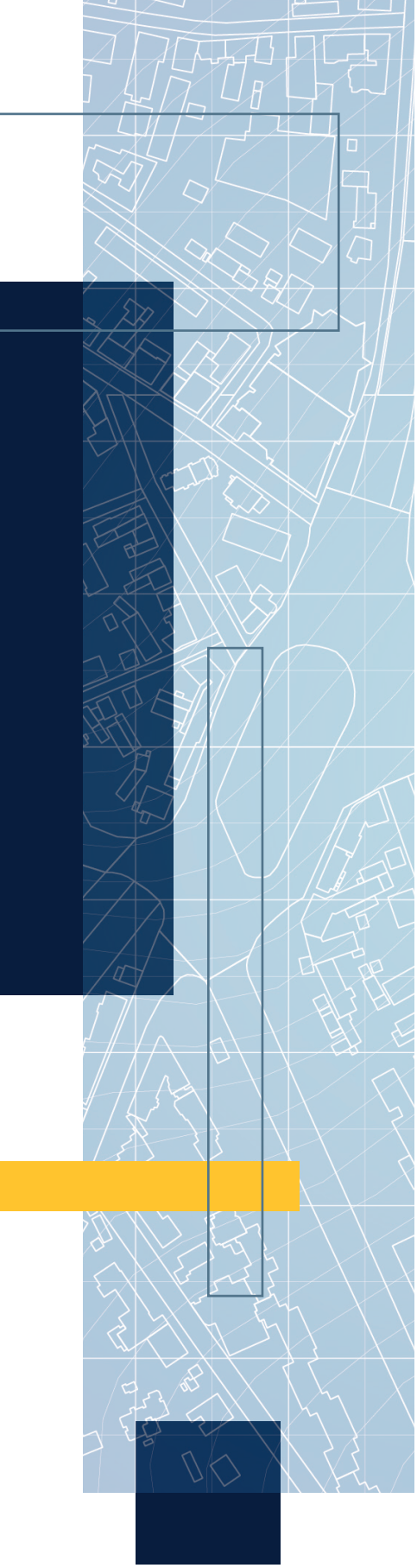

TERNER CENTER FOR HOUSING INNOVATION
UC BERKELEY

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Improving Impact Fees in California: Rethinking the Nexus Study Requirement

Introduction

California's housing crisis has only become more acute amid the COVID-19 pandemic. As the legislature grapples with the emergency response for economically vulnerable households, the need to address longer-running supply constraints remains. Even amid the ongoing challenges of the pandemic, there are elements of the production puzzle that can be addressed to improve processes and ease potential barriers to building affordable homes.

One factor that has contributed to escalating costs of building housing in California is the slate of fees charged to new development, including impact fees. Impact fees help jurisdictions pay for critical infrastructure needed to support new housing. But fees are not always transparent, and the number, type, and methodology for setting fees can vary widely across jurisdictions. They can also add up to more than $100,000 per unit.

Fees can be assessed under many different authorities, but recently the legislature has paid particular attention to fees charged under the Mitigation Fee Act (MFA). Lawmakers in Sacramento passed several bills in 2019 aimed at reforming the rules around impact fees governed by the state's MFA, including bills to help increase transparency and to address potentially excessive fees. For instance, Assembly Bill 1483 (Grayson) requires jurisdictions to clearly post impact fee schedules and nexus studies online, and Senate Bill 13 (Wieckowski) limits impact fees on some Accessory Dwelling Units. Senate Bill 330 (Skinner) locks in fee amounts once a project application is deemed complete to ensure predictability around total costs. Several other impact fee reforms were proposed in 2020, though these proposals were shelved as the state prioritized more immediate COVID-19 response and relief.

