COLANTUONO HIGHSMITH WHATLEY, PC

CHW Bulletin: *Update on Public Law*

August 2018

California Supreme Court Upholds General Fund Transfer from Power Utility

By Michael G. Colantuono

On August 27, 2018, the California Supreme Court issued its long-awaited decision in *Citizens for Fair REU Rates v. City of Redding*, governing the lawfulness of transfers from an electric utility to a city's general fund under 2010's Proposition 26. As almost every municipal power utility in California has a similar transfer to its general fund, the case was closely followed by the public power industry. The case is a major victory for local governments.

Municipal utilities have long transferred money to the general funds of their host cities to support general city services under a number of labels, including: general fund transfers, payments in lieu of taxes (PILOTs), franchise fees, and operating transfers. The rationales for these transfers are: reimbursement for services provided to the utility (like police and fire protection of its staff and assets and use of city rights-of-way) and to allow public power without removing a very substantial part of the local economy from a community's tax base. Communities should not have to choose, this view maintains, between the benefits of public power and adequately funded local government.

> CITIES ARE FREE TO MAINTAIN PILOTS AND OTHER GENERAL FUND TRANSFERS TO THE EXTENT OF AVAILABLE NON-RETAIL-RATE REVENUE WITHOUT RISK UNDER PROPOSITION 26.

Such transfers were upheld against challenge under Proposition 13 in 1986's *Hansen v. City of San Buenaventura*, but the 2002 decision of *Howard Jarvis Taxpayers Association v. City of Roseville* and 2005's *Howard Jarvis Taxpayers Association v. City of Fresno* invalidated them as to water, sewer and solid waste utilities under 1996's Proposition 218. However, Proposition 218 expressly exempts fees for gas and electric service from its rules for so-called "property related fees" — likely to preserve lifeline rates for low-income seniors who are an important constituency to HJTA.

In 2010, business interests affiliated with the California Chamber of Commerce sponsored Proposition 26 to define all local government revenues as taxes requiring voter approval unless one of seven stated exceptions applies. The second exception is for "charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of providing the service or product." Thus, Proposition 26 limits gas and electric rates to service cost.

Since the 1970s, Redding has transferred Redding Electric Utility (REU) funds to its

general fund. Starting in 1988, it did so as a PILOT — a charge approximating property tax on its assets REU would pay it were a private utility. When it increased power rates in December 2010, residents sued to challenge those rates as non-voter approved "taxes" under Proposition 26 because they funded the PILOT and therefore necessarily exceeded the cost of service.

The City persuaded the Shasta Superior Court that its budget actions to establish the PILOT were pre-Proposition 26 legislation grandfathered by the measure. The trial court also found the challengers had not shown power rates funded the PILOT because the utility had enough non-rate revenues (mostly proceeds of wholesale transactions) to cover the PILOT. The challengers appealed and the Sacramento Court of Appeal reversed in a split decision. Two justices concluded the PILOT was legislated anew with each biennial budget and, therefore, the budget for the 2011–2013 biennium (adopted in June 2011) could not lawfully renew the PILOT without voter approval. It remanded to the trial court to determine whether the rates exceeded service cost.

> "ARTICLE XIII C DOES NOT COMPEL A LOCAL GOVERNMENT UTILITY TO USE OTHER NON-RATE REVENUES TO LOWER ITS CUSTOMERS' RATES."

Justice Elena Duarte dissented, arguing the PILOT was a "reasonable cost of service" under Proposition 26 because it approximated taxes a private utility would pay. Such utilities are regulated by the PUC to ensure reasonable rates and REU's rates are lower than PG&E's — the private utility serving areas outside the City. Redding won California Supreme Court review in 2015.

The Supreme Court reversed the Court of Appeal, reinstating the trial court decision, because the record showed REU's total revenues were sufficient to cover all undisputed costs of electric service **and** the PILOT and therefore the challengers could not show that retail power rates fund the PILOT. The Supreme Court treats revenues from wholesale transactions as unrestricted. Such rates are not "imposed" on anyone, as participants in wholesale power markets are willing sellers and buyers. All our initiative restrictions on local government finance — Propositions 13, 62, 218 and 26 — apply only to revenue measures governments "impose" by compelling people to pay them.

The Supreme Court did not decide two questions of vital interest to local governments:

- Does Proposition 26 grandfather local legislation which predated it which imposes costs on the utility which are not costs to generate, store, and distribute power? This will affect not only general fund transfers, but also such things as "public goods charges" that fund conservation and clean energy programs and discounted rates for low-income and senior households.
- Does Proposition 26 allow Justice Duarte's theory the PILOT is a reasonable service cost because it approximates costs a private utility would pay?

Cities are now free to maintain PILOTs and other transfers to the extent of non-retail-rate revenue without risk under Proposition 26. A larger transfer will require answering a question *Redding* did not decide

— whether Proposition 26 grandfathers earlier local legislation allowing transfers?

It may make sense for local governments that operate gas and electric utilities to account for utility reserves so as to distinguish those arising from rate proceeds (or debt backed by rate proceeds) from those arising from wholesale and other discretionary revenue. This will allow reserves not associated with retail rates to be used as discretionary revenues of the utility under Proposition 26.

The case had other implications, too. An important distinction is now drawn between Proposition 218 (which applies to water, sewer, trash and some other fees) and Proposition 26 (which applies to gas, electric and a wide range of permit and other regulatory fees). The former regulates use of the proceeds of a property related fee, the latter does not regulate the use of the proceeds of a non-property related fee nearly as tightly. This will provide helpful flexibility to rate-makers.

The Supreme Court cites *Hansen v. San Buenaventura* as good law, noting only that Proposition 218 has limited its reach to the fees that measure regulates. This may be the seed of further helpful holdings for local government revenue authority. The Court nicely states the "no free-riders" rule of Proposition 26 is not violated by a fee which not all customers pay or if some customers pay more than others without a cost differential — provided there are non-fee revenues to over the difference.

The Court states discretionary revenues need not subsidize retail rates: "such subsidization is not required by California law." "Article XIII C does not compel a local government utility to use other non-rate revenues to lower its customers' rates."

We will defend a transfer from Glendale Water & Power to that City's general fund in early October to the Los Angeles Court of Appeal and similar disputes are pending around the state. Some of these cases may decide the questions *Redding* did not. So this is not the last chapter in this story, but it is an important victory for local government revenue authority.

As always, we will keep you posted!