

REPORT
ON THE
FINANCIAL SETTLEMENT PROVISIONS
OF THE
CITY OF WAYNESBORO—COUNTY OF AUGUSTA
ANNEXATION ACTION



COMMISSION ON LOCAL GOVERNMENT
COMMONWEALTH OF VIRGINIA

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NATURE OF RECOMMENDATIONS

On August 24, 1982 the City of Waynesboro gave notice to the Commission on Local Government of its intention to petition the court for the annexation of approximately 9.1 square miles of territory in Augusta County containing an estimated 4,280 persons, 638 public school students in average daily membership (ADM), and \$110.5 million in property values subject to local taxation. Following its review of the proposed annexation, this Commission rendered a report to the parties on July 8, 1983 recommending that the City of Waynesboro be granted an annexation of approximately 6.23 square miles containing an estimated 3,500 persons, 600 public school students in ADM, and \$70 million in property values subject to local taxation.¹ Under the Commission's recommendations the City would be granted 4.75 square miles of territory which it sought to annex (52% of the total the City proposed) and an additional 1.48 square miles not requested by the City in its annexation notice.

In balancing the equities in an annexation case the special three-judge court is given broad authority. Based upon the size and nature of an annexation awarded to a city, the court is empowered to make equitable adjustments regarding the county's indebtedness, relative to county-owned public improvements affected by the annexation, and with respect to

¹Report of the Commission on Local Government:
City of Waynesboro -- County of Augusta Annexation Action,
July 1983.

the county's prospective loss of net tax revenue during the years immediately following an annexation. In anticipation of the court's addressing these issues, the City of Waynesboro and Augusta County submitted financial data relative to these issues to the Commission for review and recommendation. The data presented to the Commission, however, were based upon the area proposed for annexation by the City (9.1 square miles) and are not amenable to adaptation by the Commission to conform to the area which we have recommended for annexation. While the Commission does not have available the discrete data required for precise recommendations on each financial settlement concern, we do wish to address a number of major issues raised by the parties relative to the financial settlement provisions. Our endeavor in the following sections of this report is to offer comment and recommendations on the pragmatic and governmental aspects of the settlement provisions and to leave questions of law for judicial resolution.

ASSUMPTION OF DEBT BY CITY

The Code of Virginia empowers an annexation court to require a city to assume "a just proportion of any existing debt of the county" in recognition of the effect of an annexation on a county's ability to retire such indebtedness.² In the current City of Waynesboro -- Augusta County annexation case two points have arisen which the Commission wishes to address.

²Sec. 15.1-1042(b), Code of Virginia.

PERCENT OF DEBT TO BE ASSUMED

In its submissions to the Commission the County has asserted that the percentage of its long-term indebtedness to be assumed by the City should be based upon the percentage of total County tax revenues annexed by the municipality.³ The City, on the other hand, proposes to assume a percentage of the County's debt equal to the percentage of the County's property assessables which it annexes.⁴ While in this case, based upon data for the area the City seeks to annex, both methods of calculation produce virtually the same result (assumption by the City of approximately 9.1% of the County's outstanding long-term indebtedness), the different methodologies will yield substantially different results in other instances.

The Commission recommends that the percentage of a county's debt to be assumed by an annexing city be based upon the percentage of a county's total local tax revenues (as that term has been defined by the Virginia Supreme Court) which are annexed.⁵ While the Commission recognizes that

³County of Augusta, Waynesboro Annexation Proceedings, Financial Exhibits (hereinafter cited as Financial Exhibits), February 1983, Exh. III; and County of Augusta, Proposed Findings of Fact, Waynesboro Annexation Proceedings (hereinafter cited as County Proposed Findings), April 1983, pp. 94-95.

⁴City of Waynesboro, City of Waynesboro Annexation Proceedings, Annexation Notice, Vol. I, August 1982, p. 223. A later City submission estimated that the area proposed for annexation contained 9.22% of all County property assessables and proposed that the City assume that percentage of the County's outstanding indebtedness [City of Waynesboro, City of Waynesboro Annexation Proceeding, Annexation Notice, Vol. I - A (hereinafter cited as Notice - IA), February 1983, p. 63].