One area of much-needed reform is to provide cities with more guidance on how to conduct "nexus studies," which are the required analyses that justify fee levels. In effect, these studies are required to illustrate the "nexus" between new development and its incremental impacts on infrastructure. Yet as we found in our 2019 Residential Impact Fee report, the approaches to how cities conduct nexus studies vary significantly, ranging from rigorous assessments to more lenient "rubber stamps" for the fees the city wants to collect. We determined the processes around how nexus studies are conducted warrants further analysis.

In this analysis, we reviewed a selection of fire protection, parks, transportation, and utility nexus studies in eight jurisdictions across the state. The goal of the research was to understand how nexus studies are currently conducted, and to identify areas for improvement. Our review suggests that the following steps could be taken to improve the setting of fees:

- **Clarify requirements around level of service.**

  Currently, nexus studies do not always explicitly state the existing level of service that jurisdictions provide, or they set fees based on a higher level of service that the jurisdiction is seeking to attain. This results in new residents bearing the cost of increasing services for all residents. Nexus studies should clearly identify the current level of service and establish fees based on offsetting incremental impacts to the existing level of service.

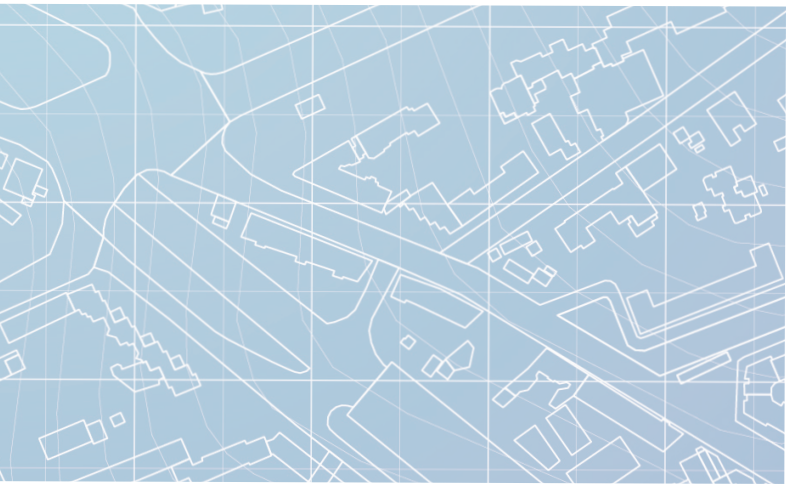
- **Tie fees more closely to direct impacts of new development.**

  Some methods of establishing fees make it difficult to ensure fees are only being used to maintain service levels in jurisdictions impacted by new development. Adopting methodological best practices can better target fees to the incremental infrastructure costs related to new housing.

- **Incorporate consideration of feasibility and create mechanisms for triggering review.**

  Nexus studies should be required to include the current fees and exactions charged by a locality and other local entities alongside the maximum allowable fee estimated in each study. New mechanisms should be established to trigger state review and/or more stringent feasibility analysis for potentially unreasonable or exclusionary fee programs.

After a brief background on nexus study methods, we explore each of these areas for improvement in more detail.



A Note on Methods

Nexus studies are meant to quantify the impact of new development on local infrastructure and determine the cost of this impact, establishing the maximum fee amount that can be charged on the construction of new homes. They also establish the legal authority for jurisdictions to charge those fees, so they are a critical component to the impact fee setting process.

That said, there are no required methodologies for conducting nexus studies. As a result, there is wide variation in the methodologies used by the cities and/or consultants who prepare these studies on the jurisdiction's behalf. For reference, Table 1 lays out a few of the most common approaches used to calculate impact fees and the circumstances under which each is used.

To better understand ways in which the nexus study process could be improved to prevent unreasonable fees, we reviewed at least two studies for each of the following fee types: fire protection, parks (allowed by the Mitigation Fee Act, not the Quimby Act), transportation, and utilities. We collected studies from a range of different jurisdictions of various sizes and densities (Table 2).

