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The Future of Impact Fees and Tiered Rates

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Water Ratemaking Challenges Under Proposition 218: Tiered Water Rates and Other Puzzles

By

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I. Introduction and Summary

Water rates are a frequent target of challenges under 1996's Proposition 218 (Cal. Const., art. XIII C and XIII D). Since the 2015 decision in *Capistrano Taxpayers Assn., Inc. v. City of San Juan Capistrano* (2015) 235 Cal.App.4th 1493 striking that city's tiered water rates for insufficient record evidence to support the costs allocated to each rate tier, such challenges have proliferated. Until recently, cases upholding such rates were few and unpublished and the published authorities generally struck down rates. Recently, the City of Los Angeles successfully defended its tiered rates in *Dreher v. Los Angeles Dept. of Water & Power* (2025) 116 Cal.App.5th 977, review granted. However, the California Supreme Court's grant of review in that case, after declining review of other cases invalidated tiered rates, has maintained uncertainty in this area of the law.

This paper provides an overview of the key cases, describing the state of the law, and concludes with advice on how to set water rates while we await decision in *Dreher*, which may not be filed until 2028.

A. The Background: Propositions 218 and "Property-Related Fees"

In 1996, California voters adopted Proposition 218, "The Right to Vote on Taxes Act," adding articles XIII C and XIII D to our Constitution. Article XIII C placed in our Constitution relatively familiar rules for general and special taxes. Article XIII D imposed new restrictions on assessments on real property and a new class of property-related fees, defined as:

> any levy other than an ad valorem tax, a special tax, or an assessment, imposed by an agency upon a parcel or upon a person as an incident of property ownership, including a user fee or charge for a property related service.

(Cal. Const., art. XIII D, § 2, subd. (e).) "Property-related service" is defined, somewhat unhelpfully, as "a public service having a direct relationship to property ownership." (*Id*., subd. (h).)

In 2004, the California Supreme Court suggested in dicta in *Richmond v. Shasta Community Services Dist*. (2002) 32 Cal.4th 409 that:

> A fee for ongoing water service through an existing connection is imposed "as an incident of property ownership" [and therefore a property-related fee under Prop. 218] because it requires nothing other than normal ownership and use of property.

In 2006, the Court made this a holding in *Bighorn-Desert View Water Agency v. Verjil* (2006) 39 Cal.4th 205 and ordinary water rates were now subject to Proposition 218's procedural and substantive requirements. Of interest now is article XIII D, section 6, subdivision (b), which provides:

> (b) Requirements for Existing, New or Increased Fees and Charges. A fee or charge shall not be extended, imposed, or increased by any agency unless it meets all of the following requirements:
>
> (1) Revenues derived from the fee or charge shall not exceed the funds required to provide the property related service.

> (2) Revenues derived from the fee or charge shall not be used for any purpose other than that for which the fee or charge was imposed.
>
> (3) The amount of a fee or charge imposed upon any parcel or person as an incident of property ownership shall not exceed the proportional cost of the service attributable to the parcel.
>
> (4) No fee or charge may be imposed for a service unless that service is actually used by, or immediately available to, the owner of the property in question. Fees or charges based on potential or future use of a service are not permitted. Standby charges, whether characterized as charges or assessments, shall be classified as assessments and shall not be imposed without compliance with Section 4.
>
> (5) No fee or charge may be imposed for general governmental services including, but not limited to, police, fire, ambulance or library services, where the service is available to the public at large in substantially the same manner as it is to property owners.
>
> Reliance by an agency on any parcel map, including, but not limited to, an assessor's parcel map, may be considered a significant factor in determining whether a fee or charge is imposed as an incident of property ownership for purposes of this article. In any legal action contesting the validity of a fee or charge, the burden shall be on the agency to demonstrate compliance with this article.

(Cal. Const., art. XIII D, § 6, subd. (b).)

Compliance with the first, total-cost limitation has not been problematic as few agencies make rates without demonstrating they are needed to cover service costs. The second and fifth requirements, that fees funded only water service, have led to a number of cases involving transfers of utility rate proceeds to other agency funds (including agency general funds), but those are not our present topic. The fourth requirement, limiting standby fees, has made those fees historical relics which can be maintained, but not adopted anew or increased; it has generated few cases. The third requirement — that rates be apportioned among customers in proportion to the cost of service — has been the subject of most of the litigation and is our topic today.

