Chesapeake VIRGINIA

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The Honorable Mayor Alan P. Krasnoff and Members of Council
City of Chesapeake, Virginia

Dear Mayor Krasnoff and Members of Council:

We propose the Fiscal Year 2011-12 Operating Budget at a time when most economic indicators are trending positively after three years of declines. The major exception to this trend is the real estate market upon which the City's General Fund depends for nearly one-half of all resources. The real estate market continues to be impacted by the record number of foreclosures. Our real estate revenues for FY 2011-12 are based on January 2011 property assessments; market conditions at that time were down 3.13% from the previous year. This difficult economic picture requires focus on core services. **This budget includes no expansions of City services.**

While real property values have continued to decline, the City's financial position has improved compared to original budget estimates for FY 2010-11. The FY 2010-11 budget projected General Fund revenues at $484.8 million while current revenue estimates indicate we are likely to collect between $492 million and $494 million during the year. The budget for some revenues, including business and professional licenses (BPOL) has dropped reflecting the reduced economic activity of the previous year. However, overall General Fund revenues are expected to improve due to:

- Stronger than expected lodging taxes
- Stronger than expected building permits and construction activity
- Strong personal property tax collections
- Restaurant tax collections showing strong growth
- Sales tax revenue growing slightly

One of the guiding principles in the development of the FY 2011-12 Operating Budget was the Council's stated position that locally generated revenues (taxes) should not be used to supplant budget reductions made by the Commonwealth. In keeping with that principle, the budgets of individual units or departments have risen or shrunk based on funding decisions made by the Governor and the General Assembly.

General Fund – Total General Fund revenues are expected to grow $3.7 million (0.8%) in FY 2011-12. We expect to experience a $2.5 million (1.6%) decline in real estate taxes collections that is offset by growth in most other revenue categories. Personal property tax growth is particularly strong, growing $6.8 million (14.4%) and more than offsetting the decline in real estate tax collections. Total General Fund property tax collections grow slightly from $277.4 million in FY 2010-11 to $281.7 million in FY 2011-12.

Propelled by growth in sales and utility taxes and restaurant taxes, Other Local Taxes increase 1.5% rising from $110.7 million to $112.4 million. State categorical aid increases by $825,970 (2.2%) largely because of increased transportation funding that is partially offset by reductions in state funding of local police departments. Other General Fund revenues are expected to decline by $3.1 million (5.3%) – largely due to the sunset of the solid waste disposal fee (revenue decline of $2.4 million) and a reduction in interest earnings.

The FY 2011- 12 budget is based on no change in real estate tax rates – $1.05 per hundred dollars of valuation (includes Mosquito Commission tax). While we recommend no change in the real estate tax rate, the owner of the average $250,000 home can expect an $80 reduction in property taxes due to overall declining assessments. Since property assessments are based on market conditions within each neighborhood, individual homeowner costs will vary.

School Operating Fund - School revenues are projected to decline by $3.6 million based on the funding levels recommended by Governor McDonnell. Based on the budget approved by the General Assembly, we are confident that the school budget reduction will be reversed. The budget approved by the General Assembly is expected to increase school funding by $4.1 million above the Governor's proposal. The school budget reflects the superintendent's proposal presented in January (before the Assembly passed the state budget).

Tax Increment Finance Districts – Because TIF funding is derived from the incremental increase in assessments above a baseline amount, any decline in assessments impacts the TIF more than it does the General Fund. Tax revenues of the Greenbrier TIF are expected to fall $1.1 million (20.7%); the South Norfolk TIF will see a decline of $821,000 (18%). While these revenue declines are significant, they do not impact the ability of either TIF to meet existing debt obligations.

Other Funds – Revenue in the Debt Service Fund is expected to decline by $1.0 million based on less money available for investment and lower interest rates. Increases of $500,000 expected in both the Public Utility and the Stormwater Funds are based on current collection rates and trends. We have recommended an increase in toll rates for the Chesapeake Expressway in order to increase funding for improvements to the roadway. The $6.6 million increase in Expressway revenue reflects that recommendation; differences between the tolls authorized by Council and those previously recommended may require an adjustment in the revenue projection.

FY 2011-12 Spending Plan

The Proposed FY 2011-12 Operating Budget of $829.4 million is approximately $9.4 million above the budget for the current year and includes all City and school functions except the school special revenue funds (textbooks, grants, cell tower rentals, and food services). These funds (which totaled $82.1 million in FY 2010-11) are excluded from all data for FY 2009-10 and FY 2010-11 in order to provide better comparability between the three years appearing in this report. Additionally, we have restated the FY 2010-11 budget to combine the Solid Waste Fund and the General Fund. The two funds are combined due to the elimination of the solid waste fee beginning January 2011.

