

LAFCo GUIDELINES FOR EVALUATING INCORPORATION PROPOSALS

This appendix provides specific guidance to applicants submitting incorporation proposals regarding the LAFCo's evaluation of those proposals. The appendix is divided into four sections, including sections concerning the proposed city's capability and effectiveness, its revenue impact on existing agencies, its financial feasibility and the efficiency of the proposed city.

A. CAPACITY AND EFFECTIVENESS

This section describes the application of LAFCo General Policy regarding incorporation proposals. The LAFCo seeks to ensure that the most effective service provider will serve any given territory, subject to other goals, including efficiency, minimal environmental damage, and minimal adverse social or economic effects upon neighboring territories and agencies. Though the effectiveness of a proposed city is difficult to assess, the LAFCo will compare the proposals effectiveness with that of the current service providers by reviewing the following indicators:

1. Thoroughness of the feasibility study and the Master Services Element of the Sphere of Influence Plan included in the proposal;
2. Planned realistic service provision capacity to provide acceptable quantity and quality of service as may be required by evidenced service needs; and
3. Proposed organization chart and operating plans.

The feasibility study and Master Services Element are particularly important, because their contents will allow the LAFCo to make a comparison of the proposed source of service provision capacity to the current source.

B. REVENUE IMPACT ON EXISTING AGENCIES

Sales tax revenues have historically funded most or all of the County services which could be assumed by the new city. These services include:

1. Public protection and traffic enforcement;
2. Animal control;
3. Local streets and roads;
4. Planning and community development;
5. Environmental impact section; and
6. Other municipal services.

Property tax revenue which is transferred to a new city is equal to more than one-third of the cost of services assumed. Based upon an analysis of Sacramento County's fiscal 1988/89 final budget, about 42 percent of general purpose revenue is made up of property tax revenue. That proportion is applied to the net cost of services transferred to determine the amount of property tax revenue to be transferred. Net cost of services is that part which is funded by general purpose revenues.

Because sales tax revenues have been sufficient to fund most municipal services, the Cortese-Knox Act requirement to transfer a part of property tax revenue to incorporating cities partially duplicates the requirement to transfer sales tax revenues. When the County transfers municipal services to a new city, it must also transfer both the sales tax revenue that was sufficient to fund most of those services, and property tax revenue equal to more than one-third of the cost of those services. Essentially, the County must transfer one and one-third more revenue to a new city than is required to fund services that are being transferred.

This section describes the application of LAFCo General Policies to incorporation proposals. The LAFCo's policies require proposals to be revenue-neutral in their financial effect, or to include agreements that will achieve revenue-neutrality. To apply these policies, the LAFCo will review the reduced costs of current service providers and the revenue that existing service providers must transfer to the new city when it assumes service provision responsibility.

1. Measuring Costs

To measure costs, the LAFCo must determine the costs associated with a service, allocate costs to the subject territory, and identify the amount of costs. In measuring costs for the most recent complete fiscal year, the LAFCo will rely upon the most recently completed financial audit statements compiled by the County or the appropriate oversight agency. The LAFCo will ensure that costs are measured completely and accurately by using the following guidelines:

- a. Cost Definition - Cost definition requires identification of the types of service concerned, and identification of cost categories.
 - (1) Types of Service - A new city must assume certain municipal services upon incorporation, including:
 - (a) Law Enforcement/Police Protection;
 - (b) Planning and Land Use Control;
 - (c) Engineering and City Street Construction and Maintenance; and
 - (d) Building Inspection.

A city may also agree with the current service provider(s) to assume responsibility for a variety of other services, such as:

- (e) Animal Control;
 - (f) Cemeteries;
 - (g) Drainage;
 - (h) Fire Protection;
 - (i) Libraries;
 - (j) Parks and Recreation;
 - (k) Sewers;
 - (l) Solid Waste Disposal;
 - (m) Street Lighting; and
 - (n) Any other services which a city is legally permitted to provide.
- (2) Cost Categories - Total costs, regardless of the particular service, should include:
- (a) Wages, salaries, benefits, payroll taxes, training, and other employment related items;
 - (b) Office space, including rent, lease, allocated space costs, and utilities;
 - (c) Consumable equipment and supplies;
 - (d) Capital equipment, including rental, lease, or depreciation;
 - (e) Purchased services;
 - (f) Casualty and liability costs, including insurance premiums, self insurance reserve contributions; and
 - (g) Allocated agency administration and overhead.

Failure to include all of these items, or others which may be defined, in the calculation of cost reductions available to a current service provider would make the proposal appear less favorable to the existing service provider than it really is.

