Executive Summary

Introduction

The County of Orange is committed to long-term strategic financial planning to ensure its ability to respond to economic changes and unanticipated events in a way that allows the County to preserve the quality and range of services provided to the community. The year leading up to the 2017 Strategic Financial Plan process was marked by continued moderate economic growth. While growth after the Great Recession allowed the County to re-baseline some Department budgets and reprioritize one-time projects, the level of growth does not allow for material increases in levels of service. The County is committed to maintaining current service levels to the extent possible while using fluctuations in revenue growth to prepare for or complete previously deferred projects.

A continued disciplined approach to fiscal management of the County's limited resources will ensure alignment with countywide strategic priorities and values. Commitment to the Board of Supervisors' priorities of budget stabilization, preparation for contingencies, and funding of agency infrastructure, in addition to the VLFAA repayment to the State, emphasizes the need for long-term strategic planning including building a reserve balance that best positions the County to weather future economic variations with minimal impact on the community it serves.

Notwithstanding that costs of doing business continue to outpace revenue growth, the County is committed to implementing key initiatives and moving toward a future that will enrich the lives of Orange County residents and visitors including:

- **Building a System of Care:** The County continues to move forward with several key initiatives to improve the overall response to homelessness across the region, including: Bridges at Kraemer Place, the Whole Person Care (WPC) Pilot Program, and Continuum of Care housing initiatives.

- **OC Animal Care:** The County is progressing with the construction of the new animal care center being built on 10 acres of land at the former Tustin Marine base. The new facility, projected for completion in early 2018, includes a state-of-the-art design with outdoor areas, kennels and a training center.

- **Civic Center Facilities Strategic Plan (CCFSP):** The CCFSP initiative addresses the County's long-term occupancy in the Orange County Civic Center. The goals are to: improve delivery of services to the community, space usage and Departmental adjacencies, address the aging portfolio of County facilities, and better manage long-term occupancy and maintenance costs.

- **Integrated Services:** Integrated Services is an umbrella concept that covers eight Strategic Priories submitted for the 2017 SFP. These proposed initiatives focus on leveraging overlap in the provision of multiple services to address: mental health and substance abuse treatment, recidivism reduction, and post incarceration reentry to the community. An integrated approach in program implementation provides the ability to leverage funding and construct a more effective and efficient service delivery.

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 gauge Departments' needs and resources to ensure the County's financial position is sufficient to support ongoing services and long-term needs while ensuring genuine sustainability within potential future economic constraints. The Plan provides policy makers with a tool for evaluating the potential financial impact of policy decisions related to General Fund operations, capital requirements, emerging initiatives, and strategic priorities.

The Plan provides the framework for a five-year operating budget and prepares for development of the next fiscal year budget with the stipulation that assumptions used in developing the plan may change over time. The Plan is developed with a goal of identifying any significant issues that must be addressed to achieve the County's mission, goals and long-term plan for financial stability. The County continues to focus on the following key fiscal goals:

- 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 streams. 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 chiefly funded with State and Federal revenues.

As in prior years, the SFP focuses on General Fund gap analysis to highlight the continuing impact of projected moderate 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 2018-19 annual budget process. Summary analyses of capital and information technology (IT) project needs was also conducted. This year's SFP lays the groundwork for establishing budget priorities and funding solutions for FY 2018-19 prior to the usual timeframe of the annual budget process, thereby 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. Additionally, this Plan includes the updated Debt Management Policy as approved by the Board on May 9, 2017.

Relevant economic data was used in preparing the County's 2017 SFP including:

- General Purpose Revenue forecast developed in conjunction with forecasts by the Auditor-Controller, the 2017-18 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 2017 was included as part of the 2017 SFP instructions. As changes occur in the economy, projections will be updated during the FY 2018-19 annual budget development process.

<u>Key Assumptions</u>:

- The total cost of salaries and benefits is expected to increase over the five year plan and includes the following assumptions:
    - Salary growth factors include general salary increases consistent with existing memorandum of understanding (MOU) terms. Assumptions for salary increases beyond the existing MOU terms include 0% growth for Year 1 and 2% growth for Years 2 through 5 of the plan. Salary projections are developed independently and not in consultation with Human Resource Services or the Board. The use of growth factors is for planning purposes only and does not represent a commitment for bargaining purposes.

    - Retirement Rate Assumptions (Tier II) assume the market rate of return is 7.25% for all years, which resulted in the following retirement rates:
        - Safety Rate ranges from 69% to 72% (3@50; excludes retiree medical)
        - Non-Safety Rate ranges of 28% to 30% (2.7@55; excludes retiree medical)

    - Retiree Medical for Safety ranges from 3.8% to 4.4% (7.0% to 7.3% for Law Enforcement Management)
    - Retiree Medical for Non-Safety is 4.0%

- Health Benefit Cost Assumptions
    - 5-Year Growth from $194M to $271M (39%)

