HansonBridgett

JUNE 30, 2017 | HANSON BRIDGETT LITIGATION & DISPUTE RESOLUTION PRACTICE GROUP

Supreme Court Clarifies Application of Proposition 218 Requirements to Franchise Fees

by Adam W. Hofmann & Jerett T. Yan

Prior to imposing, extending, or increasing any tax, a public agency must submit the tax to a vote of the electorate. However, public agencies need no such approval to impose certain types of fees. In *Jacks v. City of Santa Barbara*, the Supreme Court considered whether and when municipal franchise fees—fees charged to utilities and others for the use of public rights of way—constitute taxes requiring voter approval. The Court held that where a franchise fee does not exceed the reasonable value of the franchise it is not a tax. But any part of the fee that exceeds the reasonable value of the franchise is a tax.

Background

In 1996, California voters enacted Proposition 218 to close perceived loopholes in the tax limits established by Proposition 13, adding Articles XIIIC and XIIID to the California Constitution. Section 2 of Article XIIIC requires voter approval for all measures imposing, extending, or increasing any general or special taxes. During the years since, California courts have struggled to differentiate between taxes requiring voter approval and other kinds of government revenue measures that do not.[1]

Most recently, in *Jacks v. City of Santa Barbara*, Case No. S225589 (June 29, 2017), the California Supreme Court confronted this difficulty in the context of local franchise fees.

California local governments have long conferred franchises—the privilege of using local streets and rights of way—on privately owned utilities and charged so-called "franchise fees" as the price for conferring that right. The Public Utilities Code regulates the franchise fees that general-law cities charge, but charter cities are not bound by those restrictions. And the Public Utilities Commission ("PUC") regulates the way that privately owned utilities recover the cost of the franchise fees that exceed regional averages, but plays no role in establishing the validity of those fees.

California courts have always viewed franchise fees as negotiated compensation for the valuable use of public property, not as taxes. However, in *Jacks*, local residents and businesses challenged a portion of the City of Santa Barbara's electrical franchise fee as a tax requiring voter approval. The case arose

from a 1999 franchise agreement between the City of Santa Barbara and Southern California Edison ("SCE"). In this agreement, the City wished to set the franchise fee at 2% of SCE’s gross receipts from sales in the city, but SCE advised that it would need approval from the PUC for the amount in excess of the 1% regional average. As a result, the parties split the agreement’s term; SCE could maintain its existing franchise for two years paying a 1% fee, but the remaining 28 years would be triggered if the PUC approved the 1% increase. The PUC approved the franchise fee, but only permitted SCE to recover the first 1% as part of its general electricity rates. SCE had to recover the additional 1% from Santa Barbara residents in the form of a separately itemized surcharge. Some local residents viewed this surcharge as a tax and sued claiming that it had not been approved by voters pursuant to Proposition 218.

The trial court ultimately upheld the 2% franchise fee, finding that it was not a tax governed by Proposition 218; it was negotiated compensation for use of the City’s right of way. But the Second District Court of Appeal reversed. Relying on the Supreme Court's seminal Proposition 218 case, *Sinclair Paint Co. v. State Bd. of Equalization* (1997) 15 Cal.4th 866, the court held that the surcharge was a tax because it’s purpose was to generate general revenue for the City. The Supreme Court granted review, reversed, and remanded for factual findings.

The Supreme Court's Analysis

In a 6-1 decision (Justice Chin dissenting), the California Supreme Court reversed, ruling that franchise fees are not taxes, but negotiated compensation for the use of public property. Under Proposition 218, however, franchise fees must bear a reasonable relationship to the value of the franchise being conferred. In effect, any amount that exceeds the "reasonable estimate of the value of the franchise" is not actually compensation for the franchise and constitutes a tax subject to voter approval.

