Larry J. Calemine
Executive Officer
Los Angeles Local Agency Formation Commission
700 North Central Avenue, Suite 350
Glendale, CA 91203

Re: Request by the City of Los Angeles for the State Controller’s Review of the Comprehensive Fiscal Analysis for the Proposed Special Reorganization for the San Fernando Valley

Dear Mr. Calemine:

INTRODUCTION

Pursuant to former California Government Code § 56833.3(a), a provision of the Cortese-Knox Local Government Reorganization Act of 1985, as amended,¹ the City of Los Angeles, a party “interested” in the proposed special reorganization involving the San Fernando Valley, requests that you, as LAFCO’s Executive Officer, request the Controller of the State of California to review the Comprehensive Fiscal Analysis (“CFA”) for the San Fernando Valley Special Reorganization that was presented to the LAFCO Commission on January 9, 2002. While this request is made in

¹ Former California Government Code §§ 56000 et seq. The Valley special reorganization is governed by the Cortese-Knox Local Government Reorganization Act of 1985, as amended, former California Government Code §§ 56000 et seq. That statutory framework for the organization and reorganization of local governmental entities was substantially revised by the Cortese-Knox-Hertzberg Act of 2000, California Government Code §§ 56000 et seq. The newer Act is made expressly applicable only to reorganization applications filed on or after January 1, 2001. See California Government Code § 56101. The Valley application was filed in 1999. Hence, the citations throughout this report are to “former” sections of the California Government Code.
conformity with the procedures for making such requests adopted by LAFCO on January 23, 2002, the City does so in protest of some of these procedures (as explained below). Subject to this qualification, the City has enclosed with this application a check for $25,000 and agrees to pay the additional costs of the review as set forth in the procedures. While this request concerns the January 9, 2002 CFA, the City similarly lodges a protest of having been given the opportunity to seek Controller review only of a fiscal analysis of a special reorganization proposal which by all indications appears to be dead. Our concerns in this regard are also explained below.

This request has been presented to ensure that LAFCO makes a decision regarding the proposal studied in the CFA that is informed by a sound and complete fiscal analysis. We have supplied the additional data we believe is required in the package of documents that accompanies this letter. However, to the extent that the Controller requires additional information, the City will make every effort to accommodate that need, such as, by supplying additional documentation or City staff assistance. The Controller has advised you that it would be prudent to allow for work space at LAFCO’s consultant’s offices for auditors from her office. In this regard, the City will provide the Controller’s office with work space for its auditors in City facilities should that be desired.

SUMMARY OF MAJOR CONCERNS

A. Fiscal Viability and Effects on Other Agencies

The concerns raised herein relate to both subjects:

Several suspected errors or omissions bear on fiscal viability. Some examples: the low level of reserves, the unresolved cash flow situation, the questionable assumptions on revenue growth.

Concerns are raised with regard to the incorporation’s effect on other agencies, most notably but not exclusively, the remaining City of Los Angeles. Chief among these concerns is the CFA’s failure to contemplate what happens to the remaining City’s fisc at the end of transition and any service contracts. Another major concern – the fiscal uncertainty transmitted to the remaining City by a new city that is shaping up as fiscally unstable and may thus be unable to make substantial, regular payments to the remaining City.

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2 Procedures for Requesting that LAFCO Request the State Controller to Review a Comprehensive Fiscal Analysis (January 23, 2002).
B. Material Effect of Suspected Errors on the CFA’s Findings

The proposal’s placement of the new city on a precarious financial perch represents a material concern.

The apparent error regarding documentary transfer tax revenue may make the proposed new city inviable, if LAFCO staff has correctly analyzed the matter.

The CFA’s incorrect interpretation of the revenue neutrality obligation has catastrophic implications for the remaining City’s future after transition and the termination of any service contracts.

C. Material Effect of Suspected Omissions on the CFA’s Findings

With insufficient detail presented regarding the service level planned for the new city, a miscalculation in this regard could materially affect the proposal if it is desired that the Valley city continue with the same level of municipal services now being received.

The CFA’s failure sufficiently to account for certain costs, including the new city’s start-up costs and its payment of transition costs to the remaining City, could have a material impact on the analysis.

