MEMORANDUM OF LAW

DATE: July 26, 1995

TO: Milon Mills, Jr., Director of Water Utilities

FROM: City Attorney

SUBJECT: Transfers and Sales of Water and Sewer Capacity

Questions Presented

You have asked the City Attorney to review the propriety and legality of sales and transfers of water and sewage capacity by private individuals. Specifically, you have asked us to review the following issues:

1. Whether a property owner may transfer water and sewage capacity (collectively referred to herein as capacity) allocated to his or her property for use at a different property without paying a capacity charge for the new connection or increased capacity.
2. Whether a property owner may sell the capacity allocated to his or her property to another property owner.

Conclusion

1. Capacity may not be transferred from one property to another; however, if a property owner subdivides his or her property he or she may apportion the capacity among the subdivided parcels.
2. A property owner is not authorized to sell capacity in the City's water and sewerage systems.

Background

On February 6, 1995, the Water Utilities Department received an inquiry from James P. Courtney, Excess Land Manager of the California Department of Transportation, regarding the feasibility of selling capacity in the City of San Diego's water and sewerage systems. Of specific interest to Mr. Courtney are the properties acquired by the State for the construction of the Interstate-15 highway project. The State purchased approximately ten blocks of houses, businesses, and multi-family residences bounded on the west by 40th Street, on the south by El Cajon Boulevard, on the east by Central Avenue, and on the north by Meade Avenue for the highway project.

According to Mr. Courtney, there is a perception that each of the properties purchased by the State has a "water permit" which at present

is idle but which has a resale value to the State. Since each of the properties purchased will not be used by the State for residential or business purposes, Mr. Courtney has inquired whether the "permits," if any, have a resale value or whether they are site specific and therefore not transferrable to a third party.

The particular properties in question were constructed prior to 1973 when the City of San Diego first instituted capacity charges. Capacity charges were never paid by the State, any developer, or any previous property owner of these properties unless a new or expanded connection was made to a property after 1973.

In addition to the inquiry about the above referenced properties, the Water Utilities Department has received other inquiries from property owners regarding whether they may transfer the capacity they currently have at a particular property to another property without paying for the capacity. At present the Department does not have any formal policy regarding such transfers.

Analysis

This memorandum will address the nature of capacity charges in general, the applicable State statutes, San Diego Charter ("Charter") sections, San Diego Municipal Code ("SDMC") sections, and case law governing capacity charges. After discussing the nature of capacity charges, we will examine whether the transfer of capacity without payment is permissible pursuant to existing case authority, bond covenants, and Charter provisions. We will comment on how the Water Utilities Department, however, may allow apportioning of capacity. Finally, we will review whether sales of capacity are authorized.

I. Nature of Capacity Charges

A. Capacity Charges As Special Assessments

A capacity charge is a one-time charge for a new, an additional, or a larger connection to the City's water and sewerage systems. The charge is imposed for both the right to connect to the existing systems as well as for the need to provide for existing and new facilities which will benefit the property being connected.

SDMC section 67.72 provides that a capacity charge "shall be paid when any person, firm, corporation or other entity shall request a new water connection or in any way cause an increase in the water usage by the addition of any type of dwelling, commercial or industrial unit. . . ." (Emphasis added.) This charge is due and payable at the time the building permit fees or water connection fees are paid. SDMC section 64.0410 has similar provisions regarding capacity charges for new sewer connections, an additional or larger connection, or a connection which in any other way increases the flow of sewage into the system. These Municipal Code provisions fully comport with the provisions of the California statutory provisions governing capacity charges.

California Government Code section 66013 authorizes local agencies to impose capacity charges and establishes the parameters for setting

the rates. Section 66013 provides:

(a) Notwithstanding any other provision of law, when a local agency imposes fees for water connections or sewer connections, or imposes capacity charges, those fees or charges shall not exceed the estimated reasonable cost of providing the service for which the fee or charge is imposed . . . .

(b) As used in this section:

(1) "Sewer connection" means the connection of a building to a public sewer system.

