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July 10, 2006

The Honorable Bill Campbell
Chair, Board of Supervisors
10 Civic Center Plaza, Fifth Floor
Santa Ana, CA 92701

Dear Supervisor Campbell:

I am pleased to submit this annual report to you, the Board of Supervisors, our participants, and the residents of the County of Orange for the fiscal year ended June 30, 2006. This will be my last annual report as your elected Treasurer-Tax Collector.

During this fiscal year the Federal Open Market Committee (FOMC) continued its streak of raising interest rates by 25 basis points at every meeting. This phenomenon started on June 30, 2004 when the short-term overnight rate was increased from 1.00 to 1.25 percent. By June 29, 2006 the FOMC had issued its seventeenth consecutive rate increase, bringing the rate to 5.25 percent.

Our Treasurer's Investment Committee anticipated every one of these interest-rate increases and managed our investment durations accordingly. In fact, in last year's annual report I noted that, "it appears we will be in an interest rate-tightening environment for the next 12 to 18 months."

This is what I observed last year and it continues to seem appropriate once again for the upcoming fiscal year:

"Will the FOMC continue its measured pace? Have the recent interest rate increases slowed down our economy? Do we really have inflation as a strong threat? And what does the current flattening yield curve portend for the economy? Believe it or not, doing market research and staying close to the pulse of the economy is one of the most gratifying aspects of this job. It is when the waters are choppy and the horizon is not in sight that we find managing the County's precious dollars the most exhilarating. We hope you'll enjoy this next year's economic reports in our Monthly Treasurer's Reports even more than you did this last years'."

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Treasury Oversight Committee (TOC)

The Treasury Oversight Committee continues to meet on a quarterly basis to assist in the annual review of the investment policy statement and our compliance to it. The firm of Moreland and Associates, Inc. completed the audit for the year ended December 31, 2005, and we expect the report to be issued later this month.

I wish to acknowledge my appreciation to Charles Schroeder, Committee Chairman during the first half of the fiscal year. Due to term limits he has been replaced by Jeff Thomas, former Mayor of the City of Tustin and an original member of the County's first Treasurer's Oversight Committee established shortly after its Chapter 9 filing to address this issue. I want to thank Mr. Schroeder for his many years of service on this Committee. I am pleased to announce that he has consented to serve on the Treasurer's Advisory Committee to fill a vacancy created by my hiring of Chriss Street as Assistant Treasurer-Tax Collector.

I also wish to share my appreciation to the other committee members, including Robert Fauteux, Committee Vice Chairman, Tom Mauk, County Executive Officer, David E. Sundstrom, Auditor-Controller, and Bill Habermehl, Superintendent of the Orange County Department of Education for their assistance in this critical area of responsibility.

Treasurer's Advisory Committee (TAC)

The Treasurer's Advisory Committee continues to be a professional resource in critiquing and constructing the technical aspects of the investment policy statement. Their collective wisdom is an invaluable asset to the County. Many have been with me since my appointment to this office in 1995.

I would also like to extend my deep appreciation to Wendy Benkert, Ed.D., Chair, Jerry Slusiewicz, Vice Chair, Blake E. Christian, C.P.A., Honorable Pall Gudgeirsson, Honorable Ken Henderson, George Jeffries, Clyde E. Kendzierski, Chriss Street, and Timothy Tunney, for their dedication to this committee.

I am deeply appreciative of all their time, expertise and devotion to the task of making ours the best Treasurer's Department that we can possibly be.

Investment Policy Statement

The December submission of our annual investment policy statement review provided the following modifications:

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- Added short term ratings for municipal debt for Standard & Poor's Corporation and Moody's Investors Service Inc.
- Allowed for a fund to purchase of up to 12.5% of its total market value in the securities of a single issuer for a period of three business days.
- Credit Watch-Negative was amended to allow for issuers who maintain A-1+ or F-1+ short term ratings; or at least an AA or Aa2 long term rating.
- Some items were edited for clarity.