⁵See County of Rockingham v. City of Harrisonburg, 224, Va. 62, 89.

this recommendation departs from the past practice in Virginia of basing a city's debt assumption upon the percentage of a county's total assessed property values (or, in instances, solely upon the percentage of assessed real property values) annexed, the current significance of non-property tax revenue in many Virginia counties requires the Commission to recommend a change in that practice. In reality, it is a county's revenue from all tax sources which is used to retire its debt, not merely that obtained from property assessables. Further, we observe that the urbanizing areas of counties adjacent to cities and, thus, subject to annexation are likely to produce a disproportionate share of a county's sales, consumer utility, business and professional license, and other non-property tax receipts. Such non-property tax revenue loss should be included in the determination of the debt assumption question.

DEBT BASE OF COUNTY

In determining the debt base upon which the amount of debt to be assumed by the City of Waynesboro should be calculated, Augusta County has argued that such base should include the County's unfunded past service liability resulting from its participation in the Virginia Supplemental Retirement System (VSRS).⁶ This unfunded past service liability was calculated to be \$2,057,198 as of June 30, 1981. Assuming that the City was required to accept responsibility for the discharge of 9.1% of that "liability," the City of Waynesboro would be confronted with the discharge of \$187,205 of that County "obligation."

The City has contended that the inclusion of unfunded

⁶Financial Exhibits, Exh. III A.

past service liability in the County's debt base is inappropriate.⁷ In support of this position the City has submitted a letter from the State's Auditor of Public Accounts which states that:

. . . , it is the position of this office that unfunded accrued liability is not properly recognizable as long-term indebtedness of a locality in that a legal liability does not presently exist for the payment of the actuarially estimated amount.⁸

While the above statement from the Auditor of Public Accounts may be sufficient to dispose of this issue, the Commission observes that Augusta County's VSRS unfunded past service liability is not current debt owed, but, rather, it is a potential expense calculated on the basis of a number of actuarial assumptions, including those regarding mortality rates, retirement ages, and interest to be earned on VSRS investments. As these actuarial assumptions change, as they will, the amount of Augusta County's unfunded past service liability will likewise change, making that statistic a figure fluctuating with time and circumstances. Further, the Commission notes that the personnel services for which this unfunded actuarial liability was calculated have already been performed, and we consider it inappropriate for the City of Waynesboro to be expected to bear any portion of such prior service cost. The Commission recommends that the court not consider the County's unfunded past service liability as part of the County's debt base from which may be determined an appropriate amount for City assumption.

⁷City of Waynesboro, City of Waynesboro v. County of Augusta Annexation Proceeding, Proposed Findings of Fact and Conclusions of Law by the City of Waynesboro (hereinafter cited as City Proposed Findings), April 1983, pp. 48-52.

⁸Charles K. Tribble, Auditor of Public Accounts, Commonwealth of Virginia, letter to Sarah H. Finley, Special Counsel, City of Waynesboro, January 20, 1983, in City of

COMPENSATION FOR COUNTY-OWNED
PUBLIC IMPROVEMENTS

The only County-owned and maintained public improvement in the area proposed for annexation by the City is the Ladd Elementary School located adjacent to U. S. Highway 340 southwest of the City of Waynesboro.⁹ The County has contended that the annexation proposed by the City of Waynesboro will require the closing of that educational facility and the construction of a new school at another site in the County. Calculations by Augusta County school officials indicate that as many as 220 students attending the Ladd Elementary School (43% of its 1982-83 enrollment) would be annexed by the City, leaving that school with too few students to operate efficiently.¹⁰ Augusta County has determined that its cost to replace the Ladd Elementary School would be approximately \$2,750,000 and has requested that the City be directed to pay the County such replacement cost.¹¹

The City of Waynesboro, on the other hand, has asserted that the County will not need to replace the Ladd Elementary School due to the fact that sufficient capacity exists in other County schools to accommodate the approximately 290 Ladd Elementary School students who would remain County

Waynesboro, City of Waynesboro Annexation Proceeding, Annexation Notice, Vol. I - B, April 1983, pp. 55-56.

⁹The Ladd Elementary School is also located within the area recommended for annexation by the Commission.

¹⁰Testimony of Edward G. Clymore, Superintendent of Schools, County of Augusta, Hearings before the Virginia Commission on Local Government, Re: Waynesboro Seeking to Annex Portions of the County of Augusta (hereinafter cited as Hearings), Vol. II, p. 258.

