ARIZONA

MONTHLY FISCAL HIGHLIGHTS

October 2005

Summary

General Fund revenue collections were $858.7 million in September, which was $104.2 million above the forecast for the month and 22.3% more than September 2004. Collections for the first 3 months of the fiscal year total $205.6 million over the budgeted forecast. The forecast comparison is based on projected FY 2006 revenues from the enacted budget.

September collections for the largest revenue categories continued to grow at a high rate. Sales tax revenue was 17.9% above September of last year, corporate income tax collections grew by 39.2%, and individual income tax revenue was up 20.1%, after adjusting for this year's higher withholding rates.

The enacted budget requires any FY 2006 revenues above forecast to be deposited into the Budget Stabilization Fund. The first deposit will not be made until JLBC Staff and the Governor's Office of Strategic Planning and Budgeting (OSPB) report in February 2006 on revenues for the first six months of the fiscal year.

The JLBC and JCCR met on September 28th and October 26th (see page 6). The highlights of the agendas included:

- JLBC approval of an increase in the state motor vehicle travel mileage reimbursement rate, from 37.5¢ per mile to 40.5¢.
- An unfavorable review by the JLBC of the Department of Economic Security's (DES) Child Protective Services caseload standards. The Committee directed DES to reevaluate the standards and to work with the Attorney General's office to resolve discrepancies between the 2 agencies in their reporting of the number of children awaiting placement.
- JLBC approval of a 12.85% increase to the cost-per-square-foot factors used in the School Facilities Board's New School Facilities and Building Renewal formulas. The adjustment is estimated to have a $28.9 million impact on the New School Facilities program over the next 4 years and increase the Building Renewal formula by $16.7 million.

(Continued)

Table of Contents

This report has been prepared for the Arizona Legislature by the Joint Legislative Budget Committee Staff on October 28, 2005 This report can also be found on our Website at http://www.azleg.state.az.us/jlbc.htm

Summary (Continued)

- A favorable review by the JLBC of the Arizona Board of Regents' (ABOR) plan for the Phoenix Medical Campus, with the provision that the favorable review did not constitute an endorsement of any level of General Fund appropriation for the Phoenix Medical Campus. ABOR was also asked to report back by February 15, 2006 on how the medical school will alleviate the doctor shortage in Arizona. The Legislature appropriated $7 million to the University of Arizona in FY 2006 for the campus.

The October Monthly Fiscal Highlights includes an update of some current budget issues, including (see page 7):

- The Department of Public Safety's (DPS) fuel budget: Recent press reports indicated that DPS may be facing a $2.0 million to $2.9 million shortfall in its fuel budget. DPS, however, has already set aside funding in its current budget to cover this expense. DPS plans to use $536,900 in additional funding appropriated in FY 2006 and $1.6 million reallocated from its equipment budget to solve any shortfall.

- Projected FY 2006 General Fund revenues and ending balance: JLBC Staff is statutorily required to update its projection by mid-October. JLBC Staff currently estimates a FY 2006 ending balance of $357.5 million. This amount is $326 million above the $31.5 million balance enacted in the FY 2006 budget. This estimate is likely to grow throughout the fiscal year as revenue estimates are further updated.

- Distribution of Lottery revenues: The lack of a large Powerball jackpot in FY 2005 shifted more sales to the in-state games such as The Pick, which also affected the distribution of lottery monies. While Powerball proceeds benefit local mass transit programs, the in-state games are distributed to health and welfare programs. Mass transit proceeds dropped from $13.5 million in FY 2004 to $5.1 million in FY 2005. Health and welfare distributions increased from $3.7 million in FY 2004 to $17 million in FY 2005. As a result of the large October Powerball jackpot, there may be a shift in Lottery sales that reverses the FY 2005 result and generates a greater distribution for Mass Transit than the health and welfare programs in FY 2006.

The October Monthly Fiscal Highlights includes a summary of recent statutory reports submitted to the JLBC, including (see page 9):

- A report by the Department of Revenue (DOR) on the implementation of the Business Re-Engineering/Integrated Tax System (BRITS). To date, BRITS has generated $61.4 million in additional revenues, which is $8.5 million less than projected. The department reports that delays in the implementation of BRITS have adversely affected its revenue generating program

During the summer, JLBC Staff has compiled a number of Program Summaries, which provide information on a number of programs and topics of interest across state government. These 2-4 page summaries include a program overview as well as funding and performance measure information and can be found on the JLBC website at http://www.azleg.state.az.us/jlbc/progsumm.htm. The latest Program Summaries include:

- Human Resources Information Solution
- Workers' Compensation
- Building Renewal
- Higher Education 2+2 Partnerships
- Commerce – CEDC Fund
- Rural Economic Development
- Corrections Health Care
- DES JOBS
- Community Health Centers
- Emergency Medical Services
- Sexually Violent Persons
- Vaccines
- Library and Archives – Grants-in-Aid
- Racing Funding Sources and Provisions

State of Arizona
General Fund Revenue: Change from Previous Year and May Forecast
September 2005

