Purpose

Humboldt County's 7-year Financial Forecast report is intended to provide the Board and public information on trends in anticipated revenues, expenditures and fund balance for the county's major operating funds for the next seven fiscal years. This report covers only the largest county funds and funds with significant deficits. Forecasts for funds not included were reviewed by county administrative staff and projected to have no noteworthy changes or issues over the 7-year period.

Economic Outlook

Economic indicators for the United States (US), California and Humboldt County predict that the economy will continue to grow, according to federal Congressional Budget Office (CBO), through (FY) 2019-20 and that over a 10-year outlook that growth will average 1.9 percent. Beacon Economics in its Winter 2018 report published a forecast that was "boringly optimistic" because, outside of the rapidly growing federal budget deficit, the US economy looks to be well-balanced in terms of the structure of growth with solid fundamentals including private sector debt levels, consumer savings rates, rising wages, the overall pace of homebuilding and business investment. While unemployment is low, job growth remains steady.

The US economy is now in the 10th year of its current expansion, and at this point there is little reason to believe that will end in 2019. If that occurs, it will end being the longest period of continuous expansion in US history, with the longest period being 10 years. Historically recessions have occurred about 5 years apart and this suggests another recession may occur during the 7-year forecast period.

Local economy: The Humboldt Economic Index is a report that has tracked economic indicators since January 1994 and is produced by the Economics Department at Humboldt State University. It measures changes in the local economy using data from local business and organizations, and uses January 1994 as its baseline. The report includes a Composite Index which is a weighted average of seven individual sectors of the local economy. The November 2018 report states the Composite Index is 104.3 (meaning 4.3 percent above 1994 levels), up 0.1 points from this time last year. Retail sales have dipped 2.5 points lower when compared to October 2017, and the 4-month average is down by 1.0 points. The Index of Home Sales has increased from this time last year by 0.4 points; moreover, the bigger issue is the availability of affordable housing and housing stock in general. The median home price in November was $310,000 versus $300,000 in January 2018. The seasonally adjusted unemployment rate for Humboldt County decreased from 4.1 percent last year to 3.6 percent, which is comparable to the state rate decreasing from 4.9 to 4.1 percent. The national unemployment rate dipped slightly from 4.1 compared to 3.7 in November 2018.

Building permits: The numbers for local building permits have dropped, and still remain lower compared to pre-recession levels. Local building permit numbers, when compared to the prior year for the same period, reflect a drop of 8.44 points compared to October 2017.

Unemployment: According to the Congressional Budget Office's fall 2018 update, the country's unemployment rate was 3.8 percent on average in 2018. In CBO's projections, the unemployment rate continues to drop to about 3.3 percent by the end of 2019, and then rises gradually and approaches its natural rate of 4.6 percent over the 2020–2022 period as economic growth slows. The labor force, in contrast, approaches (but remains below) its estimated potential size in 2018 and 2019 and slightly exceeds its potential between 2020 and 2022. While the labor shortage should increase wages, it is likely to play a factor in slowing economic growth in years to come.

Minimum wage: State law requires the minimum wage to increase to $11.50 per hour at the beginning of calendar year 2019 for organizations with 26 or more employees, with the rate rising to $15 by 2022. Between 30 and 35 percent of Humboldt County workers earn less than $12.50 per hour, meaning that a large portion of citizens received a raise at the beginning of the year.

State economy: Beacon Economics Winter 2018 report states California's job growth is virtually the same as last year, adding 337,000 jobs in 2018, and the overall economy continues to grow for the seventh consecutive year. In terms of economic indicators, California has been outpacing the national average over the past year. Wages are growing by 4.6 percent compared to 3.4 percent for the rest of the county. Gross state product out-produced national gross domestic product (GDP) 3.3 to 3.1. However, the US labor force grew by 1.0 compared to 0.4 for California. Looking ahead to 2019, job growth is likely to occur in the population serving sectors, which is where half the state's job gains have come from over the last 3 years. This trend was led by health care (22 percent), followed by leisure and hospitality, and government. Growth in terms of output is likely to come from the information industry, which has contributed 40 percent since 2015. In all, California can count on increases in employment among its population serving industries, but if the state wants to increase the size of the economy it will likely need to do so with industries other than information, such as health care, manufacturing, and transportation. Home sales continued to increase in 2018, with the statewide median sold price at $554,760 as of November 2018 according to the California Association of Realtors. The median price has risen 1.5 percent, with a 13.4 percent decrease in sales. The median home price for Humboldt County however is identical to November 2017's price of $310,000, and local sales have grown by 3.2 percent. While home sales decreased statewide, single-family home inventory increased to 3.7 percent from 2.9. An increase in the number of available homes on the market also impacts the availability and price for rental housing.

Sales tax: A review of the Hinderliter, de Llamas & Associates (HdL) comparison of sales tax receipts for the first three quarters of 2017 and 2018 shows a 20.2 percent decrease in point-of-sale tax revenue for Humboldt County. This is in stark contrast to the Beacon Economics analysis that state sales tax revenues are anticipated to steadily increase for 2019. Actual Bradley-Burns sales tax revenue for the county at the end of December was down roughly 10 percent from FY 2017-18, and Measure Z revenue is down roughly 5 percent from initial projections. While staff cannot be certain as to the causes for the dip in sales tax revenue, it is worth mentioning that the drop coincides with the first full year of cannabis legalization and a record number of individuals and businesses moving in to the legal market, and paying associated costs and fees.

It should be noted that in June 2018 the US Supreme Court ruled in favor of the Wayfair decision, which allows states to require online retailers to collect and remit sales tax, regardless of whether they have a "physical presence" in the state. In California, retailers subject to this decision are those who have sales for delivery in to the state exceeding $100,000, or retailers who have more than 200 transactions for delivery in to the state. The California Department of Tax and Fee Administration will begin requiring out-of-state retailers to collect online sales tax beginning April 1, 2019.

According to the U.S. Bureau of Labor Statistics, online sales have grown 66 percent since January 2008, while other retail trade has grown by 1 percent. The California Board of Equalization estimated that total revenue losses for local governments as a result of online sales for both businesses and household consumers were about $756 million in FY 2016-17, with projections growing to $879 million in FY 2018-19. It is unclear how much, if any, additional revenue the county will receive as a result of the Wayfar decision, and no additional sales tax (Measure Z or Bradley-Burns) has been factored in to these estimates.

State and federal governments: The county receives a large amount of revenue that is dedicated to funding mandated state and federal programs. For this reason the state and federal budgets have the potential to impact the General Fund and programs delivered through various funds, several of which are maintained by the Department of Health & Human Services.

Fortunately, even though California has a new Governor, the state continues to make significant progress towards building up Reserves and could have as much as $14.8 billion by the end of 2019-20. This is good for local governments because Reserves have the potential to provide a buffer against state budget problems if a negative economic situation such as a recession were to occur.

The state Legislative Analyst's Office (LAO) forecast is similar to last year, but pushes out economic growth two years. It assumes continued moderate economic growth for California through 2020 but recognizes the potential for mild recession as soon as the beginning of FY 2020-21. If the state continues to increase its financial commitments in 2019-20, the LAO assumes the state could exhaust its reserves by 2022-23 in a recession scenario.

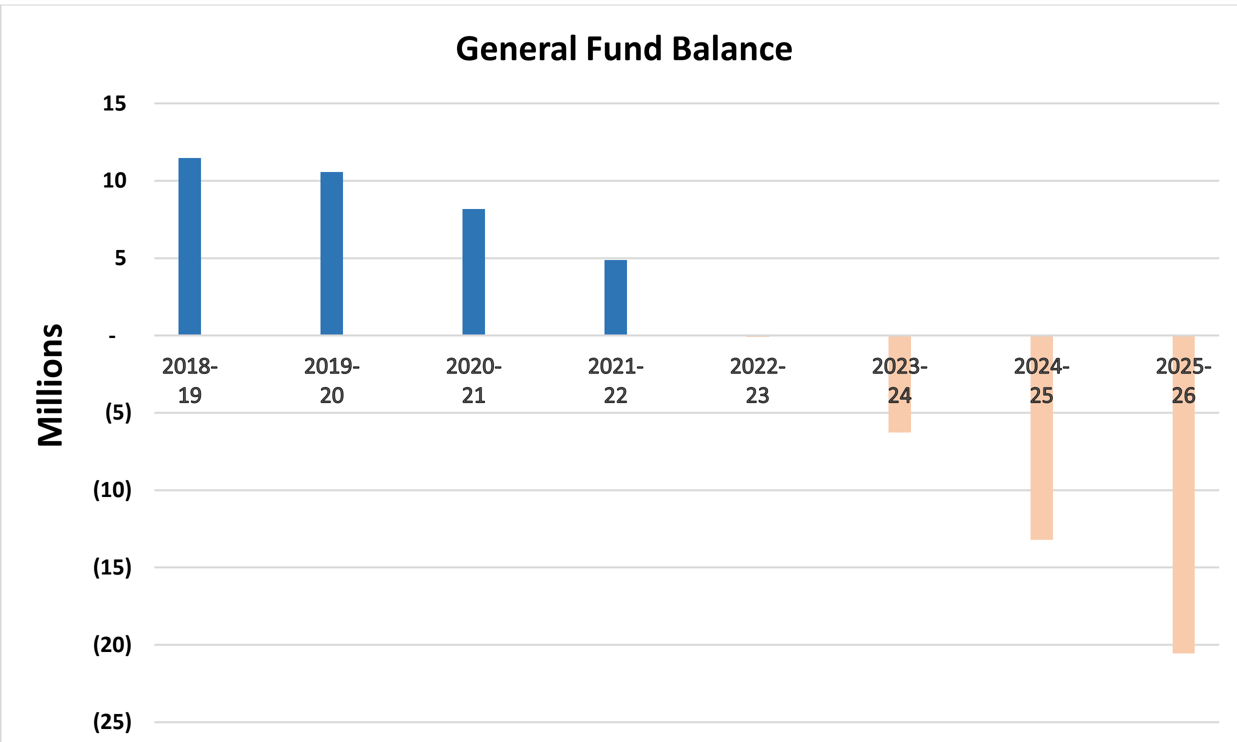
While the Congressional Budget Office (CBO) expects the federal Tax Cuts and Jobs Act of 2017 to have a positive effect on Gross Domestic Product (GDP), it also projects the federal budget deficit to grow substantially over the next 10 years. In total, CBO shows there was strong economic growth in 2018 (3.1 percent) and projects tapering growth in future years (2.4 percent in 2019, then 1.6 percent on average through 2022). This growth is expected to create excess demand for goods and services, which lowers the unemployment rate, but also puts upward pressure on interest rates, and price and wage inflation.

