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A Tax by Another Name: Beware of Excessive Fees Included in Exclusive Waste Hauling Franchise Contracts

by Gideon Kracov and Jordan R. Sisson***

"There's no Democrat or Republican way to pick up the trash."

– New York Major LaGuardia

INTRODUCTION

While presidential hopefuls debate issues like foreign policy and international trade agreements, local elections concern basic matters like filling potholes and picking up garbage. In Los Angeles County, 59 of 88 cities grant exclusive franchises to private party waste haulers to pick up trash and recyclables from the city's residents or businesses.[1]

In December 2015, a California Court of Appeal held in *Crawley v. Alameda County Waste Management Authority* (*Crawley*) that household hazardous waste fees are "property-related" and subject to Article XIII D of Proposition 218.[2] Enacted into law through the voter initiative process, Proposition 218 puts procedural and substantive limits on local government's ability to raise revenue through "property-related fees."[3] Proposition 218 protects property owners from arbitrary fees by requiring local governments to cost-justify their fees.

Inside this Issue

Crawley is the latest in a line of cases confirming that exclusive waste-hauling franchises fees may be property-related. Therefore, fees imposed under such exclusive franchise agreements should be cost-justified–including service, franchise, regulatory, and signing fees. Municipal lawyers in cities awarding exclusive waste-hauling franchises should scrutinize these fees carefully. Moreover, a municipal franchise case –*Jacks v. Santa Barbara (Jacks)*[4]–is among several cases pending before the California Supreme Court that will likely provide important further guidance in this area

I. BRIEF CONSTITUTIONAL AND CASE LAW BACKGROUND ON MUNICIPAL FEES AND TAXES

Prior to Proposition 13, each California city, county, and special district could impose a property tax rate without limitation. The average property tax rate throughout the state was just shy of three percent [5]

A. Propositions 13 and 62

In 1978, voters passed Proposition 13 to "provide effective tax relief and to require voter approval of tax increases."[6] The measure added Article XIII A to the California Constitution to limit property tax rates and to prevent cities, counties, and special districts from raising "special taxes" (i e. property taxes) without two-thirds voter approval.[7] However, Proposition 13 did not define "special tax," which courts subsequently interpreted as a tax imposed for a "special purpose."[8] This allowed local governments to raise property taxes without voter consent if used for general government.[9]

In 1986, voters passed Proposition 62, declaring all taxes as "special" or "general," thus requiring voter consent.[10] Proposition 62 prevented local governments from raising "general taxes" without majority approval [11] Although held constitutional,[12] the constitutional amendment was later held inapplicable to charter cities which were free to raise revenues without triggering the voter approval requirement [13]

B. Proposition 218

Voters changed that rule in 1996 with Proposition 218 Under Article XIII C, local governments must secure voter consent before imposing special taxes (two-thirds) or general taxes (simple majority).[14] Under Article XIII D, substantive and procedural requirements prevent local government from raising general funds through assessments, fees, or other charges for property-related services (exempting only gas and electrical services).[15] Substantively, a local government may not extend, impose, or increase fees that exceed the funds required to provide the service.[16] Procedurally, all new or increased fees must include a 45-day majority protest period requiring notice to all affected property owners.[17] Except for certain services (i e., sewer, water, and refuse collection), the public agency must also get approval from either a majority of property owners or two-thirds of the electorate.[18] "[I]n any legal action contesting the validity of a fee or charge," the agency must demonstrate compliance with these substantive and procedural requirements [19]

C. *Sinclair Paint*

In 1997, the California Supreme Court decided *Sinclair Paint Co v. State Board of Equalization* (*Sinclair Paint*), holding a regulatory fee (a special fee used for the benefit of non-fee payers) is not a tax when used "to mitigate the actual or anticipated adverse effects of the fee payers' operations" and the amount "bear[s] a reasonable relationship to those adverse effects "[20] The Court upheld a state-imposed fee on manufacturers of lead products to fund lead poisoning prevention efforts. The Court held the fee was not a tax because its "primary purpose" was not to raise revenue, but rather a "reasonable police power decision" to shift the costs imposed onto the public back to those persons deemed responsible (i.e , lead industry).[21] On remand, the fee was still subject to challenge on grounds it "exceeded the reasonable cost of providing the protective services . . . or that the fees were levied for unrelated revenue purposes."[22]