Though certain of the above costs are fixed in the short run and would not be saved if service is no longer provided by the current service provider, most of the costs become variable over time. That is, they can be eliminated, or depreciable

assets can be redeployed to other uses or sold. For that reason, the above guidelines provide for the definition of long run marginal costs, the costs borne by the current service provider of providing the incremental units of service required by the subject territory.

- b. Cost Allocations - The cost allocation must accurately and equitably assign indirect costs, and must accurately and equitably assign service costs to the subject territory on the basis of service level received. Ideally, the actual cost of service provided should be used. Only if such costs cannot be identified as to amount, or identification is unusually burdensome, should another allocation method be chosen. Alternate allocation methods should be based upon the measure of work that most accurately reflects the level of service received. The following are examples of allocation methods that the LAFCo expects agencies to use in allocating costs to a territory for several major types of municipal services:
- (1) Sheriff/Law Enforcement - actual cost, based upon workload analysis estimates of patrol, detective, and surveillance hours, arrests, and other measures of work in the territory to which costs can be assigned;
 - (2) Planning and Community Development - actual cost, based upon work load analysis estimates of costs for developing, updating, or implementing the community plan for the subject territory, costs for zoning the subject territory, and costs for any expected special studies;
 - (3) Public Works - cost per lane mile, or cost per other unit of effort; and
 - (4) General Government Administration, including Executive, Legislature, Legal Counsel, etc. - general government administrative cost per dollar of budget expenditure.
- c. Cost Identification - The LAFCo is concerned with identifying the amount of cost that will remain the responsibility of the current service provider. The LAFCo will request and review cost calculations and supporting accounting records to ensure that all of the above defined costs have been included. The review will also ensure that, if possible, actual costs are identified, and if actual costs cannot be identified, that allocation methods used are related to service levels.

2. Transfer of Property Taxes

The Cortese-Knox Act, in Section 56842, provides that, if a new city will assume responsibility for all services provided by the current service provider, the new city or district shall receive all property tax revenue previously received by the current provider. Otherwise, the LAFCo must determine the part of property tax revenue to be transferred. Since the County is the current provider of services to the territory included in most proposed new cities, and since new cities legally cannot assume responsibility for all County services, the LAFCo will usually have to determine the partial property tax transfer amount.

- a. The Cortese-Knox Act requires the LAFCo to determine the amount of property tax transfer based upon the following formula:

$$\text{Property Tax Transferred} = \frac{\text{Property Tax Revenue}}{\text{Total General Purpose Revenue}} \times \text{Net Cost of Services}$$

Total General Purpose Revenue

For this formula, the County Auditor is required to determine the proportion of property tax revenue to total general purpose revenue for each affected local agency. The LAFCo is required to determine

... an amount equal to the total net cost to each affected local agency during the prior fiscal year of providing those services which the new jurisdiction will assume within the area subject to the proposal. For purposes of this paragraph, 'total net cost' means the total cost that was funded by general purpose revenues of the affected local agency...

General purpose revenue is defined by the Cortese-Knox Act as:

[T]he total amount of revenue which an affected agency may use on a discretionary basis for any purpose, and [which] does not include any of the following:

- (A) Revenue that, by statute, is required to be used for a specific purpose;
 - (B) Revenue from fees, charges, or assessments which are levied specifically to offset the cost of particular services and do not exceed the cost reasonably borne in providing these services; and
 - (C) Revenue received from the federal government that is required to be used for a specific purpose.
- b. The LAFCo specifically interprets only the following County revenues to be general purpose revenues:
- (1) Taxes - Current Property;
 - (2) Taxes Other than Current Property;
 - (3) Use of Money and Property;
 - (4) Miscellaneous Revenues; and
 - (5) Other Financing Sources.

- c. The LAFCo specifically interprets the following revenues to be non-general purpose, or restricted, revenues:
- (1) Licenses and Permits;
 - (2) Fines, Forfeitures and Penalties;
 - (3) Aid - State;
 - (4) Aid - Federal;
 - (5) Aid - Other; and
 - (6) Charges for Current Services.
- d. As with total cost identification for purposes of comparison with total revenue transferred, the LAFCo will attempt to determine the actual part of service costs which are funded by general purpose revenues. In some cases, the entirety of service costs are funded through either general purpose or restricted revenue. For example, building inspection is funded through various construction permit charges, which are restricted revenues. In other cases, the service is funded partly through general purpose revenues, and partly through restricted revenues, but there is a clear delineation of the separate parts. For example, Planning and Community Development services rely partly on permits and charges for service, which are restricted revenues, and partly on general purpose revenues from the Unincorporated Area Services Fund.

