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Interim Chief Administrative Officer

Date: February 4, 2009

To: Butte County Board of Supervisors

From: Greg Iturria, Interim Chief Administrative Officer
Sean Farrell, Deputy Chief Financial Officer

Subject: **Fiscal Year 2008-2009 Second Quarter Financial Report**

Overview

The declining economy and the State of California's complete failure to respond to it have worsened the financial position and outlook for Butte County. Rather than proactive solutions, the State appears to be simply creating new ways to pass its cash, credit and budget problems onto local government. Largely because of the State's negligence, the Board of Supervisors, over the next few months, will find itself in the unenviable position of having to make major cuts, even possible elimination of vital public services.

Several significant changes have occurred since the last quarterly financial report provided to the Board on November 4, 2008. The County's local tax base has continued to deteriorate, although not to the degree of the overall statewide tax base. Revenues tied to the statewide retail economy are deteriorating to a greater degree than projected by the State last quarter. This has been evidenced by sharp drops in Social Service Realignment revenues and Proposition 172 Public Safety Sales Tax receipts, both based on statewide sales transactions.

Subventions and grants from the State of California to the County are very likely to decline further, since the State has yet to address its massive \$42 billion budget deficit. For example, it has become clear that the County will probably not receive any of its \$650,000 per year Williamson Act (Open Space preservation) subvention this fiscal year, and that holds true for the foreseeable future. This will be a major loss of discretionary revenue.

These factors have significantly increased the County General Fund annualized structural budget deficit from \$10 million estimated in October 2008 to about \$18 million. The County is spending \$1 million to \$1.5 million per month more than it is collecting in

general purpose revenue. In December 2008, the Board took several actions to ensure a balanced budget for the current fiscal year, including many cost reduction efforts to achieve needed short-term savings. These actions were in addition to the cutbacks in operating costs approved by the Board last summer when it adopted a much smaller budget, which included a 7% workforce reduction. Unfortunately, many more cutbacks in operations and workforce are needed to address the current structural deficit.

On average, County departments will need to reduce their use of general purpose revenue by approximately 22 percent in the fiscal year beginning July 1, 2009. This percentage may be reduced if the County initiates significant ongoing cost reductions much earlier. If broad and ongoing cost reductions can be enacted by the end of this quarter, then the County may reduce the overall impact to next fiscal year's budget to 20 percent or less.

Distinct and separate from the structural budget deficit, the County may be forced to sharply reduce or shut down a wide range of health and human services, and other State-funded programs, if the State decides to defer payments for these services this spring and/or this summer. The Governor and Legislature are reportedly working on a budget deal that would include a seven month delay in payments for services provided by counties on their behalf. The State proposal assumes that counties can find a way to front the costs of these programs by accessing reserves or borrowing from financial institutions. Butte County does not have any General Fund reserves and there is insufficient available cash in restricted funds. At this time, staff does not believe Butte County can access sufficient cash flow loans from the private sector.

The Economy

Most economists expect a gradual recovery in economic activity will begin later this year, but the downside risks to that outlook are significant. Global demand appears to be slowing significantly and there is growing concern about deflation. In the United States, the Gross Domestic Product fell 3.8% and personal consumption fell 3.5% in the last quarter. The housing sector continued to deteriorate with distressed liquidations representing a larger portion of sales.

Jobless claims continue to rise and consumer confidence continues to decline. Offering more evidence that 2009 will be much worse than 2008, a dozen big companies in the U.S. and Europe announced layoffs on January 26, 2009, adding up to more than 76,000 workers. Among them were household names: Caterpillar, Home Depot, ING, Philips Electronics. Still more companies joined the chorus over the next couple of days, including Starbucks, who will lay off 6,700 workers.

In California, 2008 was the worst year on record for new housing starts. Permits were down 42% from 2007 and 69% from the 2004 peak. State unemployment averaged 7.1% in 2008. The California Department of Finance forecasts state unemployment will average 9.1% in 2009, peaking at 9.6% next fall, and then slowly declining to 9.1% again in early 2011. Some economists believe our state will reach 10% unemployment

by the end of the year. In any event, most economists forecast a very slow economic recovery in California, predicting it will take several years to come out of the slump.

Cash Flow

The State of California's cash flow crisis continues to deteriorate as the State Legislature neglects its duty to correct a growing budget deficit. The State's current budget deficit is estimated to exceed \$42 billion over the next 18 months without immediate corrective action by the Governor and Legislature.

