



**California Special
Districts Association**

Districts Stronger Together

Introduction to Special District Revenues

FIRST EDITION

A PRIMER ON THE REVENUE TOOLS AVAILABLE IN CALIFORNIA.

Forward

This introductory publication is intended for special district board members and staff, as well as interested community members and others. It was written to engage the reader in a high-level discussion of revenues as the life blood of any special district. The focus is on the basic concepts of their importance, their rationale, and their need for regular maintenance, just like the other assets of any special district.

As background, it is important to understand that we are living and working in the post-Proposition 13 era of California, as that 1978 voter-approved measure severely limited local property tax revenues. Moreover, local governments must actively work to justify their revenue streams on a regular basis. It is imperative that special district staff and board members think about and then take action on revenues, whether they are rates, fees, or other property-related charges. It is also crucial that districts regularly educate their communities about the vital services they provide and the revenues needed to make those services available. Special district staff and board members have the responsibility to be proactive in maintaining the fiscal health of their agency; neglecting this duty is not a sustainable option.

This publication has two primary sections. The first volume provides an overview of these primary revenue tools for special districts, though not all are applicable to all district types:

- Utility rates
- User and regulatory fees
- Development impact fees, Quimby Act fees, and connection/capacity charges
- Parcel-based revenue tools (such as benefit assessments and parcel taxes)

The second volume provides basic background information, including an overview of property taxes and the impact of Propositions 13, 218, and 26, a discussion of cost recovery and cost allocation, roles of special district board and staff in managing revenues, and a summary of available debt financing tools when pay-as-you-go is not sufficient to provide the necessary public improvements.

We hope you find this information to be helpful as you move your community forward in a fiscally-sustainable manner.

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A CSDA/NBS Revenue Publication



CSDA extends its gratitude to Tim Seufert of NBS for this publication, with contributions from Nicole Kissam of NBS and Albert Reyes of Kutak Rock LLP.

A CSDA member since 1999, NBS has supported many special districts with a wide variety of revenue tools, including Special Financing Districts (SFDs); special assessments/taxes, utility rate studies, fee studies, cost allocation plans, and other fiscal/financial analyses.

NBS (NBS Government Finance Group) is a registered municipal advisor with the Municipal Securities Rulemaking Board (MSRB) and the Securities Exchange Commission (SEC). Note that the information found within this CSDA publication is not meant to provide specific advice nor to solicit such business.

VOLUME 1

The Tools



Utility Rates: Overview

When water or wastewater services¹ are provided by any local government agency, the rates charged must be fair and cost-based. As to context, water management in general is a critical tool for any civilized society, and even more so for a desert state with 40 million people living in it.

Water, including potable water, wastewater, recycled water, and storm water, should be viewed and managed in a holistic manner. Water is a “common pool item” and as such, “government’s role is to develop policies to ensure [its] continuance or sustainability.”² This is especially true in California where water is precious and increasingly in short or erratic supply. Unfortunately, the array of public and private agencies is not always in sync in terms of public policy and general management of the resource and pricing thereof.



Water - A Public Resource

Depending on varying viewpoints, water has been called a public resource, defined as an economic good, and user-charges characterized as a “tax.” It is also subject to the rigors of California’s electorate, under the rules of Proposition 218.

1. While some special districts provide electricity, solid waste, or other services, those are more specialized in nature and not the focus of this publication.

2. Kraft, Michael E and Scott R. Furlong. (2007) Public Policy – Politics, Analysis and Alternatives. Third Edition. CQ Press: Washington DC.

UTILITY RATES: DISCUSSION

The availability of water is a basic need in society. The pricing of water is a fundamental public policy issue in our quest for environmental sustainability, in California and in the rest of the world. It was not uncommon in the past for public agencies to provide water at practically no cost to users. Water was considered to be a cheap resource and a basic necessity. This is no longer the case today and water pricing is an important management tool.

Moreover, water utilities throughout California and across the United States are facing significant challenges:

- Operating costs and the costs of new supply sources are generally rising faster than inflation.
- Deteriorating infrastructure must be funded with little assistance from federal or other grant money.
- Drought-related water shortages are more frequent.

On top of this, interactions with ratepayers can sometimes become strained if there are drastic spikes in rates or when there are continuous and significant increases in water and wastewater rates. And the more rates go up, the more likely they are to be perceived as inequitable, which increases

the chance they might be challenged at your special district board meeting or even in court.

Public water agencies, for a host of economic, public policy, and practical reasons, use a variety of water rate structures today. These structures range from flat (or fixed) rates to metered rates to conservation-based tiered or block rates. More recently, water budget rates (or customer-specific, allocation-based rates) have become technically feasible in California. A water budget rate is an increasing block rate structure in which the block definition is different for each customer based on an efficient level of water use by that customer. In the recent past, water budget rates linked with an increasing block rate structure have been implemented successfully in more than 20 utilities. However, there are real equity concerns with such a structure and the motivations they can foster (to build a larger home, for example).



