

## Article

# Paying for Water in California: The Legal Framework\*

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*Over the past four decades, California voters passed a series of initiatives that amended the California Constitution to limit the power of the state legislature and local governments to enact taxes and restrict their authority to adopt fees and other charges to fund government programs. Three of these initiatives—Proposition 13 (enacted in 1978), Proposition 218 (passed in 1996), and Proposition 26 (approved in 2010)—have placed significant constraints on the funding of water resources projects. Although each of these laws has enhanced the transparency and accountability of the decision-making process, the funding constraints now jeopardize an array of vital water supply, management, and regulatory functions. These include funding for the development of new water supplies, integrated water management, protection of groundwater resources, development of alternative water sources (including recycled and conserved water programs), control of stormwater discharges, and regulation of water extraction and water use to protect water rights, water quality, aquatic species, and other beneficial uses of the state’s water systems.*

*This Article is a companion to the report Paying for Water in California and focuses on the legal aspects of water financing. The Paying for Water study demonstrated the*

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*critical importance of local funding to support California's water system: local utilities and governments raise eighty-five percent of the more than thirty billion dollars spent annually on water supply, quality, flood, and ecosystem management through local fees and taxes. The study identified a two to three billion dollar annual funding gap, with critical gaps already evident for provision of safe drinking water in small, rural communities, prevention of stormwater pollution, protection of people, property, and infrastructure from flooding, recovery efforts for aquatic ecosystems, and integrated water management. In most cases, these gaps reflect legal obstacles to raising more funds locally. In addition, urban water and wastewater systems—now in relatively good fiscal health—face looming challenges related to rising costs and legal constraints on the ability to raise fees to support modern, integrated water management.*

*This Article begins with an overview of the traditional sources of funding for water development, management, and regulation, and proceeds to a detailed analysis of the effects of the constitutional constraints (especially of Propositions 218 and 26) on these essential governmental programs. Topics include: (i) analysis of the effects of Proposition 218 on water rates and fees charged by public retail water agencies for water service and integrated, portfolio-based water management; (ii) consideration of the special problems of Proposition 218 for groundwater regulation and stormwater discharge programs; (iii) predictions about the effects of Proposition 26 on wholesale water rates, water stewardship charges, and regulatory fees; and (iv) suggestions for harmonizing the fiscal strictures of Propositions 218 and 26 with the reasonable use mandates of Article X, Section 2, of the California Constitution, which form the foundation of the state's water law and policy.*

*Our key conclusions are that: (1) Propositions 218 and 26 have created significant impediments to economically rational and sustainable funding of California's most important water service, management, and regulatory programs; (2) judicial interpretations of the constitutional restrictions generally have compounded these impediments; and (3) reform of the law is needed. The Article concludes with recommendations that water agencies, the legislature, the courts, and the voters should consider as a means of correcting (or at least ameliorating) those aspects of the law that are inconsistent with sound and creative water resources administration.*

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## INTRODUCTION

Better is it that thou shouldest not vow, than that thou shouldest vow and not pay.

— *Ecclesiastes* 5:5 (King James).

The development and management of water resources is vital to California’s economic and social well-being.<sup>1</sup> This water service includes a variety of interrelated activities:

- Supplying water for drinking and household purposes, commercial and industrial uses, agriculture, landscaping, firefighting, and other beneficial uses;

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1. This Article is a companion to the report *Paying for Water in California* and focuses on the legal aspects of water financing. ELLEN HANAK ET AL., PUB. POLICY INST. OF CAL., PAYING FOR WATER IN CALIFORNIA (2014) [hereinafter PAYING FOR WATER].

- Developing new sources, including imported, recycled, and desalinated water and water purchased through transfers;
- Managing surface water impoundment, transportation, distribution, and use;
- Promoting conservation and efficient use to reduce demands on freshwater sources;
- Managing groundwater by regulating pumping, and replenishing groundwater supplies and protecting aquifers from overdraft, saltwater intrusion, and pollution from surface sources;
- Managing stormwater and stormwater discharges through collection of surface runoff, treatment of sewage, reduction of debris, and protection of surface permeability;
- Managing floodwaters through levees, channelization, catchment basins, and protection of wetlands;
- Regulating water rights and resolving disputes over water use;
- Protecting water quality through regulation of water rights, discharges, and land use;
- Protecting aquatic ecosystems that both provide essential habitat for fish and wildlife and serve as the sources of the state's developed water supplies.

These functions often overlap. For example, stormwater that is collected and allowed to percolate into managed groundwater basins can augment water supplies. Discharges of treated sewage and polluted runoff may harm water quality, but also may be blended with other surface water and groundwater supplies to serve industrial and agricultural users. Regulation of groundwater withdrawals may be necessary to ensure the achievement of overall water service by allowing for coordinated (or “conjunctive”) management of surface and groundwater supplies. Protection of aquatic ecosystems is necessary, not only to comply with the federal and state Endangered Species Acts, but also to allow for sustainable and reliable diversions to supply water to households, farms, and non-farm businesses. Indeed, integrated and conjunctive management of surface and groundwater resources is a hallmark of contemporary water resources policy.<sup>2</sup>

An array of governmental structures and financing arrangements pays for these water services.<sup>3</sup> The state and federal governments provide water on a large scale through the State Water Project and Central Valley Project, and also build and maintain various flood works. Cities and counties provide water supply and groundwater management,

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2. See ELLEN HANAK ET AL., PUB. POLICY INST. OF CAL., *MANAGING CALIFORNIA'S WATER: FROM CONFLICT TO RECONCILIATION* 253–313 (2011) [hereinafter *MANAGING CALIFORNIA'S WATER*].

3. Private water purveyors also play an important role, supplying approximately twenty percent of California's urban (non-farm) water demand. Because this Article focuses on the legal context for raising funds by public agencies, we discuss the investor-owned utilities only in passing. The California Public Utilities Commission regulates the rates charged by these utilities.

as well as sewer, stormwater, and other water-related services. Many different kinds of special districts also provide water supply, sewage treatment, stormwater management, flood protection, groundwater replenishment, and other water-related services within their geographic boundaries. Joint powers authorities, consisting of ad hoc assortments of cities, counties, and districts, have been formed to facilitate integrated water services or to achieve economies of scale. Federal, state, and local agencies also regulate the tens of thousands of water diverters, dischargers, and land users whose actions may adversely affect California's water resources.

These diverse water service providers, water managers, and regulatory agencies have developed a variety of methods to pay for their services.<sup>4</sup> For example:

- The state has authorized \$19.6 billion in general obligation (“GO”) bonds since 2000 to provide grants and other contributions to fund water projects.<sup>5</sup> These bonds are repaid from state general fund revenues, mostly from income and sales taxes paid by people and corporations in California. The state also pays some of the costs of the Department of Water Resources, the State Water Resources Control Board, the Department of Fish and Wildlife, and other state agencies that manage water resources, either with state general revenues or sometimes with revenues from fees.<sup>6</sup>

- The federal government covers part of the cost of the Central Valley Project by charging water service rates. It also pays for some of California's flood control investments, as well as for water quality, wetlands, and fisheries protection through agencies such as the Army Corps of Engineers, the Environmental Protection Agency, the U.S. Fish and Wildlife Service, and the National Marine Fisheries Service.<sup>7</sup>

- Most of the costs of providing water in California are paid with funds raised by cities, counties, and special districts. Each relies on some or all of the following basic income sources:<sup>8</sup>

- *Property taxes.* Owners of real property pay an annual tax of approximately one percent of the value of their property at the time of its purchase. Before passage of Proposition 13 in 1978, cities, counties, and districts were allowed to levy property tax percentage rates to fund their operations; and the combined property tax percentage was usually considerably higher than the current one percent. Revenue from the one percent rate is divided among cities, counties, school districts, and other special districts, including those that provide water services.<sup>9</sup>

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4. See *infra* Table 1 for a summary of expenditures on various components of California's water system by local, state, and federal agencies.

5. See *PAYING FOR WATER*, *supra* note 1, app. C at 5.

6. See *id.* at app. C for details on bond spending and repayment.

7. See *id.* app. B at 3–4 tbl.B1.

8. See *PAYING FOR WATER*, *supra* note 1, at app. C for details on local revenues.

9. See *id.* at 19.

○ *Other general revenue.* Cities and counties have other general fund revenue sources, which can be used for any lawful purpose, including water service and administration. The sales tax is the most important “other” general revenue source, followed by taxes on business licenses, utility users, and tourists.<sup>10</sup>

○ *Water fees.* Local agencies also levy fees for water services. For example, most homeowners and businesses receive a monthly water bill (which usually combines a flat monthly rate and a charge for metered use, and sometimes includes rate tiers that increase with the amounts of water used). Water bills also frequently include charges for sewer service (often based on the volume of water used). Agricultural users may pay similar fees. Cities, counties, and other local water supply agencies may levy a standby charge for water service that is available but not used, such as for a plot on which a house has not yet been built. Some impose fees to discourage excess pumping and to acquire water to recharge groundwater basins that contribute to overall water service.<sup>11</sup>

○ *Special assessments and taxes.* Many local agencies also levy special parcel assessments and parcel taxes for water services (often for flood control and in some cases for stormwater programs). Assessments are supposed to be proportional to the special benefit received by each parcel for the specific services provided, whereas parcel taxes can be used for any voter-approved purposes. These charges are usually included on property tax bills.<sup>12</sup>

• The costs of water resources regulation are paid by tax revenues or fees. For example, the State Water Resources Control Board (“SWRCB”) and the California Department of Fish and Wildlife obtain some revenues through permit fees, and some local groundwater management agencies in California collect fees from groundwater users to manage the aquifers.<sup>13</sup>

## I. CONSTITUTIONAL COMPLICATIONS

Nearly all of these revenue sources have been constrained, or at least complicated, by a series of amendments to California’s Constitution approved by the state’s voters, beginning in 1978 with the landmark Proposition 13, followed by Proposition 218 in 1996 and Proposition 26 in 2010. Judicial interpretations have clarified many aspects of these laws, often in ways that further complicate the funding of water management and administration. Yet, there remain significant unanswered legal questions, and water agencies, property owners, and water users continue to grapple with the complexities and uncertainties of the constitutional constraints on the sources of funding for water service and water

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10. MAC TAYLOR, CAL. LEGISLATIVE ANALYST’S OFFICE, CAL FACTS 27 (2013).

11. Ellen Hanak et al., *Funding Sustainable Groundwater Management in California*, CALIFORNIA WATER BLOG (Apr. 3, 2014), <http://californiawaterblog.com/2014/04/03/funding-sustainable-groundwater-management-in-california>.

12. PAYING FOR WATER, *supra* note 1, at 16; *see infra* Box 2.

13. Hanak, *supra* note 11.

resources regulation. As a guide to this discussion, Table 1 summarizes the key changes in water-related finance resulting from these reforms.

TABLE 1: IMPACTS OF PROPOSITIONS 13, 218, AND 26 ON STATE AND LOCAL REVENUE RULES

		Pre-1978	Prop. 13 (1978)	Prop. 218 (1996)	Prop. 26 (2010)
State	Taxes	50% of legislature	<b>2/3 of legislature</b> <sup>14</sup>	→	→
	Regulatory fees	50% of legislature	50% of legislature	50% of legislature	<b>Stricter requirements (more likely a tax)</b>
	GO bonds	50% of state voters	50% of state voters	50% of state voters	50% of state voters
Local	General taxes	Flexible <sup>15</sup>	Flexible	<b>Simple majority for cities and counties, not available to special districts</b>	→
	GO bonds <sup>16</sup>	2/3 of local voters	2/3 of local voters	2/3 of local voters	2/3 of local voters
	Special taxes	Undefined	<b>2/3 of local voters</b>	→	→
	Property taxes	Flexible	<b>1% of purchase price + 2% annual increases</b> <sup>17</sup>	→	→
	Property-related fees and assessments	Flexible	Flexible	<b>1) All water-related services: Strict cost-of-service requirements 2) All water-related services: Property owner protest hearing 3) Floods and stormwater: 50% of property owners or 2/3 popular vote</b>	→
	Non-property-related fees	Flexible	Flexible	Flexible	<b>Stricter requirements (more likely a tax)</b>
	Wholesale fees	Flexible	Flexible	Flexible <sup>18</sup>	<b>Stricter cost-of-service requirements</b>

14. Bold text in the columns under the propositions shows the changes resulting from each constitutional reform.

15. "Flexible" typically means that rate decisions could be made by governing boards. Before Proposition 218, there was variation in voting requirements for different types of general taxes.

16. In 2000, voters passed Proposition 39, which lowered this vote threshold to fifty-five percent for school bonds. *See generally Proposition 39: Text of Proposed Law*, CALIFORNIA BALLOT PAMPHLET: GENERAL ELECTION NOV. 7, 2000 at 73.

17. Property taxes may be increased for GO bonds with two-thirds local voter approval (or fifty-five percent for schools). CAL. CONST. art. XVI, § 18.

18. As described *infra* Part II.A, water wholesale agencies have assumed that they are exempt from Proposition 218 because they do not deliver services directly to properties, but this issue has not been decided by the courts.

#### A. PROPOSITION 13 (ENACTED JUNE 6, 1978)

California's most famous tax initiative, Proposition 13, arose as a protest against the rapid increases in property taxes that accompanied California's booming real estate markets in the 1960s and 1970s. It limited the property tax that local governments may levy to one percent of each parcel's estimated value, and it provided that local governments could increase the assessed (that is, taxable) value of each parcel by no more than two percent annually.<sup>19</sup> This change immediately reduced local property tax revenue by more than five billion dollars, or slightly over fifty percent.<sup>20</sup> Previously, cities, counties, school districts, and other local agencies—including water, sewer, and flood control districts—levied their own property tax rates, usually without voter approval. The revenue from the one percent levy is divided among these agencies, more or less in proportion to each agency's pre-Proposition 13 share of revenues. Many water-related agencies continue to receive this money.<sup>21</sup>

Proposition 13 also changed the approval process for other taxes. It required that all changes in state taxes be approved by a two-thirds vote of the legislature,<sup>22</sup> and introduced a new requirement that local special taxes be approved by two-thirds of local voters.<sup>23</sup>

#### B. PROPOSITION 218 (ENACTED NOVEMBER 5, 1996)

Many local governments responded to the reduction in revenues caused by Proposition 13 by increasing their use of fees, charges, and special assessments, including those for water services. Some special districts levied non-property-related "general" taxes (which were not addressed by Proposition 13) after approval by a majority of their local voters, especially for transportation purposes.<sup>24</sup>

Proposition 218 amended the California Constitution to restrain many of these local government practices.<sup>25</sup> Among other changes, the law:

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19. CAL. CONST. art. XIII A, §§ 1–2.