These nexus studies were originally collected for the Terner Center's 2019 study, *Residential Impact Fees*. As we noted in that report, the process of accessing the studies was often onerous: in many cases nexus studies were only available in city council agendas or via public records requests. While not representative of all nexus studies across the state, this review surfaced strengths and limitations of current nexus study methodologies, and suggest potential paths forward to further refine the setting of fees.

Table 1. Common Methodological Approaches Used in Nexus Studies

Name of Method	Basic Mathematical Calculation	Uses
Planned facilities method	$\frac{\text{Cost of Planned Facilities}}{\text{New Development Demand}}$	Used when a jurisdiction has planned facilities that will only serve future growth, or can calculate which portion of planned facilities will serve future growth.
Incremental cost method (used for utilities)	$\frac{\text{Cost of Planned Facilities}}{\text{New Development Demand}}$	Used when an existing utility system has limited to no capacity to serve new development and new or incremental facilities are needed.
Existing inventory method	$\frac{\text{Current Value of Existing Facilities}}{\text{Existing Development Demand}}$	Used when a long-range plan for new facilities is not available, but new facilities are needed to maintain the existing level of service.
System buy-in method (used for utilities)	$\frac{\text{Current Value of Existing Facilities}}{\text{Existing Development Demand}}$	Used when the existing utility system has sufficient capacity to serve new development now and over the long-term.
System plan method	$\frac{\text{Value of Existing Facilities + Cost of Planned Facilities}}{\text{Existing + New Development Demand}}$	Used when planned facilities are part of an integrated system benefitting both existing and new development and jurisdictions cannot (or do not) delineate which portion of planned facilities will serve future growth.

Note: The information in this chart was gleaned from several sources, including the City of Fremont's Comprehensive Development Impact Fee Update, Background Report (2014) and the City of Santa Cruz's Water System Development Charge Report (2015).

Table 2. Nexus studies review by location and type

Fee Types	Localities	
Fire	Elk Grove	Truckee
Parks	Fresno	Fremont
Transportation	Riverside County	Irvine
Utilities	Santa Cruz (water)	Roseville (electric)

Findings

Our review of this sample of nexus studies yields three key areas for action to improve the transparency, calibration, and assessment of methodologies used to set impact fees. In this section we present each of the findings.

Clarify expectations around the treatment of levels of service.

Ideally, nexus studies should offer a clear statement of the existing level of service provided by the locality, assess to what degree new development would impact that infrastructure, and estimate the resources needed to keep that infrastructure at its existing level of service after additional development takes place.

Riverside County's Transit Nexus Study offers an example of this approach. Consultants based their calculations on ensuring roadways maintain a volume-to-capacity ratio of less than 0.9 (the existing level of service standard).[1] After identifying roads that would experience increased traffic above that standard as a result of the new development, consultants identified specific infrastructure projects that could accommodate the new traffic patterns. Accordingly, the jurisdiction ensured that its transit fee represented the actual cost of maintaining a similar level of service before and after new development.

But in many cases, the current level of service is not clear or the level of services is purposefully set above current levels. In some of the cases that we reviewed, jurisdictions based fees on the cost of planned infrastructure without explicitly calculating the current service level, making it unclear whether a proposed fee would maintain or increase services. In the park nexus studies we reviewed, each clearly stated the ratio of park acres to people, but they did not clearly identify whether the level of amenities planned for on park lands exceeded or maintained the existing level of service. For example, while Fremont's fee was based on maintaining the current ratio of park acres to people, Fresno's Park Nexus Study based its impact fee on providing three park acres per 1,000 new residents, a benchmark three times higher than Fresno's current level of service.[2]

All jurisdictions in California are limited in their ability to raise new revenues to pay for infrastructure—and that is especially true for resource-constrained jurisdictions. Yet assessing the full costs of new infrastructure on new housing could prove exclusionary in cases where fees increase local housing prices, and therefore place an outsized burden on or prevent the accommodation of new residents.[3/4/5/6/7/8] Given that future residents will not be the sole beneficiaries of newly developed park facilities, for instance, this approach asks newcomers to pay the full cost to raise a city's level of service for all residents.