D. Proposition 26

In 2010, to further limit fees that exceed the reasonable cost of actual regulation,[23] voters passed Proposition 26, "the Supermajority Vote to Pass New Taxes and Fees Act." Proposition 26 amended Article XIII C of the California Constitution to define a tax as "any levy, charge, or exaction of any kind imposed by a local government," unless it falls into one of seven exemptions.[24] Local governments bear the burden of proving the fee is not a tax, is limited to the "reasonable costs," and bearing a "reasonable relationship" to the benefit conferred or burden imposed.[25]

II. EXAMINING WASTE HAULING EXCLUSIVE FRANCHISE AGREEMENTS AND COST JUSTIFICATION RULES

Under most exclusive waste franchises agreements, the rate charged to customers is a combination of service, franchise, and regulatory fees.[26] The service fee covers curbside collection; the franchise fee is a percentage charged on the total bill and usually transferred to the local government's general fund; and the regulatory fee supports recycling programs in the jurisdiction. Recently, winning bids for exclusive waste franchises in Southern California have also included a large, lump sum signing fee directed to the general fund.

A. Waste Hauling Fees Are Property-related under Proposition 218

Proposition 218's procedural and substantive protections apply to "lev[ies] ... imposed by an agency upon a parcel or ... person as an incident of property ownership ... including a user fee or charge for a property-related service."[27] Fees for trash and recycling pick-up, such as those imposed under exclusive waste hauling franchises, are subject to these protections. Article XIII D explicitly references waste hauling services (i.e., refuse collection) as fees exempt from the voter-approval requirements—implying all other protections apply. Additionally, in Proposition 218's ballot pamphlet, voters were told waste hauling fees "probably meet ... [the] definition of property-related fee."[28] Moreover, absent the willingness to tolerate mounds of accumulated waste, most people consider weekly garbage collection as a necessary and unavoidable service. As explained in the "*Proposition 218 Implementation Guide*" prepared by the League of California Cities (The League), waste hauling services are "indispensable—and sometimes mandatory—for most uses of property."[29] This is particularly true where services are compelled for health and environmental reasons and without a meaningful opt-out provision allowing for self-hauling. Due to fiscal impacts, complicated bookkeeping, mandatory recycling requirements under new state law,[30] and grave risks associated with improper disposal, workable opt-out provisions are rare and often limited to rural communities.

In *Crawley*, households in Alameda County were charged an additional hazardous waste fee, authorized by ordinance, which took effect after a Proposition 218 majority protest process was held. A homeowner challenged the fee, contending it was not a property-related fee imposed incident to property ownership, but rather an assessment subject to Proposition 218's more stringent voter approval requirements. The County successfully demurred and the First District Court of Appeal affirmed. The *Crawley* court held the fee was a property-related fee citing *Howard Jarvis Taxpayers Assn. v. Roseville (Roseville)*, (2002) 97 Cal.App.4th 637, a case where in lieu franchise fees for refuse services were deemed property-related under Proposition 218.[31] "[B]y the [o]rdinance's own terms, [the fee] [was] imposed on 'each [h]ousehold in Alameda County' ... requir[ing] nothing other than normal ownership and use of property."[32] Additionally, the majority protest procedure was sufficient without the additional voter approval because the household hazardous waste was similar to refuse collection service, thereby falling within Article XIII D's voter approval exception.[33] *Crawley's* Proposition 218 reasoning applies with equal force to residential or commercial waste hauling and recycling under an exclusive franchise because the fees are incident to property ownership.

In *Torres v. City of Montebello (Torres)*, the Los Angeles Superior Court used the same rationale to invalidate an exclusive waste franchise agreement between the City of Montebello and a private hauler Athens Services.[34] As is common in exclusive franchise agreements, the City included a direct assessment on the property tax bill of every property owner, collected it from the county, and then remitted it to the private hauler. For the court, it did not matter that fees were not retained by the City because it "use[d] its authority to impose a fee on persons for residential trash collection ... nothing in the [c]ity's handling of residential trash hauling fees under the Athens Contract renders it distinguishable from the voters' general intent in Prop[osition]

218."[35] Therefore, while falling within the voter approval exemption for sewer, water, or refuse services, these trash fees remained subject to Article XIII D's substantive cost-justification requirements. Ultimately, Montebello's franchise contract was voided because no evidence was presented demonstrating the fee was based on the actual cost of services.[36]

Crawley, *Roseville*, and *Torres* suggest that exclusive waste franchise fees are property related under Proposition 218, and therefore subject to its procedural and substantive requirements.