¹¹County Proposed Findings, pp. 95-96. The County does propose an alternative by which the City would be required to pay the County initially the current value of

pupils after the annexation.¹² The City proposes to compensate the County for its acquisition of the Ladd Elementary School, if such is ordered by the court, based on that facility's "present value" at the time of annexation. Contending that neither the City nor the County will need the Ladd Elementary School subsequent to the proposed annexation, the City has argued that the "present value" of the facility at the time of annexation would be minimal.¹³

The Commission notes that the Ladd Elementary School, which was built in the mid-1960's, is an air conditioned, campus-styled facility having both a gymnasium and cafeteria. The County's Superintendent of Schools has described the facility as being in "excellent condition."¹⁴

Further, the data indicate that between school years 1978-79 and 1981-82 the elementary ADM in Augusta County's public schools decreased from 6,194 to 5,121, or by 17.3%.¹⁵

Given the condition of the Ladd Elementary School and the pattern of decreasing enrollment in Augusta County schools, the proposal by the County to construct a new elementary

Ladd Elementary School (estimated by the County to be \$1,702,745) with the difference between that school's current value and replacement cost being paid if a replacement facility is built by the County within five years of the effective date of annexation.

¹²City Proposed Findings, pp. 52-58.

¹³City Proposed Findings, p. 52. In determining the value of county-owned and maintained property for purposes of compensation in annexation proceedings, the court is directed to take into consideration "the original cost thereof less depreciation, reproduction cost at the time of annexation less depreciation, as well as present value" (Sec. 15.1-1043, Code of Virginia).

¹⁴Clymore, Hearings, Vol. II, p. 256.

¹⁵Superintendent of Public Instruction, Commonwealth of Virginia, Annual Report 1978-1979 and Annual Report 1981-1982, Tables 17 and 16 respectively.

school at this juncture should be critically evaluated. While the Ladd Elementary School may not be located in the optimum position subsequent to the proposed annexation, it is a serviceable facility which should, in our judgment, be utilized.¹⁶

With the above considerations in mind, the Commission recommends that the court encourage the County and the City to develop a plan for the joint utilization and operation of the Ladd Elementary School for educational purposes. If such a plan cannot be developed, the Commission recommends that the court direct the City to compensate the County an amount equivalent to 25% of the present value of the facility used as a school, with the City acquiring no interest in the title to that property as result of such payment.¹⁷ Such compensation by the City would be in recognition of the County's diminished educational use of the Ladd Elementary School and would leave the County free to use the facility for any public purpose.

COMPENSATION FOR THE
PROSPECTIVE LOSS OF NET
TAX REVENUE

A third element in the financial settlement provisions of city annexation cases is that providing compensation to a county for its prospective loss of net tax revenue (LNTR) resulting from the annexation of "taxable values" by a city. The law empowers an annexation court to direct a

¹⁶It is significant to note that the Ladd Elementary School has served the general community in a variety of ways, including use as a meeting facility for industrial groups and scout organizations and as a recreational facility. See Clymore, Hearings, Vol. II, pp. 257-258.

¹⁷If agreement is not immediately available as to the present value of the Ladd Elementary School, the Commission recommends that such value be established through

city's payment of LNTR sufficient to cover the five-year period after annexation "to such an extent as the court in its discretion may determine, . . ." The court may also permit the city's payment of LNTR in five annual installments over the five-year period.¹⁸

In the case presently before the Commission, and based upon the area originally proposed for annexation by the City of Waynesboro, both parties have calculated the LNTR which should be paid the County. The City has determined that the compensation due the County for its five-year prospective loss of net tax revenue should be \$2,220,835, while the County has calculated that the appropriate compensation due it for its five-year prospective LNTR should be \$7,002,320, a figure more than three times that proposed by the City.¹⁹ While the Commission does not have available the data required to propose an appropriate LNTR award based upon the area it recommends for annexation, it does wish to offer recommendations regarding the methodology to be used in the calculation of LNTR compensation. The Commission notes that parties to annexation cases have often invested significant sums in the generation of data and in the development of conflicting methodologies for the determination of LNTR compensation. The Commission believes that to the extent a simple but equitable methodology can be evolved which is accepted and utilized by parties in annexation actions the length and cost of such actions can be reduced.

the generally accepted negotiation process (i. e., the value being determined by a team of appraisers -- with one being selected by each party and with the third appraiser being selected by those appointed by the parties).

¹⁸Sec. 15.1-1042(c), Code of Virginia.

¹⁹Notice - IA, p. 59; and Financial Exhibits, Exh. II E. The County data set utilized is that for the 1984-88 period.

The Commission's recommendations which follow are guided by this concern.

