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FEES FOR DUMMIES

In a Post-Proposition 218 World

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INTRODUCTION

When Proposition 218 was adopted by California voters in November 1996 (Articles XIII C and D of the State Constitution), it resulted in sweeping changes in the way that cities manage and control their revenues. It imposed new requirements for voter approval of all taxes; and property-owner approval of almost all assessments and many (but not all) fees.

While this paper will focus on the current fee-setting environment in a post-Proposition 218 world, the fact is that Proposition 218 was just another in a very long line of voter and legislative limits on the ability of cities to manage their fiscal affairs. While there were limits in place before Proposition 13 was approved by the voters in June 1978 (Article XIII A of the State Constitution), it is certainly the spiritual godfather of the litany of restrictions that followed, including:

- **Proposition 4: Gann Spending Limit.** Adopted by the voters in November 1979 (Article XIII B of the State Constitution), Proposition 4 first surfaced the notion that the amount of fees set in excess of the reasonable cost of providing the service are taxes. (It should be noted that the “spending limit” it establishes is in fact a limit on receipts from “proceeds from taxes,” not a limit on expenditures per se. And given the current revenue experience of virtually every city in California, most finance officers would be delighted to find that they are anywhere close to exceeding their city’s appropriations limit. I would, anyway!)
- **Proposition 62.** In the aftermath of the *Farrell* decision in 1982 (which had the affect of broadening tax approval authority by elected officials in General Law cities), Proposition 62 was a statutory initiative approved by voters in June 1986 that established voter approval requirements for non-property taxes: general purpose taxes required majority voter approval and special-purpose taxes required two-thirds voter approval. (Sound familiar? You heard the concept first in 1986.)

Of course, in a theme that would recur time and again in the continuing saga of voter initiatives and subsequent judicial review, an appellate court in 1991 found that Proposition 62's voter-approval requirements were an unconstitutional referendum (*Woodlake v. Logan*). And this conventional wisdom (CW) lasted for four years until the *Guardino* decision in 1995, when the California Supreme Court found that Proposition 62 wasn't unconstitutional after all. At the time, while most of us were certainly aware of the case, the “CW” – before the State Supreme Court’s decision – was that *Guardino* was a “Proposition 13” case, not a “Proposition 62” one. And like the *Bighorn* decision that that followed in 2006, (more on this later), virtually all of us in local government finance (and I suspect not a few city attorneys) were genuinely stunned by the decision: we just didn't see it coming.

The only good news: it didn't apply to charter cities (like San Luis Obispo). However, whatever sighs of relief that may have caused us at the time, was short-lived with the adoption of Proposition 218 in 1996.

- **AB 1600: Mitigation Fee Act.** During this on-again, off-again Proposition 62 interregnum, the State legislature adopted Assembly Bill 1600 (Government Code Section 66000) in 1987. This set in place comprehensive procedures for adopting development-related fees, such as

impact fees for facilities needed to serve new development and review fees for planning, building and engineering services. It addresses both the analytical approach that must be used in developing fees as well as the process for adopting and implementing them.

Analytics. There has to be a nexus between the amount the fee and the benefit received. For example, in the case of development impact fees: What's the purpose of the fee? What facilities will it be used for? Is there a reasonable relationship between the fee's use and the type of development project on which the fee is imposed? Is there a reasonable relationship between the need for the public facility and the type of development project on which the fee is imposed? Is there a reasonable relationship between the amount of the fee and the cost of the public facility or portion of the public facility attributable to the development on which the fee is imposed?

Process. Notice must be sent to those who have requested it at least 14 days before a "public meeting" where fee adoption of new or increased fees will be considered. The data supporting the new or increased fee must be publicly available at least 10 days prior to the meeting. And any new or increased fees cannot go into effect until at least 60 days after adoption.

These three actions set the stage for adoption of Proposition 218 in 1996. In a nutshell, it controls the lion's share of a city's most significant city revenues (for context, about 85% of total revenues in San Luis Obispo are controlled by either Propositions 13 or 218):

- **Taxes:** General purpose taxes required majority voter approval and special-purpose taxes required two-thirds voter approval, with limits on when general-purpose tax measures can be considered by voters. While this general principle was in place by 1995 for general law cities; Proposition 218 extended it to charter cities as well.
- **Assessments:** The 80-year "protest process" is out – property-owner approval is in. And many of the things that could previously be funded via maintenance assessment districts, no longer can be.
- **Property-Related Fees,** At one time, the "CW" was that very few services were actually covered by this. First, any fees set via Government Code Section 66000 - development impact and review fees – are exempted. And until *Bighorn*, the "CW" was that water fees based on consumption were not "property-related" fees: in this case, water services were provided not as an "incidence of property ownership," but provided upon request and billed based on how much was voluntarily used. It short, if it was possible to own property but not receive the service and thus not pay the fee, then the "CW" concluded that it was not a property-related service. (This argument was buttressed further in situations like San Luis Obispo, where the customer is responsible for paying the bill, not the property owner; and liens are not placed on the property for non-payment, since the property owner didn't request the service and isn't responsible for paying for it.)