	Current Month					FY 2006 YTD (Three Months)				
		Change From					Change from			
	Actual	September 2004		Revised Forecast		Actual	September 2004		Revised Forecast	
	September 2005	Amount	Percent	Amount	Percent	September 2005	Amount	Percent	Amount	Percent
Taxes										
Sales and Use	$343,784,559	$52,260,340	17.9 %	$32,336,959	10.4 %	$1,025,610,790	$149,341,178	17.0 %	$86,074,290	9.2 %
Income - Individual	322,958,721	64,650,720	25.0	31,205,921	10.7	810,611,909	164,037,873	25.4	71,765,009	9.7
- Corporate	170,380,388	48,021,988	39.2	36,391,588	27.2	229,088,185	64,483,433	39.2	42,060,385	22.5
Property	92,274	336,733	--	112,274	--	459,677	131,626	40.1	(740,323)	(61.7)
Luxury	5,764,666	830,667	16.8	414,666	7.8	16,024,548	839,053	5.5	(25,452)	(0.2)
Insurance Premium	29,636,178	3,221,869	12.2	678,178	2.3	109,217,671	8,781,655	8.7	3,519,871	3.3
Estate	1,322,222	(3,206,341)	(70.8)	(377,778)	(22.2)	8,930,669	(3,823,822)	(30.0)	3,830,669	75.1
Other Taxes	40,653	819	2.1	(191,347)	(82.5)	152,135	3,644	2.5	(543,865)	(78.1)
Sub-Total Taxes	$873,979,661	$166,116,795	23.5 %	$100,570,461	13.0 %	$2,200,095,584	$383,794,640	21.1 %	$205,940,584	10.3 %
Other Revenue										
Lottery	2,391,600	61,600	2.6	(1,908,400)	(44.4)	4,857,800	(733,400)	(13.1)	(3,242,200)	(40.0)
License, Fees and Permits	3,325,099	653,064	24.4	461,699	16.1	8,034,664	971,330	13.8	(598,536)	(6.9)
Interest	3,692,847	2,340,835	173.1	1,692,847	84.6	7,623,787	3,850,500	102.0	3,152,687	70.5
Sales and Services	6,060,346	2,466,970	68.7	2,431,746	67.0	13,322,810	4,756,857	55.5	3,653,510	37.8
Other Miscellaneous	1,581,237	33,136	2.1	1,437	0.1	3,744,184	737,071	24.5	(191,616)	(4.9)
Disproportionate Share	0	0	--	0	--	0	0	--	0	--
Transfers and Reimbursements	3,074,615	3,244,000	--	914,615	42.3	3,400,135	(3,110,327)	(47.8)	(3,079,865)	(47.5)
Sub-Total Other Revenue	20,125,744	8,799,605	77.7 %	3,593,944	21.7 %	40,983,380	6,472,031	18.8 %	(306,020)	(0.7) %
TOTAL BASE REVENUE	**$894,105,405**	**$174,916,400**	**24.3 %**	**$104,164,405**	**13.2 %**	**$2,241,078,964**	**$390,266,671**	**21.1 %**	**$205,634,564**	**10.1 %**
One-Time Revenue										
Urban Revenue Sharing	(35,435,744)	(4,346,363)	14.0	0	0.0	(106,307,232)	(13,039,089)	14.0	0	0.0
Judicial Enhancement	0	(227,300)	(100.0)	0	--	0	(2,086,500)	(100.0)	0	--
Sub-Total Transfers In	(35,435,744)	(18,174,862)	105.3 %	0	0.0 %	(106,307,232)	(28,726,788)	37.0 %	0	0.0 %
TOTAL REVENUE	**$858,669,661**	**$156,741,538**	**22.3 %**	**$104,164,405**	**13.8 %**	**$2,134,771,732**	**$361,539,883**	**20.4 %**	**$205,634,564**	**10.7 %**

VP% = Percent change from comparable period in prior year

VF% = Variance from forecast

F% = Forecast percent change for the fiscal year.

R% = Average percent change from comparable period in prior year which must be attained over remaining months to realize the forecast for year.

SEPTEMBER REVENUES

Sales Tax revenue increased by 17.9% on a year-over-year basis in September and was $32.3 million above the forecast for the month. Year-to-date, collections are $86.1 million above the forecast. Based on collections through September:

- **Retail** receipts have increased by 17.9%.
- **Contracting** continues to generate strong returns, with year-to-date growth of 25.5%.
- **Utilities** collections are up 11.1%.
- **Use** tax receipts (all of which are retained by the state) have grown by 13.6%.
- **Restaurant and bar** collections are up 13.2%.

Individual Income Tax collections were $323.0 million in September, a 25.0% increase above last September and $31.2 million above the forecast for the month. Withholding collections grew by a total of 17.9%, or 11.1% after adjusting for the higher withholding rates implemented in January 2005. Estimated payments increased 41.2% over September 2004. Year-to-date, collections are $71.8 million above the forecast.

Corporate Income Tax collections were $170.4 million in September, a 39.2% increase from a year ago. The September results were $36.4 million above the forecast for the month. For the fiscal year to date through September, corporate income tax revenue increased 39.2% from last year and was $42.1 million above the forecast.

The General Fund portion of **Luxury Tax** collections for September was 16.8% greater than September 2004, and $0.4 million above the forecast for the month.

Among the remaining categories, **Insurance Premium Tax** collections increased 12.2% from a year ago and were $0.7 million above the forecast.

Table 2

General Fund Revenues
Compared to Adopted Forecast and FY 2005 Collections
($ in Millions)

	FY 2006 Collections	Difference From Forecast 1/	Difference From FY 2005
September	$ 858.7	$ 104.2	$ 156.7
Year-to-Date	$ 2,134.8	$ 205.6	$ 361.5

1/ Enacted FY 2006 budget (May)

RECENT ECONOMIC INDICATORS

The hurricanes that pummeled the Gulf Coast continued to have an impact on price inflation, mostly through higher fuel costs. The **U.S. Consumer Price Index (CPI)** jumped 1.2% in September, with energy prices climbing by 12%. Excluding food and fuel costs, the core CPI increased 2% on a year-over-year basis in September. Overall, the CPI's 3-month moving average increased 0.7% and was 3.8% higher than a year ago.
The hurricanes also had a predictable effect on consumer sentiment. After plummeting (17.1)% in September, the Conference Board's **U.S. Consumer Confidence Index** dipped another (2.9)% in October. While consumers' assessment of current conditions sagged following the storms, the outlook for the business conditions in the next 6 months and the job market was especially gloomy. Historically, such shocks have had a short-term impact on consumer confidence, so it is too soon to tell whether the recent disasters will have a lingering effect.

While the **U.S. Leading Economic Indicators Index** was also pushed downward by the hurricanes' effects, the (0.7)% drop reported for September was the third consecutive decline. Consumer expectations and initial unemployment insurance claims were the largest negative contributors, while vendor performance and building permits were positive factors.

The technology sector was gaining ground earlier this summer. **U.S. semiconductor billings** (3-month moving average) improved 3.4% in August but were (5.1)% below sales results from the prior year. The Semiconductor Industry Association reported that worldwide sales increased sharply in recent months, bolstered by strong sales of flash memory, cell phones and MP3 players.