20. CAL. BD. OF EQUALIZATION, PUB. 29, CALIFORNIA PROPERTY TAX: AN OVERVIEW I (2012).

21. See PAYING FOR WATER, *supra* note 1, app. B at 6 tbl.B3 for recent property tax revenues of water-related special districts in California.

22. CAL. CONST. art. XIII A.

23. *Id.* art. XIII A, § 4; as described *infra*, Proposition 26 amended the language of this limitation, but it did not alter the two-thirds majority requirement.

24. See generally CALIFORNIA CITY FINANCE.COM, LOCAL COUNTYWIDE TRANSPORTATION SALES TAXES (2010).

25. CAL. CONST. art. XIII C. Indeed, the law included a finding that "Proposition 13 was intended to provide effective tax relief and to require voter approval of tax increases. However, local governments have subjected taxpayers to excessive tax, assessment, fee and charge increases that not only frustrate the purposes of voter approval for tax increases, but also threaten the economic security of all Californians and the California economy itself." *Proposition 218: Text of Proposed Law*, CALIFORNIA BALLOT PAMPHLET: GENERAL ELECTION NOV. 5, 1996 at 108. Proposition 218 then declared

- Clarifies that local general taxes always require majority voter approval and local special taxes require approval by a two-thirds vote of the local electorate.<sup>26</sup>
- Prohibits special districts from levying general taxes.<sup>27</sup>
- Makes it more difficult to levy special benefit parcel assessments, which were sometimes used to fund water supply and flood protection projects and other water programs.<sup>28</sup>
- Places the burden of proof on local agencies to demonstrate that assessments are proportional to the special benefit that each parcel receives from the facility or service.<sup>29</sup>
- Requires that proposed assessments be approved through an election in which votes are weighted by the amount of assessment each parcel owner would have to pay.<sup>30</sup>

Before the enactment of Proposition 218, the courts largely accepted local agency determinations that the fees, assessments, and other charges that they levied on property within their jurisdiction benefitted from the charges in a manner fairly proportionate to their share of the services funded by the charge.<sup>31</sup> Proposition 218 now requires local agencies to prove that they have complied with the substantive standards of the law, including the requirement that each parcel benefit in proportion to the share of the assessment levied against it and that the assessment not exceed the cost of the property-related service provided to each parcel.<sup>32</sup> Many local agencies have found it difficult to satisfy these criteria.<sup>33</sup>

In addition, Proposition 218 established new substantive standards for fees and charges levied “as an incident of property ownership” or for a “property-related service.”<sup>34</sup> The meaning of these standards caused considerable confusion, with several courts concluding that the law did not cover water rates and fees because they were charged for water

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that its purpose was to protect taxpayers “by limiting the methods by which local governments exact revenue from taxpayers without their consent.” *Id.*

26. CAL. CONST. art. XIIC, § 2, cl. b, d. “‘General tax’ means any tax imposed for general governmental purposes.” *Id.* § 1, cl. a. Cities, counties, and other local entities that exercise general governmental powers may levy general taxes with approval by a majority of the electorate. *Id.* § 2, cl. b. Special purpose districts and agencies do not have authority to levy general taxes. *Id.* § 2, cl. a. “‘Special tax’ means any tax imposed for specific purposes, including a tax imposed for specific purposes, which is placed into a general fund.” *Id.* § 1, cl. d. As noted in the text, special taxes require approval of two-thirds of the electorate. *Id.* § 2, cl. d.

27. *Id.* § 2, cl. a.

28. *Id.* art. XIID, § 4.

29. *Id.* § 4, cl. f.

30. *Id.* § 4, cl. g.

31. *Dawson v. Town of Los Altos Hills*, 547 P.2d 1377, 1382–83 (Cal. 1976).

32. CAL. CONST. art. XIID, § 4.

33. *Silicon Valley Taxpayers Ass’n v. Santa Clara Cnty. Open Space Auth.*, 187 P.3d 37, 55–56 (Cal. 2008); *Tiburon v. Bonander*, 103 Cal. Rptr. 3d 485, 508–09 (Cal. Ct. App. 2009).

34. CAL. CONST. art. XIID, §§ 3, 4, 6.

service to property rather than imposed as an incident of property ownership.<sup>35</sup> In two cases, however, the California Supreme Court held that, except for the initial utility connection, water supply is a “property-related service” and is therefore subject to Proposition 218.<sup>36</sup>

[O]nce a property owner or resident has paid the connection charges and has become a customer of a public water agency, all charges for water delivery incurred thereafter are charges for a property-related service, whether the charge is calculated on the basis of consumption or is imposed as a fixed monthly fee.<sup>37</sup>

Proposition 218 imposes five substantive standards with which public retail water agencies must comply before they increase water rates or fees or make changes in their rate structures. The law states:

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. . . .
5. No fee or charge may be imposed for general governmental services . . . where the service is available to the public at large in substantially the same manner as it is to property owners.<sup>38</sup>

If an affected property owner challenges a fee or charge in court, the agency has the burden of proving that it has complied with these requirements.<sup>39</sup>

Proposition 218 also created two procedural requirements that public retail water agencies must fulfill before they may adopt a property-related fee or charge. First, the agency must conduct a public hearing on the proposed change in rates, fees, or rate structure.<sup>40</sup> “If written protests against the proposed fee or charge are presented by a majority of owners of the identified parcels, the agency shall not impose

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35. *Howard Jarvis Taxpayers Ass’n v. City of Los Angeles*, 101 Cal. Rptr. 2d 905, 907–08 (Cal. Ct. App. 2000).

36. *Bighorn-Desert View Water Agency v. Verjil*, 138 P.3d 220, 225 (Cal. 2006); *Richmond v. Shasta Comm. Svcs. Dist.*, 83 P.3d 518, 528 (Cal. 2004).

37. *Verjil*, 138 P.3d at 227.

38. CAL. CONST. art. XIIIID, § 6, cl. b.

39. *Id.* § 6, cl. b, pt. 5.

40. *Id.* § 6, cl. a, pt. 2.

the fee or charge.”<sup>41</sup> Second, property-related fees and charges, except those for “water, sewer, or refuse collection services,” must be approved by local voters.<sup>42</sup>

For these elections, the agency has two options. It can seek approval by a majority of the property owners who would be subject to the fee or charge, or from two-thirds of the registered voters in the same area.<sup>43</sup> The Proposition 218 election options create an odd and perhaps unexpected choice. If the agency takes the seemingly easier path of seeking approval from a majority of the property owners who would be subject to the fee, it risks being accused of using an “undemocratic” approval procedure.<sup>44</sup> But if the agency believes that it can obtain approval from two-thirds of local voters, it is likely to ask them to approve the measure as a special tax rather than as a property-related fee, because the agency can thereby avoid the Proposition 218 substantive standards and protest requirements. With a few exceptions not relevant here, assessments, fees, charges, and rates that were enacted before July 1, 1997 do not have to comply with the procedural and substantive requirements of Proposition 218.<sup>45</sup>

Finally, Proposition 218 makes it unlawful for water agencies to use the proceeds of water rates and other charges for projects and programs that are unrelated to water service. Before Proposition 218, for example, it was common for municipal water departments to transfer surplus water

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41. *Id.* The California Court of Appeal recently held that Proposition 218 does not require water agencies to conduct individual protest hearings and votes for each class of customers or each type of rate increase. *Morgan v. Imperial Irrigation Dist.*, 167 Cal. Rptr. 3d 687, 698 (Cal. Ct. App. 2014). Rather, water agencies may conduct a single “omnibus” hearing in which all of its customers vote. *Id.* As the court explained:

Given the goals of section 6 [of Proposition 218] to minimize water rates and promote dialog between rate payers and rate makers, public agencies must be permitted to reasonably structure their revenues to cover costs and meet customer needs using a rate setting process that includes notice and hearing requirements sufficient to allow meaningful public participation, but tolerably administrable and flexible to avoid needless expense and delay. . . . The individual protest procedure . . . would create an almost unworkable system, where a minority of voters could frustrate the purposes of section 6.

*Id.* at 702–03.

42. CAL. CONST. art. XIII D, § 6, cl. c.

43. *Id.*

44. This occurred in Los Angeles County and Contra Costa County elections for stormwater fees. *Unanswered Questions at the Los Angeles County Clean Water, Clean Beaches Protest Hearing*, LAKEWOOD ACCOUNTABILITY ACTION GROUP (Jan. 15, 2013), <http://www.laag.us/2013/01/unanswered-questions-at-los-angeles.html>; Lisa Vorderbrueggen, *County Taking Weeks to Determine Results of Contra Costa Water Fee Election*, CONTRA COSTA TIMES, Apr. 26, 2012, AVAILABLE AT [http://www.mercurynews.com/rss/ci\\_20481576](http://www.mercurynews.com/rss/ci_20481576). Property owner ballot measures have had relatively low pass rates (68%) as compared with general tax measures mentioning water that require a simple majority vote of the general public (100%). They have done no better on average than special tax measures, including water, that require a two-thirds majority vote of the general public (65% PAYING FOR WATER, *supra* note 1, app. E at 3.

45. CAL. CONST. art. XIII D, §§ 5(a), 6(d).

revenues to the city's general fund. This practice would now violate the law's express directive that "[n]o fee or charge may be imposed for general governmental services . . . where the service is available to the public at large in substantially the same manner as it is to property owners."<sup>46</sup>

C. PROPOSITION 26 (ENACTED NOVEMBER 2, 2010)

The most recently enacted constitutional amendment in this trilogy of financing reforms, Proposition 26, applies to both state and local governments.<sup>47</sup> Its stated purpose was to redefine the term "tax" so that "neither the Legislature nor local governments can circumvent [the Proposition 13 and 218] restrictions on increasing taxes by simply defining new or expanded taxes as 'fees.'"<sup>48</sup> Indeed, the law was based on the "finding" that:

[T]he legislature and local governments have disguised new taxes as "fees" in order to extract even more revenue from California taxpayers without having to abide by these constitutional voting requirements. Fees couched as "regulatory" but which exceed the reasonable costs of actual regulation or are simply imposed to raise revenue for a new program and are not part of any licensing or permitting program are actually taxes and should be subject to the limitations applicable to the imposition of taxes.<sup>49</sup>

Proposition 26 amended Proposition 13 by requiring that any change in state law that "results in any taxpayer paying a higher tax" be enacted by a two-thirds vote of the legislature.<sup>50</sup> This represents an important change, because previously the legislature—by simple majority vote—could enact or authorize taxes or fees that were "revenue-neutral" overall, even if they raised levies on some individuals.<sup>51</sup>

Local taxes remain subject to the requirements of approval by majority vote of the electorate for "general taxes" and approval by two-thirds of the voters for "special taxes." But Proposition 26 defines "tax" broadly to mean "any levy, charge, or exaction of any kind" imposed by the state or local governments, except:

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46. *Id.* § 6, cl. b, pt. 5; see *In re City of San Bernardino*, 499 B.R. 776, 789 (Bankr. C.D. Cal. 2013).

47. See generally *Proposition 26: Text of Proposed Law*, CALIFORNIA BALLOT PAMPHLET: GENERAL ELECTION NOV. 2, 2010.

48. *Id.* at 114.

49. *Id.*

50. CAL. CONST. art. XIII A, § 3, cl. a. As defined by Proposition 13, the two-thirds legislative approval requirement was applicable to "any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation." *Id.* § 3, cl. a (amended 2010). The new supermajority vote requirement of Proposition 26 was a response to several statutes by which the legislature increased taxes for some people and lowered them for others, with an overall "revenue neutral" effect designed to avoid Proposition 13's two-thirds vote requirement. *Id.*

51. *Proposition 26: Text of Proposed Law*, *supra* note 47, at 114.

1. A charge imposed for a specific benefit conferred or privilege granted directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the State [or local government] of conferring the benefit or granting the privilege to the payor.
2. A 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 State [or local government] of providing the service or product to the payor.
3. A charge imposed for the reasonable regulatory costs to the State [or local government] incident to issuing licenses and permits, performing investigations, inspections, and audits, enforcing agricultural marketing orders, and the administrative enforcement and adjudication thereof.
- ...
5. A fine, penalty, or other monetary charge imposed by the judicial branch of government or the State [or a local government], as a result of a violation of law.<sup>52</sup>

For local governments, Proposition 26 also excludes from the definition of tax:

6. A charge imposed as a condition of property development.
7. Assessments and property-related fees imposed in accordance with the provisions of Article XIII D [that is, Proposition 218].<sup>53</sup>

In addition, Proposition 26 states that:

The state [or local government] bears the burden of proving by a preponderance of the evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity.<sup>54</sup>

Proposition 26 became law on November 2, 2010, and does not apply to fees and other charges that were in effect on that date. It does apply, however, to any subsequent changes in existing fees and charges.<sup>55</sup>

One of the most important unresolved questions under Proposition 26 is whether it includes “regulatory fees” in its definition of taxes. Regulatory fees are charges levied for the purpose of deterring certain

52. CAL. CONST. art. XIII A, § 3, cl. b; *id.* art. XIII C, § 1, cl. e.

53. *Id.* art. XIII C, § 1, cl. e.

54. *Id.* art. XIII A, § 3, cl. d; *id.* art. XIII C, § 1, cl. e.