CALCULATION OF LNTR FOR INITIAL YEAR

With respect to the data base to be utilized in the determination of the County's prospective LNTR for the initial year, the Commission recommends that the court require the utilization of audited data for the fiscal year ending June 30 prior to the effective date of the annexation. While preliminary calculations may be required prior to the availability of audited data for the last fiscal year, and while the parties may agree on estimated revenue or expenditure figures obviating the need to refer to an accepted data base, the establishment of a generally accepted data base should facilitate the resolution of initial year LNTR calculations.

Revenue Losses from Annexed Area

In its recent review of the City of Harrisonburg -- Rockingham County annexation case, the Virginia Supreme Court considered specifically the question of which revenues lost by a county through annexation are eligible for compensation from the annexing city. Referring to Section 15.1-1042(c) of the Code of Virginia, the Court stated:

The loss this statute addresses is a county's loss of prospective "tax revenue" resulting from "annexation of taxable values." We construe this language to mean monies a county collects from taxes it levies upon assets, transactions, and privileges within its taxing jurisdiction. If the General Assembly had intended compensation awards to extend to all types of budgetary receipts, it would have said so. Since it did not, we hold that the funds a county hopes to derive from State and federal appropriations are not prospective "tax revenues" within the contemplation of Code, Section

15.1-1042(c).²⁰

Based upon the above judicial pronouncement, the City of Waynesboro and Augusta County have submitted estimates of the County's loss of revenues which would result from the annexation proposed by the City. The City has estimated that the County's local revenue loss for the initial year would be \$1,097,130, while the County has calculated that its local revenue losses for the first year would be \$1,244,972 -- a difference of \$147,842.²¹ With respect to the calculations of the County's prospective revenue loss from the area proposed for annexation two comments are appropriate. First, the County has generally calculated its revenue loss on the basis of direct measurement, while City calculations have been generated through a variety of methods. The direct measurement of local revenue loss is both desirable and practicable, and we recommend the court's endorsement of that methodology. Second, the Commission notes that the County has included in its calculation of revenue loss \$19,459 of nontax revenue generated by penalties, interest, fines, forfeitures, and permits.²² The inclusion of this nontax revenue in the County's revenue loss eligible for compensation appears, in our view, inconsistent with the Supreme Court's ruling in the Harrisonburg case. Such nontax revenue is not derived from "taxes" which the County has levied upon assets, transactions, or privileges within its jurisdiction. In our judgment, such nontax

²⁰County of Rockingham v. City of Harrisonburg, 224, Va. 62, 89 (note omitted).

²¹Notice - IA, p. 59; and Financial Exhibits, Exh. II.

²²City Proposed Findings, pp. 61-64.

revenue should not be eligible for compensation from the City.

While the Commission does not have available the data which would enable it to calculate the revenue loss which would be experienced by the County if the area recommended for annexation by the Commission were awarded to the City, the parties should have little difficulty in agreeing on such revenue loss utilizing direct measurement for the last fiscal year and agreeing to the exclusion of nontax revenue.

County Expenditure Reductions

In the Harrisonburg annexation case the Supreme Court stated that the LNTR experienced by a county required a determination of the difference between a county's loss of local tax revenue and "the amount of budgetary expenditures annexation saves a county."²³ Thus, an integral element in the calculation of LNTR is the determination of the expenditure savings experienced by a county as a result of an annexation. As with the calculation of revenue loss, the Commission recommends that a county's expenditure savings be based upon data for the last fiscal year ending prior to the effective date of annexation. The Commission also recommends that, to the extent practicable, savings to a county resulting from an annexation be made by direct measurement of the incidence of facilities, services, and program clients within the area proposed for annexation. Further, it is important that the data provided the Commission, and subsequently the annexation court, be presented in similar format such that each party's derivation of local expenditures in the area proposed for annexation can be determined. The format should indicate the total expenditure for

²³County of Rockingham v. City of Harrisonburg, 224, Va. 62, 89 n.

each public function or service in the area, the amount of each such expenditure provided by intergovernmental aid and charges/fees, and the net local expenditure for each function or service. This detailed presentation, offered in the same format, will facilitate the identification of major variances in the parties' estimates, an analysis of the bases for such variances, and judgment regarding the merits of each.

With respect to the data developed by the parties in this case, the City has calculated that the County should experience an initial year total local expenditure savings of \$662,876 as a result of the annexation which it proposes.²⁴ The County has calculated that the annexation proposed by the City would permit it expenditure savings of only \$54,593.²⁵ A detailed examination of the calculations of prospective expenditure savings by the City and the County indicate the areas of major disagreement and the reasons for such.