In October 2010, the budget forecast anticipated a $6.2 million shortfall between expected revenue and expenditures. This proposed budget bridges that gap with no increase in tax rates while the real estate assessments declined 3.13%. Listed below is a summary of the significant changes from the FY 2010-11 budget:

• A City employee pay raise of 1.5% effective July 1, 2010 and 1.5% July 1, 2011	$5,051,000
• Central Fleet increases for fuel costs and vehicle replacement backlog	1,212,000
• Risk management fund increase to address underfunding	566,000
• Increased employee and retiree health care costs	478,000
• Increase contribution to City OPEB Trust Fund	1,000,000
• Chesapeake Expressway – repaving and related costs	815,000
• Funding for newly mandated tax relief for disabled veterans	600,000
• Assumption of state mandated Line of Duty supplements	275,000
• Increased funding of road maintenance (funded by VDOT)	1,105,000
• Reduction in solid waste disposal costs	(2,996,000)
• Reduction in School Operating Fund (based on early State data)	(513,000)
• Reduction in debt service costs	(2,165,000)

Generally, department budgets are recommended at the same level as in FY 2010- 11 unless funding increases are provided through other agencies. For example, we have recommended an increase in the budget for the Interagency Consortium because we were able to identify a strong likelihood of additional state funds. In other cases, department budgets were increased due to rising costs, replacement facilities, or reinstatement of previous reductions that were not sustainable.

It is important to note that while the School Operating Fund declines slightly in FY 2011-12, the decline is based on projected reductions in State funds; City funding of School operations increases $3.1 million including $2.5 million one-time funds from year end surplus of FY 2009-10 and $607,000 available under the revenue sharing formula that allocates half the revenue growth in general tax sources to Schools. In contrast, the Governor's budget proposal would reduce school funding by $3.6 million and increase retirement costs by $3.3 million.

The school funding recommendation included here is based on the School Superintendent's recommendation in late January. That budget recommendation did not include funding for increased teacher pay via bonuses. The Superintendent and School Board are considering a budget revision that will be subsequently forwarded to City Council.

Since the Superintendent released his budget proposal, the General Assembly has completed its work on the state budget and has recommended an increase in school funding. Under the budget approved by the Assembly, Schools are expected to receive $4.1 million more than noted in this budget document. Additionally, teacher retirement costs will drop $1.4 million since the Assembly also reduced the rate that school divisions will pay in FY 2011-12. If approved by the Governor, the budget approved by the General Assembly will increase funds available for School operations by approximately $5.5 million. However, the Assembly's action regarding the teacher retirement rate further exacerbates the underfunding of the teacher retirement plan which will require action in the future. This, coupled with the expected end of federal stimulus funds in 2012 will present challenges for Schools in FY 2012-13 similar to those which the City addressed in FY 2009-10 and FY 2010-11.

Strategy for Addressing Budget Imbalance

Over the last two years, the City has reduced the General Fund budget by 9.3% from $523.2 million in FY 2008-09 to $474.4 million in FY 2010-11. In so doing, nearly 400 full and part-time positions were shed and the City is a much leaner organization than before the downturn in the economy. Even as the City reduced its spending and workforce, costs for employee benefits continue to rise (primarily employee and retiree health care and worker compensation). Further reductions in spending would require a curtailment of existing service levels.

While previous budgets have been pared as local tax revenues have declined, the City has maintained reserves until the extent of the downturn was more apparent. As part of the process leading to development of this budget, fund balance policies have been developed to provide guidance for use of such reserves. Additionally, the City realized positive budget results in FY 2009-10 in the form of $12.5 million in budget savings and the collection of $6.6 million more in revenue than was anticipated due to our conservative budget philosophy. Budget savings were realized in FY 2009-10 because of a hiring freeze and the concerted efforts of departments to reduce spending. The Proposed FY 2011-12 Operating Budget utilizes a portion of the FY 2009-10 surplus and draws down on the Debt Service Fund balance to pay a portion of interest and debt payments. Excess reserves in the Debt Service Fund are adequate to pay between $4 million and $6 million per year during each of the next four years. We believe this a very prudent strategy that will protect core City services as the economy gains strength.

Significant undesignated fund balances are proposed for use as follows:

- School operations from FY 2009-10 surplus revenue (one-time payment) $2,495,945

- City operations from FY 2009-10 budget savings (employee raise) 5,050,700
- Social service agencies funding to address recession-driven service demand 274,500
- Mosquito Control Commission – service level imbalance 930,400
- Debt service fund – prepayments from school and City lockboxes 1,888,100
- Debt service fund – current city debt payments 4,428,700
- Central Fleet Internal Service Fund – address deferred vehicle replacements 1,906,100

Future Challenges

While we believe our strategies address the immediate requirements of the FY 2011-12 operating budget, we also recognize the City faces a number of serious challenges beyond FY 2011-12. Current trends indicate that tax revenues are recovering from the steep declines that occurred in FY 2009-10 and FY 2010-11; however, the recovery appears slow and we believe that FY 2008-09 level revenue levels will not be attained for several more years. In light of slow revenue growth, we face several pressing challenges:

Mosquito Control Commission: The service level of the Mosquito Control Commission exceeds current revenue, a situation that has existed since the Commission's real estate tax rate was cut by 50% starting July 2008. Since the Commission relies heavily on the real estate tax, the subsequent decline in the real estate market and property assessments has significantly and negatively affected resources. Because the Commission had a healthy fund balance at the time the tax rate was reduced, no significant change in service levels was made. The Commission has reduced both its expenditures and its staff; however, spending levels still outpace current revenue. In FY 2011-12, we expect the Commission's undesignated fund balance to be reduced by 50%. The current trend is not sustainable beyond FY 2012-13. We recommend a review of the service model of the Mosquito Control Commission in order to bridge the current spending/resource gap. We understand changes in the service model may require Council consideration and endorsement.

Chesapeake Public Schools: During the recession of the last several years, both city and state revenue for schools was significantly reduced. The impact of budget cuts was not as severe because the school district received stop gap funding through the American Recovery and Reinvestment Act of 2009 (ARRA or Stimulus Grant). While ARRA funding ends September 30, 2011, Congress granted a one year extension on the program in the form of the Federal Education Jobs Act. Under the Jobs Act, Chesapeake Schools is expected to receive $9.35 million in order to maintain jobs of school personnel. The Jobs Act expires September 2012 and we do not expect local or state revenue growth to be sufficient to replace the loss of these funds.

In addition to the scheduled end of federal stimulus and jobs funds, the school division also faces a large unfunded liability for other post-employment benefits (OPEB). The school operating budget does not include a provision for its annual required contribution (approximately $50 million per year). In the past, the school district has made transfers to its OPEB Trust Fund based on savings identified at year end, but it has not included a commitment to funding the annual required contribution within its operating budget.

City employees pay and benefits: The City faces a challenge in meeting both the approved level of employee wages and benefits and the 2008 pay study indicating that City employees are paid significantly below market levels. In January 2011, Council recognized that (1) City employees have gone several years without pay raises and (2) the work level of individual employees has expanded as nearly 400 positions were eliminated. In recognition of this, the Council approved an across-the-board pay raise of 3% in two phases; one 1.5% retroactive to July 2010 and the other 1.5% increase starting July 2011. The pay raise is funded from savings realized in FY 2009-10 as most City positions were frozen and departments actively reduced spending. In order to maintain approved salary levels, $5.0 million will need to be identified annually. In addition, employee health costs have grown between 6% and 12% each year. The FY 2011-12 budget includes $25.76 million for employee and retiree health care; if current costs continue to rise by 8% each year, an additional $2.1 million annually is required to maintain current benefit levels.

In 2008 a compensation study was completed indicating that City pay was generally below market. With the downturn in the economy, funding to implement the study was not available. Full implementation of recommendation was estimated to cost approximately $17 million in on-going annual funding. Changes in our personnel complement will likely require a re-evaluation of the cost of implementing the pay study.

Infrastructure Renewal: Both City and School facilities are aging and require renewal or replacement. Many of the City's recreation centers and fire stations are in need of major system replacement and Schools have identified significant renewal needs for facilities. Over the next five years, a strategy will need to be developed to prioritize and fund the most critical of these needs to both protect the investment the City has in these facilities, to prevent deterioration of the facilities and to ensure continued ability to deliver services from these facilities.

In summary, we are presenting a spending plan that balances existing revenue and other resources with immediate demands without compromising our ability to sustain citizen services. No changes are proposed in general tax rates or fees, except for the modest fee increases proposed by the Parks and Recreation Advisory Board. This budget plan addresses the factors propelling municipal costs while holding other costs in check. It does not add new service capabilities, but neither does it require curtailment of current services. There are challenges for the future which we believe can be met.

Looking forward, I am committed to further review of existing services to better align resources with Council priorities. We are beginning the implementation of Priority-Based Budgeting as a tool that in future years can help focus resources on programs that effectively address City priorities. We will continue working with you to refine priorities, their definitions, and our assessment of programs designed to address those priorities.

In the coming weeks we will also schedule work sessions for Council to thoroughly review the budget, discuss its priorities, and align the budget with those priorities. At the request of the Budget and Finance Liaisons, we will present budget scenarios that would address a one-cent reduction in the real estate tax rate.

The City staff remains committed to providing quality public services. While recommending a prudent spending plan that protects the City's financial position, we have aggressively sought to maintain existing services during a period of slow economic growth. This budget proposal builds on the significant efforts of the last several years to reduce the local cost of government services while continuing to provide citizen services, even in an unstable world market.

I am confident that the strategies recommended in this proposed budget meet citizen demands while also sustaining the City's strong financial position. Further, I am optimistic about the future of Chesapeake and I look forward to working with City Council in meeting citizen expectations while preserving the quality of life the City already offers.

Sincerely,

William E. Harrell
City Manager