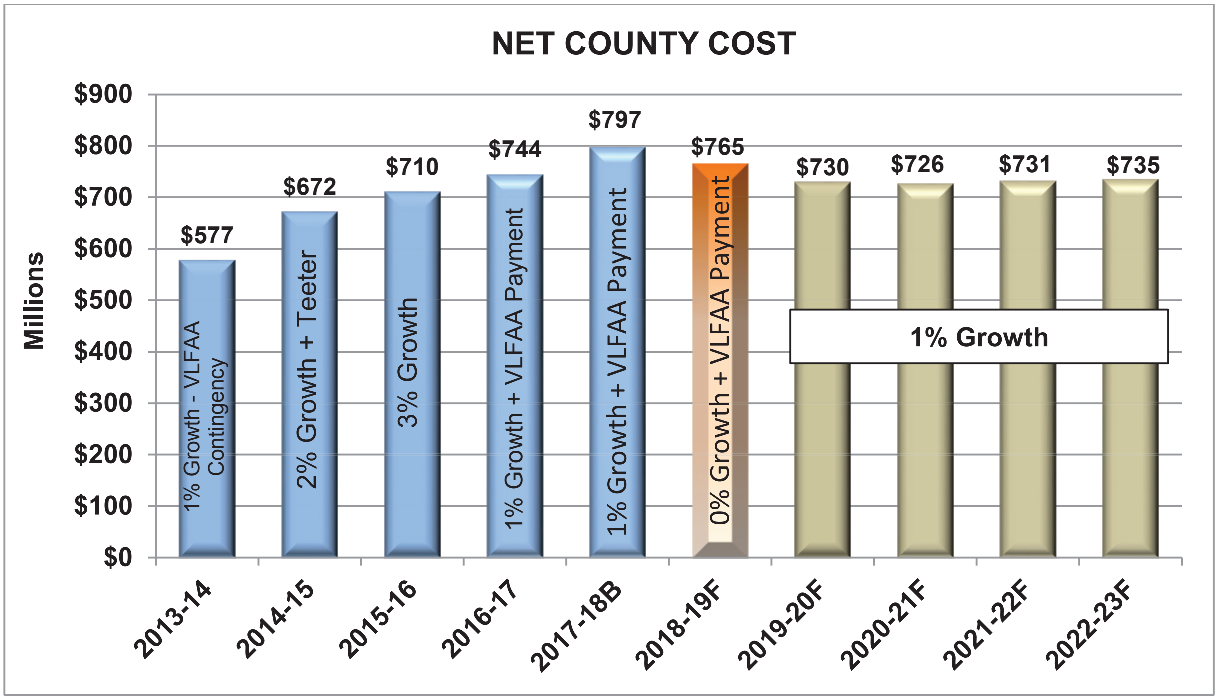
Not included in the assumptions for the 2017 SFP are the following economic and demographic assumption changes adopted by the Orange County Employees Retirement System (OCERS) Board on October 16, 2017, which will be used to establish retirement contribution rates effective July 1, 2019:

- Reduced the assumed investment rate of return from 7.25% to 7.00%
- Reduced the assumed rate of price inflation from 3.00% to 2.75%
- Adopted the use of generational tables, which have identified reduced rates of mortality for members

Additionally, the OCERS Board adopted a three-year phase-in of the impact to the contribution rates associated with the Unfunded Actuarially Accrued Liability (UAAL). The cumulative effect of these assumption changes will have the impact of increasing contribution rates for members and plan sponsors.

- Consumer Price Index (CPI) Assumptions for Services & Supplies: 2.8% to 2.9%

- Departmental NCC limits were set for ongoing baseline operations (current levels of service). FY 2018-19 NCC limits were projected using the adopted FY 2017-18 limits ($797 million) as a starting point, with amendments for technical adjustments and removal of one-time items resulting in proposed baseline limits for FY 2018-19 of $765 million. Departments have identified $72 million in appropriation reductions that would be required to meet the FY 2018-19 NCC limits. After factoring in NCC limit growth of 0% in FY 2018-19 followed by 1% in years two through five of the Plan and removing any one-time items, Departments identified a 5-year cumulative budget gap of $159 million. The following table summarizes historical budgeted and forecasted NCC.



The following table summarizes prior and current year Adopted Budget and Plan year projected NCC by program:

Program	14-15	15-16	16-17	17-18B	18-19F	19-20F	20-21F	21-22F	22-23F
Public Protection	$358.50	$395.39	$413.37	$454.05	$405.92	$411.51	$413.13	$416.81	$420.51
Community Services	132.34	125.56	127.23	128.77	128.65	129.93	131.21	132.50	133.81
Infrastructure	32.35	20.98	22.33	22.27	36.14	36.31	36.48	36.65	36.82
General Government	105.80	125.19	121.27	123.84	116.16	120.71	117.84	122.46	120.16
Capital Improvements	23.97	21.80	20.31	15.74	20.88	30.19	23.09	19.15	19.30
Debt Service	19.29	0.87	0.87	0.87	0.87	0.00	0.00	0.00	0.00
Insurance, Reserves & Misc.	(0.23)	20.36	38.87	51.36	56.36	1.36	3.92	3.92	3.92
GRAND TOTAL NCC	**$672.02**	**$710.15**	**$744.25**	**$796.90**	**$764.98**	**$730.01**	**$725.67**	**$731.49**	**$734.52**

Note: FY 17-18B NCC is the adopted budget. SFP years are forecasted (F); and FYs 2021-22 and 2022-23 differ from the Plan Summary due to adjustments for projected $2.8 million payments in each year from participating cities for the new Animal Care Center.

Outlook and Opportunities

In general, trends in key economic indicators reflect continued modest economic growth now and into the near future. Although economic growth is still projected, it is not sufficient to offset the rising costs of salaries and benefits and other costs of doing business. 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.