IDENTIFICATION OF SPECIFIC ELEMENTS FOR REVIEW BY THE STATE CONTROLLER (listed in order of priority)

Issue No. 1:
Does the CFA provide for a sufficient level of reserves for the reasonable operation of the proposed new city?

Reasons for Review:
The City believes that the projected reserve levels are insufficient and that the following fiscal impacts are likely:

a. A decrease in services beyond the level stated in the CFA.
b. An increase in taxes or fees in the new city after incorporation.
c. An increased risk to the remaining City of Los Angeles budget, as the new city may default on payments to the City (e.g., debt, service contracts, mitigation payments) and thereby potentially cause massive adverse service level impacts to the remaining City. This concern has been raised by Moody’s Investor Service and should be factored into the findings of the CFA.
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Section/Page Numbers:  
CFA (Fiscal Viability of New City) at 6-12.  
CFA App. I (Analysis of Final Proposal and City Response) at 12.  
CFA Table R-1, Allocation of General Fund Revenue.

Suspected Error or Omission:  
The CFA adopts a structural reserve level of approximately 0.7% and assumes accumulation of all reserves over a three-year period to achieve a reserve level of approximately 2%. CFA at 12; App I at 12. Sound financial management requires a reserve considerably higher than 0.7%. Unforeseen circumstances, such as payouts required by litigation, call for a sufficient reserve. The CFA has assumed a level of fiscal stability in the proposed new city greater than in the existing City of Los Angeles without having a basis for doing so.

Proposed Remedy:  
Consideration should be given to the reserve levels of and relative fiscal risks undertaken by cities of comparable size to the secession area and the opinions of the major rating agencies on these levels and risks. The assumption that all reserves will accumulate over the first three years should be reviewed. The three major rating agencies should be surveyed. The budget for the proposed city should incorporate the reserve levels recommended by these rating agencies. See Moody’s Investor Service, 2001; CAO Response, June 11, 2001; RJ Rudden Report, 2001.

Suspected Error or Omission:  
The CFA appears to assume revenue growth equal to expenditure growth. Fiscal year 2002-2003 is expected to experience declining revenues. Certain costs -- such as employee compensation, costs of goods and services, postage, leases, petroleum, and electricity -- are projected to increase in 2002-2003. Consider, for example, current labor contracts (“memoranda of understanding” or “MOUs”) that call for salary increases. See MOUs enclosed. Under Cortese-Knox, those labor contracts must be honored.3 Hence, the apparent assumption appears to be flawed. CFA at 12-35; App I at 4; App III.

Proposed Remedy:  
A more realistic view of anticipated revenues and expenditures should be assumed by a revised CFA. See RJ Rudden Report, 2001; CAO Report on Draft CFA, 2001; CAO Financial Status Report (monthly -- most recent enclosed). The fiscal experience of other comparable municipalities and governmental agencies should factor into the analysis.

Suspected Error or Omission:  
In providing a complement of 19 employees to administer essential municipal functions and ensure compliance with service contracts with the City of Los Angeles, the CFA has provided a staffing

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3 See former California Government Code § 56844.2(b).
level insufficient to sustain current service levels in the proposed new Valley city. See CFA at 15-16, 19; App I at 7.

Proposed Remedy:
The CFA should be revised to reflect the staffing required to sustain current service levels, with the projected reserve adjusted accordingly. See CAO Report on Draft CFA, 2001.

Suspected Error or Omission:
The CFA contains inaccurate election and contract administration costs and does not appear to account for repayment to the City of all transition costs (costs incurred by the City as a result of the special reorganization). CFA App. I at 11-12.

Proposed Remedy:
The CFA should be revised to reflect accurately and completely the costs mentioned. See CAO spreadsheet on transition costs; CAO Report on Initial Fiscal Analysis ("IFA"), June 2001; CAO Contract Administration Memorandum.