Arizona's economy continued to post relatively good results. Although the **unemployment rate** rose to 5% in September, **non-farm employment** continued to increase and was up 4% from a year ago. The construction sector continued to expand rapidly and accounted for almost 25% of the 95,500 jobs added since September 2004. Professional, scientific and technical services provided 5,400 new jobs in the last 12 months, a 5% increase, while employment in finance and insurance also increased by 5%.

The latest **Arizona personal income** statistics reflected the expanding job market with a with a year-over-year increase of 8.6% reported for 2005's 2nd quarter. Arizona's 1.9% growth from the previous quarter ranked 5th in the nation. Net earnings for Arizona residents, which represented 69.1% of total personal income, increased by 10.2% from the 2nd quarter of 2004.

According to the Real Estate Center at Arizona State University, the Greater Phoenix housing market remained robust in September. The **single-family median resale price** increased to $263,000, a 46.5% jump from a year ago and a 1.7% gain from August. However, the number of single-family homes sold fell (8.1)% from the prior month.

The **Arizona Business Conditions Index**, derived from a monthly survey of supply chain managers, climbed 2.2% in September and stood well above the benchmark of 50 associated with an expanding economy. A significant improvement in the new orders component, which reached its highest level since December 2003, contributed to the increase.

The state's business leaders were increasingly apprehensive about the near-term outlook. The University of Arizona's

Business Leaders Confidence Index (BLCI) decreased (7.4)% in 2005's fourth quarter. The BLCI remained above the 50 mark associated with positive sentiment. However, at 40.7, the index component reflecting expectations for the national economy was significantly more pessimistic.

The **Department of Corrections' inmate population** increased by an average of 108 inmates per month from July through September. The total population increased by 836 inmates from a year ago.

The number of TANF recipients edged down by less than (0.1)% to 98,279 in August and was (14)% below the level from August 2004. The **AHCCCS caseload** declined (0.3)% in September but was 3.4% higher than the enrollment total from a year ago.

Table 3

RECENT ECONOMIC INDICATORS

Indicator	Time Period	Current Value	Change From Prior Period	Change From Prior Year
Arizona				
- Unemployment Rate	September	5.0%	0.4%	0.2%
- Jobs	September	2.48 million	1.2%	4.0%
- Contracting Tax Receipts (3-month average)	Jul-Sep	$69.5 million	8.7%	25.5%
- Retail Sales Tax Receipts (3-month average)	Jul-Sep	$155.3 million	2.2%	17.9%
- Residential Building Permits - (3-month moving average)				
Single-unit	Jun-Aug	7,204	0.2%	(5.8)%
Multi-unit	Jun-Aug	987	39.3%	38.9%
- Greater Phoenix Existing Home Sales				
Single-Family	September	9,805	(8.1)%	26.0%
Townhouse/Condominium	September	1,770	(10.4)%	31.6%
- Greater Phoenix Median Home Sales Price				
Single-Family	September	$263,000	1.7%	46.5%
Townhouse/Condominium	September	$161,875	1.8%	42.6%
- Arizona Tourism Barometer	August	107.0	1.3%	15.9%
- Phoenix Sky Harbor Air Passengers	August	3.50 million	(6.0)%	3.8%
- Arizona Average Natural Gas Price ($ per thousand cubic feet)	July	$7.07	9.4%	26.3%
- Leading Indicators Index	July	119.3	(0.8)%	(0.6)%
- Business Conditions Index (>50 signifies expansion)	September	65.1	2.1%	(2.2)%
- Consumer Confidence Index	3rd Quarter 2005	102.8	5.5%	1.5%
- Business Leaders Confidence Index	4th Quarter 2005	54.7	(7.4)%	(16.5)%
- Arizona Personal Income	2nd Quarter 2005	$176.3 billion	1.9%	8.6%
- Arizona Population	July 1, 2004	5.74 million	3.0%	3.0%
- AHCCCS Recipients	September	816,493	(0.3)%	3.4%
- TANF Recipients	August	98,729	(0.0)%	(14.0)%
- DOC Inmate Growth (3-month average)	Jul-Sep	32,917	108 inmates	836 inmates
United States				
- Gross Domestic Product (seasonally adjusted annual growth rate)	2nd Quarter 2005	$11.1 trillion	3.3%	3.6%
- Consumer Confidence Index	October	85.0	(2.9)%	(8.5)%
- Leading Indicators Index	September	136.8	(0.7)%	1.2%
- U.S. Semiconductor Billings (3-month moving average)	Jun-Aug	$3.2 billion	3.4%	(5.1)%
- Consumer Price Index (3-month moving average)	Jul-Sep	196.9	0.7%	3.8%

JLBC MEETING

The Joint Legislative Budget Committee met on September 28 and October 26. At the September 28th meeting, the Committee considered the following issues:

Arizona Department of Administration – Consider Approval of Mileage Reimbursement – The Committee approved increasing the mileage reimbursement rate from 37.5 cents per mile to 40.5 cents per mile for motor vehicles as recommended by the Arizona Department of Administration. ADOA estimates that the increase in reimbursement rates will cost the General Fund $66,000 and Other Funds $237,000 annually, excluding the universities.

Department of Economic Security – Review of Arizona Specific Child Protective Services Caseloads **–** The Committee gave an unfavorable review to the Department of Economic Security's (DES) Child Protective Services Caseload standards. 2003 legislation required DES to develop Arizona-specific caseload standards. DES' proposed caseload standards are 10 cases per month for investigators, 19 cases per month for families receiving in-home services and 16 children per month in out-of-home care.

The Committee gave an unfavorable review to the report, indicating that the proposed standards submitted by DES reflect only current workload and procedures and do not attempt to address what is the most appropriate level of staffing. In addition to the unfavorable review, the Committee asked that: 1) DES reevaluate the standards and report back to the Committee by September 1, 2006 and 2) DES and the Attorney General resolve their differences in the reporting of the number of children awaiting placement by December 31, 2005.

The Committee also asked that the statutorily required semi-annual Financial and Program Accountability Report include performance measures that would assist in evaluating DES' success in moving children from temporary to longer-term or permanent placements.

Finally, the Committee requested information on actual caseloads in each service category if all funded positions were fully staffed and how DES' methodology compared to how CWLA standards were established.