A copy of the 2006 Investment Policy Statement (IPS) is available on our website at <http://www.oc.ca.gov/treas/>.

Treasurer's Investment Committee (TIC)

Our investment management committee enjoyed a year that it anticipated from day one, accurately predicting every regularly scheduled Federal Open Market Committee (FOMC) meeting decision on interest rates prior to their meetings. Our record of precisely anticipating the FOMC's decisions is now 82 out of 86. The investment staff is to be commended for the excellent market update and economic research they prepare and present to the TIC every week.

The information provided in each of our monthly reports, including this one, is informative and displays a professional acumen concerning the direction of short-term interest rates. They are a contemporaneous read and we hope our participants have found them helpful. The charts, tables, graphs and numerical representations in our monthly reports are provided to our readers solely as a general overview of the current economic and market conditions, which the Treasurer utilizes in making investment decisions.

The credit analysts, along with the assistance of our local University interns, continue to compile and update a broad database of issuers whose capital assets and credit ratings are thoroughly reviewed, researched and approved as qualifying under our overly restrictive policies.

Pension Obligation Note

In January of this year our staff had the opportunity to work with those of the County Executive Officer's to develop an innovative opportunity to lower costs associated with the County's retirement system contribution. The Orange County Employees Retirement System (the "Plan") adopted a policy on December 19, 2005 that expanded their prepayment incentive procedures. Previously, if a Plan sponsor made a contribution of

50 percent or more of its total liability for the year by the end of the first month of the fiscal year, July 31, one-half of the Plan's interest rate assumption would be provided as a discount. The new policy provided for the entire discount if the payment was made no later than January 31 of the preceding year. In other words, if one-half or more of the fiscal year's liability was paid six months in advance, a 7.75 percent discount would be provided. The difficult issue is finding the necessary cash to take advantage of this policy.

After considering various options a pension obligation note (PON) was determined to offer the best solution. The County issued a short-term note that fell within the money market investment restrictions of the State Government Code. We purchased the note for our County Money Market Fund and the proceeds were deposited into the Plan. The Treasurer has a sound investment in its portfolio and it is earning a competitive yield that floats with the current market interest rate. And the County is projected to incur present value cost savings of approximately \$4.0 million. Even The Wall Street Journal was complimentary of this innovative financing technique.

Economic Observations for the Year

During the past fiscal year, the economy continued to show remarkable strength. Nationally, housing prices appeared to have peaked around June of 2005, but have rebounded in recent months and are continuing to appreciate (Exhibit 1). Additionally, the southern part of the U.S. was devastated by multiple hurricanes and is currently undertaking the Herculean task of rebuilding. During all of this the consumer just kept on spending. To help cool the pace of economic growth the Federal Reserve continued to raise short-term interest rates, doing so eight times in the past year bringing the level from 3.25% in July 2005 to the current level of 5.25% (Exhibit 2). It appears the Fed is beginning to have an effect on the economy. The pace of home price appreciation has slowed and cash out refinancing has nearly dried up (Exhibit 3).

Employment is still very strong, but wage growth has slowed in the past few months (Exhibit 4). The main focus of the market's attention is determining when the Fed will stop raising rates. The Federal Open Market Committee usually raises rates to slow down the economy when it appears to be over heated and liable to raise inflation rates. The Treasurer's office anticipates further slowing of the economy in the months to come and will adjust our investment strategy accordingly.

Interest Rate Forecast

At this time, the Treasurer's Investment Committee is estimating an interest yield of 5.00 percent for the portfolio during fiscal year 2006-2007.

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Staffing Updates

Thanks to the retirement benefit enhancements, our department incurred a dramatic loss of long-term employees. Wonderful co-workers who have recently retired include Gary Cowan, Assistant Treasurer-Tax Collector and Vickie Pazanti, Administrative and Human Resources Manager. In the month of March we saw six of our longest longevity holders leave the County.