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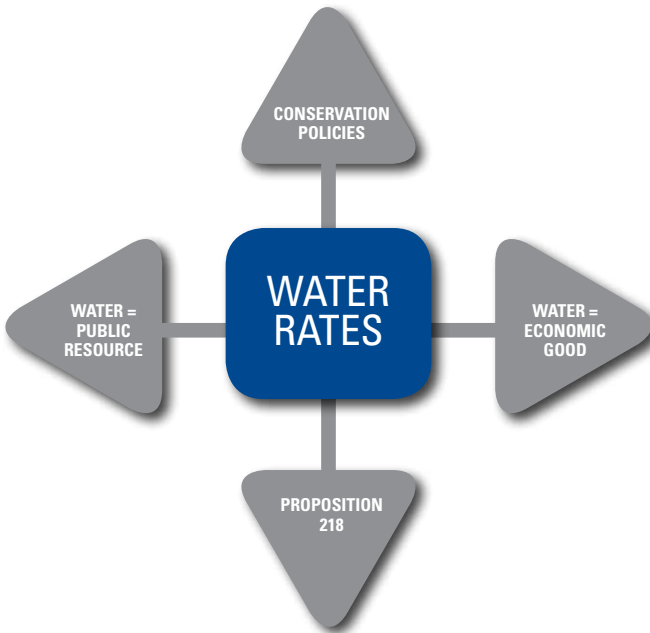
RATES AND STRUCTURES TABLE

Rate Structure	Description	Considerations
Flat/Fixed Rate	Flat or fixed charge per billing cycle	Simplicity, no conservation incentive, often metered consumption
Uniform Rates	Uniform volumetric charges	Simplicity, minimally conservation oriented, must have water meters
Inclining Block Rates	Rates increase with consumption	Multi-tiered, conservation-oriented
Declining Block Rates	Rates decrease with consumption	Economic- or business-oriented, uncommon today
Water-Budget Rates	Customer specific allotments, typically with inclining tiers	Requires detailed monitoring and billing systems

A special district's financing plans and resulting rate and fee strategies must be kept current. There are many considerations critical to an agency's successful provision of real-time, on-demand, and perpetual service to its customers.

Rates must be set to achieve intergenerational equity, which is to say they must meet the needs of future generations in addition to the present. An agency should have well-defined and adopted fiscal policies that support its pricing policies. And above all, rates must be set within an overall public policy framework, requiring in-depth discussions and a deliberate approach to the analysis.

When setting water rates, there are sometimes conflicting policy goals, mandates, and other realities to address before commencing the technical analysis. As seen in the diagram below, there are many dynamic forces to consider when setting these rates in California. There are discussions of the nature of water as a public resource and an economic good, as well as the mandates of Proposition 218 (the voter-approved California constitutional change dealing with rates, charges, property-related fees, etc.) and an overall statewide desire for water conservation.



BASIC ANATOMY OF A WATER/SEWER RATE STUDY

In general, a water or sewer (wastewater) rate study follows a three-step process. It is a good practice to have high-level policy discussions before this process starts to ensure the rate study team has direction and a solid framework in which to operate. Policy discussions should address such items as cost recovery, equity, and future plans for the district.

The initial step is not what most people think about first, which is the actual rate design. Rather, the rates are designed only after the overall financial plans and revenue requirements are well-vetted and the costs of service between various customer classes are understood.

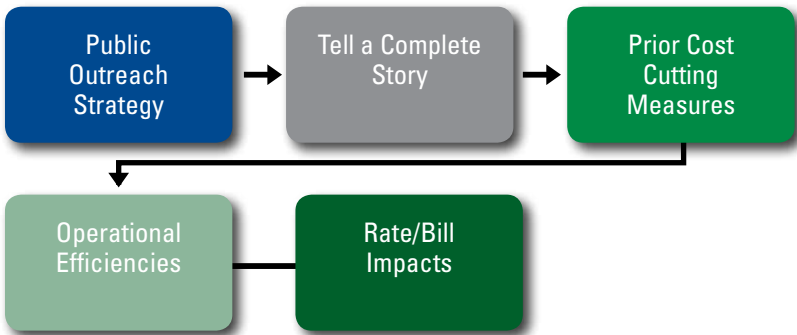
*For further discussion on rates overall, the *Principles of Water Rates, Fees, and Charges – Manual of Water Supply Practices/M1*, published by the American Water Works Association, is a comprehensive and well-regarded publication on water and wastewater related matters.*

- 1. Financial Plan and Revenue Requirements Analysis** – This defines the annual revenue the utility/special district needs to collect from ratepayers, to pay current costs, and contribute to infrastructure improvements.
- 2. Cost-of-Service Analysis** – Results in equitable and fair allocations of revenue requirements to each customer class; this is a critical aspect of meeting Proposition 218 mandates for proportionality.
- 3. Rate Design** – Defines the rate structure or the means by which rate revenue is collected from each customer class.

COMMUNICATION

Communication is key to the overall success of a special district, and especially so when a rate increase is on the horizon. A proactive approach to educating your community is the first step. Well before a notice of increase is sent out, you should be providing regular updates on water quality data, system improvements, cost-cutting efforts, and so on.

TIPS FOR A SUCCESSFUL RATE SETTING PROCESS



A proactive approach to educating your community is the first step. Well before a notice of increase is sent out, you should be providing regular updates on water quality data, system improvements, cost-cutting efforts, and so on.



User and Regulatory Fees: Overview

User fees are for the use of public goods and services, while regulatory fees are paid to enforce certain powers of the local agency for the public good. It is important to have a strong overall understanding of a special district's cost structure before designing such fees and then to have a dialogue about cost recovery for those fees. Special districts should regularly update and compile all fees into a Master Fee Schedule.

USER AND REGULATORY FEES: DISCUSSION

User and regulatory fees represent cost recovery opportunities entirely within a special district's control. Fees can be implemented or modified upon public hearing, without further public process or approval. A Proposition 218 process is not required, nor are such fees covered by the strict guidelines of the Mitigation Fee Act.

There is a difference between a user fee and a regulatory fee. User fees are charges collected for a service provided or required due to the request or voluntary action of an

individual or entity, while regulatory fees are those imposed to recover costs associated with an agency's power to govern certain activities.

