

# Seattle Public Utilities

## Developer Charges and Funding Requirements Issue Paper

June 1, 2018

### Summary

Resolution 31760, adopted in November 2017, calls for SPU to change the method of calculating the water system development charge (SDC)<sup>1</sup> and to establish a wastewater (sewer) SDC and a stormwater (drainage) SDC. The intent is to improve uniformity in the charges and the equitable allocation of costs between ratepayers and developers.

The Resolution responded to recommendations made by the Mayor and Council-appointed Customer Review Panel that oversees SPU's Strategic Business Plan. To complement SDCs, SPU is also evaluating the funding of infrastructure requirements on development projects to determine if there are ways to more equitably assign costs between developers and ratepayers.

This issue paper describes the work that needs to be completed to submit a proposal to Council, specifically the analyses required to make recommendations. The analyses include evaluating options for establishing the SDC calculations, using the SDC revenue, allocating infrastructure costs via latecomer agreements, and minimizing negative impacts on affordable housing development. The issue paper also discusses ways to engage with our customers to get their input, how SPU is aligning its efforts with other City initiatives and efforts, and how we will apply an equity lens during the development and implementation phases.

The Executive will submit a proposal with recommendations to the Civil Rights, Utilities, Economic Development and Arts (CRUEDA) Committee by the end of first quarter 2019, and possibly earlier. We will coordinate with Council throughout the proposal development process.

### Current Status

System development charges (SDCs) are one-time charges on new customers to buy into or access the entire utility system or on existing customers with increased demand for system capacity. SDCs are also known as connection fees/charges, capacity charges, or general facility charges and are authorized by RCW 35.92.025:

***RCW 35.92.025. Authority to make charges for connecting to water or sewerage system—  
Interest charges.***

*Cities and towns are authorized to charge property owners seeking to connect to the water or sewerage system of the city or town as a condition to granting the right to so connect, in addition to the cost of such connection, such reasonable connection charge as the legislative body of the city or town shall determine proper in order that such property owners shall bear their equitable share of the cost of such system. The equitable share may include interest charges applied from the date of construction of the water or sewer system until the*

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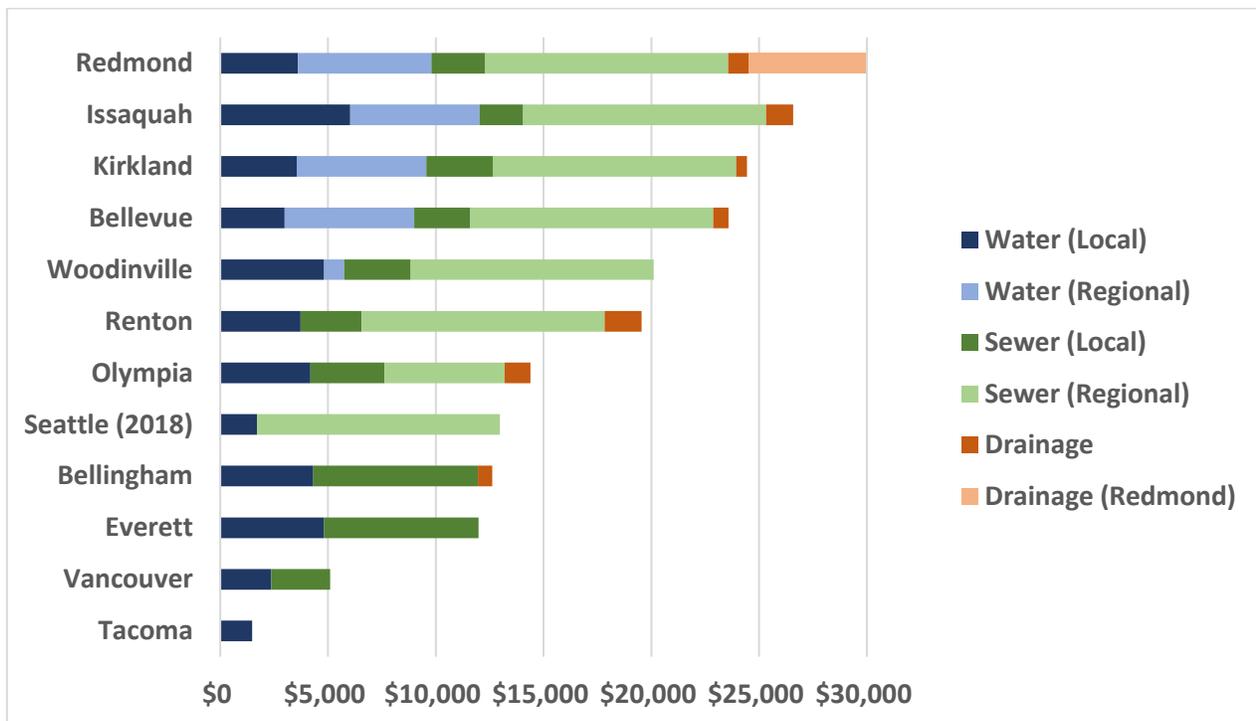
<sup>1</sup> Currently referred to as the water connection charge.