Our Accounting Manager, Emily Lin, left the County to eventually work for another municipality closer to her home in Los Angeles County and our Investment Officer, Judy Jacobson, took a medical leave and is not expected to return.

Chriss Street was recruited to replace Gary Cowan and Robin Russell was hired to replace Vickie Pazanti. Paul Cocking, our Assistant Investment Officer, was promoted to the position of Chief Portfolio Manager. And, with short staffing workload constraints, we are near completion of our recruitment process to replace Emily Lin.

Investment Pool Ratings

Both Fitch Ratings and Moody's Investor Services have maintained their highest ratings for our investment pools throughout the entire fiscal year and we anticipate no alteration on this course in the future.

Expense Ratio

Due to our diligence in watching our overhead expenses and from the increasing balances under management, we were able to reduce our expense ratio on January 1, 2005, from 12.5 basis points to 11.25 basis points. We will be seeking the Treasury Oversight Committee's approval to again reduce this charge at its next meeting.

Compliance

Monitoring the investment policy statement (IPS) compliance and the rectification of any noncompliance issues is documented in an internal noncompliance report summary and included in our monthly reports. Moreland and Associates, Inc.'s quarterly reports on compliance are also provided in the monthly reports promptly after receipt.

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Legislative Pursuits

Our Department had one treasurer related proposal in 2005. Three years ago, then-Assemblyman John Campbell carried AB 2182 that was signed into law by then-Governor Gray Davis. When we drafted the legislation we inadvertently left out some language that would streamline California law to be compliant with Federal Rule 2a-7 language for investment portfolios. The bill Senator John Campbell introduced, SB 268, corrected that minor oversight on our part.

The legislation allowed up to twenty-five percent of the fair market value of the total assets in the County Treasurer's Money Market Investment Pool to be invested in the First Tier Securities of a single issuer for a period of up to three business days after the acquisition thereof. The securities of only one issuer may be invested according to this provision at a time.

The bill passed the State Senate and the Assembly and was signed by the Governor on July 27, 2005. It became law January 1, 2006.

Our Department has one treasurer related proposal pending for 2006. In 2002, AB 2182 contained a 5-year sunset provision which would expire January 1, 2007. Assemblyman Chuck DeVore agreed to carry AB 1794 for us which would make minor technical corrections to the bill and eliminate the sunset provision. The bill passed the Assembly in tact but was amended in the Senate to impose yet another sunset provision.

This bill extends the January 1, 2007 sunset date to January 1, 2011 on the code section allowing counties to invest in specified short-term investments subject to certain restrictions, making it permanent. It also eliminates the prohibition on specified local agencies' investing in more than 10 percent of the outstanding commercial paper of any single corporate issuer and provides that no more than 10 percent of the total assets of a local agency's investments may be invested in any one issuer's commercial paper.

We expect the amended version of the bill to obtain Assembly concurrence in August and we anticipate approval by the Governor.

Annual Business Plan

Our ninth annual Business Plan clearly delineates the tasks performed by this department and discusses our plans for the current calendar year. It also provides a detailed explanation of our performance measurements and our efforts to achieve them. A copy of the 2006 Business Plan is available on our website at <http://www.oc.ca.gov/treas/>.

GASB 31

Our conservative Money Market Investment Pools provide a safe, liquid, and competitive money market yield at a net asset value in the \$1 range. The investments are marked-to-market on a daily basis and comply with Governmental Accounting Standards Board (GASB) 31, which became effective on June 15, 1997. However, as of June 30 our Extended Fund had a net asset value of \$ 0.995. This is the result of the recent rise in interest rates, which causes values to decline. Accordingly, those participants required to prepare Comprehensive Annual Financial Reports, including the County, may be required to report an unrealized loss fair market value adjustment for the fiscal year ended June 30, 2006.

Apportionment of Commingled Pool Interest Earnings

We have prepared a forecast for the timing of the County Pool's May 2006 and June 2006 interest apportionments. We anticipate posting the May 2006 and June 2006 interest apportionments to participants' cash accounts in the County general ledger by approximately July 17, 2006 and August 30, 2006, respectively.