Examples of common types of user fees include those charged for development-related approvals and regulations (planning, engineering, and building) and recreational classes and community sports programs. An example of a regulatory fee is one charged for public safety services, such as a California Fire Code permit. In most cases, the primary legal consideration on the establishment of user and regulatory fees is that they may not exceed the estimated and reasonable costs incurred to provide the service for which the fee is charged.

To determine the maximum estimated and reasonable cost eligible for recovery as a fee, a thorough cost analysis is necessary. These efforts identify the full cost of service eligible for recovery from fees and translate those costs into a fee structure for various programs and services. Determination of the full cost of service is an analytical exercise combining expenditure and organizational information with time-tracking data, time estimates, and workload information. The full cost of service should be projected for each service or activity, and

include labor, services or supplies, and various types of operational overhead costs.

Additionally, fees should be structured for fairness and equitability in the amount charged to the fee payer. Examples of common fee structures include:

- **Flat fees** - The fee is the same regardless of the size of the project or request.
- **Variable fees** - The fee amount is tiered according to the size of the project or request.
- **Deposit-based fees** - An initial amount is collected from the fee payer and the amount of time and materials required to accomplish the request are expensed against the deposit.

Fees should reflect an economy of scale as a project's size or service request increases. Properly-designed fee structures collect revenues in direct relationship to the cost of the services performed. State law prohibits the structuring of fees that would require one category of fee payers to pay more than their fair share to make up for a discount provided to another category of fee payers receiving the same service. For example, providing a subsidy to reduce a fee for a low-income payer fee is allowed. However, an alternate revenue source to cover that subsidy, such as non-dedicated property taxes, miscellaneous income (cell-tower rents) or grant funding, must be identified.

Compiling all individual fees across multiple departments or service areas into a single Master Fee Schedule document is recommended. In this way, all fees are reviewed at the same time and both staff and the public have a single point of reference for fee amounts.

In summary, the benefits of realigning user fees include:

- Reduction in general fund subsidies (i.e., more funds for other uses)
- Realization of revenue for services that have been reduced or eliminated
- Ensuring departments are budgeted and funded efficiently, with adequate staffing
- Continued provision of necessary and basic local services

Understanding the full cost of providing services and structuring fees properly helps management and policy makers allocate available financial resources effectively. Ensuring that fees are calibrated to the costs of providing service provides an opportunity for your special district to optimize revenue sources and ensures compliance with State law that requires fees to be set at the estimated and reasonable cost of providing each service.



Developer-Related Fees: Overview

Development impact fees (DIF) and Quimby Act fees (Quimby), as well as utility-related connection charges or capacity charges, differ in some ways. However, all are a one-time fee – not a tax but a type of exaction – imposed to generate funds for new or expanded infrastructure required because of new development, whether commercial or residential. They are not to be used for ongoing operations and maintenance needs.

In general, a local government can unilaterally approve and implement such developer fees. However, special districts typically cannot directly implement a DIF or Quimby but need to work cooperatively with their local city or county to secure approval of such fees. Quimby fees are specifically for parkland acquisition costs. DIFs on the other hand are constrained by the Fee Mitigation Act and are most commonly used by fire protection districts and recreation and park districts.

A special district may directly collect a utility-related connection charge or capacity charge. These charges directly pay for the costs associated with adding a new parcel to a water or wastewater system, whether it be the physical connection of pipes or the added capacity or burden that will be placed on the collection and treatment system.

DEVELOPER-RELATED FEES: DISCUSSION

Various types of DIFs have been valuable tools used by local governments throughout the United States. The authority nationwide to charge DIFs comes from a local government's police power – the right to make laws and regulations to protect the public's basic health, safety, and welfare. State-enabling legislation for DIFs is in place in approximately half of the 50 states, including California, and legal cases in both state and federal courts have affirmed their thoughtful use.

To develop any form of a DIF, there must be these three primary elements:

- A need for the facilities caused by the new development
- A benefit to the payer from the facilities
- Proportionality in fees charged, allocated on a fair and rational basis, as demonstrated by appropriate analysis and calculations