55. In addition, Proposition 26 states that:

Any [state tax] adopted after January 1, 2010, but prior to the effective date of this act, that was not adopted in compliance with [its] requirements . . . is void 12 months after the effective date of this act unless the tax is reenacted by the Legislature and signed into law by the Governor in compliance with the [new] requirements.

CAL. CONST. art. XIII A, § 3, cl. c.

activities (such as the discharge of pollutants or excessive groundwater pumping) or of requiring land and water users to bear the full costs of their activities, including external costs (such as loss of wetlands or harm to endangered species). Before the enactment of Proposition 26, it was well-settled California law that these types of regulatory fees were valid (that is, did not have to be enacted as a tax) if they met two criteria: First, the fee did not “exceed the reasonable cost of providing services necessary to the activity for which the fee is charged and which are not levied for unrelated revenue purposes.”<sup>56</sup> Second, the fee “was ‘imposed . . . to mitigate the actual or anticipated adverse effects of the fee payers’ operations.’”<sup>57</sup>

Although the courts will ultimately have to decide this question, we believe that Proposition 26 did not overturn this long-standing definition of regulatory fees. Rather, the new law had a narrower purpose: to prohibit the enactment of environmental mitigation fees that are designed to raise funds to compensate victims of past environmental harm or to remediate existing environmental degradation that stems from actions and resource management decisions (that is, water and land use) that have already taken place. These types of broader environmental mitigation fees may only be enacted as taxes. We reach this conclusion for several reasons.

First, as noted above, Proposition 26 candidly describes what it covers and does not cover, prohibiting only those fees that are (1) “couched as ‘regulatory’ but which exceed the reasonable costs of actual regulation”; (2) fees that “are simply imposed to raise revenue for a new program”; and (3) fees that “are not part of any licensing or permitting program.”<sup>58</sup> In contrast, regulatory fees are (as their name connotes) regulatory in nature—that is, they apply prospectively to activities that are governed by permitting and licensing requirements and are tailored to help achieve the goals of deterring potentially harmful activities and of forcing the individuals or entities who are subject to the fee to pay the full costs of their activities—including the external costs that they otherwise would impose upon other land and water users or the general public. Regulatory fees therefore do not conflict with any of the articulated purposes of Proposition 26.

Second, Proposition 26 expressly states that a fee is not a tax if it is “imposed for a specific benefit conferred or privilege granted directly to the payor” (such as the right to discharge stormwater or to pump groundwater) and “does not exceed the reasonable costs to the [government] of conferring the benefit or granting the privilege to the

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56. Cal. Farm Bureau Fed'n v. State Water Res. Control Bd., 247 P.3d 112, 126 (Cal. 2011).

57. *Id.* For more on this case, see *infra* Box 1.

58. *Proposition 26: Text of Proposed Law*, *supra* note 47, at 114.

payor.”<sup>59</sup> The law then explains this latter criterion in more detail, stating that a fee is not a tax if the government proves that the amount of the fee “is no more than necessary to cover the reasonable costs of the governmental activity”—that is, protecting water quality, regulating stormwater discharges, and managing groundwater resources—and “the manner in which those costs are allocated to a payor *bear a fair or reasonable relationship to the payor’s burdens on, or benefits received from, the governmental activity.*”<sup>60</sup> This language indicates that Proposition 26 continues to allow the state and local agencies to adopt fees that are designed to deter activities (such as excessive pumping that in the aggregate may cause groundwater overdraft), or compel land and water users to pay for the negative externalities that they impose on neighboring landowners, downstream water users, or the environment.

That the fee may also raise money to fund the governmental program does not render it a tax. The California Supreme Court has held that “if regulation is the primary purpose of [a] fee measure, the mere fact that the measure also generates revenue does not make the imposition a tax.”<sup>61</sup> Again, Proposition 26 does not alter this principle, as its “findings and declarations of purpose” states that it was enacted to address “[f]ees couched as ‘regulatory’ but which exceed the reasonable costs of actual regulation *or are simply imposed to raise revenue for a new program and are not part of any licensing or permitting program.*”<sup>62</sup>

Proposition 26 does change the substantive law governing regulatory fees in one significant respect: it prohibits the use of fees that require resource users to pay for harm that they may have caused by past activities or for harm caused by others.<sup>63</sup> In this respect, the new law overturns part of the California Supreme Court’s decision in *Sinclair Paint*, which upheld the Childhood Lead Poisoning Prevention Act of 1991 against claims that it was a “special tax” that must be approved by a two-thirds majority of the legislature under Proposition 13. The Act requires paint manufacturers and others who produce or distribute products that contain lead to pay a fee to fund medical services for children who are at risk of lead poisoning.<sup>64</sup> It states that the fee shall be assessed on the basis of each individual contributor’s “past and present responsibility for environmental lead contamination” and “‘market share’ responsibility for environmental lead contamination.”<sup>65</sup>

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59. CAL. CONST. art. XIII A, § 3, cl. b, pt. 1; *id.* art. XIII C, § 1, cl. e, pt. 1.

60. *Id.* art. XIII A, § 3, cl. d; *id.* art. XIII C, § 1, cl. e (emphasis added).

61. *Sinclair Paint Co. v. State Bd. of Equalization*, 937 P.2d 1350, 1358 (Cal. 1997).

62. *Proposition 26: Text of Proposed Law*, *supra* note 47, at 114 (emphasis added).

63. *Id.*

64. CAL. HEALTH & SAFETY CODE § 105310(b)(1)–(2) (West 2014).

65. *Id.* As noted above, Proposition 26 also changed the burden of proof applicable to judicial review of regulatory fees. Before Proposition 26, the plaintiffs challenging a fee had “the burden of

The court concluded that “the police power is broad enough to include mandatory remedial measures to mitigate the *past, present, or future* adverse impact of the fee payer’s operations, at least where, as here, the measure requires a causal connection or nexus between the product and its adverse effects.”<sup>66</sup> Section 105310 “imposes *bona fide* regulatory fees,” the court reasoned, because the statute “requires manufacturers and other persons whose products have exposed children to lead contamination to bear a fair share of the cost of mitigating the adverse health effects their products created in the community. . . . From the viewpoint of general police power authority,” the court saw “no reason why statutes or ordinances calling on polluters or producers of contaminating products to help in mitigation or cleanup efforts should be deemed less ‘regulatory’ in nature than the initial permit or licensing programs that allowed them to operate.”<sup>67</sup>

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proof to establish a prima facie case showing that the fee is invalid.” Cal. Farm Bureau Fed’n v. State Water Res. Control Bd., 247 P.3d 112, 122 (Cal. 2011).

[O]nce plaintiffs have made their prima facie case, the state bears the burden of [producing evidence] and must show “(1) the estimated costs of the service or regulatory activity, and (2) the basis for determining the manner in which the costs are apportioned, so that charges allocated to a payor bear a fair or reasonable relationship to the payor’s burdens on or benefits from the regulatory activity.”

*Id.* at 123 (quoting *Sinclair Paint*, 937 P.2d at 1357). Proposition 26 places the burden of proving compliance with its substantive standards on the government throughout the litigation. CAL. CONST. art. XIII A, § 3, cl. d; *id.* art. XIII C, § 1. As noted *supra*, Proposition 218 similarly placed the burden of proving compliance with its substantive directives on local governments.

66. *Sinclair Paint*, 937 P.2d at 1356.

67. *Id.*

## BOX 1: STATE WATER RESOURCES CONTROL BOARD FEE LITIGATION

The California Supreme Court's most recent decision on regulatory fees came in *California Farm Bureau Federation v. State Water Resources Control Board*, 247 P.3d 112 (Cal. 2011). Since the creation of the first water rights regulatory system in the Water Commission Act of 1913, the Water Rights Division of the board (and its predecessor agencies) were supported by the state's general fund. In 2004, however, the legislature changed this funding system by enacting Senate Bill 1049, which directed the board to establish a schedule of annual fees and special application fees that would be charged to all appropriators of surface water that operate under permit or license issued by the SWRCB. CAL. WATER CODE §§ 1525–1560 (West 2014). Riparians, pre-1914 appropriators, and pueblo water right holders are exempt from the fees. The fee schedules are set forth in the SWRCB's regulations. CAL. CODE REGS. tit. 23, §§ 1061–1078 (2014).

The California Farm Bureau Federation and other water users sued, claiming that the annual fees were a tax that required a two-thirds vote of the legislature. Although Proposition 26 was enacted while the case was on appeal, none of the parties contended that the fees were subject to the new law, and the Supreme Court consequently did not address Proposition 26's substantive standards. The court's opinion is nevertheless important because it provides an instructive analysis of how the courts should evaluate regulatory fees.

The court rejected the claim that the fees are facially unconstitutional. It reasoned that the legislature had taken care to ensure that the fees would not be classified as a tax that would require a two-thirds majority vote under Proposition 13 because it did not authorize the Board to use the proceeds of the fees for activities other than regulation of permittees and licensees: "Section 1525 does not require the SWRCB to collect anything more than the administrative 'costs incurred' in carrying out the functions [covered by the fees] . . . Thus, the fees charged . . . are linked to the activities the Division performs." *Cal. Farm Bureau Fed'n*, 247 P.3d at 124–25.

The Supreme Court remanded the case to the superior court, however, for resolution of the question of whether the Board fairly apportioned the 2003 annual fees among the various fee-payers' proportion to their respective burdens on California's water systems. It emphasized that the superior court should consider "whether the fees are reasonably related to the total budgeted cost of the Division's 'activity,' keeping in mind that a *government agency should be accorded some flexibility in calculating the amount and distribution of a regulatory fee.*" *Id.* at 126 (emphasis added).

In November 2013, the Sacramento County Superior Court held that the 2003 annual fees violated these principles. It found that because of the statutory exemption of riparian, pueblo, and pre-1914 appropriative rights, the fees only covered approximately sixty-two percent of surface water right holders. Yet, the water rights administrative programs funded by the fees benefit all water right holders as well as the general public. Under these circumstances, the court concluded that the fees "do not provide a fair, reasonable, and substantially proportionate assessment of all costs related to the regulation of the affected payors." The court also ruled that the Board failed to justify the fees charged to the U.S. Bureau of Reclamation. Judgment, *N. Cal. Water Ass'n v. SWRCB*, No. 03CS01776 (Cal. Super. Ct. 2013).

Although the superior court correctly decided that the annual water use fees should include all surface water right holders (not simply permittees and licensees), the court's conclusion that the fee is unconstitutional because it funds activities that benefit the general public is inconsistent with the California Supreme Court's definition of a valid regulatory fee—one that compels the affected water users to pay for the external costs of their activities, including the costs of regulation to resolve water rights disputes and to protect water quality, fish, and other aspects of the environment. We expect that the Board will raise this issue on appeal.

This part of the *Sinclair Paint* holding is no longer good law. Proposition 26 expressly limits the use of regulatory fees to mitigation of prospective environmental harm likely to be caused by the payor's actions. If enacted today, the Childhood Lead Poisoning Prevention Act's collection of a fee to redress harm from past contributions of lead would therefore have to be passed as a tax by a two-thirds vote of the legislature.<sup>68</sup>

California courts will ultimately decide the precise meaning and consequences of Proposition 26. A careful reading of the stated purposes and implementing sections of the initiative, however, should lead to the conclusion that prospective regulatory fees continue to be fees rather than taxes. Moreover, in the absence of explicit repealing language, the courts are likely to be wary of the conclusion that the new law completely eliminates regulatory fees, which are a long-standing and vital feature of environmental stewardship and regulation. As the U.S. Supreme Court recently emphasized: "Insisting that landowners internalize the negative externalities of their conduct is a hallmark of responsible land-use policy,

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68. The Legislative Analyst's explanation of Proposition 26, which was published in the Official Voter Information Guide, also supports the interpretation that the initiative applies only to fees that fund remedial projects that are designed to compensate for or mitigate past environmental harm or that generate revenues that are allocated to unrelated governmental programs. According to the Legislative Analyst:

Generally, the types of fees and charges that would become taxes under the measure are ones that government imposes to address health, environmental, or other societal or economic concerns. Figure 3 provides examples of some regulatory fees that could be considered taxes, in part or in whole, under the measure. This is because these fees pay for many services that benefit the public broadly, rather than providing services directly to the fee payer. The state currently uses these types of regulatory fees to pay for most of its environmental programs.

*Proposition 26: Analysis by the Legislative Analyst*, CALIFORNIA BALLOT PAMPHLET: GENERAL ELECTION NOV. 2, 2010 at 58 (emphasis added). In Figure 3, the Legislative Analyst briefly described three types of fees that could only be enacted as taxes if Proposition 26 were enacted: the Oil Recycling Fee, the Hazardous Materials Fee, and Fees on retail stores that sell tobacco products. All three resemble the lead contamination fee at issue in *Sinclair Paints*. (What would make these fees unlawful under Proposition 26 is the fact that the proceeds are used for things besides mitigation of prospective harm that is likely to be caused by the fee-payers' actions.) The principal argument in support of Proposition 26 that appeared in the official Voter Information Guide also confirms the interpretation that enactment of the initiative would not eliminate prospective environmental mitigation fees. "Don't be misled by opponents of Proposition 26," it urged the voters: "California has some of the strongest environmental and consumer protection laws in the country. Proposition 26 preserves those laws and PROTECTS LEGITIMATE FEES SUCH AS THOSE TO CLEAN UP ENVIRONMENTAL OR OCEAN DAMAGE, FUND NECESSARY CONSUMER REGULATIONS, OR PUNISH WRONGDOING . . ." *Proposition 26: Argument in Favor of Proposition 26*, CALIFORNIA BALLOT PAMPHLET: GENERAL ELECTION NOV. 2, 2010 at 60. The California Supreme Court has held that if the text of an initiative is "clear and unambiguous, the plain meaning governs. But if the language is ambiguous, we consider extrinsic evidence in determining voter intent, including the Legislative Analyst's analysis and ballot arguments for and against the initiative." *Silicon Valley Taxpayers Ass'n v. Santa Clara Cnty. Open Space Auth.*, 187 P.3d 37, 47 (Cal. 2008) (citations omitted).

and we have long sustained such regulations against constitutional attack.”<sup>69</sup>

## II. IMPLICATIONS OF PROPOSITIONS 218 AND 26 FOR THE ADMINISTRATION OF CALIFORNIA’S WATER RESOURCES

Proposition 218 was enacted almost two decades ago, yet its effects on water service and water resources management have only lately come to public attention and debate. As a result of recent judicial interpretations, the law is likely to alter ratemaking and water administration in several important ways.