connection, or for a period not to exceed ten years, at a rate commensurate with the rate of interest applicable to the city or town at the time of construction or major rehabilitation of the water or sewer system, or at the time of installation of the water or sewer lines to which the property owner is seeking to connect but not to exceed ten percent per year: PROVIDED, That the aggregate amount of interest shall not exceed the equitable share of the cost of the system allocated to such property owners. Connection charges collected shall be considered revenue of such system.

SPU currently has a water SDC but no SDC for sewer<sup>2</sup> or drainage. SPU’s water SDC doesn’t assume the full system cost basis that is supported by Washington statute and case law in calculating the water charge. Consequently, the current water SDC is among the lowest in the region.

The table below shows SPU’s water SDC of \$1,700 (effective later in 2018) for one equivalent residential unit (ERU)<sup>3</sup> relative to several utilities in the region. SPU’s regional sewer fee is the King County sewer capacity charge. As a regional water provider, SPU doesn’t have a separate regional water fee. More information on how SPU’s program compares to that of other utilities is provided in the “Other Utilities’ Programs” section on pages 3-4 and in Attachment A.

**Graph 1. Local and Regional SDCs per ERU<sup>4</sup>**



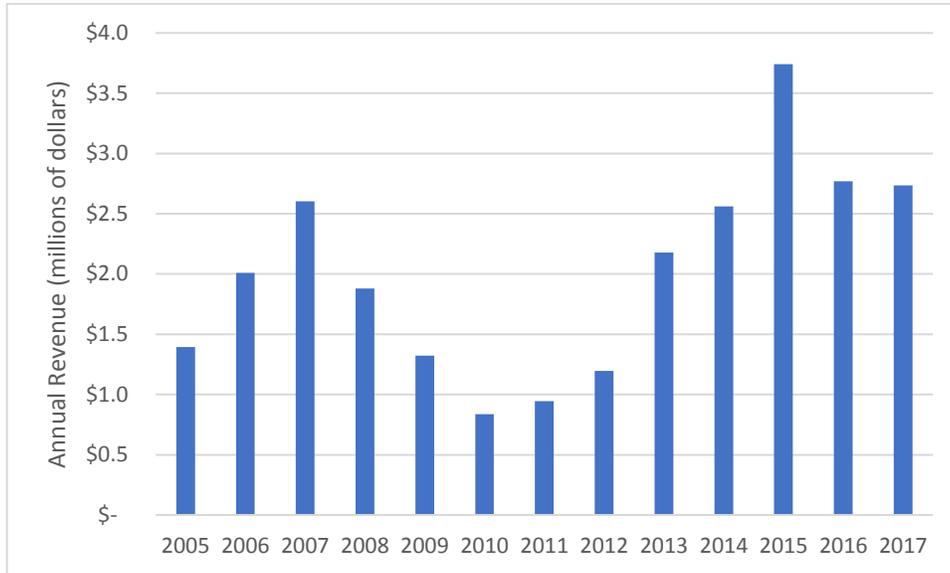
<sup>2</sup> SPU does impose a “special sewer connection charge” on certain connections to the sewer system which is further described at the end of this section.