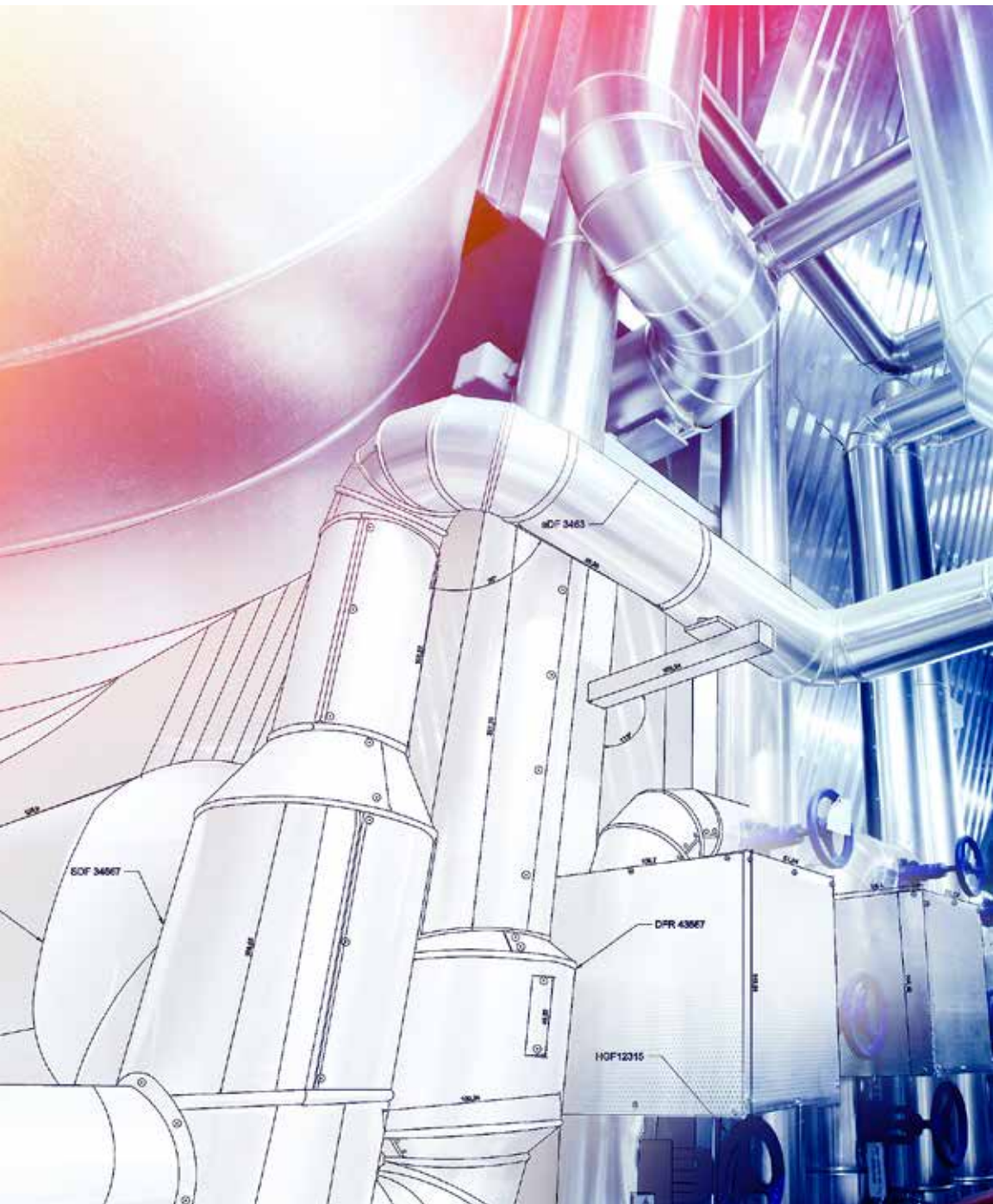


Impact Fee Definition

According to Robert L. Bland of the University of Texas, a noted expert in this field, the specific definition of impact fee is as follows:

A charge to developers for the cost of off-site capital improvements needed to serve new development. Impact fees provide up-front financing for the expansion of public facilities, such as water and sewer treatment facilities or arterial roads, needed to serve a new development.²

2. Bland, R.L. (2005) A revenue guide for local government (2nd edition). Washington D.C.: International City/County Management Association



DIFs, connection charges, and capacity charges have been an indispensable tool in the development and rapid growth of California and are used extensively today. There are developer-related fees for a wide range of items.

The more traditional infrastructure items financed with such fees include:

- Water provision facilities
- Sewer treatment facilities
- Storm drain systems
- Streets and arterials
- Parks, trails, and open space areas
- Community and public-safety buildings and apparatus

In addition, the law in California has allowed some more creative uses of DIFs, including:

- Child care facilities
- School facilities
- Cemetery infrastructure

The adoption of impact fees is both a policy and fiscal choice, requiring discussion and due diligence. Conceptually, development is a privilege, not a right, and that privilege comes at a cost. This cost can be paid

with a DIF. In 1971, the California Supreme Court upheld these general DIF concepts in the case of *Associated Home Builders v. City of Walnut Creek*. There have been other lawsuits and cases heard since then that further define the use of DIFs.

The Mitigation Fee Act, California Government Code Section 66000-66025, codifies some generally-accepted practices and uses of municipal police power in the world of DIF. The most important tenets of this Act are as follows:

- Nexus or connection between impact and regulation
- Costs must be well documented and proportionally allocated
- Procedures for adopting and protesting impact fees
- Reasonable relationship between fee amount and actual impact of the associated development

DIF revenues must be strictly segregated and only used for the purposes allowed. It's important to monitor and report on funds collected and use them on a timely basis for the purposes identified.

The Quimby Act has long been used by California local agencies to provide parkland and recreational facilities, setting fees on residential subdivision developments as a condition for approval. Special districts work with cities and counties to receive such lands and/or fees.



Parcel-based Revenue Tools: Overview

Special assessments were used across the United States in the early 20th century and became a significant revenue source for some California municipalities, including Los Angeles and Oakland, as well as for irrigation districts in the Central Valley. In this burgeoning state, a number of assessment laws were established after 1910 and many more have been added since then. Assessments fell out of favor during the Great Depression, becoming less commonly used until the passage of Proposition 13 in California in 1978, at which time various parcel taxes also became more prominent.

In California today, significant special assessment and tax activity exists, collectively known as parcel-based revenue tools. The state maintains a lengthy list of enabling statutes, while many charter city ordinances authorize such revenue tools, also known as Special Financing Districts (SFDs). The current system is complicated and requires a variety of support, including:

- Community leadership
- Public outreach
- Political will
- A myriad of approval processes
- Many expert consultants and legal counsel
- An ongoing administration process to ensure a smooth application

Unless a drastic change occurs in either the financial or political landscape, the use of SFDs in California will increase as the population and the desire for additional services and infrastructure increases. The funding for most new or enhanced services and projects is typically unavailable except through the use of SFDs. Occasionally, statewide bond measures or one-time funding sources emerge; however, in most cases, these needs must be funded locally.