Suspected Error or Omission:
The CFA appears to have misstated the revenue impact of the documentary transfer tax. CFA at 28. LAFCO staff indicates that general law cities, such as the proposed new city, cannot raise as much of this tax as can charter cities, such as the City of Los Angeles. A January 23, 2002 report from LAFCO staff indicated that this error in the CFA would diminish revenues by $30.9 million and require a demonstration of fiscal viability through cost savings and/or additional revenue to achieve fiscal viability. See Report at 8-9.

Proposed Remedy:
Assuming this difference in taxing authority, the CFA should be revised accordingly. LAFCO Staff Report, January 2002.

Suspected Error or Omission:
The CFA fails sufficiently to account for start-up costs (additional costs the new city would incur as a result of the special reorganization). CFA at 12-20, 38-41; App I at 1-3.

Proposed Remedy:
The CFA should be revised to account for these costs. See CAO spreadsheet on transition costs; CAO Report on IFA, June 2001.

Other:
The CFA studied a proposal for a city whose territory included the Cahuenga Pass area. On January 23, 2002, the LAFCO Commission voted to exclude this area from the territory of the proposed Valley city. As explained more fully below, all indications are that LAFCO will be considering a
dramatically different proposal than that studied in the CFA. All indications are that this new proposal will exclude the Cahuenga pass area. If LAFCO proceeds to consider a proposal so revised, a fiscal analysis for the new proposal will need to take this into account. See LAFCO Staff Report, January 2002.

Identification of Supplemental Information:
See attached Schedule of Supplemental Information (Attachment A).

Issue No. 2:
Does the CFA adequately analyze whether the remaining City of Los Angeles will be subjected to financial harm?

Reasons for Review:
Cortese-Knox requires that a CFA study the “effects on the costs and revenues” of any affected agency. The remaining City obviously would be an affected agency. Also, AB 62 in the 1997 California Legislative Session paved the way for the feasibility of special reorganizations. The history of that measure reflects the intention that the remaining City not be subjected to financial harm. The most obvious form of financial harm would present itself in the need to raise revenues and/or cut service levels for the residents and businesses in the remaining City.

Section/Page Numbers:
CFA (Fiscal Impact on the City of Los Angeles) at 37-41.

Suspected Error or Omission:
The CFA fails to analyze the fiscal, service level, and employee impacts to be incurred by the remaining City after the termination of the transition period or service contract. CFA at 9-10. The CFA does discuss the possibility of a decrease in certain federal and state funding in the remaining City. See CFA at 10. But the larger consequences of the closure of the revenue stream from the Valley are not examined.

Proposed Remedy:
The CFA should correctly and fully analyze the fiscal effects of the proposal on the remaining City. See CAO Response to IFA, June 2001; CAO response to Draft CFA, December 2001.

Suspected Error or Omission:
The CFA does not take into account a comprehensive list of transition costs (the costs the City incurs implementing the special reorganization). CFA at 38-41; App I at 1-3; CAO Report on IFA, June 2001; CAO spreadsheet on transition costs.

Proposed Remedy:
The CFA should do so.
Suspected Error or Omission:
The CFA proposes that the new city would be required to make payment to the City by paying a portion of its revenues no longer collected by the City following incorporation. The new city will have a negative cash flow during its first year attributable to lags in revenue receipts. The CFA does not recognize the negative cash flow and mitigate the risk that the City would face of non-payment under these circumstances. CFA App I at 2-3; RJ Rudden Report, 2001.

Proposed Remedy:
The CFA should incorporate cash flow consequences into its analysis.

Suspected Error or Omission:
Some of the formulae used in the CFA for allocation of debt change the existing debt burden. This change is unfair because the debt was incurred in reliance on revenue streams that included those coming from the Valley. A result of this change is a reduction in the level of debt service to be received from the Valley by the remaining City. CFA App II at 173-77; CFA E Tables.

Proposed Remedy:
The existing debt burden for all parties should be maintained. See CAO Report on IFA, June 2001; CAO spreadsheets on debt distribution.