During this past year, Butte County has struggled to manage its own cash flow needs due to delayed payments from the State. The Governor is asking the State Legislature to withhold payments to counties from February 1st to September 1, 2009. The deferral represents approximately \$5.7 million per month, or **\$40 million** for the duration, in delayed State payments to the County. Even without Legislative action, the State Controller has announced intentions to withhold payments to counties due to the lack of sufficient cash and inability to garner cash flow loans from the private financial sector. Whether by action of the Legislature or the State Controller, any delay beyond a month or two will have a crippling effect on all California counties and may force Butte County to close State-funded programs this spring.

The County currently expects that the average daily cash balance in the County's General Fund this fiscal year to be about one-half of the average for last fiscal year. There are a variety of reasons for this shortage, as reported in the First Quarter Financial Report, but the primary reason is the delay in State payments to the County.

The cash flow differences for the second quarter of fiscal year 2008-2009, compared to earlier reports, are as follows:

While the Behavioral Health Department now appears to be structurally balanced with accrued revenue at least equal to expenditures, the Department's cash flow problems are continuing. At the end of the 1st quarter the state owed the County \$11 million. As of January 22nd, the State owed the County approximately \$8.5 million in revenues that should be received in this fiscal year. While this shows improvement from the first quarter, it still reflects an unreasonable delay in state payments.

The Behavioral Health Department started the fiscal year with a \$5.35 million cash deficit from fiscal year 2007-2008. Furthermore, the Department is short an additional \$1.8 million in cash for a total cash deficit of over \$7 million dollars at the end of December. The Department's existing cash deficit is due primarily to delays by the State in passing on federal billing revenues to the County, as well as State match requirements for the Early Periodic, Screening, Diagnosis and Treatment (EPSDT) program. If the State Controller begins deferring payment of State funds in February, it will only add to the Department's existing cash crisis. The monthly impact of Alcohol and Drug payment deferrals will be approximately \$73,588. Also, in February, the Department is scheduled to receive \$834,815 in Mental Health Services Act (MHSA)

funds and \$45,254 in Individuals with Disabilities Education Act (IDEA) funds; both State payments may be deferred per the Governor's and State Controller's proposals.

The Department of Employment and Social Services' (DESS) revenue is currently flowing at a normal pace. However, this will change in February if the State Controller begins deferring state administrative and assistance revenues, totaling over \$2.3 million monthly, as well as the quarterly MediCal advances which total approximately \$2 million per quarter. The next MediCal advance is scheduled for the end of March. Additionally, the Governor's proposed deferral of state payments from February through September would create a cash shortfall in excess of \$20 million for these programs.

- ***What does all this mean?*** It means that with an average daily balance half that of last fiscal year's balance, the County is receiving much less in interest earnings, and the State's payment delays so far this fiscal year are contributing to the County's budget shortfall. It also means that the County is in no position to finance the State's cash shortfall and, therefore, further payment deferrals from the State will likely result in the closure of vital programs administered by Butte County on behalf of the State.
- ***What can be done about this?*** The Board could advise the State that any additional deferral of State payments to the County will likely force the County to close most of its employment, economic assistance, social service, mental health and paved road maintenance programs this spring and summer.

Credit Market

As we enter February 2009, the financial markets continue to be besieged by news of failing institutions, severely diminished capital reserves, looming loss write-offs of unimaginable size and financial scandals of epic proportions. Trust in financial systems worldwide has been eroded. At the state and local government levels, administration and legislators are facing unprecedented challenges, compounded by the political process and a frightening dearth of viable alternatives. Diminished confidence and loss of available capital at the banking and investment level have affected credit markets to a degree that could not have been anticipated only a few short months ago.

Local government debt issuance has long been viewed by the market as a relatively "safe" investment, certainly stronger than corporate debt, and that belief has historically been reflected in the readily available and favorably priced credit markets. Issuance of debt is reliant, however, upon a balanced budget and predictable revenues, both of which are in jeopardy in the current situation – not just for Butte County, but for counties throughout California. Uncertainty and distrust have affected traditional funding sources, along with diminished available funds. The resulting credit crunch translates to a scenario where the feasibility of relying upon the extension of credit for cash flow management is increasingly questionable and may even be unavailable as an option in the short term.

Staff continues to work closely with commercial banks and other lenders to determine the availability of credit lines, but have found thus far that the banks are not in a position to consider lending to the County. Financial institutions are not even entering into the credit application and review process. It is probable that a close review of the County's financial condition at present, and projected balances over the next year, which would be part of any credit approval process, would likely result in a disinclination to lend. In the municipal markets, the limited availability of bond insurance and letters of credit continues to be an unhappy reality, which makes the underlying strength of the issuer the most important factor in successful debt issuance.