The federal budget deficit has doubled in the last 10 years and is projected to approach 100 percent of GDP by 2028. That amount is far greater than the debt in any year since just after World War II. Though wages seem to be on an upward tick, the above factors could have serious consequences both for the economy and federal budget. This poses a risk to the local economy as well as the county budget and services, as the federal government would need to either raise taxes or cut spending to deal with the debt.

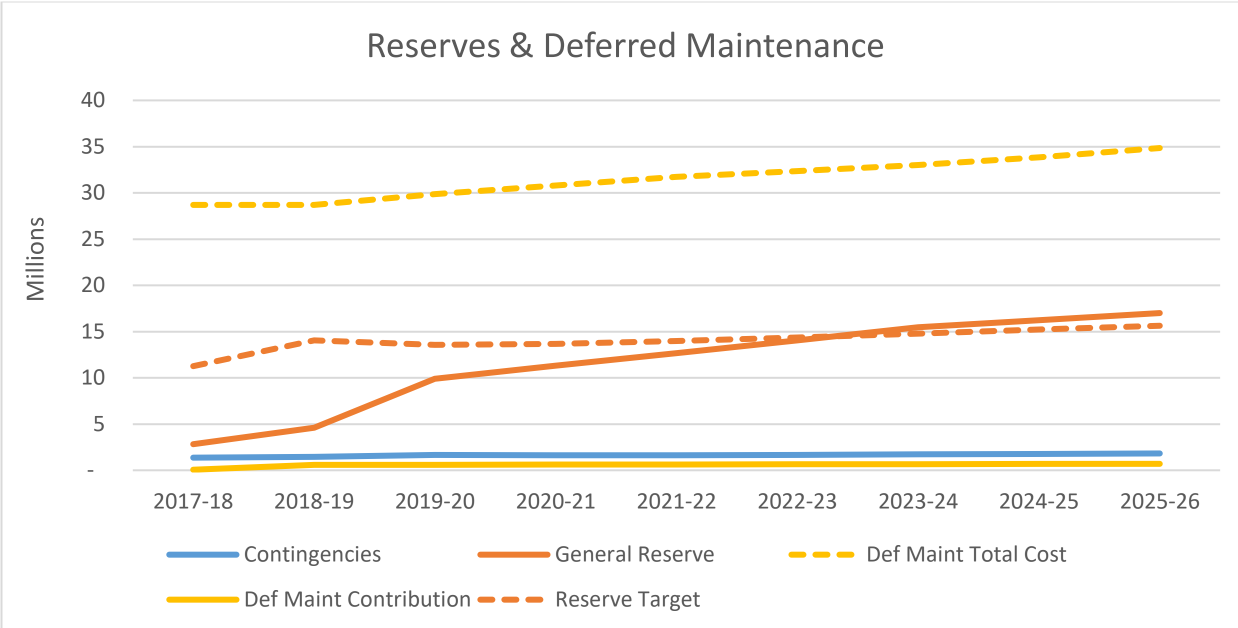
Conclusion: The good news is that unemployment remains low and there is steady growth in the overall economy in Humboldt. Challenges such as affordable housing and availability of housing stock remain issues for sustained growth in the employment sector. Even though consumer confidence is moderately up, local retail sales have declined and while some suspect legalization of cannabis is a contributing factor to this recent trend, it remains undetermined. The state government has built up its reserves and is generally in good shape in case of a moderate recession or slight change in federal policy. Nationally, the economy is strong and signs show that growth could taper within the next two years. Federal policy changes have a chance to affect California and Humboldt County in a significant way, but those effects are yet to be realized.

General Overview and County Outlook

The 7-year forecast for the General Fund shows expenditures exceeding revenues in all 7 years of the forecast. A negative fund balance develops at the end of FY 2022-23 and fund balance is projected to be negative $20.5 million at the end of the forecast period. Major contributing factors to the declining fund balance include increasing retirement costs, costs for ADA and infrastructure financing, and slow to moderate revenue growth, particularly sales tax and cannabis excise tax. If either of these factors changes for the better, such as cannabis revenue, forecast figures would need to be revised and the fund balance issue would not portray such a bleak picture. In addition, since the Board cannot adopt an unbalanced budget, measures to reduce the negative fund balance and bring forth a balanced budget will be required in future years if expenditures outpace revenues.

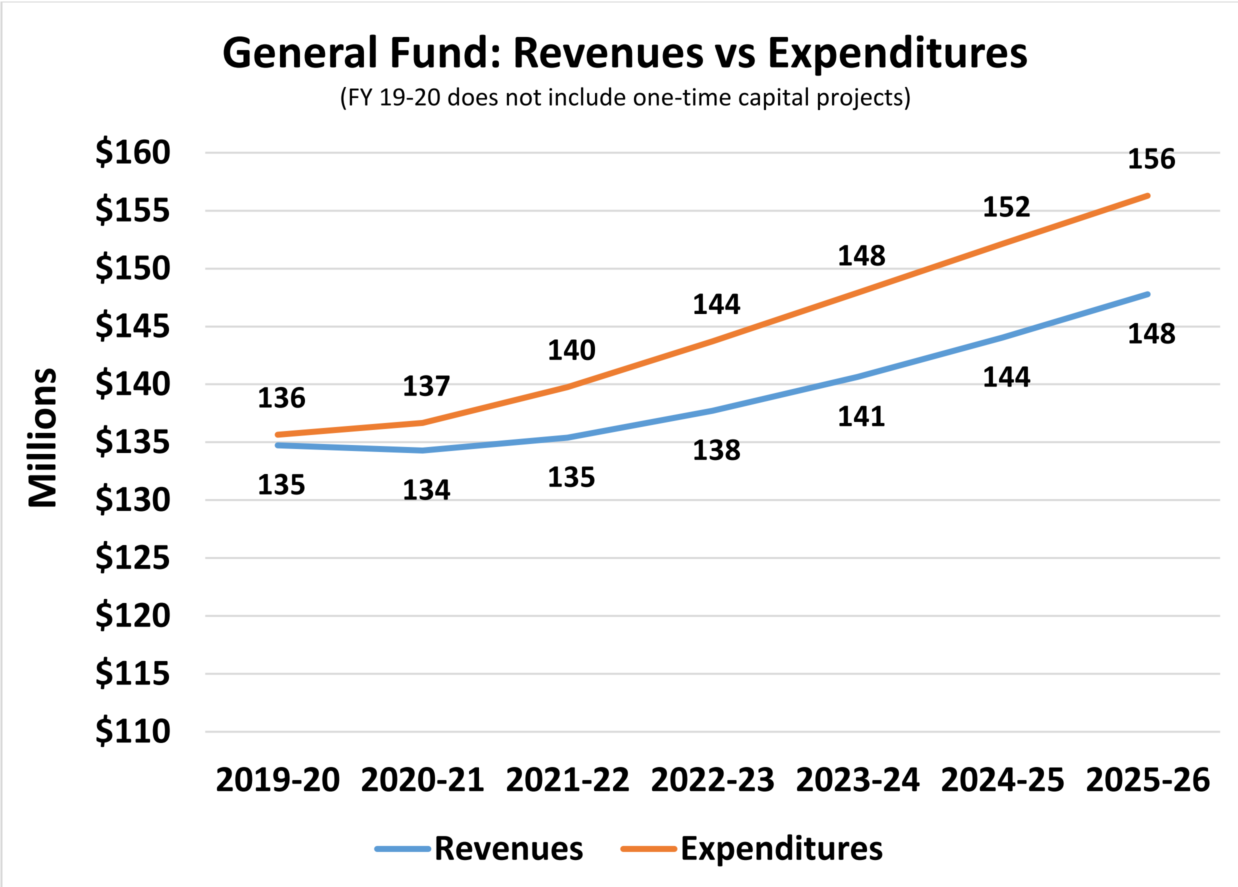


Property tax values and other tax revenues are significant factors in the forecast outcome. A change of 1 percent in property tax values is equivalent to approximately $360,000 in revenue. There is potential that property taxes could be lower or higher than projected. Property tax assumptions are based on recent trends in Humboldt County with a conservative growth factor being added to the estimated Consumer Price Index (CPI). However, trends and the outlook for steady growth, even with factoring in a mild recession, depict increasing property tax revenues throughout the span of the forecast.



The depicted fund balance scenario includes contributions to Contingencies, Reserves and Deferred Maintenance at policy levels as adopted by your Board last year. With many unknown variables in both revenues and expenditures, it is important to retain fund balance and continue to contribute to the General Reserves and Contingencies to ensure that negative financial impacts can be absorbed without the threat of service reductions. Contingencies would remain at 2 percent of General Fund revenues (roughly $1.7 million, on average each year). The balance in the General Reserve would be $17 million if cannabis excise tax revenues come in as forecast and the county contributed each year at policy levels.

Per policy, contributions to the General Reserve are made at 10 percent of cannabis excise tax revenues until the General Reserve reaches 10 percent of General Fund expenditures. At that point 5 percent of cannabis excise tax revenues will go towards the General Reserve. While this forecast has the reserve reaching 10 percent of General Fund expenditures in 2023-22, it should be noted that the Government Finance Officer's Association recommends as a best practice that reserves should equal no less than 2 months of regular operating expenses, or 16 percent. In FY 2019-20 that amount would equal $21.7 million, and $25 million at the end of the forecast period. Healthy reserves are vital to weathering economic recessions, especially as the cannabis industry goes through growing pains associated with a new legal industry. Reserves are also essential to minimizing disruptions to programs and services.