Suspected Error or Omission:
The CFA fails to examine the cumulative effect of fiscal conditions being planned for the new city. The low reserve when coupled with the substantial payments that are to be made to the remaining City for debt service, mitigation payment, transition costs, and service contracts collectively will place the new city under tremendous fiscal pressure. With the remaining City so dependent upon these payments, the remaining City similarly will be put at substantial fiscal risk. This overall circumstance is not examined by the CFA. CFA at 36; App I at 12-15; CAO Report on IFA, June 2001; Moody’s Investor Service, 2001; RJ Rudden Report, 2001; CAO Report on Cash Flow Evaluation, December 2001; CAO spreadsheets on debt distribution.

Proposed Remedy:
The CFA should do so.

Identification of Supplemental Information:
See attached Schedule of Supplemental Information (Attachment A)

Issue No. 3:
Does the CFA adequately address the fiscal impact of the proposal on other affected agencies?
Reasons for Review:
The fiscal impact on other affected agencies should be analyzed in the CFA, as required by Cortese-Knox.

Section/Page Numbers:
CFA (Financial Viability of New City) at 11-13, 20-36
CFA App. II at 6-9

Suspected Error or Omission:
The CFA does not appear to account for the impact on other cities throughout California related to the decrease in receipts of Vehicle Licensing Fees ("VLF") that would result from the redistribution of these funds to a newly incorporated city. State law provides an increased level of VLF revenues for newly incorporated cities. There is finite amount of VLF revenues statewide. Therefore, an increase for one means a decrease for others. CFA at 33.

Proposed Remedy:
The CFA should analyze these consequences. See CLA spreadsheets on LAFCO VLF Analysis.

Suspected Error or Omission:
The CFA also does not appear to account for the decrease in revenues caused by the loss of a portion of documentary transfer tax which impacts both the City and County of Los Angeles. CFA at 28; App I at 20.

Proposed Remedy:
The CFA should account for the correct level of these revenues. LAFCO Staff Report, January 2002.

Suspected Error or Omission:
The CFA does not consider the impact on the County of Los Angeles of a shift of Older Americans Act funds from the City for administration of aging programs in the secession area previously administered by the City. CFA at 31; App I at 21.

Proposed Remedy:
A revised CFA should examine this issue. CAO Response to Initial CFA, June 2001.

Suspected Error or Omission:
The CFA does not consider the potential impact on the County of Los Angeles concerning that portion of Universal City located in unincorporated territory that would result from a change in responsibility for fire and law enforcement services once a transfer of service from the City of Los Angeles to a proposed new city occurs. That area attracts a substantial number of tourists and other visitors.
Proposed Remedy:
A revised CFA should consider this matter.

Identification of Supplemental Information:
See attached Schedule of Supplemental Information (Attachment A)

Suspected Error or Omission:
The CFA does not consider the potential impact on the City of San Fernando of a change in responsibility for fire services once a transfer of service from the City of Los Angeles to a proposed new city occurs. By contract, the City Los Angeles currently provides fire services to the City of San Fernando.

Proposed Remedy:
A revised CFA should consider this matter.

Issue No. 4:
Does the CFA establish an accurate service level for the proposed new city (a) equal to the current level and (b) based upon a base year budget of the City of Los Angeles?

Reasons for Review:
Accuracy of the service level and associated cost is essential to a realistic assessment of the nature of the government being proposed. This information is also required to estimate a baseline for a transition year and for future contract negotiations.

Section/Page Numbers:
CFA App. II (Cost of Purchased Services) at 1-177

Suspected Error or Omission:
Insufficient detail is provided in the CFA to support the service level presented. Specific positions, classifications, and costs are not detailed enough in their allocation to support the apportionment contained in the CFA. CFA App II. Hence, it is not known whether the service level and associated costs have a fiscally sound foundation.

Proposed Remedy:
Augment the CFA with the requisite detail and determine whether the CFA correctly reflects service level and cost information. CAO Response to Draft CFA, December 2001; CAO Report on Stranded Costs, January 2002.

Identification of Supplemental Information:
See attached Schedule of Supplemental Information (Attachment A)
Issue No. 5:
Did the CFA’s calculation of revenue neutrality reflect the cost impacts the City will realize at the end of the transition or service contract period? CFA at 37; App. I at 10-11.

