Coates' Canons Blog: System Development Fees are the New Impact 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.

As detailed **here**, in 2016, the North Carolina Supreme Court held that municipalities (and by analogy counties) lack the statutory authority to impose certain upfront charges for water and sewer services. Upfront charges are charges imposed on new or existing development before a property parcel is actually connected (or under contract to connect) to a local government's water or sewer system. Local government utilities across the state impose a wide variety of upfront charges, some that are assessed only on developers as a condition of securing development approvals, and others that are imposed on both new and existing property owners. The purposes of these fees range from reimbursing the utility for past investments, to reserving capacity, to covering the costs of extending infrastructure, to establishing a reserve for future maintenance or expansion of the system. In ***Quality Built Homes Inc. v. Town of Carthage*, No. 315PA15, ___ N.C. ____ (Aug. 19, 2016)**, the supreme court invalidated certain types of upfront charges. Questions remained, however, as to whether government utilities have authority to impose other types of upfront charges pursuant to their general rate-making authority. As detailed in this **post**, local government utilities were left to make difficult decisions about who to charge, when to charge, and how to calculate the amount of the charge.

A new law, the **Public Water and Sewer System Development Fee Act, S.L. 2017-138**, clarifies a local government utility's authority to assess upfront charges for water and sewer. The new law grants local government utilities specific authority to assess one type of upfront charge—a system development fee—albeit with significant limitations. It also preserves the authority of local government utilities to impose certain other upfront fees. At the same time, however, it prohibits local government utilities from assessing many of the types of fees that have become routine in recent years. Local government utility providers will need to act soon to bring their fee schedules into compliance.

This post sets out the basic contours of the new law. It discusses who must comply, who can be assessed and when, what the processes are for calculating and adopting the fee schedule, and how a local unit must administer the fee proceeds. It also lists the other types of allowable water and sewer charges. Finally, it identifies a few drafting quirks that may cause some implementation issues. The Generally Assembly has specified that the new law's provisions be narrowly construed by the courts. To that end, local officials should carefully follow the statutory requirements and proceed cautiously when interpreting any statutory ambiguities. (Future posts will flesh out the details for the calculation requirements and deal with potential liability issues for past fees that were assessed unlawfully.)

Who Must Comply with the New Law?

The new law applies to all local government entities that own or operate water and/or wastewater supply, treatment, storage, or distribution facilities (including facilities for the reuse or reclamation of water). In other words, it applies to municipalities, counties, sanitary districts, water and sewer authorities, county water and sewer districts, metropolitan water districts, metropolitan sewerage districts, metropolitan water and sewerage districts, and any joint agencies formed by two or more of these entities. It also applies to any local government entities created by local act of the general assembly, including Fayetteville Public Works, and Greenville Utilities Commission. For the remainder of the blog post, I will refer to these local government entities collectively as "local governments," "local units," or "local utilities."

Note that the new law only applies to fees assessed for water and wastewater systems owned or operated by these government entities. It does not apply to any other public enterprise activities (such as solid waste, stormwater, electric, or natural gas). And it does not apply to local governments that purchase water or wastewater services from other

government entities.

What is the New Law?

The new law grants a local utility the authority to assess a *system development fee* on new development within its territorial boundaries to fund certain capital costs attributable to that new development. Although the name suggests a single fee, the new law actually authorizes a fee schedule. The fee schedule will comprise multiples or derivatives of a base service unit fee. With a few notable exceptions, the new law also likely prohibits local units from assessing other types of upfront charges on new development (in the absence of local act authority). The law very specifically defines what constitutes new development, how to calculate the fee/fee schedule, what capital projects may be funded with the fee, and what process must be used to assess the fee.

New Development (aka Who Can be Assessed)

A local unit may assess a system development fee on the owner(s) of new development within the local unit's territorial jurisdiction. The fee may not be assessed on existing development.

New development is defined as any of the following that occurs after the beginning of the fee adoption process, but no more than 1 year before the local unit adopts the fee:

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 authority is thus triggered whenever a parcel of land within the local utility's territorial jurisdiction is divided into smaller tracts that can be developed independently of one another.