B. Justifying Exclusive Waste Franchise Services Fees

Each waste franchise includes a service fee paid by the property owner for weekly curbside collection of waste, which is often sorted into color-coded bins for recyclables, yard clippings, and general refuse. These service fees, or "trash pickup rates," vary greatly; the monthly residential service fee for cities in Orange County, for example, ranges from $10.79 in Irvine to $22.66 in Placentia.[37]

These exclusive trash franchise service fees, absent *bona fide* evidence that they are truly optional for City residents, are property-related and likely governed by Proposition 218. This rule should apply even where local governments merely set a maximum ceiling for the exclusive franchise service fee. Where local governments require residents to accept the service and pay the haulers' fee (especially where the fee is placed on the property tax bill), they must show the fees are cost-justified under a substantial evidence standard.[38] Otherwise, an agency could set an artificially high, not cost-justified fee ceiling and argue that Proposition 218 no longer applies. In addition, the service fee ceiling would not exempt the franchise, regulatory, or signing fee from Proposition 218's cost-justification requirements.[39]

Several recent water ratemaking cases demonstrate local governments can meet this cost-justification standard when they rely on multi-year, cost-of-service (COS) studies prepared by independent consultants, provided they follow commonly accepted professional standards including "reliable estimates" based upon "ample evidence,"[40] relying "strictly on COS principles,"[41] and not using 'what-will-the-market-bear' methodology."[42] This same methodology must be used under exclusive waste franchise contracts when determining service fees property owners, (i.e., the ratepayers) must pay.

The courts examine these COS studies closely. In *Newhall Cty Water Dist. v. Castaic Lake Water Agency*, a water district imposed higher wholesale fees on its retail purveyors based on a groundwater use that it had not provided.[43] The Second District held the fee was invalid under Proposition 26 because purveyors received no "specific benefit ... not provided to those not charged."[44] In *Capistrano Taxpayers Ass'n, Inc. v. City of San Juan Capistrano*, the Fourth District reached a similar conclusion under Proposition 218 where the city imposed a four-tier water rate structure without first calculating the actual cost of service at all tiers.[45] Proposition 218's "cost of service language would be meaningless the court reasoned," if the local agency did not ascertain a cost of service to that particular parcel.[46]

C. Tethering Fees to Associated Costs

Generally, a public entity will impose a franchise fee on a utility provider by charging a percentage of its gross receipts collected from customers within the jurisdiction. However, unlike a tax, franchise fees are considered "voluntary" payment for the privilege of the local right of ways.[47] In 2014, local governments across the state collected over $1 billion in these voluntary payments.[48] Fees vary widely for waste-haulers in Southern California. Residential waste-haulers are charged 5% in Irvine while Santa Ana charges haulers 18%.[49] For commercial haulers, rates can range from 2% to 27%.[50] These "voluntary" fees, if not cost-justified, can operate as taxes under Propositions 218 and 26 when imposed by local governments, passed-through the hauler, and paid by ratepayers. This is especially true for exclusive trash franchise agreements where fees exceed the costs incurred by the public entity and go straight to the general fund. This cost-justification requirement applies whether or not the exclusive franchise fees are separately identified on the ratepayer's bill.[51]

Courts have invalidated franchise fees that are not cost-justified in the public utility context. In *Roseville*, the Third District struck down a 4% "in-lieu franchise fee" imposed by the City of Roseville on its own utilities' annual budget, paid by ratepayers, and deposited to the general fund. A study comparing "franchise fees" imposed in other cities failed show the in-lieu fee "reasonably represent[ed] the cost of providing service."[52] The flat rate "[o]n its face" did not represent costs, the study merely reflected "[w]hat the market [would] bear." The City violated Proposition 218 in a "more direct way" by placing fees unpledged, formally or informally, for any specific purpose into the general fund to pay for general governmental services, including waste collection.[53]