First, public retail water agencies will have to explain more carefully and clearly the relationship between their water rate structures and the cost of providing water service to their customers, link new fees and rates to the projects and programs they are designed to fund, and justify any differential treatment between or among classes of customers based on differences in the cost of providing services to those classes. Second, they will have to justify water service charges that fund water management activities that may not directly benefit all individual customers, but rather, provide indirect benefits to customers by reducing either aggregate demand for freshwater supplies or the aggregate cost of providing water service. Third, local groundwater and stormwater management agencies will have to explain how fees that they employ to address the external costs of their constituents’ water and land use activities are consistent with Proposition 218’s cost-based allocation scheme. Indeed, this may be the most challenging issue for agencies that are subject to the law’s requirements.

Proposition 26 is relatively new. As discussed above, the courts have not yet had a chance to decide whether it applies to all regulatory fees or only those that address past environmental harm or provide funds for unrelated governmental programs. The effects of Proposition 26 on California water policy therefore remain more speculative. The law may require public *wholesale* water agencies—which deliver water to retail agencies but not to individual businesses and residences—to explain and justify their fees, charges, rates, and rate structures in a manner similar to Proposition 218’s directives to retail water agencies.<sup>70</sup> This could include proof of compliance with Proposition 26’s substantive standards—including evidence that water rates and fees do not exceed the reasonable costs of the specific service provided, and that rates and rate structures “bear a fair or reasonable relationship to the payor’s burdens

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69. *Koontz v. St. Johns River Water Mgmt. Dist.*, 133 S. Ct. 2586, 2595 (2013).

70. Most wholesale agencies have operated under the assumption that they are not subject to similar requirements under Proposition 218 because they do not deliver water directly to properties. ASS’N OF CAL. WATER AGENCIES, PROPOSITION 26: LOCAL AGENCY GUIDELINES FOR COMPLIANCE II (2012).

on, or benefits received from” the agency.<sup>71</sup> The latter requirement may also make it more difficult for the state or local governments to raise funds to support environmental cleanup and habitat restoration programs because of the tighter burden of proof regarding the link between the fee and the burden caused by specific activities.

In addition, both water agencies and the courts will have to address the relationship between Propositions 218 and 26—especially as these laws may apply to water management programs that have some aspects of water service to property (and to the consumers who inhabit and use the property), but which are primarily designed to ensure that activities that take place on such property do not harm neighboring lands, public waters, or environmental quality. We believe that these types of regulatory fees are an uneasy fit within Proposition 218 and should be evaluated only under Proposition 26. There is also the potential for conflict between the cost-based allocation standards of Proposition 218 and the constitutional cornerstone of California water policy, article X, section 2, of the state constitution. Overly literal interpretation of the Proposition 218 standards could undermine a variety of water conservation and integrated management programs that are key features of contemporary water resources administration.

The remainder of this Article explores these issues and proposes a set of constitutional reforms to these laws to enable sustainable funding of California’s water system. It also suggests a variety of ways that water agencies, the courts, and the legislature can respond constructively to the challenges posed by these laws in their current form.

#### A. PROPOSITION 218 AND RETAIL WATER RATES

Proposition 218 has already had significant effects on water rates and rate structures, and its influence is likely to expand as the courts continue to explicate its various restrictions and requirements. To date, these judicial decisions have been limited to retail water service.<sup>72</sup> The law applies only to assessments on real property and to fees and charges levied “as an incident of property ownership” or for a “property-related service.”<sup>73</sup> Because fees and charges for wholesale water service are paid by the retail water supplier, they probably are not covered by Proposition 218.<sup>74</sup>

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71. CAL. CONST. art. XIII A, § 3, cl. d.

72. *See, e.g., infra* notes 76–77 and accompanying text.

73. CAL. CONST. art. XIII D, § 2.

74. The courts have not yet decided this question. It is possible that a court would conclude that because the combined pricing decisions of retail and wholesale agencies make up the “cost” used to justify a property-related fee, both retail and wholesale ratemaking are subject to Proposition 218. The text of Proposition 218, however, does not compel this conclusion. Moreover, the legislature has declared that changes in wholesale rates that are passed along from a retail water supply agency to its

Although Proposition 218 expressly exempts “fees or charges for . . . water . . . services” from its *election* requirements,<sup>75</sup> most water rates are nonetheless subject to its *substantive* standards.<sup>76</sup> To date, the California courts have interpreted these standards broadly to require public retail water agencies—those that provide water service directly to residential, commercial, and agricultural users—to justify their specific rates, ratemaking formulas, and rate disparities based on differences in the cost of providing service to different classes of customers. Two recent cases are illustrative.<sup>77</sup>

In *City of Palmdale v. Palmdale Water District*, the California Court of Appeal struck down a tiered-rate structure that the Palmdale Water District (“PWD”) adopted to encourage conservation and efficient use and reduce demand on its surface and groundwater sources of supply.<sup>78</sup> The new rate structure imposed a fixed monthly service charge based on the size of the customer’s meter and a variable commodity charge that increased in four tiers based on the level of each customer’s exceeding of his or her base use allocation.<sup>79</sup> The specific rates for each of the four tiers differed, however, depending on whether the customer’s water use was for residential, commercial, or irrigation purposes.<sup>80</sup>

The court concluded that this differential among classes of customers violated Proposition 218’s third substantive standard—that the rate charged to individual parcels or customers “shall not exceed the proportional cost of the service attributable to the parcel”:

[A] review of the tier structure alone establishes that irrigation customers such as the City are charged disproportionate rates reaching tier 5 (\$5.03/unit) rates at 130 percent of their budgeted allocation as compared to other users who do not reach such high rates until they exceed 175 percent (SFR/MFR) or 190 percent (commercial) without

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customers are exempt from Proposition 218. See CAL. GOV’T CODE § 53756 (West 2014) (“An agency providing water, wastewater, sewer, or refuse collection service may adopt a schedule of fees or charges authorizing automatic adjustments that pass through increases in wholesale charges for water, sewage treatment, or wastewater treatment or adjustments for inflation. . . .”).

75. CAL. CONST. art. XIIIID, § 6, cl. c.

76. According to the California Supreme Court, the only such water charges that are categorically exempt from Proposition 218 are those for new water service connections. See *Bighorn-Desert View Water Agency v. Verjil*, 138 P.3d 220, 225–26 (Cal. 2006); *Richmond v. Shasta Cmty. Servs. Dist.*, 83 P.3d 518, 528 (Cal. 2004).

77. The *Palmdale* case is a decision by the California Court of Appeal and is binding precedent on all courts of the state, except for the California Supreme Court. See *City of Palmdale v. Palmdale Water Dist.*, 131 Cal. Rptr. 3d 373 (Cal. Ct. App. 2011). The *Capistrano* case was decided by the Orange County Superior Court, and it has no precedential value. See Statement of Decision (Proposed), *Capistrano Taxpayers Ass’n v. City of San Juan Capistrano*, No. 30-2012-00594579 (Cal. Super. Ct. Aug. 6, 2013) [hereinafter Proposed *Capistrano* Decision]. The *Capistrano* decision is likely to be appealed.

78. *Palmdale*, 131 Cal. Rptr. 3d at 381.

79. *Id.* at 376.

80. *Id.*

any showing by PWD of a corresponding disparity in the cost of providing water to these customers at such levels.<sup>81</sup>

It also rejected the district's argument that the differential tiered-rate structure was authorized by article X, section 2, of the California Constitution and sections 370–374 of the Water Code (see *infra* Box 2) because the tiered rates were designed to prevent waste and unreasonable use, and create incentives for conservation and more efficient use.<sup>82</sup> The court did not rule that these laws are irrelevant in a ratemaking context. Indeed, it emphasized their importance in promoting efficient water use and management. Rather, the court again focused on the lack of justification in the record for the disparities among the classes of customers subject to the differential tiered rates based on differences in the costs of providing water service to each customer class: “PWD fails to explain why [these other laws] cannot be harmonized with Proposition 218 and its mandate for proportionality. PWD fails to identify any support in the record for the inequality *between* tiers, depending on the category of user.”<sup>83</sup>

*Capistrano Taxpayers Association v. City of San Juan Capistrano* was a challenge to the city's changes to its tiered water rate structure and adoption of a charge on all residential customers for recycled water that was made available only to other customers within the city.<sup>84</sup> The Orange County Superior Court ruled that the new tiered rates violated Proposition 218 because the city “failed to carry its burden of establishing credible evidence that the rate increases were proportional to the costs of providing water services to its customers.”<sup>85</sup>

The court also invalidated the city's recycled water charge as levied on residential customers who do not have access to the recycled water.<sup>86</sup> It rejected the city's argument that “it is appropriate to distribute the cost of recycled water to all ratepayers because they benefit from this practice in that by supplying recycled water to ratepayers who can use it, this displaces demand for local potable supplies that can thus be made available to other customers.”<sup>87</sup> The court held that this proffered

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81. *Id.* at 381. SFR represents single-family residences and MFR represents multifamily residences.

82. *Id.* at 380–81. The legislature enacted sections 370–74 as a means of effectuating article X, section 2's water conservation and reasonable use mandates. We discuss these mandates, as well as the relationship between article X, section 2, and Propositions 218 and 26, in detail below.

83. *Palmdale*, 131 Cal. Rptr. 3d at 380.

84. Proposed *Capistrano* Decision, *supra* note 77.

85. *Id.* at 3. The city simply added a new water tier to its existing three-tiered structure by holding Tier 1 constant, increasing that rate by 33.33% to create a new Tier 2, increasing old Tier 2 by 50% to create a new Tier 3, and increasing old Tier 3 by 83.33% to create a new Tier 4. The court concluded that these rate increases were illegal because there was no “specific financial cost data in the [administrative record] to support the substantial rate increases” and the city “failed to identify any support in the record for the inequality between tiers depending on the category of use.” *Id.* at 3–4.

86. *Id.* at 4.

87. *Id.*

justification was inconsistent with the third Proposition 218 standard, which requires that the “service is actually used by, or immediately available to, the owner of the property in question.”<sup>88</sup>

These decisions offer several valuable lessons for public retail water agencies, but they also present significant challenges to sound water resources management. The state has promoted the expanded use of recycled water since the early 2000s through grants and regulatory changes.<sup>89</sup> The Department of Water Resources estimates that the use of recycled water for industrial, agricultural, and landscaping purposes is likely to rise from about 500,000 acre-feet annually in 2005 to more than two million acre-feet annually over the next two decades.<sup>90</sup> The blending of treated wastewater is an increasingly important part of groundwater replenishment in Southern California, and some agencies are now considering potable reuse as a way to improve water supply reliability.<sup>91</sup> In addition, tiered water rates are now a common feature of local retail water service as the linkage between higher water use and higher marginal pricing creates incentives for more efficient use and conservation. “By 2006, roughly half of California’s population lived in a service area with tiered rates,” and this practice has grown since then, “as urban utilities have sought to change consumer behavior in response to drought conditions and restrictions on Delta pumping.”<sup>92</sup> Following encouragement from the California Public Utilities Commission, all ten

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88. *Id.*

89. Several of the state bonds approved in the 2000s made matching funds available for recycled wastewater development. See *PAYING FOR WATER*, *supra* note 1, at app. C. More recently, the State Water Resources Control Board has adopted policies governing recharge groundwater basins with recycled water. See CAL. STATE WATER RES. CONTROL BD., RESOLUTION NO. 2013-0003, ADOPTION OF AN AMENDMENT TO THE POLICY FOR WATER QUALITY CONTROL FOR RECYCLED WATER CONCERNING MONITORING REQUIREMENTS FOR CONSTITUENTS OF EMERGING CONCERN (2013), [http://www.waterboards.ca.gov/board\\_decisions/adopted\\_orders/resolutions/2013/rs2013\\_0003.pdf](http://www.waterboards.ca.gov/board_decisions/adopted_orders/resolutions/2013/rs2013_0003.pdf); CAL. STATE WATER RES. CONTROL BD., RESOLUTION NO. 2009-0011, ADOPTION OF A POLICY FOR WATER QUALITY CONTROL FOR RECYCLED WATER (2009), [http://www.waterboards.ca.gov/board\\_decisions/adopted\\_orders/resolutions/2009/rs2009\\_0011.pdf](http://www.waterboards.ca.gov/board_decisions/adopted_orders/resolutions/2009/rs2009_0011.pdf) [hereinafter *QUALITY CONTROL FOR RECYCLED WATER*]. In addition, Governor Brown recently signed Senate Bill 322 (October 8, 2013), which directs the California Department of Public Health to develop uniform water recycling criteria for direct potable reuse. S.B. 322, 2013–14 Reg. Sess. (Cal. 2013) (enacted).

90. *QUALITY CONTROL FOR RECYCLED WATER*, *supra* note 89.

91. Water agencies in Orange and Los Angeles Counties infiltrate tertiary-treated wastewater into local aquifers. See ORANGE CNTY. WATER DIST., GROUNDWATER REPLENISHMENT SYSTEM, <http://www.gwrssystem.com/images/stories/AboutGWRs/GWRs%20Technical%20Brochure.pdf>; *Recycled Water*, W. BASIN MUN. WATER DIST., <http://www.westbasin.org/water-reliability-2020/recycled-water/about-recycled-water> (last visited Aug. 1, 2014). The City of San Diego is considering blending highly treated wastewater into its potable water supplies. CITY OF SAN DIEGO PUB. UTILS. DEP’T, LONG-RANGE PLANNING & WATER RES. DIV., FACT SHEET: WATER PURIFICATION DEMONSTRATION PROJECT (2013), <http://www.sandiego.gov/water/pdf/waterreuse/prdemo.pdf>.