To address this concern, the state should set standards for nexus study design requiring that (1) the studies focus on maintaining existing service levels, and (2) the studies clearly report the current levels of service and what they reflect. If a city aspires to a higher level of service, then they should use other, less regressive approaches to achieve it, such as a local bond measure or parcel tax that is borne by all city residents. In addition, the state should call for other nexus study methodological best practices (including those presented below) that help calibrate fees to only target added costs caused directly by new development.

Tie fees more closely to direct impacts of new development.

There are a number of ways nexus study methodologies can calibrate fees to tie them to the incremental costs associated with accommodating new development. For instance, nexus analyses based on the *planned facilities method* summarized in Table 1—or *incremental cost method* in the case of utilities studies—identify the infrastructure needed to serve future growth and calculate how much each new development will need to contribute to cover the cost of expanding facilities, thus tying fees directly to estimated demand for services.

In contrast, other methodologies can result in higher costs disproportionately impacting new residents. In the *system buy-in method,* for example, agencies calculate the total value of the existing infrastructure system and divide by the city's current population to identify a per capita cost for new development.[9] This method offers a straightforward way to assess fees, especially for jurisdictions that are already largely built-out, but can also result in overstating the costs for new residents. In its water nexus study, for example, Santa Cruz calculated the value of its water system based on what it would cost to replace the entire system in today's dollars, rather than how much the local agency originally paid for the system.[10] This approach results in a larger estimation of the system's value and ultimately places higher fees on new residents. In addition, the local agency did not factor depreciation caused by wear and tear into the estimate.

Jurisdictions that use the *system buy-in method* could strengthen the link between the level of fees charged and the actual impact of new development by using more conservative assumptions throughout their analysis, such as basing calculations on the depreciated value of infrastructure.

In addition, jurisdictions could base fees on a Capital Improvement Program (CIP), a locality's plan for constructing and financing new public facilities, some of which will serve both new and existing residents. The MFA encourages, but does not require, the use of CIPs. Jurisdictions that set impact fees based on a CIP are often able to use the *incremental cost method* or *planned facilities method* to establish a nexus. Our review found that two out of three jurisdictions using CIPs calculated more precise fees by identifying the portion of each new facility that will be used to support newcomers, rather than using the less targeted approach of dividing existing and planned facilities costs by the number of existing and expected new residents.

As we noted in *Residential Impact Fees*, another best practice that can work in concert with the approaches noted above is to target fees geographically. Given that infrastructure needs can vary across a locality, setting geographically-specific fees helps to ensure new developments only contribute to infrastructure needed to serve their site. In less populous areas, or in districts that span incorporated and unincorporated areas, geographic targeting can help tie fees to infrastructure needs directly resulting from new development. In the City of Elk Grove's Fire Fee Nexus Study for the Cosumnes Community Services District, the local agency used the CIP to identify which fire facilities would exclusively serve future development in the cities of Elk Grove or Galt, and which facilities would be used district-wide.[11] The city then set six fee zones, which partially reflected differences in facility costs.

Together these methodological changes should be used to prevent unreasonably high fees and ensure fees are targeted to areas and incremental costs specific to supporting new development.