Important Definitions

Special Financing District (SFD) – This term, while not part of the legal lexicon or state statutes, generally refers to all special assessments and special taxes levied by local public agencies on property or parcels of land, whether technically a “district” or not. Not to be confused with a special district, an SFD is not a local agency but rather a funding mechanism that is always tied to a city, county, special district, school or other form of local government.

Special Assessment – Also known as a Special Benefit Assessment (or Benefit Assessment), this is a charge levied on parcels of land or businesses, based on the special benefit received from the service or capital improvement, or both. The benefit criteria and formula are typically called a “Method of Assessment.”

Special Parcel Tax (Parcel-based) – This is a voter-approved charge calculated via some type of special tax formula – or Rate and Method of Apportionment, in the case of a Community Facilities District (CFD) – and is levied annually on property for a defined period of years.

Property-Related Fee – Not to be confused with fees for water, sewer and trash, this property-related fee is a charge to property for some type of service provided. An approval process is required. County Service Areas (CSAs) can charge such a fee for road maintenance, for example. The fee shall be based on the proportional cost to provide the service.



PARCEL-BASED REVENUE TOOLS: DISCUSSION

Attempting to understand the nuances behind special assessments and special taxes involves an awareness of two major ballot initiatives that affect the California landscape: Proposition 13 and Proposition 218.

Proposition 13, known as the “property tax revolt of 1978,” mandated a rollback to a one percent property tax rate at the commensurate assessed

value (ad valorem) of the property. With the passage of Proposition 13, California’s local governments lost 60 percent of property tax revenue and became severely limited in their ability to raise additional revenues for various efforts. In contrast, some states have ad valorem property tax rates that range from three percent to as high as six percent to fund local government services.

Proposition 218, the “Right to Vote on Taxes,” was approved by voters in 1996. This created a complicated categorization of assessments, taxes, property-related fees and charges, with an equally complicated approval process for each category. The implementation of Proposition 218 has been long and arduous and continues even today. For the purposes of this publication, the key point to consider is that special assessments and special taxes are two distinct groupings that require differing methods of approval and start-up as well as ongoing administration. The terms “Special Assessment” and “Special Tax” are confusing even to experts in the field and are often mistakenly used interchangeably.

Proposition 26 was approved by the voters in 2010. The emphasis for this measure was to further distinguish between fees and taxes with regard to their definition, use, and approval process.

WHY FORM AN SFD?

SFDs can provide funding for a myriad of ongoing services and financing for capital improvements. Although they have been in application for many years, the economic and political trends over the past few decades have bolstered their use and popularity.

In newly developing areas, the trend has been toward a national consensus that new development

must pay its own way. This trend has been fostered by a number of factors, chiefly the downturn in federal and state spending. Such spending peaked in the 1960s and again in the 1980s, but has declined significantly since then. Exacerbating this trend has been the numerous efforts to limit taxes by the voters. The most notable milestones were Proposition 13 and Proposition 218, as mentioned previously. SFDs can provide the necessary funding for new development in the face of these challenges.

In developed areas, requests continue for replacement and additional facilities as well as increased and enhanced services. Added to these demands are additional mandates with which local governments must comply, such as the evolution of requirements around stormwater and the National Pollutant Discharge Elimination System.

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The emphasis for this measure was to further
distinguish between fees and taxes with regard to
their definition, use, and approval process.**



All of these demands come at a time of shrinking revenue sources and voter-backed tax limitations and reforms. That makes a strong case for the creative, but well crafted, use of SFDs.

Whether the need is in a developing area or a long-established community, there is a trend for specific local sources of funding with direct accountability. Many recent initiatives have focused on dedicated revenues for various projects or concerns, often resulting in the unintended effect of limiting government's flexibility. In any case, an SFD can provide focused and accountable revenues for local projects and services of importance to the community.

SFD APPROVAL PROCESS

Since the passage of Proposition 218, all SFDs require an approval mechanism. Even with all of the required analyses prepared, the local economic conditions and customs understood, and the best type of SFD selected, the process would be for naught without consideration of the potential for approval.

In general, there is either a simple majority protest procedure or a two-thirds supermajority vote requirement, as follows:

- **Special Assessments:** Also known as benefit assessments or special benefit assessments, special assessments are subject to a protest ballot process, not an election. Property owners have the opportunity to voice approval or disapproval and may stop the district formation if a majority of those ballots returned are against the assessment. The ballots returned are weighted based upon

the financial obligation placed on each property. The financial obligation is determined based on the benefit the associated property is expected to receive from the funded services and infrastructure.

- **Special Taxes:** Special taxes require a two-thirds supermajority approval by the voters voting in an election. Special district taxes fund specific services and, because special districts only provide specific services, all special district taxes are inherently special taxes. As Proposition 13 restricts ad valorem taxes beyond one percent, special taxes may only be imposed in the form of a parcel tax, which is a flat charge per parcel regardless of its assessed value. Legislation has been discussed which could reduce the voter approval threshold for special taxes to 55 percent, similar to the threshold for school bonds, but such proposals have not moved forward at this time.
- **Property-Related Fee:** This particular type of fee (not for water, sewer, and trash) may be approved by either the registered voters with a two-thirds approval level or via ballot mailed only to property owners.

For an agency to gauge the potential for approval of the proposed fee, it is critical to understand the voters' and/or property owners' perspective. Polls, community meetings, public outreach, discussions with local leaders, and other vehicles are highly recommended.

