

# Analysis of Assembly Bill 46 (Perez)

by Capitol Matrix Consulting

February 28, 2011

## **Fiscal Effect:**

- Potential loss of \$1.5 billion in economic output, 11,620 jobs and \$420 million in wages.
- This would result in a major reduction in state and local revenues - possibly exceeding \$42 million annually.
- Direct state General Fund revenue losses of potentially several millions of dollars annually due to increased business fees and taxes, which are deductible on state corporation and personal income taxes.
- Potential increased General Fund costs of several million dollars for additional demand for Medi-Cal and social services due to job and wage losses and loss of health benefits.
- Increased costs to the successor local agency of up to \$50 million, partly offset by redirection of existing property and sales taxes allocated to Vernon and its redevelopment agency and partly offset by the application of higher successor agency business license and utility tax rates to Vernon businesses.
- Potential default on over \$1 billion in revenue bonds and contracts secured by the city electrical system, with potentially major impacts on the future borrowing costs of the acquiring local agency and the State of California.

## **Background:**

The City of Vernon comprises 5.2 square miles south of downtown Los Angeles. The city was incorporated in 1905 to promote industrial development along the railroads in the area.

Vernon is an economic and jobs powerhouse, as illustrated by the following statistics provided by the Los Angeles Economic Development Corporation<sup>1</sup>:

- a total of 105,000 jobs in the region are directly or indirectly attributable to Vernon;
- Vernon's economy accounts for \$4.5 billion in wages, \$1.1 billion in taxable sales and \$343 million in state and local revenues;
- 15.3 percent of L.A. County's food industry employment;
- 10.7 percent of L.A. County's apparel related employment;
- 5.5 percent of L.A. County's furniture industry employment; and,
- 3.4 percent of L.A. County's employment in the fabricated metal industries.

Vernon has long been a stable and reliable source of blue collar jobs that pay living wages and health benefits. While its economic success can partly be explained by its geographic proximity to the LA/Long Beach port facility and the Alameda rail corridor, many other factors are also in

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<sup>1</sup> "Vernon Economic Impact Study, The Economic Contributions of Vernon To the Los Angeles County Economy," Los Angeles Economic Development Corporation, March 2008.

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play. The intensity of economic activity is much greater within the city boundaries than in neighboring communities.

This is evidenced by the number of jobs per square mile (8,600 for Vernon versus 3,000 for the City of Los Angeles), lower vacancy rates (4.1% for Vernon versus over 7% for Commerce and other neighboring communities), and much more favorable performance of its manufacturing industries (where its share of total manufacturing employment in Los Angeles County has increased by well over one-third during the past decade).<sup>2</sup>

The city's motto -- Exclusively Industrial -- captures the major reason for Vernon's success. With this focus, the city has become, according to Kosmont Companies<sup>3</sup> business cost analysis, the most competitive among 12 other industrial cities (6 in Southern California and 6 in the rest of the nation). The specific strategies Vernon has developed over time to achieve this competitive edge are described below.

## **One-stop Business Service**

The city offers prospective and existing businesses expedited and personalized response on issues of zoning, building codes and public works. Businesses in Vernon speak of the differences between Vernon and other local agencies, saying that dealings with Vernon are simple and direct, with none of the run-arounds and hand-offs that are experienced elsewhere. Local business officials tell us that permits often can be had the same day.

## **Environmental Protection**

One of only four cities in the state of California with its own health department, Vernon is focused on protecting the environment and ensuring the health and safety of its residents, workers, visitors and the neighboring communities. The Vernon Health & Environmental Control Department provides comprehensive and efficient services to accomplish this goal, tailoring its operations to regulate and meet the needs of the city's large industrial sector.

## **Class 1 Fire Protection**

Vernon's Fire Department is rated Public Protection Class 1 by the Insurance Services Offices, the national agency which gauges the capacity of the local fire departments to respond if a fire threatens real property. Vernon's average fire response time is three minutes, as compared to the recommended time of under 9 minutes<sup>4</sup>. This is substantially quicker than the neighboring cities

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<sup>2</sup> Sources: U.S. Census Bureau, County Business Patterns, Zip Code Business Patterns, 2009. <http://www.census.gov/econ/cbp/>; Marketbeat : Central Los Angeles Industrial Report, 2010:4, Cushman & Wakefield Research Publication ( <http://www.cushmanwakefield.com/knowledge>); and City of Vernon.