Non-Educational Operating Expenditures. The Commission notes that the variance in City and County estimates of non-educational operating expenditures is modest. The City has estimated that the County will save \$43,777 in non-educational operating expenditures during the initial year after annexation, while the County has estimated such savings to be \$52,556.²⁶ The difference in estimated

²⁴Notice - IA, p. 61. The City's tabulation of the County's estimated total local expenditure savings (\$652,963) is affected by a mathematical error due to the use of a wrong subtotal for educational fringe benefits. The elimination of this error changes the City's estimate of such savings to \$662,876.

²⁵Financial Exhibits, Exh. II B.

²⁶Notice - IA, pp. 60-61; and Financial Exhibits, Exh. II B. The County's higher estimate of its potential expenditure savings is due principally to anticipated

County savings in this expenditure category is minor, suggesting that a reconciliation of the difference should not be difficult.

Debt Service Expenditures. The disparity in City and County calculations of debt service savings is also minor. The City has estimated that the County will experience an average annual savings in debt service during the five years following annexation of \$34,796, while the County has calculated that its debt service savings during the initial year after annexation would be \$42,680.²⁷ The debt service savings of the County can be calculated precisely once a determination has been made regarding the amount of County debt to be assumed by the City.

Educational Expenditures. There is a major disparity in the estimates made by the City and the County regarding the amount of educational expenditures to be saved by Augusta County as a result of the annexation proposed by the City. This disparity in estimated educational expenditure savings is largely responsible for the overall variance in the calculations of total expenditure savings to be experienced by Augusta County as a result of the City's proposed annexation. The City has estimated that the County can be expected to save \$584,303 in education-related expenditures during the first year after annexation, while the County has calculated that, rather than experiencing any local expenditure savings, it will encounter an increase in local outlays of \$40,643 for educational services during the ini-

savings in the areas of general/financial administration (\$4,485) and mental health (\$5,119). The City did not identify any County savings in these areas.

²⁷Notice - IA, p. 61; and Financial Exhibits, Exh. II B.

tial year after annexation.²⁸ This significant variance in estimates is due principally to several major distinctions in the methodologies and assumptions used by the parties. These major distinctions are reviewed below.

First, in its calculations of the County's educational expenditure savings the City has included an amount of \$121,719 which represents the anticipated increase in the State's basic school aid which would be provided the County after the proposed annexation.²⁹ This increase in State aid would be the consequence of a change in Augusta County's composite index (i.e., a measure of the County's relative ability to finance its educational services which is used to determine the level of the State's basic school aid to the County) resulting from the proposed annexation. Thus, the City proposes to attribute to the County a local expenditure savings which is, in actuality, a prospective increase in State aid. The Commission recommends that the prospective increase in State educational aid not be considered an expenditure savings to be realized by the County. It appears to this Commission that the inclusion of prospective State aid as an anticipated expenditure savings of the County for purposes of calculating LNTR is conceptually wrong and inconsistent with the Supreme Court's previous ruling.

²⁸City of Waynesboro, "Methodology for Determining Expenditure Reductions for Augusta County for Purposes of Calculating Waynesboro's LNTR Payment" (hereinafter cited as "City Expenditure Methodology"), undated mimeographed document, p. 20; and Financial Exhibits, Exh. II B. The total of the expenditure savings reported in the City document (\$574,390) is in error due to the wrong subtotal being used for "Fringe benefits."

²⁹Notice - IA, p. 61.

Second, in its calculations of the impact of the City's proposed annexation on its educational expenditures, the County asserts that it will be required to substitute local funds for all State aid lost as a result of the annexation. While the County acknowledges gross expenditure savings for educational services of \$388,103 (comprised of savings for teacher's salaries, instructional materials, library resources, pupil transportation, etc.), it contends that the annexation will also result in a constriction of State aid by \$424,417 which will require replacement with local monies. As a result of such assumption, the County asserts that its educational operating expenditures will increase initially by \$36,314 annually after annexation.³⁰ The County's method of calculation has the effect of requiring the City's compensation for the loss of intergovernmental aid which has been held inappropriate by the Supreme Court. It might be noted further, however, that basic school aid is distributed by the State on the basis of certain objective criteria. The proposed annexation will alter these criteria relative to Augusta County and result in a change in the County's basic school aid consistent with legislative intent. The Commission recommends that Augusta County's prospective loss of intergovernmental aid for educational purposes not be considered a mandated local expenditure increase for purposes of determining LNTR compensation from the City.