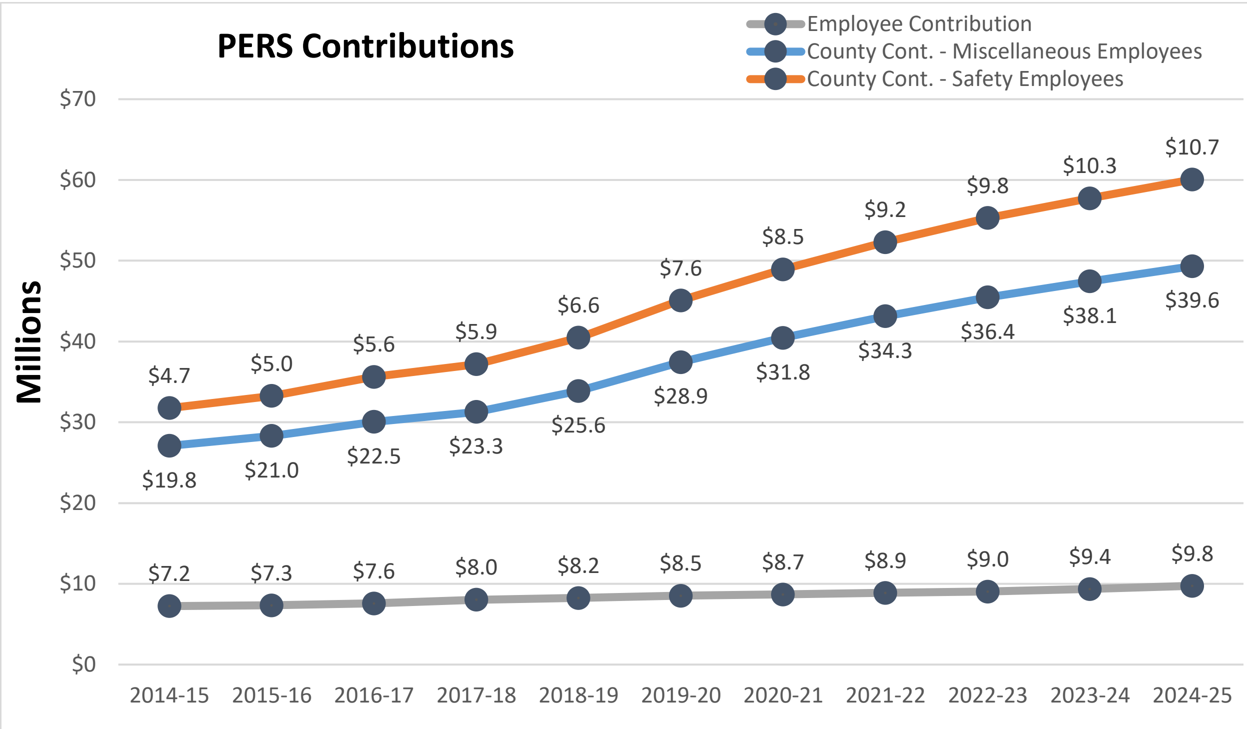


Based on the forecast the General Fund is starting to show improvement, however revenues and expenditures are still not in agreement and that disparity is apparent in future years with declining and negative fund balance predictions. There are a number of fiscal concerns/issues, such as lower-than-expected sales tax revenue; fixed costs increasing faster than revenue growth; unreliable cannabis excise tax revenue; and reliance on fund balance to produce a balanced budget, that are manageable with a long-term plan and a disciplined approach.

Challenges

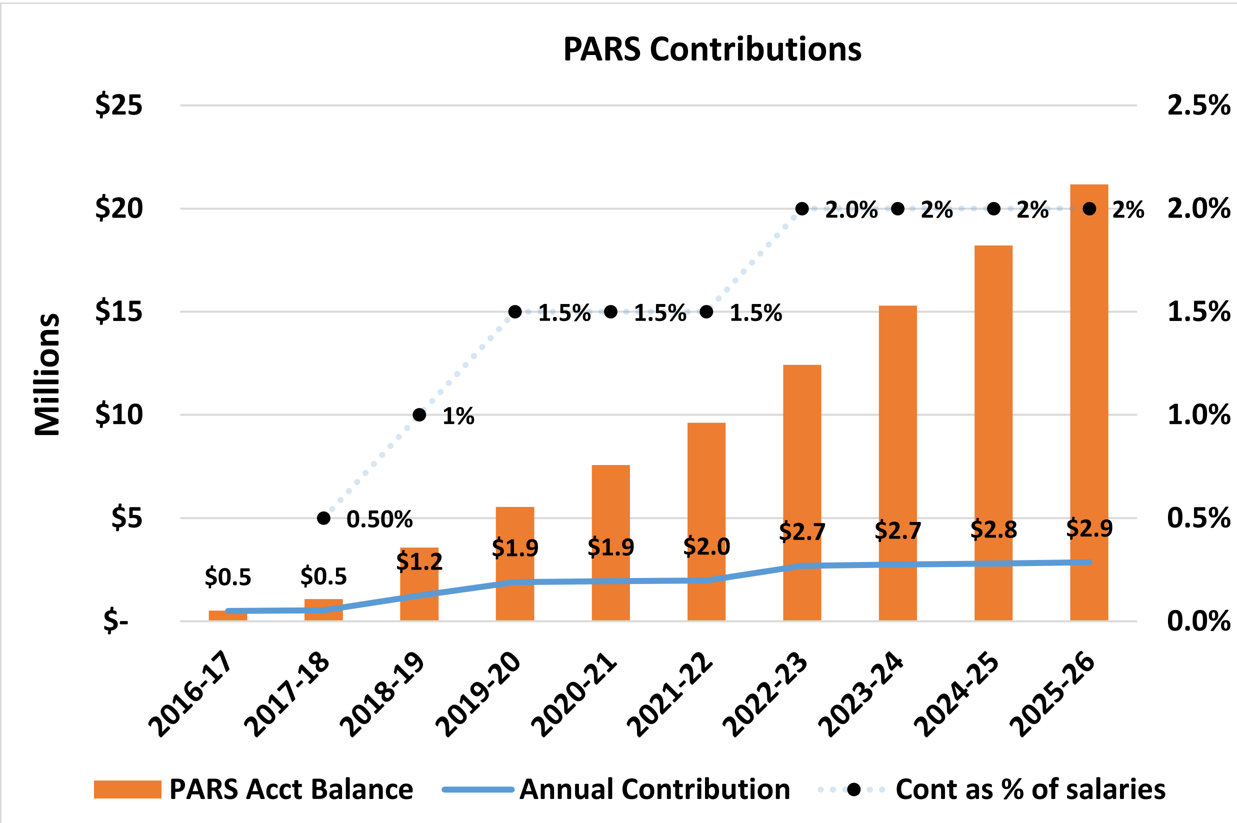
There are a number of financial issues that continue to face the county in terms of meeting minimum obligations while still providing programs and services to the citizens of Humboldt County. Long-term fiscal stability is a Board priority in safeguarding the public trust by managing resources to ensure sustainability of services. Therefore, the challenges present hurdles that can be managed to coincide with the Board's strategic framework. The main hurdles again facing the county are the county's unfunded liability for the California Employee Pension Retirement System (CalPERS), Americans with Disabilities Act (ADA) consent decree and upcoming transition plan with the Department of Justice (DOJ) and a large backlog of deferred maintenance costs and ageing facilities. The county continues to chip away at its outstanding pension obligations but must continue making increased investment to adequately address this challenge. Several funds, such as Mental Health and Aviation, are operating at or near a deficit due to declining revenue or operational imbalances, and if not addressed could further impact the General Fund.

Retirement: Humboldt County provides defined-benefit pensions to its retirees through the California Public Employees Retirement System (CalPERS). These plans are pre-funded, meaning both employer and employee make contributions during the working life of the employee and these contributions are then invested and the earnings on the funds are re-invested. If the contribution rates and investment earnings achieve their targets over the working life of the employee, there will be sufficient funds available at the employee's retirement date to pay a defined benefit over the remainder of the employee's life span. Given CalPERS is a pre-funded plan, changes to, or a failure to realize, any of the assumptions that underlie its targets for funding must be made up by adjusting employer contributions in future years. In the past decade, several changes have occurred that have resulted in an unfunded liability of over $288 million for FY 2018-19 and is expected to increase in the coming FY 2019-20.



Retirement costs continue to increase, but growth rates may slow. The county's contribution rates towards pension costs are expected to rise through the full 7 years of the forecast. CalPERS is now requiring fixed payments towards the county's unfunded liability, rather than a percentage of payroll, which should provide predictability to contribution amounts. The estimated minimum required total employer contribution for FY 2019-20 is $36.5 million and employee contribution is $8.5 million, which reflects the annual required contribution but does not address the increasing unfunded liability. In addition, CalPERS several years ago began lowering its estimates on expected returns, which is forcing local governments to contribute more to retirement. The reduced expected returns dropped from 7.5 percent to 7.0 and was phased in over a 3-year process. The FY 2019-20 projected contributions reflect a 7.25 percent estimated return. If the actual investment return differs from these projections, the actual contribution requirements for projected years will differ from those shown above.

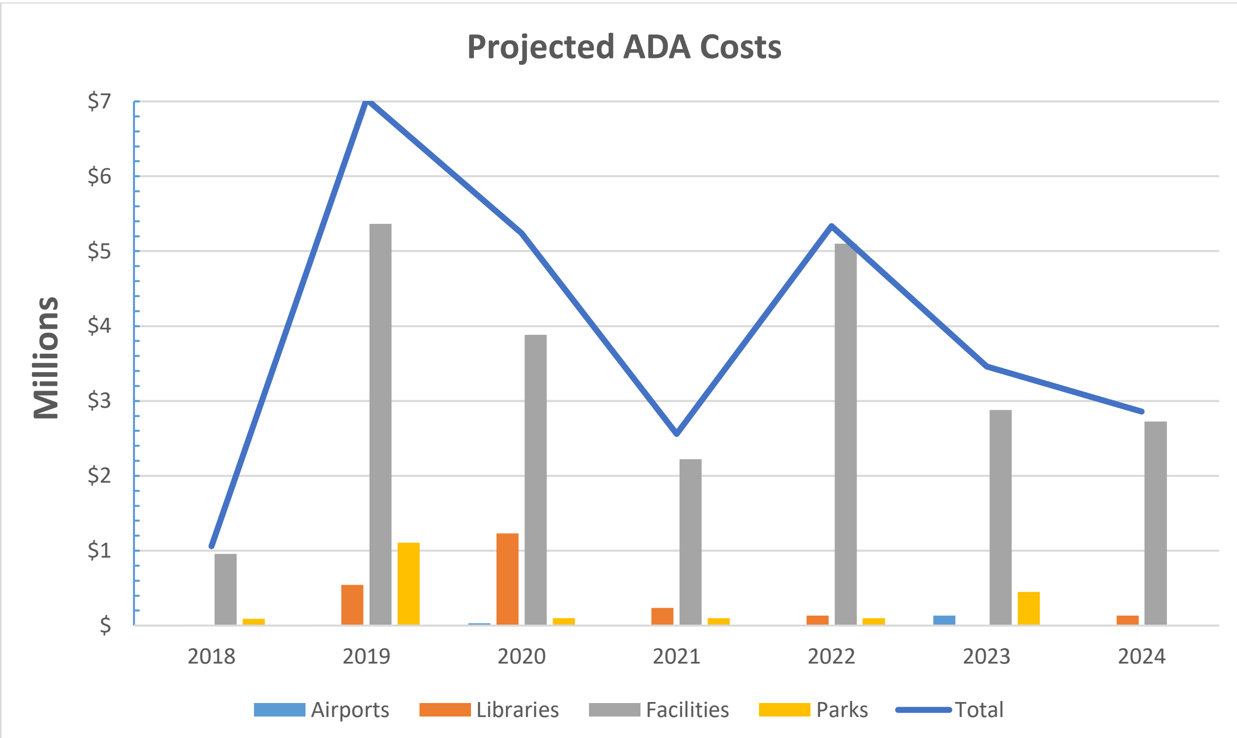
Pension stabilization: The Board of Supervisors several years ago approved a Public Agency Retirement Services (PARS) Pension Rate Stabilization Program (PRSP) in order to begin addressing the mounting unfunded liability. As the balance in the PARS trust grows and produces investment returns, those funds can be utilized to reduce the contribution rate increases, thereby reducing the effect of the contribution rate increase on the county and potentially preventing service reductions.



