LAKE COUNTY LAFCo

Review and Recommendations Regarding the Proposed South Lakeport Annexation

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I. EXECUTIVE SUMMARY

During our conversations with both City of Lakeport ("City") and Lake County ("County") management teams, it was clear that both parties are committed to providing the best possible services to their citizens. The City and County have indicated they want to make the annexation successful and provide the best outcome for the residents and business owners in the area. However, years of frustration and concern about fiscal impacts have diverted attention from the City's and County's common interests. To facilitate this process and focus the discussion toward positive outcomes, Municipal Resource Group, LLC developed three broad principles that both parties can use to pave the way to a mutually beneficial solution. These are:

- <u>The City and County need to recognize and embrace the public purpose of the other and acknowledge that both communities can benefit significantly if the annexation is completed</u>. Both jurisdictions can benefit from the annexation.

- <u>A sense of urgency is needed</u>. The area has been allowed to develop for years without adequate water service, creating a public health hazard. Also, December 1 is the annual deadline for tax exchange agreement implementation with the Board of Equalization.

- <u>The City is in a better position to provide improved public services</u>. The annexation area is in the City's sphere of influence, and the City is in a better position to extend and manage new infrastructure and growth.

<u>Sales Tax</u>

Because the City has two voter-approved sales tax measures totaling 1.5%, overall sales tax revenues will be significantly increased when the annexation is completed, creating an opportunity for tax sharing in which both jurisdictions can benefit.

- If the South Lakeport area is annexed, the City will receive approximately $661,000 in sales tax revenues above the amount currently accruing to the County.

- Without annexation, current annual sales tax revenues equal $490,000 and accrue to the County. With annexation, annual sales tax revenues would increase to $1.151 million and could be shared between the City and County as negotiated. Without annexation, the additional $661,000 in sales tax revenue is not available for the provision of needed services.

- The City and County could consider an equitable sharing of sales tax revenues between the City and County, including future growth. This gives both the City and County an incentive to work collaboratively to make improvements and develop new business opportunities in the annexation area.

Revenue Neutrality

The Lake County Local Agency Formation Commission ("LAFCo") policy (the "policy") requires that the annexation be revenue neutral, as defined in LAFCo policy section 2.13. Fiscal analysis shows that:

- The County receives $560,226 in revenues annually from the annexation area, and spends $56,205, leaving $504,021 that the County spends on services in other areas of the County. The policy requires that the County should not lose more revenue than it saves in reduced expenditures after annexation.
- The City anticipates spending $196,096 each year to provide services to the annexation area, in addition to costs already incurred. The policy requires that the City and County can negotiate a tax sharing agreement to help offset the City's increase in costs.
- Thus, the City and County could negotiate a tax sharing agreement that transfers between $56,205 and $196,096 in revenues annually from the County to the City, leaving the County with revenues from $364,130 to $504,021 for other services.

The following table summarizes the potential fiscal impacts on the City and County after annexation, and subject to the terms of a final agreement between the two agencies.

Potential Fiscal Impact	City	County
Change in revenue from the area after annexation (existing revenues, before revenue sharing)	$560,226	$(560,226)
Change in revenue from the area after annexation (City voter-approved sales tax)	$661,000	$0
Total Potential Change in Revenue	$1,221,226	$(560,226)
Change in costs of serving the area after annexation	$196,096	$(56,205)
Net fiscal impact before revenue sharing	$1,025,130	($504,021)
Potential impact of revenue sharing to ensure revenue neutrality	$(364,130) to $(504,021)	$364,130 to $504,021
Net fiscal impact after revenue sharing	$661,000 to $521,109	$(139,891) to $0 (fiscally neutral)

Thus, after annexation, the City could experience a net increase in resources available to provide services city-wide ranging from $661,000 to $521,109 annually. Conversely, the County could experience either fiscal neutrality (revenues lost equal expenses lost) or a net fiscal loss of up to $139,891 annually.

The 1997 City-County Tax Exchange Agreement ("1997 Agreement")

The 1997 Agreement does not explicitly address LAFCo's revenue neutrality policy. The permanent shift of all sales tax revenues, regardless of limited term reimbursement, might not be consistent with the revenue neutrality policy. At this point, the 1997 Agreement has limited utility, and continued focus on its applicability will likely result in costly litigation for both parties, with no positive outcome. We encourage the City and County to set aside the applicability of the 1997 Agreement and focus on forging an agreement that benefits both parties and the citizens in the area.

Water

The City has an adequate water supply and can construct water infrastructure more efficiently than the County. The area is in the City's sphere of influence and the City is in the best position to provide water service to residents and businesses. The City should construct water infrastructure after annexation.

Road Improvements

The City is in the best position to construct needed road improvements along with the water line extension. However, depending on how far along the County is in design and right-of-way acquisition, transition of the project to the City may not be practical. If the project cannot be transitioned to the City, the County can continue to complete the project with coordination and assistance from the City. The City and County will need to negotiate reimbursement of the County's local Highway Users Tax ("HUTA") funds used in the project.

Sanitary Sewer Services

Both the City and County agree that the current arrangement will work satisfactorily for the next few years. After annexation, the City and County could negotiate transfer of Lake County Sanitation District ("LACOSAN") infrastructure to the City and the City will be responsible for wastewater collection, as well as treatment.

