Wastewater Impact Fees: A Recent Ruling with National Implications

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INTRODUCTION

The threat of legal challenges related to wastewater and water rate making has become a reality for many utility professionals across the nation. Traditionally, the preponderance of these lawsuits were triggered by cost-of-service disputes regarding rate design, the calculation of revenue requirements, and the allocation of such requirements to an individual customer or customer class. Yet another set of lawsuits revolves around disputes over the financial responsibility of growth-related costs through impact fees, also known as system development charges, connection fees, and plant investment fees. In this paper, we discuss the recent State of Colorado Supreme Court ruling regarding the development and implementation of impact fees, in this case called plant investment fees, by the Breckenridge Sanitation District in 1996. The District's fees were challenged by a developer, and after appeals were exhausted in District and Appellate Courts, ruled on by the Colorado Supreme Court in 2001. This ruling is, naturally, relevant to other enterprise funds in Colorado organized under the same statutory provisions and, possibly, may be used in future rulings in other jurisdictions. We also append a sample resolution interested parties might wish to review that demonstrates how to structure the utility's philosophy for costs associated with growth so that impact fees will rationally relate to this goal.

A Case Study: Impact Fees and the Law

Many lawsuits involving impact fees revolve around the existence of a "rational nexus" for the assessment of the fee. The case of *Krupp v. Breckenridge Sanitation District* is one such example[1]. As part of its ruling, the Colorado Supreme Court reviewed and commented on the criteria used in this case for approving the validity of impact fees for utilities within the State of Colorado. We recognize that the legal considerations surrounding the development and implementation of impact fees may vary by state. Therefore, we encourage utilities to consider state and local requirements when developing impact fees. This paper provides a short overview of impact fees and the criteria commented on in the recent Colorado Supreme Court ruling.

The History of Impact Fees and Challenges. An impact fee is a one-time charge to users requesting new service or an increase in existing service. Impact fees, initially developed because of the capital-intensive nature of utilities, are a common source of capital that utilities can use to fund capital improvements necessary to accommodate growth. Impact fees have become a significant source of financing capital improvements of publicly owned utilities. Privately owned utilities, to the contrary, rarely use this source of financing because it would be classified as contributed capital. Contributed capital dilutes the rate base and, therefore, would not allow the owner to earn a return, nor expense depreciation costs, on those contributions.

Many states have statutes that allow utilities to collect impact fees. In a 1994 AWWA article[2], Don Clark presented a summary of the legislative history of impact fees. With one exception, these laws started in the early 1980's, and by 1994, there were 26 states with

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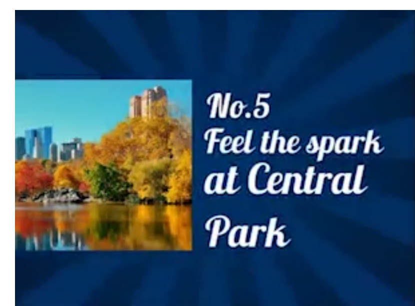

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impact fee related laws. These statutes are often vague, or appear to be inconsistent in the details prescribing the calculation of the impact fees. As a result, over the past few decades, various groups and individuals have challenged impact fees assessed by utilities.

Most successful challenges have relied on the limitations set forth by two landmark cases, the *Nollan*[3] and *Dolan*[4] cases. These cases held that development exactions may be subject to a constitutional "takings" analysis, requiring that there be a rational nexus between the fee and the impact of the proposed development. If plaintiffs demonstrate that the impact fee is unfairly determined, the utility's impact fee could be invalidated.

On February 26, 2001, the Colorado Supreme Court, in a unanimous decision, upheld the Breckenridge Sanitation District's impact fees. The court's ruling provides a well-written analysis of the legal and technical issues of the case and provides a guideline for other enterprise funds contemplating the implementation, or revision, of impact fees.

The Case. Breckenridge Sanitation District (District) serves a winter resort community in the Colorado mountains approximately one hour from Denver. The District adopted a "growth pays for growth" policy in its financial procedures and policies. Thus, its current customers were not expected to subsidize growth. Furthermore, the District adopted a Single-Family Equivalent (SFE) conversion schedule which set forth the system for determining SFE units and converting these into impact fee assessments. Colorado law authorizes the District to collect both impact fees and recurring user charges.

Marshall B. Krupp and others filed a lawsuit against the District in 1996. They asked a District Court to review the District's action to determine whether the District had exceeded its jurisdiction and abused its discretion. The plaintiffs claimed that the District's impact fee assessment amounted to an unconstitutional taking. They particularly objected to the schedule which assigned a higher value to multi-family units than comparably sized single-family units.

The District engaged an independent firm with expertise in utility economics and, specifically, experience in the development of rates and fees for wastewater utilities. A consulting engineering firm was also engaged to provide needed engineering input to the rate economists.