Expenditures

Key Issues –

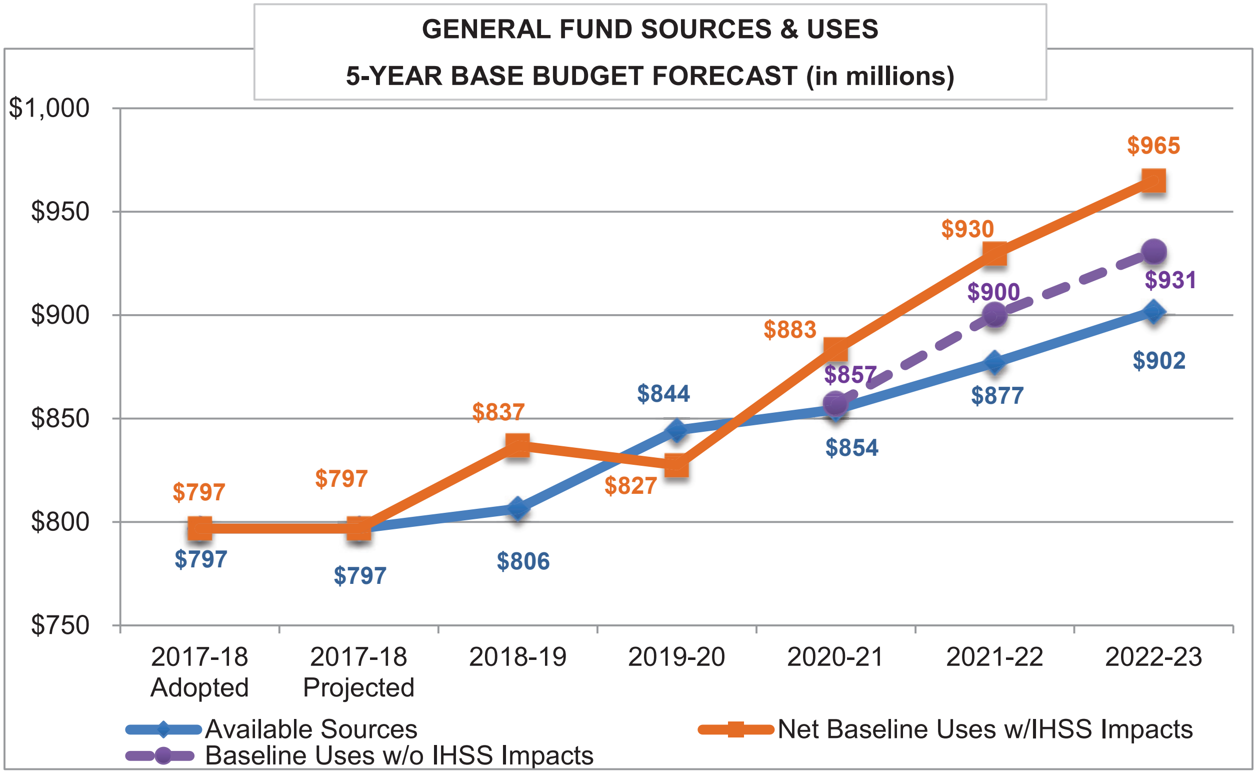
- The cost of doing business continues to grow.
- Competing needs exist for General Funds, including the need to fund new and deferred capital and information technology projects and ongoing strategic priority requests.

The following chart illustrates the projected General Fund Sources and Uses. The Net Baseline Uses encompasses Department NCC requests including restore augmentations. The Baseline Uses assumes payment of the remaining $105 million in VLFAA payments to the State within available baseline sources rather than use of reserves previously set aside for the payments, contributing to the large gap between sources and uses in FY 2018-19. This gap closes for one year after the final payment is made, but grows again over the last three years of the plan as costs of doing business outpace revenue growth. The County will attempt to make the VLFAA payments from the baseline budget to preserve reserve balances, but may draw on reserves, if needed, to ensure no impact on mandated levels of service.

The gap between sources and uses begins at $31 million in the first year of the Plan; reverses in year two with sources exceeding uses by $17 million due largely to removal of the $55 million VLFAA payment included in the base budget of year one; and then grows to $63 million by year five. The projected cumulative additional funding needed for the five years is $159 million if all restore requests were to be supported.

An additional line was added to the chart to demonstrate the estimated funding gap between baseline uses and sources if the projected impacts of shifting responsibility for the In-Home Supportive Services (IHSS) program from the State to counties is removed from consideration. The revised gaps begin with no changes in years one and two as Social Services Agency reserve sources are exhausted to fund the IHSS impacts, while years three through five would experience smaller gaps ranging from

$26 million to $34 million. The projected cumulative gap would be $104 million or $55 million less than the aggregate gap including the IHSS impacts.

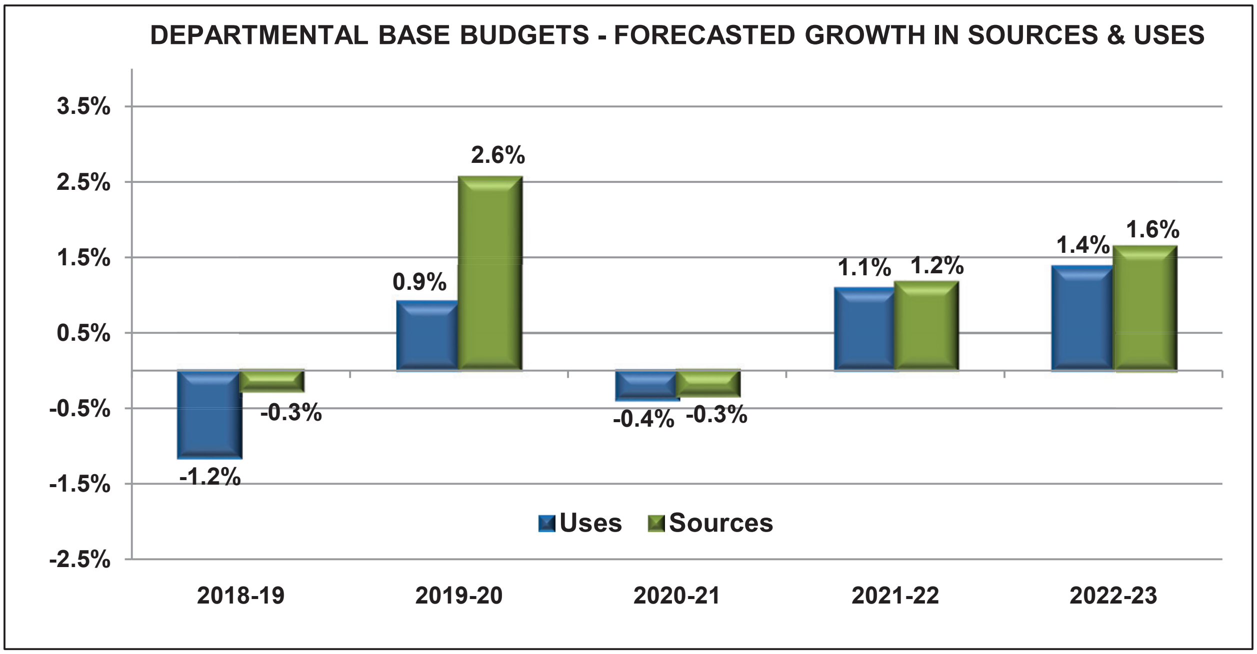


Notes:
[1] Available Sources is General Purpose Revenue and may include use of one-time revenue sources
[2] Net Baseline Uses w/IHSS Impacts is NCC limits plus restore augmentations, and includes the remaining $105M in VLFAA payments in FYs 2017-18 and 2018-19