92. *MANAGING CALIFORNIA’S WATER*, *supra* note 2, at 270.

large investor-owned water utilities adopted tiered rate structures in the late 2000s as a means of promoting conservation.<sup>93</sup>

BOX 2: ALLOCATION-BASED CONSERVATION WATER PRICING  
(CALIFORNIA WATER CODE §§ 370–374)

In 2008, the California Legislature expressly authorized public water supply agencies to use “allocation-based conservation water pricing.” Under this type of pricing system, the water rate includes:

- A basic (or base) charge per volumetric unit of water service. The amount of water covered by the basic charge may vary by customer class or by individual water service connection. The factors that an agency may use to determine each customer’s (or class of customers’) basic allocation may include “the number of occupants, the type or classification of use, the size of lot or irrigated area, and the local climate data for the billing period.” *Id.* § 371(b).
- A conservation charge per volumetric unit of water service that is in excess of the basic charge. The agency can choose to have one or more conservation charges. The increment between the basic charge and the conservation charges (and the increments between ascending conservation charges) may be fixed or variable; they also may ascend in uniform or non-uniform increments. The only legal requirement is that the “volumetric prices for the lowest through the highest priced increments shall be established in an ascending relationship that is economically structured to encourage conservation and reduce the inefficient use of water.” *Id.* § 372(a)(4).

The legislature thus granted public water suppliers significant discretion to enact tiered water rates. Consistent with Proposition 218, the law does state that “[r]evenues derived from allocation-based conservation water pricing shall not exceed the reasonable cost of water service including basic costs and incremental costs.” *Id.* § 373(a). It also provides that the rates charged to individual customers or class of customers shall not exceed the reasonable cost of water service to them individually, taking into account their basic use allocations, meter size, metered volume of water consumed, and the goals of achieving conservation and efficient use. *Id.* § 373(b). As noted in the text, the legislature expressly declared that allocation-based conservation water pricing “is one effective means by which waste or unreasonable use of water can be prevented and water can be saved in the interest of the people and for the public welfare, within the contemplation of section 2 of article X of the California Constitution.” *Id.* § 370(a).

“Allocation-based rate structures have been successful for several Southern California utilities since the early 1990s, including the City of Los Angeles and the Irvine Ranch Water District.” *MANAGING CALIFORNIA’S WATER*, *supra* note 2, at 272. The Eastern Municipal Water District, the Coachella Valley Water District, and the Rincon del Diablo Water District have also recently adopted allocation-based conservation pricing. For more information about these rate programs and other types of tiered water rate structures, see *id.* at 270–73.

Agencies with allocation-based tiers typically use revenues from the upper tiers to fund conservation programs within the service area. The Irvine Ranch Water District (“IRWD”) also uses some of these revenues to capture and treat polluted runoff that results from overwatering of outdoor landscapes. In Assembly Bill 810, enacted in 2001, the legislature granted IRWD and another Orange County water supplier, the Santa Margarita Water District, authority to include stormwater management among its mandates to be able to carry out this program. *CAL. WATER CODE* § 35539.10–35539.16 (West 2014). This legislation did not authorize similar activities by other water districts in the state, however.

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93. *Id.* at 273.

To respond to the judicial decisions on water rate structures—and to help ensure that the strictures of Proposition 218 do not interfere with innovative and responsible water management—public retail water agencies will have to alter their administrative practices in two important ways. First, water agencies will have to explain their ratemaking processes and decisions in a relatively simple way that will allow lay readers—interested members of the public and the judges who will ultimately review agency decisions—to understand how and why the agency made the choices that it did. This explanation, of course, will include the water management studies, economic analyses, cost accounting, environmental review, and other materials that constitute the administrative record. But it also must include a narrative explanation that simplifies these details so that individuals who are not schooled in engineering, economics, accounting, or other technical disciplines may understand both the ratemaking process and the agency’s final decision to adopt a particular fee, charge, or rate structure. To the extent that Proposition 218 and its judicial interpretations cause greater transparency in ratemaking, they will serve as positive contributions.

Second, water agencies will have to include in the administrative record detailed ratemaking studies that explain how proposed new fees, charges, and rate structures are consistent with the substantive standards of Proposition 218. Thus, an agency that seeks to create a fee, increase rates to pay for additional water supplies, or create a new conjunctive use program will have to prove that the charges do not exceed the capital and operating costs of the program and that it will use the revenues exclusively to fund construction and administration of the program. The agency also will have to prove that the new charges are proportional to the cost of providing service to each parcel (or class of parcels) and demonstrate how the program will benefit all of its customers who are subject to the new charges—for example, by providing greater security and reliability in water service. In addition, the agency will have to demonstrate that the charges do not distinguish between or among customers for reasons other than differences in cost of service. As the court of appeal held in *Palmdale*, an agency may not justify a fee or rate differential between or among classes of customers based on type of water user or comparative ability to pay.<sup>94</sup>

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94. In its recent decision in *Morgan v. Imperial Irrigation District*, the California Court of Appeal explained that the question of whether an agency has adequately explained and justified increases in water rates based on the cost of service to individual parcels or customer classes is primarily a question of fact and that the trial courts must uphold the rates if they are supported by substantial evidence in the administrative record. *See generally* 167 Cal. Rptr. 3d 687 (Cal. Ct. App. 2014). The court also held that, although Proposition 218 requires the agency to produce reliable data on water use and cost of service, the law “does not require perfection.” *Id.* at 708.

The transparency requirements of Proposition 218 do not, in and of themselves, require any changes in rate structures. In contrast, the law's substantive standards may force public retail water agencies to make significant changes in how they structure their rates. For example, the *Palmdale* court's rejection of the district's tiered rate structure—because it created steeper tiered rates for irrigation and commercial uses than for residential uses—legitimately calls into question the social utility of allowing water rate structures (either expressly or inadvertently) to deviate significantly from the cost of providing the service to which they are attached.

Public retail water agencies therefore will have to explain why they charge some classes of customers (such as agricultural users) different rates than other customers. Lower rates for irrigation supplies (once a common practice for agricultural customers within water agencies that serve a diverse customer base) may still be justified based on differences in cost of service—for example, where agricultural users receive raw water while residential and commercial customers receive treated water, or where some lower-priced water is available only on an interruptible basis. An agency could easily justify such rate distinctions because raw water does not include the capital and operating costs of treating water for delivery to domestic customers, and interruptible service requires fewer capital costs because the agency does not have to build its infrastructure and water supply portfolio to the same size that it would have if it had to provide firm supplies to all customers.

The *Palmdale* decision may also cast doubt on a public retail water agency's authority to enact a less expensive "water lifeline" rate for guaranteed water supplies to low-income customers if the rates charged to these customers are less than those charged to other residential customers and the agency cannot explain the rate difference on the basis of differences in cost of service.<sup>95</sup> For example, agencies with a flat water rate structure—which either charge a fixed monthly fee per connection or a single volumetric rate for water service that does not increase with consumption—will have a difficult time justifying the lifeline rate because there is no cost of service difference between its lifeline customers and its general customers. In contrast, an agency that has

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95. The argument against enactment of Proposition 218, set forth in the Official Voter Information Guide, stated that the initiative could eliminate lifeline utility support for seniors and disabled citizens. *Proposition 218: Argument Against Proposition 218*, CALIFORNIA BALLOT PAMPHLET: GENERAL ELECTION NOV. 5, 1996 at 77. Proponents of the initiative responded that "[l]ifeline' rates for elderly and disabled for telephone, gas, and electric services are NOT affected." *Proposition 218: REBUTTAL TO Argument Against Proposition 218*, CALIFORNIA BALLOT PAMPHLET: GENERAL ELECTION NOV. 5, 1996 at 77. They did not mention lifeline rates for water service. We are not aware of any Proposition 218 challenges to lifeline programs to date, but they are potentially vulnerable under the current law.

tiered water rates could justify the rate difference by having a low base (that is, “lifeline”) rate that applies to all customers regardless of their income. (As noted above, however, these agencies may face Proposition 218 challenges in establishing the higher tiers for increased levels of water use if they cannot be justified by the costs of service.) The only unambiguously lawful way to provide lifeline services is to use other pre-existing revenue sources—such as property tax proceeds—to pay for subsidized lifeline rates or to enact a new special tax (with a two-thirds supermajority of local voter support) to fund the lifeline program.

In addition to these changes in ratemaking and expenditure, the substantive standards of Proposition 218 may create significant difficulties for public retail water agencies that seek to diversify their water supply portfolios if the courts interpret them literally without regard to the realities of contemporary water resources management. The *Capistrano* case provides a useful illustration.

The superior court struck down the recycled water charge because it applied to all of the city’s customers, while only some had access to the recycled water itself.<sup>96</sup> Yet, the city offered a persuasive justification for the system-wide charge: the provision of recycled water to some customers (predominately irrigation users) reduces aggregate demand for more expensive imported potable supplies.<sup>97</sup> All customers therefore benefit from the recycled water charge because this enables the city: (1) to reduce its reliance on an increasingly unreliable source (imported Delta and Colorado River water supplied by the Metropolitan Water District through the Municipal Water District of Orange County); (2) to lower system-wide water rates; (3) to reduce its ocean discharges of treated wastewater; and (4) to enhance the reliability of its overall water supply portfolio.

The court’s rejection of this justification for the recycled water charge—on the basis that it violates the Proposition 218 requirement that the water service “is actually used by, or immediately available to, the owner of the property in question”—ignores the realities of contemporary integrated water resources management in which multiple sources (including native surface supplies, imported water, groundwater, recycled water, and in some cases desalinated water) constitute the agency’s water supply portfolio.<sup>98</sup> Indeed, if the *Capistrano* analysis were followed by other courts, the result would be a balkanization of water rates that would force agencies to “dis-integrate” the rates they charge to

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96. Proposed *Capistrano* Decision, *supra* note 77.

97. Recycled water is not yet available for direct potable use in California and therefore must be supplied through a parallel plumbing system for non-potable uses (e.g., irrigation and some industrial purposes).

98. Proposed *Capistrano* Decision, *supra* note 77, at 4.

individual customers for integrated water service whenever some customers have different access to different sources of water.

Fortunately, the California Court of Appeal recently issued a countervailing (and controlling) interpretation of Proposition 218. *Griffith v. Pajaro Valley Water Management Agency* addressed the legality of that agency's groundwater augmentation charge in light of Proposition 218's substantive standards, and is therefore analyzed in Part II.D.<sup>99</sup> For now, we simply note that the court of appeal in *Griffith* took a dramatically different view of water service than the superior court in *Capistrano*, recognizing that water service is an integrated activity in which agencies draw from a portfolio of sources that include surface water, groundwater, recycled water, stormwater, and water conservation and other demand reduction programs.<sup>100</sup> If other courts adopt this more realistic understanding, then they will avoid applications of Proposition 218 that risk stifling creative and prudent contemporary water resources management.

#### B. PROPOSITION 26 AND WHOLESALE WATER RATES

Wholesale water agencies are important components of California's water delivery system. The State Water Project is a wholesale agency that delivers water from the Feather River and the Sacramento-San Joaquin River Delta to twenty-nine public agencies in the Sacramento Valley, the Bay Area, the Central Valley, the Central Coast, and Southern California.<sup>101</sup> The Metropolitan Water District of Southern California ("MWD") supplies State Water Project and Colorado River water acquired from the U.S. Bureau of Reclamation to twenty-six agencies that serve nineteen million customers throughout Southern California.<sup>102</sup> The San Diego County Water Authority ("SDCWA") provides wholesale water service to twenty-four member agencies in San Diego County.<sup>103</sup> The San Francisco Public Utilities Commission supplies water from the Tuolumne River system and local sources to twenty-seven cities and other retail water purveyors.<sup>104</sup> The Kern County Water

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99. See generally *Griffith v. Pajaro Valley Water Mgmt. Agency*, 163 Cal. Rptr. 3d 243 (Cal. Ct. App. 2013).

100. See *id.* at 251–52.

101. *California State Water Project Overview*, CAL. DEP'T OF WATER RES., <http://www.water.ca.gov/swp> (last modified Aug. 11, 2010).

102. METRO. WATER DIST. OF S. CAL., *THE DISTRICT AT A GLANCE I* (2014), [http://www.mwdh2o.com/mwdh2o/pages/news/at\\_a\\_glance/mwd.pdf](http://www.mwdh2o.com/mwdh2o/pages/news/at_a_glance/mwd.pdf)

103. *FAQ and Key Facts*, SAN DIEGO CNTY. WATER AUTH., <http://www.sdewa.org/frequently-asked-questions-and-key-facts> (last visited Aug. 1, 2014).

104. *Water: Overview*, SAN FRANCISCO WATER POWER SEWER, <http://www.sfwater.org/index.aspx?page=355> (last visited Aug. 1, 2014). The number twenty-seven includes the city of San Francisco as a customer.

Agency delivers water to thirteen predominantly agricultural water districts.<sup>105</sup> Other wholesale suppliers are located around California.<sup>106</sup>

Proposition 26 may affect wholesale ratemaking and wholesale water rates. In contrast to Proposition 218, Proposition 26 applies to *all* levies and charges—not just those imposed by local government agencies as an incident of property ownership or for a property-related service—and it defines these charges as taxes unless they fall within a specific statutory exemption. Those exemptions include “[a] charge imposed for a specific government service . . . provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the State [or local government] of providing the service.”<sup>107</sup>

Although this language probably does not allow retail customers to challenge wholesale water rates (because wholesale water service, by definition, is not “provided directly to” the retail ratepayer), it may allow retail water agencies who purchase directly from the wholesaler to claim that a fee or charge is unlawful because it exceeds the reasonable costs of providing the wholesale water service. Wholesale agencies have countered that Proposition 26 applies only to levies and charges that are “imposed” by government agencies. In the usual cases where wholesale water rates are negotiated rather than imposed, they argue, Proposition 26 does not apply.