Suspected Error or Omission:
The CFA’s calculation of revenue neutrality does not reflect the cost impacts to the City after the end of the transition or service contract period. The CFA evidently pegged revenue neutrality at $65.8 million by deducting the City’s budgeted expenditures for services that would be paid by the Valley city through a service contract with the City (i.e., the cost of purchased services) from revenues that would accrue to a Valley city (i.e., revenues lost to the City).\(^\text{4}\) The City has voiced objection to LAFCO concerning this approach on several previous occasions. See, e.g., letter of June 7, 2000 from Frederick N. Merkin of the City Attorney’s Office to Assistant County Counsel John F. Kratli. The City believes that the correct approach required an assessment of the savings the City would enjoy by not having to service the Valley. In the City’s view, these cost savings should then be deducted from lost revenue to yield the mitigation payment (or other lawful form of mitigation) required by the revenue neutrality law. These savings will be much less than the projected cost of purchased services, because the City will need to maintain many centralized and non-divisible services (resulting in “stranded costs”) in order to continue the same service level of service to the residents of the remaining City post-secession. While the question of what methodology Cortese-Knox requires to calculate revenue neutrality is a legal one to be resolved, if at all, in the courts, this request asks only that the Controller review and confirm that the CFA’s calculation of revenue neutrality did not take these costs into account.

The CFA noted the City’s contention that certain municipal functions are not divisible, that secession would not result in a reduced workload for certain City personnel, and that new personnel would have to be hired to maintain the same level of service for the remaining City. The CFA observed that with a reduction in the City’s population of over 36% (more than 1.3 million people), with certain noted exceptions “the remaining workload confronting City departments would decrease significantly across the range of municipal operations.”\(^\text{5}\) According to the CFA, to make its case, the City would need to produce data demonstrating the absence of workload reduction. The CFA went on to state that since these data had not been supplied, “it is difficult to substantiate the

\(^{\text{4}}\) CFA at 8.

\(^{\text{5}}\) CFA at I-11 (footnote omitted).

\(^{\text{6}}\) The City disputes this contention. The City supplied data requested by LAFCO’s consultant and more, and demonstrated the correct methodology in submissions to LAFCO more than once and early on. Thus, LAFCO’s consultant had a road map as to how to analyze the true workload reduction that would be realized should the City no longer provide services to the Valley.
argument that the City’s workload would not decrease.” Yet, in the end the CFA asserts that it avoids the problem raised by the City because of the service contract model studied. According to that approach, few, if any, City employees would be transferred to the Valley city, as the City would continue to render virtually all services to the Valley. Hence, the City would not be required to hire additional personnel.\(^8\) CFA App I at 10-22; App II Cost of Purchased Services; CFA E Tables. The result of such an approach is to ignore the substantial fiscal impacts that the City of Los Angeles will realize at the end of the transition period or termination of any service contracts, when the City is no longer compensated for centralized and non-divisible costs through contract payments from the Valley, and these costs become stranded. Absent mitigation, the proposal under study would push the remaining City of a financial cliff at this point. The CFA approach also fails to address the need for that impact to be mitigated by a revenue neutrality payment (or other lawful form of mitigation) in order to preserve existing service levels in the remaining City.

The Controller is requested to confirm only that: the description above accurately reflects how the CFA went about calculating revenue neutrality. Whether this was the correct methodology is a different question altogether. Whatever methodology is to be applied constitutes a derivative of the interpretation of the revenue neutrality law.\(^9\) Disputes over that interpretation must be resolved, if they are to be resolved, in the courts. This issue’s low placement on the City’s priority list should not be seen as a reflection of the City’s belief in the relative unimportance of the issue. On the contrary -- the revenue neutrality methodology to be applied here represents an issue of prime importance to the City. The City has placed this issue here because it clearly turns on the interpretation of a statute.

**Proposed Remedy:**

**OTHER ISSUES**

1. **LAFCO’s Procedures Unduly Constrain the Controller’s Review of a CFA**

On January 23, 2002 LAFCO adopted written procedures for requesting the Controller’s review of incorporation proposals. Some of these procedures unduly constrain that review. While the City has

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\(^7\) CFA at I-11.

\(^8\) CFA at I-11.