The Third District reached the same result under Proposition 26 in *Citizens for Fair REU Rates v. City of Redding (Redding)*, now pending California Supreme Court review, and invalidated a similar "payment in-lieu of taxes" imposed on the city's electric utility.[54] In Redding, ratepayers had "in reality . . . no economically viable alternatives" to the City service; therefore, the City had to show fees were limited to "reasonable costs ... that ... bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity."[55] Under Proposition 218 analysis in another case, the Fifth District agreed in striking down a 1% "in-lieu fee" imposed by the City of Fresno on its utilities, "'blended' into user fees," and "pass[ed]-through" to ratepayers, because the City first had to calculate the "unbudgeted costs" it incurred and could recover only those "proportional ... cost of providing service to each parcel."[56]

For private utilities, The League suggests franchise fees may be exempt from these rules under Proposition 26's "local government property" exemption, suggesting that waste franchise fees need not be cost-justified, even if passed on to the ratepayer.[57] While in theory, franchise fees are voluntarily negotiated between private enterprise and government entities, in practice, arbitrary franchise fees not tethered to actual costs incurred by franchise operations (e.g., repair to the city roads, direct administrative costs, etc.) can amount to invalid taxes under Propositions 218 and 26—as explained in the *Jacks* opinion, now on review before the California Supreme Court.

In *Jacks*, the Second District held a 1% surcharge on a private electric utility was "an illegal tax masquerading as a franchise fee" under Proposition 218 when its "primary purpose" was to "raise revenue ... for general spending purposes" (citing *Sinclair Paint*).[58] For over 50 years, SoCal Edison (SCE) paid the City of Santa Barbara a 1% "franchise fee" pursuant to the Franchise Act of 1937.[59] In 1999, the City agreed to a 30-year extension if SCE collected and remitted to the City an additional 1% surcharge, subject to approval by the Public Utilities Commission (PUC). Challenged in 2011, the City successfully demurred. On review, the Court stated the surcharge had all the "hallmarks of a utility user tax" because it was "purely" passed along to City ratepayers. From the consumer's perspective, there was "no functional difference" between the surcharge and a utility user tax with SCE "acting as tax collector for the city."[60]

The analysis in *Jacks* could be found directly applicable to exclusive waste hauling franchises. Like *Jacks*, the market for exclusive municipal waste franchises "bears no resemblance to a competitive market" because a city can "exercise its monopoly power to impose whatever franchise fee it likes," with private haulers having "little incentive to resist whatever fee the [c]ity demands."[61] As a result, any excessive fee negotiated between city and private hauler is considered "city-imposed" when passed through to the customers who have no practical means of avoiding the fees added into their rates.[62] Under these circumstances, a city can raise general revenue by merely demanding higher franchise fees (e.g., 25%, 50%, or even higher) not justified by the true costs of the franchise. Effectively, the city has imposed a tax on ratepayers—called a franchise fee—without receiving voter approval and with the hauler acting as tax collector. Local governments have one of two options: either "[]prove the amount collected is necessary to cover the reasonable costs to the city to provide [a] service" (suggested in *Redding*);[63] or "seek taxpayers' consent before subjecting them to new and increased taxes" (endorsed in *Jacks*).[64] This burden is not "onerous" or "too great" if it is what the Constitution requires.[65] These approaches should pass muster if challenged. In the meantime, *Jacks* is fully briefed, awaiting hearing before the California Supreme Court, and will likely provide further clarity to municipal lawyers.

D. "Regulatory Fees" In Exclusive Waste Franchises Must Comply With *Sinclair* and Proposition 26

Exclusive waste franchises also often include a regulatory fee to fund recycling programs such as "AB 939" fees authorized by the California Integrated Waste Management Act of 1989. Such regulatory fees are increasingly important as local jurisdictions must implement and enforce state-mandated commercial and organics recycling requirements. In Los Angeles County, depending on the jurisdiction, commercial waste haulers pay AB 939 regulatory fees equal to 7.5% to 16% of their annual gross receipts, with the City of Los Angeles charging 10%.[66]

While such trash regulatory fees imposed under the police power may be "flexible," they may "not exceed the reasonable cost of providing services necessary to regulate the activity for which the fee is charged (citing *Sinclair Paint*)."[67] At minimum, local government must establish estimated costs of the regulatory activity and the basis for determining the manner in which the costs are apportioned.[68] In *Griffith v. City of Santa Cruz*, the Sixth