<sup>3</sup> One ERU is the charge that would typically be imposed on a new single-family development. Larger developments would typically be subject to some multiple of the one ERU base.

<sup>4</sup> The City of Redmond imposes two types of drainage SDCs: 1) a citywide charge (dark orange on the graph) applicable to all parcel-based development projects; and 2) sub-basin charges (light orange on the chart), applicable only to development in the downtown and Overlake sub-basins.

Presently, water SDC revenue is used to fund current general Water Fund CIP, which serves to offset rate increases by reducing the amount of capital funded with rates revenues. The graph below shows the variability in Water Fund SDC revenue from 2005 to 2017.

**Graph 2. Seattle’s Historic Water SDC Revenue**



While SPU does not currently have a sewer SDC, SMC 21.24.030 authorizes a “special connection charge” (SSCC) on “owners of properties which have not been assessed or charged or borne an equitable share of the cost of the City’s sewerage system” prior to connection. Annual revenues collected for the SSCC are much smaller than the current water SDC, totaling \$1.1 million between 2005 and 2017 compared to more than \$26 million for the water charge across that same period. There are other distinct differences in both the calculation methodology and applicability of the SSCC, further discussed under Issue #1 of this paper.

### **Other Utilities’ Programs**

SPU interviewed eight utilities in the region. We focused most of our research on utilities in Washington, because laws governing SDCs and use of utility revenue can vary from state to state. For the utilities we interviewed, the points below highlight our research to date. **Attachment A** provides a more detailed comparison of the various utilities.

- **SDCs in place.** All utilities, except Tacoma, have local water and sewer SDCs, and several have drainage SDCs. Tacoma charges an SDC for water only. About half the utilities include future system costs in their calculations while the others only include existing system costs. In addition to local SDCs, customers in several municipalities must also pay regional SDCs. Examples of regional charges include Cascade Water Alliance’s water SDC and King County’s sewer capacity charge.
- **Payment.** All utilities, except Bellevue, impose the local SDC as an upfront charge on development. Bellevue recovers the SDC directly from utility customers via their bimonthly

utility bills. King County recovers its regional sewer capacity charge directly from utility customers via separate bills.

- **Use of revenue.** Utilities use SDC revenue in a variety of ways in support of their capital improvement programs (CIP). Some use the revenue to pay down debt on existing infrastructure or to cash fund current year CIP, including general capital needs or targeted growth-related projects.
- **Infrastructure requirements.** All utilities require the developer to pay the costs of the mainline extension in cases where a main does not abut the parcel.
- **Latecomer agreements.** None of the utilities interviewed has implemented municipal latecomer agreements, a tool that the State of Washington authorized in 2015. Municipal latecomer agreements allow cities and towns to proactively construct and finance system improvements and then seek reimbursement from future developers who benefit from the improvements. Only Bellevue has a program similar to municipal latecomer agreements called Direct Facility Connection Charge (DFCC). More information on municipal and other latecomer agreements is provided in the “Latecomer Agreements” section on pages 7-10.

SPU will continue to research other utilities’ programs, particularly regarding their SDC calculation methods and use of revenue.