It is important to note that unexpected shifts in economic conditions could cause the gaps between available sources and net baseline uses to widen; and the shift of IHSS program responsibility to counties as approved in the FY 2017-18 State budget is likely to constrain the ability to fully fund current and future operations.

Base Budget Sources & Uses

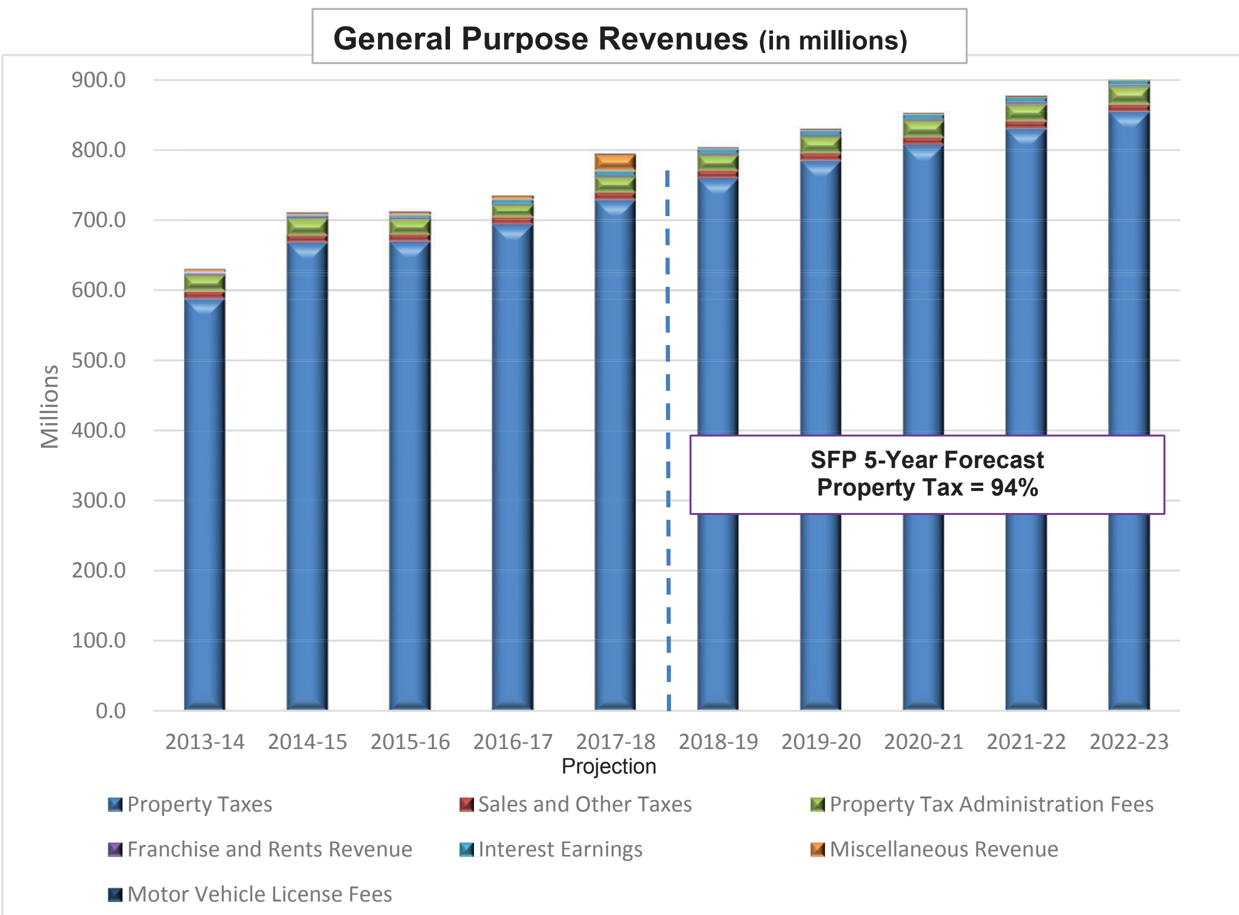
The following chart summarizes variances in General Fund Departments' forecasted base sources and uses, inclusive of technical and reduction augmentations, and before application of any General Fund contribution (NCC). The reductions to base budget appropriations that General Fund Departments employed in each fiscal year to meet the NCC Limits were: FY 2018-19 - $72.1 million; FY 2019-20 - $97.4 million; FY 2020-21 - $157.8 million; FY 2021-22 - $195.5 million; and FY 2022-23 - $227.8 million.



Revenues

As previously illustrated, Departmental base revenues (sources) are projected to decline and be below growth in Departmental base expenditures (uses) in year one, grow at a moderate rate in year two, decline again in year three, and experience steady but low growth in years four and five.