District upheld a per-unit annual inspection fee on rental properties where uncontroverted evidence showed estimated fees collected did not exceed the approximate cost of the inspection program.[69] Besides satisfying Proportion 218, no administrative costs violated Proposition 26's exemption for a proper "regulatory fee." In *City of Dublin v. Cty. of Alameda*, the First District upheld a per-ton surcharge on deposited materials in the county landfills where it was "undisputed" the recycling program was not levied for "general revenue purposes" and fees were distributed in proportion to the contribution of each waste generator.[70] Citing *Dublin*, the Fifth District reached same conclusion when it upheld a landfill assessment because it rationally related to the costs to the county's landfills[71]

E. Signing Fees for Exclusive Franchise Contract Awards Should be Cost-Justified

A signing fee is a lump sum payment made by a private hauler to secure an exclusive waste franchise contract, often going to the local government's general fund. This approach is becoming increasingly common in Southern California. When the City of Whittier solicited bids in 2015 for its exclusive waste franchise, each of the four bidders proposed lump-sum signing fees ranging from $2 to $7 million for the City's coffers[72]

Signing fees that go to a general fund, unpledged for a specific purpose, are highly suspect if they are not cost-justified with an adequate COS study. Even if not paid directly by the ratepayers, the signing fee must come from somewhere. Like franchise fees, signing fees can be passed through in the form of higher rates with ratepayers ultimately bearing the cost. This reality has been recognized by courts (*Redding* and *Jacks*), elected officials, municipal lawyers, and community groups.[73] Without the signing fee, the ratepayer's rate for refuse collection services under the exclusive franchise would be lower. A $5 million signing fee that goes to the general fund, where the city already collects a separate franchise fee, should be used instead to reduce the costs of the service to the ratepayer. Without tethering fees to costs or a persuasive showing the fees are purely from the hauler's profits, courts cannot assume the signing fee is not passed-through to ratepayers with the hauler "merely a conduit ... with no real interest in the ... validity or amount."[74] The signing fee may become a transparent way to avoid the cost-justification requirements of Proposition 218 and 26.

III. REMEDIES IF FEES IN AN EXCLUSIVE FRANCHISE ARE IMPROPER TAXES

Several remedies exist to challenge an exclusive trash franchise contract under Propositions 218 and 26. First, a writ of mandamus requiring a public entity to comply with Proposition 218's procedure requirements (i.e., notice and 45-day majority protest process, followed by a public hearing).[75] Second, Article XIII D authorizes voter initiatives to repeal or reduce any fee, including those for refuse service.[76] However, this political remedy may "turn Proposition 218 on its head."[77] As expressed by the *Jacks* court, "[t]he point of Proposition 218 is that cities must obtain voter approval of taxes before imposing them," not to force voters to the ballot box to express their displeasure for elected officials imposing exorbitant fees—neither cost-justified, nor approved by voters.[78] A third option, declaratory relief lawsuits to invalidate an improper fee typically can be brought within a three-year limitations period.[79] In *Torres*, the court invalidated the City of Montebello's exclusive waste franchise contract for violating Proposition 218. Where an administrative remedy to challenge the franchise is available, that remedy must be pursued before a lawsuit may be filed.[80]

CONCLUSION

For nearly 40 years, California voters have used the initiative process to roll back or invalidate taxes. *Crawley* is the latest in a line of cases suggesting that exclusive waste hauling services fees are property-related and imposed upon property owners As suggested in *Jacks*, now pending California Supreme Court review, service, franchise, regulatory and signing fees imposed under exclusive waste hauling franchise agreements likely must be cost-justified under Propositions 218 and 26. Municipal lawyers should ensure that their clients carefully consider these laws and the cost-justification of fees when awarding exclusive waste hauling franchises.

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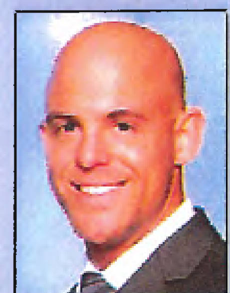

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ENDNOTES

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19 *Id.*, subd., (b)(5); see also *Silicon Valley Taxpayers Ass'n, Inc. v. Santa Clara County Open Space Authority* (2008) 44 Cal.4th 431, 448.

20 *Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866, 870.

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26 League of California Cities (2007) Proposition 218 Implementation Guide, p. 55.

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78 *Id.*

79 *Howard Jarvis Taxpayers Associatıon v. City of La Habra* (2001) 25 Cal 4th 809.

80 *Unfair Fire Tax Committee v. Cıty of Oakland* (2006) 136 Cal.App 4th 1424, 1428