(2) "Water connection" means the connection of a building to a public water system, as defined in subdivision (e) of Section 4010.1 of the Health and Safety Code

(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 which are of benefit to the person or property being charged.

Cal. Gov't Code Section 66013 (emphasis added).

In analyzing the nature of capacity charges the courts have determined that a capacity fee is "in effect a special assessment under a different name." San Marcos Water Dist. v. San Marcos Unified School Dist., 42 Cal. 3d 154, 161 (1986); cert. den. 479 U.S. 1079 (1987); accord Regents of Univ. of Calif. v. City of Los Angeles, 100 Cal. App. 3d 547, 549-550 (1979); County of Riverside v. Idyllwild County Water Dist., 84 Cal. App. 3d 655 (1978). In San Marcos, the Court found that:

A special assessment, sometimes described as a local assessment, is a charge imposed on particular real property for a local improvement of direct benefit to that property. . . . This view makes a clear distinction between taxes, which are levied for general revenue and for general public improvements; and special assessments, which are levied for local improvements which directly benefit specific real property.

San Marcos, 42 Cal. 3d at 162 (emphasis added) (quoting Solvang Mun. Improvement Dist. v. Bd. of Supervisors, 112 Cal. App. 3d 545, 552-553 (1980); accord Knox v. City of Orland, 4 Cal. 4th 132 (1992); City of Los Angeles v. Offner, 55 Cal. 2d 103 (1961).

In reviewing the propriety of water and sewer fees as special assessments, the courts have concluded that the fees must not exceed the estimated reasonable cost of providing the service for which the fee is imposed, and must bear a reasonable relationship to the benefits accruing to the connected property.F

In 1987, the state legislature adopted California Government Code sections 66001 et seq. (commonly referred to as AB 1600) which codified many of the constitutional tests which previously had been applied to development exactions by the California courts. While it can be argued the fees contemplated by AB 1600 may or may not govern capacity charges (both

California Government Code sections 66001 and 66005 concern fees "as a condition of approval" and capacity fees are established on a uniform basis and are collected at the time a building permit is issued or a connection/expansion of capacity is made), this memorandum of law will not address capacity fees as development exactions. The above analysis is consistent, however, with the provisions of AB 1600.

See Winnaman v. Cambria Community Services Dist., 208 Cal. App. 3d 49 (1989); Assoc. Homebuilders v. City of Livermore, 56 Cal. 2d 847, 852 (1961); Town of Los Altos Hills, 16 Cal. 3d 676 (1976); City of Los Angeles v. Offner, 55 Cal. 2d 103, 108 (1961).

B. City's Capacity Fees Must Be Reasonably Related

From the foregoing it is evident that a capacity fee levied pursuant to SDMC sections 67.72 and 64.0410 is an assessment fee and therefore must be reasonably related to the cost of constructing the capital improvements directly benefiting a property connecting to the system. In the City of San Diego, the fees are established from time to time, taking into account the capital improvement projects necessary for the system to meet the demands of all users of the system. Each property connecting to the system receives the direct benefit of those improvement projects. Payment of capacity fees guarantees that the property will have a certain amount of capacity in and use of the water and sewerage conveyance, treatment, and delivery systems. See Dawson v. Town of Los Altos Hills, 16 Cal. 3d 676, 689 (1976).

Payment of the capacity charge secures a commitment from the Water Utility to provide sufficient capability to provide the water and sewer service to the property. By accepting the capacity charge, the Water Utility has reserved capacity in and has made a legal commitment to provide the necessary facilities for conveyance, treatment, and delivery to the property. Inherent in this commitment are the necessary preparatory tasks of engineering, designing, and constructing the facilities required to make the capacity available. Carlton Santee Corp. v. Padre Dam Mun. Water Dist., 120 Cal. App. 3d 14, 25 (1981). The costs associated with these preparatory tasks are then used by the Water Utility to determine the capacity charge rates. Hence, the capacity charges are reasonably related to the benefits accruing to the property for which a capacity charge is paid.

Applying these general principles regarding capacity fees, we now turn to whether a transfer of capacity from one property owner (for ease of reference, "Blackacre") to another property ("Whiteacre") without a payment of a capacity fee for this new connection or expansion is permissible.

