

## 2003 Legislative Changes to Oregon's SDC Statutes

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“It’s not just the way we collect SDCs that can be challenged, but the way we spend them,” is a quote from Bend City Attorney Jim Forbes about amendments to Oregon’s system development charge (SDC) laws. His comment was made in a briefing to the City Council about the impact of legislative amendments to ORS 223.297 et al on Bend’s capital improvement program. (See [City street-funding crunch getting tighter](#), Bend.com, October 7, 2003). The outcome was... undecided. That is because the amendments, while intended primarily to clarify certain aspects of the law, raise issues that are untested -- leaving some administrators feeling uneasy. In this article, we highlight the significant changes in the enacted amendments, some of which are thorny enough that the courts likely will have the last word.

For readers not familiar with SDC “lingo”, here are a few important terms and concepts. SDCs, which usually are collected when a building permit is issued, are calculated using a formula that is spelled out in a *methodology*. Each SDC program methodology is tailored to local conditions. SDCs may include two different types of fees. A *reimbursement fee* recovers the value of system capacity that is available today to serve future users. In this regard, it is akin to a late-comers fee. An *improvement fee* recovers a fair-share of the cost to build new improvements that are needed to serve future users over the planning horizon. SDC revenue from these two fees must be accounted for separately and improvement fee revenues may be spent only on capital improvements and direct administrative costs.

In Oregon, SDCs may be collected to build water, sewer, drainage, transportation, and park and recreation infrastructure. SDCs may not be used to operate or maintain these systems, nor can they be used for schools, general purpose government facilities, or solid waste facilities. Moreover, proceeds are restricted to the system for each type of fee, so, for example, water system fees may only be used for water projects. Equity and proportionality are very important underlying concepts for calculating SDCs, both in terms of the amount of the fee and how the use of this revenue. For example, the level of service on which an SDC is calculated cannot exceed the level of service currently provided to system users. The fee must be developed based on generally accepted *rate-making principles*, and future users are intended to be the sole program beneficiary.

The 2003 Oregon Legislature amended portions of ORS 223.297 – 223.314, when it enacted Senate Bill 939. In this paper, enacted deletions are shown italicized in *[brackets]* and additions are shown **in bold**. Local governments should carefully review these changes the next time they update their SDC administrative procedures to ensure their program complies with these requirements. Existing fees may not be challenged on the basis of the revisions, per se, but future expenditures may be called into question if the use of revenue is alleged not to comply with the statute.

### **Statutory Clarifications**

Most of the enacted changes clarify the existing statute. For example, one amendment expands the law’s purpose statement by adding: “... **to provide equitable funding for orderly growth and development in Oregon’s communities...**” This phrase augments the statute’s policy framework but has no direct effect on SDC calculation or related procedures. Many other amendments do not

change the meaning of the statute but were made to clarify legislative intent. For example, Subsection 3 of ORS 223.302 is amended to say:

...If any governmental unit expends *[any such]* revenues **from system development charges** in violation of the limitations described in ORS 223.307, the governmental unit shall replace the misspent amount with moneys derived from *[other]* sources **other than system development charges. ...**

This text change does not alter the original meaning of the statute. Rather, it expresses legislative intent using more direct language. As another example, the word **must** is substituted for the word *[shall]* in many parts of the statute. This substitution does not have a significant effect on meaning, other than perhaps to clarify that an SDC program must have all the proscribed elements in place when adopted, as opposed to implying that a program shall conform to those requirements sometime in the future. Likewise, substitution of the term *[unit of government]* with **governmental unit** does not result in any substantive change to the meaning of the law, but clarifies that the intent was to cross reference the definition of “governmental unit” codified at ORS 223.001(7).

## **Administrative Clarifications and Definitions**

ORS 223.299 is amended as follows:

(3) “Reimbursement fee” means a fee for costs associated with capital improvements already constructed, or under construction **when the fee is established, for which the governmental unit determines that capacity exists.**

This revision requires that local governments consider any capacity created by capital improvements “in the pipeline” when they adopt their SDC reimbursement fee. For example, if a project is approved for capital improvement expenditure in the current budget, but the project has not broken ground, that project is not yet “under construction,” and must be considered as part of an improvement fee. As another example, if the project has broken ground but financing is only in place to complete the first phase of the project, then the different phases of the project may need to be addressed separately. Jurisdictions should carefully consider how they measure system capacity under these circumstances.

