CITY OF NEWPORT NEWS

OFFICE OF THE CITY MANAGER

March 25, 2008

TO: Honorable City Council

FROM: City Manager

SUBJECT: Recommended FY 2009 Operating Budget

I am submitting for City Council's consideration, my Recommended Operating Budget for the fiscal year beginning July 1, 2008. Because of changing economic conditions in Virginia, and in Hampton Roads, our City government can expect only a 4% growth in General Fund Revenues for the next fiscal year, which is about half of the revenue growth that was experienced in the Operating Budgets for FY 2007 and FY 2008.

Of particular concern is that the trend we are seeing in the revenues will likely continue, at least through FY 2010. This expectation has greatly influenced the development of my Recommended Operating Budget for next fiscal year. Adjusting to this reality of very limited growth in local tax collections and cutbacks in State Aid dictates that significant cuts be made in spending and that these reductions are ones that can be sustained for two years, if necessary. Curtailing overall spending is an absolute necessity for FY 2009, but this is especially difficult because there are several areas in the Operating Budget where expenditures must increase. Two of the more obvious are for fuel expenditures and in our funding for the City's Retirement Program.

The magnitude of the fiscal challenge facing the City in FY 2009 becomes quite evident when considering how the $16.6 million in General Fund revenue growth must be allocated to address unavoidable spending requirements. In the FY 2009 Operating Budget, most of our new revenue will be used to add monies for the following purposes:

Pension Trust Fund Contribution	$ 1,482,000
Post-Retirement Welfare Trust Fund Contribution	2,070,000
Contribution to Schools	3,882,000
Fuel Price Increase	569,000
Cash Capital	2,844,000
Debt Service	3,018,000
Total	**$13,865,000**

The $13.9 million in increased funding required in these six areas account for almost 83% of the General Fund revenue growth and leaves just $2.7 million for all other purposes, including salary increases.

The recommended General Fund Operating Budget I am presenting to City Council totals **$432,235,000**, which is a 4.0% increase over the Adopted FY 2008 Operating Budget. No adjustments in locally-controlled tax rates such as real estate, personal property, machinery and tools, meals or lodging are being proposed. Real estate property assessments, which are based on market values established for the 12-month period of July 1, 2006 to June 30, 2007, will be expected to increase on average by 5.5% and, therefore, most property owners will be paying more taxes for FY 2009. All other General Fund revenue has been estimated at levels that are at the limit of what can be reasonably expected, given the slowing in economic growth for the next 12 to 18 months.

Another negative influence on our revenue picture has been the fallout from budget reductions already made by State government in FY 2008 and planned in the next biennium. The October 2007 cuts announced by the Governor will cost the City approximately $700,000 in annual revenue through FY 2010 and the General Assembly's budget, which was adopted on March 13, 2008, assumes a further 4.2% cut in State Aid to localities, exclusive of public education. While the precise impact of these latest cuts is not known at this point, it appears that it will fall within the range of $1 million to $2 million.

Overall General Fund revenue growth at current tax rates is forecasted to increase by only 4%, even before factoring in the latest round of State Aid cuts. Taking into consideration those additional spending requirements for which there is little discretion, it is clear that recommending a lowering of the real estate tax rate for the fourth consecutive year is not prudent. As I will explain in greater detail below, the current service funding levels of City departments have already been cut by $5.7 million, just to keep the overall General Fund spending within the anticipated revenue growth at current tax rates.

Because the cost of providing services such as solid waste collection and disposal, drinking water, the collection of wastewater and the management of stormwater continue to increase, the user fees that fund these activities are being adjusted**.** These services are heavily influenced by state and federal regulations, and the City has no choice, but to pass resulting cost increases on to our citizens in the form of higher user fees. The specific adjustments being proposed are discussed later in this memorandum.

EMPLOYEE COMPENSATION AND BENEFITS

Like all citizens, our City employees are experiencing rising gasoline, utility, housing and food prices. I, therefore, have made the funding for a modest pay increase averaging 3%, a high priority in the development of next year's Operating Budget.