Arizona Board of Regents – Review of Operational and Capital Plans for the Phoenix Medical Campus – The Committee gave a favorable review to the operational and capital plans for the Phoenix Medical Campus. The FY 2006 Higher Education Budget Reconciliation Bill directed the University of Arizona (UA) to establish a medical campus at the former site of Phoenix Union High School. The bill appropriated $7 million from the General Fund for this purpose. Half of this funding was made available on July 1. The other half became available upon the Joint Legislative Budget Committee's (JLBC) September 28th favorable review of the Arizona Board of Regent's operational and capital plan. The favorable review by the Committee contained the provision that the favorable review did not constitute endorsement of any level of General Fund appropriations for the Phoenix Medical Campus.

The Committee discussed a number of issues, including how the creation of a medical school would solve the physician shortage in the state, the number of residencies in Arizona and how a new medical school would increase that number, how the creation of a medical school would address physician shortages in rural areas of the state, and whether or not the medical school could flourish without a teaching hospital.

At the October 26th meeting, the Committee considered the following issues:

JLBC Staff – Consider Approval of Index for Construction Costs – The Committee adjusted the cost-per-square-foot factors used in the School Facilities Board's (SFB) building renewal and new school construction financing by 12.8%. JLBC Staff estimates that the impact on new construction costs over the next 4 years would be $28.9 million and that building renewal formula would be increased by $16.7 million. This adjustment applies to construction projects not yet approved by SFB. While both nationwide and local construction cost indices increased by 5% to 6% in the past year, the Committee adjusted the cost-per-square-foot factor by 12.85% due to concerns that prior year adjustments may not have reflected local inflationary costs.

Arizona Board of Regents – Review of FY 2006 Tuition Revenues – The Committee gave a favorable review of an expenditure plan by the Universities on tuition revenue. The Committee also recommended that the Universities not fund alumni associations with tuition revenues. According to the report, total tuition collections are estimated to be $52.6 million above the original FY 2006 budget. The higher revenue is primarily due to increases in tuition approved by ABOR in March 2005. Of the $52.6 million, the universities plan on using $30.1 million in the appropriated budgets to cover operating inflationary increases, unfunded enrollment from prior years and academic and support planning priorities. Most of the non-appropriated tuition increase is allocated to financial aid.

Arizona Department of Administration – Review of Risk Management Deductible – The Committee gave a favorable review to the Department of Administration's risk management deductible amount of $10,000. According to the department, no deductible has ever been charged to a state agency.

JCCR MEETING

At its September 28th meeting, the Joint Committee on Capital Review considered the following issues:

Arizona Lottery Building Renewal – The Committee gave a favorable review to the combined FY 2006 Building Renewal and Lottery Facilities Improvements and capital appropriations for upgrading the fire system and bathroom fixtures, as well as carpet replacement. The $124,500 of funding for the renovations will be allocated from the appropriated building renewal ($47,600) and capital monies ($76,900) of the State Lottery Fund.

ADOT 5-year Transportation Plan – The Committee received ADOT's 5-Year Transportation Facilities Construction Program summary. The information provided estimated expenditures and revenues by fiscal year for major highway projects totaling $5.1 billion over the 5-year period.

The Committee also requested information on the recent federal highway legislation related to distribution of the federal monies, fund sourcing for earmarked highway projects, seat belt law incentives, Canamex projects, potential expansion of state infrastructure bands, and overall impact of the federal legislation on the 5-year plan.

In addition, an Executive Summary of ADOT's 5-year Transportation Facilities Construction Program for FY 2007 – FY 2011 was requested by July 31, 2006.

ASU/Industrial Commission Elevator Code Upgrades – The Committee gave a favorable review to the $3 million elevator code upgrade component of the Academic Renovations and Deferred Maintenance, Phase I project. The Committee has discussed this item at the previous 2 meetings. The elevator code requires that elevator hydraulic cylinders be replaced. The Director of the Industrial Commission of Arizona indicated that ASU's proposed schedule for completing the elevator code upgrades over a 2-year period is acceptable.

At its October 26th meeting, the Joint Committee on Capital Review considered the following issues:

School Facilities Board – The Committee deferred its review of the New School Construction Report until May 1, 2006 when the School Facilities Board (SFB) will have completed its project approval process.

The SFB estimates that new school construction will cost approximately $308.4 million in FY 2007. Of this amount, $272.4 million is projected to be for construction projects and $35.0 million is projected for land costs, with the remaining $1.0 million being used for emergency deficiencies.

The SFB projects that funding for these projects will be primarily from a $250.0 million appropriation from the General Fund in FY 2007, with the remaining revenues coming from other sources. Previous estimates of new school construction costs would have required the Legislature to appropriate $300.0 million in that year.

Arizona Board of Regents – The Committee gave a favorable review to constructing a $33 million joint University of Arizona (UA) and Arizona State University (ASU) Biomedical Research Collaborative Building. The 85,600 square foot facility will be used for wet and dry research, and biomedical research and informatics. In addition, the building will also accommodate administration and office areas for graduate students, post-doctorate students, research fellows, and principal investigators.

The building's debt service will be paid from 2003 legislation, which authorized research infrastructure lease-purchases.

Legislative Council – The Committee received an update from Legislative Council Staff concerning the Legislative Archive and History Building project. Laws 2004, Chapter 194 appropriated $2.0 million in FY 2005 for design and site preparation for the building. The design assumed a project scope estimated to cost $35.7 million. Subsequently, a total of $30.0 million was appropriated to Legislative Council, $15.0 million in each of FY 2006 and FY 2007. The Committee discussed issues associated with the scope, site, and procurement method for the Building.

UPDATES ON BUDGET ISSUES

Department of Public Safety Fuel Budget – According to recent press reports, the recent increase in gas prices had led to a shortfall in the DPS fuel budget. As a result, DPS was planning to reduce the duration of their highway patrols. The Governor directed DPS to retain their current patrols and said that they would find sufficient funds within the DPS budget.

Even before these press accounts, however, DPS had already sent information to the JLBC Staff indicating that they had set aside an additional $2.9 million to cover their extra fuel costs. These monies had previously been spent on one-time items in FY 2005 and are available for reallocation to fuel costs in FY 2006. With this extra set-aside, DPS will have a total of $5.2 million available for fuel in FY 2006, which is a 73% increase over their FY 2005 fuel budget.