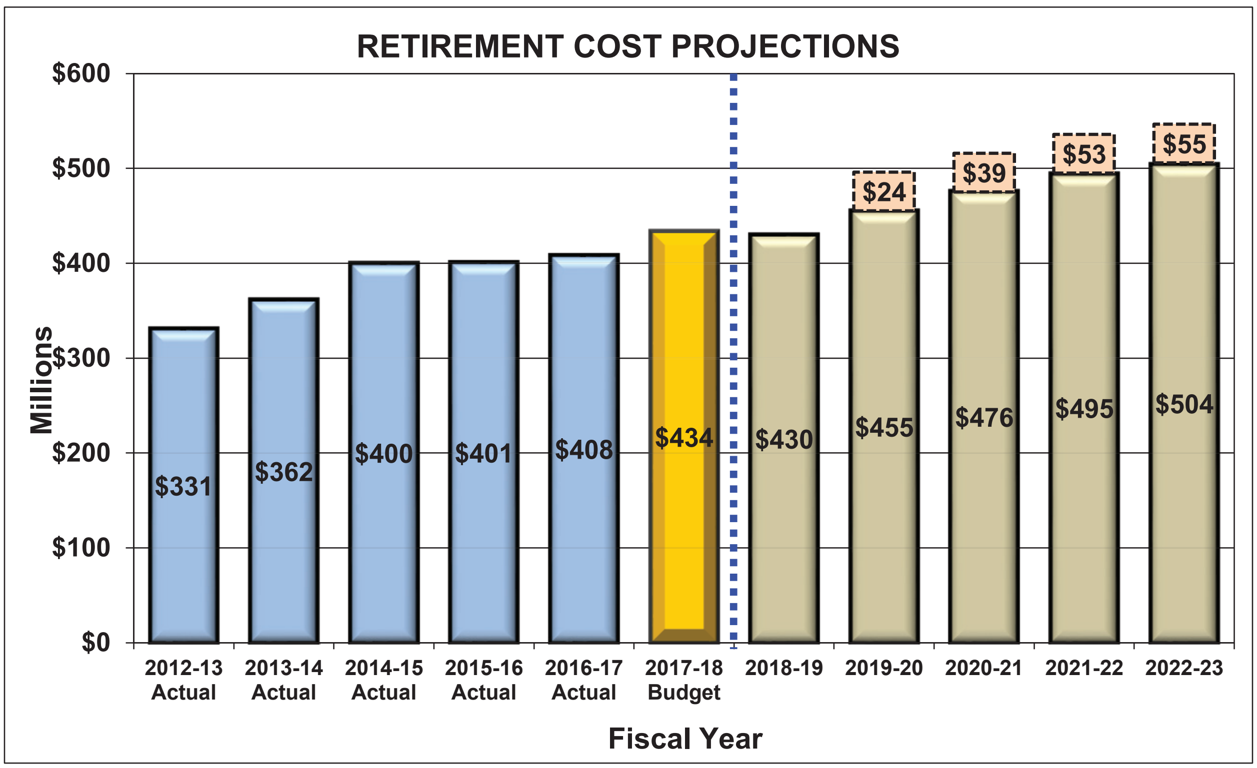
The Plan forecasts moderate increases in General Purpose Revenue (GPR) consistent with current economic trends. The following chart summarizes historical and forecasted growth in GPR. Detailed analysis of each component of GPR and Fund Balance Unassigned is provided in the *General Purpose Revenue Forecast* section of this document.



Note: Miscellaneous Revenue includes transfers in from other funds.

Retirement

The County's projected cost of retirement shows a significant decrease from the 2016 SFP primarily due to: a) decreases in the growth of regular salaries resulting from a 0% growth assumption in Year 1 of the 2017 SFP; b) a decrease in retirement costs resulting from the OCERS' December 31, 2016 Actuarial Valuation; c) a 7.25% market rate of return assumption for retirement used for all years of the 2017 SFP, whereas the 2016 SFP assumed a 0.00% market rate of return assumption for calendar year 2016; and d) an increase in the number of budgeted positions in PEPRA (Public Employee Pension Reform Act) retirement plans. As illustrated in the following chart for retirement cost projections, preliminary forecasts for retirement reflect annual costs growing from $434 million budgeted in FY 2017-18 to a forecast of $504 million in FY 2022-23, an average annual increase of 3.3%.



Note: All years exclude Pension Prepayment and Retiree Medical.

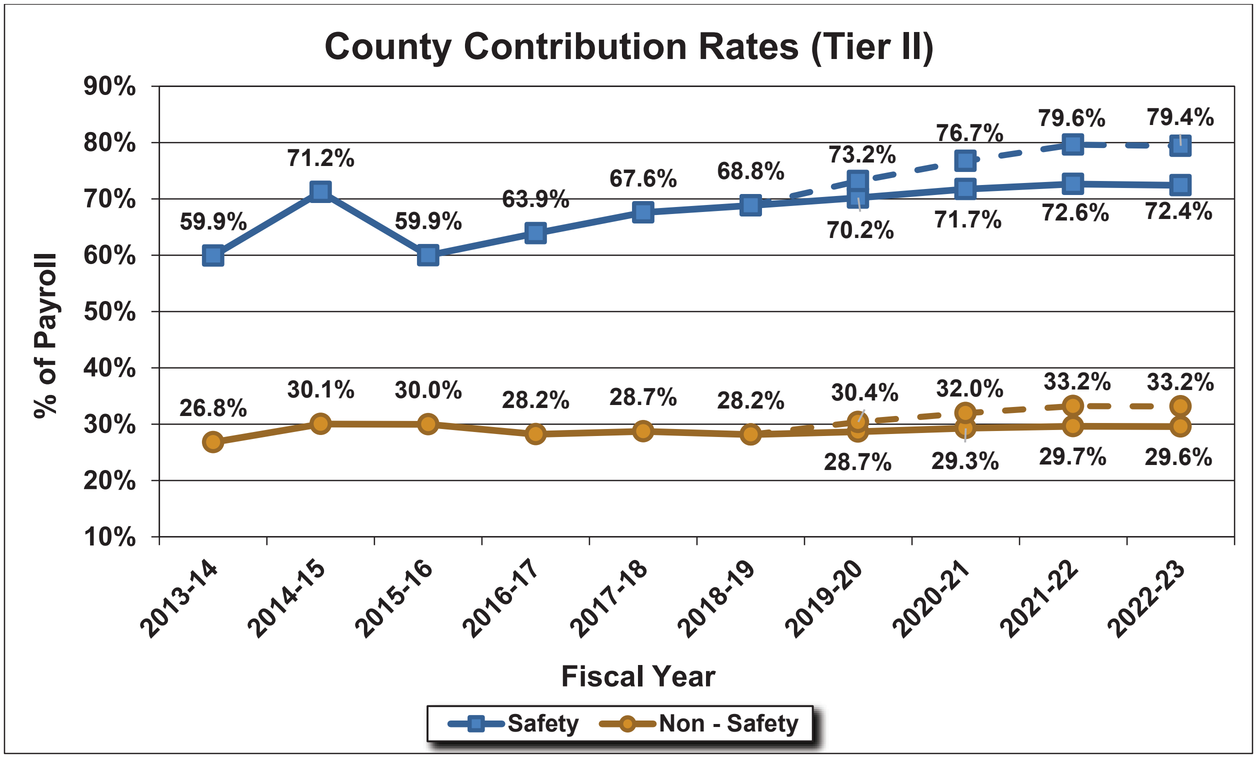
For illustrative purposes, included in the chart for retirement cost projections are the impacts from the economic and demographic assumption changes adopted by the