II. *Capistrano* and Tiered Water Rates

The first published case to address tiered water rates was *City of Palmdale v. Palmdale Water Dist.* (2011) 198 Cal.App.4th 926, which held that the district's tiered rates for irrigation water violated Proposition 218 because the District had not allocated costs between domestic and irrigation customers appropriately. The District transferred substantial costs away from domestic ratepayers (i.e., voters) to irrigators (i.e., non-voter institutions like the city) at the ratemaking hearing despite contrary advice of its staff and ratemaking consultant. The court had little difficulty concluding the District had not borne its burden to prove its rates were proportional to the cost of service and concluded that rate tiers must be cost-justified, too, not just rates in total.

Next came *Capistrano* in 2015. *Palmdale* had ruled tiered water rates comply with Proposition 218 if supported by a record demonstrating the tiered prices reflect service costs. *Capistrano* states the same rule but makes clear that judicial review of cost justifications can be very demanding.

The *Capistrano* plaintiffs originally had four concerns: they thought the City's groundwater recovery plant was wastefully inefficient; its failure to issue a bond to cover capital costs that had been predicted by its cost of service study meant rates were too high; the proceeds of potable water rates should not be used to develop recycled water service; and the City had not sufficiently cost-justified its price tiers. The plaintiffs abandoned their attack on groundwater recovery in the trial court and did not appeal the trial court's ruling against them on what they called the "phantom bond."

The Court of Appeal found use of potable water rates to fund new recycled water services is permissible because the new service displaced demand for potable water and thus made more water available for all customers. (*Capistrano, supra*, 235 Cal.App.4th at pp. 1503–1504.) As a result, properly allocated recycled water costs can be recovered from domestic water rates if recycled water service offsets demand for potable water use, effectively increasing potable water supply. Curiously, though, the Court also remanded for proof in the trial court that no recycled water costs were covered by the Tier 1 water rate on most efficient uses of water. Logically, if recycled water benefits all, all can be asked to pay for it — even Tier 1 users. The then-conservative City Council accepted the loss and settled the case for full refunds, obviating the need for the remand trial.

The Court also found the city had not attempted to cost-justify its upper tiers, a concession compelled by the absence of record support for the ratemaking consultant's approach to tiers, which relied (in form) on the different cost of the District's water sources without confronting the fact that nearly all its water supplies in every tier came from a single source — the Metropolitan Water District of Southern California.

Capistrano contradicted *Griffith v. Pajaro Valley Water Management Agency* (2013) 220 Cal.App.4th 586 and the *Morgan v. Imperial Irrigation Dist.* (2014) 223 Cal.App.4th 892 which had reviewed water rates far more leniently. *Moore v. City of Lemon Grove* (2015) 237 Cal.App.4th 363 similarly applied deferential review of that city's sewer rates and the allocation of costs between its sewer and other services.

So, *Capistrano* and these competing cases provided trial courts with alternative approaches to Proposition 218 challenges — one that afforded some flexibility to ratemakers and one that allowed very exacting judicial review of ratemaking judgments. The division in the cases continues to date.

III. *Patz* & *Coziahr* — Recent Cases Invalidating Tiered Rates

A class action challenged tiered water rates imposed by the Otay Water District (which serves an area along the Mexican border south and east of San Diego) and the City of San Diego in a single case. The case was severed and produced two adverse rulings for water ratemakers.

Coziahr v. Otay Water Dist. (2024) 103 Cal.App.5th 785 affirmed a trial court ruling invalidating the District's tiered rates. The Court applied deferential, substantial-evidence review and found the trial court properly accepted an after-the-fact expert's report to invalidate the rates.

The District raised on appeal many open issues in Proposition 218 cases. This Court addressed all of them — ruling against government on nearly all. The Court's many unwelcome conclusions include: refunds are available in Proposition 218 cases (since addressed by Government Code, section 53758.5), water rates require firm justification in historical cost data, not reasonable projections and estimates (to be addressed by the pending AB 2180 (Ward, D-San Diego)), policy goals like ensuring water affordability and encouraging conservation cannot justify rates, Otay's record showed that tiering rates for residential but not commercial and irrigation customers was discriminatory, refunds could not be based on estimates and projections because historic data could be made available, evidence can be submitted to a court that was not submitted in agency hearings (since addressed by Gov. Code, § 53759.2), ratemaking decisions are not "quasi-judicial" such that some judicial deference is appropriate, the issues are not primarily legal so as to allow more searching appellate review, reasonableness of ratemaking judgments is not sufficient to comply with Proposition 218 — firm rooting in "relevant, verifiable data" is needed (disagreeing with the earlier cases noted above), refunds can be established using expert evidence, and a remedy based on average cost (i.e., after-the-fact uniform rates) could not be justified without obtaining customer payment data and historical cost information. Whew! The Court remanded for retrial of damages.

