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COURT OF APPEAL HOLDS GROUNDWATER PUMP CHARGE SUBJECT TO PROP. 218 AND PROVIDES GUIDANCE REGARDING REGULATORY FEES WHICH ARE EXEMPT FROM PROP. 218

by

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Introduction. On May 21, 2007 the 6th District Court of Appeal in San Jose ruled that a groundwater extraction charge levied to fund groundwater basin replenishment and other water supply programs was a property related fee subject to Proposition 218 in *Pajaro Valley Water Management Agency v. Amrhein*, 2007 WL 1464411. The Association of California Water Agencies filed an *amicus curiae* ("friend of the court") brief in the case, urging the Court to find the fee exempt from Proposition 218 as a regulatory fee to fund a program of environmental regulation and not a fee for a property related service subject to Proposition 218. While the case will be of most significance for groundwater management agencies and those who pay charges to those agencies, it also sheds some light on the scope of Prop. 218's property related fee provisions and provides some guidance for local governments which wish to fashion regulatory fees which are not intended to be subject to Prop. 218.

It should be noted that the decision will not be final until June 20, 2007 and that a petition for rehearing by the 6th District or for review by the California Supreme Court may be likely. Both the majority and concurring decisions seem to invite California Supreme Court review of this case, so it may be that the Court of Appeal decision is not the last word.

Background. The Pajaro Valley is an agricultural region including Watsonville and has a serious groundwater quality problem. Over-pumping of the groundwater basin is allowing salt water from the Pacific Ocean to invade the Valley's groundwater supplies, causing environmental damage that threatens the agricultural economy of the area. The Legislature responded to this problem by creating the Pajaro Valley Water Management Agency to regulate groundwater use in the basin, to fund water imports to replenish the groundwater basin, and other regulatory efforts. The Agency imposed a groundwater extraction charge to fund pipelines and water purchases to increase groundwater, the purchase of other supplies to eliminate the over-drafting of the basin, and efforts to address salt water intrusion. The charge was not collected via the tax roll, but billed to property owners or to tenants who operated wells in the basin of whom the Agency had notice. In 2003, the Agency increased this fee from $80 to $120 per acre-foot to finance a program of capital improvements. In order to sell bonds backed by the fee, the Agency

filed a validation action against "all interested persons" to obtain a judgment validating the fee, ensuring bondholders that the fee would be collected to repay the bonds. Farmers and residents subject to the fee answered the action, arguing the fee was invalid for, among other reasons, Agency's failure to conduct a protest proceeding pursuant to Prop. 218.

The trial court found the fee to be exempt from Prop. 218 and gave judgment to the Agency. Initially, the 6th District Court of Appeal affirmed that result, concluding that the fees in issue not property related. That decision, however, came two days after the California Supreme Court decided *Bighorn-Desert View Water Agency v. Verjil*, 39 Cal.App.4th 205 (2006), concluding that charges for metered water service were property related fees subject to Prop. 218. Because the reasoning of the initial appellate decision in the *Pajaro Valley* case was inconsistent with *Bighorn*'s analysis, the 6th District granted rehearing, accepted additional briefing and oral argument, and redecided the case, this time reversing the trial court and concluding Prop. 218 compliance is required.

Analysis. The two-judge majority in the case concluded that the fee was not a special tax primarily because the cases cited by the opponents of the fee holding other kinds of revenues were taxes were not on point. The court noted:

> "Under modern, law the central distinction between a tax and a fee appears to be that a tax is imposed for revenue purposes, rather than in return for a specific benefit conferred or privilege granted."[1]

However, it then stated:

> "The augmentation charge here exposes the falseness of this supposed dichotomy. While it is intended to finance improvements, and thus to raise 'revenue,' it is also charged in return for the benefit of ongoing groundwater extraction and the service of securing the water supply for everyone in the basin. Indeed, if not for the prohibitive cost of metering smaller wells, which necessitates charging those extractors on the basis of estimated usage, the fee might well be justified on regulatory grounds, as bringing the actual cost of groundwater nearer its true replacement cost and thus subjecting it to the regulation of the marketplace. This rationale might still be readily involved with respect to metered extractions and perhaps those estimated based upon particular facts such as the nature of the crops grown. In any event we are far from persuaded that the charge can be characterized as a 'tax.'"[2]

This is not an especially helpful analysis, as it amounts to a flat statement that the Court is not persuaded this charge is a tax without a plain rationale for that conclusion.