The FY 2018-19 budget development incorporated an annual departmental contribution to PARS equal to 1.0 percent of salaries totaling $1,244,719. This is a significant contribution for Humboldt, and represents a step towards addressing the unfunded liability, however sustained contributions to PARS will be needed to make substantial progress towards this effort. Staff anticipates the FY 2019-20 budget development will include a recommendation to increase the contribution rate to 1.5 percent, bringing the contribution to approximately $1.9 million.

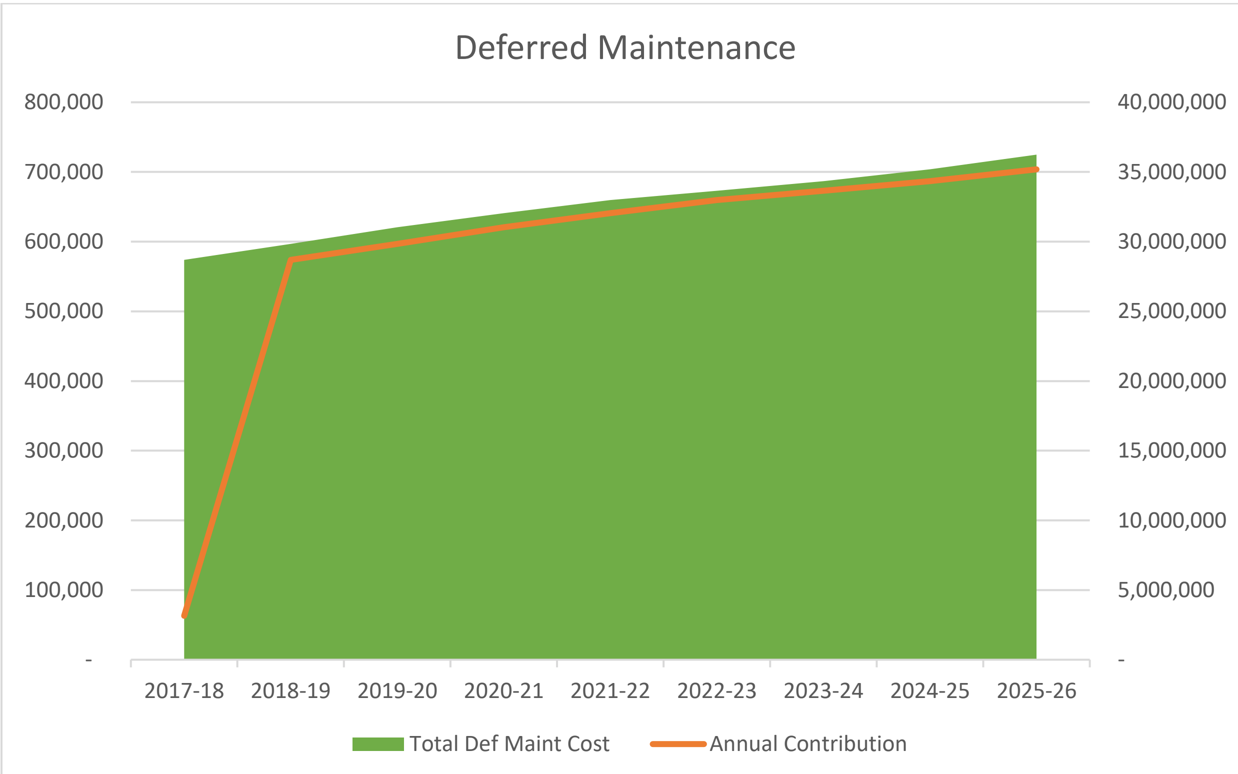
The chart above reflects a FY 2019-20 PARS contribution rate of 1.5 percent or a $1.9 million contribution and increased contribution rates in subsequent years in an effort to depict possible growth rates to include an estimated interest earned rate between 3 and 6 percent.

Americans with Disabilities Act (ADA): The county continues to work with the Department of Justice (DOJ) to implement ADA-related projects laid out in its 2016 consent decree with Humboldt County. The county, as a requirement of the consent decree, retained an independent licensed architect (ILA) in April 2017. The ILA is responsible for assessing all county facilities for compliance with the ADA that offer a program, service or activity to the public. The ILA also certifies "barrier removal," or projects that remove obstacles to ADA compliance, performed by the county, and reports the county's progress in terms of compliance with the consent decree to the DOJ. The county has also retained the services of four design firms for project design and project management for ADA barrier removal. Additionally, the county has also increased staffing with a Deputy County Administrative Officer, Project Manager, Administrative Analyst and two carpenters to address ADA issues identified within the consent decree.



The county has established an internal service fund (ISF) to pay for and allocate costs for required ADA projects. Cost estimates in terms of barrier removal in the form of public projects, including the $7.5 million for the correctional facility and $3.6 million for the Garberville Government Complex, total $27.5 million. Staff anticipates declining, but still significant costs over the next 2 years, then a jump in 2022 mostly due to a one-stop permitting project and the aforementioned Garberville complex. Cost projections depend significantly on the county's "transition plan," which will be determined after the DOJ reviews the county's final report in September regarding the items in the consent decree. While the consent decree focused on projects that must be done in the immediate future, the transition plan will lay out actions the county needs to take to become and remain compliant with the ADA over the long-term.

Deferred maintenance: Deferred maintenance costs continue to rise, and your Board this year adopted a policy that requires a contribution of 2 percent of estimated deferred maintenance costs to be allocated toward maintenance on an annual basis. There are several county facilities that require extensive repair and/or rehabilitation, while many others are well behind in regular maintenance. The county contribution to these projects has historically not kept up with costs and will require continued funding to address deferred maintenance issues and maintain facilities in a serviceable condition.

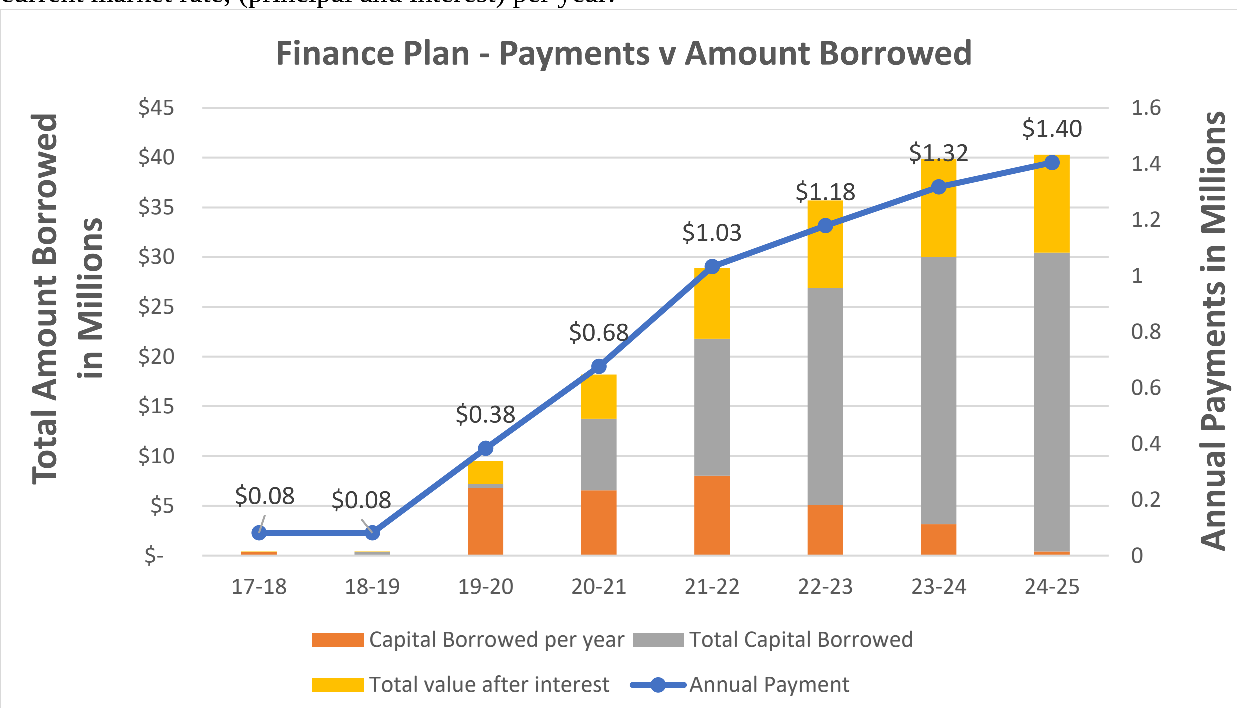


The annual contribution to meet policy levels however may increase as construction costs rise each year. Providing for and maintaining infrastructure is one of the Board's core roles in the 2018 strategic framework. Currently, as depicted in the Deferred Maintenance Costs graph, FY 2018-19 deferred maintenance costs are estimated at $28.7 million. In order to keep up with inflation of construction costs, annual contributions should rise annually by a factor that is at least twice the Consumer Price Index, estimated at 2 percent for next year.

