

## Memorandum

**To:** Susan Parker, Assistant Administrative Officer, County of Lake

**From:** Aaron Nousaine, Vice President

**Date:** August 19, 2019

**Re:** Response to ADE Comments on BAE Peer Review of South Lakeport Annexation Fiscal Impacts Analysis

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This memorandum is in response to comments provided by Applied Development Economics (ADE) regarding the peer review conducted by BAE Urban Economics of the analysis conducted by ADE for the South Lakeport annexation. The ADE comment letter is dated July 29, 2019, and was provided to BAE by County staff on August 15, 2019.

The key findings of BAE's peer review, dated July 17, 2019, identified a variety of issues and fundamental errors that render the results of the original fiscal impacts analysis prepared by ADE insufficient for use in directing well informed and equitable decisions regarding public service provision in Lake County and the City of Lakeport. Foremost among those are the following: 1) the failure to acknowledge the invalidity and unenforceability of the 1997 revenue sharing agreement as asserted by Lake County; 2) the use of inappropriate data as the basis for developing local growth projections (i.e., the Longitudinal Employment Household Dynamics, or LEHD, dataset published by the U.S. Census Bureau); 3) the inappropriate use of an unrelated Tax Rate Area (TRA) to model the distribution of property tax revenue between the City of Lakeport and Lake County, and; 4) the failure to evaluate the likely significant fiscal impacts to the local County water district. In addition, the peer review identified a number of lesser issues that required greater clarification, such that experts and lay people alike might better understand the assumptions and calculations that underly the ADE analysis and its conclusions.

In response to BAE's peer review, ADE submitted a comment memorandum to the City of Lakeport, which is dated July 29, 2019. The comments provided reflect only a cursory reading of the BAE peer review report, with some of the comments reflecting a fundamental misunderstanding of BAE's key findings. The following is a brief response to ADE's comment memorandum that is aimed at moving the conversation toward a set of mutually agreeable

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baseline facts and assumptions that can be used as the basis renewed negotiations between the City and the County.

## **Fundamental Issues of Concern**

### ***Item 1 – Applicability of the 1997 Tax Sharing Agreement***

Neither the ADE fiscal impacts analysis, nor the comment memorandum, address the fundamental assumption of whether the 1997 tax sharing agreement can reasonably form the basis for modeling the fiscal impacts associated with annexation. It is the position of the County of Lake, as documented in the BAE peer review report (page 6, lines 12-19; and Appendix C), that the 1997 tax sharing agreement between the City of Lakeport and Lake County regarding annexation of the South Lakeport area is void and unenforceable. If this opinion is upheld, then the fiscal analysis would need to be revised to reflect a mutually agreed-upon revenue sharing arrangement. While it is likely not within ADE's purview to determine the applicability of the agreement, the analysis should acknowledge that the enforceability of the agreement is contested and that, at best, fiscal impact calculations based on the provisions of the 1997 agreement are merely illustrative of the potential fiscal impacts if the City and County ultimately agreed to similar revenue sharing terms.

### ***Item 2 – Using LEHD as the Basis for Growth Projections***

Our peer review report identified a number of issues in the way that ADE prepared the growth projections used for the original fiscal impacts analysis. Foremost among them is the use of LEHD data as the basis for apportioning county-level employment growth by industry. The LEHD dataset is inappropriate for such use, as it is well known for being unreliable, especially when used to describe employment dynamics within small geographic areas, as is the case with the ADE analysis. Also, the most recent available LEHD data is current only through 2015, which means that ADE based their projections on outdated information when newer and more reliable information was available from other sources, such as the EDD.

Although ADE indicates in the comment memorandum (page 2, lines 10-11) that they "calibrated the LEHD numbers to the countywide EDD job figures to eliminate any undercounting error that may occur in the LEHD data set," it is unclear exactly what calibration was done and how that "calibration" could effectively account for the inherent error in the data. The reason for this is that ADE does not identify any other benchmark for citywide employment that they could have used to ensure that the ratio of citywide to countywide employment by industry reported in the LEHD data was accurate. For this reason, BAE recommended that ADE purchase historical place-level data on jobs by industry for an appropriate reference period from the Quarterly Census of Employment and Wages (QCEW) which is available from the California Employment Development Department (EDD), as BAE does frequently for other projects. This recommendation is discussed in detail on pages 10 (line 32) and 11 (lines 1-4) of BAE's peer review report. Doing so would ensure that the city-level jobs numbers that ADE is using as the basis for their projections are internally consistent

with the county-level data that they are already using. Also, the QCEW data published by the EDD represent official governmental estimates of employment, as published by the State of California, and are therefore considered the industry standard for this type of analysis. BAE requests that ADE obtain the necessary data for an appropriate historical reference period, identify assumptions based on that data that they believe would be an appropriate basis for a revised analysis, then provide the data and desired assumptions to County staff and BAE for review. This request is intended to help identify mutually agreeable growth assumptions that may form the basis for a revised fiscal analysis, if and when such an analysis is appropriate.