OCERS Board on October 16, 2017. The table below reflects the estimated total impact to the County's retirement costs as a result of these changes:

	FY 2018-19	FY 2019-20	FY 2020-21	FY 2021-22	FY 2022-23
Total County Impact	$0M	$24M	$39M	$53M	$55M
General Fund Impact	$0M	$18M	$29M	$40M	$41M

Note: Estimates based on OCERS Actuarial Experience for the Period January 1, 2014 through December 31, 2016.

The following chart of estimated County Contribution Rates for Tier II employees reflects increased retirement rates for Safety employees beginning in FY 2016-17 related to the impact of the three-year phase-in of a decrease in mortality rates for Safety employees, and the unfavorable investment returns (after smoothing) due to the lower than assumed actual 2014 and 2015 market returns. Included in the chart for estimated County Contribution Rates for Tier II employees are the projected impacts to contribution rates from the economic and demographic assumption changes adopted by the OCERS Board on October 16, 2017.



Notes:

1) **All years exclude Retiree Medical.**
2) **Dashed lines in the chart indicate the projected impact to County contribution rates from the economic and demographic assumption changes adopted by the OCERS Board on October 16, 2017.**

Unfunded Actuarial Accrued Liability (UAAL) – Accelerated Funding Plan Analysis

In an effort to manage long-term liabilities, the County, during the 2017 Strategic Financial Plan process, evaluated the concept of accelerating payments toward the long-term unfunded pension liability associated with the defined benefit plans provided to employees at retirement. Accelerating the payments toward the long-term unfunded pension liability, could achieve the following benefits.

- Reducing the County's unfunded pension liability sooner, with the potential of positively impacting the County's credit rating.
- Accelerating contributions into the retirement system for the unfunded pension liability leads to a greater return on investments. While accelerating payments increases the exposure to market risk, doing so in a methodical "dollar cost average" basis mitigates market risk.
- Although making greater payments toward the unfunded pension liability increases costs in the short-term, it results in lowering the County's total annual retirement costs over the long-term.

Background – The County participates in the Orange County Employees' Retirement System (OCERS), a cost sharing multiple-employer, defined benefit pension plan. The County's funding policy is to make periodic contributions to OCERS in amounts such that, when combined with employee contributions and investment income, fully provide for member benefits by the time they retire. At the end of each calendar year, OCERS conducts an actuarial valuation which establishes the employer and employee retirement contribution rates. The total employer retirement contribution rate includes two components: the Normal Cost Component; and the current year's cost for the Unfunded Actuarial Accrued Liability (UAAL). The Normal Cost Component is the cost to pay for the current year's value of retirement benefits as earned. The UAAL Component is the accrued liability for past services which were not funded by prior contributions and investments. Ideally, all benefits are funded through the Normal Cost Component only. However, a UAAL can arise due to the following factors:

- Benefit enhancements are retroactively applied.
- Actuarial losses due to actual growth in factors such as the number of retirees, improved mortality rates, or investment return losses.
- Changes in actuarial assumptions for factors such as the assumed rate of return, member mortality rates, rate of salary increases, or age at retirement.

In FY 2016-17, the County's total annual retirement cost was approximately $408.3 million, with an estimated UAAL cost of $250.1 million or approximately 61% of total retirement costs. Based on the December 31, 2016 actuarial valuation by OCERS, the County's total UAAL was an estimated $3.86 billion. The following table summarizes the County's UAAL, current funding level and five-year projected funding level by the County's four rate groups:

County of Orange
Unfunded Actuarial Accrued Liability (UAAL) and Funding Level by Rate Group
Based on December 31, 2016 OCERS Actuarial Valuation Prepared by Segal Consulting

Rate Group	Rate Group Members	UAAL (1)	Current Funding Ratio (1)	OCERS 5-Yr Proj. Funding Ratio (1)	5-yr Target Funding Ratio
1	American Federation of State, County and Municipal Employees (AFSCME) & Sheriff Deputy Trainees	43,129,000	82.60%	85.30%	85.30%
2	General Employees	2,541,802,000	71.20%	77.10%	82.10%
6	Probation	213,650,000	70.80%	79.00%	84.00%
7	Law Enforcement	1,058,165,000	69.90%	76.60%	81.60%
Total		**3,856,746,000**	**70.93%**	**77.14%**	**82.10%**

(1) UAAL, current funding ratio and five-year projected funding ratio data provided by OCERS.