To reach this result, the Court rejected the Court of Appeal's view that the surcharge was a tax because SCE received the benefit of the franchise but passed the charge on to the ratepayers. The Court found this to be immaterial because publicly regulated utilities are allowed to recover their costs and expenses, including their cost of purchasing a franchise from the City, by passing them on to ratepayers. It also rejected the appellate court's focus on the purpose of the charge. As it held, “a fee paid for an interest in government property is compensation for the use or purchase of a government asset rather than compensation for a cost. Consequently, the revenue generated by the fee is available for whatever purposes the government chooses rather than tied to a public cost."

Because of the procedural posture of the case, however, the Court could not reach the factual question of whether this surcharge reflected such a reasonable estimate of the franchise's value. It found that the plaintiffs' complaint could be construed to contain allegations sufficient to survive a motion for judgment on the pleadings, but the parties had not actually established whether the surcharge was reasonable. Accordingly, the Court remanded the matter for further proceedings to determine whether the surcharge satisfied the standard articulated by the Court.

Notably, though nominally reserving the question for expert opinions and subsequent case law, the Court briefly reflected on the kind of evidence that the trial court might consider when resolving this question. First and foremost, the Court acknowledged that the negotiated agreement between SCE and Santa Barbara could constitute evidence of the franchise's value, so long as that agreement was reached through bona fide negotiations. However, it also indicated that unspecified "other indicia of value" could be used.

Practical Impacts

Jacks reflects a significantly better decision for local government than did the Court of Appeal's decision. It rejects the lower court's finding that a true franchise fee cannot generate general revenue and cannot be passed through to utility customers as a surcharge. Further, though the Court expressly declined to consider the operation of these principles in the context of 2010's Proposition 26, the decision may be the first indication we have of how the Court may rule on the scope of Proposition 26's term excepting charges for "entry or use of local government property" from the definition of a tax.

Nonetheless, the Court did articulate a new standard that agencies may not have consciously considered when adopting franchise fees. And the Court did not explain who would bear the burden of proving the value of the franchise. As a result, cities with existing franchise fees, and especially those with franchise surcharges, should evaluate what evidence they have available for their existing fees and prepare their records of decisions for new fees with this consideration in mind.

As the Court reflected, one likely indicia of value is the price set by parties negotiating in good faith and at arm's length. This seems natural. In other contexts, the value of property is generally considered to be whatever a reasonable buyer would pay a reasonable seller in the marketplace. It is hard to imagine a clearer indication of that value than the price agreed to by an actual utility in the course of an actual negotiation. Accordingly, cities should look to retain as much as possible any documentation showing that their past and future franchise negotiations were undertaken in good faith and free from any collusion or coercion. Following the Broughton Act and Franchise Act of 1937, Pub. Util. Code, §§ 6001, et seq., 6201, et seq., the statutes that regulate franchise fees set by general law cities, would also seem likely to be presumptive evidence of compliance with constitutional limitations. Whatever the reasonable value of a franchise is, it seems unlikely to be less than the amount found reasonable by the state legislature. But the Court expressly declined to rule on the precise scope of relevant evidence. Accordingly, cities should consider what other "indicia" of value can be generated to demonstrate the value of their franchises.

[1] In 2010, voters passed Proposition 26, amending Article XIIIC to add the first constitutional definition of a "tax." That definition has raised at least as many questions as it has answered regarding the scope of municipal revenue authority. Regardless, it does not apply retroactively. (See *Brooktrails Township Community Services Dist. v. Board of Supervisors of Mendocino County* (2013) 218 Cal.App.4th 195.) As a result, many revenue measures established before 2010 are still evaluated under Proposition 218 without the aid of Proposition 26's definitions, as was the franchise fee in this case.

For more information, please contact:

Adam W. Hofmann, Partner
415-995-5819
ahofmann@hansonbridgett.com

Jerett T. Yan, Associate
415-995-5122
JYan@hansonbridgett.com

DISCLAIMER: This publication does not constitute legal advice. Readers should consult with their own legal counsel for the most current information and to obtain professional advice before acting on any of the information presented. Copyright © Hanson Bridgett LLP