These interpretations of Proposition 26 are being tested in ongoing litigation between SDCWA and MWD. SDCWA alleges *inter alia* that the wholesale water rates that MWD adopted for 2013 and 2014 violate Proposition 26 because the rates exceed the cost of service to SDCWA.<sup>108</sup> San Diego also alleges that MWD failed to demonstrate that the rates bear a “fair and substantial relationship” to the burdens and benefits received by each member agency and unlawfully discriminate against SDCWA.<sup>109</sup> Two of these claims are especially relevant to this

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105. *Member Units*, KERN COUNTY WATER AGENCY, [http://www.kcwa.com/about\\_kcwa/districts.shtml](http://www.kcwa.com/about_kcwa/districts.shtml) (last visited Aug. 1, 2014).

106. The Central Valley Project, which is owned and operated by the U.S. Bureau of Reclamation, delivers water from the Trinity, Sacramento, and San Joaquin River basins for irrigation and municipal and industrial uses in the Central Valley and portions of the Bay Area. *Central Valley Project*, BUREAU OF RECLAMATION, U.S. DEPT. OF THE INTERIOR, [http://www.usbr.gov/projects/Project.jsp?proj\\_Name=Central+Valley+Project](http://www.usbr.gov/projects/Project.jsp?proj_Name=Central+Valley+Project) (last modified Mar. 15, 2013). The Bureau supplies most of this water on a wholesale basis to irrigation districts, water agencies, and cities. The rates for this water are set by federal law. *See* Reclamation Reform Act, 43 U.S.C. §§ 390aa–390zz1 (2011); Central Valley Project Improvement Act, Pub. L. No. 102-575, §§ 3404(c)(3), 3405(a)(1)(C), 3405(d), 3405(f), 3406(c)(1), 3407(c), 106 Stat. 4706 (1992).

107. CAL. CONST. art. XIII A, § 3, cl. b, pt. 2; *id.* XIII C, § 1, cl. e, pt. 2.

108. San Diego County Water Authority’s Petition for Writ of Mandate and Complaint for Determination of Invalidity, Damages, and Declaratory Relief at 19, *San Diego Cnty. Water Auth. v. Metro. Water Dist. of S. Cal.*, No. 10-510830 (Cal. Super. Ct. June 8, 2012).

109. *Id.* at 20.

Article. First, MWD unlawfully defines the “water stewardship rate” that it charges member agencies as a transportation charge, even though it funds water conservation and regional water supply development within the MWD service area.<sup>110</sup> Second, the water stewardship rate overcharges SDCWA because other member agencies receive most of the benefits of the program.<sup>111</sup> For these reasons, SDCWA contends that MWD’s wholesale water service rates are a special tax, which must be approved by a two-thirds vote of the voters in MWD’s service area.<sup>112</sup>

Following a five-day trial on these claims, the San Francisco Superior Court invalidated MWD’s wholesale water rates. It first held that Proposition 26 applies because MWD “imposes” its wholesale rates on its member agencies.<sup>113</sup> Although MWD “negotiated” the rates with its members, SDCWA and the other members had no power to decline the rates ultimately set by MWD if they wanted to receive or wheel water.<sup>114</sup> The court then concluded that the administrative record did not establish a valid relationship between the water stewardship rate and the benefits that MWD provides to its individual member agencies from the proceeds of the fee.<sup>115</sup>

The court stated that the water stewardship rate “recovers the costs of ‘demand management programs,’ and those in turn provide incentives for recycling, groundwater recovery, desalinization programs, and other water conservation efforts.”<sup>116</sup> It also acknowledged that these programs benefited all of MWD’s members by reducing demand and allowing MWD in turn to reduce its purchases of imported water: “The record shows that at least the primary benefit of these programs is the creation of new water ‘supply.’”<sup>117</sup> The court nonetheless invalidated the water stewardship rate under Proposition 26 because MWD had failed to explain why the rate should be charged as a transportation cost: “It is certainly reasonable to conclude that transportation capacity needs are reduced when supply needs are reduced, including reductions attributable to the demand management programs. . . . But the record does not show correlation between those avoided costs and water stewardship rates.”<sup>118</sup>

The superior court’s decision provides a useful illustration of how Proposition 26 may affect wholesale water rates and ratemaking. The

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110. *Id.* at 3.

111. *Id.* at 20.

112. *Id.* at 19–20.

113. Tentative Determination and Proposed Statement of Decision on Rate Setting Challenges at 48, *San Diego Cty. Water Auth. v. Metro. Water Dist. of S. Cal.*, No. 10-510830 (Cal. Super. Ct. Feb. 25, 2014).

114. *Id.*

115. *Id.* at 59–60.

116. *Id.* at 58.

117. *Id.* at 58–59.

118. *Id.* at 60.

court determined that Proposition 26 applies to wholesale rates, and it insisted on clarity, transparency, and rigor in wholesale ratemaking decisions—just as the courts have done in reviewing retail ratemaking under Proposition 218. If affirmed on appeal, the court’s decision would require wholesale water providers to justify specific charges on the basis of cost of service, and probably compel wholesale agencies to explain differences in rates among their member agencies, as well as the use of single or common rates where either water service or the cost of such service may differ among member agencies.

Yet, the court was also mindful that ratemaking is a complex task involving the allocation of large fixed costs, and that wholesale agencies must have some discretion to decide how best to fund projects and programs that are part of their integrated water portfolios. Although it struck down MWD’s water stewardship rate because it was unjustifiably tied to water transportation charges, the court’s recognition that all member agencies benefit from fees that encourage and fund water conservation, recycling, desalination, and integrated groundwater management is an especially valuable contribution to our understanding of Proposition 26.

#### C. THE SPECIAL CHALLENGES OF FUNDING STORMWATER MANAGEMENT

Proposition 218 has created special challenges for the funding of stormwater management programs. The courts have held that local stormwater discharge fees are subject to the law’s voter approval and other procedural requirements.<sup>119</sup> The substantive standards of Proposition 218 may also require many stormwater discharge fees to be enacted as “special taxes” that require a two-thirds vote of the electorate.<sup>120</sup>

The U.S. Environmental Protection Agency and California’s Regional Water Quality Control Boards have recently tightened National Pollution Discharge Elimination System permit standards for stormwater discharges.<sup>121</sup> As a result, many cities and water agencies now must find ways to fund the necessary expenditures through rate increases, fees, property assessments, or special taxes. Proposition 218 has restricted most local stormwater agencies’ ability to fund stormwater management through fees or assessments. Our interviews with stormwater managers in August and September 2013 revealed that it has been challenging for agencies to gain the political support needed to gain

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119. See *Howard Jarvis Taxpayers Ass’n v. City of Salinas*, 121 Cal. Rptr. 2d 228 (Cal. Ct. App. 2002).

120. CAL. CONST. art. XIII C, § 2, cl. d.

121. CAL. REG’L WATER QUALITY CONTROL BD., SAN FRANCISCO BAY REGION: MUNICIPAL REGIONAL STORMWATER NPDES PERMIT (2011).

property-owner or general voter approval of new funds to pay for stormwater programs.<sup>122</sup>

In *Howard Jarvis Taxpayers Association v. City of Salinas*, the California Court of Appeal ruled that the city's storm drainage fee was a "property-related" fee that required voter approval under Proposition 218.<sup>123</sup> The city had imposed the fee on all parcels based on their percentage of impervious area—that is, portions of the land with structures and pavement that prevent or diminish absorption of precipitation and runoff, and thereby contribute water to the city's stormwater system.<sup>124</sup> The city proposed to use the proceeds of the fee to finance improvements to storm and surface water management facilities as required by state and federal water quality and discharge standards.<sup>125</sup>

The court rejected the city's argument that the fee was levied on the basis of the fee payers' use of the stormwater system, rather than land ownership.<sup>126</sup> It then invalidated the fee because the city had not complied with the voter approval requirements of Proposition 218.<sup>127</sup> The court also rejected the city's contention that the stormwater drainage fee was a fee for water or sewer service under section 6(e) of Proposition 218 and was thus exempt from the election requirements.<sup>128</sup> It reasoned that the voters who enacted the initiative probably understood the terms "water and sewer service" to embrace only water supply and removal of waste from homes and businesses and not as a "program that monitors storm water for pollutants, carries it away, and discharges it into the nearby creeks, river, and ocean."<sup>129</sup>

The *Salinas* decision thus requires agencies that seek to increase fees or to impose new charges to pay for capital improvements to separate stormwater systems—that is, those that only carry stormwater—to submit the proposed fees and charges to the affected property owners or voters for approval.<sup>130</sup> Municipal public works departments and other

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122. See *PAYING FOR WATER*, *supra* note 1, at 25–28.

123. *Howard Jarvis Taxpayers Ass'n*, 121 Cal. Rptr.2d at 229.

124. *Id.*

125. *Id.*

126. *Id.* at 230.

127. *Id.* at 233–34.

128. *Id.*

129. *Id.* at 234. The court's surmise of voter intent is reinforced by the reference in the assessments section of Proposition 218 to "sewers, water, flood control, [and] drainage systems." CAL. CONST. art. XIIIID, § 5, cl. a. The drafters' separation of "flood control" and "drainage" from "water" and "sewer" in this section indicates that they did not intend that the exemption of "fees or charges for sewer [and] water" from the election requirements of section 6(c) would implicitly incorporate either of the two primary functions of stormwater management—*viz.*, flood control and drainage.

130. All but two of California's stormwater systems are separate. San Francisco and Sacramento have combined systems that carry both treated sewage and stormwater. These combined systems probably fall within Proposition 218's election exemption for fees and charges for "water, sewer, or refuse collection services." CAL. CONST. art. XIIIID, § 6, cl. c.

stormwater management agencies have found it difficult to persuade property owners within their jurisdiction to vote for fees and assessment to support new stormwater expenditures.<sup>131</sup> Stormwater pollution programs are designed to mitigate flooding and pollution caused or exacerbated by land use and other activities. Yet, property owners have few incentives to approve charges for these services, which do not directly benefit them or their property in proportion to their share of the costs of the fee. For these reasons, many independent stormwater agencies have continued to finance these programs through general fund revenues and grants.<sup>132</sup> As the costs of stormwater management increase with new pollution prevention mandates, however, the existing funding pool is becoming increasingly inadequate. In addition to seeking funds from property owners, alternatives include the enactment of new special taxes, and state or local regulatory fees.<sup>133</sup> Inasmuch as stormwater is collected and channeled by a variety of sources—including impervious private land, but also streets and highways and other sources of pollutants such as litter—multiple funding sources are appropriate.<sup>134</sup>

Although the *Salinas* court did not address the substantive requirements of Proposition 218, these, too, may present obstacles to

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131. It appears that only twelve cities or counties have attempted property-owner ballot measures for stormwater assessments or fees since the enactment of Proposition 218. Measures passed in seven of these: San Clemente (2002, 2007, 2013), Palo Alto (2005, after a failed attempt in 2003), Rancho Palos Verdes (2005, then recalled and reduced in 2007), Ross Valley (2007, but later overturned by lawsuit), Solana Beach (2007), Burlingame (2009), and Santa Clarita (2009). Communities where elections have failed include: Carmel (2003), Encinitas (2005), Woodland (2007), Stockton (2009), and Contra Costa County (2012). See *PAYING FOR WATER*, *supra* note 1, app. E at 44 n.70 (information provided by SGI Consulting Group). In 2012, Los Angeles County supervisors decided not to proceed with an election following protests at the rate hearing (the first part of the two-part Proposition 218 election process). As described in Appendix E, some localities have been successful at passing other types of ballot measures. Notably, in 2004, Los Angeles City voters approved Measure O, a \$500 million bond to support stormwater programs, funded by an increment on local property tax bills. As described in Box 3, *INFRA*, San Mateo County voters approved transportation-related charges in 2005 to support stormwater programs by simple majority vote under special authorization from the legislature. A few communities have passed special taxes focused on stormwater (Ferndale and Corte Madera in 1997, Santa Monica in 2006, and Santa Cruz in 2008), and nine have passed special taxes or GO bonds for stormwater management along with local road improvements. Some communities have also enacted new general taxes that include stormwater among many other functions. See *PAYING FOR WATER*, *supra* note 1, app. E at 9 tbl.E1.

132. Expenditures on stormwater and urban runoff management are usually embedded in the budgets of municipal public works departments, and it is not possible to separately identify the sources of funding for these activities. See *PAYING FOR WATER*, *supra* note 1, at app. B. Our discussions with stormwater managers in August and September 2013 revealed that these programs face serious funding challenges and are most commonly funded by a combination of general fund resources, grandfathered (pre-Proposition 218) stormwater charges, and grants. See *id.* at app. E (providing examples of successful new revenue measures).

133. As described above, special taxes must be passed by a two-thirds majority vote of local taxpayers; a majority of the California legislature must approve statewide fees, while local fees require majority approval by local governing boards. See *supra* Table 1.

134. See *infra* Box 3.

those agencies that choose to fund stormwater improvements through fees or assessments.<sup>135</sup> For example, opponents of a stormwater fee, such as the one at issue in *Salinas*, could argue that the amount of the fee “exceed[s] the proportional cost of the service attributable to the parcel[s]”<sup>136</sup> covered by the charge or that the stormwater service funded by the fee “is available to the public at large in substantially the same manner as it is to [the] property owners” who are subject to the fee.<sup>137</sup> Similarly, opponents of a stormwater assessment may question whether the properties subject to the assessment in fact “receive a special benefit over and above the benefits conferred on the public at large”<sup>138</sup> and that the amount of the assessment “is proportional to, and no greater than, the benefits conferred on the [assessed] . . . properties.”<sup>139</sup>

But these substantive standards of Proposition 218 also suggest that the “fee for services” theory of stormwater financing may be misguided. Instead, a better way to analyze stormwater discharge fees may be to view them as regulatory fees that are designed to compel all who contribute to stormwater collection and channelization to pay their fair share of the costs of addressing the flooding or pollution problems that they create or exacerbate. Regulatory fees are now governed by Proposition 26, and we address the potential benefits of regulatory fees for stormwater discharges following an analysis of the effects of Propositions 218 and 26 on groundwater management.

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135. *Howard Jarvis Taxpayers Ass’n v. City of Salinas*, 121 Cal. Rptr. 2d 228, 228 (Cal. Ct. App. 2002).