Analysis – For the UAAL Accelerated Funding plan analysis, the County set a target of increasing the funding level by 5% for Rate Groups #2, #6 and #7 over a five-year period. Rate Group #1 was excluded from the analysis, since Rate Group #1 is currently 82.6% funded as of December 31, 2016 and is projected to be 85.3% funded within a five-year period. The County requested OCERS' actuary, Segal Consulting, to estimate the additional level dollar annual payments required to increase the projected funding level by 5% for the targeted Rate Groups over the five-year period. In addition, Departments were tasked with analyzing various program funding sources to assess whether additional contributions toward reducing the liability could be reimbursable under applicable guidelines.

Results – In order to achieve the targeted funding level over the five-year period, the County would have to contribute an additional $157 million annually to OCERS, of which $120 million would be required from the General Fund. The following table summarizes the amount required annually over the five-year period by Rate Group:

Additional Annual UAAL Payment			
Rate Group	Rate Group Members	Total Annual County Contributions	Total General Fund Portion
2	General Employees	$ 104M	$ 80M
6	Probation	10M	10M
7	Law Enforcement	43M	30M
Total Additional Annual Contributions		**$ 157M**	**$ 120M**
Total Additional Contributions Over Five-Year Period		**$ 785M**	**$ 600M**

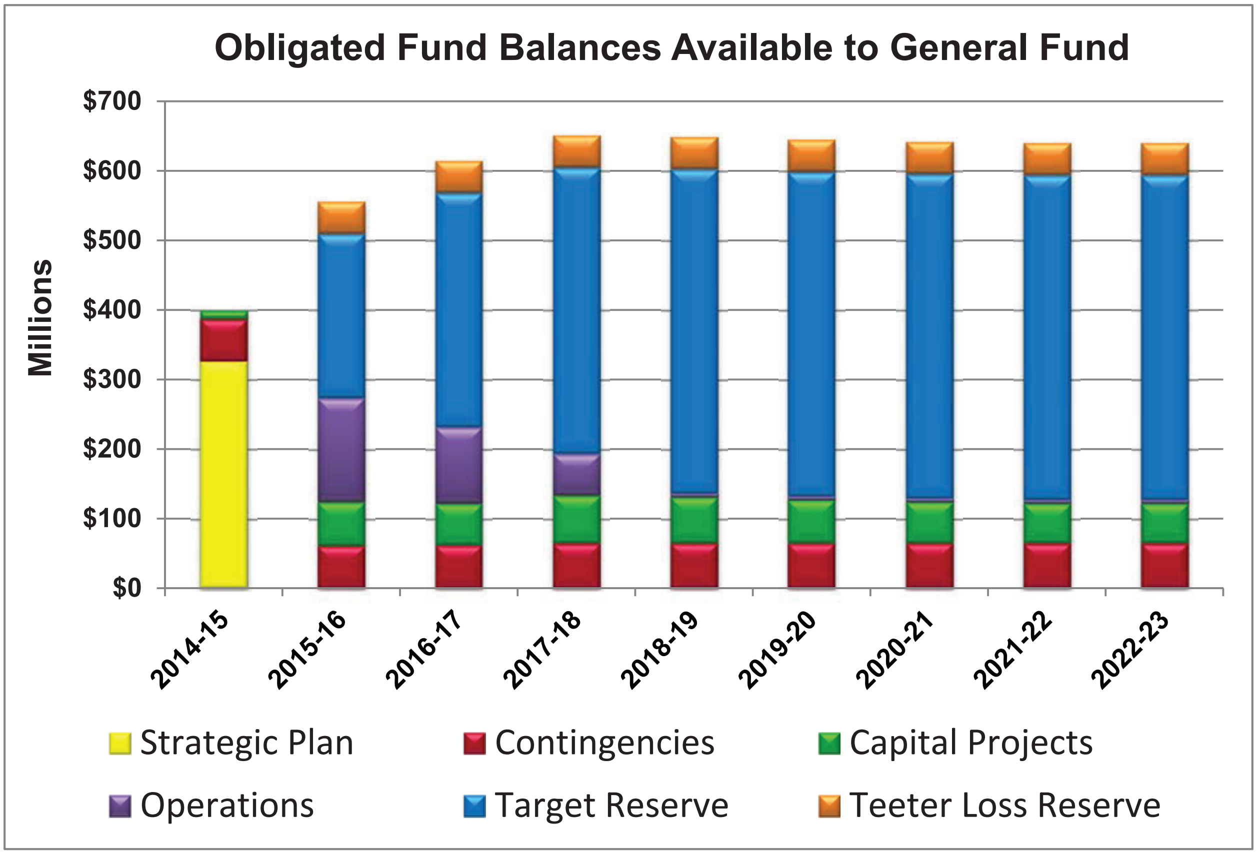
The following challenges were identified which would limit the County's ability to achieve the targeted funding level over the five-year period:

- General Fund discretionary funding is limited and the funding priority is for County mandates.
- Applicable guidelines for many program funding sources do not allow for the advance payment of unfunded pension liabilities.
- Numerous County programs have limited program funding which is currently being fully utilized to cover existing expenditures and service levels.
- Additional sources of funding, such as program user fees, would have to be increased to cover the cost of additional payments toward the unfunded pension liability.
- Charges to contract partners would have to be increased to cover the cost of additional payments toward the unfunded pension liability.

In summary, due to the challenges faced by the County, a plan to accelerate payment of the unfunded pension liability is not currently feasible. However, based on the December 31, 2016 OCERS actuarial valuation, it is projected that the County will achieve an adequate funding level of 80% by 2023, as a result of the steps taken by the County and the OCERS Board of Retirement. In 2013, the OCERS Board adopted a reduction in the amortization period of the UAAL from 30 years to 20 years, which was a sound financial decision to ensure a more timely payment of the UAAL, eliminating an additional ten years of interest payments. To control and reduce the growth of the UAAL, the County implemented a hybrid retirement plan (1.62% @ 65) prior to implementation of the California Public Employees' Pension Reform Act of 2013 (PEPRA). The County will continue to evaluate and pursue other opportunities to build upon and improve the County's financial position and reduce long-term liabilities.