The Supreme Court denied review and depublication and the case was remanded to retry the refund amount, but the parties settled, obviating need for that trial.

Much the same was *Patz v. City of San Diego* (2025) 113 Cal.App.5th 225. There, another panel of the Fourth District affirmed the ruling against the City, but vacated the remedy and remanded for application of Government Code, section 53758.5's rule that any monetary relief to burdened upper-tier water users should come via an offset in a future ratemaking. A lengthy and articulate dissent by Justice Frank Menetrez argued that *Coziahr* and *Patz* had micromanaged legislative ratemaking and invalidated rates without providing any guidance to ratemakers. He noted that the trial court had adopted without substantive change an overreaching statement of decision drafted by plaintiffs' counsel. His dissent noted the tension between the approach of *Patz* and *Coziahr* with the more flexible approach of earlier cases and *Great Oaks Water Co*. v. *Santa Clara Valley Water Dist*. (2025) 110 Cal.App.5th 260 (applying Prop. 26 to groundwater augmentation charges). His dissent is a joy to read for a ratemaker's lawyer. He began with these words:

> This is an appeal from a $79 million judgment that is based on nothing. Plaintiffs' briefing in the trial court and on appeal relentlessly misrepresents the record and the law, and the trial court's statement of decision — drafted by plaintiffs' counsel and adopted virtually without alteration by the court — does as well."

(*Patz, supra*, 113 Cal.App.5th at p. 311 [Menetrez, J., dissenting].) His conclusion begins:

> Defendant used the only known methodology for constructing a tiered cost calculation and allocation and setting tiered rates, and it applied that methodology to all of the appropriate data and the only data that defendant had, which is the only data that anyone has (with the possible exception of any utilities that use smart meters). Holding defendant liable for that is like holding an accountant liable for using generally accepted accounting principles.

(*Id*. at p. 346.) Rehearing and review were denied and the Court of Appeal remanded for application of Government Code, section 53758.5's alternative to refunds. The parties are in settlement discussions as this paper is written, so that remand trial may not occur.

IV. *Dreher*: A Win for Local Ratemakers.

Dreher, *supra*, 116 Cal.App.5th at p. 997 was a rare and welcome win for tiered water rates and, despite the grant of review, remains persuasive, but not binding authority. The trial judge (a former Santa Monica Deputy City Attorney) had addressed two central issues: Whether Health and Safety Code, section 5472's payment-under-protest requirement applies to municipal water rates, and whether Los Angeles's four-tiered residential water rates comply with Proposition 218's proportionality requirements. The Second District ruled for the City on both points.

A. The City's Tiered Water Rates Comply with Proposition 218.

Los Angeles has four primary sources of water supply and in 2016 developed a rate study to support four rate tiers, with Tier 1 allotted 800 cubic feet of water per month for basic, indoor water needs, and increasing allotments for Tiers 2, 3 and 4. The rates allocate local groundwater, the cheapest source, to Tier 1's forecast demand until the supply is exhausted, and then allocate the next-lowest-cost water until Tier 1's remaining demand is satisfied, before allocating that source to Tier 2's forecast demand, supplementing that tier's forecast demand with the third-cheapest source, and so on until each tier's forecast demand is satisfied. In short, Los Angeles did what San Juan Capistrano had claimed to do, but did not. The *Dreher* plaintiffs argued this rate structure could not meet Proposition

218's proportionality requirement without tracking which parcels used which sources of supply.

The Court of Appeal disagreed: "The Constitution does not require the City to trace the flow of water from each source of supply to each parcel, molecule by molecule." (116 Cal.App.5th at p. 1028.) Citing *Capistrano*, the Court found Proposition 218 does not require an exact measure of the cost to serve each parcel. Departing from *Patz*, *Dreher* concluded: "We read nothing in [art. XIII D,] section 6(b)(3) that would require a water agency to trace drops of water from source of supply to parcel … ." (*Id*. at p. 1029.) It departed from *Patz* further, finding that using water budgets to establish tier breakpoints [i.e., the volume sold in each tier] is not, in and of itself, unconstitutional provided the agency calculates the proportional costs of service within each tier. The Court also held the City could consider conservation goals and parcel characteristics in setting water budgets, so long as rates remain proportional to service cost.

