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## Coates' Canons Blog: CRFs for SDFs (aka Capital Reserve Funds for System Development Fees)

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**UPDATED August 2018: The legislature made a few changes to the System Development Fee law during the 2018 legislative session (S.L. 2018-34). For information on those changes, [clickhere](#).**

Local governments and public authorities (collectively, local units) that own or operate water and sewer systems must implement the new **system development fee** schedule by July 1, 2018, in order to begin charging (or continue charging) certain upfront fees for new development. Units are now looking to put policies in place to administer those fees according to state law directives. The fee revenues are restricted to specific purposes, and they must be “accounted for by means of a capital reserve fund....” This blog briefly describes the new system development fee law and details the purposes for which system development fee proceeds may be expended. It then explains the purpose of, and process for creating, a capital reserve fund. Finally, it provides a sample capital reserve fund for system development fee proceeds.

### What are system development fees (SDFs)?

SDFs are charges assessed on new development within a unit’s territorial boundaries to fund certain capital costs of the local unit’s water or wastewater system, that are attributable to that new development. New development is defined as any of the following:

1. subdivision of land;
2. construction, or any change to an existing structure, that causes an increase in the need for service; or
3. any use or extension of the use of land which increases the need for service.

The fees are calculated based on one of three possible methodologies—the buy-in method; the incremental/marginal cost method; and the combined cost method. Under the buy-in method, new development bears a proportional share of the capital costs previously incurred by the unit to provide sufficient capacity to serve the new development. This method is most appropriate when the unit can serve the new development with existing capacity. The incremental/marginal cost method requires new development to pay the proportional share of new capital costs that are attributable to the new development. This method is most appropriate when the local unit needs to expand its capacity to serve the new development. The combined cost method is a mix of the buy-in and incremental/marginal costs methods.

The law prescribes detailed substantive and procedural requirements for calculating, adopting, and collecting the SDFs, according to the chosen methodology. Click [here](#) for a summary of these requirements.

### What may a local unit use SDF revenue to fund?

The law also places certain restrictions on how a local unit may spend SDF proceeds. The restrictions differ depending on the methodology used to calculate the SDFs.

If the local unit uses the *incremental/marginal cost method* or *combined method* the fee proceeds may only be used to:

- Pay the costs of a new facility or the expansion of capacity of an existing facility that is necessitated by and attributable to the new development. Costs are limited to the following: construction costs, surveying and engineering fees, land acquisition costs, principal and interest on bonds, notes, or other obligations issued by or on behalf of the local unit to finance construction, land acquisition or surveying and engineering costs.
- Pay for professional fees incurred by the local unit for the preparation of the system development fee analysis.
- If no capital improvements are planned for construction within 5 years, or the costs are otherwise paid for through other means, pay the debt service on borrowings used to fund the construction or acquisition of existing capital

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improvements.

If a local unit employs the *buy-in method* to calculate the SDFs, the revenue may be used to reimburse the unit for previously completed capital improvements for which capacity exists to serve the new development. They are not unrestricted monies, though. As per the requirements detailed below, the buy-in SDF proceeds must be allocated either to pay debt service on past water or wastewater projects or to pay for future capital projects.

### **Administering SDF proceeds**

These legal earmarks, particularly the ones imposed on SDFs derived from the incremental/marginal cost or combined methods, are fairly restrictive. A local unit will have to track all SDF payments in a manner that allows the revenues derived from new development to be matched up with future capital expenditures that are “necessitated by and attributable to” that new development.

Furthermore, the law provides that all SDF proceeds be accounted for in a capital reserve fund (CRF). A CRF is a savings mechanism within an accounting fund. Unlike the general fund, enterprise fund, or revenue fund, a CRF is not an accounting fund itself. A local unit could have one or more CRF(s) in each of its accounting funds. It is simply a more formalized way to save fund balance for a future capital purpose. A local unit may establish a CRF to save monies for any types of capital projects for which it is authorized to issue bonds. For counties and municipalities, that equates to any capital projects they are authorized to undertake. For public authorities, the list of allowable projects will correlate directly to the purposes for which they are authorized to issue revenue bonds.

Monies, including SDF proceeds, must be allocated within the CRF to specific capital projects. A board may not simply state that the monies will be used for “future capital outlay,” or “future general fund projects,” or “future water projects.” Thus, whether the proceeds are derived from the incremental/marginal cost, combined, or buy-in methods, they will need to be appropriated to a CRF and allocated to one or more specific future capital project(s). In other words, the CRF is the mechanism to link up the SDF collections with the capital projects in the CIP that were used to calculate the amount of the SDFs.

### **How to establish a CRF?**

To establish a CRF a unit’s governing board must adopt an ordinance or resolution which states the following:

1. *The purpose(s) for which the CRF is being created.* A board may accumulate moneys for multiple capital projects within a single CRF, but it must list each project separately.
2. *The approximate periods of time during which the moneys will be accumulated for each capital project.* A board must provide a rough estimate of when moneys will be expended from the capital reserve fund for each capital project.
3. *The approximate amounts to be accumulated for each capital project.* A board must provide a rough estimate of the total amount of money it intends to save toward each of the listed capital projects.
4. *The sources from which moneys for each capital project will be derived.* A board must indicate the revenue sources it intends to allocate to the CRF to finance each project (e.g. property tax proceeds, utility fees, local sales and use tax proceeds, grant proceeds, etc.).

If a local unit has separate enterprise funds for its water and wastewater systems, the board could establish a CRF in each fund. Alternatively, it could establish one CRF that includes projects from both funds. If a unit maintains a separate revenue fund, pursuant to a revenue bond covenant, it may establish the CRF within the revenue fund. (That way the local unit can comply with both the bond covenant and the statutory requirement.)