The authority is also triggered when there is a change to land or structures within the local utility's territorial jurisdiction that increases the need for service. Examples include construction of new structures that require water and/or wastewater services, as well as changes to existing structures or land that require more or larger meters and/or more water and/or wastewater system capacity to serve the property.

The statute further defines new development temporally. A local unit may assess a system development fee on any new development (as defined above) that occurs after the fee is enacted by the unit. It also may apply the fee retroactively to new development that occurred after the commencement of the fee adoption process and no more than one year before the unit adopts the fee. The beginning of the fee adoption process is triggered when the local government begins the written analysis of the fee. (As detailed below, before enacting a fee a local government must obtain a written analysis from a financial professional or licensed professional engineer detailing how the fee is calculated.) Although the statute is not entirely clear as to when the written analysis is deemed to begin, a reasonable interpretation is the date that local government executes a contract with the professional to perform the analysis. (To be safe, a local unit may want to specify in the contract that its execution marks the beginning of the written analysis.)

Note that this section sets out **who** can be charged. It does not address **when** a local unit may assess the fee. That will be discussed below.

Currently, many local utilities assess upfront charges on existing development, as well as new development. Under the new law, there is no authority for a local government to assess a system development fee on existing development, which is development that exists before the written fee analysis begins or development that occurs after the written fee analysis begins, but more than 1 year before the local government adopts the fee. (Note that the law includes a limited definition of "existing development" but it does not actually authorize a local government to assess a system development fee on this development.) As discussed below, a local unit likely has authority to assess other types of upfront charges on existing development.

Adopting the Fee

A unit must follow several procedural steps to adopt a system development fee schedule. Note that although a local unit

may not assess a system development fee before October 1, 2017, it may begin the process before this date.

- **Step 1: Professional Analysis.** The local unit contracts with a financial professional or licensed professional engineer to perform an analysis as to how to calculate the system development fee schedule (according to the statutory parameters). The professional must be "qualified by experience and training or education to employ generally accepted accounting, engineering, and planning methodologies to calculate system development fees for public water and sewer systems." The law seems to envision that a local unit will contract with an outside professional (as opposed to an employee of the unit) to perform the analysis, but it is not clear that this is a legal requirement. Whether the utility contracts with an outside professional or uses an in-house expert, at a minimum, the unit should document that the individual or firm meets the statutory qualifications and should clearly define the scope of work.
- **Step 2: Public Input.** The local unit posts the professional's written analysis, and proposed system development fee schedule, on the unit's website and solicits written comments from the public. (As noted below, the fee schedule will include the service unit rate, as well as a conversion table that applies some multiple or derivative of the service unit rate to the various categories of demand.) The law requires the local unit to "furnish the means" for providing the comments. The unit could allow for electronic comments or provide a downloadable form. The analysis must be posted for at least 45 days before the unit "consider[s] the adoption of [the] system development fee analysis…."
- **Step 3: Professional Analysis Reconsidered**. The local unit submits any comments the unit receives from the public to the professional for consideration of possible modifications or revisions.
- **Step 4: Public Hearing.** The local unit holds a public hearing on the proposed system development fee schedule, including any modifications or revisions stemming from the public comment period. Note that the new law does not specify notice requirements for the public hearing. It is likely implied that the unit must publish notice, and, if so, it should follow the default provisions in G.S. 1-597. Note also that a separate law, that applies to counties, municipalities, sanitary districts, and water and sewer authorities requires that these local units also provide certain notice and permit an opportunity for public comment, before imposing or increasing fees oar charges applicable to subdivision development. These requirements are detailed **here**.
- **Step 5: Adopt Resolution or Ordinance.** The unit's governing board adopts a final system development fee schedule by resolution or ordinance.
- **Step 6: Notice of System Development Fee Schedule**. The local unit publishes the system development fee schedule in its annual budget ordinance or incorporates it into its water or wastewater fee ordinance(s). Note that a unit likely can comply with steps 5 and 6 by adopting the system development fee as part of its budget ordinance or water/wastewater rate ordinance to begin with.
- **Step 7: Periodic Updates.** A local unit updates the system development fee analysis periodically, at least once every five years.