<sup>3</sup> [www.MayoCommunications.com](http://www.MayoCommunications.com)

<sup>4</sup> <http://www.nfpa.org>

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of Montebello (8.07 minutes), Monterey Park (7:48 minutes), San Gabriel (6:45 minutes) and Alhambra (6:54 minutes).<sup>5</sup>

Although Vernon only spans 5.2 square miles, its fire department has 4 fire stations, 2 Hazardous Materials units (LA City Fire Department and LA County Fire Department only have 2 each by comparison), 8 fire engines, 2 paramedic units and 2 Urban Search and Rescue Units. Every Vernon firefighter is certified in Urban Search and Rescue at the highest certification possible and all are HAZMAT certified. All of this has helped place the Vernon Fire Department into the top 35 highest rated departments in the United States.<sup>6</sup>

This level of fire protection is one of the major benefits of siting industrial operations in Vernon. It is essential in protecting the public and the environment from the dangers inherent in industrial operations. It also results in significant reductions in insurance costs for Vernon businesses.

## **Focused Police Protection.**

Vernon's Police Department's commitment to the business community is evidenced by its level of response (the average response time is 4 minutes, compared to as much as 6 minutes for the County Sheriff<sup>7</sup>). The Department uses cutting edge technology, training and personnel resources to address the unique requirements of an Exclusively Industrial city. The resulting lower crime rates and near total absence of gang activities makes Vernon a more attractive workplace place for employees as well. Business officials indicate that these intensive police services reduce costs they would otherwise incur for security services.

## **Lower Business Taxes and Fees**

Vernon offers lower business license taxes. Other area agencies generally base their taxes on a business' gross receipts, while Vernon's are based on the number of employees. Vernon's rate is a tiered amount per employee, topping out at a maximum of \$4,740 for 1,900 or more employees, while surrounding localities charge from \$1.50 to \$6 per \$1,000 of gross receipts. In addition, Vernon has no utility user's tax at all, while other area localities charge rates of 5% to 10% on utility billings.<sup>8</sup>

## **Low Cost and Reliable Utility Services**

Vernon's publicly-owned and operated Light & Power Department provides its business community with some of the most reliable and low-cost utility service in the State of California.

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<sup>5</sup> <http://verdugofire.com/newsletter/Winter2001.pdf>

<sup>6</sup> [http://www.cityofvernon.org/city\\_services/fire.htm](http://www.cityofvernon.org/city_services/fire.htm)

<sup>7</sup> "LA County sheriff's deputies taking longer to respond to emergencies," LA Times, October 6, 2010.

<sup>8</sup> 2009 Kosmont-Rose Institute Cost of Doing Business Survey.

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In operation for more than 70 years, the Light & Power Department offers electric, gas, water and fiber optic service.

The Vernon Light & Power Department's electrical power and distribution system helps to guarantee uninterrupted electrical service for Vernon's businesses and costs up to 30 percent less (40 percent less for certain classes of industrial users) than other utility providers nearby.<sup>9</sup> The city is able to offer these low rates in part because its customer base is predominately made up of commercial and industrial users, which consume electricity relatively evenly throughout the day. Because of this, the city is able to avoid substantial expenses associated with meeting the peak late-afternoon energy demands that characterize residential usage. In fact, Vernon Light and Power officials indicate that they are able to sell electricity into the broader market at a significant profit during these high-cost, peak periods.

Vernon's natural gas distribution system also provides significant advantages for the city's businesses, charging 10 to 30 percent less than the private utility alternative in the city.<sup>10</sup>

Vernon Light & Power is able to offer water rates that are among the lowest in Southern California, particularly for large industrial users, as a result of its unique blend of water sources and the makeup of Vernon's customer base, which is relatively small but uses a high per capita volume of water. The City obtains water by pumping its own wells, leasing water rights from other entities and through a connection to the Metropolitan Water District.

The City has also installed 35 miles of fiber optic cable throughout its five-square mile area. This allows it to offer "dark fiber" and "lit fiber" services. This advanced network of fiber optic cables provides businesses in Vernon with new ways to virtually connect their office buildings and to access the Internet at higher-speeds for lower rates.

## **Analysis:**

The legal question of whether the Legislature has the authority to disincorporate the City of Vernon is left to others. It may well be that AB 46 has no effect. This analysis, however, takes the bill at face value and addresses the likely effects of disincorporating Vernon.

### **Reduced Services to, and Increased Costs for Vernon Businesses**

Following disincorporation, the area now served by the City of Vernon would fall under the jurisdiction of another local government agency. The businesses and individuals in Vernon would then be subject to that agency's system of taxes, fees, charges, and provision of services.

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<sup>9</sup> <http://www.cityofvernon.org/>

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Assembly Bill 46 does not specify whether jurisdiction over the area now served by the City of Vernon would pass to the County of Los Angeles, the City of Los Angeles or one of the other adjacent cities (Commerce, Maywood, and Huntington Park among others.)