FY 2006 Revenue and Ending Balance Projection – Laws 2005, Chapter 286 requires the JLBC Staff to report to the Committee by October 15, 2005 as to whether the estimated FY 2006 General Fund revenues and ending balance are expected to change by more than $50 million from budgeted projections. In a memo to Committee members, JLBC Staff reported that it did anticipate that FY 2006 revenues and the FY 2006 ending balance will exceed the budget by more than $50 million. The report noted three main factors JLBC Staff anticipated influencing the magnitude of the increase:

- *FY 2005 Revenue Performance*: Preliminary actual revenue collections exceeded the $7,629.3 million forecast established by Laws 2005, Chapter 286 by approximately $320 million. The Governor line-item vetoed a provision in Chapter 286 transferring excess FY 2005 revenue collections into the Budget Stabilization Fund (BSF); the $320 million in excess revenue, therefore, will carry into FY 2006.

- *FY 2006 Revenues*: The enacted FY 2006 budget was based on total revenues of $8.25 billion, which assumed a growth rate of 7.4% in permanent on-going revenues. Applying the same growth to the higher-than-expected FY 2005 base generates an additional $344 million in revenues.

  Revenues have been growing more strongly than this budgeted rate. For the first quarter, General Fund revenues grew at a 20% rate. As the housing market stabilizes and interest rates increases, we are unlikely to sustain this growth for the remainder of the fiscal year. Based on the 4 different projections in the JLBC's consensus model, the current FY 2006 projected growth rate is 9.1%. Revising the FY 2006 growth rate to 9.1% would increase revenues another $140 million, for a total of $484 million in excess FY 2006 revenues.

  Laws 2005, Chapter 286 requires that excess FY 2006 revenues be deposited into the BSF (unlike the FY 2005 provision, the Governor did not veto the FY 2006 language). Permanent statutory language, however, limits the BSF balance to 7% of the fiscal year's revenues. If this provision is applied, only $417 million of the $484 million would be transferred to the BSF.

- *FY 2006 Spending Shortfalls*: JLBC Staff is monitoring 3 possible shortfalls totaling $61 million: Arizona Department of Education, $32 million for higher-than-expected FY 2005 student growth; AHCCCS, $14 million for higher-than-assumed Long Term Care inflation; Department of Health Services (DHS), $15 million for increased capitation rates targeted at Maricopa County's Seriously Mentally Ill population. Lower-than-expected FY 2006 caseloads in AHCCCS and DHS could reduce the shortfalls in those agencies.

The total impact of the changes noted above is currently estimated at $326 million above the estimated FY 2006 ending balance of $31.5 million in the enacted budget. As noted earlier in the Monthly Fiscal Highlights, first quarter revenues are already $205 million above forecast. As a result, this estimate will be subject to considerable change during the remainder of the fiscal year.

FY 2005 Lottery Fund Distributions – Due to a significant change in the Lottery Commission's ticket sales mix, several health and welfare programs had a large increase in their FY 2005 distributions, while the Mass Transit Fund experienced a decline. Table 4 shows the Lottery's fund distributions for FY 2004 and FY 2005. Since these monies are distributed at the end of the fiscal year, they are actually expended in the following fiscal year.

After receiving $3.7 million in FY 2004, the health and welfare funds received $17 million in FY 2005, the maximum statutory amount. The three Lottery games that provide monies for these programs -- The Pick, Fantasy 5, and Instant Scratchers – had a combined 22.3% sales increase in FY 2005.

Mass Transit, which received $13.5 million from the Lottery in FY 2004, received $5.1 million in FY 2005. Powerball sales revenue, which is the sole source of Lottery monies for Mass Transit, fell by (19.8)% in FY 2005, due to fewer large jackpots than in FY 2004.

The decline in large Powerball jackpots apparently led more individuals to play the in-state Lottery games. With the recent large Powerball jackpot in October, there could be a shift away from the health and welfare distribution to Mass Transit in this fiscal year.

Table 4

Arizona Lottery Fund Distribution
FY 2004 - FY 2005

	FY 2004	FY 2005
LTAF	$23,000,000	$23,000,000
CAF	7,650,000	7,650,000
HERITAGE	20,000,000	20,000,000
GENERAL FUND*	32,837,700	35,250,900
CEDC	2,674,500	2,958,400
MASS TRANSIT	13,528,100	5,084,700
HEALTH AND WELFARE:		
Healthy Families - DES	1,079,186	5,000,000
AZ Health Education Center - ABOR	862,615	4,000,000
Teen Pregnancy Prevention - DHS	646,043	3,000,000
Disease Control Research - DHS	433,143	2,000,000
Health Start - DHS	433,143	2,000,000
Women, Infants and Children - DHS	216,571	1,000,000
SUBTOTAL: HEALTH AND WELFARE	3,670,700	17,000,000
TOTAL DISTRIBUTION*	$103,361,000	$110,944,000

* Excludes appropriations transfers and CASA

SUMMARY OF RECENT AGENCY REPORTS

Arizona Department of Administration/Government Information Technology Agency – Quarterly Report on AZNET Implementation – The Statewide Telecommunications Management Contract, signed by the Arizona Department of Administration (ADOA) in January 2005, created a statewide telecommunications program now known as the Arizona Network (AZNet). The AZNet contract was awarded to Accenture to build, manage, and maintain the statewide converged voice, video and data network. Pursuant to Laws 2005, Chapter 301, the state Telecommunications Program Office (TPO) was created within ADOA to manage the contract and contractor performance. This is the second quarterly report by ADOA and the Government Information Technology Agency (GITA) required by JCCR on AZNet progress.

Network Transition

During the first quarter of FY 2006 the primary contractor transitioned 3,181 of 4,406 planned seats (telephones) from the Arizona Health Care Cost Containment System (AHCCCS), the Arizona Game and Fish Department, the Department of Environmental Quality, the Department of Health Services, and the Department of Revenue. As of October 1, the primary contractor had transitioned 13,393, or 33% of the revised total 40,052 seats to AZNet.

During the second quarter of FY 2006, the primary contractor plans to transition 17,109 telephones within the following agencies.