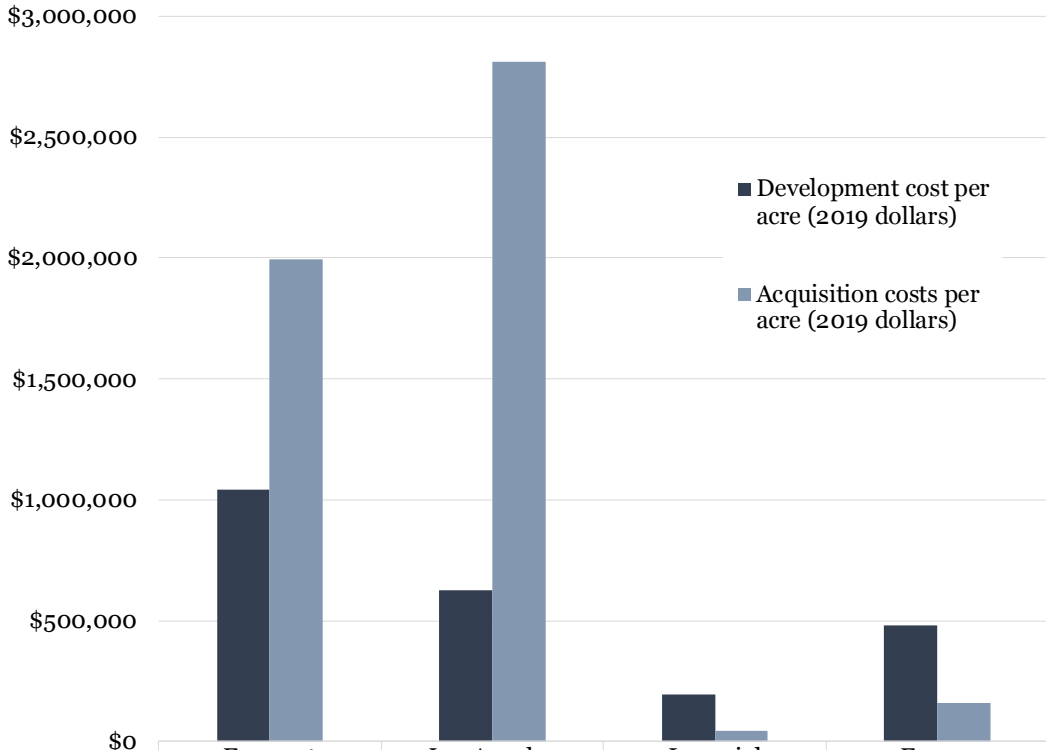
Incorporate consideration of feasibility and mechanisms for triggering review.

Considering the feasibility of a fee— which in this case means determining whether or not the cost would have negative financial consequences for potential housing development—is not a required element of a nexus study or of the fee setting process more broadly. Only one of the nexus studies we reviewed mentioned feasibility concerns within the nexus analysis. While some cities do voluntarily conduct a feasibility analysis, these often rely on informal methods (e.g., scanning fees set in neighboring jurisdictions) and do not include rigorous analyses based on actual market conditions and data.

Conducting a feasibility analysis should no longer be an informal add-on. It is critical that cities calculate the total fees and exactions charged to new construction, and compare that total against what is financially viable. An important step would be to require that a nexus study include not only the legal maximum established for that specific service, but also an estimate of the total cost of existing fees and exactions. While fees are not always set below the legally allowable maximum (two of our eight case studies set fees below the legal maximum), having the full fee stack included in the nexus study would offer more clarity as to how much a new fee would add to the collective costs on new development.

This type of analysis could also make it easier to determine when a locality's fee or set of fees might merit additional review or a more stringent feasibility test. With that information, California's Department of Housing and Community Development (HCD) could use its statutory authority to set a threshold at which an audit of a jurisdiction's fee program would be triggered. For instance, if the total fees and exactions charged by a locality surpass a certain threshold (e.g., 10 or 15 percent) of (a) construction costs per unit or (b) the median home value of housing constructed within a certain time frame (e.g., since 2000), it would be within HCD's purview to review each of the city's impact fees to (1) ensure they are based on nexus studies that conform to state law, and (2) determine whether the cumulative cost of the fees function as a regulatory constraint that would impede the jurisidiction's compliance under housing element law. There is precedent for these actions through HCD's existing authority to review, approve, and decertify each city's Housing Element. Specifically, 2017's Assembly Bill 72 (Santiago) grants HCD authority to review any action or failure to act by a local government that HCD determines is inconsistent with an adopted Housing Element and to take action to decertify that local government's Housing Element. The review authority proposed above would fall under this existing authority. A limitation to using construction costs per unit as part of the audit trigger is that it would require privately held data (except in the case of LIHTC or other publicly-funded developments), while using something like median home value could be derived from public (although somewhat lagged) data sources like the American Community Survey.