II. BACKGROUND AND METHODOLOGY

The City of Lakeport is the county seat in Lake County (population approximately 65,000), and one of only two incorporated cities in the County. The City of Lakeport has approximately 5,200 residents and serves as the primary commercial area on the west side of Clear Lake, with the City of Clearlake serving as a commercial center on the east side of the lake.

Immediately to the south of the City of Lakeport, along Soda Bay Road and State Highway 29, is the South Lakeport Annexation area. The area is provided wastewater collection and treatment services through an agreement with the County (the Lake County Sanitation District) and the City. The area is not served with any domestic water service and property owners rely on wells and other methods to obtain water. The Lakeport Fire District Chief has raised concerns about the lack of adequate water for fire suppression in the area.

Despite the lack of water service, the County has approved commercial development in the area, including a movie theater, a gas station, several restaurants, retail and other commercial uses. The County generates significant sales tax revenues from the area, which it uses to provide services throughout the County. Growth in the area has increased traffic, and regional transportation funds have been committed to a significant road widening and bike lane project, currently under development. There are approximately 21 residents in the proposed annexation area.

The City and County have discussed the potential for annexation of this area into the City for at least 25 years. In 1997, the City annexed several large parcels south of the City limits, with the provision that the tax sharing agreement would serve as a model for future annexation of parcels in the area. In 2015, LAFCo approved an updated sphere of influence for the City, including the South Lakeport Annexation area. The City updated its General Plan and completed pre-zoning for the area at that time, setting the stage for the annexation application filed in August 2019.

Believing the 1997 Agreement would serve as a model for the current application, the City prepared a fiscal analysis based on the tax sharing provisions contained in the 1997 Agreement. The County disagreed with both the assumption that the 1997 Agreement was still valid and the findings in the City's fiscal analysis. Despite attempts to negotiate an agreement, the City and County remain at odds over the potential sharing of revenues in the annexation area.

In an attempt to break the stalemate and conclude the annexation so that residents and businesses can benefit from improved services, LAFCo hired Municipal Resource Group, LLC ("MRG") to review the annexation, including the fiscal analysis, and offer recommendations for a successful annexation agreement.

To complete this task, consultants at MRG engaged in the following tasks:

- Read numerous documents provided by LAFCo, including the fiscal analysis and the County's response, the City's application for annexation and all of its attachments, the 1997 Agreement and subsequent supplemental agreements, correspondence from the Lakeport Fire Protection District Chief, LAFCo policy documents, legal opinions from both the City and the County, the County's response to the City's annexation application, maps of the annexation area, City and County budget documents, and a variety of other documents and correspondence;

- Prepared a summary of the issues related to annexation for discussion with the LAFCo Executive Officer and City and County executives;

- Met with the City Manager and her key staff members, and also met with the County Administrative Officer and her key staff members;

- Met separately with City and County management and fiscal staff to discuss the fiscal analysis and findings;
- Met with the City's and County's fiscal consultants, Applied Development Economics and Bay Area Economics, respectively;
- Met several times with John Benoit, LAFCo Executive Officer, to review project status and findings;
- Researched various issues related to the LAFCo policy and other matters, including conversations with experts and other MRG consultants;
- Completed the fiscal analysis and prepared a draft report; and
- Met with the City Manager and the County Administrative Officer before finalizing the report.

In all cases, City and County staff members, as well as their fiscal consultants, were gracious with their time and transparent with information. We very much enjoyed working with everyone on this project and appreciate the opportunity to be of assistance.

III. SOLUTION PRINCIPLES

During our conversations with both City and County management teams, it was clear that both parties are committed to providing the best possible services to their citizens. The City and County have indicated they want to make the annexation successful and provide the best outcome for the residents and business owners in the area. However, years of frustration and lack of progress have diverted attention from the City's and County's common interests. The narrow focus on fiscal winners and losers and applicability of the 1997 Agreement has impeded progress. We encourage the City and County to set aside the applicability of the 1997 Agreement and focus on forging an agreement that benefits both parties and the citizens in the area. To facilitate this process, we developed some broad principles that both parties can use to pave the way to a mutually beneficial solution.

<u>First, the City and County need to recognize and embrace the public purpose of the other and acknowledge that both communities can benefit significantly if the annexation is completed</u>. The City and County share common commissions, including the desire (and, in some cases, mandate) to serve their communities, to raise revenue, to adopt a budget, and to work cooperatively with other public agencies to benefit their communities. Both the City and County have limited financial resources and service demands that exceed those resources.

Similarly, the City and County have overlapping but separate functions. The County serves all residents of Lake County and the City serves only those residents and businesses within its boundaries. In some cases the services each provides are similar, in other cases the services are different. But, in all cases, the services are important. The annexation agreement should ensure that both parties benefit; no party should benefit at the expense of the other.

LAFCo policy requires that the annexation must be revenue neutral (see page 9 regarding revenue neutrality). This policy is intended to ensure that the County can continue to provide necessary services to all its residents and that the City will have sufficient resources to provide services to the annexation area.