- AHCCCS
- Attorney General
- Board of Osteopathic Examiners
- Department of Agriculture
- Department of Banking
- Department of Commerce
- Department of Economic Security
- Department of Insurance
- Department of Juvenile Corrections
- Department of Land
- Department of Real Estate
- Department of Transportation
- Department of Water Resources
- Registrar of Contractors
- State Retirement System

State inventory records show that agencies had 4,987 internet-based telephones prior to the commencement of AZNet. The Statewide Telecommunications Management Contract requires state agencies to install 22,000 new internet phones over the 5-year contract term. ADOA has established a target of 3,000 phone installations by January 2006, with additional targets for each subsequent year. Through the end of August 2005, 313 internet phones had been added.

AZNet Highlights

Of the 32 state employees affected to date, 24 have transitioned to the primary contractor, 4 have moved to other state positions, and 4 have left state service.

In FY 2004, the state spent an average of $2.8 million monthly on services related to the previous telephone system (ATS) operated by ADOA. The costs consisted of $2.3 million for ATS operations and $0.5 million for carrier charges. Not all state agencies used ATS for their telecommunication needs. ADOA was able to cancel all contracts associated with ATS without incurring cancellation charges.

During the first quarter of FY 2006, the state spent $1.4 million on contractor services, $0.7 million on carrier charges, and $0.4 million on TPO and other charges. These total costs will rise as additional users join the network and will eventually exceed the state's previous spending on ATS. This is because unlike the voluntary participation in ATS, Chapter 301 requires all agencies to participate in AZNet.

The primary contractor has begun reducing annual telecommunications carrier costs. The contractor continues to consolidate carrier services between large agencies, as well as reviewing new service orders to maximize sharing among departments. Through August 2005, ADOA reports $436,000 in carrier savings. Additionally, ADOA has issued an RFP for new carrier services, which the agency will award before the end of the second quarter of FY 2006.

ADOA has prepared a transitional pricing plan for FY 2006 and FY 2007. In doing so, the agency discovered that total state spending on telecommunications in FY 2005 was below that for FY 2004, the year on which the Statewide Telecommunications Management Contract based its pricing. Therefore, ADOA is considering implementation of certain cost-cutting contract modifications, including the creation of restricted (dial-tone only) seats. The agency is also developing a proposal to address FY 2007 budget issues, due by February 15, 2006.

Meanwhile, since the start of AZNet, state agencies have purchased $1.6 million in new telecommunications capital equipment through the contract. This amount is in addition to the $1.4 million spent on contractor services previously mentioned. The capital equipment purchased is replacing obsolete systems, outfitting new facilities, and upgrading call centers. A Demand Management Team, consisting of large agency Chief Information Officers and telecommunication managers, is evaluating telecommunications investment proposals.

Other notable progress during the first quarter included development and TPO approval of the Network Security and Disaster Recovery plans and implementation of online tools to monitor AZNet performance.

GITA generally concurs with ADOA on the status of AZNET. GITA advises, since restricted seats do not include any allowances for changes of location or information, that consideration be given to the costs of those modifications.

Attorney General – Quarterly Report on Expenditures from Appropriation for Crane Lawsuit – In September 2001, 7 school districts filed the Crane lawsuit, which claimed that the current Arizona school finance system is unconstitutional because it does not provide at-risk students with programs and funding needed in order to meet state academic standards. In FY 2004, the Legislature appropriated $500,000 to the Attorney General for legal fees incurred by outside counsel in defending the state.

Pursuant to Laws 2003, 2nd Special Session, Chapter 4, the Office of the Attorney General is required to report on a quarterly basis to the JLBC the amount expended from the appropriation for the Crane lawsuit. As of September 30, 2005, a total of $466,600 has been spent. Of this amount, $457,600 was spent on outside legal services, $4,500 was spent on expert witnesses, and $4,500 was spent on external printing. The remaining unexpended amount is $33,400. The agency spent a total of $430,400 in FY 2004 and $36,200 in FY 2005. No expenditures were reported in the first quarter of FY 2006.

Corporation Commission – Report on Corporations Division Filings – Pursuant to a footnote in the General Appropriation Act, the Corporation Commission has submitted a quarterly report on the status of reducing processing delays in its Corporations Division. The Legislature added $629,700 in Other Funds in FY 2006 to hire staff to reduce the filings backlog and reduce processing times. This appropriation annualizes supplemental funding added in FY 2005, when the Legislature appropriated $356,200 in Other Funds to hire part-time and temporary staff to reduce backlogs. Significant backlogs and processing delays had developed in the Corporations Division because of increases in the number of corporation filings, which in FY 2005 grew 20% over FY 2004 levels.

Between March 25, 2005 and September 30, 2005, a total of 59,002 filings were received by the Corporations Division, and 67,714 were processed. In the last quarter, a total of 29,874 filings were received by the Corporations Division, and 33,322 were processed.

For expedited filings, the amount of time required to process the filings fell from an average of 59.2 days on March 25 to 8.4 days on September 30 (an 85.8% decrease). During the past quarter, the amount of time required to process filings fell from an average of 13.4 days to 8.4 days (a 37.3% decrease).

For regular filings, the amount of time required to process the filings fell from an average of 150.5 days on March 25 to 78.6 days on September 30 (a 47.8% decrease). During the past quarter, the amount of time required to process filings decreased from an average of 100.7 days to 78.6 days (a 21.9% decrease).

Department of Corrections – Report on Transition Release Program – Pursuant to A.R.S. § 31-285B, the Arizona Department of Corrections (ADC) is required to submit a quarterly report that details the cost reductions to the department from an inmate early release Transition Program. Statute requires ADC to contract with a private or nonprofit entity to provide eligible drug offenders with transition services. These transition services include employment assistance, job training, mentoring, and assistance in finding housing, food, health insurance coverage, and medical assistance. In addition, the contract entity must coordinate with ADC to place inmates in programs for basic or continuing education, anger management, communications skills, drug treatment, alcohol treatment, or character education. Eligible offenders include inmates convicted of a drug offense, except those also convicted of a sexual offense, arson, or an offense involving death, physical injury, or the use of a deadly weapon or dangerous instrument. Statute requires a savings of at least $17 per day per inmate by releasing eligible inmates 90 days early from confinement and placing them in the Transition Program. The cost savings are to be deposited from the department's operating budget into the Transition Program Drug Treatment Fund and used to fund the program.

