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 2012-13 Operating Budget as the country continues to struggle with the lingering impacts of the great recession. While the consensus among economists is that we are in a recovery period, the City continues to have revenue streams significantly below the level of earlier years. Additionally, we are facing increasing costs of long-standing obligations made to employees and an extremely volatile energy sector. In short, the City Operating Budget is squeezed between declining resources and growing cost to maintain existing services. We recognize that as the economy improves, growth will be modest.

During the most recent five years, revenue for city and school operations declined $58 million from $947 million contained in the FY 2008-09 Budget to $889 million projected next year. As noted in the table below, practically every revenue category has declined except for enterprise earnings.

	FY 2008-09	FY 2011-12	Proposed FY 2012-13	Change Since FY 2008-09		Change Since FY 2012-13
General property taxes	318,065,432	293,841,460	291,009,396	(27,056,036)	-8.5%	(2,832,064)
Other local taxes	128,159,477	120,696,370	121,779,003	(6,380,474)	-5.0%	1,082,633
Public Utilities	50,851,980	57,978,150	57,485,150	6,633,170	13.0%	(493,000)
Stormwater Management	13,998,347	14,908,550	14,953,094	954,747	6.8%	44,544
Chesapeake Expressway	7,768,370	10,001,034	10,255,892	2,487,522	32.0%	254,858
Commonwealth of Virginia (city)	103,104,019	100,448,560	101,531,670	(1,572,349)	-1.5%	1,083,110
Federal revenue (city)	8,743,639	10,933,062	9,585,998	842,359	9.6%	(1,347,064)
All other sources	33,498,428	27,301,491	28,486,169	(5,012,259)	-15.0%	1,184,678
Public education (includes local, state, and federal resources)	282,750,765	269,064,180	253,850,523	(28,900,242)	-10.2%	(15,213,657)
	946,940,457	905,172,857	888,936,895	(58,003,562)	-6.1%	(16,235,962)

Revenue for FY 2012-13 is expected to fall $16.3 million below the FY 2011-12 Budget, including a $15.2 million (5.6%) reduction in school revenue and a $2.8 million (1%) decline in general property taxes. The drop in general property taxes is primarily related to the depressed housing market; new assessments for existing parcels declined 3.7%. The decline in real estate assessments is offset by new construction and by increased collections for personal property taxes. We expect small increases in other local taxes and state assistance that are largely offset by a decline in federal revenue. The drop in school revenue is related to the expiration of federal grants received under the American Recovery and Reinvestment Act. State assistance for schools is nearly flat; increased state funding for teacher retirement is completely offset by the change in the Composite Index (the Commonwealth's measure of each locality's relative ability to fund schools) and by a small decline in student enrollment.

Other local revenue is down partly due to declines in expected collections from Business and Professional Occupations Licenses (BPOL) because of two recent events. First, in an effort to expand the number of new businesses locating in Chesapeake, Council agreed to waive the BPOL tax for the first two years for all new licensees. While this effort to increase the number of businesses locating in Chesapeake may result in a positive budgetary impact, it will be several years before the City realizes new revenue from those businesses. The second issue depressing BPOL estimates concerns location of a trade or business. For many years, Chesapeake has benefited from federal contractors whose primary office was located within the City. Under a recent ruling from the Attorney General, many of these contractors will now pay their licenses to the city or county in which their customers are located if they also maintain an office on the customer's premises. We anticipate loosing BPOL taxes for federal contractors working on military installations in adjacent cities.

In accordance with Council's budget principles, the FY 2012-13 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 $200,000 home can expect a $77 reduction in real estate taxes due to overall declining assessments. Since property assessments are based on market conditions within each neighborhood, individual homeowner costs will vary.

