a moderate increase in GPR and key departmental revenue sources such as Public Safety Sales Tax. While intended to reimburse dollar for dollar actual expenditures, 2011 Public Safety Realignment (AB109) funding has not kept pace with program expenses.

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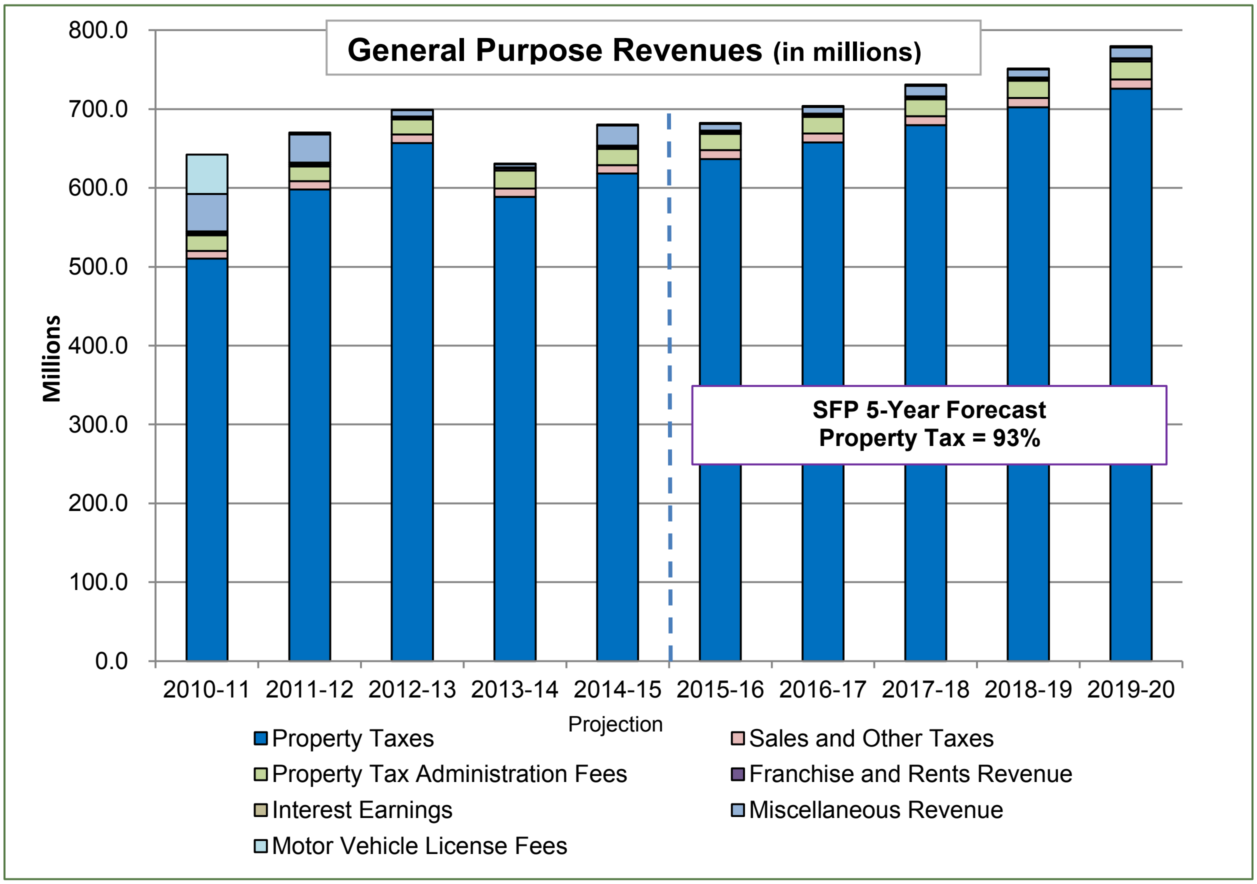
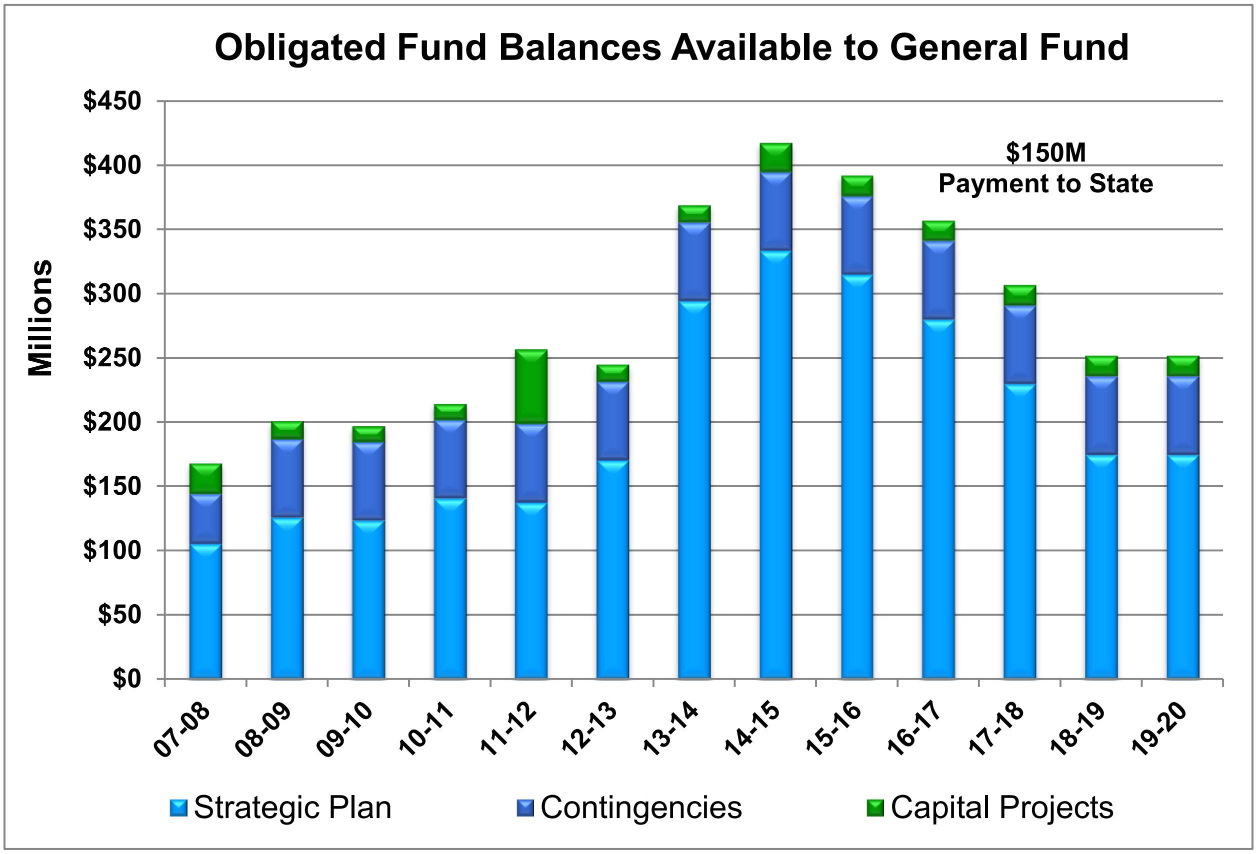
The following chart summarizes historical and forecasted growth in GPR. Detailed analysis of each component of GPR and Fund Balance Unassigned is provided in the *General Purpose Revenue Forecast* section of this document.