[1] 2007 WL 1464411 at *9, slip op. at 16.
[2] *Id*. at *9, slip op. at 16-17.

Agencies which wish to distinguish their revenue measures from taxes should note several crucial aspects of the charge in issue here: the amount of the charge was demonstrated not to exceed the cost of the regulatory program it was to fund, the proceeds of the charge could only be used for that purpose, and those subject to the charge are those that benefit from the program and create the environmental problems it addresses – those who pump groundwater and not merely those who own property or reside in the area served by the Agency.

Next, the majority concluded that the charge was not an "assessment" because it is not secured by an automatic lien on property, but could become a lien only as a judgment lien following a debt action:

> "the charge differs from many other levies in that no mechanism exists for reducing delinquent payments to a lien short of filing suit, obtaining a judgment, and executing the judgment on real property belonging to the debtor – a remedy available to any creditor."[3]

Put more simply, Prop. 218 defines the assessments it regulates as "a levy or charge *upon real property*."[4] The charge in issue here is not imposed on real property and collected via the tax roll, but billed to those who operate groundwater wells many, but not all, of whom are property owners.

The Court specifically rejected the fee opponents' claim that, because the charge had a capacity component (*i.e.,* a charge for existing or planned capital facilities[5]) are necessarily assessments, citing *Richmond v. Shasta Community Services District*, 32 Cal.4th 409, 422 (2004), which had rejected this same argument in a case holding that connection charges for new development are not property related fees subject to Prop. 218.[6]

The Court did conclude that the Agency's fee was a property-related fee subject to Proposition 218. It noted the tension between the *Bighorn* ruling that water service charges are subject to Prop. 218 and the decision in *Apartment Ass'n of Los Angeles County, Inc. v. City of Los Angeles*, 24 Cal.4th 830 (2001). In that earlier decision, the California Supreme Court ruled that a property-tax roll fee on landlords to fund housing code enforcement was not imposed "as an incident of property ownership" but on voluntary decisions to operate rental housing businesses. Voluntary decisions of that sort can be subject to non-Prop. 218 fees to fund business regulation. Thus, the question is the case is this: Is the Pajaro Valley fee more like a water service charge or more like a regulatory fee on those engaged in the extraction of groundwater in a manner that is causing discernible harm?

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[3] *Id*. at *10, slip op. at 18; *see also id*. at *17 – 18, slip op. at 32-33 (absence of power to impose automatic lien suggests, but does not establish, that charge is not a property related fee).
[4] California Constitution, Art. XIII D, § 2(b).
[5] Gov't Code § 66013(b)(3): "'Capacity charges' means charges for facilities in existence at the time the charge is imposed or charges for new facilities to be constructed in the future that are of benefit to the person or property being charged."
[6] The author of this paper was counsel for the successful local government in the *Richmond* case.

While the amicus brief for ACWA and the briefs for the Agency argued that the regulatory fee exception to Prop. 218 applies, the Court concluded to the contrary:

> "It would appear that the only question left for us by *Bighorn* is whether the charge on groundwater extraction at issue here differs materially, for purposes of Article 13D's restrictions on fees and charge, from a charge on *delivered* water. We have failed to identify any distinction sufficient to justify a different result …"[7] (Original emphasis.)

The Court appeared to be swayed by the fact that the fee was imposed on 660 agricultural users and 3,000 residential well owners and that, while the majority of the fees were paid by farms, there was no exemption for the amount of water consumed for domestic use by residents. From the Court's perspective, the fee an urban water user pays for metered service is not meaningfully different from the fee a rural well operator pays for groundwater replenishment and both fees should be subject to Prop. 218:

> "Under *Bighorn*, a homeowner or tenant who uses extracted water for bathing, drinking, and other domestic purposes cannot be compared to a businessman who, as described in *Apartment Association*, elects to go into the residential landlord business."[8]

I would argue that there is a meaningful difference between the two – the mitigation of the environmental consequences of water supply is the responsibility of an urban water provider and it charges its customers for those costs, which an economist would label "externalities." In the rural well setting, a property owner drills a well and uses it to provide water for his or her use. The environmental consequences of that water use are not mitigated by those individual property owners and that mitigation is not funded by them unless a regulatory or other fee is imposed on them by an agency with authority to do so. As the facts of the *Pajaro Valley* case demonstrate, the environmental consequences of well operation can be significant and, if something is not down to address the overdraft of the Pajaro Valley basin, all who depend on it may find it too salty for their use, which drastic consequences for the agricultural economy of their region. This argument may well be re-asserted in the California Supreme Court. It is not, however, the law. Once it becomes final, the *Pajaro Valley* decision will be the rule unless the California Supreme Court grants review of the case.