Figure 1: Levels of Service for Parkland



	Fremont	Los Angeles	Imperial	Fresno
Development cost per acre (2019 dollars)	$1,039,680	$625,862	$196,627	$481,500
Acquisition costs per acre (2019 dollars)	$1,995,698	$2,810,176	$41,880	$160,500
Acres per 1,000 residents	5	4.2	3	3

Other mechanisms could also be established to trigger a review or additional feasibility analysis to help rein in unreasonable or potentially exclusionary fees. One example of this is for the state to compare local fee levels to state benchmarks, calculated at different levels of service, and subject those jurisdictions that are significantly above the state benchmark to automatic review. Existing levels of service vary widely across jurisdictions. Park acreage is one example (Figure 1).

If each nexus study is required to clearly identify the current level of service a jurisdiction is providing, the state would be able to clearly establish and track the range of service provided for that type of infrastructure, including an average (mean) or typical (median) level of service across the state or in certain types of jurisdictions. With that context, a jurisdiction that establishes a level of service significantly above the standard (e.g., 20 percent higher than the standard) for one or more fees could be subject to a fee review or be required to demonstrate feasibility.

Even in jurisdictions that may not trigger review or additional analysis under these scenarios, the state could support efforts to more rigorously assess feasibility by drafting guidelines for analysis or build on tools like the Terner Center Housing Development Dashboard to enable jurisdictions to assess the effect of the full stack of fees on new housing supply.

Conclusion

Impact fees play an important role in funding the infrastructure necessary to support new housing development. But as the state works to overcome its long-running production shortfall and to contribute to an economic recovery through the construction of new housing, impact fee reform merits attention.

A few of the recommendations included in this analysis have recently been the subject of legislative efforts. For example, Assembly Bill 1484 (Grayson), which was stalled in the 2020 legislative session, would have limited fee calculations to a locality's existing level of service. This legislation would have also required a rough proportionality standard for determining fees, with the intention of requiring a stronger link between fees charged and the actual impact of development than currently exists with the "reasonable relationship" MFA standard. In addition, Assembly Bill 3145 (Grayson)—which was also tabled for the year—would have required HCD review of local fees in instances where total fees make up more than 12 percent of the median home price in the corresponding jurisdiction.

As legislators consider these provisions, there is also an opportunity to improve methodological transparency in nexus studies (e.g., by clearly indicating the existing level of service used as a baseline) and to advance best practices, considerations of feasibility, and mechanisms for review. It is also important to ensure that fees aren't set at levels that hinder construction or erode housing affordability. Local governments should prioritize this important work in the context of reviewing regulatory constraints as part of their existing process of assessing housing programs for the forthcoming housing element sixth cycle. In addition, HCD should consider producing technical advisories and guidance to clarify these best practices and affirm the centrality of fee impact in its assessment of regulatory constraints as part of the housing element certification process. Furthermore, HCD should set clearer parameters for how nexus studies should be performed and commit to a review of those methodologies that may be unreasonable. Administrative actions such as these would make the process more equitable and help rein in excessive fees without resorting to a blunter instrument of capping fees in already revenue-constrained jurisdictions.

These changes will help to ensure that fees are being set and used as intended: to support the expansion of critical infrastructure needed to accommodate more housing.

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9. The *system buy-in method* is used for utilities. The *system plan method* is used for other types of fees and functions slightly differently in that it takes into account existing and planned infrastructure and current and expected demand to calculate the per capita cost.

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