Third, apart from the above-mentioned issues concerning intergovernmental aid, the parties differ on other assumptions regarding educational expenditure savings which the County would experience as a result of the proposed annexation. The City has based its calculations of the County's

³⁰County of Augusta, "Method of Calculating the Prospective Loss of Net Tax Revenues" (hereinafter cited as "County Method of Calculating LNTR"), pp. 8-11, presented to

prospective expenditure savings on the assumptions (1) that the proposed annexation will enable the County to close, and not replace, the Ladd Elementary School, with local expenditure savings of \$192,912 for the initial year after annexation, and (2) that the proposed annexation will permit other savings, principally through the elimination of 18 teaching positions in grades 6--12, representing local expenditure reductions of \$259,759 during the first year following annexation.³¹ The County, on the other hand, has asserted that the proposed annexation, if granted, will require the replacement of the Ladd Elementary School and that its educational expenditure savings estimated by the City are generally overstated.³²

As noted previously, the Commission does not have available data conforming to the area which it recommends for annexation and, thus, is unable to offer a precise recommendation relative to Augusta County's educational expenditure savings. We do observe again, however, that the parties' presentation of detailed data in the same format will facilitate the analysis of variances in their calculations and the development of reasonable estimates by the Commission and the court. To this end, the Commission recommends that the parties, in this annexation case and others, submit data showing gross educational expenditure

the Commission as an attachment to letter from Richard K. Bennett, Special Counsel, County of Augusta, to the staff of Commission on Local Government, April 13, 1983; and Financial Exhibits, Exh. II B. The County also lists as a revenue loss, requiring additional County expenditures after annexation, \$4,329 in textbook fees which would have been collected from students in the annexed area.

³¹"City Expenditure Methodology," pp. 14-20.

³²County Proposed Findings, pp. 56-59.

savings resulting from the proposed annexation, the amount of such expenditure reductions provided by intergovernmental aid and charges/fees, and the net local expenditure savings. We recommend that such detailed data be presented for each line item of expenditure (except those for capital outlay, debt service, and refunds of revenue) listed in the "Disbursements" portion of the "Virginia Department of Education Annual School Report: Financial Section" which is submitted yearly to the State by each school division. Such submissions would provide local expenditure estimates for all operational costs including those for administration (e. g., compensation of school board members, superintendent, assistant superintendents, etc.), instruction (e. g., compensation of principals and teachers, library books, instructional supplies, etc.), attendance and health services (e. g., compensation of doctors, dentists, school nurses, compulsory attendance personnel, etc.), pupil transportation (e. g., compensation of drivers, gasoline, etc.), school food services, operation and maintenance of plant (e. g., compensation of custodial personnel, water, telephone, fuel, etc.), fixed charges (e. g., insurance, rent, etc.), summer school, adult education, and other educational programs.

The Commission well understands that in some categories of educational expenditure the County will experience little or no savings in the first year or two following annexation. From our perspective the County cannot be expected to realize any significant savings immediately in areas such as administration and plant operation. Further, given the varied curriculum and the size of classes in its secondary schools, the loss of high school students will not enable a pro rata reduction in teaching positions. However, in time, the County should be able to effect savings in virtually all

major expenditure categories. As a general principle, the Commission believes that expenditure savings should be sought in the provision of public services and that the financial settlement provisions in annexation issues should be predicated upon a reasonable expectation of such.

CALCULATION OF LNTR OVER FIVE-YEAR PERIOD

The court is empowered to require the City to compensate the County for its prospective LNTR for the five-year period following annexation. The City has proposed that the aggregate amount of such a five-year LNTR payment be determined by multiplying the first year LNTR calculation by "5."³³ This City-proffered methodology rests upon the assumption that, while local revenues and expenditures may change annually within the area annexed, the annual loss of net tax revenue is likely to remain relatively constant during the five-year period following annexation. The County, on the other hand, proposes two methodologies for use in determining its aggregate LNTR during the five years after annexation, both of which rest upon the assumption that the LNTR from the area annexed will increase annually following annexation.³⁴

With respect to the calculations of LNTR over a period of years, the Commission observes that numerous factors will have a bearing on that statistic and that all projections will be hazardous. To be sure, both local tax revenues from the area and local public expenditures to serve it will change, but the degree of their change is far from certain. The changes in local revenues and expenditures in the area

³³Notice - IA, p. 59.