From preliminary information gathered from other local governments in Hampton Roads, it appears most city and county governments will be proposing compensation increases that fall within the range of 2% to 4%. My recommended compensation package, while less than the 4% provided in the FY 2007 and FY 2008 Budgets, is the most that I believe the City can fund in the next fiscal year, given the fiscal constraints we are experiencing. Our studies on comparable pay in the private and public sectors indicate that despite only a 3% average adjustment, our overall salaries will remain competitive. From a fairness perspective, however, I am concerned that like the last two operating budgets, in FY 2009, Newport News School employees are slated to receive higher overall salary adjustments than municipal employees.

Another very high funding priority for FY 2009, of course, is our commitment to address the long-term under-funding of the City's Pension and Post-Retirement Health and Welfare Trust Funds. Funding for an increase in the composite contribution rate for the Pension Fund from 4.8% to 5.8% is included in my Recommended Operating Budget. This fulfills the commitment made in the spring of 2006, to bring our contribution rate up from a 1.4% composite rate in FY 2006, to a rate of 5.8% in FY 2009 -- a level which equates to the normal contribution rate as determined by the City's Actuary. Honoring this three-year interim funding commitment has required a $1.5 million increase in our General Fund contribution to the Pension Trust Fund for FY 2009.

In addition to this three-year planned increase in contributions for the Pension Trust Fund, the City must also address the under-funding of our Post-Retirement Health and Welfare Trust Fund. The rapid increase in benefit payments in recent years and declining assets in this Trust Fund demand immediate corrective action. This is illustrated by the fact that in the current fiscal year, the City planned to make $9.1 million in contributions to this Trust Fund, but expenditures are estimated to reach $14.1 million. Our benefit costs in this Trust Fund have more than doubled in the past five years. Unless significant steps are taken to close this gap in FY 2009, the City will be faced with the likelihood that the assets in this Trust Fund will be depleted before the end of FY 2010. To address this untenable situation, I am recommending a $2.5 million increase or 28%, in our contributions to this Trust Fund for the next fiscal year, along with proposing a modification in the life insurance benefits which, along with other cost-containment measures, will reduce expected expenditures by $1 million. These actions, while painful for beneficiaries and an added burden on next year's Operating Budget, are in my view, absolutely necessary. Even with these cost reduction measures and a large increase in contributions, the expenses for this Trust Fund are still expected to exceed our contributions by $3.4 million in FY 2009. What these actions do accomplish is significant; they delay the depletion of remaining Trust Fund assets by at least one more year, thereby allowing the City time for a careful and deliberate consideration of the type and level of post-retirement benefits that the City is able to fund in the long term. As I have advised, my goal is to have to City Council by the end of June, a comprehensive recommendation on an approach to assure the long-term financial stability for both the Pension and the Post-Retirement Health and Welfare Trust Funds.

Another major component of our benefit plan for City employees is healthcare. As you know, the City is self-insured for employee healthcare costs and our health plan is administered through a contract with Anthem. Based on a preliminary analysis of forecasted claims expenses, it appears that the premium rates for FY 2009, can be set so that they will be no more than 5% above the current-year rates. The City has historically paid 75% of the premium for whatever coverage is selected by an employee and the General Fund cost to fund the City's share of these premiums will be $14.5 million in next year's budget. Should our final premium negotiations with Anthem, which are scheduled for this spring, exceed our target of a 5% premium increase, I propose drawing down a portion of the $6 million in accumulated reserves in our health benefit account to cover the added expense, rather than increasing the premium any higher. I do so because I believe that holding the premium adjustment to no more than the 5% ($12 per month for family) is important, in light of the modest 3% average salary increase funded in my recommended budget.