\(^9\) Former California Government Code § 56845.
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filed its request in accordance with these procedures, it does so under protest and reserving its right 
to challenge their legality. As we shall explain, the procedures are of dubious provenance and 
include certain provisions that are plainly unlawful.

The proposed Valley secession would be a “special reorganization” of the City -- a reorganization 
that entails both detachment of the Valley territory and its incorporation as a new city.\textsuperscript{10} Cortese- 
Knox requires that for proposals that include incorporations, LAFCO’s executive officer is to prepare 
or cause to be prepared a CFA, an analysis that is to constitute part of the executive officer’s report 
to the LAFCO Commission.\textsuperscript{11} Cortese-Knox then offers an “interested party” the opportunity to 
request through the executive officer a “review” of the CFA by the State Controller.\textsuperscript{12} Cortese-Knox 
requires that a LAFCO Commission approving a proposed incorporation “accept or reject” each of 
the findings and recommendations in your report on the proposal and in the CFA and that rejection 
of any such finding or recommendation shall require a Commission finding presenting the “basis” 
for doing so.\textsuperscript{13}

The request for the Controller’s review be shall in writing and specify the “element or elements” of 
the CFA that the Controller is being requested to review and the “reasons” the Controller is being 
requested to review them.\textsuperscript{14} LAFCO “may” adopt procedures for “acceptance, referral, and payment” 
regarding these review requests. These procedures “shall” include a time period within which the 
request may be made, which period may not be less than 30 days following notice by publication in 
the manner specified by statute.\textsuperscript{15}

Within 45 days of “receiving” the CFA, the Controller “shall” issue a report to the executive officer 
“regarding the accuracy and reliability of the information, methodologies, and documentation” used 
in the CFA. The Controller’s report is to form part of the executive officer’s report to the LAFCO 
Commission concerning the incorporation proposal.\textsuperscript{16} The Controller may charge LAFCO for 
“actual costs,” which LAFCO may pass on to the requesting party.\textsuperscript{17}

\textsuperscript{10} Former California Government Code § 56075.5.

\textsuperscript{11} Former California Government Code § 56833.1.

\textsuperscript{12} Former California Government Code § 56833.3(a).

\textsuperscript{13} Former California Government Code § 56852.3.

\textsuperscript{14} Former California Government Code 56833.3(a).

\textsuperscript{15} Former California Government Code §§ 56833.3(b); 56153.

\textsuperscript{16} Former California Government Code § 56833.3(c).

\textsuperscript{17} Former California Government Code § 56833.3(d).
When the CFA in question was presented to the LAFCO Commission on January 9, 2002, no procedures for Controller review were in existence. It was not until two weeks later (January 23, 2002) -- but 19 days before the deadline for filing the requests for review -- that procedures were considered and adopted by the Commission. This sequence of events was manifestly unfair to the City and other interested parties.

The procedures themselves contain constraints and requirements that cannot be squared with Cortese-Knox or accepted notions of fundamental fairness. In authorizing LAFCOs to adopt procedures for “acceptance, referral, and payment” in regard to requests for the Controller’s review, Cortese-Knox has not authorized LAFCOs to adopt procedures which in their totality have the obvious effect of insulating CFAs from review and discouraging those who would seek such review. Consider the following problematic procedures:

- Recovery of LAFCO staff or consultant costs from the requesting party.¹⁸

Cortese-Knox calls for recovery of the Controller’s costs from the requesting party. Not a word is said about any other costs. It is to be borne in mind that as to the pending special reorganization proposals, the CFAs were funded by state, county, and City funds. These funds should be looked to for any costs incurred by LAFCO in connection with the Controller’s review.

- LAFCO’s right to reject all or part of a request that “would require significant data discovery efforts or that would otherwise delay or inhibit or prevent” the Controller from meeting the 45-day deadline.¹⁹

While the 45-day deadline is clearly established by state law, this restriction finds no foundation in Cortese-Knox. LAFCO’s Executive Officer has a duty under former California Government Code § 56833.3(a) to request the Controller’s review. Factors that might affect the Controller’s ability to meet the 45-day deadline should be for the Controller, not LAFCO, to address.