If the South Lakeport area is annexed, the area will generate significant new sales tax revenues. The City will receive approximately $661,000 in sales tax revenues that significantly increase the total revenues for the City, making it possible to craft an agreement in which both sides will benefit financially. The agreement must acknowledge that future growth in sales tax revenues will be shared, benefitting both agencies. For example, the County could share in the future growth of the base sales tax while the City receives the sales tax revenues from its local 1.5% rate. This gives both the City and County an incentive to work collaboratively to make improvements and develop new business opportunities in the annexation area.

<u>Second, a sense of urgency is needed</u>. Development in the area has occurred without adequate water service, and several of the property owners have water systems that are not in compliance with State Water Board requirements. The Fire Chief has made it clear that fire flow is inadequate and a danger to public safety. Public safety in the area will also be enhanced as City police response time and available officer coverage will be improved after annexation. However, without annexation, the additional sales tax revenues in the City, funds that could be used to provide critical services, are unrealized.

It is important to note that the deadline to notify the State Board of Equalization regarding tax exchanges is December 1. After that date, any agreement will be continued until the next year, losing a year of increased revenue.

<u>Finally, the City is in a better position to provide improved public services</u>. The State of California recognizes the difference between city and county activities and created laws to direct growth and urbanizing activities to cities. The state created local agency formation commissions with the express purpose to regulate jurisdictional designations, ensuring that growth is orderly and efficient. Upon annexation or incorporation, a city assumes responsibility for the government functions not reserved for the county, ownership of public right-of-way and public streets, and responsibility for land use controls, economic development and extension of services to the area.

The proposed annexation area has been in the City's sphere of influence for several years, and, as such, improvements that enhance or encourage growth should be the responsibility of the City. Upon annexation, the City would be in the best position to extend water services and construct street improvements.

IV. 1997 AGREEMENT

In anticipation of an annexation in 1997, the City and County entered into a tax sharing agreement. This annexation was completed later in 1997, and the specified tax sharing components of the agreement were fulfilled. The 1997 Agreement does anticipate future annexations and concludes that the tax sharing provisions may be used as a model for future annexations (1997 Agreement, § 4.1.2).

Believing the agreement to be a valid model for the proposed annexation, the City used the tax sharing provisions as the basis for its fiscal impact analysis and LAFCo application for annexation. However, County Counsel disagrees that the agreement remains valid and the County's position is that the tax sharing provisions do not serve as a basis for consideration of the current annexation proposal. In her letter dated October 2, 2019, County Counsel argues that because of its vagueness regarding the territory proposed for annexation, changes in law and circumstances since adoption, and other factors, the 1997 Agreement is no longer valid and cannot be used as a model for consideration of a current tax sharing agreement. In his response dated November 8, 2019, the City Attorney rebuts County Counsel's opinion, finding the 1997 Agreement to be valid and suggesting the tax sharing formulas can be applied in the current annexation application.

It is worth noting that the 1997 Agreement was adopted prior to 2002 when Lake County LAFCo first adopted its revenue neutrality policy. The tax sharing provisions of the 1997 Agreement permanently shift all sales tax revenues from the County to the City, including incremental growth. In exchange for this shift, the City paid a fixed, limited-term reimbursement to the County. The City and County could certainly agree that this arrangement is satisfactory and complies with the 2002 revenue neutrality policy. However, the 1997 Agreement does not explicitly address the revenue neutrality policy, and the permanent shift of all sales tax revenues, regardless of the limited-term reimbursement, may not be found consistent with the policy (discussed later in this report).

Legal Counsel for both agencies have written extensive opinions supporting their positions. The City has indicated a willingness to litigate the matter and enforce the tax sharing provisions of the 1997 Agreement. While a court could ultimately determine the applicability of the 1997 Agreement, it is not clear that such a step is necessary or beneficial. It has been our experience that litigation over questionable tax exchange agreements results in both parties spending considerable sums without a satisfactory outcome. Without confirming the validity of the 1997 Agreement, or even agreeing to use it as a model, the City and County could agree to a framework for a tax sharing agreement.

V. SALES TAX

The annexation area contains a variety of commercial uses that generate sales tax revenue for the County. Per the County Administrative Officer, the County received revenue from the Bradley-Burns base sales tax in the amount of $463,953 from sales in the annexation area for fiscal year 2016/2017. Although more current data is not available, City and County agree that current sales tax revenues are approximately $490,000 annually (we recommend that the County obtain more current sales tax revenue data to ensure accuracy during negotiations.)

In addition to the Bradley-Burns base sales tax, the City receives sales tax from two voter-approved measures, 1/2% from Measure I (approved in 2004) and 1% from Measure Z (approved in 2016). Neither of these measures have sunset dates and will continue indefinitely. If the annexation is successful, these local sales tax rates will apply to retail sales in the area. Total sales tax revenues after annexation would then be approximately:

Bradley Burns (1%)	$490,000
Measure I (1/2%)	$220,000[1]
Measure Z (1%)	$441,000[1]
TOTAL annual sales tax, estimated first year	$1,151,000

The Fiscal Impact Analysis estimates an additional $56,000 per year in annual sales tax (total of all three sources) by 2030 and an additional $236,600 per year in annual sales tax (total of all three sources) at buildout based on the Applied Development Economics ("ADE") growth projections. Some revenue growth should be expected and MRG recommends a conservative approach. However, we did not specifically analyze the ADE growth projections and cannot comment on them.