Even with predictable and steady allocation, deferred maintenance costs will continue to increase annually based upon a future CPI increase forecasts. Even with an annual allocation at policy levels, deferred maintenance costs would continue to increase over a 7-year period by at least $6 million.

Finance Plan: In February 2016, the Board of Supervisors approved the 2016 Finance Plan to fund capital improvement projects, which are approved, designed, and built over a period of years. Since capital improvement projects are usually done in stages/phases, it is more cost effective to borrow money as needed for each stage of the project versus borrowing the amount needed for the entire project at the beginning, or first stage of the project. These are projects which often take years to get to the point of actual construction, but which have significant costs leading up to that construction including design, site work, and match funding for state and federal grants. The method of this type of as-needed borrowing is known as "interim period financing," which allows the county to secure debt on an as-needed basis. Interim period financing is typically refunded or paid back by replacing it with long term or permanent financing.

The current 2016 Finance Plan has sufficient debt capacity to finance approved capital projects and ADA barrier removal as shown in the Finance Plan chart ($30.4 million). The debt capacity of the 2016 Finance Plan would be reached in FY 2020-21. Incurring debt means that it has to be paid back over a period of time and the cost to the county over a 30-year period would equate to $1.4 million, or more depending on current market rate, (principal and interest) per year.

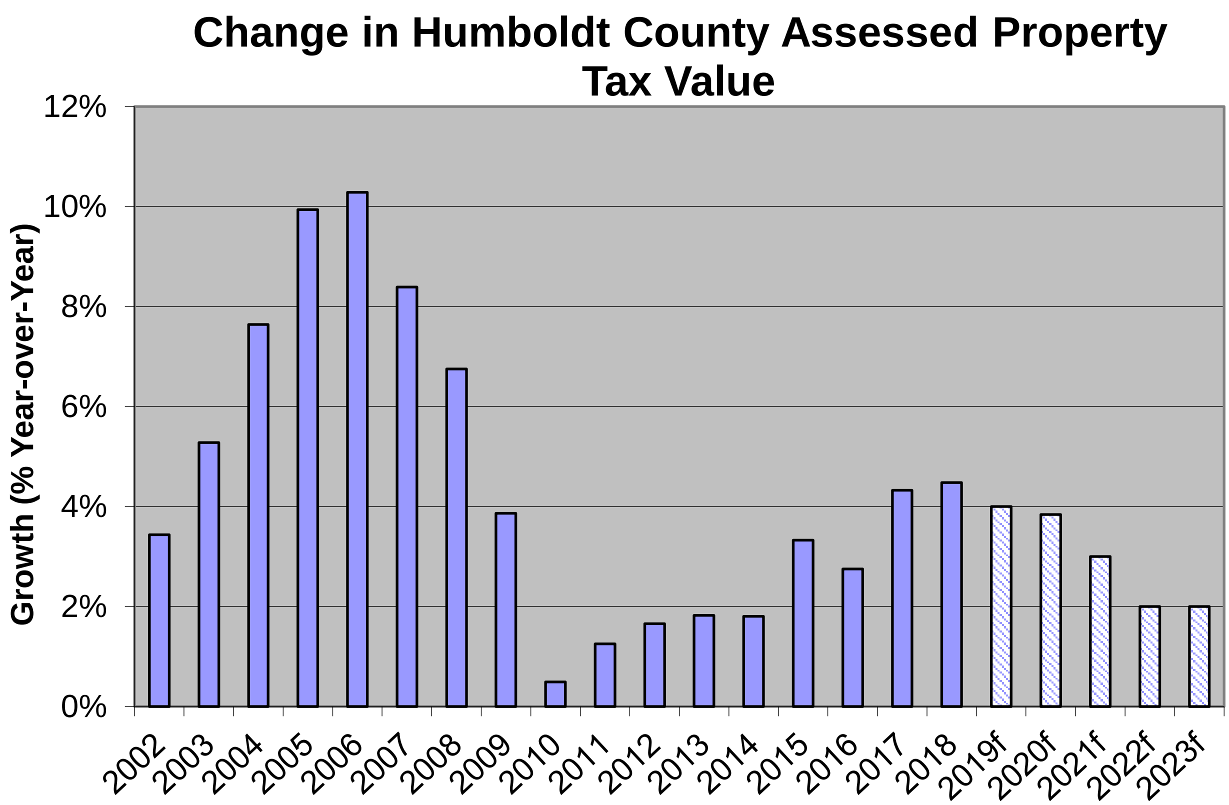


This estimate includes the first steps on major projects like acquiring and building a facility on 4th Street in Eureka, however it does not include construction on that facility. Construction costs for that project, in particular, will significantly increase the debt the county holds. The finance plan estimate clearly shows there is a need to address ADA barrier removal and still proceed with capital improvement projects for the next 7-year period. That need would entail expanding the debt capacity and also utilizing General Fund monies to pay back such financing on an annual basis.

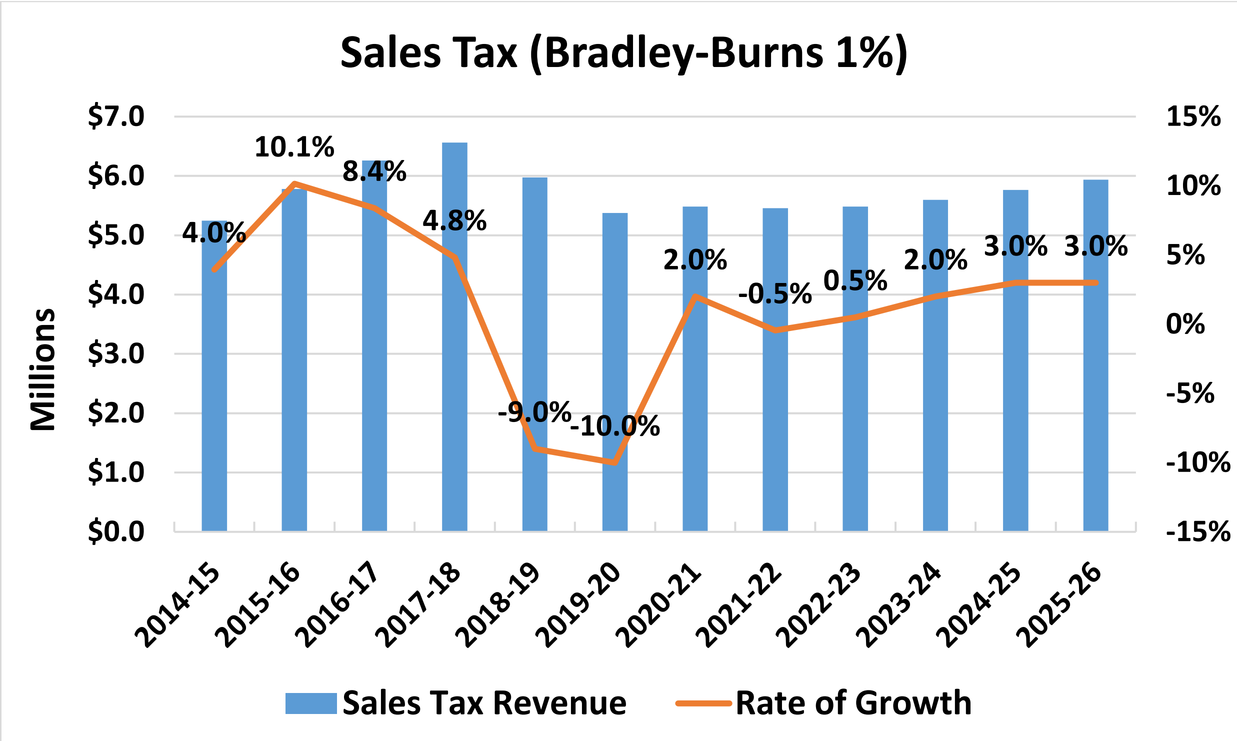
Revenues

Property tax growth stabilizing: Assessed property values are estimated by combining the CPI (from the LAO and Department of Finance, which cannot exceed 2.0 percent for property taxes per Proposition 13), and local growth (sales and new construction). Over the last 20 years assessed property tax values in Humboldt County have increased on average by 4.5 percent (1.7 percent from CPI and 2.8 from growth). However, over the last 5 years the average total value increase has been only 3.34 percent, with roughly half of the increase (1.74 percent) coming from growth. Also of note is that there have only been two times where the assessed property values in Humboldt grew less than the state inflation rate, with both of those occurring in the last 7 years. The changes in growth since the last recession continue to make forecasting property tax revenues difficult.

Assessed values have seen three consecutive years of growth that is more typical of the steady growth patterns witnessed in the late 1990s and early 2000s, and is generally a good sign in terms of future stability. The forecast includes an increase of 4.0 percent in FY 2019-20, with 2.0 percent from CPI and 2.0 from sales and new construction. Property tax dips to 2.0 to correspond with a mild recession scenario before rebounding to 3.0 by the end of the forecast period.