Regardless of which entity assumed jurisdiction over Vernon, the specialized and targeted services would be eliminated and replaced by the services currently provided in the entity assuming jurisdiction. Nothing in the bill requires the assuming jurisdiction to continue the same levels and types of services provided by Vernon, nor could it effectively require such increased services. In fact, it would be difficult, if not impossible for any government to carve out the higher levels of service now provided by Vernon. Many adjacent jurisdictions are in fact reducing public service levels. As a result, emergency response times would drastically increase, creating substantially greater risks that industrial accidents would become more widespread. This would not only imperil the environment, but also drive up business costs, especially the costs for property and liability insurance. Requiring businesses to use the environmental, health and permitting services provided by the entity assuming jurisdiction would create delays that would ultimately lead to a reduction in the economic output of the region and the state, as well as increased environmental and health risks.

In addition, the higher taxes and fees imposed by the county and by the surrounding cities would result in immediate direct costs to businesses of significant amounts, due to the payment of higher business license fees, and the imposition of new utility user's taxes.

Finally, eliminating the City of Vernon would immediately require businesses to procure electric and other utility services from the utilities that serve the surrounding area. This would result in an immediate increase in utility costs to Vernon's businesses of 20 to 40 percent, based on a comparison of utility rates charged by Southern California Edison and the Los Angeles Department of Water and Power<sup>11</sup>. In addition, replacing the industry-focused utility services provided by Vernon with the more generic utility services provided by the far larger utilities that serve the surrounding area would make the operation of the businesses more subject to interruption, thereby threatening cost increases, output reductions or even business failure.

## **Increased Costs On a Typical Manufacturing Business**

Putting together the additional costs from higher utility rates, taxes, and insurance, we estimate that a manufacturing business would face substantial increases - ranging from 20% to 40% depending on the type of firm and the acquiring jurisdiction. Other businesses such as trucking and warehousing also may experience increased costs. As one example, Chart 1 shows that if the acquiring jurisdiction were the City of Los Angeles, a mid-sized food processing manufacturer

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<sup>11</sup> Preliminary survey by City of Vernon Department of Light and Power, February 2011.

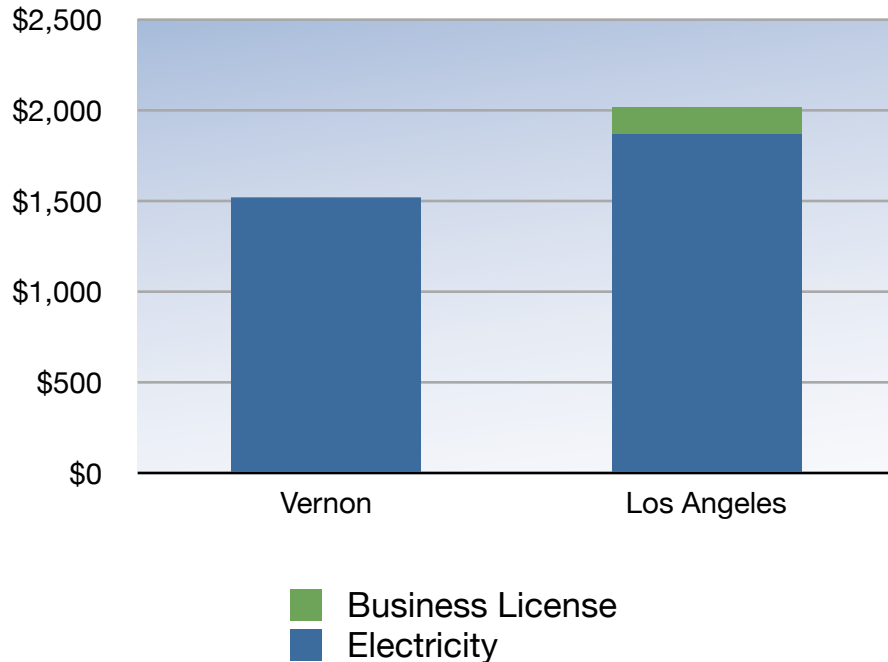
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located in Vernon would see its electrical utility bills and business taxes rise from about \$1.5 million up to \$2 million annually - a one-third increase.<sup>12</sup>

Chart 1  
Expenses For Typical Food Processing Firm  
(annual expenses, dollars in thousands)



## Impact of Disincorporation on Economic Output, Employment, Wages, and Revenues

The lower business costs currently enjoyed by businesses in Vernon are extremely important to business representatives in the community, who stress that that these lower costs – along with high government service levels - are key factors in their companies' decisions to continue manufacturing activities in California. This is particularly true of businesses in the food services, basic chemical, textile, and other commodity industries characterized by intense price competition and relatively low profit margins.