Without annexation, current annual sales tax revenues equal $490,000 and accrue to the County. With annexation, annual sales tax revenues would increase to $1.151 million and could be shared between the City and County as negotiated. Without annexation, the additional $661,000 in sales tax revenue is not available for the provision of needed services. These three scenarios further show the possible distribution of sales tax revenues:

Scenario	Sales Tax to City	Sales Tax to County	Total Sales Tax Generated
Scenario One: No annexation	$0	$490,000	$490,000
Scenario Two: Annexation and County Retains Current Sales Tax Revenue	$661,000	$490,000	$1,151,000
Scenario Three: Annexation and Current Sales Tax Revenue Transfers to City	$1,151,000	$0	$1,151,000

The recommended agreement is a negotiated tax transfer between scenarios two and three, with the City and County sharing sales tax revenues, including future growth. There is unlikely to be growth in sales tax revenues for the next few years, and the demand for service and institutional uses may grow. However, over time, development in the area could help resolve sales leakage from the County, generating additional revenue for both the City and County.

[1] Revenue estimates from ADE report, page 20.

VI. PROPERTY TAX

The proposed annexation area includes 50 parcels of land, primarily used for retail, automotive, restaurant and similar commercial uses and zoned for institutional and commercial uses. The current assessed valuation of the secured roll is $23.8 million. The annexation area includes two Tax Rate Areas (“TRAs”): 057-032 and 057-042. Within these two TRAs, property tax revenues are distributed among 12 different local government agencies according to AB8 allocation factors. After adjusting for the ERAF shifts, currently the County receives approximately 24.3% of the base property tax collected in these two TRAs, and the County Road Fund receives 1.4%.

The County General Fund currently receives the following property tax revenues from the annexation area:

	General Fund	Road Fund
Secured roll	$57,894	$3,414
Unsecured Roll	$8,416	$496
Total	$66,316	$3,910

After annexation, the City anticipates the area will develop additional commercial uses over time until it reaches a maximum buildout; the fiscal impacts analysis includes three growth scenarios. Property tax revenues will increase in the coming years as growth occurs. The fiscal impact analysis assumes that baseline property tax revenues will be retained by the County and incremental property tax revenues will be split between the City and County after annexation using the formula in the 1997 Agreement.

After annexation, property values will likely increase over time, particularly if water service is provided to the area. The increase in assessed value will result in increased property tax revenues, in excess of the current property tax shown above. These revenues, along with revenue growth, can be split by the City and County as negotiated. Commonly used formulas for sharing property tax revenues in annexation agreements allow the County to retain the base property tax and split the growth in the increment property tax revenues on a percentage basis.

VII. REVENUE NEUTRALITY

California Government Code section 56815, which governs new city incorporations, includes language requiring a “similar exchange of both revenue and responsibility for service delivery among the county, the proposed city and other subject agencies.” However, the law does not apply this same language to annexations. Thus, there is no state law requiring an annexation to be revenue neutral to any impacted party. However, the Lake County LAFCo has adopted revenue neutrality policies[2] that apply to the proposed annexation. This policy, which applies to

[2] Lake County LAFCo first adopted a revenue neutrality policy in 2002 and amended it a couple of times since. However, the LAFCo Executive Officer indicated that the changes were not significant and did not alter the fundamental nature of the policy. In 2019 Lake County LAFCo began the process of updating its policies, and a draft update is available on the LAFCo website. However, that update is not yet complete and this analysis is

all proposals, was first adopted by Lake County LAFCo in 2002, and is shown below (with emphasis added).

2.13. Revenue Neutrality

a) **Revenue Neutrality Applicable to All Proposals.** LAFCO will approve a proposal for a change of organization or reorganization only if the Commission finds that the proposal will result in a similar exchange of both revenues and service responsibilities among all affected agencies. *A proposal is deemed to have met this standard if the amount of revenue that will be transferred from an agency or agencies currently providing service in the subject territory to the proposed service-providing agency is substantially equal to the expense the current service provider bears in providing the services to be transferred.*

b) **Adjustment to Create Revenue Neutrality**. *In the event the expense to the new service provider is substantially greater than or less than that amount of revenue transferred from the current service provider, the current service provider and new service- providing agency must agree to revenue transfer provisions to compensate for the imbalance*. Such provisions may include, but are not limited to, tax-sharing, lump-sum payments, and payments over a fixed period of time.

c) **Failure to Achieve Revenue Neutrality**. Where achieving substantial revenue neutrality is not possible because of the limitations of state law, the Commission shall impose all feasible conditions available to reduce any revenue imbalance, or it may deny the proposal. The Commission recognizes that strict compliance with the revenue neutrality standard may be infeasible for certain proposals and that the need for service may sometimes outweigh the requirement for complete revenue neutrality. Where the failure to achieve revenue neutrality is primarily due to the disagreement of the affected agencies, the Commission shall normally deny the application.

d) **Revenue Sharing Agreements**. Paragraphs a, b, and c of this section will be considered to be complied with if:

   i) The affected agencies have agreed to a specific revenue split for the proposal and have filed a copy of that agreement with the Executive Officer with a statement that the agreement adequately provides for revenue neutrality, or

   ii) A master tax exchange agreement or agreed-upon formula is in effect between the affected agencies and the agencies confirm in writing that such agreement is applicable to this proposal and that it provides for a balanced exchange of service costs and revenues.