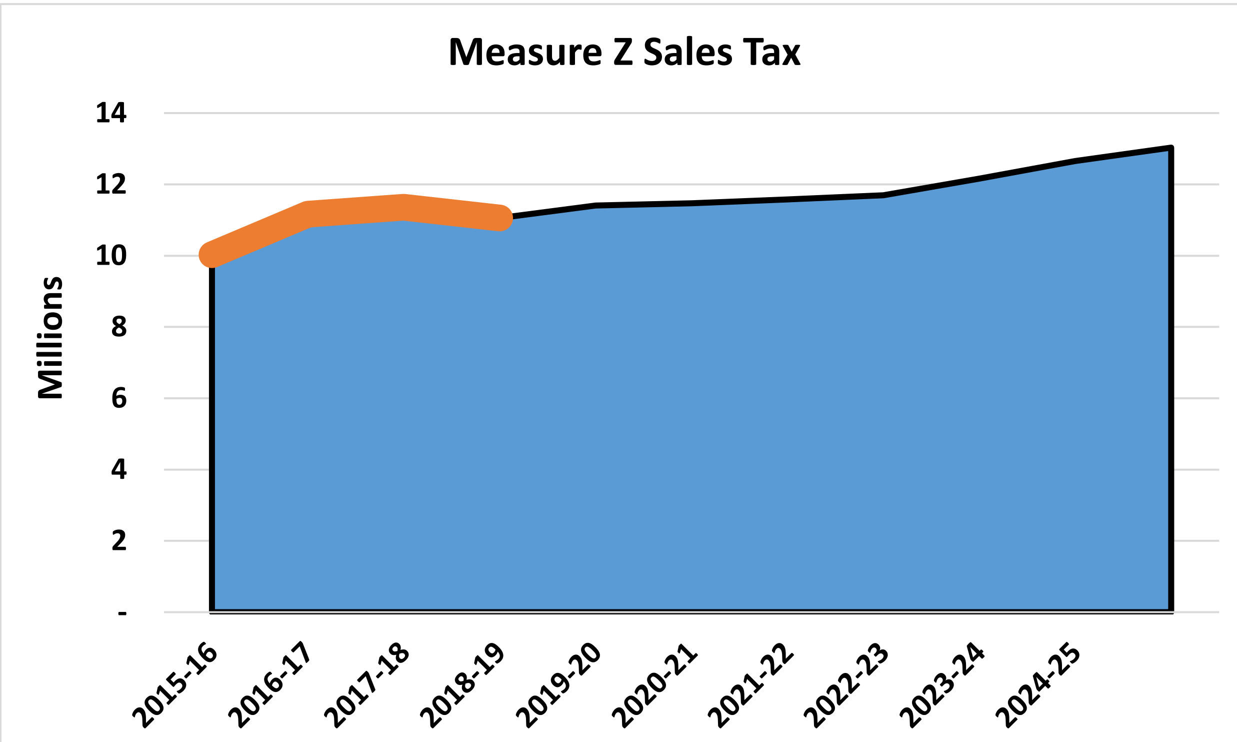
Sales tax: Bradley-Burns Sales Tax is based on state-wide sales tax and is expected to trend in the direction of slow revenue growth over the last several years of the forecast. Based on actual revenue received for the first 6 months of this fiscal year this revenue is forecasted to decrease 9.01 percent below estimates made when the budget was adopted.



While this decrease is concerning, it should be noted that the California Department of Tax and Fee Administration beginning in 2018 changed its allocation methodology which disrupts the timing of "true-ups," or the difference between projections and actual amounts. This change make sales tax more unpredictable than usual. Therefore, a conservative estimate is to assume a 10 percent decrease for FY 2019-20 followed by 3 years of relatively flat growth to correlate with a modest recession beginning in late 2020. This pattern of future modest growth is similar to the behavior we saw after the 2008 recession.

Local sales tax: Measure Z Sales Tax is expected to remain relatively flat in the short term and slowly rise at the end of the 7-year forecast. Based on current year trends, this is projected to decrease 4.7 percent by FY 2018-19 year-end. This sales tax includes the incorporated cities and does not directly correlate to the Bradley-Burns sales tax. However, local sales behavior showed a change in 2018 and warrants further attention. This change has forced staff to keep estimates on growth limited through FY 2021-22.

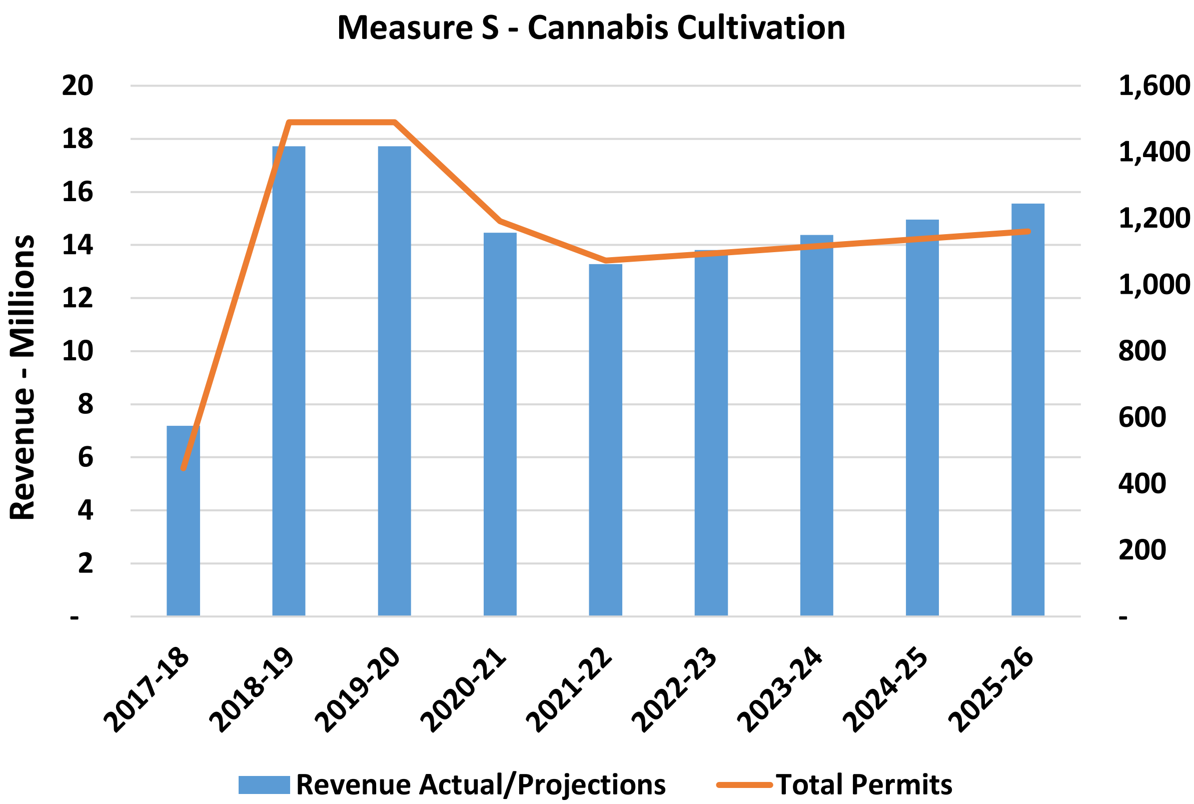
Point of sale information from HdL Companies shows that all major categories except Fuel & Service Stations are down through the first three quarters of 2018 compared to the same period in 2017. Sales from the Business and Industry group is down the most at 43 percent ($552,263), and it is down 33 percent compared to averages from 2015 through 2017. Autos and Transportation is down from 2017 by 27.8 percent ($169,381). Local sales tax growth trends have climbed over the last 5 years. A positive 0.5 percent growth rate is forecast for FY 2019-20 with a gradual increase in rate of growth in future years.



Voters in November 2018 decided to renew Measure Z. This provides a source of local funding that can be used to support local public safety and essential services such as 911 emergency response, volunteer fire, emergency communications, repairing deteriorating roads, and other essential services. It is vital that your Board continue to allocate these funds the way the voters intended to provide security that these critical services will continue.

Cannabis cultivation tax: Measure S, a local commercial marijuana cultivation excise tax (general tax) on the Nov. 8, 2016 ballot, was approved by the voters. Revenues generated from this measure maintain essential services, such as public safety, mental health services for children and families, drug prevention and rehabilitation services, environmental clean-up and restoration and other essential services. Revenue from the excise tax is based on the number of permits issued and the square footage declared on a cultivator's permit. In FY 2017-19, $7.8 million in revenue was budgeted, and increase of $3 million over the prior year. However, due to intense interest in the industry, as well as strong efforts on the part of staff in the Planning & Building Department to work with cultivators and regulators, more than $17.7 million in revenue is estimated for FY 2018-19. Looking forward, it is likely that 2019-20 will be the peak of the cannabis excise tax revenue for the remainder of the forecast period, for a number of reasons.

More than 75 percent of current permits are on interim status, meaning they have local approval but are waiting on state approvals. The state currently allows "interim permits" to operate legally, however, current regulation will require this practice to be discontinued in 2020. While staff is confident that a majority of those in the interim permit stage will move on to become fully permitted, it is also likely that a number of cultivators will not have a permit in 2020, either because they will not successfully obtain the necessary state approvals or as a result of market forces. While this likely decline in the total number of permits in 2020 could be partially offset by new cultivators seeking permits, staff is factoring in a 20 percent decline in FY 2020-21, a rate roughly equivalent to the rate of non-payment for the excise tax.

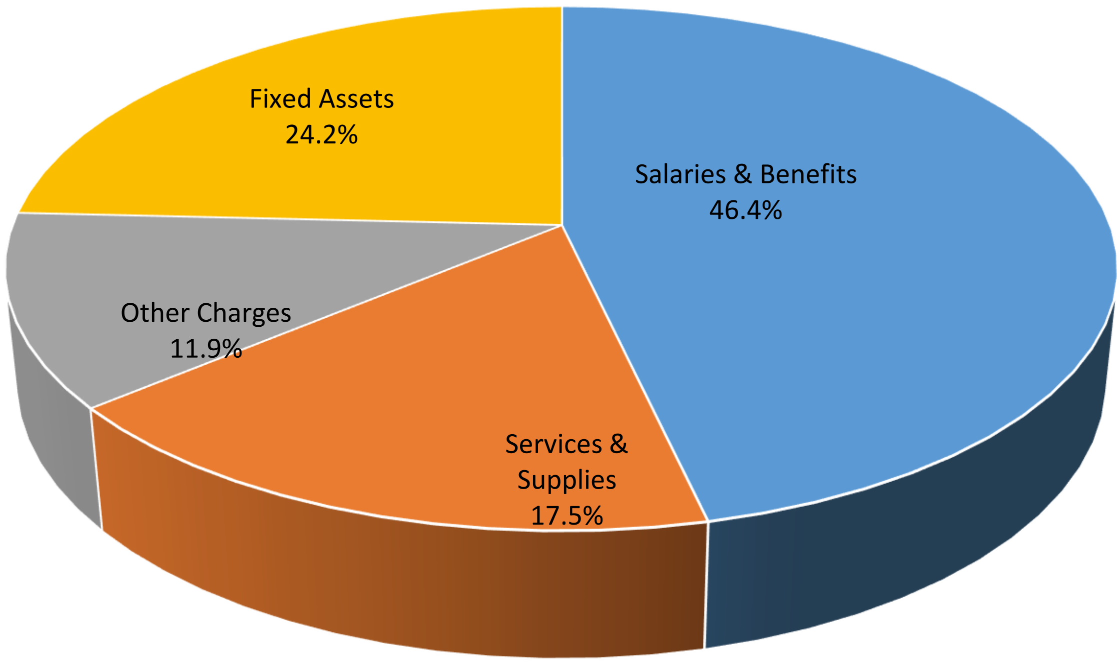


Going forward, there are a multitude of factors that will contribute to cannabis excise tax revenues, including whether federal regulations allow interstate selling at some point and pending litigation against the county. Staff is estimating the number of cultivation permits to grow slowly for the remainder of the forecast period with a small but steady increase in the average size of cultivation permit, and therefore a steady increase in revenue. The first 2 years of Measure S has proved unpredictable in terms of revenue projection, and GFOA recommends that it takes roughly 8 years to create reliable estimates for new revenue sources such as this.

