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Supreme Court Upholds Regulatory Fee Under Prop. 26

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California voters added Proposition 26 to our Constitution in 2010. Building on Propositions 13 and 218, it defines most government revenue sources as "taxes" requiring voter approval (for local governments) or two-thirds legislative approval (for the State) with two implied and seven express exemptions. The Supreme Court is just now beginning to clarify disputed issues under Proposition 26. Late last year, the Court decided just one issue in Ventura's dispute with its groundwater agency, concluding only that groundwater augmentation charges are subject to Proposition 26 rather than Proposition 218, as the Courts of Appeal had decided in earlier cases. It remanded that case for the Court of Appeal to apply the Proposition 26 test requiring the groundwater agency to show its charges reflected a "fair or reasonable relationship to the payor's burdens on, or benefits received from" its groundwater recharge efforts.

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May 7th brought the Court's second Proposition 26 decision, this time providing a bit more substance. In *California Building Industry Association v. State Water Resources Control Board*, the BIA challenged the State Board's fees under the general construction permit to enforce water quality measures, like erosion control during grading. The State Board accounted for its cost to implement eight water quality programs collectively, blending costs to regulate construction with the other programs. The BIA argued the general construction permit was less costly to implement than others and that construction fees therefore subsidized other water quality programs.

The Supreme Court disagreed, concluding the State Board satisfied Proposition 26's "flexible" cost apportionment requirement. The decision applies the *Sinclair Paint* line of cases involving regulatory fees challenged as special taxes under Proposition 13, as well as Proposition 26. Among the Court's more significant holdings are these:

Fees do not violate Proposition 26 if fee proceeds fall below or exceed projections. Rate-makers can estimate costs and revenues when making rates and, of course, predictions about the future will never be precisely accurate.

Under Proposition 13, a challenger must make an initial showing (a "prima facie case") before a rate-maker is obliged to produce an adequate record to justify its fee, and the challenger bears the burden to

persuade a court the fee is actually a tax. Proposition 26 reversed the burden of proof. No court yet holds that the challenger must make a prima facie case under Proposition 26, but Proposition 26's silence on the topic should establish that the rule is the same.

A public agency can defeat a challenge to rate-making legislation on its face (i.e., in general, as applied to all rate-payers) if its fee is intended to recover only costs, proceeds are accounted in a separate fund, and may be spent only for specified purposes. When a record on appeal is insufficient to allow application of this test, an appellate court may remand for more "findings," but not necessarily more evidence.

Proposition 26 was plainly intended to tightened the standards our Supreme Court articulated in *Sinclair Paint* in 1997. To date, the Court had not determined precisely how the law was changed. This case now identifies Proposition 26's three significant changes to the earlier rule: (i) as to the State, a tax is imposed only by statute rather than by any state action to raise revenue, such as agency regulations; (ii) "tax" is now a defined term and the exception for regulatory fees is defined by a list of allowable costs; (iii) it shifted the burden of proof from challengers to government.

Although the statute contested in the *BIA* case had not been amended post-Proposition 26, the Court applied Proposition 26, concluding it did not matter whether this case is decided under Proposition 13 or 26 because the only difference between two of significance here is the burden of proof. That does not matter here — or in most cases, apparently — because whether a fee is a tax is a legal question the court decides "on an independent review of the facts the Board is now required to prove by a preponderance of the evidence under Proposition 26." The burden of proof applies to disputed **facts**, not disputed legal questions. This levels the playing field for public agencies on legal issues, although they still bear the burden of proof on factual issues in Proposition 26 (and Proposition 218) cases.

That a fee is increased without growth in the costs it recovers does not prove it is a tax because a reduction in subsidies from non-rate proceeds can require fees to rise. This confirms that such subsidies are permissible, as most public lawyers conclude, but which some litigants contest.

The Court decides with minimal analysis that the State Board could account for its eight water-quality programs collectively. Thus, it seems the definition of a "regulatory program" or a "service" to be fee-funded is a legislative determination to be reviewed by judges only for reasonableness. This seems appropriate, as neither Proposition 218 nor 26 provides any guidance as to what constitutes a "program" and whether the State Board's eight programs could be cost-accounted as one. Nor does the Constitution compel, for example, a water agency to serve raw water, treated water, or both. What service to provide, and how to define its scope, are questions for elected officials — not courts. Courts review those decisions for reasonableness and support in the record on which the agency acted, but they do not second-guess them.

To defeat a challenge to a fee as applied to an individual rate-payer, an agency must show the fee was not designed to generate excess revenue (i.e., there is reasonable basis to conclude it is limited to total cost to serve or regulate all payors); the legislation explicitly limits fees to cost of service or regulation; fees are deposited in a separate

fund; and fees cannot be spent for unrelated purposes.

Proposition 26's cost-of-service rule is applied "flexibly," and does not require "a precise cost-fee ratio" because "regulatory fees ... are often not easily correlated to a specific, ascertainable cost." Only a "reasonable basis in the record for the manner in which the fee is allocated" is required. Here, a 3 percent different between: (i) the State Board's historic cost to regulate under the eight water quality programs and (ii) its budget estimates used to make the rate did not prove it was a tax. The Court noted the difference between actual costs and budget estimates trended toward smaller surpluses in recent years.

The Court found the 2015 *San Juan Capistrano* decision invalidating that city's tiered water rates did not require a victory for the BIA. The Court noted that Proposition 218's cost-of-service standard for property related fees is more demanding than Proposition 26's "fair or reasonable relationship" test and *San Juan Capistrano* found "the [city] had failed to show its property-related fees did not exceed the cost of services attributable to each parcel" as Proposition 218 requires.

This first, substantive Proposition 26 case of the Supreme Court helpfully answers a number of questions under that measure and shows it is not as demanding of rate-makers as some had argued and is less demanding than Proposition 218. It is a significant victory for the State and local governments!

On May 30, the Supreme Court will hear the last major rate-making case on its docket — *Citizens for Fair REU Rates v. City of Redding*. That case tests whether a pre-Proposition 218 payment in lieu of taxes (PILOT) from Redding's electric utility to its general fund is grandfathered by Proposition 26 or violates its cost-of-service principle. A decision — much anticipated by California's public power agencies since review was granted more than three years ago — will be due by late summer.

Stay tuned. We will keep you posted!