Disincorporation would eliminate the cost and service advantages these companies now enjoy. With these losses, cost-sensitive companies will have less reason to continue operations in this state, given much lower labor and regulatory costs elsewhere. Over time, this will lead to

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<sup>12</sup> Calculations based on a typical food processing manufacturing business with 500 employees, \$150 million annual receipts, and electricity usage of 16,667,000 k WH.

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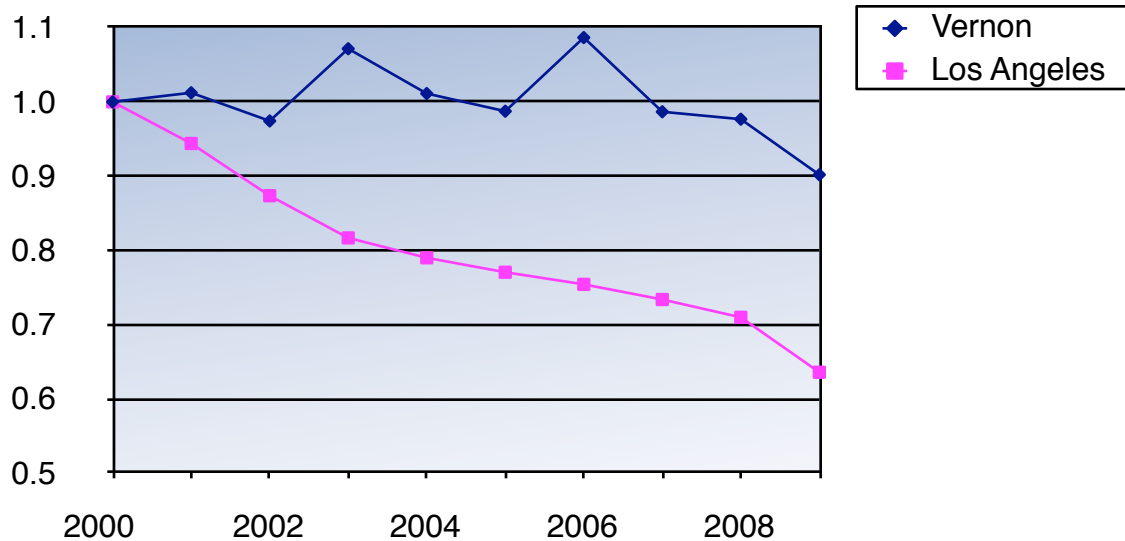
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attrition of manufacturing in the community, similar to what has been transpiring in the rest of the southern California region for the past two decades.

As evidence of how dramatic the attrition could be, consider that between 2000 and 2009, manufacturing employment fell by over 36 percent in the Los Angeles metropolitan statistical area. During the same period, employment in Vernon fell a much more modest 10%, with most of the decline occurring following the steep recession (see Chart 2).<sup>13</sup>

Chart 2  
Comparison Of Manufacturing Employment  
(Indexed to 2000=1.0)



Businesses leaving Vernon seeking lower costs would be unlikely to stop at California's border. We would expect them to move operations out of state to lower-cost U.S. regions or even abroad.

For illustration purposes, we demonstrate what would happen if the loss in competitive advantage caused Vernon's manufacturing sector to fall by an additional 25 percent, bringing it in line with what has happened in the rest of the region over the past decade.

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<sup>13</sup> Los Angeles MSA employment data from Employment Development Department, Labor Market Information Division. (<http://www.labormarketinfo.edd.ca.gov/>). Vernon data from the city and the U.S. Census Bureau, County Business Patterns, Zip Code Business Patterns, 2009. (<http://www.census.gov/econ/cbp/>)

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## Direct Impacts on Vernon's Economy

A 25-percent reduction in the manufacturing sector would translate into a loss of 6,120 manufacturing jobs. Based on data from the U.S. Census Bureau, the average manufacturing wage in Vernon was about \$36,000 in 2008, meaning that a drop in 6,120 jobs would translate into \$220 million in wages. Similarly, a 25-percent reduction would translate into an \$800 million decline in economic output in Vernon. These losses are related to just the manufacturing sector, which accounts for about 60 percent of the jobs in Vernon. To the extent that disincorporation negatively affected other industries in the community (such as wholesale trade, warehousing and transportation), the total losses in jobs, wages, and output would be larger.