ORS 223.304 (1)(a), which also concerns reimbursement fees, is amended as follows:

**(D)** The value of unused capacity to future system users<sup>]</sup>, *rate-making principals employed to finance publicly owned capital improvements and other relevant factors identified by the local government imposing the fee* **or the cost of existing facilities; and**

**(E) Other relevant factors identified by the governmental unit imposing the fee.**

This change was intended to clarify how one may calculate the value of available capacity for future system users but it raises as many questions as it answers. It is now possible to argue that the new statute allows the use of replacement cost in the calculation so long as the cost is apportioned on a fair-share basis for future system users. If this is indeed the legislative intent, then local governments might be able to charge new growth a significant premium for existing capacity in an existing facility. For example, if 50% of an existing water reservoir’s capacity is available to serve future customers, and it would cost \$2 million to build that reservoir today, then the SDC might recover \$1 million for the value of that available capacity through a reimbursement fee. However, local governments should be hesitant to use replacement cost as a valuation method, at least in the absence of a depreciation factor

added in. In most cases, the “value” of existing systems does not approach the “value” of a new system. A much safer alternative is to use actual historic cost as the basis for the reimbursement fee.

## **SDC Credits and Accounting Procedures**

The legislature also amended sections of the SDC statute related to SDC credits. ORS 223.304.(5). These amendments clarify the conditions under which a local government may deny a credit claim, and make an important cross reference to ORS 223.309 (see discussion below). Most importantly, the statute now places the burden on the governmental unit to demonstrate that the applicant is not entitled to a credit.

Depending on how your jurisdiction tracks costs and expenditures for your SDC program, the amendments to ORS 223.311 (2) may require local governments to develop more stringent internal cost accounting procedures. In order to ensure that SDC program accounting passes muster with an audit, particular attention should be made to in-house labor costs related to the SDC program (e.g. – administrative, force account work, project management, etc).

One of the most important clarifications to the statutes is in ORS 223.307, which specifies how SDC revenue may be spent. It is amended as follows:

- (1) Reimbursement fees [*shall*] **may** be spent only on capital improvements associated with the systems for which the fees are assessed including expenditures related to indebtedness.
- (2) Improvement fees [*shall*] **may** be spent only on capacity increasing capital improvements, including expenditures relating to repayment of debt for such improvements. ... The portion of [*such*] **the** improvements funded by improvement fees must be related to [*current or projected development*] **the need for increased capacity to provide service for future users.**
- (3) System development charges [*shall*] **may** not be expended for costs that are associated with administrative facilities ...**or for the expenses of the operation or maintenance of the facilities constructed with system development charge revenues.**

These changes raise important accounting issues regarding the use of SDC revenue. The change has little, if any, effect on how local governments may spend reimbursement fee revenue. Local governments retain considerable discretion over the use of those funds. The accounting need only verify that this revenue was spent on capital improvements related to the system for which the fee was collected, even if those improvements do not add capacity to the system.

With regard to the expenditure of improvement fee revenue, however, 223.307 (2) is made more restrictive by the amendment. Improvement fee revenue may only be spent on *capacity increasing* capital improvements. When considered in conjunction with revisions to 223.309, the new language suggests that this test applies on a project by project basis (see Improvement Fee discussion below). The accounting implication is that on a project by project basis, the amount of SDC revenue expended must be in proportion to the level of benefit that project provides to future system users.

## **Adjusting SDC Fees**

New provisions codified at ORS 223.304 allow SDCs to be adjusted periodically without subjecting the whole ordinance and methodology to review. Depending on how the local methodology is designed, the fee may be adjusted by updating the cost estimates for the capital improvement projects on which the fee is based, or by using an index procedure (e.g., a recognized price index which provides a relevant measurement for the cost of labor, materials, or real property).

Acceptable procedures for periodic adjusting of SDC fees were added in ORS 223.304 (8) as follows:

**(8) A change in the amount of a reimbursement fee or an improvement fee is not a modification to the system development charge methodology if the change is based on:**

**(a) A change in the cost of materials, labor, or real property applied to projects or project capacity as set forth on the list adopted pursuant to ORS 223.309; or**

**(b) The periodic application of one or more specific cost indexes or other periodic data sources. A specific cost index or periodic data must be:**

**(A) A relevant measurement of the average change in process or costs over an identified time period for material, labor, or real property or a combination of the three;**

**(B) Published by a recognized organization or agency that produces the index or data source for reasons that are independent of the system development charge methodology; and**

**(C) Incorporated as part of the established methodology or identified and adopted in a separate ordinance, resolution, or order.**

A jurisdiction may adjust their improvement fee by updating project costs on their 223.309 (1) list, and then re-calculating the resulting change in the fee. Project costs may be adjusted for changes in materials, labor, and real estate variables. Local jurisdictions should document the basis for these adjustments to each project on their list. As projects are completed and new ones are added to the 223.309 (1) list, the amendments allow any resulting change to the improvement fee to be challenged (see Section 223.309 discussion below).