³⁴See Financial Exhibits, Exh. II E; and County Proposed Findings, pp. 87-94.

will depend upon the extent and nature of future development, population growth, changes in property values, zoning decisions, and other factors. While revenue growth in an area will not always exceed the increase in public expenditures required to serve it, the evidence does suggest, in our view, that the area proposed for annexation by the City of Waynesboro, and that recommended by this Commission, is likely to yield an annual increase in net tax revenue in the years immediately ahead. The precise determination of the growth in net tax revenue, however, is fraught with considerable difficulty.

Projection of LNTR by County Methodology

The County proposes that the local tax revenue growth in the area proposed for annexation be based upon the historical pattern of such growth in the County during the previous decade. On the basis of tax revenue growth in the County between 1973 and 1982, and using what it terms a "lag variable regression analysis," Augusta County has projected its local tax revenue receipts from the area proposed for annexation during the five-year period following the effective date of the annexation.³⁵ The County estimates that its local expenditures in the area proposed for annexation will increase by 11% annually during the ensuing five-year

³⁵See "County Method of Calculating LNTR"; and Wanda A. Wallace, Professor of Accounting, Southern Methodist University and Regression Analysis Consultant to Price Waterhouse, "Selection of Regression Analysis as a Methodology and its Application in the Estimation of the Proper Compensation to Augusta County for the 'Prospective' Loss of Net Tax Revenue," presented to the Commission on Local Government as an attachment to letter from Bennett, April 13, 1983. It should be noted that the projection of real property revenues is based upon the growth of such revenues in the area proposed for annexation during the period 1973-82, while the projections of revenue from all other sources are based upon the growth of such revenue in the County generally during the previous decade and the

period.³⁶

With respect to the County's projection of the growth of local tax revenues, the Commission questions the propriety of basing future revenues from the area on the revenue experience of the previous decade. As suggested previously, many factors will affect future tax revenue collections from the area proposed for annexation, including the extent and type of future development in the area, its rate of population growth, and the general economic environment. We have considerable difficulty endorsing revenue projections which are based solely on historical revenue data. The County consultant's statement addressing this concern should be noted:

The factors influencing revenue growth are numerous, including population growth, inflation, and economic development. However, the objective is to formulate projections from 1983 to 1989 (or such other time periods as might be appropriate), and no objective source of information is available as to what population, inflation, or similar factors will be in 1989. If we try to project these factors, rather than effectively formulating an objective forecast for tax revenue, we would have merely substituted one forecast for another, and the validity of projections would depend upon the accuracy with which we were able to project economic factors over the long term.

A more reasonable approach to forecasting revenue is to use historical data for each of the revenue items that we wish to project, expecting that these numbers efficiently summarize reactions of the community to popula-

assumption that the percentage of the County's total revenue from each source coming from the proposed annexation area as of 1982 will continue to be the same during the five years following annexation.

³⁶"County Method of Calculating LNTR," p. 12. The County advises, "This [expenditure] growth rate is based upon the approximate annual growth rate of expenditures which the County has encountered during the five-year period ended June 30, 1982."

tion growth, inflation, and economic development.³⁷

The above statement may explain the County's sole reliance on historical revenue data for its projections; it does not, in our view, validate the methodology. Use of a time series regression formula for projection requires an assumption that past events constitute an appropriate predictor for the future and that the historical data upon which the projections are based were not affected by unusual events. It should be noted that the historical time period proposed as a basis for the projection of revenues in this case (1973-82) experienced three recessions, two of them quite severe, and several years of rapid inflation particularly in real estate. The ensuing years are likely to be quite different. The Commission cannot accept the premise underlying the County's methodology that the future revenue growth in the area proposed for annexation can be projected on the basis of the experience of the preceding decade.

Annual Calculation of LNTR

As an alternative to its proposed methodology for the projection of LNTR over the five-year period following annexation, the County recommends a "wait and see" approach which calls for the annual determination of LNTR for the preceding year. While this approach theoretically has much to commend it, this method of calculating LNTR confronts a number of major practical difficulties. For the "wait and see" approach to function properly, it will require the development of a detailed methodology for the determination of revenues and expenditures in the area annexed, a well-designed data collection system, and a spirit of cooperation

³⁷Wallace, "Selection of Regression Analysis as a Methodology and its Application in the Estimation of the Proper Compensation to Augusta County for the 'Prospective'

between the parties. There is no assurance that these prerequisites can be easily met.