A Community Facilities District (CFD), sometimes referred to as a Mello-Roos District after the authors of the legislation, can be used for a myriad of services and infrastructure. For example, a CFD can be used to provide additional park-related services for a community.

CFDs and Parcel Taxes

NOT BENEFIT-BASED	APPROVAL MECHANISM	SAMPLE PROJECTS
<ul style="list-style-type: none">• Reasonable metrics• Achieves local goals and policies	<ul style="list-style-type: none">• Voter approved, still 2/3 required• CFD landowner vote(s)	<ul style="list-style-type: none">• Parks• Libraries• Open space acquisition

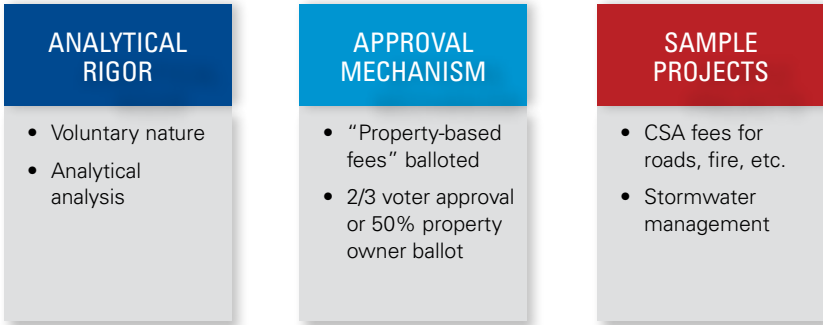
A special assessment or benefit assessment can be implemented for a variety of needs, such as the provision of new water or wastewater utilities to a community that had previously been served by wells or local septic systems.

Special Assessments

ARE BENEFIT-BASED	APPROVAL MECHANISM	SAMPLE PROJECTS
<ul style="list-style-type: none">• Subject to rigors of assessment engineering• Exclude general benefit costs	<ul style="list-style-type: none">• Property-owner• Protest ballot• 50% protest	<ul style="list-style-type: none">• Infrastructure, new and replacement• Ongoing maintenance

The use of a property-related fee for a special district in this SFD context is rather limited. However, for example, County Service Areas have the ability to use a property-related fee to fund a wide variety of services.

Property-related Fees



PARCEL-BASED REVENUE TOOLS: THE POLITICAL CONSIDERATIONS

With the passage of Proposition 218, public outreach, solicitation of community input, and a subsequent campaign have become necessary to ensure the passage of any measure. In fact, an approval process is required for any new or increased special assessment or special tax. Thus, the development of any SFD calls for a vibrant public policy component involving affected property owners and local voters.

Planning for an SFD often requires a long lead time to ensure success. Ultimately, a timeline with important milestones and clear responsibility for achieving the tasks is required. Strong leadership is needed throughout the process. This monumental topic is the subject of many other books and resources, so only a summary of the concepts is provided here. In general, however, the following questions must be asked:

- How strong is the desire or need for the project or service?
- What is the overall ability and desire to pay the proposed assessment or tax?
- Which is more appropriate - an assessment, tax, or fee?
- What are the commensurate approval thresholds and processes required?
- How long will the process take and how will other events and proposed measures affect the timeline?
- How much outreach is required?
- What is the chance of success?

These key elements represent the essence of the proposed SFD and must be addressed to achieve success.

Local governments may not advocate for a new measure. However, they can educate the community with clear information about the measure, its commensurate costs and benefits, and the overall process. If any advocacy is needed, and it usually is, private individuals or non-profit groups should be involved.

TAX INCREMENT FINANCING

Tax increment financing (TIF) has been used for decades in dozens of states, including California. TIF financing was popular in California, via the widespread use of redevelopment agencies (RDA) throughout the State. However, RDAs were officially dissolved in 2012. There are

ongoing legislative efforts to promote Infrastructure Financing Districts (IFDs) and Enhanced Infrastructure Financing Districts (EIFDs), though these financing mechanisms are not nearly as flexible or profitable as RDAs once were.

School districts and their property tax share may not be part of an IFD or EIFD process, and they are unable to force the diversion of property taxes away from special districts and other local agencies without their consent as RDAs were once able to do. IFDs and EIFDs also allow for greater involvement and collaboration from special districts than RDAs afforded.



School districts and their property tax share may not be part of an IFD or EIFD process, and they are unable to force the diversion of property taxes away from special districts and other local agencies without their consent as RDAs were once able to do.

VOLUME 2

The Context





Property Taxes: Overview

Property taxes are California's second largest source of revenue, generating \$60 billion annually for local agencies. The basic property tax is ad valorem, based on the value of the property. While the concept sounds simple, the base property tax system is complicated. This is due in large part to Proposition 13, which was passed by the voters as a constitutional amendment in 1978.

During the 1970s, property values were increasing rapidly and there was virtually no cap on the rate local governments could charge each year to generate revenues.

Prop 13 reacted to this situation by restricting local authority to impose and collect property taxes. The initiative locked in these three important factors:

- Capped the base ad valorem property tax rate at one percent
- Limited the growth in assessed value to two percent annually, unless a property is sold or reassessed for other specific reasons
- Shifted the allocation of property taxes to the State Legislature

If a new agency is created today, it will not receive any property tax revenue unless another agency gives up a portion of its share of the one percent.

After legislation, court cases, and four decades of practice, it is fair to say that local government is limited in general property tax revenues statewide. Additional

property taxes can come in just a few forms, all of which require a supermajority approval of two-thirds. This includes:

- A general obligation bond, with a two-thirds voter requirement, to finance certain capital projects
- Any parcel taxes are not ad valorem taxes as they are deemed to be "special taxes" and require a two-thirds approval to be approved

Given that a special district cannot typically rely 100 percent on property taxes, local agencies and their elected leaders must be mindful of all revenue sources that can help them remain fiscally sustainable.