136. CAL. CONST. art. XIID, § 6, cl. b, pt. 3.

137. *Id.* § 6, cl. b, pt. 5.

138. *Id.* § 4, cl. f.

139. *Id.*

BOX 3: THE SAN MATEO COUNTY MOTOR VEHICLE LICENSE FEE AND FUNDING FOR  
STORMWATER MANAGEMENT

In the early 1990s, the cities and county governments in San Mateo County decided to place responsibility for their stormwater programs under the management of the City/County Association of Governments of San Mateo County (“CCAG”), a joint powers authority with voting representatives of elected officials from the county and each city government, which has responsibilities for traffic congestion management and several other functions. In 2004, the California Legislature authorized CCAG, by a vote of its members representing two-thirds of the county’s population, to enact an annual four dollars per vehicle registration fee surcharge to fund programs to reduce traffic congestion and stormwater pollution management from 2005 to 2009. CITY/CNTY. ASS’N OF GOV’TS OF SAN MATEO CNTY., FINAL SAN MATEO COUNTY CONGESTION MANAGEMENT PROGRAM 11-1 (2011). Subsequent legislation extended the surcharge an additional four years. CAL. GOV’T CODE § 65089.11–65089.15 (West 2014). One purpose of the law was to fund stormwater regulation and management so as to enable the San Mateo governments to comply with their regional National Pollution Discharge Elimination System permit for stormwater discharges under the federal Clean Water Act. The state law provided, however, that only “stormwater pollution prevention programs that directly address the negative impact on creeks, streams, bays, and the ocean caused by motor vehicles and the infrastructure supporting motor vehicle travel are eligible for funding.” *Id.* § 65089.12(d).

The San Mateo governments enacted the fee in 2005, which was collected by the California Department of Motor Vehicles. CAL. VEH. CODE § 9250.5 (West 2014). During the eight years it was in effect, the fee raised approximately twenty million dollars, half of which was allocated to stormwater regulation and management throughout the county. The legislature did not extend its authorization of the fee beyond January 1, 2013. It did pass a law in 2010, however, that authorized all congestion management agencies to levy a ten-dollar surcharge on vehicle registrations to support stormwater and congestion management with a simple majority vote of the public. CAL. GOV’T CODE § 65089.20 (West 2014). San Mateo County voters approved this new surcharge in the November 2010 election by a fifty-five percent majority. FINAL SAN MATEO COUNTY CONGESTION MANAGEMENT PROGRAM, *supra*, at 11–7. The surcharge generates about six million dollars annually. Half of the revenues are allocated to local agencies and are used for stormwater or traffic congestion management. Another twelve percent goes to CCAG for countywide stormwater programs, while the remainder is assigned to various local transportation programs (such as mass transit and senior mobility). The San Mateo County motor vehicle stormwater fee is an important example of integrated management of stormwater, and it represents an effective way to ensure that road and highway users contribute to the costs of stormwater discharge prevention. The vehicle license fee does not fully resolve the funding problem, however, and CCAG is now evaluating a special tax or property-related fee to help fill the gap.

#### D. PROPOSITION 218 AND GROUNDWATER MANAGEMENT

As with stormwater discharges, groundwater management raises special problems under Proposition 218. Two cases—both involving the Pajaro Valley groundwater basin, a coastal aquifer in Santa Cruz County—illustrate and largely define these challenges.

The legislature created the Pajaro Valley Water Management Agency in 1984 to address persistent problems of overdraft, well-lowering, and seawater intrusion in the coastal reaches of the freshwater

aquifer.<sup>140</sup> The agency responded to these problems by enacting a “groundwater augmentation charge” on the extraction of groundwater from the basin.<sup>141</sup> One purpose of the charge was to create a financial disincentive to pump groundwater that, in the aggregate, would exceed the safe yield.<sup>142</sup> A second purpose was to raise funds to support a variety of conjunctive water management programs that help to prevent overdraft and saltwater intrusion.<sup>143</sup> These include creation of a water recycling program that treats wastewater for blending into the native waters of the aquifer, a program to capture stormwater to recharge the aquifer, and construction of a coastal distribution system to distribute this blended water to agricultural users along the coast both for direct water supply and for basin recharge to repel sea water intrusion.<sup>144</sup>

The first groundwater augmentation charge, adopted in 2002, was eighty dollars per acre-foot. The agency increased the charge in 2003 to \$120, and again in 2004 to \$180 per acre-foot.<sup>145</sup> Because it believed that Proposition 218 did not apply to groundwater extraction fees, the agency adopted each of these charges without submitting the matter to the affected property owners and voters as required by that law.<sup>146</sup>

In *Pajaro Valley Water Management Agency v. Amrhein*, the California Court of Appeal held that the groundwater augmentation charge is a “property-related fee” and therefore is subject to Proposition 218.<sup>147</sup> The court had previously concluded that the groundwater extraction fee was not related to the ownership of property “because it is imposed not on property owners as such, or even well owners as such, but on persons *extracting groundwater* from the basin.”<sup>148</sup> This was unquestionably true, as the fee applied both to groundwater extractors whose rights are based on their ownership of land overlying the aquifer and to appropriators whose water rights are based solely on the act of pumping the groundwater.<sup>149</sup> Nevertheless, the court felt constrained, by the California Supreme Court’s decision in *Bighorn-Desert View Water Agency v. Verjil*, to hold that groundwater pumping is an incident of property ownership and therefore the fee is subject to Proposition 218.<sup>150</sup> The court of appeal also noted that “the charge here is not actually predicated upon the *use* of water but on its *extraction*, an activity in some

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140. *Pajaro Valley Water Mgmt. Agency v. Amrhein*, 59 Cal. Rptr. 3d 484, 486–87 (Cal. Ct. App. 2007).

141. *Id.* at 487–89.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.* at 489.

146. CAL. CONST. art. XIII C.

147. *Amrhein*, 59 Cal. Rptr. 3d at 497–98.

148. *Id.* at 498.

149. *Id.*

150. *Bighorn-Desert View Water Agency v. Verjil*, 138 P.3d 220 (Cal. 2006)

ways more intimately connected with property ownership than is the mere receipt of delivered water.”<sup>151</sup> Because the agency had not complied with the public notice requirements of Proposition 218, the court invalidated the groundwater augmentation charge.<sup>152</sup>

Following the *Amrhein* decision, the agency repealed the 2003 and 2004 charges and entered into a settlement agreement that paid \$1.8 million to the plaintiffs who had brought that lawsuit and related litigation.<sup>153</sup> In 2010, it enacted a new groundwater augmentation charge, this time attempting to follow the Proposition 218 public notice and election requirements.<sup>154</sup> A group of landowners, many of whom were plaintiffs in the earlier litigation, sued, claiming *inter alia* that the weighted voting procedures adopted by the agency were unlawful and that the new charges violated the substantive standards of Proposition 218.<sup>155</sup>

In *Griffith v. Pajaro Water Management Agency*, the California Court of Appeal held that, because the groundwater augmentation charges are “fees for water service,” they are exempt from the voter approval requirements of Proposition 218.<sup>156</sup> More importantly, the court also rejected the claims that the 2010 groundwater augmentation charge violated the substantive standards of Proposition 218.<sup>157</sup> In contrast to the *Capistrano* court’s interpretation of these standards,<sup>158</sup> the court of appeal applied the standards in a way that reflects an understanding of the realities of contemporary portfolio-based water resources management.

For example, the court rejected the plaintiffs’ argument that, because they did not use the blended water produced by the recycled water program, they could not be charged a groundwater extraction fee that supported this program.<sup>159</sup> The court responded that this argument “overlooks that ‘the management of the water resources... for

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151. *Amrhein*, 59 Cal. Rptr. 3d at 502–03.

152. *Id.* at 504.

153. *Griffith v. Pajaro Valley Water Mgmt. Agency*, 163 Cal. Rptr. 3d 243, 249 (Cal. Ct. App. 2013).

154. The Agency held an election in addition to providing public notice, because the earlier case had not ruled on whether it was providing a water service that would have been exempt from Proposition 218’s election requirements, only that the service was property-related. The 2010 charge is comprised of three categories: “\$195 per acre-foot for metered wells inside the coastal delivered-water zone, \$162 per acre-foot for metered wells outside the delivered-water zone (primarily municipal, industrial, and agricultural users), and \$156 per acre-foot for unmetered wells (primarily rural residential).” *Id.* at 249 n.4. The agency also adopted a \$306 per acre-foot charge for water that it delivered to customers. *Id.*

155. *Id.* at 249.

156. *Id.* at 251; see CAL. CONST. art. XIII D, § 6, cl. c. Although, like water and sewer services, groundwater augmentation charges are subject to the public hearing and notice requirements of the law.

157. *Griffith*, 163 Cal. Rptr. 3d at 251.

158. See generally Proposed *Capistrano* Decision, *supra* note 77.

159. *Griffith*, 163 Cal. Rptr. 3d at 253–54.

agricultural, municipal, industrial, and other beneficial uses is in the public interest” and that the agency “was created to manage the resources ‘for the common benefit of all water users.’”<sup>160</sup> Additionally, it “overlooks that the augmentation charge pays for ‘the activities required to prepare or implement any groundwater management program.’”<sup>161</sup>

The court also rejected the plaintiffs’ contention that the trifurcated augmentation charge<sup>162</sup> was not sufficiently tailored to the cost of service to each parcel. It reasoned:

Given that Proposition 218 prescribes no particular method for apportioning a fee or charge other than the amount shall not exceed the proportional cost of the service attributable to the parcel, defendant’s method of grouping similar users together for the same augmentation rate and charging the users according to usage is a reasonable way to apportion the cost of service. That there may be other methods favored by plaintiffs does not render defendant’s method unconstitutional. Proposition 218 does not require a more finely calibrated apportion.<sup>163</sup>

Finally, the court dismissed the plaintiffs’ claim that the groundwater augmentation charge violated Proposition 218 because its proceeds benefit everyone who uses water within the agency’s purview, not simply those who extract groundwater.<sup>164</sup> The agency “is not using money from the augmentation charge for general governmental service,” the court concluded.<sup>165</sup> Rather, “it is using the money to pay for the water service provided.”<sup>166</sup>

*Griffith* brings much-needed realism to the judicial application of Proposition 218 to water resources management. The court recognized that water service is a multifaceted and integrated endeavor and that component activities—such as management of native surface and groundwater supplies, acquisition of imported water, recycled water programs, capture of stormwater for recharge, regulation of groundwater pumping and water use, and addressing threats to water resources from overdraft, saltwater intrusion, and pollution—cannot be segregated from one another. As such, it is lawful to charge individual property owners and water users a share of the costs, regardless of whether they use or benefit directly from each of them, because it is the aggregate and integrated portfolio of water supply and demand reduction programs

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160. *Id.* at 254.

161. *Id.* (citation omitted).

162. *Id.*

163. *Id.* at 255.

164. *Id.* at 256.

165. *Id.* (internal quotation marks omitted).

166. *Id.*

that makes possible the “water service” that the agency provides to each of its customers.<sup>167</sup>

The *Griffith* court correctly recognized that a groundwater extraction fee system that pays for sustainable conjunctive management and assigns the costs based on the demands each groundwater user places on the system by pumping from the aquifer, does not exceed the proportional cost of integrated water service to any individual user.<sup>168</sup> Yet, groundwater extraction charges are really a hybrid of two distinct types of fees. As in *Griffith*, they may be fairly characterized as fees for the costs of the *service* of effective groundwater management. But the extraction charges are also *regulatory* fees designed to protect against overdraft and to ensure long-term equilibrium in the aquifer by increasing the cost of groundwater extraction over and above the capital and electricity costs of the pumping itself. In this respect, the fees are less charges for water service than they are fees designed to deter individual actions that in the aggregate harm all users of water from the managed groundwater basin. It is therefore worth considering groundwater

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167. Groundwater management agencies must explain and justify differences in the amount they charge to different classes of customers. In April 2013, for example, the Santa Barbara County Superior Court concluded that the United Water Conservation District (“UWCD”) failed to justify the differences between its groundwater extraction charge for agricultural use and the charge for municipal and industrial use. Notice of Ruling, at Ex. A, *San Buenaventura v. United Water Conservation Dist.*, No. VENCI-00401714 (Cal. Super. Ct. May 1, 2013). UWCD manages the surface water and groundwater resources of the Santa Clara watershed pursuant to a grant of authority from the legislature. *Id.* For 2012 to 2013, the district enacted an agricultural extraction charge of \$39.75 per acre-foot and \$119.25 per acre-foot for municipal and industrial (M&I) uses in Zone A, and charges of \$18 and \$54 respectively in Zone B. *Id.* The City of San Buenaventura sued, claiming inter alia that these disparities violate Proposition 218 because the rate ratios are “not in proportion to the relative cost between agricultural water and M&I water.” *Id.* The district defended the charges on the ground that, measured on a cost per parcel basis, agricultural users paid an average of \$1,457.78 per parcel, while M&I users averaged \$29.06 per parcel. *Id.* UWCD also argued that the approximate three-to-one ratio between agricultural and M&I charges per acre-foot is authorized by Section 75594 of the Water Code, which provides that groundwater extraction charges “shall be established at a fixed and uniform rate for each acre-foot for water other than agricultural water which is not less than three times nor more than five times the fixed and uniform rate established for agricultural water.” *Id.* (quoting CAL. WATER CODE § 75594 (West 2014)). The superior court concluded that “UWCD’s differential rate between agricultural water and non-agricultural water was set because of the requirement of Water Code section 75594 and not because of a determination that the costs relating to agricultural water as compared with non-agricultural water support that differential.” *Id.* Indeed, “the record is remarkable in its lack of factual discussion of the basis for the differential rate. Consequently the court must conclude that, notwithstanding the statutory requirement of Water Code section 75594, UWCD has failed in its burden of proving compliance with [Proposition 218].” *Id.* The superior court was careful to note that its decision did not mean that “differential rates between agricultural water and non-agricultural water can never be supported or that rates complying with Water Code section 75594 cannot comply with Proposition 218. This conclusion is only that UWCD . . . has not made the factual showing necessary to support its differential rates.” *Id.* The case is awaiting trial on the appropriate remedies.