## Issue #1 – SDC Calculation

### Summary of Issue

The basic approach to calculating an SDC is as follows:

$$\text{SDC} = \frac{\text{System Cost}}{\text{Customer Base}}$$

Beyond this simple equation, there are different ways to define system cost and customer base to reflect policy choices. “System cost” falls into two main categories:

- **Existing system cost.** This is the value of the investments made to date into the current system. There are no clear requirements whether this should be original cost (value at the time assets were constructed) or net book value (original cost less accumulated depreciation). The existing system cost may also include interest charges for up to 10 years as specified in RCW 35.92.025.
- **Future system cost.** This cost includes future capital projects, such as a six-year adopted capital improvement program (CIP). To avoid duplicating costs for a single system asset, future cost excludes asset replacement projects.

As noted in the previous section, some utilities surveyed only include existing system cost in their calculations while others include existing plus future system cost. It is also possible to base the fee exclusively on future growth-related cost, although this is more suitable to jurisdictions with significant greenfield development. SPU's current water SDC uses the existing system cost (depreciated) basis but does not include interest charges.

The "customer base" is essentially the number of units across which the system cost is spread to calculate the base charge (one ERU). The applicable units for an SDC using an existing system cost basis assumes current customers. The units for an SDC using a future system cost basis includes the projected growth in the customer base over the period that future cost is captured.

The units used to define the customer base vary by line of business. For water, this is typically based on equivalent meter units, which is calculated by multiplying the number of meters of a given size within the jurisdictional service area by flow capacity for that meter. ERUs for smaller meters will be less than ERUs for larger meters. The American Water Works Association (AWWA) defines the standard flow capacity (or flow progression) for different sized meters for water SDC calculations. Sewer SDCs also typically use equivalent meters as the base (using the same AWWA standards), although some jurisdictions use a count of plumbing fixtures. Drainage SDCs are usually based on square footage of impervious surface.

Updating the water SDC and creating SDCs for drainage and sewer require changes to the SMC. When SPU takes this action, we propose eliminating the SSCC that's described in the "Current Status" section, as it would be superseded by the new SDC provision. Although the SMC's description for the SSCC is similar to that for SDCs described in RCW 35.92.025, the SSCC is significantly out of alignment with the proposed options in two main areas:

- **Calculation methodology.** The SSCC calculation methodology only captures a fraction of overall system costs, which is vastly different than existing and future system costs for SDCs.
- **Applicability.** The SSCC applies to new connections from undeveloped lots or properties previously on septic. It does not apply to existing services with expanded system impacts.

#### Issues to be Analyzed

- **Identify SDC calculation options.**
  1. Determine the inputs for the existing system costs. For example, do we use net book value or original cost? Do we include localized assets, conservation deferred assets, and/or interest charges?
  2. Determine the data source/inputs for future system costs. For example, do we use the adopted six-year CIP or a 20-year capital facilities plan? Should any types of projects be excluded from the cost basis?
  3. Define the customer base for both the existing system cost and future system cost and identify the sources for this data. Evaluate the impacts on charges of alternative methods for calculating the total number of customer units, including alternative AWWA flow progressions.
  4. Identify different methods to calculate the SDCs for each line of business.

- **Analyze alternative bases for defining the schedule of SDC charges (how different categories of development are charged).** Evaluate options regarding fee schedules for residential versus commercial development, and specifically identify options for multi-family development.
- **SDC credits.** Evaluate whether to provide credits when system improvements are constructed beyond the infrastructure that SPU requires of the developer.
- **Estimate customer impacts.** Estimate the impacts for each calculation option on different types of development, such as single-family, multi-family, small commercial, large commercial, mixed use, industrial, etc.
- **Forecast the SDC revenue.** Estimate a range of revenue for each calculation option, including the different ERU progression methods, and for each line of business.
- **Identify roll-out options.** Identify timing options to implement the updated water SDC and new drainage and sewer SDCs, such as an all-at-once or a phased-in approach. Also estimate the implementation timeframes for the different options being explored.