Tax Collection

We continue to provide one of the best collection operations in the state. Recent tax collection percentages are at record levels, and are projected to be at these levels again this year. As of May 2006, we have collected \$3.7 billion.

Our secured collection percentage rate of 98.8 is the 3rd highest of the 58 California counties for the fiscal year 2004-05. Our unsecured business property tax collection ranks 12th with a rate of 97.5 percent.

Technology enhancements are a focus of the Treasurer-Tax Collector Department. In 2004-05 we added a supplemental estimator, tax clearance certificate online request option and a secured tax bill reminder subscription service. This year we replaced the multiple payment template with a new multiple payment upload and tax payment cart feature. This allows title companies the ability to verify the amount of property taxes due prior to remitting funds electronically. We received electronic collections, through May 2006, of \$106.3 million, representing 46,433 paid parcels, thus saving the manual expense of making duplicate tax stubs for each parcel and processing each payment with an individual check.

We continue to be amazed at the increased usage of our tax information website by public and commercial users. This fiscal year there were approximately 10 million

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inquiries, or hits, to our website compared to 8 million last year. The dollar amount of ACH web payments has increased from \$160 million last year to \$320 million this year. In addition, credit card payment dollar volumes increased from \$84 million to \$110 million, including automated telephone payments.

In conclusion, the 2005-06 fiscal year for the Tax Collector's office has been full of accomplishments and there is excitement in our office for the new challenges ahead.

Other County Involvements

I have the privilege of serving as a board member of the Orange County Employees Retirement System. This Board meets monthly, and I serve as Chairman of the Audit Oversight Committee. I also serve as an ex-officio member of the County's Public Financing Advisory Committee, which meets biweekly.

Treasurer's Report

In order to assist you in reading this report, please note that the current balances reflect the investments recorded in the portfolios for each particular fund as of June 30, 2006. Each money market fund has an average maturity of less than 90 days, with a net asset value (NAV) falling within the range of \$0.9950 and \$1.0050. The extended fund will have an average maturity of up to 549 days and a fluctuating NAV. All investments are marked to the market at the end of the reporting period due to the narrow valuation range prescribed by the Pools' Investment Policy Statement.

The reports reflect the par value (face value), the book value (cost to the County of the investment) and market value (the price of each security at the close of the market on the last trading day of the month). The difference between the market value and net book value is the unrealized gain or (loss). The Detail Transaction Report Section is provided in compliance with California Government Code Section 53607, which requires that the Treasurer file such a report with the Board of Supervisors, from whom his investment authority has been delegated.

Last Term

I have served in this position since my appointment on March 17, 1995. This job has been an amazing career opportunity. I have had a ball! And I have been blessed with an outstanding staff that is constantly looking for ways to improve on how we perform our tasks. This transmittal letter shows just a glimpse of the professionalism and enthusiasm displayed by my staff. I really do not want to leave this job.

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Last month the residents of the Second Supervisorial District overwhelmingly voted me in to serve as their next Supervisor. I assume this challenging new role in January of 2007. With nearly twelve years of county experience I look forward to serving in this new role.

I have been succeeded by Chriss Street, who also won overwhelmingly in his countywide campaign for the elected position of Treasurer-Tax Collector. I look forward to the leadership, freshness and experience he will bring to his new job. As a Supervisor, I also look forward to assisting in his success.

Conclusion

I am most thankful for the opportunity to serve our community in this capacity these past eleven years. I am very grateful to my staff for the extraordinary efforts they have provided in making this department such a professional one. Your encouragement and continued assistance have helped to make it so.

Very truly yours,

A handwritten signature in black ink that reads "John Moorlach". The signature is written in a cursive style. To the right of the signature is a vertical red line.

John M. W. Moorlach, C.P.A., CFP®
Orange County Treasurer-Tax Collector