The Auditor's and Treasurer's Offices will continue to be in communication with financial advisors, underwriters and other experts in the industry to remain informed and able to take advantage of any market opportunities that become available, including any possibility of a Tax and Revenue Anticipation Note (TRAN) issuance for the upcoming fiscal year. While Butte County's financial situation is dire, we are not alone. We are hopeful that, with appropriate management and budgetary measures put in place soon at the County and State levels, the credit markets will see this as a temporary and redeemable situation. If the County is able to participate in a TRAN issuance for fiscal year 2009-10, it is likely that the overall borrowing costs will be much higher than the current market interest rates might indicate, with increased costs of issuance being a factor.

In the meantime, it is critical that the County be proactive in its efforts to identify and manage budgetary issues on a monthly basis, closely monitoring cash flow and ensuring that projections are on target. Assumptions and explanations for variances must be based on careful analysis and be well documented. The measures taken to implement strong, effective strategies in this budgetary crisis are critical to our future ability to show credit analysts the financial and management strengths of the County, both essential to the overall credit rating of the County and, therefore, our ability to borrow.

- ***What does this all mean?*** It means that we will need to address our structural deficit in such a manner as to turn it around by this fiscal year end in order to survive the coming fiscal year. In light of a probable inability to access additional cash flow loans, we will need to utilize internal borrowing for temporary cash flow management for the remainder of this fiscal year. In order to attract a lender for a 2009-2010 TRAN, the County will need to demonstrate in March that it will make the difficult decisions necessary to decisively control expenditures and balance the budget despite severely reduced revenues.
- ***What can be done about this?*** The Board could direct staff to return on March 3, 2009 with specific measures to reduce ongoing expenditures. The Board could take further action in March to address the structural operating deficit.

County Budget

The Chief Administrative Office continues to work closely with the Treasurer's Office, Assessor's Office, Auditor's Office, and other County departments to proactively monitor declining economic trends, the status of the County's fiscal year 2008-2009 budget and projections for fiscal year 2009-2010.

County tax receipts always lag behind the economy, ranging from 6 months for sales taxes to more than a year for property taxes. Economic activity is expected to be even slower in 2009 than in 2008. Therefore, staff is forecasting steeper declines in revenues next fiscal year than we are experiencing this fiscal year.

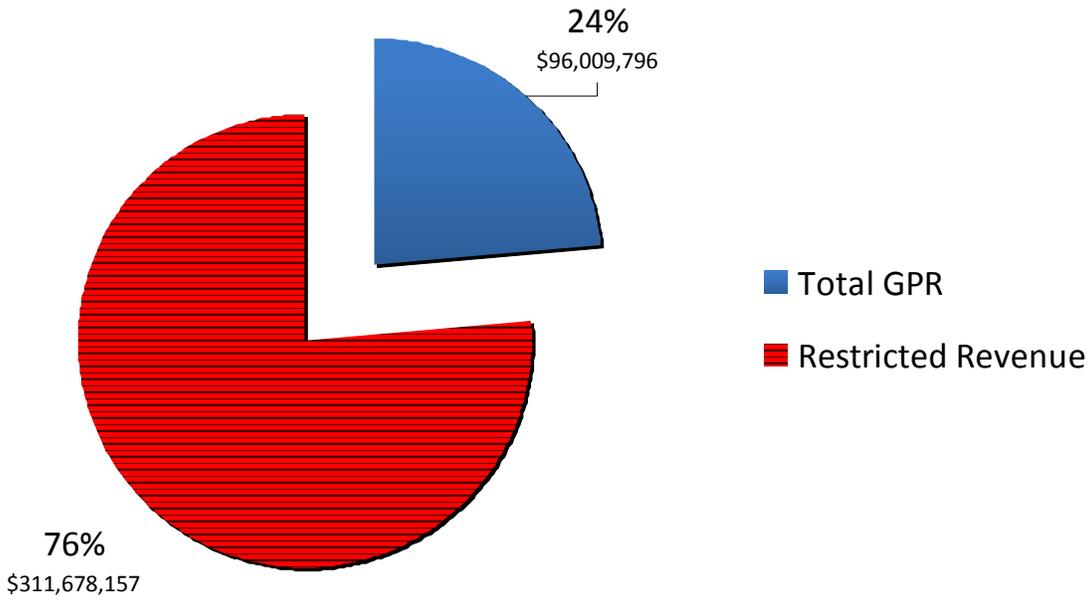
At its meeting of November 4, 2008, the Board accepted the First Quarter Financial Report from the Chief Administrative Office and approved all of the actions recommended by staff. The Board also directed staff to proceed with a list of other suggested actions described in the report, including a \$4 million Required Expenditure Savings (RES) allocated to departments, needed to resolve the County's budget gap for the current fiscal year (2008-2009).