Jurisdictions may also use an index method to adjust their fees, provided that both the substantive basis for the adjustment and the procedure is set forth in their SDC methodology. For example, Bend Metro Parks and Recreation District SDC methodology includes an index adjustment procedure that combines the Engineers News Record Construction Cost Index for Seattle, Washington, and the County Assessor's estimated change in real property value net of new improvements. Their formula is weighted with 90% of the adjustment related to construction costs and 10% to land cost.

Finally, it is worth noting that an indexing procedure may only be adopted for a SDC program by ordinance, and an amendment to an existing SDC ordinance to include an index procedure will likely subject the entire methodology to review.

## ***Substantive Changes***

There are a number of enacted changes that either expand the meaning of the statute or specify how certain aspects of the law must be interpreted and implemented. Substantive changes fall into three areas. They are labeled for discussion based on their effect.

### **Increasing Improvement Fees by Adding New CIP Projects**

When a jurisdiction adds new projects to their ORS 223.309 project list, their SDC fee may be increased, but a new set of review requirements have been added in 223.309 (2) to provide an opportunity for public review and challenge to the increase in certain circumstances.

ORS 223.309 is amended as follows:

(2) A governmental unit that has prepared a plan and the list described in subsection (1) of this section may modify [*such*] the plan and list at any time. **If a system development charge will be increased by a proposed modification of the list to include capacity increasing capital improvements as described in ORS 223.307 (2):**

(a) **The governmental unit shall provide, at least 30 days prior to the adoption of the modification, notice of the modification to the persons who have requested written notice under ORS 223.304 (6).**

(b) **The governmental unit shall hold a public hearing if the governmental unit receives a written request for a hearing on the proposed modification within seven days of the date the proposed modification is scheduled for adoption.**

(c) **Notwithstanding ORS 294.160, a public hearing is not required if the governmental unit does not receive a written request for a hearing.**

(d) **The decision of a governmental unit to increase the system development charge by modifying the list may be judicially reviewed only as provided in ORS 34.010 to 34.100.**

This provision was added to ensure that local governments allow for public review when increasing SDC fees by adding new projects to their capital improvement project list. Primarily, the governmental unit will have the burden to demonstrate that the new capital improvements being added to the list are needed because of growth anticipated over the financing horizon. This change is consistent with other changes in the statute that establish a link between the amount of an improvement fee and the related benefit to future system users provided by each projects on their 223.309 list. This change requires that if a jurisdiction wants to add a project to their 223.309 list, and if the benefit-cost of that project warrants an increase in their SDC fee, then the fee increase must be subject to public review. Theoretically, a governmental unit has the option of adding a project to the list without increasing their fee, although this practice may be ill-advised in some cases.

The link created between the amount of an improvement fee and a specific list of projects likely will result in the need to update SDC methodologies more frequently. As projects are built, the 223.309 list will need to be changed. When that happens, the connection between the benefit that new projects provide future users, and the amount of SDC revenue that may be spent on the new projects, may be inconsistent with the amount of the SDC fee. Jurisdictions may find it easier, therefore, to update their 223.309 list and their improvement fee by ordinance rather than following the adjustment process outlined above.

### **Combined Reimbursement and Improvement Fees**

Many Oregon communities have implemented SDC charges that consist of both a reimbursement fee component and improvement fee component. For these jurisdictions, ORS 223.304 makes an important clarification in the law. As amended, this provision states:

**(3) A governmental unit may establish and impose a system development charge that is a combination of a reimbursement fee and an improvement fee, if the methodology demonstrates that the charge is not based on providing the same system capacity.**

This change was added to clarify that when jurisdictions collect a combination reimbursement and improvement fee, they may not charge duplicative fees. It is intuitive that when a fee is based on units of impact caused by development, that a development that causes one “unit” of impact cannot be charged one unit of reimbursement fee and one unit of improvement fee for that same impact. Stated another way, the methodology should use the same factors to measure existing system capacity and future improvement needs. The formula should net out available capacity from total future need and recover the value of existing capacity using a reimbursement fee. The improvement fee calculation then should be based on the difference in demand between total future need less available capacity.

Using a water storage example, if community “A” needs 2 million gallons of water storage to serve projected demand for the next 20 years, and it has 1 million gallons of available unused storage capacity, then the SDC should recover the value of 1 million gallons of available storage via a reimbursement fee, and recover the cost to build the additional 1 million gallons of needed storage using an improvement fee. A weighted average formula can be used to charge each new permit for a portion of the reimbursement and improvement fees.

## Improvement Fee Spending Limitations

There are a number of statutory changes related to improvement fees. These changes are significant because, when taken together, they limit the expenditure of improvement fee revenue on a project-by-project basis. Although the changes are an improvement, they leave some room for speculation as to their exact meaning.