The problems of establishing a methodology for the "wait and see" approach are considerable. The fundamental difficulty is that the "wait and see" approach requires the determination of prospective County revenues and expenditures in an area administered and served by the City. Should, for example, all revenue growth in the area annexed be considered growth the County would have experienced, or should some of the area's revenue growth be considered the result of City stimulation (i. e., municipal services and policies) and excluded from the determination of compensation due the County for the loss of net tax revenue? Further, should all City expenditures on behalf of the area annexed be considered as expenditures the County would have incurred, or should it be assumed that County expenditures would have varied in some, or all, service categories? Finally, and most significantly, the financial settlement provisions of the annexation would be five years delayed in final implementation, with a continuing possibility of controversy surrounding the annual calculations. While the "wait and see" approach is conceptually appealing, we envisage difficulty in its implementation. For reasons cited above, the Commission does not recommend the utilization of the "wait and see" approach for the calculation of LNTR.

Commission Recommendations

As stated previously, the Commission considers the area proposed for annexation in this case as one which is likely to have produced for the County an annually increasing net tax revenue during the forthcoming five-year period.

Compensation awarded the County for its LNTR should be based upon this expectation.

The Commission recommends that compensation paid to the County for its aggregate LNTR during the five-year period after annexation be determined by multiplying the first year LNTR calculation by the factor "5," with full payment required prior to the effective date of annexation. Alternatively, the Commission recommends that the City be permitted to pay this determined amount in annual installments with interest being charged on the unpaid balance and compounded annually. The interest charged the City on the unpaid balance should be the interest yield on U. S. Treasury five-year notes as of a specified time prior to the effective date of annexation. Such interest rate is an appropriate measure of the investment opportunity lost by the County as a result of the City's selection of the annual payment alternative. These recommendations rest upon our judgment that the proposed prepayment of LNTR or, alternatively, the City's payment of interest on the unpaid balance, provide the County with a financial adjustment which equitably offsets any prospective growth in its loss of net tax revenue.

CONCLUDING COMMENT

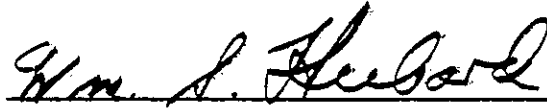
The financial settlement provisions in the annexation statutes are intended, it appears to us, to provide equitably for the transfer of assets and liabilities from one jurisdiction to another and to assist a county during a period of transition. There is a public interest, in our judgment, not only in the terms of settlement but in the procedural cost of their determination. The Commission

believes that the public interest is served by the development and utilization of standard and simple measures for determining the terms of settlement in annexation cases.

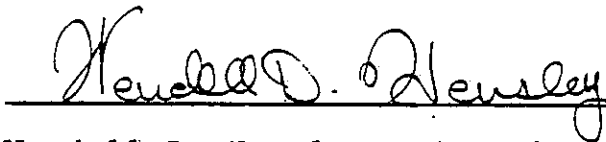
In particular, the Commission notes the inherent difficulty in any attempt to measure with precision a county's prospective loss of net tax revenue during a five-year period of uncertain future. At issue here is an attempt to quantify a concept which is not amenable to precise measurement. No foresight, analytical skill, nor methodology can do more than offer an approximation of a county's prospective loss of net tax revenue. Compensation to a county for its prospective loss of net tax revenue should not rest on an elusive quantity which is incapable of calculation; such compensation should be set, from our perspective, with its ultimate purpose in mind -- financial assistance during a period of transition. Such a determination is an achievable end, and one served, we believe, by our previous recommendations.

The Commission is prepared to assist the court, if such is deemed appropriate, by the development of specific recommendations regarding the financial settlement provisions subsequent to the court's determination of the area to be annexed.

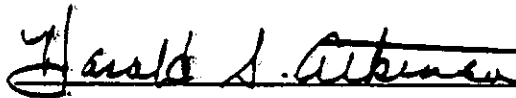
Respectfully submitted,



William S. Hubbard, Chairman



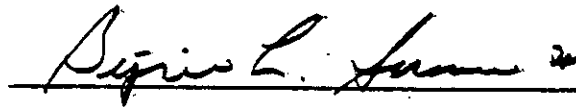
Wendell D. Hensley, Vice-Chairman



Harold S. Atkinson



Edward A. Beck



Benjamin L. Susman, III