Visit the CSDA Bookstore for helpful publications including Special District Reserve Guidelines, Proposition 218 Guide for Special Districts, and Proposition 26 Guide for Special Districts.

PROPOSITION 13, 218, AND 26

As discussed in Volume 1, local governmental agencies today are revenue-constrained. It's widely believed that the 20th century "tax revolt" against local government was founded in California, as evidenced by the passage of Proposition 13 in 1978. 64.79 percent of the voters approved this proposition, which rolled back property taxes significantly, and effectively abolished local governments' control over property taxes charged.

The major provisions of Proposition 13 can be summarized as follows:

- ***Property tax rate is capped at one percent and values rolled back:***
Prop 13 mandated a reduction of the tax rate to a flat one percent, and this rate was multiplied by the "assessed value" which was rolled back to the 1975-76 year value. Previously, tax rates varied but were typically in the two-three percent range.
- ***Reassessment only upon change in ownership:***
Prior to Prop 13, the assessed value of a property was changed based on the market. Prop 13 states the value will increase by no more than a two percent annual inflation factor, unless ownership changes.

- ***Tax allocation process transferred to the State:***
Prop 13 gave state lawmakers the authority to allocate all property taxes among local jurisdictions, where previously local governments could increase taxes and allocate them as they saw fit.
- ***Two-thirds voter approval for new special taxes:***
The proposition stated that the only other property taxes would be "special" and require a two-thirds vote of the community for approval.
- ***Any taxes imposed by the Legislature require a two-thirds vote:***
New taxes must receive a supermajority for implementation.

In 1986, California voters approved Proposition 46 which restored the option of approval for bonded indebtedness for capital projects. Today, for example, we see General Obligation (GO) bonds with a two-thirds approval funding many local improvements. Such indebtedness will increase the one percent tax rate for the duration of any such debt.

In November 1996, the voters approved Proposition 218. This measure added additional restrictions to the raising of revenues, as found in Article XIIC and XIID of the California Constitution. It



allows voters to repeal or reduce taxes, assessments, or fees through the initiative process and it reiterates certain requirements for approval of any new general or special tax. Prop 218 also mandates procedural requirements for benefit assessments imposed on property as well as certain types of fees.

After passage of Prop 218, most thought that charges such as water rates were not subject to these regulations. The Bighorn-Desert View Water District case (decided July 20, 2004) would change all of that, providing direction that water consumption charges were indeed a property-related fee subject to certain provisions of Prop 218.

For more in-depth treatment of both Proposition 218 and 26, please refer to CSDA's publications: *Proposition 218 Guide for Special Districts and Proposition 26 Guide for Special Districts*. In addition, while not special district-focused, the California Municipal Revenue Sources Handbook published by the California League of Cities

is an excellent source of information on revenues for local governments in California. As noted previously, the Principles of Water Rates, Fees, and Charges – Manual of Water Supply Practices/M1, published by the American Water Works Association, is a comprehensive and well-regarded publication on water and wastewater related matters.

COST RECOVERY THROUGH USER AND REGULATORY FEES

Special districts in California have varying levels of need for cost recovery through user and/or regulatory fees. Common examples of districts that recover costs through fees for services include:

- **Fire districts for fire prevention programs:** review of planning entitlement applications for conditions of approval, plan check and inspection of new residential and commercial buildings for access and fire code compliance, plan check and inspection

of new or retrofitted sprinkler and alarm systems, annually-required California Fire Code permits, and State mandated annual inspections of existing businesses.

- **Recreation and parks districts:** recreational classes and programs, child care, aquatics, and park and facility rentals.
- **Utility districts:** plan check and inspection of new development's engineered improvements, installation or removal of water meters, account registration, water turn on or shut off, lateral repair or installation, hourly billings for system damage repair, and annual stormwater compliance inspections.

Regardless of whether your district fits within one of the primary examples above, knowing the costs of providing services and identifying areas where new fees may be charged is an important aspect of overall cost recovery policy and procedure and paramount to solid financial management and sustainability.

In California, a fee is defined as a fee and not a tax because the amount charged does not exceed the cost of providing the service. It is important for special district staff and board members

to understand the bigger picture of the total costs of providing a service before deciding what the price of each service will actually be, whether at or below the total cost. The total costs of providing services should include consideration of both direct costs and indirect costs.

Direct costs are the obvious types of costs of doing business, such as staff's salary and benefits per hour required to provide a particular service. Less obvious are indirect costs such as the appropriate share of operational supplies or overhead costs at both the program and district-wide level. To define a reasonable share of indirect costs associated with any service, a cost allocation approach is useful.

Many districts are aware that indirect administrative costs can be quantified and recovered from various funds, grants, fees, and charges. However, staff may be unsure of the best method of assigning and effectively recovering these costs, which can be substantial. In many cases, hundreds of thousands or even millions of dollars are left on the table annually, due to a lack of awareness about indirect costs associated with various programs and services.

Even before an analysis of the costs of services is undertaken,

An Overhead Cost Allocation Plan is an analysis, accompanied by supporting documentation, which distributes the indirect support services costs of an organization to the direct services and activities provided in a fair and equitable manner.

you may already be aware that the full cost of providing a service is higher than the price the local community can bear. For a variety of reasons, local governments sometimes adopt fee amounts at lower than the full cost amount eligible for recovery.