## Issue #2 – Use of SDC Revenue

Updating the water SDC and implementing drainage and sewer SDCs will generate increased revenue. A key policy question is how to use the revenue. Although the RCW does not specify how municipalities must use SDC revenue, in a 2009 report, SPU’s consultant (FSC Group) stated the following:

*Connection charge revenues are variously recorded to operating or construction funds and accounts. In some systems, the revenues go to the operating fund but generate an equal transfer to construction in order to retain an adequate audit trail.*

*Clearly, the connection charge revenues must be recognized as revenues of the utility enterprise for which they are paid. This ensures that the funds are directed to the system. In addition, the charges are essentially based on a share of capital costs. Their use is appropriately limited to capital purposes to ensure consistency with their basis.*

*We routinely recommend that this be done through commitment to a construction or capital fund, where the resource becomes a source of equity capital funding. This is consistent with their basis and the unreliability of this revenue stream. We have also noted that the use of connection charges to pay debt service retains the linkage to support of system capital costs. While an option, this can introduce financial risk due to the unpredictability of annual revenues from new growth. There are utilities across the nation now struggling to meet debt service and related coverage due to their casual reliance on utility connection charges as a source of funding for those purposes.*

*We also strongly advise against their use to support system operating and maintenance expenses that cannot be capitalized, in order to maintain the consistency of the charge basis and use and to avoid the adverse effects of revenue volatility.*

As noted in the “Other Utilities’ Program” section, all the utilities we interviewed put their revenue towards their current general CIP or debt service on previous bond issues. SPU currently uses water SDC revenue for Water Fund general CIP, which offsets rates.

The additional revenue could continue to be used to exclusively offset rate increases (assuming constant CIP spending levels), exclusively to expand the CIP, or some combination of the two approaches. There are different ways to expand the capital program beyond what has already been planned, including:

- Invest in additional capital projects to address general system needs.
- Invest in additional capital projects that specifically address capacity issues and growth-related infrastructure needs.<sup>5</sup>
- Set aside funds to pay the costs of system improvements extending beyond the first-in developer's property frontage.<sup>6</sup>
- Set aside funds for opportunity projects. Where appropriate and needed, invest in additional system improvements when developers are required to put in a main extension or other infrastructure.<sup>7</sup>

Issues to be Analyzed:

- **Evaluate system gaps.** Identify and quantify, as best as possible, infrastructure gaps in SPU's system that could be addressed, at least partially, with additional SDC revenue. Focus on areas that are likely to see the most growth.
- **Evaluate options for use of revenue.** Using the information on forecasted revenue as described in Issue #1, evaluate the benefits, costs and risks of the various ways to use SDC revenue. Assess whether using SDC revenue to fund additional capital projects improves the equitable allocation of infrastructure costs between current developers, future developers, and ratepayers.
- **Apply the equity tool.** Apply an equity lens to the options for using SDC revenue.
- **Estimate rate impacts.** Estimate the impact to each fund's rate path if some or all SDC revenue were used to offset rates.

### **Issue #3 – Latecomer Agreements**

Summary of Issue

The RCW specifies two types of latecomer agreements: utility and municipal. **Utility** latecomer agreements are reimbursement agreements that allow a developer who has installed a utility improvement to recover a portion of the improvement costs from other property owners who later develop in the vicinity and use the improvements. At the local level, utility latecomer agreements are authorized by SMC 21.80.