And for ten years, the "CW" prevailed – until the State Supreme Court's *Bighorn* decision in 2006, which decided that regardless of how billed, or who was held responsible, water, sewer and trash fees were subject the provisions of Proposition 218.

The Moral of this Tale

As hard as it may be today manage City finances in light of these restrictions, take heart that these are actually the good old days that we will pine for someday. Because just as Proposition 13 begat Proposition 4 begat Proposition 62 begat Proposition 218 – and follow-up court decisions like *Farrell*, *Guardino* and *Bighorn* undid and then redid the “CW” about they meant – there is another proposition out there, or another court case, that will make us nostalgic for the current situation.

Charles Darwin once observed: “It is not the strongest of the species that survive, nor the most intelligent, but the ones most responsive to change.” Given where we’ve been, this is excellent advice in navigating the challenges that are undoubtedly ahead of us in prudently setting and managing city fees.

SETTING FEES: THE CURRENT SITUATION

The one we’ll be nostalgic for in the future

In setting and managing fees in a Post-Proposition 218 world, I think there are four key principles for success (until further notice):

- The standard is reasonable, not perfect
- Take a policy based approach in setting fees
- Be transparent in the process (or as the Don Vito counseled his son Michael: keep your friends close; your enemies closer)
- Be responsive to change

Reasonable, Not Perfect

As your consultants or staff finance wizards prepare fees studies, keep in mind that the standard (at least so far) is that the analysis needs to be reasonable, but not perfect – which is good, because no analysis that apportions costs between users is going to be perfect. That said, it does need to make sense: Is there a reasonable basis for identifying costs? And is there a reasonable basis for allocating that cost to different types of users based on benefit?

Take a Policy-Based Approach in Setting Fees

Taxes vs. Fees in Financing City Services

User fees, enterprise fund rates and regulatory charges are among the few remaining areas of resource discretion available to elected officials. This includes user charges that are part of the General Fund, as well as water and sewer rates, and development impact fees under AB 1600.

But setting user fees is not simply a cost accounting exercise, although having good analytical data is an essential part of the process. It is fundamentally a policy decision by elected officials in determining those city services that will be paid from general purpose revenues (primarily taxes) that everyone pays, and those that will be funded from user fees. For this reason, the City of San Luis Obispo sets user fees based on a clear policy foundation that is formally adopted by

the Council as an integral part of our comprehensive *Budget and Fiscal Policies*. (These are on the City's web site at: <http://www.slocity.org/finance/download/budget09-11/budgetpolicies09-11.pdf>.)

Under our user fee policy, we consider the following four factors when determining cost-recovery levels and setting user fees:

- **Communitywide vs. Special Benefit.** The level of user fee cost recovery should consider the communitywide vs. special service nature of the program or activity. The use of general purpose revenues is appropriate for communitywide services, while user fees are appropriate for services that are of special benefit to easily identified individuals or groups.
- **Service Recipient vs. Service Driver.** After considering community-wide vs. the special benefit of the service, the concept of service *recipient* vs. service *driver* should also be considered. For example, it could be argued that the applicant for a building permit is not the beneficiary of the city's development review efforts; the community is the primary beneficiary. However, the applicant is the *driver* of development review costs, and as such, cost recovery from the applicant is appropriate.
- **Effect of Pricing on the Demand for Services.** The level of cost recovery and related pricing of services can significantly affect the demand and subsequent level of services provided. At full or high cost recovery, this has the specific advantage of ensuring that the City is providing services for which there is genuinely a market that is not overly stimulated by artificially low prices. Conversely, high levels of cost recovery will negatively impact the delivery of services to lower income groups. This negative feature is especially pronounced — and works against public policy — if the cost recovery is high for services that are specifically targeted to low-income groups.
- **Feasibility of Collection and Recovery.** Although a high level of cost recovery may be appropriate for specific services, it may be impractical or too costly to establish a system to identify and charge the user. Accordingly, the feasibility of assessing and collecting charges should also be considered in developing user fees, especially if significant program costs will be financed from that source.