ADC awarded a service contract in March 2004. From July 1 through September 30, 2005, the department reports that 96 inmates, or 78% of program participants, successfully completed the Transition Program and their term of community supervision. As a result, there were 9,086 bed days saved and $154,500 in savings, based on savings of $17 per day for each bed during this time period. Calendar year-to-date, 238 inmates, or 65% or participants, have completed the program and community supervision, 111 inmates, or 30%, have completed the program and are continuing community supervision, and 19 inmates, or 5%, have failed the program. Since program inception, a total of 271 inmates, or 43% of program participants, successfully completed the Transition Release Program and their term of community supervision with savings of 40,664 bed days and $691,300.

Department of Economic Security – Report on Adequacy and Appropriateness of Title XIX Reimbursement Rates for Developmental Disabilities Programs – Pursuant to A.R.S. § 36-2959 the Department of Economic Security (DES) has provided its annual independently contracted study of the adequacy and appropriateness of Title XIX Medicaid reimbursement rates to service providers in the developmentally disabled (DD) program. The contracted firm states that the adopted rates are adequate and appropriate for FY 2006. In FY 2006, the Division received an appropriation of $13.6 million in total funds. The Division used these monies to increase the adopted rate from 95.75% to 97.61% of the FY 2005 benchmark rates. The Division notes that even though this is a 1.94% increase and will have "a positive impact on access to services and quality of care," the overall change is not rising as quickly as the FY 2006 3.3% inflation for health care costs. Although the current rates are adequate and appropriate, the contracted firm warns that without an annual inflation adjustment, the adequacy and appropriateness of the rates will deteriorate.

Governor's Office of Strategic Planning and Budgeting – Report on Federal Revenue Maximization Initiative – Pursuant to a General Appropriation Act footnote, the Governor's Office of Strategic Planning and Budgeting (OSPB) has submitted its quarterly report on the status of a Federal Revenue Maximization Initiative. To date, there are 9 projects completed, 7 of which are designed to increase federal Title XIX Medicaid reimbursement. The other 2 projects were newly completed:

- *Medicare/TEFRA Exception at ASH:* The Department of Health Services (DHS) has prepared retroactive Tax Equity and Fiscal Responsibility Act (TEFRA) Exception appeals to generate additional Medicare dollars. DHS' appeals generated $17,000 in retrospective FY 2004 claims; FY 2005 revenues are unknown.
- *Community-Based Local IV-E Enhancement*: The Department of Economic Security (DES) has received federal approval of a state plan permitting counties to obtain Title IV-E funding for entities other than DES that provide child welfare services (e.g., through juvenile probation). The project is estimated to save Maricopa and Pima Counties (though not the state) $1.2 million annually.

In addition to these projects, the summary lists 11 ongoing projects. Among the more notable items OSPB reports that 2 DHS projects with budget implications had new developments from the prior report:

- *Medicare Bad Debt*: In this new item, DHS will look to include unrecovered costs such as bad debts in the State Hospital's allowable calculation for reimbursement, which is expected to save $66,000 yearly.
- *Medicare Part B*: In this new item, DHS will establish the billing of Medicare Part B using a per diem method.

In addition to the projects with new developments, AHCCCS has 2 new Potential Task Order Projects:

- *Family Planning/Behavioral Health*: AHCCCS and DHS are reviewing whether family planning-related behavioral health services would be eligible for enhanced federal match.
- *Traumatic Brain Injury Claiming*: Investigating whether a new waiver would allow for a more expansive scope of services.

Department of Racing – Semi-Annual Report on Boxing Events and Revenue – Pursuant to a General Appropriation Act footnote, the Department of Racing is required to report semi-annually on the number of boxing events, gross receipts, state revenues, and license fee collections. The department submitted its latest report on September 30, 2005.

Between January 1, 2005 and June 30, 2005, a total of 19 boxing events were held in Arizona. During that time period, the total gross tax receipts and license fee collections were

$42,900. The state also received $10,700 in additional revenue - $9,000 by way of an Intergovernmental Agreement with Indian tribes and $1,700 in fines.

In total, the state held 40 boxing events in FY 2005, generating $95,600 in revenue.

Department of Revenue – Report on Revenue Generating Program – A footnote in the General Appropriation Act requires the Department of Revenue (DOR) to report quarterly to the Committee on the effectiveness of the revenue generating program and the department's overall enforcement and collections program, including a comparison of projected and actual revenue enforcement collections for FY 2005. The revenue generating program was expected to produce $75.1 million of gross additional enforcement revenue, including a net increase of $53.2 million to the State General Fund.

DOR has reported their General Fund enforcement revenue, which includes both their baseline and revenue generating program monies. They did not separate out the enforcement monies attributed to the revenue generating program. DOR had General Fund enforcement revenues of $341 million in FY 2005, which was $27.7 million above their goal of $313.3 million. There were shortfalls of $(15.6) million in collections, and $(611,400) in transaction privilege tax audit, which DOR attributes in part to the conversion of the transaction privilege tax system to the Business Re-Engineering/Integrated Tax System (BRITS) in January 2004. DOR reports that they continue to manually review all BRITS transaction privilege tax audit bills prior to mailing. The total overage of $27.7 million includes results which exceeded the goals by $23.7 million in corporate tax audit, $2.4 million in individual tax audit, $9.8 million in license compliance, and $8.1 million in accounts receivable. The following table summarizes these results.

DOR had reported a $(20) million shortfall in General Fund enforcement revenue through the 3rd quarter of FY 2005. DOR reports that the $27.7 million General Fund overage for all of FY 2005 was primarily due to implementing an abusive tax unit to follow up on Internal Revenue Service leads that brought in $29 million General Fund, most in the 4th quarter; a one-time adjustment of $8.7 million General Fund to collections and accounts receivable for previously under-reported enforcement revenue; and, developing a discovery unit to better use BRITS to identify non-reporting and under-reporting taxpayers.

Department of Revenue (DOR) – Report on Ladewig Expenditures – DOR reports monthly on the status of the Ladewig litigation. In September, DOR mailed 819 warrants totaling $262,400. DOR's monthly status report shows expenditures of $75,600 for Ladewig administrative costs in September 2005. Expenditures totaled $46.9 million through September 2005, out of DOR's estimated total of $58.3 million for FY 2006. The following table summarizes these items.