While economic conditions continue to deteriorate, staff is pleased to report that the quick and decisive actions of the Board in December 2008 remain effective in closing the \$10 million budget gap for the current fiscal year. County departments have worked diligently to absorb the RES and other current year budget adjustments while minimizing service impacts to the community. Staff at all levels within the organization has contributed to the success of this ongoing effort.

While current forecasts indicate that the County's adjusted fiscal year budget is balanced, we now need to consider proactive budgetary actions to allow for a structurally balanced budget in fiscal year 2009-2010. Butte County's fiscal year 2008-2009 Final Budget assumed \$95 million in available discretionary resources. Approximately \$8.6 million of this total was appropriated to meet State mandates such as Maintenance of Effort (MOE) contributions to the Superior Court, and health and human services. \$5.5 million was planned for the General Fund Contingency Budget. The remaining \$81 million was allocated to County departments.

The following chart shows the relationship between Restricted Revenue and General Purpose Revenue as components of the County's fiscal year 2008-2009 operating budget. Butte County, like all other California counties, finances its budget with a combination of restricted and general purpose (discretionary) revenues. While restricted dollars finance the majority of the budget, they can only be used for specified purposes such as health and human services, and transportation. Restricted revenues generally are not available for many locally desired services. General Purpose Revenue (GPR) can be used as determined by the Board of Supervisors for public protection, libraries, planning, and other governmental services.

FY 2008/09 Revenue: Restricted vs. General Purpose Revenue
\$407,687,953



For fiscal year 2009-2010, the Chief Administrative Office is forecasting approximately \$79 million in available discretionary resources. Approximately \$10.4 million of this total is expected to be needed for State mandates, such as the MOE obligations. The County will need to set aside no less than \$5.5 million in the General Fund Contingency Budget for cash flow needs and unforeseen expenditures, such as last summer’s fire events. The remaining \$63 million in discretionary resources would be available for the Board to appropriate for use by County departments. ***This represents a 21.8 percent decrease in projected discretionary resources for use by County departments in FY 2009-2010***, an estimated decline of \$18 million when compared to the fiscal year 2008-2009 Final Budget. Attachment A is a spreadsheet communicating trends and a forecast of available discretionary resources.

It will be difficult to accommodate an \$18 million reduction in departmental use of discretionary resources. Attachment B is a chart that graphs a 22% proportionate reduction in the use of discretionary revenue if applied equally to all departments historically receiving discretionary allocations. Service impacts of an across the board reduction could result in closure of fire stations, satellite offices and library branches, early release of jail inmates and juvenile hall trustees, reduction in patrol deputies, and major reductions in criminal prosecution. All County departments are currently working on assessing the impacts of a multitude of budget reduction scenarios. Once their projections are completed, we will have a much clearer picture of likely service impacts.

Concurrent with an \$18 million reduction in expenditure of discretionary dollars, the County will likely lose access to many other revenues. The federal, state and other local governments often require certain funding matches, statutory contributions, or specified service levels that will probably not be achievable next fiscal year. The loss of these revenues will require additional offsetting cost reductions. We'll be able to better quantify the additional losses after departments submit budget scenarios later this month. Nonetheless, total necessary budget cuts are expected to exceed \$20 million.

- ***What does all this mean?*** It means the County is not in a financial position to maintain current services and staffing levels within locally funded programs. The County needs to make difficult decisions and sharply reduce ongoing operating costs. Since the County is primarily a service provider, it is necessary to significantly reduce workforce and contracted service expenses. It also means that we will need to address our structural deficit in such a manner as to turn it around by this fiscal year end in order to minimize impacts in the coming fiscal year.
- ***What can be done about this?*** The Board could direct staff to return with specific measures to reduce ongoing expenditures for the Board of Supervisors' consideration on March 3, 2009.

