Legal guidance on Prop 218 – Developing lawful rate recommendations

The following is an overview of Proposition 218 and water rates. Potential application to the WA-3 and WA-9 rates can be discussed during the meeting.

Proposition 218 (1996)

Proposition 218 is best understood in its historical context, beginning with Proposition 13. Proposition 13 was designed to cut property taxes. However, when called on to interpret Proposition 13, courts held that a special assessment is not a special tax and deferred to legislative determinations in upholding assessments and regulatory and user fees. In November 1996, in part to override these precedents, voters adopted Proposition 218, the "Right to Vote on Taxes Act."

Proposition 218 focuses "on exactions, whether they are called taxes, fees, or charges, that are directly associated with property ownership." (*Apartment Assn. of Los Angeles County, Inc. v. City of Los Angeles* (2001) 24 Cal. 4th 830, 839.) Proposition 218 provides no new authority to impose taxes, assessments, or fees. (Cal. Const. art. XIII D, § 1.) Under Proposition 218, the only taxes, assessments, fees, or charges that local government may impose on a parcel or a person "as an incident of property ownership" are ad valorem property taxes, special taxes, assessments approved in the provisions of its article XIII D, section 4, and fees or charges for a property-related service consistent with its article XIII D, section 6. (Cal. Const. art. XIII D, § 3.)

Proposition 218 introduced a new category of fees, labelled "property related fees and charges." A fee subject to article XIII D is one that is imposed "upon a parcel or upon a person as an incident of property ownership, including a user fee for a property related service." (Cal. Const., art. XIII D, § 2, subd. (e).) A property related service is one "having a direct relationship to property ownership." (Cal. Const. art. XIII D, § 1, subd. (h).) Again, as in the case of assessments, the proposition shifted the burden to the local government to demonstrate compliance with its new substantive and procedural requirements. (Cal. Const. art. XIII D, § 6, subd. (b)(5).) Water rates, such as RPU's charges for water service, are included in what Prop 218 defines as "fees."

Rates shall not exceed the costs required to provide the utility service

Because utility rates may not exceed the cost to provide the service, a local government must first ascertain the cost of service. Such determination of what it costs to provide water service may be determined by a cost of service analysis (COSA) prepared by a rate-making consultant.

The process for complying with the provisions of article XIII D, section 6(b)(1) is a matter of balancing a local government's total costs of service with its total revenues. (See *Capistrano Taxpayers Association*, *supra*, 235 Cal.App.4th 1506.) In calculating the cost of service, there is no requirement that data be perfect. (*Morgan v. Imperial Irrigation District* (2014) 223 Cal.App.4th 892, 915.) And in some instances, an informal process may be used, provided the fee or charge "reasonably represents the cost of providing service." (*Moore v. City of Lemon Grove* (2015) 237 Cal.App.4th 363, 368, 373; Roseville, 97 Cal.App.4th at 647- 648; but see *Capistrano*, 235 Cal.App.4th at 380 [a working backwards methodology in setting rates is reasonable, but it cannot excuse utilities from ascertaining cost of service].)

Water rates must not be used for any purpose other than that for which the rate is imposed Article XIII D, section 6, subdivision (b)(2) forbids revenues from property-related fees and charges to be used for any purpose other than that for which they are imposed. In concert with subdivision (b)(1), it ensures the proceeds of property-related fees and charges are not transferred from a utility's account and used for non-utility purposes, such as general fund purposes of a city. Notwithstanding the forgoing, a general fund may be reimbursed for costs it incurs on behalf of the utility. Such costs might include administrative services and overhead provided to a utility not recovered via general cost allocation plan, police and fire protection of utility property, and wear and tear on public streets attributable to utility operations. Any transfer of revenues from a utility account into a general fund should be supported by a well-documented cost justification. (*Moore v. City of Lemon Grove*, *supra*, 237 Cal.App.4th at pp. 368, 373; *Roseville*, *supra*, 97 Cal.App.4th at pp. 647–648.)

Tiered rates, if properly supported, do not violate Proposition 218

In *Capistrano Taxpayers Association v. City of San Juan Capistrano* (2015) 235 Cal.App.4th, the city adopted allocation-based water rates with four tiers. The first two tiers were based on the amount of water the city concluded was required for reasonable indoor and outdoor water usage. The third and fourth tiers were based on what the city concluded to be excessive or overuse of water, respectively. (*Capistrano*, *supra*, 235 Cal.App.4th at p. 1499.) The Capistrano Taxpayers Association sued, claiming the city's rates were not proportional to the cost of providing service in violation of article XIII D, section 6, subdivisions (b)(1) and (3).

The Court of Appeal held the city's rates were not proportional to its cost of service because the city did not calculate the marginal (i.e., incremental) cost of providing water at the level of use represented by each tier. Specifically, the court criticized the city for not correlating its rates within each tier to the prices of water used in each tier. In interpreting article XIII D, section 6, subdivision (b)(3), the court noted "[i]f the phrase 'proportional cost of service attributable to the parcel' is to mean anything, it has to be that article XIII D, section 6, subdivision (b)(3) assumes that there really is an ascertainable cost of service that can be attributed to a specific hence that little word 'the' parcel." (*Capistrano*, *supra*, 235 Cal.App.4th at p. 1505, original emphasis.)

The court stated that, in calculating the rates for each tier, the city

> had to do more than merely balance its total costs of service with its total revenues — that is already covered in subdivision (b)(1). To comply with subdivision (b)(3), [the city] also had to correlate its tiered prices with the actual cost of providing water at those tiered levels. Since [the city] did not try to calculate the actual costs of service for the various tiers, the trial court's ruling [against the city] on tiered pricing must be upheld simply on the basis of the constitutional text.

Significantly, *Capistrano* acknowledged repeatedly that tiered water rates are "consonant" with and "not incompatible" with article XIII D, section 6, subdivision (b), provided the rates reasonably reflect the cost of service attributable each parcel.

Conclusion Under Prop 218, a water rate must satisfy several standards in order to not be considered a tax, which would require an election to impose. Primarily, water rates must not exceed the costs

required to provide the water service, and must not be used for any purpose other than providing water service. According to the cases applying Prop 218 to water rates Prop 218's requirements are not applied inflexibly. There is room for expenses other than strictly potable water wells and pipes (such as recycled water programs to protect groundwater); customer classifications can be in blocks or classes, there is no requirement to go into such detail as individual parcels. However, as noted in those cases, determinations made to comply with Prop 218 need to be supported with facts and findings.