Furthermore, BAE strongly objects to ADE's assertion in their comment memorandum (page 2, lines 6-15) that the BAE peer review report recommended the use of data from the American Community Survey (ACS) as the basis for ADE's growth projections. A careful reading of reading of pages 10 and 11 of our peer review report makes it clear that ADE misread the BAE recommendation. Although BAE does cite a number of ACS figures, these are used only for explanatory purposes, to illustrate the significant divergence that exists between the LEHD and other comparable data sources. While ADE asserts that the figures reported by BAE represent employed residents and not jobs, this is also incorrect. The data provided by BAE are from *Table S0804: Means of Transportation to Work by Selected Characteristics for Workplace Geography*. The key distinction is that the figures that BAE reported from the ACS reflect the workplace geography of Census survey respondents, not their place of residence. The U.S. Census Bureau defines "workplace geography" based on the "geographic location at which workers carried out their occupational activities during the reference week."<sup>1</sup> Therefore, the examples provided by BAE represent the U.S. Census Bureau's most recent available estimates of the number of jobs, not employed residents, located within the City of Lakeport. Due to the inherent error present in the ACS data stemming from the fact that ACS is a survey-based dataset, BAE still recommends that ADE purchase appropriate place-level employment data from the EDD.

### ***Item 3 – Use of TRA 001-002 as the Basis for the Analysis***

The use of Tax Rate Area (TRA) 001-002 in the ADE fiscal analysis is a critical fault. ADE indicates in their July 29<sup>th</sup> comment letter (page 3, lines 1-4) that the "analysis does not assume that the annexation area would be annexed into TRA 001-002 but rather that it reflects typical property tax shares for the City and the County given existing service obligations within the City limits." Nonetheless, ADE used the net AB8 increment factors for TRA 001-002 as the basis for estimating the amount of property tax revenue that will accrue to both the City and County post annexation. There is no justifiable basis for doing so, as there do not appear to be any provisions in the 1997 tax sharing agreement or its subsequent amendments that deal with the assignment of a new TRA for the purposes of annexation. For example, while the use of TRA 001-002 does reasonably reflect the tax share of receiving entities other than the

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<sup>1</sup> U.S. Census Bureau. (May 8, 2017). *Frequently Asked Questions: 6. What is the difference between residence and workplace geography*. Available at: [https://www.census.gov/topics/employment/commuting/about/faq.html#par\\_textimage\\_174230772](https://www.census.gov/topics/employment/commuting/about/faq.html#par_textimage_174230772)

City and the County, the use of the tax rate allocation factors for the City and the County assumes that the division of revenue between those two entities is fixed, when it remains in question. ADE could therefore just as easily assume that the City received all of the County's current property tax revenue, or none of it, as there currently is no justifiable basis for determining what that split should be. The ADE analysis should clearly acknowledge that the TRA 001-002 tax splits are no more than placeholders that serve to generate a set of fiscal results which can then be used as the basis for discussions between the City and the County about an equitable split to be used for the purposes of the proposed annexation.

***Item 4 – Failure to Evaluate Impacts to the County Sanitation District***

ADE indicated on pages 19 and 22 of the fiscal impacts report that the City will assume water and sewer service within the annexation area. However, the analysis assumes that because the service costs associated with water and sewer service provision are covered by user fees that the impacts would be negligible to both agencies. As summarized on page 15 of BAE's peer review report, there is a significant concern at the Lake County Sanitation District (LACOSAN) that "if the City assumes water and sewer service within the annexation area, the service population remaining within the special district would be too small to justify the continuation of service. This would potentially leave existing residents and businesses in the remainder of the district that is not annexed to the City without water and sewer service, or if service is continued, the service charges may have to increase to unsustainable levels due to the need to spread the district's fixed costs over a smaller base of ratepayers." While ADE confirmed in their recent memorandum (page 3, lines 27-28) that the City intends to assume responsibility for water and sewer service, the dismissive and incomplete response provided on by ADE is insufficient to address the concerns raised by LOCSAN. BAE recommends conducting an analysis using case study methods to clearly quantify the impacts to LOCSAN and to confirm whether the transfer of service would have significant and unavoidable negative impacts on existing district residents and businesses outside of the proposed annexation area (i.e., leaving them without service, or subject to disproportionately high service costs).

**Other Issues of Concern/Clarification**

In addition to the fundamental issues identified above, there are a number of items identified in the ADE comment memorandum that warrant a response.