Note: Miscellaneous Revenue includes transfers in from other funds.

Obligated Fund Balances and Cash

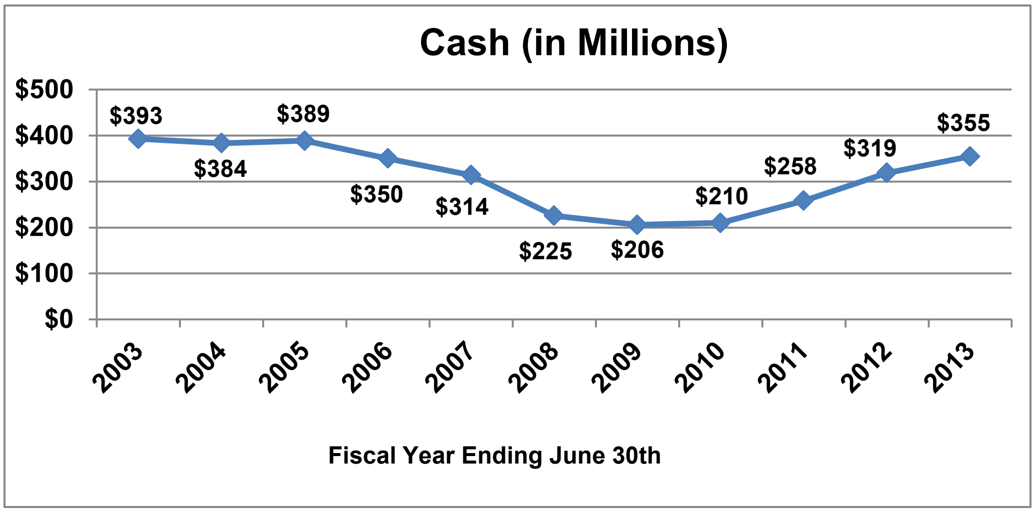
The County maintains an established reserves policy (please see the *Reserves Policy* section of this document) to mitigate cash flow impacts, maintain best debt ratings and positive borrowing position, and to provide liquidity in the event of a catastrophic event.