The use of this policy-based approach to setting fees has been a key part of the City's success in mitigating service reductions in light of the tough fiscal times that have been with us for most of the past decade.

Tax-Based Services

The following types of services have very low cost-recovery goals under the City's policy:

- Delivering public safety emergency response services, such as police patrol services and fire suppression.
- Maintaining and developing public facilities that are provided on a uniform, communitywide basis such as streets, parks and general purpose buildings.
- Providing social service programs and economic development activities.

In selected circumstances, there may be specific activities within the broad scope of services provided that should have user charges associated with them. However, the primary source of funding for the operation as a whole should be general purpose tax revenues, not user fees.

Fee-Based Services

User fees at some level are appropriate for all other City services. For example, the City has set the following user fee cost-recovery goals for recreation and development review services:

- **Recreation programs.** Cost recovery for activities directed at adults should be relatively high, whereas cost recovery for activities directed toward youth and seniors should be relatively low. From this general guideline, the City sets specific cost-recovery goals for each recreation activity.

For example, classes, adult athletics and facility rentals should have high cost recovery (defined as 60% to 100%); special events and youth track and swim lessons should have “mid-range” cost recovery (30% to 60%); and public swim, teen services and senior services should have low cost recovery (up to 30%).

- **Development review programs.** For planning, building, engineering and fire development review services, cost recovery should generally be very high. In most instances, the City’s cost-recovery goal should be

Low Cost-Recovery Factors

Factors that favor low cost-recovery levels — those services that should be funded primarily through general-purpose tax revenues — include the following:

- There is no intended relationship between the amount paid and the benefit received. Almost all social service programs fall into this category, because it is expected that one group will subsidize another.
- Collecting fees is not cost effective or will significantly impact efficient service delivery.
- There is no intent to limit the use of (or entitlement to) the service. Again, most social service programs fit into this category, as well as most public safety (police and fire) emergency response services. Historically, access to neighborhood and community parks would also fit into this category.
- The service is nonrecurring, generally delivered on a “peak demand” or emergency basis, cannot reasonably be planned for on an individual basis and is not readily available from a private sector source. Most public safety services fall into this category.
- Collecting fees would discourage compliance with regulatory requirements and adherence is primarily self-identified; as such, failure to comply could not be readily detected by the city. Many small-scale licenses and permits fall into this category.

High Cost-Recovery Factors

Factors favoring high cost-recovery levels include:

- The service is similar to services provided through the private sector.
- Other private or public sector alternatives could or do exist for the delivery of the service.
- For equity or demand management purposes, it is intended that there be a direct relationship between the amount paid and the level and cost of the service received.
- The use of the service is specifically discouraged. Police response to disturbances or false alarms might fall into this category.
- The service is regulatory in nature, and voluntary compliance is not expected to be the primary method of detecting failure to meet regulatory requirements. Building permit, plan check and subdivision review fees for large projects would fall into this category.

100%. A notable exception is appeal fees. The average appeal costs the City \$3,000 to process; however, the fee is \$250 to avoid inappropriately limiting community involvement in the review process. (Until 2003–04, there was no appeal fee at all.)

Five Key Policy Questions to Ask When Setting User Fees

- **What does it cost the city to provide various services?** Our cost analyses reflect the total cost of services—direct and indirect, such as my favorite indirect costs (accounting, payroll, collections, information technology) and your favorite: legal services. The fact that these essential “organizational infrastructure” costs are indirect doesn’t make them less real when analyzing the total cost of providing a service.
- **Are these costs reasonable?** Many fee-setting cost studies are criticized as being solely revenue driven: If revenues are not recovering costs, the solution must be to increase revenues. However, the problem may not be that revenues are too low, but that costs are too high. Before considering fee increases, elected officials and members of the community need to be sure that costs are reasonable for the level of service provided.
- **What are current cost-recovery levels?** The next step is to compare the cost of a service with the revenue it currently generates. For example, a service may cost \$100 to deliver, but the related fee is bringing in only \$75.
- **What should the cost-recovery level be?** Obviously, this question can be answered only if there are user fee cost-recovery policies in place. Without this, we don’t know if any adjustment to the \$75 fee (upward or downward) is warranted. For example, if the policy for the service is 50% cost recovery, the fee should be lowered; if it is 90%, it should be raised. In short, no matter how well we’ve technically analyzed what the costs and revenues are, knowing this alone does not help us set fees. We also need to know what the cost recovery should be.
- **What fee changes are necessary to implement the City’s cost-recovery policies?** Once we know that it costs us \$100 to provide a service, that this cost is reasonable, that the current fee recovers only \$75 and our policy is 90% cost recovery, then setting the fee at \$90 becomes an easier decision for policy makers. However, this approach doesn’t mean elected officials are on