Expert analysis indicated that the growth-related costs for a single-family residential unit were less than that of a multi-family unit. Although not intuitive, this finding was consistent with the particular circumstances of the District. As a resort community that serves skiers, Breckenridge Sanitation District sees large daily fluctuations in its wastewater flows. From a cost and engineering perspective, the District's system is designed to meet the capacity needs for the peak-flow events. For the District, peak flows occur on weekends during the winter ski season as tourists descend on the small community. Although the multi-family rental units often have fewer square feet than single-family homes, the number of occupants during the peak-period (e.g., the weekends during the ski season) is typically higher. Therefore, the per unit capacity required for meeting the peak period demands of these customers exceeds the capacity required for the typical single-family home customer. Also, because of the high altitude and low temperatures, the District's wastewater treatment system capacity is lower during the winter months than during other seasons. The cost of providing sufficient treatment capacity thus is strongly correlated with the winter season peak demand for wastewater collection and treatment services.

Integrated Utilities Group, Inc. (IUG), the expert firm engaged by the District to review its impact fees, applied a defensible methodology, called the Buy-In Method, to determine an appropriate range of impact fees.

In 1997, the District Court ruled against the plaintiffs. The plaintiffs then appealed to the Colorado Court of Appeals[5]. The Appellate Court again ruled against the plaintiffs in 1999, and the plaintiffs appealed to the state's Supreme Court. The Supreme Court reviewed the record of the case, conducted additional hearings, and ruled on the case's merits on February 26, 2001.

Besides verifying that the District relied on appropriate statutory legal powers and correct ordinances, the Supreme Court quoted the IUG study various times. The Supreme Court unanimously held that it agreed with all the District's impact fee actions.

Impact Fee Terminology. Before presenting the selected impact fee methodology, we thought it beneficial to define some of the technical terms used in our discussion.

Buy-In Fee: A type of impact fee consisting of a reimbursement and a growth-related improvement fee component.

One-Time Capital Charge: One-time capital charges are fees, such as impact fees, paid to utilities at the time a connection is made to the system. These are often referred to as impact fees, system development charges, connection fees, or plant investment fees. The important distinction between one-time capital charges and other fees is that one-time capital charges are levied to offset investments made, or prospectively required to be made, by the utility.

Growth-Related Improvement Fee: An improvement fee related to that portion of the capital improvement plan (CIP) that offsets the cost of future facilities that will need to be constructed to accommodate growth.

Reimbursement Fee: A reimbursement fee is that portion of the impact fee that pays the utility for its past investments in the utility's assets. Essentially, it assesses a charge on new customers to buy into the system.

Impact Fee: An impact fee is a one-time capital charge assessed on new connections that is used to finance a utility's capital needs. Depending on the jurisdiction, impact fees can have different meanings. For example, in some locations, impact fees refer only to the reimbursement fee as described above. In other areas, impact fees refer to both an improvement fee and a reimbursement fee. In the case of the District, the impact fee is an all-encompassing one-time capital charge that includes reimbursement fees and improvement fees.

Replacement Cost New: The cost to reconstruct an asset today is the replacement cost new. Replacement cost new accounts for inflation and changes in construction costs. It is often referred to as the asset's value in "today's dollars."

Carrying Costs of Capital: For this discussion, the carrying cost of capital will mean the depreciation expenses incurred while owning the assets and interest costs or opportunity cost of the investment.

The Buy-In Impact Fee Methodology

Impact fees, when based on the philosophy that new customers will not be subsidized by existing customers, will typically incorporate both a reimbursement fee and an improvement fee portion. These two fee components are discussed below.

Reimbursement Fee. A reimbursement fee is a "buy-in" charge assessed on new customers. The fee allows new customers to buy their share of the utility and provides intergenerational equity among new and existing customers. Essentially, the reimbursement fee is intended to level the playing field between existing customers who have paid user charges in the past and latecomers who will benefit from these investments.

Generally, the reimbursement fee is a measure of the equity or value of the system divided by its capacity. Capacity often is expressed in equivalent residential units.

Several options have emerged on how to estimate the value of the utility. Generally, the valuation process begins with original cost. The original cost is the total cost incurred to first place the asset in service. It includes the cost of professional services (e.g., engineering and legal services), interest on funds used during construction, and etc.

In a very conservative valuation method, the accumulated depreciation could be subtracted from the original cost to account for the value of past investments that were consumed by existing customers. Normally, contributed capital is subtracted to recognize that grants and developer in kind contributions were not paid by existing rate payers.

Some utilities do not subtract accumulated depreciation from the original costs. These utilities do this so that new customers will help pay the carrying cost of the capital. For example, assume a utility makes an investment that provides capacity for growth. The utility may have made this investment because of economies of scale in constructing a larger facility rather than constructing multiple, smaller facilities. The question arises as to whom should pay for the depreciation expense during the time the excess capacity was purchased and eventually needed for growth. Some utilities charge these costs to future customers by leaving the accumulated depreciation in the reimbursement fee.