The Court did note that a fee on those who consume more water than needed for domestic use would not be subject to Prop. 218, and that a fee on those who produce water for agricultural use would likewise be outside the measure.[9] The Court also suggested that the fee might have been non-property related and exempt from Prop. 218 if it had a clearer regulatory purpose:

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[7] 2007 WL 1464411 at *15, slip op. at 27.
[8] *Id*. at *16, slip op. at 29.
[9] *Id*. at *16, slip op. at 28.

> "Further, even if a predominantly regulatory purpose would save the charge, it is difficult to see how it might do so here, where the majority of the users are charged on the basis not of actual but of estimated or presumptive use. Thus, while the augmentation charge may have some tendency to inhibit consumption and provide an incentive for efficient use *by metered users*, it can have little if any effect on the residential users who make up the majority of persons paying it. Nor is there any attempt to graduate the charge to further discourage the most intensive uses and encourage conversion to less intensive ones."[10] (Original emphasis.)

This discussion seems to limit a regulatory fee to those which accomplish their regulatory purposes by raising the cost of a product or activity that has consequences which regulation seeks to mitigate and to ignore regulatory programs – like that arguably in issue here – that accept the level of activity that is regulated but seek only to fund the mitigation of the harm that activity causes. For example, *Sinclair Paint Co. v. State Board of Equalization*, 15 Cal.4th 866 (1997) upheld a fee on sellers of lead-based paint to fund health care services to children affected by that paint. That fee, like all regulatory fees, had the incidental consequence of raising the cost of lead-based paint and making other kinds of paint relatively cheaper. Its primary purpose, however, was to fund health care services to those affected by such paint. Especially given a fundamental necessity like domestic water supply, the law should not require the regulator to choose a pricing strategy that makes the regulated activity more expensive over a strategy that focuses on the cost of mitigating the consequences of the activity. This, too, however, is an argument for the California Supreme Court if it takes this case rather than a statement of the law in light of *Pajaro Valley*.

Writing separately to concur with the majority, Justice Bamattre-Manoukian concluded that the fee in issue here is subject to Proposition 218 for the simple reason that residential well owners have no reasonable alternative to the operation of their wells and thus the fee should be understood as a water service fee akin to that in issue in *Bighorn*:

> "It appeared from the record here that the vast majority of property owners in the Pajaro Valley obtained their water from wells, and that alternative sources were not practically feasible. In these circumstances, I was concerned whether the continued use of this water should be characterized as part of the 'normal ownership and use of property' (citing *Richmond*) rather than as a "voluntary act of the property owner.' (same) *Bighorn* has resolved this issue."[11]

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[10] *Id*. at *16, slip op. at 29.

[11] *Id*. at *21. slip op. at 5 (Bamattre-Manoukian, J., concurring) (citations omitted). Justice Bamattre-Manoukian is also the author of the forceful dissent in *Silicon Valley Taxpayers Ass'n v. Santa Clara County Open Space Authority*, Cal. S. Ct. Case No. 136468 (does acquisition of regional open space provide sufficient 'special benefit' to property to allow assessment under Prop. 218.) which may have contributed to the Supreme Court's decision to review the case.

Practice Tips. Some practical advice can be extracted from the Pajaro Valley decision, not only for agencies which regulate groundwater pumping, but for all the local governments subject to Prop. 218.

First, a defensible regulatory fee that is not intended to be subject to Prop. 218 should:

- be labeled as a regulatory fee when it is adopted;
- be imposed on a regulated action (like pumping groundwater) and not on a property or property owner solely due to property ownership;
- provide regulatory incentives to engage in less of the activity which has negative consequences the regulation seeks to address – e.g., to use less lead in paint or to consume less water from an over-drafted groundwater basin. While this fee design is not mandatory, the *Pajaro Valley* decision shows that it can be helpful in excluding a fee from the sweep of Prop. 218.