- The request must include a “description of the suspected error or omission.”²⁰

- The request is to include the “requesting party’s proposed remedy to the suspected error or omission.”²¹

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¹⁸ Procedures at 1, 3.

¹⁹ Procedures at 1.

²⁰ Procedures at 3.

²¹ Procedures at 3.
These requirements similarly have no root in Cortese-Knox, which requires only that the requesting party identify the “elements” to be reviewed and the “reasons” for doing so. Not only do these procedures require the requesting party to identify an error or omission, they also require presentation of a solution. Neither Cortese-Knox nor fairness considerations support shifting this obligation from LAFCO to the requesting party.

- The requesting party “may” provide “additional data” with its request. If “any supplemental data” are identified for the Controller’s consideration, they must be “submitted with the request” unless they are contained in the CFA.

- “Supplemental data” must be identified in the request and provided at that time unless they are contained in the CFA.

These data requirements impose substantial and undue burdens on requesting parties. Their application to these CFAs is particularly unfair because these procedures did not exist until about three weeks before the deadline (February 11, 2002) for requesting the review.

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The constraints and burdens discussed above cannot be harmonized with the purposes underlying the Controller’s review. The requirement that there be a CFA and an opportunity for Controller review came into Cortese-Knox in 1989 out of a concern for the accuracy of financial projections developed by LAFCOs in regard to incorporation proposals. A 1990 amendment that required the party requesting the review to identify the “elements” to be reviewed and the “reasons” therefor was animated by the concern that otherwise reviews could be requested for purposes of delay. Had the constraints and burdens discussed above been intended, this amendment to Cortese-Knox would have read quite differently.

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22 Procedures at 1.

23 Procedures at 3.

24 Procedures at 3.


26 See Floor Analysis, Senate Rules Committee at 2 (August 7, 1990) concerning AB 1535 (Farr), 1990 Legislative Session.
2. The Growing Irrelevance of the CFA

The City has every reason to believe that the proposal studied by the CFA will not be the proposal before the LAFCO Commission for decision. The Valley CFA was presented to LAFCO on January 9, 2002. The CFA employed a governmental model for the new city's first three fiscal years under which almost all governmental services for the new city would be supplied by the City of Los Angeles. The CFA assumed that these services would be delivered initially during a mandated transition period and thereafter under a negotiated service contract. The CFA further assumed that the "services provided and the costs of those services will be the same during the transition period and under contract," although it is recognized that these assumptions could be varied by the contract.27 The CFA employed a "cost of purchased service" approach to costing out the services to be rendered by the City to the Valley during transition and under contract. These projected cost data consisted largely of the allocation of personnel department-by-department, office-by-office to servicing the Valley territory. Personnel currently working in or for the Valley were identified and allocated to the Valley. A portion of personnel providing direct or indirect support for the Valley were also allocated.28 The CFA showed a surplus of about $7 million annually for the new city.

On January 23, 2002 the ground began to move underneath the assumptions on which the Valley CFA had been built. On that date the LAFCO Commission voted to exclude the Cahuenga Pass area from the Valley secession territory in favor of the Hollywood secession proposal. For that meeting LAFCO staff presented a report to LAFCO's Subcommittee on Terms and Conditions, which reported:

- Revenues for the Valley city had been overestimated by $30.9 million. (It was claimed that as a general law city, the new city would be limited in the amount of the documentary transfer tax it could levy -- a limitation not constraining charter cities such as the City of Los Angeles.) Fiscal viability of the proposed new city would thus appear to require the identification of new sources of revenue or cost savings.29

- An incorporation date of July 1, 2003 was recommended, with a transition period of 12 months: the fiscal year July 1, 2003 through June 30, 2004.30

On that date as well, the Subcommittee voted to recommend to the Commission that, among other things, (a) the Commission give serious consideration to a transition period of 18, rather than 12,

27 CFA at 5 n.8.
28 CFA at 11-1.
30 Report at 15.
months: January 1, 2003 through June 30, 2004, absent agreement of the parties to the contrary and (b) services to be rendered by the City during transition not include "certain governance functions." The Subcommittee’s chair advised the Valley applicant bluntly that the current proposal was not fiscally viable and invited a revised governmental design that was less costly -- a proposal that the applicant on that date promised for January 28, 2002.