Calculating the Fee

As stated above, the local unit must contract (or employ) a qualified financial or engineering professional to aid it in setting the system development fee schedule. A local unit may not adopt a higher rate/fee schedule than that calculated using the professional analysis. In preparing the written analysis, the financial or engineering professional must do all of the following:

- Consider and select an appropriate, generally accepted accounting, engineering, and planning methodology to calculate the fee. Possible methodologies include the buy-in, incremental cost or marginal cost, and combined cost methods. (Although the new law seems to suggest that other methods may be appropriate, it does not provide a means for expending proceeds if the fee schedule is calculated using another method.)
    - *Buy-in Method.* Under this method, new development bears a proportional share of the capital costs previously incurred by the unit that allow for sufficient capacity to serve the new development.
    - *Incremental/Marginal Cost*. This method requires new development to pay the proportional share of new capital costs that are attributable to the new development.
    - *Combined Cost*. This method uses a combination of the buy-in and incremental/marginal cost methods.
- Document the facts and data used in the analysis with sufficient detail to demonstrate their sufficiency and reliability.
- Document the analysis performed to select an appropriate methodology, and demonstrate the application of the methodology to the facts and data (including all interim calculations).

- Identify all assumptions and limiting conditions affecting the analysis and demonstrate that they do not materially undermine the reliability of the conclusions.
- Calculate a final system development fee per service unit of new development. A service unit is defined by the new law as “a unit of measure, typically an equivalent residential unit, calculated in accordance with generally accepted engineering or planning standards.”
- Incorporate a credit calculation for the value of costs of the capital improvement that exceed the new development’s proportionate share of connecting facilities required to be oversized for the use by others outside the new development. The credit will not be applied to on-site capital improvements or to costs to connect the new development to water or sewer facilities.
- Depending on the chosen methodology, incorporate a revenue or valuation credit to avoid double-dipping by the unit (*ie*. Raising revenue from different sources to cover the same costs.).
- Include an equivalency or conversion table that can be used to determine the fees applicable for the various categories of demand. This will become the fee schedule.
- Cover a planning horizon of between 10 and 20 years.

When Fee Assessed

When a local unit may assess the system development fee depends on the nature of the new development. If the new development involves a subdivision of land, the local unit must collect the fee either when the plat is recorded or when the local unit otherwise legally commits to provide the water and/or service to the development. That commitment should trigger the local utility to reserve sufficient capacity (and possibly make other infrastructure changes, expansions, etc.) to serve the future new development.

If the new development involves construction, reconstruction, redevelopment, conversion, structural alteration, relocation, or enlargement of any structure, or any use or extension of the use of land, which increases the number of service units, the local unit must collect the fee when the developer/property owner applies for connection of an individual unit of development. This timing makes sense if the new development involves a new structure. If, however, the new development involves changes to an existing structure that require increased water or sewer capacity, the directive is less clear. A local unit likely may charge the fee when a new meter is installed or when additional capacity is otherwise triggered. To facilitate this process, a unit may want to convert its existing customer base into service units and then require that a customer reapply for service whenever there is a change to the property that results in an increase in service units.

How Fee Proceeds May be Expended

The law places certain restrictions on how a local utility may spend system development fee revenue. The restrictions differ depending on the methodology used to calculate the fee schedule.

If the local unit uses the *incremental/marginal cost* method either by itself or as part of a *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 (hereinafter “borrowings”) 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, the new law states that the local unit may use the proceeds “to pay the principal and interest on [borrowings] to finance the construction or acquisition of existing capital improvements.” However, because a “capital improvement” is defined as a “planned facility or expansion of capacity of an existing facility other than a capital rehabilitation project necessitated by and attributable to new development,” it is unclear what constitutes an “existing capital improvement.”

The new law is even less clear on how the proceeds may be spent if the unit employs the buy-in method. In fact, that section of the law (codified as G.S. 162A-211(b)), actually reads as if it is defining how to calculate a fee using the buy-in

method, rather than specifying how to use the proceeds. It provides that “revenue from [the buy-in method] may be expended for previously completed capital improvement for which capacity exists and for capital rehabilitation projects.” It goes on to require that the basis of the buy-in calculation include a valuation adjustment. It makes no sense for revenue to be “expended” for a project that is already completed, unless it is used to make debt service payments. Nor should the valuation adjustment impact how the funds are spent. The statute does allow proceeds to be expended on capital rehabilitation projects. But that term is defined so narrowly (because it is limited to projects that benefit development that occurred within one year before the unit adopted the system development fee) that it may not be useful to most local units. Because the whole purpose behind the buy-in method is to reimburse the government for certain past investments, it may be reasonable for a unit to use the proceeds of a system development fee calculated using this method for any future water or sewer capital project.