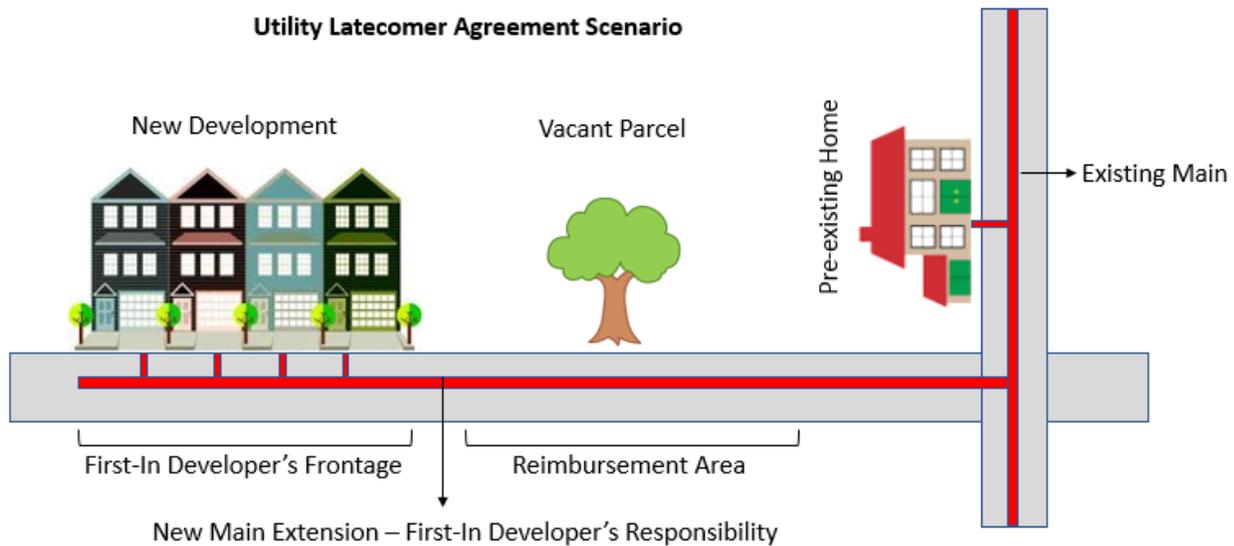
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<sup>5</sup> These expenses could potentially be reimbursed by future development via municipal latecomer agreements (discussed further in Issue #3).

<sup>6</sup> These expenses could potentially be reimbursed by future development via utility latecomer agreements (discussed further under Issue #3).

<sup>7</sup> These expenses could potentially be reimbursed by future development via utility latecomer agreements (discussed further under Issue #3).

The following simplified illustration shows the portion of the system improvement that is required beyond the developer's property frontage and could be reimbursed by future developers.



RCW 35.91.020 states that, if a developer requests a utility latecomer agreement, the municipality needs to contract with the developer, administer the agreement, collect pro rata funds from future developers who benefit from the system improvement, and reimburse the "first-in" developer. The reimbursement period is twenty years.

Currently, SPU has only executed one utility latecomer agreement for a 154-foot combined sewer main extension that was constructed in 2016. In 2018, we have received three initial utility latecomer agreement applications for water main extensions and seven initial applications for line valve installation requirements for water mains. Five of the ten applicants are actively pursuing utility latecomer agreements. We have heard from developers that the uncertainty in cost recovery, along with the efforts required to establish utility latecomer agreements, are challenging. This is likely the main reason for the low volume of utility latecomer agreements.

RCW 35.91.020 also allows municipalities to participate in funding system improvements and receive reimbursement through utility latecomer agreements. There are two scenarios by which this could occur. First, a municipality could pay the costs of the system improvement that is beyond the first-in developer's property frontage so that the developer's cost burden is limited to his/her parcel. Second, a municipality could leverage a utility latecomer agreement to fund additional system improvements, such as increasing the pipe size on a required main extension, that is beyond what's required of the first-in developer. In both scenarios, the developer and utility would be reimbursed their proportional share of the overall investment. And in both scenarios, SPU could use SDC revenue to participate in funding the improvements, as described in Issue #2.

In 2015, Washington State enacted legislation authorizing **municipal** latecomer agreements. RCW 35.91.060 allows municipalities – on their own initiative and without the participation of developers or private property owners – to construct utility system improvements and establish "assessment

reimbursement areas” prior to development of the area. The municipality finances all the improvement costs and receives all the reimbursements. As noted in the “Other Utilities’ Programs” section, none of the utilities interviewed have municipal latecomer agreements in place.