While revenue is declining, the cost to continue existing services has risen. The cost to maintain employment and retiree benefits at current levels is climbing nearly $8 million next year. A summary of changing is as follows:

- Health care costs are expected to grow by 8% next year and the budget includes an $1.1 million reserve to address increased employee health care.
- Due to lower investment returns, employee retirement costs are slated to increase from 17.27% of compensation this year to 20.5% in FY 2012-13. The City budget was adjusted by nearly $4.5 million to accommodate rising retirement costs.
- Similarly, group life insurance for employees increased from 0.28% of compensation in FY 2011-12 to 1.19% in FY 2012-13, costing an additional $1.25 million.
- The budget for retiree health care (including future benefits for current employees) is increasing by $1.2 million. A portion of this supports continued commitment to funding the City's long term retiree health liability.

In addition to rising cost for employee benefits, energy costs are fluctuating widely and have been steadily rising since the worldwide recession started several years ago. The proposed budget includes an increase of $920,000 for energy, most of which is for vehicle fuel. Because of numerous building retrofits, energy consumption for building lighting, heating and cooling have remained stable. The budget for vehicle fuels was increased 19% above the FY 2011-12 level.

The projected decline in revenue coupled with rising costs for employee benefits and energy costs required that either City services be reduced or revenue be increased. Given Council's budget principle of no increase in taxes and fees, a two pronged strategy was used in developing this Budget: (1) reduce department budgets and related services and (2) strategically deploy reserves in key areas with strategies to sustain lower services levels.

While we recommend reducing department budgets, we also recognize that expectation levels must also be lowered. Throughout the City, we recommend reductions in services. A complete description of service reductions follows this message.

In addition to reduced services, we also recommend use of non-recurring funds to avoid reductions to priority services. Normally, this is not a strategy that we would advise because it is often used to avoid difficult choices that must be made. However, we are recommending judicious use of accumulated reserves to maintain important City services while implementing numerous strategies to reduce future costs of operations until the economy returns to a growth cycle.

General Fund – Total General Fund revenues are expected to grow only $30,000 in FY 2012-13; basically no growth. We expect to experience a $6.1 million (2.6%) decline in real estate taxes collections that is offset by growth in other revenue categories. Modest growth is projected in personal property taxes, growing by $4.04 million or 7.8%. However, the growth in personal property tax collections is not sufficient to offset losses in real estate taxes. On balance General Fund property tax collections fall $1.86 million (0.66%) from the current year.

Propelled by growth in sales and utility taxes and restaurant taxes, Other Local Taxes increase 1.05% rising from $112.3 million to $113.4 million. State assistance increases by $1.9 million (2.39%) largely because of increased transportation funding, but also because of small increases in jail reimbursements and non-categorical aid. Finally, we expect charges for services to decline $730,000 primarily because of a reduction in the number of federal prisoners housed in the City jail.

School Operating Fund – School revenues are projected to decline by $15.2 million (6.0%) because of expiring ARRA Grants and declining student enrollment. State revenue projections are based on the funding levels recommended by Governor McDonnell and are subject to change by the General Assembly. The Superintendent of Chesapeake Public Schools has presented a balanced budget that addresses revenue reductions.

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 $562,000 (13.2%); the South Norfolk TIF will see a decline of $415,000 (11%). While these revenue declines are significant and will affect future investment plans, 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 increase by $906,000 due to Federal reimbursement of debt payments on Qualified School Construction and Build America Bonds.
- Community Services Board Fund revenues are up $2.19 million (17.6%) due largely to Medicaid reimbursements related to Highlands Place, the new Intermediate Care Facility for Intellectual Disabilities (ICFID).
- Virginia Public Assistance Fund revenues are expected to decline by $3.37 million (21.8%) as payments for child care services are transferred to the state.
- The Fee Supported Activities Fund revenues are expected to increase by $387,000 (40%) from increased activity in fire inspection and red light enforcement programs.
- Finally, we have moved certain non-fee supported activities and functions of Parks and Recreation to the General Fund in accordance with accounting standards governing special revenue funds. In order to provide comparable fund data over several years, prior year data has been restated to conform to the new accounting standards.