Meanwhile, the Finance Department will continue to work closely with our health benefits consultant to look at cost-containment measures and premium-sharing alternatives that will help keep the cost of this employee benefit affordable in the long term. One option that might help reduce costs is offering a wider array of coverage options which better meet individual employee health needs. Although the issues surrounding healthcare costs are complex, the City's goal should be to offer a plan for its employees that is comprehensive, affordable and comparable to what other local government employers in our region provide.

SCHOOL FUNDING

Increasing our local funding for public education will consume a significant portion of the City's new General Fund revenue. In FY 2009, I am recommending a School contribution of $116 million, which represents about 27% of the total General Fund Operating Budget. As referenced earlier, providing for this $3.9 million, or 3.5% increase over FY 2008, is one of the major factors in shaping my Operating Budget recommendation. This funding is consistent with the target which was provided to the School Division in January, and reflects the goal of equitably distributing the new revenues available for FY 2009 between municipal government and the School Division. The estimated State Aid to be received by the School Division is $196.0 million. Although the Newport News School Board has not yet adopted its FY 2009 Operating Budget, it appears that the amount of local funding I am recommending will be satisfactory to the School Board.

After consulting with the School Superintendent, I am proposing a reduction in the Cash Capital funding in FY 2009 for school bus replacement from $2,080,000 to $1,586,000. This $500,000 in savings in FY 2009 should not have a long-term impact on the Schools' Bus Replacement Program. Due to a major restructuring of their student transportation system, I understand that they have been able to reduce the number of buses needed and this has allowed the School Division to not only defer bus replacement in FY 2008, but also to absorb this additional reduction of $500,000 for FY 2009.

Cash Capital and Debt Service

A key element in our strategy for bringing down the City's debt burden (the ratio of outstanding general obligation debt to the total taxable value of real and personal property) to 3.0% or less by FY 2010, is increasing the portion of our capital spending which is financed by cash from the Operating Budget. In FY 2008, the Capital Improvement Program (CIP) called for $4,842,000 to be spent on projects undertaken with Cash Capital funding. As you may recall, prior to FY 2008, Cash Capital funding for CIP projects had not been typically included in the City's Operating Budget. In implementing this new Cash Capital financing policy, the City was able in FY 2008, to support only $1.8 million of the $4.8 million in CIP Cash Capital expenditures from new revenues; the remaining $3.0 million had to be funded from the year-end surplus generated in FY 2006.

The FY 2009-2013 CIP, which was adopted by City Council this past January, anticipated about $6.2 million in funding for Cash Capital spending through the FY 2009 Operating Budget. Given the spending constraints we are dealing with for the next fiscal year, I am proposing two actions to reduce the FY 2009 Cash Capital funding requirement to a more manageable amount. The first, as referenced, is cutting the Cash

Capital funding for school bus replacement by $500,000. The second action involves funding in the current fiscal year, $1.0 million for the acquisition of fire apparatus out of reserves, instead of from Cash Capital in FY 2009. Combined, these two actions reduce the Cash Capital funding requirement for the FY 2009 Operating Budget to $4.7 million, which is still $2.8 million above the amount funded in the FY 2008 Budget. One note of caution is that the present CIP contemplates a Cash Capital appropriation for FY 2010 of $6.4 million. This means that unless funding requirements for cash capital projects can be cut back for a second year, the City will be facing the need to increase this funding level by another $1.7 million in the FY 2010 Operating Budget.

While our General Fund debt service expenditures will actually drop from $39.7 million in FY 2008 to $38.7 million in FY 2009, there are no carryover reserves programmed for use in the upcoming fiscal year. You may recall that in the FY 2008 Operating Budget, $4 million of year-end surplus from FY 2006 was committed to offset debt service expenses; this meant that only $35.7 million of debt service cost was to be covered by revenues received during FY 2008. However, the entire $38.7 million due for debt service (principal and interest payments) must be funded in FY 2009 from current year revenues because no reserves are available for this purpose. As referenced earlier, this $3.0 million net increase in debt service expenditures is one of those six areas where the City had no choice, other than to address this additional cost in the FY 2009 Operating Budget.