Within each CRF, the local unit should list all of the specific projects that are included in its water/wastewater CIP to be funded with the SDF proceeds. (The system development fee law effectively requires that each local unit that charges SDFs create a capital improvement program (CIP) for its water and wastewater capital projects, that covers a planning horizon of between 10 and 20 years.) The board will then allocate the SDF proceeds to the specific projects within the CRF based on the statutory directives described above.

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### Allocating SDF proceeds to the CRF

A local unit's governing board must appropriate SDF proceeds to the CRF each year. (The appropriations may come from any of the unit's accounting funds but most likely will drive from the water and wastewater enterprise fund.) There are a few different ways to do this. The board could estimate at budget time the amount of SDF revenue it expects to receive during the fiscal year. It would then appropriate that revenue from the enterprise fund(s) in the budget ordinance to the CRF. Within the CRF, the board would allocate the SDF proceeds among the specific capital projects. Alternatively, the board could wait until it receives SDF revenue during the fiscal year and amend the budget ordinance (to recognize the revenues and appropriate them to the CRF) and the CRF (to receive the new revenues and allocate them among the specific projects). If the board takes the first option, it will have to amend the budget ordinance and the CRF if it receives more or less SDF revenue during the fiscal year. At a minimum, the board must amend the CRF at least once every fiscal year to appropriate the new SDF revenue for that fiscal year.

The board also may amend the CRF at any time to change the nature of the capital projects, delete projects, or add new projects, as long as the changes are consistent with the statutory directives on expenditures of SDF proceeds.

### How to spend monies that have accumulated in a CRF?

A local unit may not expend monies directly out of a CRF. Instead, the board must amend the CRF to withdraw the monies and then amend the budget ordinance or project ordinance to recognize the revenue and authorize its expenditure for the specific water/sewer projects or debt service payments associated with these projects.

### Sample CRF for SDFs

The following is a sample CRF for SDFs. The Town of Bluesky has a combined water and wastewater enterprise fund and this CRF is established within that enterprise fund. (Note that there is no set formatting required within the CRF. A local unit must ensure, however, that it provides all of the required information for each project. As new monies are appropriated each fiscal year, the local unit's board also must amend the CRF to reflect these appropriations and allocate the monies among the specific capital projects.)

## CAPITAL RESERVE FUND RESOLUTION

**WHEREAS, there is a need in the Town of Bluesky to provide funds for future capital projects related to its combined water and wastewater system, and to make debt service payments on existing debt related to past capital projects for its water and wastewater system, and WHEREAS, NCGS 159-18 authorizes the creation of a capital reserve fund, and WHEREAS, NCGS 162A, Art. 8 requires that all system development fee proceeds be accounted for in a capital reserve fund,**

**NOW, THEREFORE, BE IT RESOLVED BY THE GOVERNING BOARD THAT**

**Section 1. The Governing Board hereby creates a Capital Reserve Fund for the purpose of funding the following capital projects related to the town's water and wastewater system:**

**Water Treatment Plant Upgrade.** The existing plant on Fuller Avenue is designed to serve a population equivalent (PE) of 10,000, but is currently operating above its capacity at 11,200 PE, calling for an upgrade to meet current and projected future requirements. The estimated cost of the project is \$1.2 million. The town expects to complete the project in 2020, and intends to appropriate approximately \$300,000 of system development fee revenues to the CRF for this purpose. The town anticipates receiving a zero-interest loan from the state to fund the remainder of the cost. It will use future system development fee collections to make debt service payments on the loan.

*The 2018-2019 appropriation from the budget ordinance to the CRF of SDF proceeds for this purpose is \$100,000.*

**Construction of new elevated water storage tanks.** Estimated to be 0.650 million gallons, this new tank is

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planned for the distribution system near North Ponds Park, at a cost of \$2.2 million. Construction of the tank is expected in FY 2024-25. The town anticipates funding approximately 40 percent of the cost of the tank with system development fee proceeds. The remaining cost will be funded through existing fund balance in the water fund.

*The 2018-2019 appropriation from the budget ordinance to the CRF is \$550,000, comprised of \$150,000 in SDF proceeds from the water and sewer enterprise fund, and \$400,000 in water and sewer enterprise fund balance.*

**Regional Pump Station and Force Main:** One regional pump station project and one force main replacement project are already under design, to be complete by FY 2022. The estimated cost is \$900,000. The town anticipates funding 100 percent of the cost with SDF proceeds.

*The 2018-2019 appropriation from the budget ordinance to the CRF is \$156,000 in SDF proceeds.*

**Expansion of the Town of Bluesky Wastewater Treatment Plant:** Capacity expansion by 1.4 MGD is estimated to cost \$30 million. The project will occur in phases, with an expected completion date of 2030. Within the town's 10-year CIP planning period (FY 2018-19 through FY 2028-29), approximately \$20 million or 67% of the total cost, is anticipated to be expended. The town expects to issue revenue bonds to fund this project, to be repaid from both SDF proceeds and general wastewater user fees.

*The 2018-2019 appropriation from the budget ordinance to the CRF is \$75,000 in SDF proceeds.*

**Section 2. This CRF shall remain effective until all the above-listed projects, and any projects added in the future, are completed. The CRF may be amended by the governing board as needed to add additional appropriations, modify or eliminate existing capital projects, and/or add new capital projects.**

**Section 3. This Resolution shall become effective and binding upon its adoption.**

**Adopted this [day] of [month year].**

**Signature(s)**

## Links

- [www.ncleg.net/EnactedLegislation/Statutes/PDF/ByArticle/Chapter\\_162A/Article\\_8.pdf](http://www.ncleg.net/EnactedLegislation/Statutes/PDF/ByArticle/Chapter_162A/Article_8.pdf)