ORS 223.304 is amended as follows:

~~[(2)(a)]~~ **(2)** Improvement fees [shall] **must**:

~~[(4)]~~ **(a)** Be established or modified by ordinance or resolution setting forth a methodology that ~~[considers the cost of projected]~~ **is available for public inspection and demonstrates consideration of:**

**(A) The projected cost of the capital improvements identified in the plan and list adopted pursuant to ORS 223.309 that are needed to increase the capacity of the systems to which the fee is related; and**

**(B) The need for increased capacity in the system to which the fee is related that will be required to serve the demands placed on the system by future users.**

ORS 223.309 is amended as follows:

(1) Prior to the establishment of a system development charge by ordinance or resolution, a governmental unit shall prepare a capital improvement plan, public facility plan, master plan or comparable plan that includes a list of the capital improvement projects that ~~[may be funded]~~ **the governmental unit intends to fund, in whole or in part, with revenue from an improvement fee [revenue] and the estimated cost, [and] timing and percentage of costs eligible to be funded with revenue from the improvement fee** for each improvement.

These amendments, combined with other references to the 223.309 (1) list, limit the use of improvement fees project by project. Local governments have always been required to adopt of list of projects that were eligible to be funded with improvement fee revenue. Other than identifying

which projects could be funded, however, there was no explicit limit placed on how much SDC revenue could be spent on them. Disregarding the economic consequence of using SDC revenues to fully-fund projects that only partly benefit future users, a literal reading of the old statute implied that an SDC program generates a certain amount of revenue based on overall “system needs” and that money could be spent on capital projects that added system capacity as the local jurisdiction saw fit.

With the addition of the phrase “... timing, **and percentage of costs eligible to be funded with revenue from the improvement** fee for each improvement”, however, the statute appears to limit the use of improvement fee revenue on a project by project basis, up to the percentage of benefit that a particular project provides future users. The rest of the money for the project must come from another source. Presumably another source may include reimbursement fee revenue, since it may be used on any capital improvement project within the system, but if that source does not cover the difference, the balance must come from a non-SDC source.

This change has several significant implications. First, it implies that the improvement fee must be calculated based on costs that are related to a specific set of projects. Depending on how one interprets the new language, this could pose a problem for jurisdictions that use a “system wide” approach for calculating their improvement fee. Take, for example, a park system SDC that calculates total acreage needed to serve future users and uses average cost factors for land and improvements as the improvement fee cost basis. Historically, this has been a widely used method for calculating park SDCs. In these methodologies, the project list is typically developed independently using a separate set of criteria to identify locations for projects that best serve future needs. The question is, does the enacted change require jurisdictions to employ methodologies that use a site-specific project-based approach rather than a system-need approach. This could lead to labeling problems for projects, depending on location, as to which ones provide shared benefits vs. which ones provide 100% benefit to future system users. This, in turn, leads to a host of measuring problems for systems that deliver public services indirectly.

A significant challenge to communities that have not developed other revenue sources to augment SDC funding is how to answer the question, “If not SDC revenue, then what?” This question is relevant on all 223.309 listed projects that provide less than 100% benefit to future system users. The prevalence of partial-benefit projects on the 309-list depends on how the SDC methodology works. Assume, for the moment, that the courts approve the method of calculating an improvement fee based on aggregate demand factors, like the park example described above. In that case, all the park projects on the 223.309 list would provide 100% benefit to future system users, regardless of their location. But many SDC methodologies rely on master plans that use sub-area analysis to identify system needs. In these master plans, many projects that benefit future system users involve modifying existing infrastructure, such as increasing a pipe diameter or adding a signal at an intersection. These modifications, at a minimum, provide indirect benefits to existing users, but also may solve existing service deficiencies.

Consider that the conventional way to add traffic capacity is to construct marginal improvements to a select group of system assets whose combined effect enhances overall system performance. Because conditions in the system degrade over time, virtually all transportation system improvements provide some level of shared benefit. Most utility master plans also use some level of disaggregated need analysis. When that approach is used, there is a high likelihood that shared benefit projects will show up on the 223.309 list and there will be limits to the level of financing that can come from improvement fees on those projects.

For jurisdictions that do not have ready access to non-SDC resources for capital improvements, this change may result in a proverbial Catch-22. A jurisdiction may not want to start a project when the money is not available to finish it. But if it does not build the project, service conditions will deteriorate over time, thereby reducing the level of support that can be financed with SDCs. The extent of this dilemma will vary depending on the availability of resources, or the political will to develop them. As a starting point, local governments should review their 223.309 project lists and identify the growth-related benefit percentage for each project. This will frame the scale of the problem and help initiate the important discussion about where the rest of the money will come from.