On January 28, 2002 the Valley applicant presented what is termed a “transition plan.” This new plan represents a dramatic departure from the governmental model analyzed in the CFA. Even by its own words:

The purpose of this Transition Report is to augment the information provided by the CFA by depicting a more reasonable and likely scenario for municipal transition. While the overall financial feasibility demonstrated in this report is not dramatically different from the CFA, this document presents a more realistic option that is more characteristic of newly formed cities in California....31

The new plan estimates an annual surplus of $119.7 million prior to the revenue neutrality mitigation payment and $54.3 million after that payment.32 The new plan calls for an 18-month transition period (January 1, 2003 to June 30, 2004). The transition is envisioned as unfolding in three phases:

**Startup:** The City would continue to provide “virtually all” services for a time.33

**Transition:** Responsibility for “most services and other municipal functions” would be transferred to the new city, with the timing of each depending on various factors. “It is anticipated that at the end of this transition period many departments will be largely transferred to the new Valley City, with employees working directly for the City and resources under City ownership.”34 Service contracts could be negotiated with the City and other entities.35

**On-going operations.** After the transition period, “some services may continue to be provided under contract...”36

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31 New plan at 1.
32 New plan at 2.
33 New plan at 7, 10.
34 New plan at 7.
35 New plan at 10.
36 New plan at 7.
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LAFCO’s consideration of this new plan would blow a gaping hole in the CFA. The CFA contemplated the Valley city’s reliance on the City for virtually all services for the three fiscal years (36 months) under study. Under the new plan, the Valley city will decline certain governance related services from the outset. The new plan contemplates that thereafter the bulk of City services will be phased out within 18 months. This new approach would have a profound effect on the fiscal effects to be studied in the CFA. Most notably, they fundamentally affect the impact on the remaining City during as each service is either decline initially or phased out later.

LAFCO’s January 23 report recognized (though not sufficiently or correctly in our opinion) the connection between service contracts and fixed costs (e.g., centralized costs):

The City of Los Angeles has strong incentives to provide contract service to the new city for three reasons. The Valley Special Reorganization would leave the City without revenues to compensate about one-quarter of its current workforce unless the City provides contract service to the Valley. The City can recoup central service and other overhead costs through service contracts, and gradually downsize its administration to suit its post-breakup city size. The City’s fixed costs associated with central library services, wastewater processing and landfills would be spread over a larger revenue base during a service contract period.37

While this observation but scratches the surface of the severe fiscal consequences that would befall the City in the absence of these service contracts, it at least begins to recognize the relationship.

Cortese-Knox requires the CFA to “review and document” not only the revenues and expenditures of the new city during the first three years of incorporation; but also, the “effects on the costs and revenues of any affected local agency during the three fiscal years of incorporation.”38 The City of Los Angeles obviously qualifies as an “affected local agency.” By utilizing a service contract model of government for the full three fiscal year period required for fiscal viability, the CFA substantially masked the profound fiscal consequences that loss of the Valley revenue would have upon the remaining City. Valley revenue supports centralized costs that will become “stranded” if that revenue stream is shut off. With the new plan now advocated by the Valley applicant that calls for less than three years of service dependence on the City, the mask is removed and profound fiscal effects on the remaining City will be realized during the three-year study period. If the LAFCO


38 Former California Government Code § 56833.1(c); see former California Government Code § 56841(c) (review of proposal to include consideration of “effect of the proposed action and of alternative actions, on adjacent areas....”).
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Commission is to give serious consideration to this new proposal, Cortese-Knox requires that a fiscal analysis analyze the effect of the new proposal on the City of Los Angeles (particularly, "stranded" costs) as required by former § 56833.1(c).

Respectfully submitted,

THE CITY OF LOS ANGELES

By JAMES K. HAHN  
Mayor

JKH:fm  
cc (w/o atts.):  
The Honorable Kathleen Connell, Controller of the State of California  
The Honorable Laura Chick, Controller  
Each Member of the City Council  
William T Fujioka, City Administrative Officer  
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