State Budget: Other Risks This Fiscal Year

On December 31, 2008, the Governor released his proposed 2009-2010 State budget. The budget, which was released over two weeks before the customary release date of January 15th, included proposals for budget solutions in addition to the Governor's earlier proposals, as a result of the deteriorating economic outlook. At this point, it is unclear how many of his proposals will be adopted by the legislature. Moreover, it is likely that other budget solutions will be proposed in the coming months, making the final state budget quite different than what was proposed by the Governor in December 2008. Nonetheless, in an attempt to quantify his proposals, the following summary shows the impacts of the Governor's budget to Butte County.

The budget proposes:

- A reduction in State participation in IHSS provider wages to minimum wage. If approved, this proposal would cost the County approximately \$250,000 per year based on current provider wages.
- Various reductions to the eligibility and benefits of social services programs including MediCal, CalWORKS and SSI/SSP. The proposal includes elimination of cost of living adjustments and the elimination of the MediCal dental benefit which would shift costs to counties. Additionally, these proposals would have significant impact on many program beneficiaries by either reducing or eliminating their benefits.

- The suspension of the statutory cost of living adjustment paid to counties for the administration of the MediCal program.
- Use of Mental Health Services Act (known also as Prop 63) funds to supplant state funding of the MediCal Managed Care program, thereby significantly reducing the funds available for local Mental Health Services Act programs. This proposal requires voter approval.
- An increase to the alcohol excise tax to fund County alcohol and drug programs, and elimination of the state general fund contribution.
- The elimination of the California Children and Families Commission. The proposal would redirect all state funds and 50% of local funds to support children's programs administered by the Department of Social Services. The remaining 50% of local funds would be retained at the county level for local priorities.
- The elimination of Williamson Act subventions. Butte County receives approximately \$650,000 annually.
- An increase to Proposition 1B funding (transportation projects). Butte County may be eligible for additional transportation funding if it can be spent and/or encumbered by December 31, 2009.
- Elimination of Rural Sheriff Supplemental Funding. Butte County receives \$500,000 annually.
- Elimination of the CalMeth grant, a funding source to fight the methamphetamine epidemic in the State. In previous years, Butte County received approximately \$200,000.
- A new Local Safety and Protection Account wherein the funding for a variety of existing public safety grants (i.e. Juvenile Justice Crime Prevention Act, Citizens Option for Public Safety, booking fees, etc.) shifts from the State general fund. The budget proposes to fund this new account from vehicle license fee revenues formerly used to support the Department of Motor Vehicles. Overall, the impact of this proposal is a reduction of approximately 10% to various public safety grant programs from the State.
- A reiteration of the Governor's earlier proposal to shift the monitoring of State parolees to counties. The funding source is unclear at this point. The budget also includes the Governor's earlier proposal of a corrections reform including a "fix to AB 900", early discharge of parolees, inmate credits and revision of the property crimes threshold.

One action that the State Legislature may feel pressured to take is suspension of Proposition 1A, and consequentially, transfer County property tax revenues away from the County this fiscal year. The impact to the County depends on the prescribed methodology but, based on past experience, the impact would probably be an additional general purpose revenue loss of about \$3 million this fiscal year.

Federal Economic Stimulus Proposals

With the economic pressures and fiscal concerns Butte County faces during the current and future fiscal years, there is a ray of hope that some additional federal funding may come to the County through the proposed federal economic stimulus plan. Grant funds may be available for projects and programs that fall within the funding guidelines including watershed and flood prevention projects, economic development, access to high speed broadband service, certain law enforcement expenses, renewable energy and electricity delivery, water and wastewater projects, employment and training services, public health programs, education, roads and bridges, and housing assistance.

Though the targeted funding may assist with some services provided by the County, such as road maintenance, it will not offset the majority of reductions in general purpose revenue that the County is experiencing, nor will it backfill programs that the State may reduce or eliminate. Funding in the House approved package, for which Butte County and other local agencies may be eligible to apply, will likely flow through the following federal agencies:

- US Department of Agriculture
- Department of Commerce
- Department of Justice
- US Army Corps of Engineers
- Department of Energy
- Environmental Protection Agency
- Department of Labor
- Department of Health and Human Services
- Federal Highway Administration
- Department of Transportation
- Housing and Urban Development

Summer Fire Events and Cost Recovery

The total cost of the fires has been decreased from \$6.2 million to \$5.4 million. The major cause for the downward revision was the ability of the County to partner with agencies and community groups for debris removal and cleanup, saving about \$800,000 in unbudgeted expense.

Cost recovery efforts have gone well for Butte County. State Office of Emergency Management officials have been very impressed by the thorough cost records and fast claim submissions performed by fiscal staff in all impacted departments. The exceptional performance has made it possible for the State to process reimbursements to the County much sooner than for other counties impacted by the fires of 2008.