## Total Impacts

The loss of output, jobs, and wages in the manufacturing sector in Vernon will also have significant multiplier effects, as the reductions in Vernon in turn reduce demand and output in the region and the state. To estimate the multiplier effects, we used U.S. Department of Commerce regional input-output multipliers (RIMs) for manufacturing industries in California. The employment and earnings multipliers average about 1.9 for the manufacturing industries involved, meaning for each 1,000 jobs lost because of a plant shutdown, another 900 jobs will be lost in supplying and distributive industries in the region<sup>14</sup>. Based on the RIM multipliers, we estimate that direct losses identified in the manufacturing sector alone above would result in indirect losses of \$720 million in economic output, 5,500 jobs and \$200 million in wages. As the table below indicates, the total impact on California's economy would be a loss of \$1.5 billion in economic output, 11,620 jobs and \$420 million in wages.

	<b>Loss In Vernon Manufacturing</b>	<b>Multiplier Effect: All Industries</b>	<b>Total Loss</b>
Economic Output	\$800 million	\$720 million	\$1.5 billion
Jobs	6,120	5,500	11,620
Wages	\$220 million	\$200 million	\$420 million

## Effects on State and Local Tax Revenues

The decline in manufacturing output and income will reduce state and local tax revenues. These losses will occur in: personal income taxes, business receipts and profits taxes due to lost income; sales and use taxes, license fees, and excise taxes due to reduced sales; and property taxes due to reduced land values. We estimate that these reductions will be equal to about \$42

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<sup>14</sup> U.S. Department of Commerce, Bureau of Economic Analysis. Regional Input Output Modeling System, Regional Multipliers. <https://www.bea.gov/regional/rims/rimsii/>.

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million per year, or about 10 percent of the total loss in wages. This estimate takes into account a variety of factors, including average consumption patterns by moderate-income households (as detailed by the U.S. Consumer Expenditure Survey <sup>15</sup>), marginal income tax rates applicable to moderate-income families, and the average profitability of manufacturing businesses.

We also note that local taxes and utility costs for businesses remaining in Vernon will go up, due to the higher utility and local businesses tax rates in the acquiring agencies. These greater costs, which we estimate would be in the range of \$50 million annually, would be deductible on state corporation tax and personal income tax returns. Taking into account average tax rates and the proportion of businesses that have positive incomes in a given year, we estimate that the losses on state income tax returns would be \$2 million to \$3 million annually.

In addition, job losses of this magnitude would likely lead to increases in eligibility for Medi-Cal and other state government-funded services, which could easily increase costs by several million dollars annually.

The costs for utilities, insurance and taxes in Vernon will reduce its attractiveness as a place to do business, and will reduce the city's ability to retain and attract business. This reduced demand for properties in Vernon will lead to reductions in property values and the resulting property taxes paid on those properties. While this impact is hypothesized, it could be significant - a 10% reduction in property values in Vernon could reduce local property tax revenues by \$3 to \$4 million annually.<sup>16</sup>

## **Default on Bonds, Power Purchase Tolling Agreement, and Interest Rate Swaps**

The city of Vernon has \$430 million in outstanding bonds that were sold by the city to finance the prepayment of a 15-year contract for natural gas. The debt service payments for these bonds are secured by net revenues of the city's electric system and certain reserves in Vernon's Light and Power Fund. The city also has a \$650 million power purchase and tolling agreement (PPTA) with Bicent Power LLC, under which the city supplies natural gas to Bicent in return for electricity produced from the Malburg Generating System (in 2008 the city sold this plant to Bicent).<sup>17</sup>

By disincorporating Vernon, AB 46 would create exposure to defaults on the bonds and the PPTA. The present value of the contract and the costs to defease the bonds would exceed \$1.1 billion. It is not clear which level of government would inherit this exposure, but presumably it would be the entity that assumes jurisdiction over Vernon or the State of California. Should the

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<sup>15</sup> U.S. Bureau of Labor Statistics. Consumer Expenditure Survey. <http://www.bls.gov/cex/>

<sup>16</sup> Based upon Vernon assessed value of \$3.8 billion in 2008-09.

<sup>17</sup> Summary of Defeasance of Debt. Prepared by Orrick Herrington & Sutcliffe for the City of Vernon.

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disincorporation result in an actual default on the bonds, that would reflect poorly on the credit ratings of both LA County and the State of California, potentially resulting in millions of dollars in increased costs for new debt issued by those entities.

In addition to the bonds and PPTA, Vernon entered into interest rate swap agreement with Morgan Stanley Inc. worth about \$22 million. The swaps are tied to bonds issued in 2004. Under the agreement, the disincorporation would trigger a default on the contract.