Finally, *Dreher* found the City's allocation of peak pumping and storage costs across tiers complied with Proposition 218. Los Angeles allocated to all four tiers base pumping and storage costs that did not vary with demand. It allocated to Tiers 3 and 4 the incremental costs of pumping and storage linked to peak demand. Again citing *Capistrano*, the Court noted that Proposition 218 protects lower water users from paying rates higher than the cost to serve them because those rates cover capital costs their consumption does not make necessary. That rationale supports the trial court's ruling, which the Court of Appeal affirmed.

In short, the Court found the City had met its burden to justify its rates under Proposition 218 by calculating the unit cost of each water source, forecasting demand within each tier, and allocating costs proportionally as customers use more water. The record supported the City's methodology, including its allocation of portions of peak pumping and storage costs to higher tiers.

B. Health & Safety Code, Section 5472 Applies to Water Rate Refund Claims.

At trial, the *Dreher* plaintiffs also challenged the City's low-income subsidy adjustment (LISA), which covered the City's cost to provide rate assistance to low-income customers. The trial court found the LISA violated Proposition 218, but ruled that Health & Safety

Code, section 5472's payment-under-protest requirement barred plaintiffs from recovering refunds of the LISA individually or for all customers. The plaintiffs argued on appeal that section 5472 applies to sanitation and sewer charges but not to water charges.

The Court of Appeal applied section 5472's plain language to reject the claim. Section 5472 applies by its terms to water service, the challenged water charges were approved by the required two-thirds vote of the City Council, and the City is a "covered entity" under the statute. Analyzing its legislative history, the Court found nothing showing a purpose contrary to that indicated in the statute's language.

The Court also rejected arguments that section 5472 provides a constitutionally inadequate remedy and that Government Claims Act compliance should make payment under protest under the Health and Safety Code unnecessary. The Court found no support for either claim, concluding section 5472 provides an adequate remedy but Plaintiffs failed to satisfy its requirements by stating their legal objections when paying the fees.

Dreher helpfully clarifies that municipal ratepayers seeking refunds must comply with section 5472's payment-under-protest requirement, and that cities may use tiered rates that allocate costs, including peak pumping and storage costs, based on use and parcel characteristics, provided they are supported by data demonstrating proportionality. The ruling affirms the City's compliance with Proposition 218 and provides meaningful guidance for other agencies designing tiered rates.

The Supreme Court granted review but provided that *Dreher* may continue to be cited as persuasive (but not binding) authority pending Supreme Court review, which typically takes from 12 to 24 months. A decision can be expected in the first half of 2028. "The issue to be briefed and argued is limited to the following: Do the methods adopted by the City of Los Angeles to set water budgets and allocate water supply costs result in tiered water rates that violate the proportionality requirement of article XIII D, section 6, subdivision (b)(3) of the California Constitution?" (Mar. 1, 2026 order granting review.)

Thus, the Court of Appeal's affirmance of the trial court's application of Health and Safety Code, section 5472 remains good law and is not at risk of being overturned.

V. Pending Cases.

The litigation boom set off by *Capistrano* was not limited to *Coziahr*, *Patz*, and *Dreher*. Other cases remain pending in lower courts, including:

A. *Toy v. City and County of San Francisco*, First DCA Case No. A173560

This is an appeal from the City's trial court win in a case challenging inclusion in domestic water rates of the cost to provide water in the volumes and at the pressures needed for firefighting. These "fire flows" are a legal requirement of water service and, in the trial court's view, a proper cost of water service. The case was fully briefed as of February 9, 2026 and can be expected to be argued and decided later this year. The case is a remnant of an earlier cast which sought to bring some 80 water agencies' rates into a single court, on behalf of some 80 customer classes. The case was defeated in the trial court in grounds on inappropriate venue and misjoinder, so the plaintiff persisted against San Francisco alone.

B. *Hiller v. Marin Municipal Water District*, First DCA Case No. A171271

This is an appeal from that agency's successful defense of its tiered water rates following settlement of an earlier challenge. It is to be argued May 1, 2026.

VI. Making Rates While We Await Guidance in *Dreher*

The law governing ratemaking under Proposition 218 is uncertain and all agencies which impose water, sewer, trash, stormwater, and other property-related fees face substantial uncertainty. What advice can I offer while we await guidance from the Supreme Court in *Dreher*? A bit:

First, avoid controversy. Plaintiffs' counsel find clients on the internet.

Second, do not make rates more often than necessary so you can maximize the protection of short statutes of limitation, such as Government Code, section 53759 which, for rates adopted after January 1, 2022, provides:

> Any judicial action or proceeding to attack, review, set aside, void, validate, or annul an ordinance, resolution, or motion adopting a fee or charge for water or sewer service, or modifying or amending an existing fee or charge for water or sewer service, shall be commenced within 120 days of the effective date or of the date of the final passage, adoption, or approval of the ordinance, resolution, or motion, whichever is later.