Development of a formal cost recovery policy unique to the district's operational and political environment has a number of advantages, the greatest of which is an agency-specific benchmark for establishing, reviewing, and updating fee amounts in the future. For example, the policy may indicate that services provided to new construction should try to recover 100 percent of their full cost of providing services, whereas certain types of regulatory inspections for public safety issues might have a recovery goal of 50 percent to encourage compliance. A district may want to promote teen recreation services as a policy goal and therefore may subsidize such services or provide them at no user cost at all.

When considering how to price services, decision-makers often find it helpful to conduct a survey of fees charged by surrounding agencies. While this might be a useful exercise politically and for establishing the market for neighboring jurisdictions' rates for

various services, comparative surveys can be misleading. Such surveys are best complimented by a robust overhead cost allocation plan study and a full cost of service (fee) analysis. Fees should be understood holistically from these analytical perspectives. Ideally, an in-depth fee study should be done every three to five years, or sooner if significant organizational changes are made or costs change dramatically.

DEBT FINANCING

If an infrastructure project or other effort prudently requires financing, per California state law, a special district is able to issue tax-exempt debt secured by an appropriate revenue stream in order to finance public improvements that will be of benefit to the district and its constituents. Such tax-exempt debt can be issued via a public offering or a private placement. Other types of financings can be accomplished via the California Infrastructure and Economic Development Bank (IBank), State Revolving Fund (SRF), USDA, an inter-governmental loan, or other methods. Each method differs in terms of timing, documentation, and costs. A financial advisor (FA) is often consulted with such a decision.

PUBLIC OFFERING

In a public offering of tax-exempt debt, a special district sells its bonds to an underwriter who, in turn, resells them to various investors, such as institutional buyers, mutual funds, and individual retail investors. The bonds are offered for sale through an official statement (OS) that describes the terms of the bonds, the security for repayment of the bonds, and the special district's demographics and finances. Special district staff's involvement in the preparation and review of the OS is required under federal securities law. The special district will need to ensure that the information being disclosed to the public does not contain any material misstatements or have any material omissions.

The underwriter purchases the bonds from the special district pursuant to a bond purchase agreement which sets forth the terms and purchase price for the bonds. Publicly-traded bonds are typically rated by a national rating agency which assesses the creditworthiness of the special district and the bonds. A public offering financing generally takes three to five months to close. After the issuance of the bonds, a special district will be required to provide on-going annual financial disclosure to investors, including its audited financial statements.

PRIVATE PLACEMENT

In a private placement of tax-exempt debt, the special district sells its bonds to one or sometimes several buyers, which can be banks, high net-worth individuals, or hedge funds. Instead of an underwriter, a placement agent is used to gather bids on the bonds. The banks provide term sheets to the placement agent setting forth the terms for purchasing the bonds, such as the interest rate, length of term, prepayment provisions, and any covenants required of the special district.

Based on the terms provided by each bank, the special district selects the winning bank and the

If an infrastructure project or other effort prudently requires financing, per California state law, a special district is able to issue tax-exempt debt.



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Since 1988, the CSDA Finance Corporation has offered public offering and private placement financing solutions to special districts of all types and sizes.

bank purchases the bonds directly from the special district. Since the bonds are not sold to the public, an official statement is not prepared and a rating is not required. The special district will not have to provide on-going annual financial information as required in a public offering, but the bank generally does require the special district's annual audit and certain other information as available. A private placement financing generally takes one to two months to close. Given the amount of time and documentation necessary in a private placement of bonds is less than required for a public offering, the legal and consultant fees as well as other costs are substantially less in a private placement financing.

Whether a special district issues its bonds via a public offering, private placement, or other form of debt is a decision that the special district should make in consultation with its legal and financial team. The factors to consider in making this decision are length of term of the bonds, expected issuance amount, market conditions, expected interest rates, and total costs under each method.

ROLES OF BOARD, STAFF, AND CONSULTANTS

In the big picture, the community must be regularly informed about your special district, and perhaps even reminded of its very existence. This holds true for the district's general revenue situation. It truly is a necessity and an obligation that special district staff monitor, evaluate, and proactively manage all current revenue streams. Each board member should understand the importance of these revenue streams and be able to provide policy direction in that regard. Consultants, attorneys, and other professionals may be called upon to provide guidance and analysis, such as performing a rate study.

When pursuing a new revenue stream, or perhaps even increasing or restructuring an existing one, it can take an army of people to make it a success:

- **Board:** The board should provide overall policy direction to staff, while taking input from the entire community. At the end of the day, the board has the responsibility and approval ability for virtually all revenue tools.
- **Staff:** The staff run the ship, and analyze, monitor, and lead the efforts. Ultimately, it is the staff recommendation to the board which can make or break the effort.
- **Consultants and advisors:** Many different types of expertise may need to be called on when pursuing the implementation of a revenue measure. Sometimes it starts with polling and moves to education and outreach. Legal advice is generally recommended. Technical experts, economists, rate consultants, special tax consultants, engineers, financial advisors, bond counsel, and many others can be tapped for their specific knowledge and experience, especially in those communities where these efforts are not performed regularly.

Alignment is key to the success of any such effort, with everyone working towards the same goal.



Conclusion

This publication is intended to provide perspective and strategic understanding of special district revenues. Special districts are an important part of local government, providing valuable services in communities across California. They vary significantly in terms of the services provided and communities they serve.

Not all of these revenue tools are available at all times to every special district, but it's important to understand the reasoning, parameters, and overall guidelines of these tools. Most importantly, we hope that readers will gain some knowledge to support the overall fiscal sustainability of special districts.



CSDA

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