If the LAFCo cannot identify which portion of services are funded by general purpose revenues, it will assume that the portion of the service funded by general purpose revenue is the same as the portion of general purpose revenues to total revenues within the smallest budget unit which funds the service. For example, animal control is currently provided by the County, and financed through the Unincorporated Area Services Fund. If a new city assumes the animal control function, the LAFCo may not be able to identify what part of the function in the subject territory is funded by general purpose revenues. In that case, if 80 percent of Unincorporated Area Services Fund revenue is made up of general purpose revenue, then the LAFCo will assume that 80 percent of animal control costs are made up of general purpose revenue.

3. Transfer of Sales Tax, Service Charge, User Fee, and Other Revenues

A new city has the authority to levy a sales tax. A city also will receive service charge and user fee revenue corresponding to the services it proposes to assume which are provided for charge or on a fee basis. The LAFCo will request that the State Board of Equalization determine the amount of sales tax revenue generated within the subject territory as part of the determination of financial impact. The LAFCo will rely upon current service providers for information regarding revenues generated by the subject territory via service charges and user fees. Similarly to service costs, the LAFCo will attempt to consider actual revenues from the subject territory. If actual revenues cannot be determined at reasonable cost, the LAFCo will consider revenues assigned to the territory using the allocation method most closely related to service levels.

4. Revenue Exchange Agreements

Though the LAFCo does not have the power to condition its approval of a proposal on a revenue exchange agreement, the LAFCo does have the power to deny proposals that have an unequal and harmful revenue impact. The LAFCo will therefore deny proposals that are not revenue neutral unless the applicant clearly demonstrates that the current revenue distribution is substantially inequitable and that the proposal will correct that inequity.

The LAFCo only will approve a proposal in which the costs borne by an existing service provider are not equal to the revenues transferred from the current provider to the incorporating city if the proposal includes a revenue exchange contract that resolves the inequity.

C. FINANCIAL FEASIBILITY

This section describes the application of LAFCo General Policy for Financial Feasibility to incorporation proposals. The LAFCo seeks to judge the initial and on-going financial viability of the proposed city. The LAFCo will determine prospective transitional and on-going revenues to be received by the new city. However, the LAFCo will rely substantially upon the applicant's feasibility study for estimates of transitional and on-going costs.

1. The costs detailed in the feasibility study must include all services that the city will assume. In addition, the feasibility study should include a projected three-year budget.
2. Additionally, the general government costs must be included, such as costs for the following functions:
 - a. City council/legislative;
 - b. City manager/administrative;
 - c. Treasurer/financial; and
 - d. Counsel/legal.
3. Costs detailed in the feasibility study for both transition and on-going operations must be included.
4. The LAFCo also will expect to see at least the following costs amongst the transition costs included in the feasibility study:
 - a. Necessary capital construction;
 - b. Recruiting and hiring;
 - c. Purchase of durable equipment and furnishings;
 - d. Hookup and connection costs;
 - e. Working capital for wages and benefits, lease/rent, consumable equipment and supplies, insurance, etc.; and
 - f. Legal and other professional fees.

If the LAFCo judges that any relevant costs have been excluded, or that any included costs appear to be substantially inaccurately estimated, the applicant may be required to resubmit a corrected feasibility study before the LAFCo takes action on the application. Appendix I presents a description of the financial information required to be submitted with incorporation proposal applications. In addition, Appendix J presents a methodology for computing the Gann limit for new entities resulting from an incorporation or a change in organization.

D. EFFICIENCY

This section describes the application of LAFCo General Policy regarding efficiency of services incorporation proposals. The LAFCo will attempt to determine if the proposal is the most efficient means of provision of acceptable quality services, or if another local agency or combination of local agencies is more efficient. In determining efficiency, the LAFCo is concerned with the net present value of total current and projected societal service costs.

The LAFCo will consider costs of service rather than simply considering an agency's charge or price because governmental agencies' costs and obligations are ultimately borne by their constituents and customers, regardless of the current price charged for service.

The LAFCo will consider the net present value of current and projected costs so that cost differences over time can be compared. For example, a city with limited water treatment capacity may be able to offer a lower monthly charge now, but may require a costly new plant in four years, while a district with ample capacity may charge a higher monthly charge now, but be cheaper in the long run since a new plant will not be needed for ten years.

The LAFCo will consider societal costs instead of only those costs borne by the agency, because some of the cost of service provision may not be borne by those who receive the service. For example, the LAFCo will consider the costs of pollution caused by a solid waste disposal agency, so that an agency with an inexpensive but heavily polluting dump will not necessarily be judged more efficient than an agency with a more expensive plant that is much cleaner.