Other taxes: Other revenue sources such as Transient Occupancy Tax (TOT) are trending upward. In FY 2017-18, $2.03 million was received in comparison to an estimated $2.14 million to be received year end FY 2018-19. The upward trend continues through the 7-year forecast using conservative increases even for the predicted mild recession that may occur in and beyond FY 2020-21. TOT may not be a significant source of revenue but it appears to provide an indication of a steadily growing economy.

Expenditures

Generally expenditures are split out into four major categories depending on the type of cost. These categories are: salaries and employee benefits; services and supplies; other charges; and fixed assets. For the financial forecast different categories may be used for each fund based on the relative size of the expenditure type and influencing factors.



General Fund

Salaries and wages: Salaries and employee benefits are the costs for employing permanent and extra help workers to conduct county business. Your Board successfully negotiated salary increases this year for all bargaining units, and the estimated salary costs for FY 2018-19 were adjusted by 3 percent to reflect the increases. Salaries and wages are forecast at 3 percent increase each successive year. Any change in benefits, wage increases and cost of living increases impact available revenues. Increases to salaries and wages are considered ongoing costs that the county must account for and budget in current and future years. Salaries and benefits for FY 2018-19 represent 46.4 percent of General Fund costs.

Supplies and services: This category includes the bulk of non-salary expenses, ranging from insurance and utilities to office supplies to contracts with outside professionals. These expenses are forecast to increase at a rate slightly below the average annual CPI increase over the last 5 years.

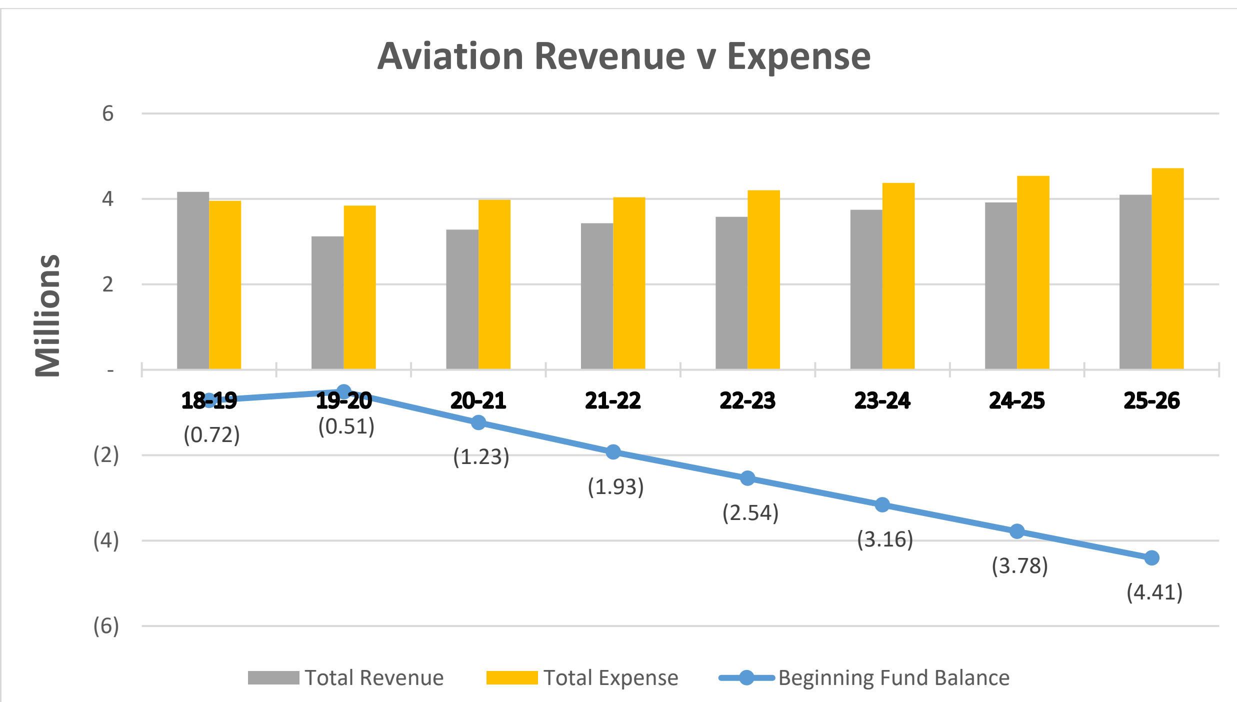
Other charges: These consist of a number of different expenditures not included in the categories above, including support for persons (such as assistance payments and jail medical), costs related to grants, payments on county debt, contributions to other county funds and non-county agencies, and intra-fund transfers which are reimbursements of expenses. Similar to services and supplies, increases related to CPI are forecasted.

Fixed Assets: Expenditures for long-term capital outlays with an expected life in excess of 1 year and an initial value in excess of $5,000. Fixed assets also include contributions to deferred maintenance, capital improvements and ADA compliance. Fixed asset contributions will see increases during the forecast period due to the need to make facility improvements, and funding levels are largely dependent on policy decisions made by your Board.

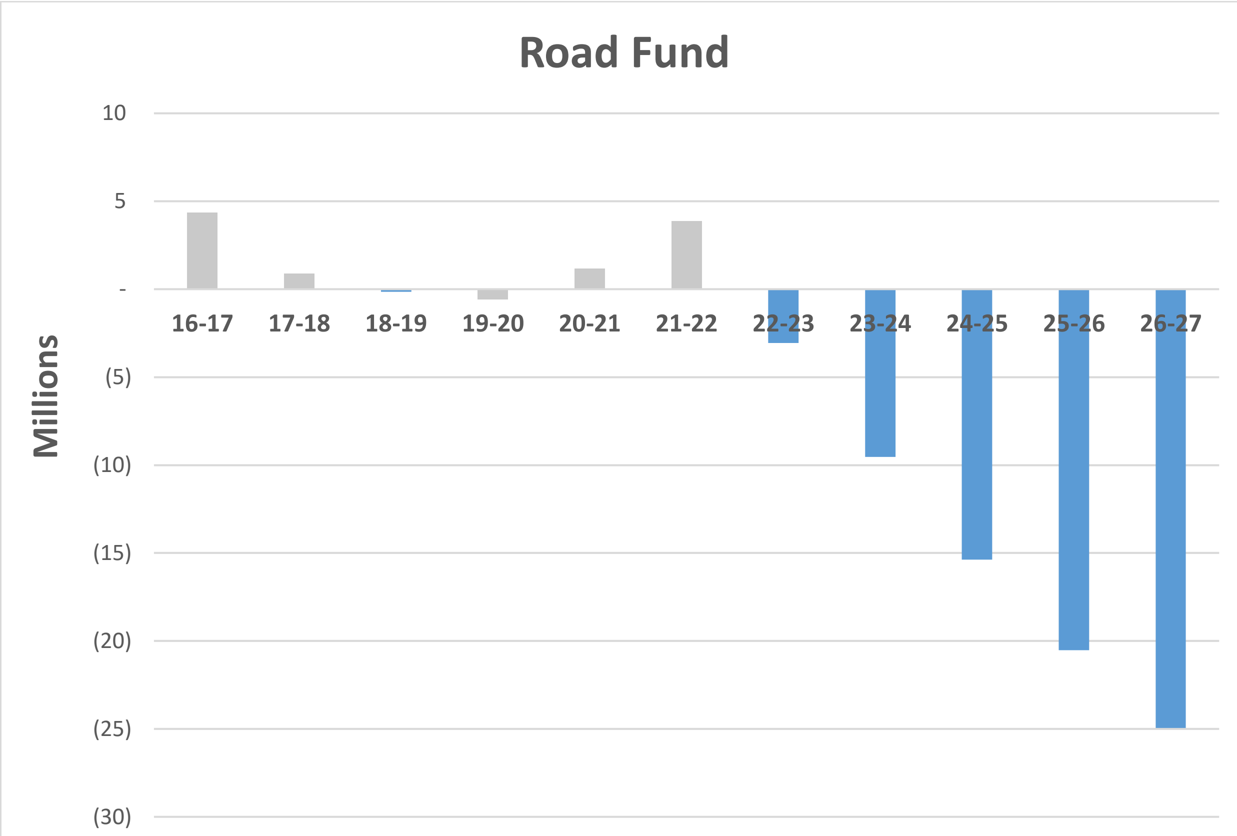
Other Funds

Other concerns and possible financial challenges include Aviation, Roads, and Mental Health funds.

Aviation Enterprise Fund: This fund ended FY 2017-18 with a negative fund balance of ($748,555), which represents an improvement in the negative fund balance of ($421,552). The budget submitted and adopted for FY 2018-19 proposed expenditures exceeding revenues by $140,276. The Airports Department is receiving a General Fund contribution to help offset staff costs, and that contribution will likely remain for the next two years. Significant changes are taking place in Aviation, including the creation of an Airports Department and hiring a Director of Aviation, as well as the addition of direct flights to Los Angeles and Denver. New air service could generate roughly $500,000 in annual revenue to Airports. In addition, long-term plans to make the Aviation Fund sustainable include changes to leasing practices, parking, increasing service and more. Airports also recently added a Senior Administrative Analyst to its staff, and may look to add more staff in future years. The county remains committed to maintaining a regional airport that offers commercial air service and will continue to pursue Aviation's long-term sustainability.



Roads Fund: The Roads fund ended last fiscal year with a negative fund balance of ($153,252), a decrease of $1.05 million from the previous year. Due to catastrophic road damage caused by winter storms, fund balance was utilized in order to address road accessibility. Emergency funding has been requested from the Federal Emergency Management Agency (FEMA). While it is anticipated this funding will be granted, it has not yet been approved.