Butte County is still advocating for a Federal Major Disaster Declaration by FEMA. If successful, the County will qualify for \$230,000 in additional reimbursement, and the Declaration will facilitate the availability of certain direct benefits for fire victims.

Updated Butte County Fire Siege Accounting – Summer 2008

Estimated Total Cost Summary

Salaries and Benefits ¹	\$ 1,514,222
Overtime ¹	536,073
Shelter/Food/Mutual Aid/etc. ²	600,578
Debris Removal	51,014
Disaster Recovery Coordinator	165,000
Additional Mutual Aid/Req. Res.	604,915
Infrastructure Replacement	1,111,000
Related Costs	844,491
Total Estimated Cost	<u><u>\$ 5,427,293</u></u>

Footnotes

¹ Salaries, overtime, and benefits are based on Kronos time entry records which are dependent on staff entries.

² Shelter/Food/etc. amount is received from procurement.

Estimated Impact to FY 2008-09 Budget

Unbudgeted Costs:

Salaries and Benefits	\$ -
Overtime ¹	-
Shelter/Food/Mutual Aid/etc.	600,578
Debris Removal	51,014
Disaster Recovery Coordinator	165,000
Additional Mutual Aid/ Req Res.	541,700
Infrastructure Replacement	368,000

Related Costs	-
Reimbursement to CSS	<u>29,596</u>
Total Unbudgeted Costs	<u>\$ 1,755,888</u>

Actual Reimbursement (08-09)	
FEMA	\$ 824,003
State	128,309
Other	-
Actual Reimbursement	<u>\$ 952,312</u>

Expected Reimbursement (08-09)	
FEMA ²	\$ 508,691
State ³	229,865
Other	<u>34,356</u>
Expected Reimbursement Total	<u>\$ 772,912</u>

Net Impact to Budget (08-09) ⁴:	<u>\$ 30,664</u>
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Footnotes

- ¹ Excludes \$200,000 of unbudgeted overtime costs incurred by the Sheriff's office. The Administrative Office will continue to work closely with the Sheriff's Office to determine if future budgetary adjustments need to be considered.
- ² Includes \$300,000 of Federal Reimbursement which may not be received until FY 2009/10
- ³ Includes \$100,000 of State Reimbursement which may not be received until FY 2009/10
- ⁴ Excludes fire-related expenses funded by redirecting existing budgeted appropriations, and loss of revenue.

The Bottom Line

The only way to achieve large ongoing cost savings is to greatly reduce staffing levels. In less than a month, staff will be able to provide an estimate regarding the number of position reductions needed to balance next fiscal year's budget. At this point in time, staff estimates an additional workforce reduction in the 10% to 15% range. (Note: The Board had already reduced the workforce by 7% when adopting the current fiscal year budget plus another 2 to 3% in midyear actions.)

While there has been and continues to be exploration of work furlough and workweek reduction ideas, it is important to understand that such measures will not resolve the General Fund budget deficit. For example, an 80 hour mandatory annual work furlough taken by all County employees would save about \$1 million in use of discretionary revenues. Another \$17 million in cost reductions would still be needed.

After February 13, 2009, staff in Administration will receive and begin analyzing a broad array of budget scenarios and cost reduction proposals generated by all departments. By the end of this month, staff will be able to more accurately describe the service and staffing impacts needed to balance next year's budget. In any event, we know that the

County will need to sharply reduce its workforce, eliminate some services, reduce others and likely will need to close a number of facilities.

If the State of California decides to defer payments to counties, as proposed by the Governor, and the County is unable to secure additional financing, then the County will have little choice but to shut down departmental programs funded by those State allocations.

Drastic measures must be taken, in part due to the general economic decline, but also in large part because of the State. Over the last 30 years, the State of California has created the most convoluted State-County funding mechanisms in this nation, including expenditure mandates that rise with an inverse relationship to declining revenues. In recent years, the State's inaction and apparent abandonment of its financial responsibilities has resulted in this huge mess we have just inherited.

Recommended Actions

1. Accept Fiscal Year 2008-2009 Second Quarter Financial Report.
2. Direct staff to return with specific measures to reduce ongoing expenditures for Board of Supervisors' consideration on March 3, 2009.
3. Authorize the Chair of the Board of Supervisors to sign a letter to State of California representatives advising that the County will likely be forced to close down health and human service programs, and transportation projects, in early spring if the State payments for these services are not provided timely.