Things to Keep in Mind When Evaluating Service Charges

The City of San Luis Obispo uses the following general concepts when evaluating service charges:

- The amount of the fee may not produce revenues that exceed the reasonable cost of providing the service.
- Cost-recovery goals should be based on the total cost of delivering the service, including direct costs, departmental administration costs and organization-wide support costs, such as accounting, personnel, data processing, vehicle maintenance and insurance.
- The method of assessing and collecting fees should be as simple as possible in order to reduce the administrative cost of collection.
- Rate structures should be sensitive to the market for similar services as well as to smaller, infrequent users of the service.
- A unified approach should be used in determining cost-recovery levels for various programs based on the factors discussed above.

“auto-pilot” in setting fees; this decision in determining cost recovery levels is clearly in the policy arena. If the fee is too high at \$90 and all the other criteria have been met, then it must be because the cost-recovery goal at 90% is too high. Since the Council sets the policy, the council can also amend it.

Staying in Touch With These Tools

In the wake of state budget grabs and recessionary pressures, many cities have taken a close look at their user fees at some point in the past. But have they been updated on an ongoing basis, and

are the policy bases and “analytics” underlying them still valid? To avoid this, San Luis Obispo performs a comprehensive benchmark analysis at least every five years and up-dates fees annually using changes in the U.S. Consumer Price Index in the interim.

If service fees are not assessed where they could be, then general purpose revenues are making up the difference. The direct consequence of this is a lower level of service (and in tough times, deeper cuts) in essential programs that have no significant user fee potential, such as police, fire, streets, libraries and parks.

When should you take a close “re-look” at your current service cost-recovery levels and user fee policies? There are two basic approaches:

- Outside the budget process, where they can be dispassionately viewed on their own analytical merits.
- Or as an integral part of the budget process, so that the resource trade-offs between setting user fees at an appropriate level vs. the ability to fund high-priority services are clear.

Either approach can work, but tough decisions may be easier to make and communicate to the community when the real-world benefits are clear and compelling, such as during the budget process when resource decisions are

Making Comparisons With Other Communities

In setting fees, the City of San Luis Obispo collects and considers information on the amount of fees charged by other communities for similar services. However, our policy is clear that fee surveys should never be the sole or primary criteria in setting city fees, because many factors affect how and why other communities set their own fees. For example:

- What level of cost recovery is their fee intended to achieve compared with our cost-recovery objectives? If our fee is \$100 and theirs is \$75, perhaps the difference is simply that our cost-recovery goal is 100% and theirs is 75%.
- What costs have been considered in computing their fees? Our policy is to set fees based on total costs. As such, even if our cost-recovery goals are otherwise the same, perhaps they are considering only direct costs.
- When was the last time their fees were comprehensively evaluated? We adjust our fees on an ongoing basis; perhaps theirs are significantly out of date.
- What level of service do they provide compared with our service or performance standards? Perhaps we simply provide a higher level of service, so our costs — and related fees — are higher.
- Is their rate structure significantly different than ours and what is it intended to achieve? Anyone who has ever tried to compare planning permit fees knows that getting an “apples to apples” comparison is very difficult because every city does it differently.

Ultimately, cities should set their financial management policies based on their unique circumstances, not those of others.

made about what will get done in the coming year (and what won't). This is one of the few remaining areas for local elected officials' judgment.

Real-World Application in San Luis Obispo

Taking a policy-based approach has had very practical results in the City of San Luis Obispo as we struggled to close an \$11 million budget gap in 2009-11. As shown in the sidebar chart, expenditure reductions played the leading role in balancing the budget for 2009-11, accounting for about 80% of the overall solution. However, improved cost recovery, largely based on a recently completed cost of services study at the time, was also an important part of our strategy, accounting for 11% (\$1.2 million) of the total solution.