Subsection a) indicates that the costs incurred by the agency currently providing the service (in this case, the County) should be substantially equal to the amount of revenue that is transferred after annexation. Or, simply put, the amount of revenue the County gives up should be the same as the amount of cost savings it incurs, making the annexation revenue neutral to the County.

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based on the last adopted policy document from 2014. The proposed language in the 2019 update is not significantly different from the 2014 language.

Subsection b) further indicates that, if the cost for the new jurisdiction (in this case, the City) is more or less than the revenues transferred from the County, the two agencies must negotiate a tax exchange to compensate for the imbalance. Thus, in order to determine if the proposed annexation complies with the Lake County LAFCo revenue neutrality policy, three data points are needed:

1. The costs currently incurred by the County to provided services to the area (that could be eliminated upon annexation);
2. The revenues currently received by the County from the area (that could be subject to transfer to the City); and
3. The costs the City will incur to provide services to the area after annexation (in excess of current costs).

A. Current County Costs to Provide Services to the Annexation Area

Counties provide a wide variety of services to residents in their jurisdiction, some of which are provided without regard for the boundaries of incorporated cities. For example, services such as public health, social programs, tax collection, property assessor, trial courts, district attorney, and many County services are provided to residents equally whether they live in an incorporated city or not. Thus, the County's costs for these programs will not change upon annexation. Other services, such as building and safety, nuisance abatement, sheriff, and road maintenance, are provided primarily to those residents who are not in an incorporated city; those functions are typically performed by city governments for their residents.

In its report dated November 7, 2019, ADE evaluated the fiscal impact of the proposed annexation on the County (beginning on page 22 of the ADE report). However, its analysis focused on County costs and revenues *after* annexation and includes only costs for programs that the County will continue to provide, as described above. Table 16, on page 24 of the ADE report, indicates that, after annexation, and assuming implementation of the 1997 Agreement, the County will receive $80,201 in annual revenues while still incurring $88,743 in expenses, leaving an annual deficit of $8,542 upon annexation. However, the LAFCo revenue neutrality policy applies to the costs and revenues that will *change* upon annexation, not the costs and revenues that *remain* after annexation.

In estimating current County costs, MRG used the same basic methodology as employed in the ADE report and included only those services for which the County will see reduced service levels after annexation. Services are presumed to apply to each resident equally. Additionally, individuals who work in the County also benefit from public services, and are included in the cost calculation at one-half the resident rate. For each service, the program cost is divided by the service population as follows[3]:

County Residents	65,081
Half of Employees in the County (16,840/2)	8,420

[3] Data for population and employment in the County from the ADE report, page 23.

Total Service Population 73,501

	County Cost per 2019/2020 Adopted Budget	County Revenues per 2019/2020 Adopted Budget	Net County General Fund Cost	Cost per Resident	Cost per Employee	Residential Share of Costs in Annexation Area (21)[4]	Employee Share of Costs in Annexation Area (569)[5]	Total Value of Services to be Transferred to City
Building and Safety	$1,740,274	$1,712,921	$27,353	0.37	0.19	$7.82	$105.88	$114
Nuisance Abatement	$210,343	$36,000	$174,343	2.37	1.19	$49.81	$674.83	$725
Planning	$1,007,481	$507,481	$500,000	6.80	3.40	$142.86	$1,935.35	$2,078
Sheriff/Coroner[6]	$8,385,575	$623,646	$7,761,929	105.60	52.80	$2,217.66	$30,044.06	$32,262
POST training	$121,634	-	$121,634	1.65	0.83	$34.75	$470.81	$506
PW Administration	$787,670	$787,670	-	-	-	-	-	-
Animal Shelter/Control	$1,137,148	$201,000	$936,148	12.74	6.37	$267.47	$3,623.54	$3,891
Marketing and ED	$605,000	$605,000	-	-	-	-	-	-
CAO Office	$1,087,424	$5,000	$1,082,424	14.73	7.36	$309.26	$4,189.73	$4,499
Total Cost of Services								$44,074

In addition to these services, costs for maintaining the roads in the annexation area will also transfer to the City. These costs are calculated per lane-mile.

	County Cost per 2019/2020 Adopted Budget	County Revenues per 2019/2020 Adopted Budget	Net County Road Fund Cost[7]	Cost per Lane Mile, Entire County (1,013 lane miles)[8]	Cost in Annexation Area (1.9 lane miles)[9]
Road Maintenance[10]	$19,623,142	$13,155,449	$6,467,693	$6,384.69	$12,131

Combined, the County spends $56,205 each year to provide services to the annexation area that will be transferred to the City upon annexation. Upon annexation, the County will no longer have to incur these costs. However, it is important to note that the County may not actually experience reduced cash outflow, as it may be impractical or impossible to eliminate the smaller incremental costs and the County may shift these resources to other areas of the County rather than eliminate the cost entirely. This is particularly apparent in the Sheriff's Department, where the County is unlikely to eliminate a portion of one Deputy Sheriff as a result of annexation. More likely, the

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4 Data for population in the annexation area from the City's application for annexation.