***Item 5 – Failure to Update from Base Year 2017***

As part of the peer review findings, BAE recommended that ADE update the projections from base year 2017 to base year 2019. ADE asserts on page 2 (lines 1-3) in their July 29 comment letter that "the procedure suggested by BAE to update the base year is simply an estimating technique no different tha[n] the projection methodology and would not [add] any more certainty to the analysis since 2019 data are not available." It is true that the approach proposed by BAE is a simple estimation method, one which ADE appears familiar with. However, failure to adjust to an appropriate base year likely exaggerates the amount of

employment growth that is projected to occur within the study area and, therefore, results in a slight overestimation of the property tax revenue that is likely to accrue to both the City and County due to new development within the annexation area. Combined with the likely overestimation of local employment growth due to the use of inappropriate data as the basis for allocating the City's share of countywide jobs growth, this assumption is likely to have a significant cumulative effect on the results of the ADE analysis.

***Item 6 – Estimation of Road Fund Revenue***

The BAE peer review report requested additional clarification regarding how ADE estimated the amount of Road Fund revenue that accrues to Lake County (page 11, lines 33-38; page 12, lines 1-15), which would be transferred to the City in the event that annexation occurred under the terms of the 1997 agreement. In the response memorandum provided by ADE (page 2 lines 22-24), they direct attention to the property tax allocation factors reported in Table 7 on page 16 of the original ADE fiscal analysis. However, the table in question only pertains to the allocation of property tax revenue. There is additional sales tax revenue that accrues to the County Road Fund as a result of sales and use tax collections from within the annexation area. It appears, based on ADE's response in the July 29 memorandum, that the sales tax component of the Road Fund revenue stream was not accounted for. This subsequently means that ADE underestimated the amount of money that would be transferred from the County Road Fund to the City following annexation. Further analysis is necessary to clarify this issue to ensure that the fiscal analysis adequately documents the likely fiscal impacts of the proposed annexation to both the City and the County.

***Item 7 – Estimation of New Development Value***

BAE requested that ADE clearly document the property valuation assumptions used as part of their analysis, some of which was omitted from the original report. In the response memorandum, ADE fails to address BAE's finding that they used a valuation estimate for commercial services that is too high, at \$250 per square foot rather than \$185 per square foot. In the response memorandum, ADE further breaks out the valuation estimates to include \$150 per square foot for both office and retail, as well as \$250 per square foot for light industrial and \$200 per square foot for institutional uses. This is a departure from what was identified in the original fiscal impact analysis report.

BAE questions the use of a valuation amount of \$250 for light industrial, which is \$100 more than for office and retail. We request that ADE provide justification for this value, as it is very rare for the per square foot value of industrial uses to exceed those of retail and office uses. Unless adequately justified, this assumption likely results in a significant overestimation of the assessed value of future light industrial development within the annexation area.

Also, on page 2 (lines 26-27) of the ADE response memorandum, they indicate that "all institutional uses are assumed to be taxable," they provide no clear justification for this. There are many categories of institutional uses that are tax exempt. If any tax-exempt uses are

anticipated for development within the annexation area, then ADE's assumption likely overestimates the value of new development in the area and subsequently overestimates the resulting property tax revenue that will accrue to both the City and the County. BAE requests that ADE more clearly identify which institutional uses are considered taxable and provide adequate justification for their inclusion in the analysis.

***Item 8 – Changes in Service Capacity of the Sheriff's Department***

On pages 14 (lines 8-35) and 15 (lines 1-8) of the peer review report, BAE recommended that ADE consider using a case study method to evaluate anticipated impacts to the Lake County Sheriff's Department. In ADE's response memorandum (page 3, lines 18-23), they argue that the fiscal analysis only pertains to service responsibilities within the annexation area, and that significant reductions in the County's ability to provide essential services countywide due to loss of revenue should not be considered. BAE contends that those impacts are indeed pertinent, as any change that might disproportionately reduce the ability of the County to provide essential services can and should be considered a significant impact resulting from the proposed annexation. This is particularly true in a case where the City stands to sustain a significant windfall, while the County would sustain a deficit.

***Item 9 – Clear Documentation of Source Data and Assumptions***

The BAE peer review report requested that ADE provide additional detail regarding the information used to calculate the net fiscal impact estimates for both the City and the County, as a detailed reading of the ADE report identified gaps in the information provided. ADE provide some limited clarification on page 3 (lines 11-16) of the ADE response memorandum. BAE would like to more specifically request clarification on whether ADE applied the same service population figure for all cost and revenue line items. If so, ADE should revise the analysis to ensure that they are excluding workers from the service population estimates where appropriate for both the City and the County. For example, the industry standard is to assume that the service population is equal to the resident population, plus one-half of the employment base, except in cases where workers are unlikely to generate much in the way of service demand. ADE seems to have already done this for Lake County (i.e., the per capita cost share for businesses is zero for Parks and Recreation, Health Services, and Social Services, as reported in Table 14 on page 23 of the fiscal analysis), but not for the City of Lakeport (i.e., the per capita cost share for parks and building maintenance, as reported on page 19 of the fiscal analysis), meaning that ADE appears to treat the City and County differently from a methodological standpoint. This should either be revised, or ADE should provide further justification for the difference in approach.