Obligated Fund Balances and Cash

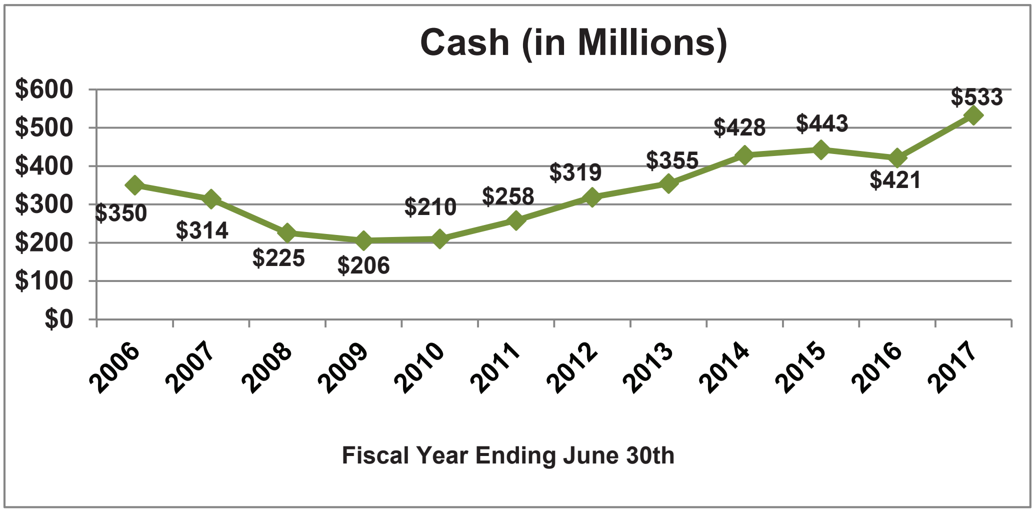
The County maintains an established reserves policy (please see the *Reserves Policy* portion of this document) to mitigate cash flow impacts, maintain best debt ratings and positive borrowing position, and to provide liquidity in the event of a catastrophic event.



(Note: Balances exclude accounts held by other authorities/agencies such as balances held by the Orange County Employees' Retirement System [OCERS]. Balances assume VLFAA payment is made from base budget rather than drawn from reserves.)

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. While the current and projected obligated fund balances available to the General Fund reflect a healthier reserve position, the Strategic Plan balance is inclusive of the remaining $55 million owed to the State in the first year of the Plan. In addition, although no increases to reserves are forecasted, in accordance with Board Resolution 10-136, any excess Fund Balance Unassigned recorded at fiscal year-end is transferred to reserves by the Auditor-Controller during the year-end closing process.

The County is diligent in maintaining an adequate balance of General Fund cash to address timing variances that occur throughout the year between expense and revenue transactions. 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 year one when the last and largest VLFAA payment is due to the State if the payments cannot be made from available baseline sources. The following chart reflects historical cash balances through June 30, 2017.



Note: Cash balances are as of June 30 of each year as reported in the Comprehensive Annual Financial Report (CAFR). Cash balance for 2017 is preliminary as of November 9, 2017.

Infrastructure & Capital Expenditures

Economic conditions and competing priorities for General Funds influence how the County addresses capital spending. Beginning in FY 2007-08, like other peer counties, Orange County deferred necessary investments in capital assets and equipment to balance strained budgets and lessen potential cuts to ongoing operations and programs. Coming out of the Great Recession, the County is using a portion of the modest growth in revenues to fund previously deferred critical projects such as the Sheriff's CCTV (closed circuit television) jail video system and maintenance at many of the County owned facilities. Continued deferral of project funding for critical infrastructure repairs and maintenance increases the risk of further deterioration and increases the possibility that costs will be greater in the future. In addition, one-time revenues are being utilized to build toward the future with new projects including Bridges at Kraemer Place, and the OC Animal Care Center.

Strategies

It is essential that Departments continue to review programs and operations to determine the best practices when sizing programs for future economic conditions and to ensure services to the community are maintained and performance goals are met within the boundaries of available resources. Departments and the County Executive Office are currently planning for the FY 2018-19 budget process with a goal of preserving the capacity to provide quality services to stakeholders, including external clients and employees. Integral to this process is seeking opportunities for additional funding to maintain ongoing operations including efforts undertaken in development of the County's Legislative Platform. In addition, projected IHSS budgetary impacts in the Community Services program area mean that re-evaluation of Department budgets and reprioritization of projects will be required during the budget process.

Summary

The County's long-term commitment to a balanced budget and early action has proven successful in maintaining core services with minimum impact to service recipients. Through their commitment to fiscal prudence, the Board of Supervisors developed a vision for the County to address critical community, capital, and organizational needs while also allowing for accommodation of new fiscal challenges and opportunities as they arise. The County continues to make significant progress with key initiatives including construction of the new Animal Care Center and a new Civic Center Building, upgrades to the Central Utility Facility, and Phase One completion of the Bridges at Kraemer Place.

An ongoing commitment to fiscal practicality will be required as the County attempts to balance the funding of identified needs and priorities and strives to provide high quality services and advance major initiatives. The combined efforts of the Board of Supervisors and County employees toward careful and responsible fiscal management will position the County to overcome new challenges as they arise, while continuing to fulfill the County's mission.

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;
- The County continue to apply discipline to financial management;

- Structural balance focused on values and core services continues to be a priority;
- The County continues to seek creative alternatives and partnerships.

The Board has demonstrated commitment to disciplined financial management. It is the continued coordinated efforts of the Board and the County employees that make it possible to exercise fiscal stewardship and to maintain government core services and priorities.