5 Data for employment in the annexation area from the ADE report, page 3.

6 Costs shown include 90% of the total Sheriff/Coroner budget expenses and revenues. The Coroner function will not transfer to the City upon annexation. The County estimates that 10% of the overall budget represents costs for the Coroner function, which are excluded from this analysis.

7 Net cost includes expenses paid by tax revenues (accounts 10-XX) and gas tax revenues (52-XX).

8 Data for lane-miles in the County per the County CIP.

9 Lane-miles in the annexation area per the County.

10 The amount shown as County cost is equal to the total budgeted costs of $23,178,415 less the unfunded portion of the budget, $3,555,273.

time spent in law enforcement activities in the annexation area will readily be shifted to other areas of the County.

B. Revenues Currently Received by the County From the Annexation Area

The County generates revenues from several sources in the proposed annexation area that could be transferred to the City upon annexation. These include:

Sales Tax[11]	$490,000
Property Tax[12]	$66,316
Property Tax - Road Fund[12]	$3,910
Total County Revenues	$560,226

The County receives other revenues from the annexation area which cannot be transferred (for example, property tax in lieu of vehicle license fees) or which are user-fee based (and are netted out of the cost estimates earlier in this analysis and do not need to be included here).

In summary, the County receives $560,226 in revenues annually from the annexation area, and spends $56,205, leaving $504,021 that the County spends on other services and services in other areas of the County. It is very common for different land uses within cities and counties to generate a "profit" or "loss." For example, commercial areas nearly always generate more revenue than they cost to serve, with sales tax, transient occupancy tax, business license fees and similar revenues outpacing the cost to provide police, building and safety, and other services to business owners. Conversely, a typical residential neighborhood generates considerably less in property tax and other revenues than the costs to provide police, recreation, and similar services to residents. In a fiscally healthy jurisdiction, the "profits" received in commercial areas are sufficient to pay for the services in areas generating a "loss." In this case, the County relies on the $504,021 "profit" to pay for services to other areas of the County. The loss of these revenues, without an alternate funding source to offset the loss, could impair the County's ability to provide services to the remainder of the County.

Pursuant to the LAFCo revenue neutrality policy subsection a), the amount of revenue transferred from the County to the City upon annexation should not exceed the County's cost savings, or $56,205 annually, and the County would retain $504,021 annually for other services.

C. Costs the City Will Incur to Provide Services to the Area After Annexation

To determine the City's costs to provide services to the annexation area, MRG employed the same estimating technique used for the County. Like the County, the City provides some (albeit fewer) services that are not likely to change as a result of annexation, and those costs are excluded from this estimate. The service population is calculated as follows[13]:

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[11] Data initially provided by County Administrative Office with further estimates in the ADE report, page 17.
[12] Secured property tax data from ADE report, page 15. Unsecured tax revenue is added based on data provided by County. See discussion of property tax in this report for additional information.
[13] Data for population and employment within the City from the ADE report, page 18.

City Residents	5,134
Half of Employees in the City (3,835/2)	1,918
Total Service Population	7,052

	City Cost per 2019/2020 Adopted Budget	City Revenues per 2019/2020 Adopted Budget[14]	Net City General Fund Cost	Cost per Resident	Cost per Employee	Residential Share of Costs in Annexation Area (21)[4]	Employee Share of Costs in Annexation Area (569)[5]	Total Value of Services Transferred from County
City Manager	$818,995	$376,161	$442,834	62.80	31.40	$1,318.89	$17,867.86	$19,187
Economic Development	$133,000	$25,000	$108,000	15.32	7.66	$321.66	$4,357.68	$4,679
CD: Planning	$324,165	$45,658	$278,507	39.50	19.75	$829.48	$11,237.45	$12,067
CD: Building	$241,823	$80,286	$161,537	22.91	11.45	$481.11	$6,517.84	$6,999
CD: Housing	$20,000	$10,000	$10,000	1.42	0.71	$29.78	$403.49	$433
Police[15]	$2,460,439	$64,000	$2,396,439	339.87	169.94	$7,137.32	$96,693.65	$103,831
PW Administration	$579,139	$426,643	$152,496	21.63	10.81	$454.18	$6,153.04	$6,607
Total Cost of Services								$153,803

In addition to these services, costs for maintaining the streets in the annexation area will also transfer to the City. These costs are calculated per lane-mile.

	City Cost per 2019/2020 Adopted Budget	City Revenues per 2019/2020 Adopted Budget	Net City Cost[16]	Cost per Lane Mile, entire City (58.9 lane miles)[17]	Cost in Annexation Area (1.9 lane miles)[9]
Street Maintenance	$1,781,477	$470,400	$1,311,077	$22,259.37	$42,293

Combined, the City anticipates spending $196,096 each year to provide services to the annexation area, in addition to costs already incurred. However, in some cases, the City may not actually experience increased cash outflow, as the City may choose to use existing resources to provide these services rather than increase staffing or other costs.

The costs of parks and recreation services are excluded from this analysis. Neither the County nor the City provide significant recreation programming, although both maintain parks (but not in the annexation area). For this analysis, MRG assumes that the residents in the area are already using the City and County parks as they desire and neither the City nor County will see changes in services as a result of the annexation.

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14 General Fund excluded as a revenue source.

15 Includes City's cost for animal licensing, control and shelter services (provided through a contract with the County).