Administering the Fee

A unit must segregate any system development fee proceeds for budgeting purposes by including them in a capital reserve fund (CRF). Note that a capital reserve fund is not a “fund” for accounting purposes. It is essentially a statutory savings account that provides an alternative to fund balance. (In other words, instead of allowing the proceeds to accumulate as fund balance, a CRF allows a unit to demonstrate to its citizens how it intends to expend the revenues in the future.) The unit must adopt a resolution or ordinance establishing the CRF and appropriate money for specific capital projects, in accordance with the process set out in G.S. 159-18. (Click **here** for more information on how to establish a CRF.) When the unit needs to expend the funds for an authorized purpose, the board must first transfer the monies from the CRF to either the annual budget ordinance or a project ordinance.

Exclusive Authority (Kind of)

As stated above, local units across the state currently assess a variety of upfront charges for water and sewer services and refer to these charges by an even wider variety names. Common labels include impact fees, capacity fees, development fees, facility fees, capital recovery fees, and capital reserve fees. The new law grants authority for a specific charge and assigns it the label of “system development fee.” A unit may choose a different name for the fee, but it must structure and enact the fee exactly as provided in the new law.

The new law generally preempts other types of upfront charges for water and sewer services. In that respect, it provides the exclusive authority for these charges. A unit must cease assessing impact fees, capacity fees, and other similar charges that do not comply with the new law’s provisions. The law carves out a few notable exceptions, though.

First, it preserves a local government’s authority to assess regulatory fees (including plan review and inspection fees), tap or hookup charges (to cover the direct costs of connecting the service unit to the system), contractual charges (negotiated payments for infrastructure expansions), and availability fees (charges in lieu of mandating connection), even though these are types of upfront charges. A future post will walk through the full array of allowable charges for water and sewer services.

Second, although the new law does not allow a local utility to assess a system development fee on the owner(s) of existing development within its territorial jurisdiction, or on the owner(s) of new or existing development outside its territorial jurisdiction, it does clarify that every local utility may use its regular utility rate-making authority to assess charges for “services to be furnished.” Water and sewer authorities and county water and sewer districts already had this authority, and it has been interpreted by the courts to allow a utility to assess upfront charges akin to impact fees, as long as the unit has a concrete plan to serve the properties for which the charges are assessed. (See this **post** for more information on the contours of this authority.) Local units, thus, have a good deal of flexibility in setting upfront charges for existing development within their territorial jurisdiction or for existing or new development outside their territorial jurisdictions.

When Does New Law Go into Effect?

The new law takes effect on October 1, 2017. That means that local governments are authorized to begin implementing the new system development fee schedule as of that date.

The law also purportedly grants local governments a grace period of sorts to convert existing upfront charges to the new system development fee. The grace period only applies, however, to “system development fees” that were lawfully

imposed under other provisions of law. The new law, however, specifically defines a system development fee as a charge assessed on new development to fund capital improvements necessitated by and attributable to that new development or to recoup the costs of existing facilities that serve the new development. Thus, the grace period only extends to fees that were calculated to cover these exact costs. It does not apply to any fees or charges that were calculated to include past, current, or future capital purposes that were not directly necessitated and attributable to the new development. If a local unit does have a system development fee in effect on October 1, 2017, that fits within these parameters and has been lawfully adopted pursuant to another law, the unit has until July 1, 2018, to make the fee conform with the new law's requirements. That essentially means that the local unit has until this time to prepare the professional analysis and follow the other statutory procedures to enact the system development fee schedule.

Links

- appellate.nccourts.org/opinions/?c=1&pdf=34625
- ced.sog.unc.edu/upfront-charges-for-local-government-water-and-sewer-capital/
- www.ncleg.net/Sessions/2017/Bills/House/PDF/H436v6.pdf