II. Transfers of Capacity

A. Application of General Principles to Transfers of Capacity

First, we note that if a capacity fee was paid for the capacity

existing at Blackacre, then that fee was levied for the local improvements which directly benefitted Blackacre. See San Marcos, 42 Cal. 3d at 162; Cal. Gov't Code Section 66013(b)(3). The language used by the courts and legislature clearly refers to the special benefit specifically conferred on the property for which the fee was paid; any transfer to Whiteacre therefore would be contrary to the very nature of assessment fees and California Government Code section 66013.

Second, since capacity fees are established to meet the specific infrastructure needs of the system as evaluated at a specific point in time, arguably the capacity fee paid for Blackacre is only applicable to those capital improvement projects projected at the time the capacity fee was paid for Blackacre. As discussed above, a capacity fee must be reason-ably related to the capital improvement projects for which it was charged. See Cal. Gov't Code Sections 66001, 66013. One cannot presume that the capital improvement projects necessary to meet the demands on the system at the time Blackacre connected will be the same as those necessary when Whiteacre would receive the transferred capacity.

For example, a transfer of capacity from Blackacre to Whiteacre may require a new connection or result in expanded capacity at Whiteacre. Moreover, the new connection or expanded capacity at Whiteacre may require additional capital improvement projects in order to meet the new demand on the system at the new location. The capacity fee paid for Blackacre would not necessarily have taken into account these capital improvement projects. The costs associated with the new capital improvements therefore would have to be passed on through capacity fees to other property owners who connect to the system or expand their capacity. If the additional capital improvements necessitated by Whiteacre's connection or expansion are not reasonably related to the fees being charged to these other property owners, then the City's capacity charges may be subject to challenge. Each property which connects to the water and sewerage systems, therefore, should pay its fair share of the cost of expansion, repair, and replacement made necessary, in part, by its use of the systems. See Longridge Estates v. City of Los Angeles, 183 Cal. App. 2d 233, 240 (1960).

B. No Free Service

Even assuming that a transfer of capacity meets the "reasonably related" test discussed above, it nonetheless may be prohibited under existing Charter provisions and bond covenants. As noted previously, SDMC sections 67.72 and 64.0410 require the payment of capacity charges when a new connection, an additional connection, or an increase in capacity at an existing connection is requested. Contrary to SDMC sections 67.72 and 64.0410, if a party transfers capacity from Blackacre to Whiteacre, then that transfer will result in a new connection, an additional connection, or an increase in capacity at Whiteacre without

any capacity charge being made. Such a connection or expansion without a commensurate charge is contrary to Charter section 53.

Charter section 53 has consistently been construed to require an independent Water Utility that is wholly dependant upon and must preserve its revenues for the operation, maintenance, and expansion of its facilities. The City Attorney has consistently opined that the concept of a fiscally self-sufficient and self-sustaining Water Utility must be preserved. See Op. S.D. City Atty. 177-182 (1932); Op. S.D. City Atty. 362-363 (1932); Op. S.D. City Atty. 526-531 (1933); Op. S.D. City Atty. 98-100 (1947); Op. S.D. City Atty. 23 (1965); Op. S.D. City Atty. 157-165 (1966); Op. S.D. City Atty. 37-40 (1967).

Moreover, existing bond covenants have express restrictions on the use of all sewer revenues. Section 6.15 of the Master Installment Purchase Agreement between the City of San Diego and the Public Facilities Financing Authority of the City of San Diego dated September 1, 1993 for the Sewer Revenue Bonds, Series 1993 provides:

SECTION 6.15. Collection of Rates and Charges: No Free Service. The City will have in effect at all times rules and regulations for the payment of bills for Wastewater Service. . . . The City will not permit any part of the Wastewater System or any facility thereof to be used or taken advantage of free of charge by any authority, firm or person, or by any public agency (including the United States of America, the State of California and any city, county, district, political sub-division, public authority or agency thereof). (Emphasis added.)F

Generally, such bond covenants are required for the issuance of water and sewer bonds and will be included in future issuances.