16 Net City Cost includes general fund revenues and gas tax.

17 Data for lane-miles provided by the City.

The ADE report also estimates the City's costs to provide services to the annexation area, and concludes that, upon annexation, the City will spend $235,508 annually[18] on services, approximately $36,500 more than the estimate above. The ADE estimate includes costs for all services, whether or not they will increase after annexation. For example, the ADE estimate includes Parks/Building Maintenance (excluded as noted above) and Non-Departmental costs (which are fixed and won't increase after annexation). To ensure that the cost calculations are equivalent for both the City and County, MRG excluded these costs and only included costs that reflect a service level change after annexation.

D. Summary

The LAFCo revenue neutrality policy subsection a) requires that the revenue transferred from the County should be equal to the County's cost savings. Thus:

County Cost Savings and Amount of Revenue Transfer to City:	$56,205
Revenues Currently Received by the County:	$560,226
Amount to be Retained by County:	$504,021

However, subsection b) states that, if the City will incur costs in excess of the County's costs, the City and County should negotiate an equitable tax sharing agreement to compensate for the imbalance. Thus:

City Cost Increase and Amount of Revenue Transfer from County:	$196,096
Revenues Currently Received by the County:	$560,226
Amount to be Retained by County:	$364,130

The City and County could negotiate a tax sharing agreement that transfers between $56,205 and $196,096 in revenues annually from the County to the City, leaving the County with revenues from $364,130 to $504,021 for other services. Note that this analysis does not include $661,000 in additional sales tax revenue that the City will generate upon annexation. (See also the table on page 2).

Note that the LAFCo policy does not specify a sunset date for revenue transfers, nor does it prohibit the City and County from negotiating a lump-sum transfer in lieu of ongoing tax sharing. As long as both parties agree that the overall agreement meets the LAFCo revenue neutrality policy, such agreements are permissible.

VIII. WATER SERVICES

The area currently is served only by individually owned wells and/or water delivery, with no municipal water service available from any local government agency. This is a significant impediment to growth in the area, and, as described in a letter from the Lakeport Fire Protection District Vice Chairman dated December 12, 2019, has left the area with unsatisfactory fire suppression services. Insufficient fire flows are likely making it difficult for property owner to

[18] ADE report, page 20.

obtain adequate and affordable fire insurance. The provision of municipal water service to the area has been the subject of much disagreement between the City and County for many years, with each believing it is best equipped to serve the area.

In the annexation application, the City proposes to extend water service from the City limits southward into the annexation area. The City indicates it has adequate water capacity to serve the area, has a main line immediately available for extension, and that it has completed preliminary engineering and can construct the water extension in the annexation area at the same time as regionally funded road improvements are built. The City intends to fund the project with local funds, unidentified grants and future connection and user fees. The City has also indicated that it will not require property owners to connect to water service, leaving the decision to each property owner.

The County proposes to extend the Kelseyville water system northward to the annexation area. However, it is unclear that the Kelseyville system has the capacity to serve the annexation area. The County's application to the United States Department of Agriculture for funding assistance was not approved and the County has recently applied to the Economic Development Administration ("EDA") for funding assistance. Success with the EDA grant will be based on the potential for job creation in the annexation area. As the County has been unable to extend water to the annexation area despite development pressures for many years, it is unclear how realistic the Kelseyville proposal would be.

Additional research could further analyze the relative technical merits of the City and County proposals to provide water to the annexation area. However, the annexation area is in the City's adopted sphere of influence. Spheres of influence are created to shape the orderly development and provision of services, and the decision as to which agency is better equipped to provide service was resolved when LAFCo included the area in the City's sphere of influence. State law prohibits LAFCo from approving applications which are inconsistent with adopted sphere of influence plans. Additionally, the City already supplies water to customers immediately adjacent to the annexation area, and the City has a ready supply of water. The City is in the best position to provide water service and could construct the necessary infrastructure upon annexation (or as part of the pending road improvement project). The annexation agreement should provide that the City will construct and operate water services in the annexation area.

IX. WASTEWATER COLLECTION AND TREATMENT

Wastewater collection services are currently provided to the area by the LACOSAN (a County dependent district). While, LACOSAN owns and operates the wastewater collection system in the proposed annexation area, the wastewater is treated at the City's wastewater treatment facility through an agreement. Under the terms of this agreement, LACOSAN pays the City for the costs of treatment. This agreement expires in 2026 and, at that time, with no annexation, the City and LACOSAN would have to negotiate an extension to this agreement or LACOSAN would need to find an alternate way to treat the wastewater. In the annexation application, the City indicates it would prefer that the "collection system be transferred to the City for maintenance and operation activities." However, it acknowledges that an extension of the existing agreement is also an acceptable option. The County, speaking on behalf of LACOSAN, has noted that the current arrangement works well.

Services are provided adequately under the current arrangement and this arrangement can continue after annexation. An annexation agreement could indicate the intent of the City and County to further consider the ownership and operation of the collection system after annexation.

X. ROAD IMPROVEMENTS

A major road improvement project, the South Main Street and Soda Bay Road Widening and Bike Lanes Project, has been planned for many years. Funding for this regional project is provided by various grants and regional transportation funds which would be available to either the City or the County to construct the project. However, the County is funding the local share using its HUTA funds. This project is planned for construction regardless of the annexation. The City indicates the County could continue to manage the project after annexation if desired, or the City could oversee the project if desired.