FY 2012-13 Spending Plan

The Proposed FY 2012-13 Operating Budget includes all City and School functions as well as required fund reserves and designations and totals $947.9 million. Excluding fund reserves and designations, the spending plan is $895.48 million, $11.31 million less than the current year. Below is a summary of the spending plan:

Operating Expenditures (millions)	FY 2011-12	FY 2012-13	Change From Prior Year	
Schools Operations	$ 441.67	$ 430.99	$ (10.67)	-2.4%
School Debt Services	36.19	36.36	0.17	0.5%
City Government Functions	334.45	332.94	(1.52)	-0.5%
City Debt Services	18.68	20.55	1.87	10.0%
Public Utilities	57.00	57.39	0.38	0.7%
Stormwater Management	8.80	8.50	(0.30)	-3.4%
Chesapeake Expressway	10.00	8.76	(1.25)	-12.5%
Total Expenditures	**$ 906.80**	**$ 895.48**	**$ (11.31)**	-1.2%

Over the five years between FY 2008-09 and 2012-13, the City's Operating Budget will have declined $25.7 million. While the contraction in the housing market began earlier and City revenue growth had already begun to slow before FY 2008-09, the City budget did not start to shrink until FY 2009-10. Below is a five year history of total expenditures.

Expenditures – All Funds	
FY 2008-09	$921.2 million
FY 2009-10	$919.8 million
FY 2010-11	$899.4 million
FY 2011-12	$906.8 million

FY 2012-13 (proposed) .... $895.5 million
Decline during period .... *$25.7 million (2.8%)*

These amounts differ from the annual appropriation in that they exclude cash transfers for capital projects and reservations and designations to the Fund Balance.

General Fund – The General Fund is used to account for most general government activities and most tax revenues. General fund revenues are projected to have declined from $527.3 million in FY 2008-09 to $488.35 million in FY 2012-13. Most of the $38.9 million decline is due to a $24.2 million (8%) drop in property taxes directly related to the decline in the housing market. During this five year period we have also experienced significant reductions in:

- Other local taxes especially sales and BPOL taxes (down $6.2 million),
- Fines and forfeitures (down $1.0 million),
- Interest earnings (down $3.7 million or 93%),
- Charges for services (down $2.2 million), and
- Assistance from the Commonwealth (down $1.0 million).

A summary of changes to the budget during the last five years appears below.

General Fund (millions)	FY 2008-09	FY 2012-13	Change From Prior Year	
Revenue				
General property taxes	$ 304.12	$ 279.88	$ (24.24)	-8.0%
Other local taxes	119.60	113.44	(6.15)	-5.1%
Commonwealth of Virginia	82.46	81.44	(1.03)	-1.2%
Federal revenue	0.07	0.09	0.03	42.2%
All other sources	21.05	13.50	(7.55)	-35.9%
Revenue	$ 527.30	$ 488.35	$ (38.94)	-7.4%
Expenditures				
School Operations - City Funding	$ 185.01	$ 171.44	$ (13.57)	-7.3%
General Government	263.98	258.25	(5.73)	-2.2%
Transfers to Other Funds	18.99	15.90	(3.09)	-16.2%
Debt service	47.21	47.49	0.28	0.6%
Total Expenditures	$ 515.19	$ 493.08	$ (22.11)	-4.3%
Operating Surplus (Deficit)	$ 12.11	$ (4.73)	$ (16.84)	-139.0%

This table include only operating revenue and expenditures of the General Fund and do not include cash funding of the Capital Projects Budget.

Note that the drop in City funding of schools is tied to reductions in general property and other local tax revenue based on the City revenue sharing formula. Within the general fund, only the debt funding increased during the five-year period.

As noted earlier, the revenue decreases were further exacerbated by cost increases. Listed below are significant changes from the FY 2011-12 Operating Budget:

Increases in cost of City operations:

• Employee health care costs	$ 973,100
• Other post-employment benefits (OPEB)	1,214,200
• Retirement and group life insurance costs	5,172,000
• Energy costs	920,000
• Road maintenance budget (state funded)	1,043,000
• Debt service costs	1,740,000

Decreases in cost of City operations:

• Departmental budget reductions (includes elimination of 55.1 FTE)	$5,196,000
• Reduction in regional solid waste tipping fees (SPSA)	1,500,000

In order to maintain essential services and present a balanced spending plan in light of rising costs of operations, we recommend the use of undesignated fund balances as follows:

• City operations from FY 2010-11 budget savings	$6,313,766
• Solid waste collection and disposal costs from designated fund balance	600,000
• Social service agencies funding to address recession-driven service demand	550,200
• Mosquito Control Commission – service level imbalance	621,900
• Debt service fund – current school and city debt payments	5,250,000

To balance resources and expenditures for core services, this budget includes reductions to every department in the City. Because the funding of most non-core services was already eliminated in past years, it was necessary to scrutinize every department to identify specific services that can be reduced while still addressing core values. In addition to the above City operational strategies, Schools have incorporated the one time use of $4.4 million in FY 2010-11 surplus revenue.

Future Challenges

While we believe our strategies address the immediate requirements of the FY 2012-13 operating budget, we also recognize the City faces a number of serious challenges beyond FY 2012-13. 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 future challenges:

Background investigations for all employees: The City Auditor recommended that background investigations be conducted for employee candidates before hiring. This recommendation would require an additional staff person in the Human Resources Department. Since the City already conducts investigations for high risk positions and since the risks are relatively small for general employees, we recommend the deferral of this initiative until resources are less scarce.

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 one cent 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 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. The Commission will advance service level reductions for City Council's consideration.

Chesapeake Public Schools: During the recession of the last several years, both city and state revenue for schools declined. 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 and the Education Jobs Act of 2010. For FY 2012-13, Chesapeake Schools will rely on $4.8 million of the Jobs Act to meet payroll. The last of these stop gap funds will expire 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 several other budgetary issues in future years:

- 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 division has made transfers to its OPEB Trust Fund from planned year end balances, but it has not included a specific commitment to funding the annual required contribution within its operating budget. It should be noted that the Superintendent and School Board have agreed to provide a plan for addressing OPEB this summer.
- Reliance on $9.5 million of accumulated resources in the Textbook and the Insurance Funds to meet current textbook adoptions and health insurance costs for school employees. The school division will need to identify funding to continue these costs in FY 2013-14.
- The question of sustainability with these one-time funding strategies must be addressed going forward.

City employees pay and benefits: While Council approved pay raises totaling 3% in January 2011, the City continues to face a challenge in maintaining market competitiveness for employees. In addition, employee health costs continue to grow between 6% and 12% each year with the City and employees sharing costs proportionately. The FY 2012-13 Budget includes $27.7 million for employee and retiree health care; if current costs continue to rise by 8% each year, an additional $2.2 million annually is required to maintain current benefit levels.

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, the City must develop strategies to prioritize and fund the most critical of these needs to protect the City's investments, to prevent deterioration, and to ensure continued ability to deliver services from these facilities. Finally, many City roads, bridges, and drainage infrastructure are in need of renewal and/or replacement.

In summary, we are presenting a spending plan that balances existing revenue and other resources with immediate demands without compromising our ability to sustain the most critical citizen services. No changes are proposed in general tax rates or mandatory fees. This budget plan addresses the factors propelling municipal costs while holding other costs in check. However, in order to balance operational costs with available resources, it is necessary to reduce some services to citizens.

Very recently the General Assembly approved a restructuring of the Virginia Retirement System. Under the restructuring it appears that employees will begin paying for a portion of their retirement costs. Currently, the City pays the entire cost for employees hired before July 2010. We believe the City must transition during the next five years so that all current employees contribute five percent of their earnings to the retirement system. The restructuring also requires that we increase employee pay by five percent to offset the increased cost to employees. During the transition period, we anticipate it will cost an additional $2.13 million to implement the restructuring. Since information of the VRS restructuring is unclear and because the Governor has not signed the legislation, we have not included this change in the proposed budget. We will continue to monitor the situation and recommend appropriate amendments to Council if the restructuring is approved by the Governor.

In the coming weeks we will also schedule work sessions for Council to review this proposed budget in light of sustainability. 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. While I am moving on to other professional challenges, I am optimistic that a firm foundation for this budget has been established, and will be built upon under the leadership of Interim City Manager Amar Dwarkanath.

Sincerely,

William E. Harrell
City Manager