If SPU were to implement municipal latecomer agreements, we could take one of two approaches or both approaches. The first would be to proactively identify areas where development is likely to occur, construct the system improvements, and establish assessment reimbursement areas. The second would be to construct system improvements and establish assessment reimbursement areas only when opportunities arise. An example would be taking advantage of a transportation project where the street will be open to put in the infrastructure needed for future development. SPU could use SDC revenue to proactively or reactively fund the improvements, as described in Issue #2.

### Issues to be Analyzed

Latecomer agreements are tools to potentially allocate the cost of system improvements more equitably between current developers, future developers, and ratepayers. As noted above, SPU already administers utility latecomer agreements but does not participate in funding the improvements. We will evaluate this option, as well as exploring the option to implement municipal latecomer agreements. We will weigh the pros and cons and apply an equity lens to both options.

- ***Evaluate participating in funding improvements via utility latecomer agreements.***
  1. Work with Law to understand the legal issues, including whether we can bond fund an improvement that we will receive reimbursement via a latecomer agreement.
  2. Get additional information from utilities that help fund system improvements to determine how their programs work.
  3. Sketch out an implementation plan to understand the operational and administrative requirements, at a high level, for this option.
  4. Identify any additional work that needs to be completed prior to participating in utility latecomer agreements, such as the need for system plans.
  5. Analyze past data to quantify how much infrastructure first-in developers have constructed beyond their property frontage.
  6. Estimate the funding needs to participate in utility latecomer agreements in future years and identify possible sources of revenue.
  7. Perform rate analyses that focus on expense impacts at the time of the improvement and the anticipation of future reimbursement.
- ***Evaluate implementing municipal latecomer agreements.***
  1. Work with Law to understand the legal issues, including whether we can bond fund an improvement that we will receive reimbursement for via a latecomer agreement.
  2. Identify the legislative options to implement municipal latecomer agreements in the SMC (i.e. blanket authority or authority on a project-by-project basis).
  3. Identify the scenarios where it would be beneficial and cost-effective for SPU to implement municipal latecomer agreements, both for the proactive and opportunistic approaches.

4. Estimate the funding needs to implement municipal latecomer agreements in future years and identify possible sources of revenue.
5. Sketch out an implementation plan to understand the operational and administrative requirements, at a high level, for this option.
6. Identify any additional work that needs to be completed prior to implementing a municipal latecomer agreement, such as the need for a system plan.
7. Perform rate analyses that focus on expense impacts at the time of the improvement and the anticipation of future reimbursement.

## **Issue #4 – Affordable Housing Development**

### Summary of Issue

To support the Mayor’s goal of making Seattle more affordable, SPU is exploring ways to minimize the impact of SDCs on rent- and income-restricted affordable housing. We are coordinating with the Mayor’s Office and departments that work on affordable housing issues to align and leverage our efforts. We also plan to engage with developers and owners of affordable housing development to better understand their interests and to identify potential options for the City.

Washington State law restricts the use of utility revenue. Because of this, SPU is consulting with the Law Department as it evaluates feasible options for SPU and the City. In looking at options, we are focused on affordable housing development projects that are focused on rent- and income-restricted affordable housing. The RCW does give municipalities the authority to waive SDCs, but specifically for low income persons.

***RCW 35.92.380. Waiver or delay of collection of tap-in charges, connection or hookup fees for low income persons.***

*Whenever a city or town waives or delays collection of tap-in charges, connection fees, or hookup fees for low income persons, or class of low income persons, to connect to lines or pipes used by the city or town to provide utility service, the waiver or delay shall be pursuant to a program established by ordinance. As used in this section, the provision of "utility service" includes, but is not limited to, water, sanitary or storm sewer service, electricity, gas, other means of power, and heat.*

### Issues to be Analyzed:

1. Work with Law to understand the legal issues.
2. Review other cities’ and utilities’ programs and work with Law to determine if any could be applied in Seattle.
3. Analyze historical data to estimate a range of future costs to SPU and customer benefits associated with waiving SDCs for low income persons, as authorized by RCW 35.92.380.
4. Identify options to waive or reduce SDCs for rent- and income-restricted affordable housing projects:
  - Analyze historical data to estimate a range of future funding needs for each option.