SDMC sections 64.0410 and 67.72 require the payment of capacity charges whenever a new connection, an additional connection, or an increase in capacity is made to a property. The capacity charges pay for the facilities necessary to provide the water and sewer service to the property. The bond covenants specifically mandate that the sewerage system or any facility thereof shall not be used free of charge by any person. Thus, if a capacity is transferred from one property to another, resulting in a new connection, an additional connection, or expanded capacity, and no capacity charge is paid, then the property is receiving the capacity free of charge. Such free service is contrary to Charter section 53, SDMC sections 64.0410 and 67.72, and existing bond covenants.

C. Gift of Public Funds

In addition to violating the above referenced bond covenants, the SDMC, and the Charter, the transfer of capacity from one property to another without payment of capacity charges for the new connection or increased capacity may constitute a gift of public funds. Expenditures of public funds for the benefit of private individuals necessitate an analysis of the law governing impermissible gifts of public funds. Such expenditures generally are prohibited pursuant to Charter section 93 and

California Constitution Article XVI, section 6.

Charter section 93 provides in relevant part:

> The credit of the City shall not be given or loaned to or in aid of any individual association or corporation; except that suitable provisions may be made for the aid and support of the poor.

Charter section 93's prohibition against giving or lending the City's credit has been construed to further bar a gift of public funds to any individual, association, or corporation.

Charter section 93 is derived from and is similar to Article XVI, Section 6 of the California Constitution which provides in relevant part:

> The Legislature shall have no power to give or to lend, or to authorize the giving or lending, of the credit of the State, or of any county, city and county, city, township or other political corporation or subdivision of the State now existing, or that may be hereafter established, in aid of or to any person, association, or corporation, whether municipal or otherwise, or to pledge the credit thereof, in any manner whatever, for the payment of the liabilities of any individual, association, municipal or other corporation whatever; nor shall it have power to make any gift or authorize the making of any gift, of any public money or thing of value to any individual, municipal or other corporation whatever. . . . (Emphasis added.)

Although the constitutional prohibitions have been held to be inapplicable to charter cities (Tevis v. City & County of San Francisco, 43 Cal. 2d 190, 197 (1954); Los Angeles Gas & Elec. Corp. v. City of Los Angeles, 188 Cal. 307 (1922)), the cases interpreting Article XVI, Section 6 are instructive.

In reviewing the constitutional prohibitions, the courts have recognized one exception to gifts of public funds. The exception, known as the "public purpose" exception, is based upon a theory that if a public purpose is served through the use of public funds, no "gift" has been made even though a private individual may benefit from the loan or expenditure. Bd. of Supervisors v. Dolan, 45 Cal. App. 3d 237, 243 (1975); Calif. Hous. Fin. Agency v. Elliott, 17 Cal. 3d 575 (1976); San Bernardino County Flood Control Dist. v. Grabowski, 205 Cal. App. 3d 885, 903 (1989).

Applying these principles to the transfers of capacity without payment of a capacity fee, we do not believe the transfers would fall within the exception. If an individual receives capacity at a property without paying for the new connection or expanded capacity, as required pursuant to SDMC sections 67.72 and 64.0410, then there is clearly a gift of public funds. The capital improvements associated with that connection or expanded capacity will directly benefit the private individual receiving the transferred capacity without any commensurate fee being paid by that property owner. Moreover, any transfer would be essentially private for the parties transferring and

receiving the capacity; the purpose would be primarily to satisfy the need or contribute to the convenience of the private parties and not the general public. See Perez v. City of San Jose, 107 Cal. App. 2d 562, 566 (1951). Such a gift of public funds is prohibited by Charter section 93.