Other utilities value the assets at replacement cost new rather than at original costs. This practice provides the utility with a return on its money used to build the facility for future customers. The return is often accounted for by the increase in the replacement cost value of the facilities. The rate of return could be equal to the interest costs incurred to finance the fixed assets. In some cases a utility will reduce the replacement cost new by accumulated

depreciation, and in other cases the utility will not. The reasons for dealing with accumulated depreciation are the same under the replacement cost new approach and the original cost approach.

In the Breckenridge Sanitation District, users pay for replacing worn out assets such as equipment through their user charges. When the replacement occurs, the new equipment is capitalized and becomes part of the District's fixed assets. Depending on how the District prepares its balance sheet, the fixed assets are offset on the balance sheet by an entry similar to retained earnings. Alternatively, if the District were to debt-finance capital replacement, the fixed assets would be offset by long-term debt. IUG calculated the value of the District's assets with all four evaluation methods: original cost, book value, replacement cost new, and replacement cost new less depreciation.

In any event, the method of funding replacement and the practice of collecting user charges to fund depreciation is not so much an issue in the selection of the valuation method for calculating the reimbursement portion of the impact fee. Rather, these are issues crucial to the development of internally consistent sources of funding addressed in the utility's long-term financial plan.

The District has a policy of collecting impact fees from developers at the time a new building permit is obtained. The underlying philosophy for the impact fee is that new development should pay its share of the cost of providing existing and new sewage collection, treatment, and disposal capital costs. Proceeds may be used for retiring debt and to pay for old and new capital investments.

Growth Related Improvement Fee. A growth-related improvement fee portion is assessed so that current customers do not subsidize growth. Primary steps in calculating an improvement fee include:

1. Estimating future capital costs associated with growth. A utility generally relies on its capital improvements plan (CIP) to estimate the cost of growth. The CIP is reviewed to identify projects that expand capacity and those that upgrade facilities. There are various methods to determine cost allocation for multiple purpose projects. For example, increment over upgrade, incremental capacity, proportionate capacity, and proportionate costs.

2. Selecting the appropriate capacity created by the improvements identified above. Again, different methods exist to determine this additional capacity. For example, total new treatment plant capacity, capacity of new projects weighted by individual project costs, and etc.

Other Adjustments. Debt service that will be assessed on future rate payers should not be charged in the improvement fee. By removing future debt service from the improvement fee, new customers will not be charged twice for the same asset: once with the impact fee, and again, in their future user charges.

The utility should only include in its reimbursement fee the costs that would otherwise be paid by rate payers. Exactions and contributions such as government grants should be deducted from the improvement fee.

What the Ruling Means

The ruling by the Colorado Supreme Court provides a useful illustration of the key principles and criteria analysts may use in the development of impact fees. Key criteria to address in developing impact fees are:

Is there a clear underlying philosophy for the fee, and is the fee legally implemented?

Is the basis for class distinctions rational and fair?

Was the study performed by competent independent experts?

Was the database used pertinent, and was the analysis correctly done?

Finally, were the fee design and resulting rates rational?

In its ruling, written by Justice Hobbs, the Colorado Supreme Court reviewed and commented on the criteria for the establishment of valid impact fees. In a discussion spanning several pages, the Supreme Court issued the following findings on each criterion in this case:

The District had a clearly defined policy, properly enacted, that growth would not be subsidized by existing customers (see the Appendix for a sample ordinance).

The impact fee is authorized under state law.

Its assessment schedule distinguishes fairly between different types of development.

The District commissioned an independent expert to evaluate its conversion schedule and assessments.

The expert's report confirmed the validity of the customer class service distinction and found that multi-family development units, in this case temporary rental units, have higher peak-flow requirements than single-family units.

The conversion units used to determine fees were reasonably based on the report's analyses.

The impact fees fell within the justifiable range of fees as provided by the report's methodology.

The District's fee design was rational.

Conclusions

The *Krupp vs. Breckenridge Sanitation District* case has now, through the Colorado Supreme Court's unanimous ruling, provided criteria that may be useful to other utilities in developing impact fees. Obviously, the development of a defensible impact fee system not only requires a sound philosophical underpinning, such as "growth pays for growth," but also requires other steps. A defensible impact fee system also includes the application of appropriate law, the collection and analysis of relevant data, the development of a sound asset valuation and cost allocation methodology, and the appropriate implementation of the selected methodology. The recent Colorado court ruling clarifies various issues relevant to conducting impact fee studies. In developing a rational and logical set of criteria, it well may set standards for future impact fee cases beyond Colorado.

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