Organizational Infrastructure Investments

The FY 2007 Operating Budget, for the first time in several years, included funding for the City's annual Vehicle Replacement Program. By including a $1.7 million General Fund appropriation in that Budget, the City recognized that with a fleet valued at more than $35.0 million, it is necessary to annually budget monies for a planned Vehicle Replacement Program. This same level of vehicle replacement funding was maintained in the FY 2008 Operating Budget. As the value of the fleet continues to increase because of the cost of new vehicles, the City should be increasing the amount it is budgeting for this purpose; in fact, a sustained level of funding at $2.1 million per year should be our goal. Because of the very severe fiscal constraints facing City government in FY 2009, I have held the vehicle replacement allocation to $1.7 million again this year. The Department of Vehicle and Equipment Services has done a commendable job of eliminating underutilized vehicles from the fleet (33 since FY 2007), but despite this, the replacement value of the remaining vehicles has grown to $36.2 million. Holding the line on the amount of funding for vehicle replacements for two more fiscal years is only manageable if $570,000 is made available from reserves before the end of FY 2008 for the replacement of four refuse collection vehicles. By advancing the purchase of these trucks, the City is will save $57,393 by avoiding price increases forthcoming in 2010 for new mandated emission controls.

Another area in which the City had not historically been budgeting for its replacement needs is information technology. As you recall, this was addressed in FY 2007, by establishing an IT Investment Fund and allocating $715,000 in the FY 2007 Operating Budget for both hardware and software replacement. This amount was increased to $1.3 million in the current year Operating Budget. However, because of budget constraints faced in FY 2009, I have proposed reducing this amount by 23% to $1 million.

To offset the impact of this reduction, I will be proposing that City Council appropriate $1.2 million from reserves for several priority software replacement projects and for the additional equipment necessary to complete the Records Management System Project, which serves the Police, Sheriff and Adult Corrections Departments. Among the significant software projects to be funded by this $1.2 million appropriation is the replacement of the Harmony Cobol/XE Mainframe System which is used by the Human Services Department.

I will be also recommending an appropriation from General Fund FY 2007 reserves of $1.3 million for the Computer Aided Mass Appraisal System or CAMA. This amount, when added to the $994,430 already available in the IT Investment Fund, will give the City sufficient funding to proceed with the CAMA implementation in FY 2009.

Once the CAMA and Harmony Cobol/XE Systems are replaced, only one other major mainframe software system is left to be addressed. This system is commonly referred to as the taxation system that provides for the billing and collection of local taxes such as personal property, BPOL, and machinery and tools among others. The City is actively seeking other Virginia localities to participate in the acquisition and implementation of a web-based taxation system. This project will cost up to $6 million, if Newport News is unable to find any partners willing to share in the expense. Getting the taxation project funded and started in FY 2010 must become a high priority.

Departmental Spending

We began preparation of the FY 2009 Operating Budget in September, in anticipation of the decline in revenue growth and recognizing the need for a thorough analysis of our expenditure priorities. At that time, I instructed the department directors to develop *Current Service Level Budgets* that would only include the minimum costs necessary to sustain the same levels of service for FY 2009, that are being provided to our citizens in the current fiscal year. When those amounts were combined with the fixed costs discussed earlier (debt service, cash funding for the CIP, and the required contributions to Schools and the retirement program), they totaled $439 million. This amount included the addition of $700,000 for the City's share of the cost of opening the Jail Annex. After making a $1.5 million reduction in the Cash Capital budget, we were still faced with the difficult task of achieving a $5.7 million reduction in departmental budgets.

To achieve this, my recommended General Fund Operating Budget proposes elimination of 32 full-time positions resulting in savings of $1.6 million. Funding for ten other vacant positions was suspended, at least through FY 2009, saving an additional $540,000. The salary and benefits appropriations for most of our larger departments were further reduced by $2.6 million to reflect normal attrition savings; this amount is $1.6 million more than in the FY 2008 Budget.