III. Apportioning Capacity

As discussed previously, transfers of capacity without payment of a capacity fee are prohibited. A capacity fee is an assessment imposed for facilities directly benefiting the property being connected. Although it is unlikely they meet the statutory requirements,F

> Cal. Civ. Code section 1461 provides that only those covenants specified in the Code are said to run with the land. Covenants running with the land must be contained in the grant of the estate, i.e., recorded in the deed. Cal. Civ. Code " 1053, 1461, 1462, 1468, 1642; see also Harry D. Miller and Martin E. Starr, Current Law of Calif. Real Est., ' 22:2, at 536-537 (2nd ed. 1970) (setting forth other restrictions for covenants running with the land). Restrictions on land which do not meet "the requirements of covenants running with the land may be enforceable as equitable servitudes provided the person bound by the restrictions had notice of their existence." Nahrstedt v. Lakeside Village Condominium Assoc., Inc., 8 Cal. 4th 361, 375 (1994). In order for capacity to be a covenant running with the land or an equitable servitude, it must be recorded.

capacity fees are similar in nature to covenants running with the land. See Cal. Civ. Code Sections 1460 et seq.; See also Cerro de Alcala Homeowners Ass'n v. Burns, 169 Cal. App. 3d Supp. l, 4 (1985) (maintenance assessments are covenants running with the land); 11 Eugene McQuillin, The Law of Municipal Corp. Section 31.31, at 289 (3d ed. 1991) (the right to connect to sewerage system runs with the land). A discussion of such covenants is useful in demonstrating how capacity may be apportioned when a parcel is subdivided.

"A covenant is an agreement by one party to do or not to do an act; the act usually concerns the use of the land of the person making the promise, and it affects the land of the party to whom the promise is made." 7 Harry D. Miller & Marvin G. Starr, Current Law of Calif. Real Est. Section 22:1, at 520 (2d ed. 1970). The covenant is made for the direct benefit of the property. Cal. Civ. Code Section 1462; Anthony v. Brea Glenbrook Club, 58 Cal. App. 3d 506, 511 (1976). California Civil Code section 1468 embodies the primary principles of covenants running with the land, providing that the covenant must relate "to the use, repair, maintenance or improvement of . . . such land or some part thereof. . . ." Certainly, allowing a property to connect to and use a designated amount of capacity in the City's water and sewerage system

directly benefits the property and is related to the use of the property.F

A capacity fee pays for local improvements directly benefitting a specific property. Cal. Gov't Code ' 66013; San Marcos, 42 Cal. 3d at 162.

Another primary characteristic of covenants running with the land is that both the liability of the covenant and its enforceability passes with the transfer of the land. The covenant is binding on all subsequent purchasers of the property. Cal. Civ. Code Sections 1460, 1465, 1468; Soman Properties, Inc. v. Rikuo Corp., 24 Cal. App. 4th 471, 483 (1994); Carlson v. Lindauer, 119 Cal. App. 2d 292, 305 (1953); Brea Glenbrook Club, 58 Cal. App. 3d 506, 510 (1976). Similarly, capacity fees are paid for the direct benefit of the property for which it was paid. Cal. Gov't Code Section 66013; San Marcos, 42 Cal. 3d 154, 161. When the property is sold, the City continues to recognize the existence of the capacity allotted specifically to the property. In other words, the promise to provide (the covenant) a certain amount of capacity in the system (the benefit) passes (runs) with the transfer of the land.

Inasmuch as the benefit to the property and the right to enforce it is binding on successive owners, we now turn to what circumstances permit a reallocation or apportionment of the benefit. Under existing statutes governing covenants running with the land, it is not necessary that a successor to a parcel of property take all of the property affected by the covenant. Rather, several transferees in the fee may succeed to different parts of the original parcel of land, and the benefits or burdens of the covenant may be apportioned among them. Cal. Civ. Code Sections 1465, 1467-1468.

Thus, although the transfer of capacity from one property to another is prohibited, a property owner may apportion capacity allotted to his or her parcel. By this, we mean that if a parcel of property has a certain amount of capacity reserved in the water and sewerage systems and the property owner subdivides that parcel, then the total capacity allotted to the one parcel may be apportioned among the several parcels. As long as an apportionment does not require a new connection at any of the subdivided parcels, it does not appear to be prohibited under any of the previous analyses. If a new connection would be required at a parcel, however, a capacity fee would have to be paid for that parcel pursuant to the provisions of SDMC sections 67.72 and 64.0410 and Charter sections 53 and 93.