(Note: Balances exclude accounts held by other authorities/agencies such as balances held by the Orange County Employees' Retirement System [OCERS]).

During the economic downturn, reserves were used to reduce the severity of impacts to clients and Departments. Since that time, the County has committed to build reserves back to a level that provides flexibility to maintain service levels and protects the County's cash position in order to meet its obligations. And, although the obligated fund balances available to the General Fund in FY 2014-15 reflect a healthier reserve position, the Strategic Plan balance is inclusive of the remaining $145 million owed to the State over the next four years. As payments are made to the State, it is anticipated that even with prudent reserve replenishment, the reserve position in FY 2019-20 will be 10% less than projected for FY 2014-15; without replenishment, the reserve position will be 39% lower than the FY 2014-15 projection.

The County is conscientious in maintaining an adequate balance of General Fund cash to address timing variances that occur throughout the year between expense and revenue transactions. Cash balances experienced a decline since FY 2004-05, but in recent years, the County has been able to reverse this trend as a result of improvements to General Fund Reserve balance. Based on the current cash management plan, it is anticipated that cash balances will remain stable throughout the financial planning period, although on a cautionary note, cash may decline in years three and four when the two largest VLFAA payments are due to the State, unless steps are taken to replenish reserves over the five-year Plan. The following chart reflects historical cash balances through June 30, 2013.



Note: Cash balances are as of June 30 of each year as reported in the Comprehensive Annual Financial Report (CAFR).

Infrastructure & Capital Expenditures

Economic conditions and competing priorities for General Funds have influenced how the County has addressed capital spending. Beginning in FY 2007-08, like other peer counties, Orange County began deferring necessary investments in plant and equipment to balance already strained budgets and lessen potential cuts to ongoing operations. This policy has helped sustain funding for critical services; however, it is not a viable long-term solution and should be considered a short term plan. Deferral of project funding for critical infrastructure repairs and maintenance increases the risk of further deterioration and increases the probability that costs will be greater in the future (e.g. construction, purchasing and design costs are typical of costs that generally increase with the passage of time). Deferral of projects impacts the County's asset base and could have a bearing on future economic development. The added cost of continued deferral continues to be evaluated to ensure that adequate project funding is preserved and that project timelines are viable to maintain a reasonable level of risk and capital cost. (See further discussion in the *Capital Improvement Plan* section of this plan).

Strategies

It is critical that departments continue reviewing programs and operations to determine the best way to continue to size programs for future economic conditions and to ensure critical services are maintained and performance goals continue to be met within the confines of available resources. Departments and the County Executive Office are currently planning for the FY 2015-16 budget process with a goal to preserve the ability to provide quality services to stakeholders, including external clients and employees. Part of this process is to continue looking for opportunities for additional funding to maintain ongoing operations including efforts recently undertaken in development of the 2015-2016 Legislative Platform.

Summary

The years since the Great Recession have been challenging; however, the County's long-term commitment to a balanced budget and early action has been successful in maintaining core services with minimum impact to end users. Through their commitment to fiscal prudence, the Board of Supervisors developed a vision for the County and enabled the County to adapt to a radically changing environment. This commitment to fiscal practicality will continue to be required as the County attempts to balance the funding of identified needs.

The Board of Supervisors will be apprised of the County's fiscal status on an ongoing basis via the annual and quarterly budget reporting processes and other methods, as appropriate. Carrying out vital services and assurance of responsible management requires:

- That impacts continue to be evaluated and communicated timely;
- That the County continue to apply discipline to financial management;
- That structural balance focused on values and core services continues to be a priority;
- That the County continues to seek creative alternatives and partnerships.

The Board has demonstrated commitment to fiscal responsibility. Their action has ensured, and will continue to ensure, that government core priorities and services are maintained while retaining fiscal sustainability.

"Economy does not lie in sparing money, but in spending it wisely." ~ Thomas Huxley