While these personnel reductions occurred across the organization, two departments had programs that I am recommending for elimination completely. In the Department of Libraries and Information Services, it is proposed that the Literacy Program and the Subregional Library for the Blind and Physically Handicapped be discontinued and the West Avenue Branch be closed to the public. The services provided by the Subregional Library are delivered primarily by mail, so responsibility for these services can be transferred to the Regional Library in Richmond, with little impact on those currently receiving these services. Together these programs account for five of the eliminated positions.

In the Department of Juvenile Services, I am proposing that the Less Secure Detention facility be closed and that the 13 juveniles currently served on a daily basis by this facility, be served instead through a combination of non-residential Juvenile Services' programs or by other avenues available through our Department of Human Services. Fourteen of the positions proposed to be eliminated are associated with this program. Because this facility is owned by the City of Hampton and operated by our Juvenile Services Department under a contract with Hampton, making this service change will require the cooperation of the City of Hampton.

Additionally, I am recommending a 26% reduction in funding for the Residential Street Reconstruction Program; this equates to a $1.7 million reduction. Because of our past efforts to ensure that residential streets are properly maintained on a timely basis, this one-year postponement for selected streets should not result in significant deterioration of these streets. The challenge, however, will be to restore this funding back to the $6.6 million annual level necessary to keep our residential streets on a satisfactory reconstruction and paving cycle in the future.

Other spending reductions I am recommending include: $450,000 in part-time and overtime costs; a $200,000 savings in Regional Jail payments due to the opening of our Jail Annex; and $150,000 in General Fund support for tourism.

Community Support and Regional Organizational Support Funding

In the last several Budget documents, we have attempted to delineate between those agencies or organizations for which the City has discretion to fund and those regional organizations that the City is obligated to fund on a formula basis with other participating jurisdictions.

In the current fiscal year, $2,683,000 was appropriated in the Community Support Category for 45 different organizations and initiatives. My recommended budget provides funding for these organizations at the same levels authorized in FY 2008, with a few exceptions. I am recommending no funding for the Ferguson Center ($100,000 reduction) and no funding for the Eastern Virginia Medical School ($25,420 reduction). Additionally, I am proposing that support to the Virginia Air and Space Center be cut from $62,500 to $25,000 for FY 2009. Meanwhile, I am recommending 3% increases for three youth-serving agencies which I believe play important roles in our Keeping Our Kids Safe Violence Prevention Initiative. These agencies are the Boys and Girls Club, C. Waldo Scott Center and YWCA. These three agencies, in total, will receive $14,719 in additional funding, but the overall funding for this category is down by $148,231.

The funding recommended for regional organizations for which Newport News is a member or participant will total $5,018,877. Of this amount, $4,201,699 represents our cost of bus service provided by Hampton Roads Transit (HRT), for operations and capital. Although HRT requested $289,818 in additional funding from our City to cover the cost of their existing route service in Newport News, I am recommending for FY 2009 that the funding be kept at the same level as in FY 2008. The difference between their request and our budgeted contribution will be made up by tapping into reserves accumulated in recent years. With this approach, there should be no reductions in bus service for FY 2009, but this differential between the actual cost and our Operating Budget support will need to be resolved in FY 2010. The only new regional organizational expense included in FY 2009 is a $41,655 item to support funding for the new Peninsula Commission on Homelessness. The total funding for this category is up only $83,856 or 1.7% from the adopted FY 2008 Budget.

<u>Fees and Revenue Growth</u>

Because of the growth in residential property assessments in recent years, I have attempted to manage user fee increases and hold them at the level necessary to continue current service levels. This has become especially difficult in the Sewer User Fund because of the impact of the EPA/DEQ Consent Order.