DOR estimates that the FY 2005 refunds included overpayments of $6.3 million to 3,000 of the 306,000 claimants due to clerical and computer matching errors. At a

DOR's General Fund Enforcement Revenue in FY 2005 (Net of Duplications)

	FY 2005 Through 6/30/05		
	Goal	Actual	Over/(Under)
Corporate Tax Audit	$53,474,200	$ 77,148,800	$ 23,674,600
Individual Tax Audit	8,250,400	10,692,500	2,442,100
Transaction Privilege Tax Audit	15,780,700	15,169,300	(611,400)
License Compliance	12,100,400	21,906,200	9,805,800
Collections	187,837,900	172,206,300	(15,631,600)
Accounts Receivable [1/]	35,807,500	43,877,400	8,069,900
Total	$313,251,100	$341,000,500	$27,749,400

1/ Taxpayer accounts paid before they would have been moved to Collections, which allows collectors to work on other accounts.

DOR's Ladewig Expenditures in FY 2006

	DOR's Estimate [1/]	Through September 2005
DOR Administration	$ 1,758,900 [2/]	$ 205,000
Plaintiff Attorneys	4,900,000	4,853,300
Taxpayer Payments	51,600,000	41,857,100
Total Expenditures	$58,258,900 [3/]	$46,915,400

1/ Reported by DOR at the June 28, 2005 JLBC meeting.
2/ JLBC favorably reviewed $1,424,700 to fully fund DOR's estimated administrative costs in FY 2006 at the June 28, 2005 JLBC meeting. $334,200 was unallocated in DOR's plan.
3/ Any unused amounts of the $58,258,900 are set aside for future Ladewig payments.

May 26, 2005 hearing, the judge agreed to allow the state to hold off mailing FY 2006 refunds to the 3,000 overpaid claimants, until the overpayment issue is resolved. The Joint Legislative Budget Committee at the June 28, 2005 meeting, asked that DOR report back to the Committee after the taxpayer refund overpayment issue has been resolved. The report is to include DOR's updated estimate of the total cost of the Ladewig settlement. A September 19, 2005 hearing was held on DOR's request to correct data and seek repayment of overpaid monies, but no decision was issued.

Department of Revenue – Report on Business Re-Engineering/Integrated Tax System (BRITS) – BRITS is the new computer system being implemented by the Department of Revenue (DOR) to integrate their separate tax systems, improve enforcement, and increase revenues to the state.
Given the importance of this issue, in April 2003 the Appropriations Chairmen asked DOR to provide quarterly reports on the additional revenue received from implementing BRITS. The implementation of BRITS began in FY 2003 with the awarding of the contract to Accenture, LLP on August 20, 2002. The original contract called for BRITS to be completed in FY 2007, for a total cost of $133.7 million including an estimated $11 million in interest (the average of DOR's $9 million to $13 million estimate). Accenture is financing the cost of BRITS, and is paid from the increased revenues generated by BRITS.

The Auditor General reported in October 2005, however, that on May 17, 2005 DOR sent a memo to the state's central procurement office, Enterprise Procurement Services, documenting contract changes that DOR had already made and requesting that the contract price be increased $6.4 million to include the cost for Accenture to operate and maintain the BRITS data center for 4 years. This had been an additional cost option in the original contract, which DOR chose on its own to implement. The state procurement office has been meeting with Accenture regarding the necessary documentation to amend the original contract to incorporate the option. If approved by the state's procurement office, the new total cost of BRITS would become $140.1 million, assuming the same $11 million in interest. The functional impact on BRITS is currently undetermined if the contract amount is not increased, and the $6.4 million has to be absorbed within the original total cost of $133.7 million.

DOR had problems with the transaction privilege tax (TPT) conversion to BRITS in January 2004, which delayed other BRITS conversions as shown in the following table. DOR reports that they have addressed the major TPT conversion issues, but that collection tasks are not fully functional and billings are still being checked before they are sent out. DOR reports that the withholding tax was converted in October 2004 with no significant issues. DOR and Accenture currently expect to determine a revised corporate income tax conversion date in October 2005. However, they have previously postponed determining a new date several times in the past few months.

Since its inception in FY 2003, BRITS has generated additional revenue, but not as much as projected. Since BRITS has not generated as much additional revenue as projected, the project has cost the state an indeterminate amount of additional interest. DOR also reports that BRITS delays, transaction privilege tax billing problems, and resource reallocations for correcting BRITS problems have adversely impacted the revenue generating program. Accenture has been paid $44.2 million through September 30, 2005 for increased collections. This amount is $7.9 million below the projected payment at this point in the contract. The state/county/city have received $8.7 million, $572,200 less than projected. The following tables summarize BRITS costs and additional revenues through September 30, 2005.

Projected Tax System Conversion Dates for BRITS

Tax System	Projected Date	Revised Date
Corporate Income Tax	September 2004	1/
Individual Income Tax	September 2006	1/

1/ DOR expects to have a revised schedule in October 2005, but has previously postponed this determination several times.

Summary of BRITS Costs

	Through 9/30/05	Total Project
Consulting Services	$72,059,600	$101,250,700
Hardware/Software	13,043,100	21,414,000
Interest	5,890,300	11,000,000 1/
Total	$90,993,000	$133,664,700 2/

1/ DOR estimates interest will cost from $9 million to $13 million.
2/ Total cost would become $140.1 million if the state's procurement office adds DOR's requested option to the contract costing $6.4 million for Accenture to operate and maintain the BRITS data center for 4 years.

Summary of BRITS Additional Revenues – Through 9/30/05

	FY 2003 - FY 2005	FY 2006	Total	Projected Total	Over/(Under) Projection
General Fund	$ 5,312,200	$ 1,933,200	$ 7,245,400		
County/City	931,700	194,500	1,126,200		
Education	269,400	59,300	328,700		
Subtotal	$ 6,513,300	$ 2,187,000	$ 8,700,300	$ 9,272,500	$(572,200)
Accenture	36,908,600	7,265,000	44,173,600	52,084,600	(7,911,000)
Total	$ 43,421,900	$9,452,000	$52,873,900	$61,357,100	$(8,483,200)