Revenues are increasing, but not at a rate to keep up with rising expenses. Senate Bill (SB) 1, the Road Repair and Accountability Act of 2017, survived a challenge at the polls in 2018 and will provide an increase in road funding through an increase in the gas tax. In FY 2019-20 $4.7 million in SB 1 funding is anticipated increasing by roughly $150,000 each successive fiscal year. The Roads Fund also has to budget for ADA barrier removal in the form of curb ramps located throughout the unincorporated areas of the county, estimated at $7.5 million. The Roads Fund is also projecting $4.5 million per year in ADA projects for the next 5 years which is a significant stressor on the Roads Fund. Finally, county roads are still in major need of increased regular maintenance. As of FY 2018-19 Roads has more than $248 million in deferred maintenance needs, and that cost will increase by roughly $20 million each year.

Mental Health Fund: The Department of Health and Human Services Mental Health fund balance is of concern and is something to monitor closely. This fund (which includes Alcohol and Other Drugs) ended FY 2017-18 with a negative fund balance of ($3,249,286). Long term resolutions to eliminate the negative fund balance for Mental Health are difficult due to the delay between when services are paid and when federal reimbursement is ultimately received. This delay is caused by the claims adjudication process that can take several months to close, and the cost report/settlement process that can take multiple fiscal years to reconcile. Long term receivables for cost report settlements due from the Department of Health Care Services (DHCS) and Substance Abuse Prevention and Treatment (SAPT) block grant total an estimated $12.8 million. These receipts go back as far as FY 2012-13. The reason these receipts continue to be outstanding is due to the state's lengthy cost settlement process. These receipts would further reduce the negative fund balance for Mental Health.

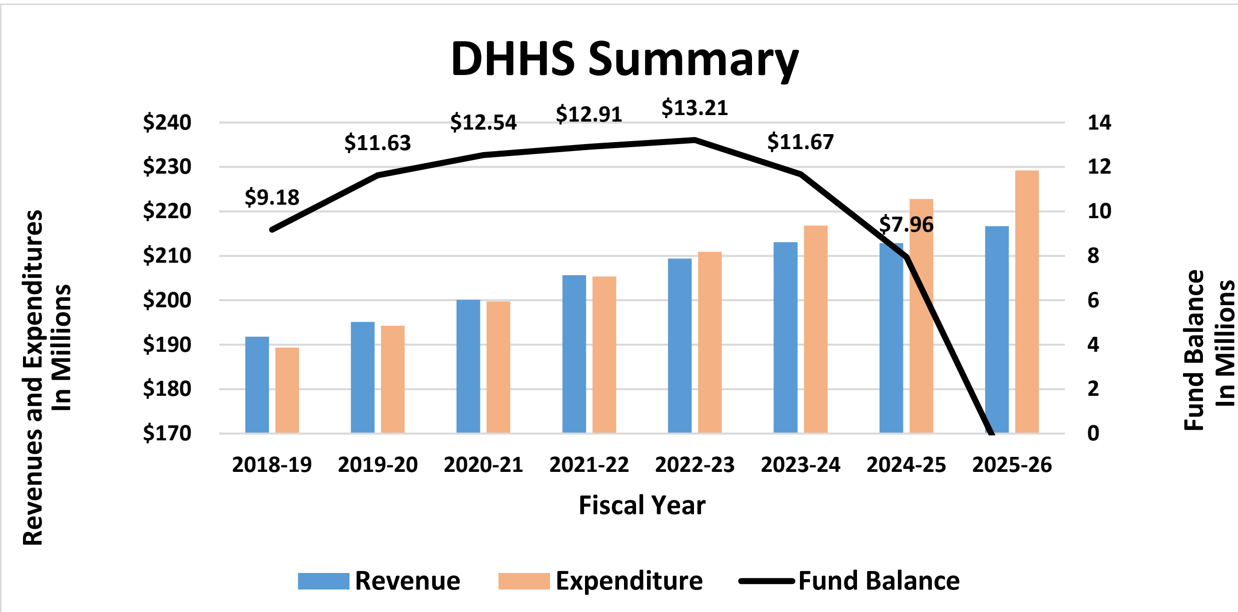
Many counties are facing declining revenues in comparison to the cost of providing services due to the methodology used by DHCS in determining reimbursement rates. Currently reimbursements are calculated using an interim reimbursement rate that is based on prior years cost reports. These rates do not sufficiently account for the fluctuations in costs from year to year such as salary and benefits, infrastructure costs, health care inflation, etc.

In late June 2018, DHCS released an informational notice stating that beginning with the state FY (SFY) 2017-18 reporting period, DHCS will complete the interim cost settlements no later than twenty months after the close of the SFY. To accomplish this goal, DHCS has established the time line below for settling cost reports for Fiscal Year 2012-13 through Fiscal Year 2016-17. The department also continues to develop tools and reports to identify and address service denials in order to maximize claiming revenue. The $12.8 million due to Mental Health has been included in this forecast, with revenue received in each of the first 3 years of the forecast period.

SPECIALTY MENTAL HEALTH COST REPORT SETTLEMENT TIMELINE		
FISCAL YEAR	**LONG-TERM RECEIVABLE**	**SETTLEMENT ESTIMATE**
2016-17	$3,871,128	
2015-16	$3,819,866	
2014-15	$2,716,539	12/31/2019
2013-14	$876,432	12/31/2019
2012-13	$1,542,882	4/1/2019

DHHS Summary:
DHHS ended FY 2017-18 with a fund balance of $9.18 million, an increase of $6.79 million from the previous fiscal year. After the FY 2016-17 closing process staff discovered that $7.2 million needed to be posted in FY 2017-18 Mental Health Accounts Receivable as a prior year adjustment for revenues that were actually receivables for FY 2016-17. These receivables were thus realized in FY 2017-18, causing an increase in the fund balance for FY 2017-18.

DHHS anticipates that the FY 2018-19 year-end fund balance will be $9.25 million, an improvement of $76,704 over budgeted projections primarily due to $768,829 in Foster Care revenue as a result of state increased assistance payments. However, the Mental Health fund will increase its negative status by ($531,799), bringing the negative fund balance to ($4 million). The long-term forecast shows MH receiving back payments from DHCS in the first 3 years of the forecast, which increases the DHHS fund balance significantly. However, expenditures outpace revenues in the final years of the forecast and bring the balance to the negative in FY 2025-26. DHHS is continuing to address increased costs in providing mental health services.



Summary

Considering all of the economic uncertainties, forecasting revenues and expenditures 7 years into the future is a difficult task. This report takes current policies and assumes no changes. That said, this report is intended to provide a baseline to help understand potential impacts of changes in revenues or costs to the county's budget. This report summarizes the County Administrative Office's assessment of the economy and county budget. The forecast focuses on projecting a middle of the road scenario, which assumes continued economic growth at a moderate pace. It is likely that there will be differences between what is being projected and actual amounts, even if key assumptions are correct.

The forecast does not attempt to predict the budgetary decisions that will be made by state and local elected leaders. Difficult choices must be made between the benefits of spending funds now on much needed services and programs versus increasing Reserves. When an economic downturn occurs, Reserves can help maintain services. The projections are an estimate of the county's fiscal condition if current law, policies and economic conditions remain mainly unchanged through FY 2025-26.

One example of the type of change that could occur is the decision of the Board to increase wages for county employees in FY 2020-21 during the next round of negotiations. Any increase in salaries and wages will impact available fund balance and increase operational expenditures thereby reducing revenues that may support programs and services in future fiscal years.

With all of that said, the 7-year financial forecast results indicate that the General Fund will experience some level of financial distress. Structural changes will be required to maintain a positive fund balance over the next 7 years. Based on current economic trends it is unlikely that property tax revenue growth will return to previous level highs in the next 7 years for the county.

The General Fund contains the majority of county programs and receives discretionary revenues primarily from property taxes. Unfortunately the General Fund forecast shows a trend of costs growing faster than revenues. Revenue growth alone is not going to be sufficient to address the predicted financial imbalance.

Over the next 7 years the county will need to address the imbalance between revenues and expenditures in order to maintain a sustainable financial outlook. There are definitely looming financial concerns that need long-term financial discipline such as pension and retirement liabilities, ADA barrier removal, and the backlog of deferred maintenance. The county has taken steps towards allocating resources to address unfunded retirement liabilities and stabilize the fluctuations in the discount rate set through CalPERS via the PARS Trust. Nevertheless, a focused and disciplined approach to managing liabilities may possibly lead to some difficult decisions sooner than later.

Glossary of Terms

ADA – Americans with Disabilities Act: is a federal law that prohibits unjustified discrimination based on disability, requires covered employers to provide reasonable accommodations to employees with disabilities, and imposes accessibility requirements on public accommodations.

CPI – Consumer Price Index: A government-issued growth factor based on the retail prices of basic household goods and services.

DHHS – Department of Health and Human Services: An integrated County department providing health and human services previously provided by six separate county departments – Mental Health, Public Health, Social Services, Employment Training, Veterans Services and Public Guardian.

DOJ – United States Department of Justice: A federal department responsible for the enforcement the law and administration of justice in the United States.

EDD/LMID – Employment Development Department/ Labor Market Information Division: A California department that tracks and reports employment and labor statistics for the state.

FY – Fiscal Year: The designated accounting and budgeting year for the County. In California, the fiscal year is July 1 through June 30.

LAO – Legislative Analyst's Office: A nonpartisan governmental agency that provides fiscal and policy advice to the California Legislature.

OPEB – Other Post-Employment Benefits: Employee benefits other than pension received after retirement. For the County this represents a required contribution to retiree health insurance premiums for insurance through CalPERS.

PARS – Public Agency Retirement Services: a company that provides retirement services to public agencies. The county contracts with PARS for administration of an irrevocable trust for pensions that allows funds to be set aside to help smooth retirement rate increases in future years.

PERS – Public Employee's Retirement System: Also called CalPERS is an agency in the California executive branch that administers health and retirement benefits for local agencies, public schools and State employers.

PTAF – Property Tax Administration Fee: A fee charged by the County to special districts, school districts and cities for their proportionate share of costs related to the administration of property tax collection.

TOT – Transient Occupancy Tax: A 10 percent tax charged on lodging accommodations unless the stay is for a period of 31 days or more. The charge is authorized under State Revenue and Taxation Code Section 7280.