Because of normal operating cost increases and pay raises, increasing the Stormwater Management Fee, Solid Waste Fee, Sewer User Fee and the Water Rates cannot be avoided in FY 2009. Water Rates will increase only by 4.1% to $3.04 for customers that exceed the six (6) hundred cubic feet usage of the Life Line Rate. For those that use a minimum amount of water, the Life Line Rate will remain the same at $2.78.

The Solid Waste Fee that provides for the City's recycling program and garbage collection and disposal services will increase for the first time in two years. The cost per week for a 90-gallon container will increase by 25 cents or 5.2%.

The Stormwater Management Fee is charged to all properties within the City, both residential and nonresidential. Stormwater runoff is measured in Equivalent Residential Units (ERU), which is based on the amount of impervious surface on a developed parcel of land. I am proposing that the ERU rate is increased by 25 cents, from $4.85 to $5.10 per month; this represents a 5.2% increase.

Funding from the Sewer User Fee is used to operate and maintain the City's sanitary sewer collection system and it supports the debt service associated with replacing our infrastructure. I am recommending that this fee increase by 10 cents or 6.5%. I further recommend imposing a Sewer User Fee Surcharge of 45 cents ($0.45) per hundred cubic feet to cover extraordinary expenditures necessary for engineering services, staffing requirements and other costs required for compliance with the State Department of Environmental Quality (DEQ) Special Consent Order. A surcharge at this level will cover the $14 million in costs that is anticipated over the next five years to do the studies required under this regional consent order. This surcharge will also enable the Sewer Fund to repay the $3.5 million advanced to it in December, from General Fund reserves, to fund a contract for engineering services. The combined cost of the normal maintenance fee increase and the special surcharge will be $89 per year for the average homeowner.

Conclusion

This budget has been one of the most difficult to prepare in recent years. Overall General Fund revenue growth has dropped back to about 4%, yet the urgent requirements to increase funding in critical areas such as retirement program contributions and Cash Capital CIP spending could not be ignored. My recommended Operating Budget holds the line on all locally controlled tax rates. Given the degree of spending curtailment already incorporated in my recommended Budget, it would not be prudent to reduce spending even further in order to lower the real estate rate again in FY 2009. Another reason to be cautious about lowering the tax rate is that our projections for the near term suggest revenue growth in FY 2010 of even less than 4%. By cutting or freezing many positions throughout the organization, I have been able to recommend a balanced General Fund Operating Budget without relying on the use of reserves in FY 2009. My recommended Operating Budget, however, has little margin for error in its execution. Revenue estimates have been pushed to the limit and most of the vacancy savings that normally provide a cushion on the expenditure side have been eliminated. For this reason, it will be imperative that revenue collections be monitored very closely during FY 2009 and additional spending controls be applied early, if it appears our revenue expectations will not be met.

I want to acknowledge the outstanding efforts of my Executive Team, Management Team and the Office of Budget and Evaluation in the development of this Budget. All of the departments worked diligently to ensure that requested budget appropriations were no more than absolutely necessary to continue to deliver services efficiently. Even in doing this, there still was not sufficient revenue available to fund our current service levels. To address this, I requested that my department directors look for areas where program cuts or service adjustments would do the least harm to the overall community and to the mission of our City government. The proposals that my Department Directors furnished for consideration were well conceived and responsible.

As you review my Recommended Operating Budget, there will be ample opportunity to debate spending priorities and policy choices. During your evaluation of the Budget, I am committed to furnishing City Council with the data, information and rationale which my staff and I used to decide what should be funded and what could not be funded. We are prepared to assist you in every way possible, as you work to find the desired balance between competing demands.

While this budget process has been more challenging than most, I strongly believe that my Recommended Operating Budget represents a solid financial plan for the next fiscal year. It is a plan that does not defer or postpone investments that will harm this City government's ability to provide not only core services, but those services and programs that contribute to the "quality of life" which our citizens have come to expect from a "City of Opportunity."

Randy

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RWH:LAV

G:Budgets:HCC Recommended FY 09 Op Budget Final.3.25.08