- Sketch out implementation plans to understand the operational and administrative requirements, at a high level, for the options.
- Collaborate with other City departments to identify ways to align and leverage SPU’s work with other affordable housing programs and initiatives.
- Evaluate the benefits, costs and risks of each option.

## Interdepartmental Coordination

SPU is one of several departments that provides services to the development community. Under the Mayor’s Office’s guidance, we are collaborating with SDCI, SDOT, OPCD and other departments to make sure our work on SDCs dovetails with other City initiatives, such as transportation and parks impact fees.

In addition to new initiatives, SPU has an opportunity to improve the services we currently provide to development customers. This includes streamlining our fee collection process, improving how we communicate system improvement requirements, and coordinating service delivery with other departments. We will address process improvements when we develop the SDC program implementation plan.

## Customer Engagement

Actively engaging customers is key to this program’s success. It will be important to get customer input during the proposal development, design, and implementation of the program. This includes hearing from all sectors of the development community, affordable housing providers, and ratepayers. SPU will apply an equity lens to its engagement plan. Our initial thoughts on engaging with customers includes:

- **Initial workshops.** SPU plans to meet with a small subset of customers to share information about the work we are doing, hear their concerns and interests, and incorporate their feedback into the development of the proposal to Council. Because interests tend to differ between customer groups, we envision holding one meeting with a group of residential and affordable housing developers and another with a group of commercial and mixed-used developers. For both meetings, we would invite customers who represent ratepayers’ perspectives and interests. We would also ask our customers how they prefer to engage with SPU during the rest of the process.
- **Future engagement.** SPU will offer venues for continued customer engagement based on the input provided in the initial workshops. Considerations include:
  1. **Audience**
    - Should we engage with customers broadly, in a targeted manner, or both? For example, should we engage with more targeted groups of customers during the proposal development and program design phases and with a broader group of customers during the implementation phase? Or should we engage with as many customers as possible during all phases of work?

- What is the most effective way to engage with affordable housing developers?
  - What is the best way for SPU to collaborate with other City departments in its engagement efforts?
2. ***Setting, Structure and Frequency***
- Should we engage customers via occasional workshops, should we create a standing committee that meets on a regular basis (similar to the Customer Review Panel), or should we do both?
  - What other means should we employ to engage with customers (e.g. electronic communications, including information in SDCI’s newsletter, attending Master Builders’ meetings, etc.)?

Regardless of the specific engagement tactics, we will continuously loop back with participating customers to inform them how we used their input throughout the process.

### **RSJI and Equity Implications**

There are several equity issues that need to be evaluated in developing a proposal to update SDCs and during the implementation phase.

As described in the “Affordable Housing Development” section, SPU is exploring ways to minimize the impact of the updated charges on affordable housing and will collaborate with other departments to align and leverage our efforts.

SPU will look closely at equity during the options analyses and implementation phases of our work. In addition to the affordable housing issue, the other analyses that will benefit from the equity toolkit or other tools are use of SDC revenue, participating in funding improvements via utility latecomer agreements, and implementing municipal latecomer agreements. If we decide to fund additional capital projects with SDC revenue, a specific issue we will address is how we take an equitable approach to prioritizing these investments.

Finally, we will apply an equity lens in engaging with our customers to involve a good cross-section of our customers throughout the process.

### **Proposal Submittal Timeline**

As mentioned at the beginning of this paper, the Executive will submit a proposal to the CRUEDA Committee by the end of first quarter 2019, and possibly earlier. We will coordinate with Council throughout the proposal development process and can engage with Committee members and staff as requested by the Committee Chair.

### **ATTACHMENTS**

- Attachment A – Other Utilities’ Developer Charges and Funding Requirements Information