Similar to water system improvements, the annexation area is in the City's sphere of influence and the City would be in the best position to construct these improvements after annexation. However, the County may be far enough along in project design and right-of-way acquisition that project transition to the City would be unnecessarily cumbersome. If the project cannot be transferred to the City efficiently, then the County can continue to manage the project in coordination with the City (including construction of the City water line extension).

The County estimated spending approximately $830,000 from its local HUTA funds on the project; however, recently the County indicated the project budget is under review and this estimate will increase. If the City assumes responsibility for the project, it will need to identify an alternate funding source for the local match. Alternately, if the County remains responsible for the project, negotiations between the City and County regarding reimbursement to the County for some or all of its HUTA funds will be necessary for annexation. During negotiations, the County should provide an updated accounting and estimate of anticipated HUTA funds required for the project.

XI. NEXT STEPS

We believe the City and County would both be best served by taking a fresh approach to negotiations, seeking solutions that benefit both jurisdictions. We encourage the City and County to proceed with the intention of reaching an agreement quickly, as infrastructure is critically lacking, revenues that could be used to provide needed services are not being collected, and the Board of Equalization annual deadline looms in December.

In our experience, negotiations are most successful when the elected bodies agree to desired outcomes and principles (addressed earlier in this report), then empower their agency executive officers to work together to reach those goals, providing regular updates and obtaining direction as needed. Ultimately the Board of Supervisors and City Council must agree to any tax sharing agreement. However, negotiating sessions are most productive when elected officials are not present. We suggest the Board of Supervisors and City Council provide direction to their executive during appropriate closed sessions, but refrain from direct involvement in negotiations.

The City and County could consider the use of a neutral third party to facilitate productive conversations and complete additional fiscal analyses if needed. It is not uncommon to involve a neutral third party to facilitate the discussions, offer alternatives, document positions and interim agreements, and provide a third-party perspective. This approach could also expedite the conversations and shorten turn-around time for proposals, recognizing the limited timeframe available to conclude these negotiations.

In order to jumpstart the conversation, we have identified several critical areas of agreement which must be addressed in a potential tax sharing agreement (attached). This is intended to serve only as a starting point for discussion, and each of the terms will require refinement and negotiation. It is critical that both parties fully explore and define the intent of each of the terms in the agreement in order to assure its long-term viability in the event of a change in circumstances.

Ultimately, annexation will be decided by the residents and property owners in the area, as state law requires LAFCo to conduct a protest hearing, allowing residents and property owners an opportunity to protest the annexation (see Government Code sections 57050-57075). We believe they will be more likely to support the annexation if the City and County can reach an agreement that benefits everyone affected by the annexation. the City and County, residents, business owners, and property owners. With the City and County in agreement, the annexation will be successful.

ATTACHMENT – POTENTIAL AGREEMENT FRAMEWORK

Annexation Agreement
City of Lakeport and County of Lake
South Lakeport Annexation Area

Negotiation Principles:

1. The City and County recognize and embrace the public purpose of the other and acknowledge that both communities can benefit significantly if the annexation is completed. The City and County will not pursue an agreement that benefits one at the expense of the other.

2. A sense of urgency is needed. The City and County agree to pursue a timely agreement that brings benefits to the residents and businesses in the area as soon as possible.

3. The City is in a better position to provide improved public services. The annexation area is in the City's sphere of influence, and the City is in a better position to extend and manage new infrastructure and growth.

Annexation Deal Points:

1. Property tax revenues generated in the area that currently accrue to the County General Fund, including both current revenues and future growth, will be split between the City and County according to the following ratios:
    a. City of Lakeport: XX%
    b. County of Lake: XX%

    Property tax revenues currently accruing to the County Road Fund will accrue to the City after annexation. Property tax revenues currently accruing to all other agencies will remain unchanged.

2. Base (1%) sales tax revenues generated in the annexation area, along with all future growth on the base sales tax revenues, will be split between the City and County according to the following ratios:
    a. City of Lakeport: XX%
    b. County of Lake: XX% (note this should be substantial enough to be consistent with the revenue neutrality requirement)

3. Sales tax revenues generated in the annexation area as a result of City sales tax Measures I and Z, including all future growth, will accrue to the City.

4. After annexation, the City will construct a water line extension to serve the annexation area and will provide water service to all property owners. The County will not pursue the extension of water service to the area.

5. After annexation, the City will construct the South Main Street and Soda Bay Widening and Bike Lanes Project. The County has already incurred $XX costs for this project, including acquisition of right of way and preliminary engineering. The City will reimburse the County in the amount of $XX and the County will provide to the City all engineering reports, appraisals, designs and other reports and documents that support project development and construction. The remaining project costs that are not funded through regional funds or grants will be the responsibility of the City.

6. The current agreement between LACOSAN and the City for the provision of wastewater treatment services expires in 2026. The City and County agree that, upon expiration of the agreement, the area will be best served by the City taking ownership and responsibility for wastewater collection in the annexation area. Both City and County will negotiate in good faith after the annexation is complete to reach agreement for the transfer of wastewater collection assets from LACOSAN to the City prior to expiration of the agreement.