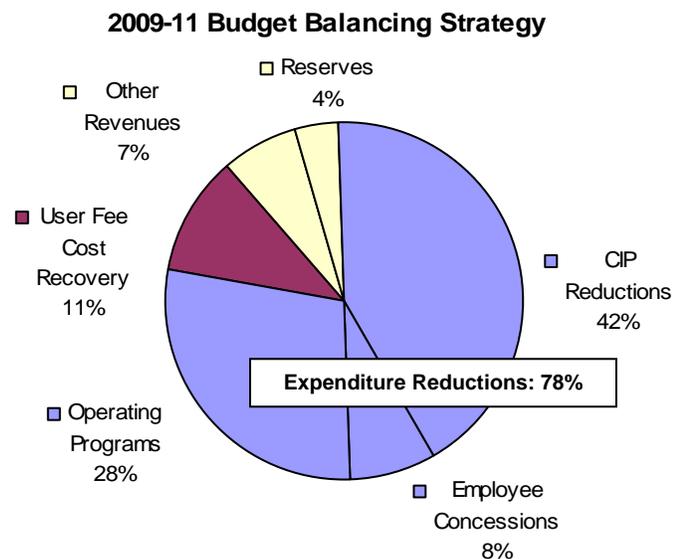
These fee increases occurred only after extensive budget workshops and hearings, which were well-publicized and well-attended. Most notably, the business and development community did not formally oppose the increases, largely due to our "missionary" work in explaining the reasons for the change and the impact on community services (including development review) if it was not made.

Given the fiscal challenges facing us, the practical consequence of not raising user fees would have been even deeper cuts in services that rely heavily on general purpose revenues, such as police, fire, street maintenance and parks.

Transparency

Taking a policy-based approach to fee-setting has been a critical factor in our success in balancing fees versus general-purpose revenues in funding City services. However, for this approach to work, it has to be partnered with a genuine commitment to transparency. As discussed above, along with solid analytics and a strong policy foundation, actively engaging the community in an open fashion was a key success factor in improving cost recovery as part of the 2009-11 budget process and in mitigating even deeper service cuts. A key part of our engagement process wasn't just to reach-out to our usual supporters, but to engage stakeholders who would be most impacted by the fee increases as well.

At the end of the day, there are many challenges on many different fronts facing cities in managing their way through the deepest economic downturn since the Great Depression. But there is really only one powerful arrow in our quiver – and that's transparency in how we conduct our financial affairs. Stated simply, effective governance only occurs when the community has confidence in our stewardship of the public resources entrusted to us. Being open and straightforward about our fiscal situation on a timely basis, and meaningfully engaging the community in the budget process, is an essential part of gaining that trust.



A wise finance officer once observed that in government, sometimes you have to go a little slower to go faster; and that the shortest distance between two points in the public policy arena is never a straight line. (Actually, that was me.) Transparency takes time and effort. As City Attorneys know well in defending their clients, if you don't have the resources to do it right the first time, what makes you think you have the resources to do it over?

Being Responsive to Change

As noted earlier, the history of city finance over the past 30 years has been constant change (almost all of it, from a finance guy's perspective, bad). And this will be the case in the years ahead. However complicated and hard it is today, it will be just that much more complicated and harder in the future. (This is the only financial prediction I am completely comfortable making.)

This doesn't mean (as a former President once suggested) that we need to "make change our friend" – because when it comes to changes in the rules of the road for city financial management, I doubt they will be friendly.

But it does mean recognizing that change will be our traveling companion for a long time to come. And when change happens, we're human, so we will need to spend time on denial, anger, bargaining and depression. However, we will need to move into acceptance quickly and focus our energy on adapting to ways of best serving our communities in light of the new ground rules.

THE GAME CHANGER

For most of us, setting fees in a Post-Proposition 218 world has been about just that: setting fees. However, the not-yet-fully appreciated, potentially profound "game changer" is not in Proposition 218's substantive or procedural requirements for setting fees, but rather, the never-over possibility for initiatives to reduce or repeal "any local tax, assessment, fee or charge."

In short, this means that a tax, fee or assessment issue is never over. (Or as William Faulkner once noted: "The past is never dead. It's not even past.")

In the Central Coast, we have already seen what could become an endless "do-loop" in the City of Paso Robles' ability to set water rates at levels sufficient to cover its contractual obligations for a new water supply due to repeated initiative efforts. At some point, I'm sure that Paso Robles will be successful in its rate-setting efforts. But in the interim, it's expensive and draining for Paso Robles to fight this battle.

So, here's my final prediction: as we become even more competent in setting new or increased fees in accordance with Proposition 218, the challenge will shift to keeping them in place afterwards.