Second, the case has consequences for water rates:

- In light of *Bighorn*, public lawyers have advised agencies which impose consumption bloc rates, which charge progressively higher rates for larger amounts of water consumed to encourage conservation, to provide a cost-justification for these rate structures. Such a justification could point to the varying costs of various water sources in an agency's portfolio of supplies and assign the cheapest water supply to the most efficient users of water. *Pajaro Valley* suggests that such a justification may not be necessary and that a purely regulatory motive to discourage inefficient use of limited water supplies may be enough. It is probably advisable to do both: demonstrate a cost justification for consumption bloc rates and state the regulatory purpose to discourage waste.
- It may now be helpful to distinguish between residential and non-residential uses of water, as it appears to be water for residential use that is most likely to be deemed a property related service under Prop. 218.
- It may be helpful to justify on expressly regulatory grounds aspects of water rate structures which have regulatory purposes – like consumption bloc rates, fines for unreported water leaks, and the like.
- As capacity charges can be defended against a Prop. 218 challenge on grounds different from those applicable to a water service charge, it may be helpful to state these charges separately in a water rate structure or at least to clearly identify the capacity component of the overall rate.

Third, as to the power to impose a lien on property to enforce delinquent charges, this power may make a court more likely to identify the underlying fee as an assessment or a property-related fee subject to Prop. 218. The value of this means of collection can be very great, especially in low-income communities where delinquency rates might otherwise be very high. However, it now comes at a price in terms of an agency's ability to defend its fee as not subject to Prop. 218. This trade-off now bears thought when a fee ordinance is drafted. No risk of a Prop. 218 problem arises from enforcement via liens that follow debt actions in court, perhaps small claims court, however.

Fourth, use of the property tax roll creates a presumption that a fee is property related.[12] According to the *Pajaro Valley* court, however, use of the tax roll to identify property owners as the presumptive person engaged in a regulated activity does not alone make the fee property related and subject to Prop. 218. However, a presumption that a property owner is engaged in regulated activity must be subject to rebuttal. That is, if the agency will bill a tenant or other user of property instead of the property owner on a showing the owner is not engaged in the regulated activity (as operating the well in the *Pajaro Valley* case), the fee will not necessarily be subject to Prop. 218. Thus, collecting a charge on the property tax roll creates a substantial risk that a court will conclude that that the charge is a tax, assessment, or property-related fee and subject to one or another of the provisions of Prop. 218 requiring voter or property-owner approval for the charge.

Fifth, *Pajaro Valley* tells us that a consequence of the Bighorn is that the notice of a proposed fee or fee increase under Prop. 218 need not be of the "amount" a person will pay (as the text of Prop. 218 states),[13] but of the "rate" that will be used to determine that amount.[14] While this would seem to be the only way to give notice of the sums a fee-payor can expect to pay, it is comforting to have a published appellate opinion to cite when we do so. Thus, it is a good idea to include a rate table in a Prop. 218 notice of a utility rate increase so that all the rates to be charged, including any inflation–adjustment or pass-through of wholesale charges or other costs reflected in the rate structure, are presented to property owners in the protest proceeding.

Conclusion. The *Pajaro Valley* decision will be a disappointment for groundwater managers if it is not taken off the books by a decision of the California Supreme Court to review the case. It will also be a lost opportunity for local governments generally to obtain a clear statement of the rules under which regulatory fees will be exempted from Prop. 218. It is not entirely unhelpful, however, in providing guidelines for the construction of regulatory fees that are not intended to be subject to Prop. 218.

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[12] California Constitution, Art. XIII D, § 6(b)(5) ("Reliance by an agency on any parcel map, including, but not limited to, an assessor's parcel map, may be considered a significant factor in determining whether a fee or charge is imposed as an incident of property ownership for purposes of this article."

[13] *Id*. at § 6(a)(1).

[14] 2007 WL 1464411 at *15, n.15; slip op. at 26, n.15.

The law of local government revenues continues develop rapidly. California Supreme Court decisions are due in 2008 involving open space assessments and regulatory fees on water permit holders. A legislative decision on A.B. 1260 (Caballero, D-Salinas) involving notice procedures for utility fees after Bighorn is in the offing, too. As always, we will keep you posted!