Subdivision (c) requires notice of this short statute in the notice of a ratemaking hearing under Article XIII D, section 6 for water and sewer fees. But it does not state that failure to give that notice denies an agency the protection of the short statute.

Third, take the steps needed to invoke the duty to exhaust administrative remedies and to litigate on the ratemaking record under Government Code, sections 53759.1 and 53759.2. These can be used by complying with their requirements for a prominent statement in the notice of a ratemaking hearing that the exhaustion requirement will apply and that protest requirements be prominently stated there, too. They also require written responses to substantive objections to proposed rates before the agency adopts new rates. (Gov. Code, § 53758.1, subd. (c)(5).) I recommend that agencies adopt a local ordinance or resolution invoking these statutes to (i) clarify their requirements and broaden their application to other fees, (ii) give your client and the public notice of these rules and (iii) put them where they are likely to be implemented , and where your client will notice them, like in the Municipal Code.

Fourth, prepare an adequate record to justify the rates. This typically means a cost-of-service analysis prepared by outside consultants, although some agencies have ratemaking staff who are up to the task. An attorney must review the study to ensure it can withstand litigation. If you had a good study done recently, an update to budgeted costs can be justified with less work. The record should be accessible to judges, lawyers, and members of the public with antipathy to math — include a slide show in plain English and graphical information to present the math — like bar and pie charts. If you rely on peaking factors, it may be especially important to depict technical concepts graphically.

Fifth, consider whether to adopt uniform or relatively simple rates. Advise your client of risks arising from more complex rates, including tiered rates. Someone may have to persuade a judge exercising independent judgment review of the fairness and rationality of your approach.

Sixth, argue recent statutes stating support for tiered water rates like Government Code, section 53750.6 and Water Code section 366, subdivision (b)(1).

Seventh, assert defenses to liability such as the duty to pay under protest under Health and Safety Code, section 5472, the duty to claim under the Government Claims Act, and the duty to pay first and litigate later under California Constitution, article XIII, section 32 and related caselaw. *Plata v. City of San Jose* (2022) 74 Cal.App.5th 736 ruled it was an abuse of discretion for a trial court to allow a plaintiff class to raise a challenge to rates which was not covered by the pre-suit claim under the Government Claims Act. *Mojave Pistachios, LLC v. Superior Court* (2024) 99 Cal.App.5th 605 is a recent case enforcing the duty to pay first and litigate later. Like *Dreher*, *Padilla v. City of San Jose* (2022) 78 Cal.App.5th enforced Health and Safety Code, section 5472; it was a Proposition 218 challenge to refuse rates.

Eighth and lastly, assert Government Code, section 53758.8's ban on refunds, but note that the plaintiffs' bar is challenging that statute as improperly retroactive and a violation of due process. *Patz* rejects both claims, but litigation continues, and the Supreme Court has, so far, refused to grant review of these issues.

VII. Conclusion

Proposition 218 requires independent judgement review of water rates. (*Coziahr, supra*, 103 Cal.App.5th at p. 798.) But as the Supreme Court notes: " '[t]he economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result.' " (*20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216, 293.) And many lawyers and judges avoid mathematic analysis. (E.g., D. Faigman, "Overcoming Judicial Innumeracy," Science and Technology Law Review, May 23, 2025 available at < https://journals.library.columbia.edu/index.php/stlr/article/view/13889 > (as of Apr. 19, 2026). The result is unpredictability in ratemaking litigation. Outcomes seem to depend on judicial assignment. Therefore, significant risk will remain until the Supreme Court, or an elusive consensus of appellate justices, establishes standards that trial courts can predictably apply.

In the meantime, water service is essential, and therefore ratemaking is, too. Clients may be unwilling to accept the policy consequences of uniform or other relatively simple rates. (E.g., D. Garrick, San Diego Union Tribune, “Conserve water? Your bill is about to go up — while your water-guzzling neighbor’s goes down. Here’s why,” March 13, 2026 available at < https://www.sandiegouniontribune.com/2026/03/13/conserve-water-your-bill-is-about-to-go-up-while-your-water-guzzling-neighbors-goes-down-heres-why/ > (as of Apr. 19, 2026). Therefore, their counsel must prepare for suit as best they can. My current best thinking about how to do so is summarized above.

Developments will continue. Stay tuned; we will keep you posted!