We will use the properties acquired by the State to illustrate. If the properties are now treated as one parcel, then that single parcel with attendant capacity could be subdivided and sold as several parcels. The State could then elect to apportion a certain amount of the total capacity in the parcel to certain parcels. As long as new connections do not have to be made at those parcels, no capacity fees would

be charged. Since such apportionment is not legally improper, we recommend that administrative regulations be established to ensure conformity in processing requests for apportionment.

VI. Private Sales of Capacity Not Authorized

As noted above, California Government Code section 66013 authorizes a local agency to impose capacity charges. A local agency is defined as "a county, city, whether general law or chartered, city and county, school district, special district, authority, agency, any other municipal public corporation or district, or other political subdivision of the state." Cal. Gov't Code Section 66000. SDMC sections 67.72 and 64.0410 provide that the City may charge fees for water and sewer capacity, which fees shall be deposited in the Water and Sewer Revenue funds. Charter Section 53; SDMC Section 64.0403. Nowhere in the state statutes, the SDMC, or the Charter is a private individual or the state authorized to sell or charge another individual for capacity in the City's water and sewerage systems.

Any sale of capacity by one party to another would result in a contract between the two parties. Since the City would not be a party to this contract, it would not be bound by its terms. Friesen v. City of Glendale, 209 Cal. 524, 529-530 (1930). The City, therefore, would not be obligated to recognize the transferred capacity at the new property. Additionally, if there is a sale of capacity, by necessity the capacity would be relocated from one property to another without a capacity fee being paid at the new location. The relocation, or transfer, would clearly result in a gift of public funds because the sale and resultant transfer would be for the private convenience and/or profit of the parties.F

See discussion on Gifts of Public Funds discussed above.

Summary

From the foregoing we draw the following conclusions. First, current case law, SDMC, Charter, and statutory provisions require that capacity fees must be reasonably related to public improvements directly benefiting the property being connected. The City of San Diego establishes its capacity fees on a system-wide basis, taking into consideration the specific capital improvement projects necessary to meet the existing and projected needs of the system. When a property connects to the water and sewer systems, it essentially pays an assessment fee for the direct benefit it receives from the City for that connection. That benefit cannot be conferred on another property; rather it is specific to the property for which the fee was paid. On this basis alone, transfers of capacity from one property to another without payment are prohibited.

Additionally, if a property owner is allowed to transfer capacity to another property without any payment being made for that new connection or expanded capacity, and capital improvements are necessary for that transfer, then the capacity charges levied other property

owners connecting or expanding their capacity may be affected. The additional costs incurred to accommodate the transfer will be passed on to other property owners connecting to or expanding their capacity in the system. If the costs for the capital improvements necessitated by the transfer are not reasonably related to the other properties, then such fees may be subject to challenge.

Second, a transfer of capacity from one property to another by necessity will result in either a new connection or expansion of capacity. The SDMC requires that capacity charges be paid whenever a new connection or expansion of capacity occurs. Such a transfer without a commensurate payment of capacity fees is contrary to Charter section 53, which requires a financially independent Water Utility. Additionally, the provision of free service would violate existing bond covenants which require that no free service be given to any individual.

Third, transferring capacity to another property without any payment may be considered a gift of public funds. Gifts of public funds are prohibited by Charter section 93.

Fourth, under limited circumstances, apportionment of capacity may be permitted. A property which has capacity in the system may be subdivided. If the property owner desires, he or she may have the capacity allotted to the one parcel apportioned among the new subdivided parcels. As long as a new connection would not be required at any of the new parcels, no capacity fee would have to be paid. We recommend administrative procedures be developed to regulate and track such apportioning.

Finally, existing statutory and SDMC provisions only allow for a local agency to charge capacity fees. There is no provision for sales of capacity by property owners. The City, therefore, need not recognize any sale of capacity. Moreover, any sale and resultant transfer without the payment of capacity charges would constitute a gift of public funds.

Sincerely yours,
JOHN W. WITT, City Attorney
By
Kelly J. Salt
Deputy City Attorney

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