168. *Griffith*, 163 Cal. Rptr. 3d at 254–55.

extraction fees, along with stormwater discharge fees, under the related—but conceptually different—rubric of Proposition 26.

#### E. PROPOSITION 26 AND REGULATORY FEES

Although Proposition 26 may cover some types of water service charges,<sup>169</sup> a central purpose of the law was to place limits on the state and local governments' use of fees that are "couched as 'regulatory' but exceed the reasonable costs of actual regulation or are simply imposed to raise revenue for a new program and are not part of any licensing or permitting program."<sup>170</sup> The law declares that these types of fees "are actually taxes and should be subject to the limitations applicable to the imposition of taxes."<sup>171</sup>

Proposition 26 contains two substantive standards relevant to stormwater discharge and groundwater extraction fees.<sup>172</sup> It states that the charge is not a tax if it is "imposed for the reasonable regulatory costs to a local government for issuing licenses and permits, performing investigations, inspections, and audits, enforcing agricultural marketing orders, and the administrative enforcement and adjudication thereof."<sup>173</sup> It also states that:

The local [or state] government bears the burden of proving by a preponderance of the evidence that a levy, charge, or other exaction is not a tax, that the amount is no more than necessary to cover the reasonable costs of the governmental activity, and *that the manner in which those costs are allocated to a payor bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity.*<sup>174</sup>

As analyzed in detail above, the last clause indicates that the proponents of Proposition 26 recognized the longstanding practice of government agencies charging regulatory fees that help to internalize the negative externalities imposed on public resources by a variety of uses of land and water, and that they did not intend to require agencies to enact such fees as special taxes. In other words, consistent with Proposition 26, stormwater management agencies may charge landowners and other members of the public stormwater discharge fees based on their respective contributions to stormwater collection and surface runoff; and groundwater replenishment agencies may impose extraction fees for the purpose of protecting against well-lowering, sea water intrusion, water quality degradation, and other pernicious effects of overdraft. To the

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169. This includes wholesale water rates. *Proposition 26: Text of Proposed Law*, *supra* note 47, at 114.

170. *Id.*

171. *Id.*

172. *Id.* at 115.

173. CAL. CONST. art. XIII C, § 1, cl. e, pt. 3.

174. *Id.* § 1, cl. e (emphasis added).

extent that the fee charged to the property owner or resource user represents the costs of preventing or mitigating these adverse effects, the fee bears a “fair or reasonable” relationship to the burdens that the property owner or resource user imposes on the government activity of protecting and managing surface and ground water resources in the public interest.<sup>175</sup>

This understanding of stormwater discharge and groundwater extraction fees does not necessarily mean, however, that these charges are exempt from the procedural and substantive standards of Proposition 218. Indeed, the courts have held that they *are* covered by that law.<sup>176</sup> But it does suggest that the characterization of these types of charges as fees for service is too circumscribed and may mislead agencies and reviewing courts into focusing exclusively on the question of how precisely the portion of the fee charged to any particular property or user relates to the cost of service to that parcel or user.

A broader, and more accurate, analysis should look both to the proportionality of the costs of the governmental service and to the question of how the fee works to internalize the external costs created by each property or user. Under such an analysis, a stormwater discharge fee would be fairly apportioned among property owners and land users based on their respective contributions to the loss of permeable land because the construction and paving that reduces overall permeability concomitantly increases the amount of stormwater runoff that must be collected, treated, and discharged. Similarly, a groundwater extraction fee may be fairly allocated on the basis of each groundwater user’s annual pumping because each extractor contributes to the risk or reality of overdraft in proportion to that use. An integrated understanding of Propositions 218 and 26 is therefore essential, not just to harmonize the two laws, but also to ensure that are implemented in a manner that comports with the realities of contemporary water resources management and regulation.

#### F. THE RELATIONSHIP BETWEEN PROPOSITION 218 AND PROPOSITION 26

The idea of addressing stormwater discharge fees, groundwater extraction charges, and other charges that protect the quality and sustainable use of California’s water resources as regulatory fees under Proposition 26, rather than as fees for water service under Proposition 218, raises the question of whether this functional division between the two laws is constitutional. In other words, what is the relationship

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<sup>175</sup>. *Id.*

<sup>176</sup>. *See, e.g.*, *Howard Jarvis Taxpayers Ass’n v. City of Salinas*, 121 Cal. Rptr. 2d 228, 233–34 (Cal. Ct. App. 2002) (stormwater); *Pajaro Valley Water Mgmt. Agency v. Amrhein*, 59 Cal. Rptr. 3d 484, 497–98 (Cal. Ct. App. 2007) (groundwater).

between the two propositions? Can fees for water resources regulation be governed exclusively by Proposition 26, or must these charges comply with the procedural and substantive requirements of both laws?

In the *Salinas* and *Amrhein* cases, the court of appeal concluded that stormwater fees and groundwater extraction charges are “property-related fees” and therefore are subject to the voter approval and other procedural requirements of Proposition 218.<sup>177</sup> These holdings necessarily imply that stormwater discharge fees and groundwater extraction charges are also governed by the substantive standards of Proposition 218. Following this precedent, the *Griffith* court evaluated the Pajaro Valley groundwater augmentation charge under these substantive standards. It concluded that, because the revenues produced by the charge funded water management programs that benefitted all landowners and groundwater users, the charge complied with the law’s cost of service-based standards.<sup>178</sup> Yet, the court did not address the fact that the groundwater augmentation charge is also a regulatory fee designed to create disincentives to pump groundwater that (in the aggregate) causes overdraft. Nor did it have occasion to consider the question of whether the proper legal framework for evaluating these types of regulatory fees should be Proposition 26 rather than Proposition 218.

As described above, the substantive standards of Proposition 218 make little sense in the case of stormwater discharge fees and apply only awkwardly to groundwater management charges because these charges are not really fees for a service provided *to* property. Rather, they are fees imposed to influence or regulate how property is used in order to protect the public against harm caused *by* that use.

The principal purposes of stormwater management—protection against flooding and reducing water pollution—do not represent the “cost of the service attributable to the parcel[s]” covered by the charge.<sup>179</sup> Nor do the parcels subject to stormwater discharge fees always “receive a special benefit over and above the benefits conferred on the public at large.”<sup>180</sup> Rather, the fees are designed to force those who contribute to the production and channelization of stormwater runoff to bear their fair share of the societal costs of their actions. Thus, a comprehensive and inclusive stormwater program would embrace all of the major sources of polluted runoff, including land uses that reduce permeability and infiltration capacity *and* motor vehicles that use roads and highways from which surface runoff is diverted, channelized, and

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177. *Howard Jarvis Taxpayers Ass’n*, 121 Cal. Rptr.2d at 229; *Amrhein*, 59 Cal. Rptr. 3d at 485.

178. *Griffith v. Pajaro Valley Water Mgmt. Agency*, 163 Cal. Rptr. 3d 243, 254–55 (Cal. Ct. App. 2013).

179. CAL. CONST. art. XIII D, § 6, cl. b, pt. 3.

180. *Id.* § 4, cl. f.

discharged.<sup>181</sup> It could also include other sources, such as producers or consumers of goods that become street trash and end up in storm drains (including the fast-food, beverage, and cigarette industries), as well as important sources of herbicides, pesticides, fertilizers, and other harmful chemicals.

Groundwater extraction fees have some characteristics of property-related service fees and some features that are regulatory in nature. On the one hand, they are designed to deter excessive pumping that in the aggregate lowers the groundwater table. This may be described as a service provided *to* the property that is subject to the fee because it protects each groundwater user's individual pumping right. Groundwater extraction fees are also frequently used to purchase imported water to augment native groundwater supplies and thus benefit all groundwater users. But groundwater extraction fees are primarily regulatory because their main purpose is to require each user to pay for the negative externalities caused by his or her groundwater withdrawals, including the costs to other users from well-lowering, seawater intrusion, concentration of pollutants, and in some cases land subsidence.

As with stormwater discharge fees, the groundwater extraction charges that are designed to capture or "internalize" these external costs do not necessarily correspond to the cost of the services that the groundwater management district provides *to* parcels covered by the charge. Moreover, it is likely that some groundwater users will benefit more from the programs funded by the extraction charge than others. In a coastal aquifer, for example, those who pump groundwater nearer to the ocean will receive greater benefits from groundwater management programs that use extraction fees to address the threat of seawater intrusion than will inland groundwater users.

If stormwater discharge fees and groundwater extraction charges are best characterized as regulatory fees, rather than charges for property-related services, the question then becomes: Can the courts choose to analyze these types of charges exclusively under Proposition 26? We believe that there is a plausible—though far from conclusive—argument to support this bifurcated approach to the two laws.

Unlike Proposition 218, which covers property-related services generally, Proposition 26 was enacted specifically to address regulatory fees—including those that apply to the use of land and water resources.<sup>182</sup> Although there is overlap between the two laws, in cases of conflict the more specific, later-enacted law should take precedence. And there are significant conflicts between the two propositions.

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181. *See supra* Box 3.

182. CAL. CONST. art. XIIIIC; *id.* art. XIIIID.

The Proposition 218 cost of service-based limitations are incongruous with regulatory fees, as they require courts to make tenuous links between the charges designed to influence or deter land and water use decisions with the costs and benefits of attendant services provided to the land or water user. In contrast, Proposition 26 applies directly to regulatory fees, asking whether the fee was “imposed for the reasonable regulatory costs to a local government for issuing licenses and permits.”<sup>183</sup>

Moreover, Proposition 26 focuses on the central purpose of regulatory fees—internalization of the external costs of land and water uses on other users and the environment—by requiring that the charges that are assigned to each user “bear a fair or reasonable relationship to the payor’s *burdens on, or benefits received from*, the governmental activity.”<sup>184</sup> In contrast, Proposition 218 requires a nexus between the charges and the costs of service to each parcel that is subject to the fee.<sup>185</sup> A regulatory fee could thus comply with Proposition 26 because it fairly and reasonably charges each landowner or water user for the burdens (that is, the external costs) that she creates, but be unlawful under Proposition 218 because the fee exceeds either the cost of government services *to* the landowner or water user or the benefits received *by* the landowner from the regulatory program.

Finally, the text of Proposition 26 shows that its drafters (and perhaps the voters who enacted it) were aware that its new standards may overlap with those of Proposition 218, and indicates that they intended that the two laws should be applied separately to avoid conflict. Proposition 26 excludes from the definition of “taxes” both assessments and other “property-related fees imposed in accordance with the provisions of Article XIID”—that is, Proposition 218.<sup>186</sup> This means that, if a property-related fee is adopted in accordance with Proposition 218, it is exempt from analysis under Proposition 26. It also suggests, however, that a “property-related fee” that fails under Proposition 218 could nonetheless be a valid fee—as opposed to a tax—under the different substantive criteria of Proposition 26. While this clause of Proposition 26 is far from conclusive, the express exemption of valid Proposition 218 fees from Proposition 26 does support the conclusion that the drafters and voters did not intend that *both* laws would apply simultaneously to the same fees and charges.

Proposition 26 did not expressly modify or repeal any aspect of Proposition 218. Yet, it is doubtful that its proponents (and the voters

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183. *Id.* art. XIIC, § I, cl. e, pt. 3.

184. *Id.* § 1, cl. e, pt. 7 (emphasis added).

185. *See id.* art. XIID.

186. *Id.* art. XIIC, § 1, cl. e, pt. 7.

who approved the initiative) would have intended the older law to frustrate the newer law's clear directives. Indeed, as just noted, the text of Proposition 26 reveals that its proponents did intend to avoid conflict between the two laws. When confronted with two potentially applicable laws that are in conflict, the courts should choose the more specific over the general, the later enacted over the former, and the law that most accurately addresses the subject matter of the litigation.<sup>187</sup> All three factors would favor a preference for Proposition 26 in cases involving regulatory fees.

Under this interpretation, the enactment of a stormwater discharge fee or groundwater extraction charge might be subject to the Proposition 218 voter approval requirements, as held in *Salinas* and *Amrhein*, but governed by the *substantive* standards of Proposition 26. Although this may appear to be an odd bifurcation, it would be better than an interpretation of the two laws that would allow one, Proposition 218, to override the more specific and germane provisions of the other, Proposition 26, whenever a "property-related" charge is also a regulatory fee.

We believe that this reading of the two initiatives is the one that best harmonizes their purposes and directives. Equally important, it is the interpretation that is most consonant with modern land and water management where the control of externalities is an essential means of ensuring that individual users do not undermine the protection of shared resources or unfairly shift the costs of their actions onto their neighbors or the public at large. Whether the courts will agree, however, is a separate question. For this reason, we suggest several ways to clarify the relationship between Proposition 218 and 26, either through legislation or, if necessary, by amending the Constitution.

#### G. PROPOSITION 26 AND WATER STEWARDSHIP FEES

Proposition 26 also raises interesting questions about the funding of ecosystem protection and integrated regional water management: Under what circumstances can these programs be funded by fees and charges on water use, rather than special taxes? This is an important question because some local and regional agencies now include environmental protection and watershed stewardship within their water supply responsibilities and some regional agencies now collect fees to support conservation as part of their water service portfolios. Two examples are illustrative.

The Sonoma County Water Agency ("SCWA") is a wholesale agency that supplies water from the Eel and Russian River watersheds to

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<sup>187</sup> *Warne v. Harkness*, 387 P.2d 377, 382–83 (Cal. 1963).

nine cities, in addition to providing sanitation and flood protection services.<sup>188</sup> The “Watershed Planning and Restoration Sub-Charge” helps fund habitat restoration, dam improvements, and other water management programs that are needed to comply with the reasonable and prudent alternatives set forth in the Russian River biological opinion that protects coho salmon.<sup>189</sup> These investments improve water supply reliability for SCWA and its member agencies because they reduce the risk that federal and state fisheries agencies may limit the impoundment and diversion of water to protect the salmon.

These programs include improvement of the Russian River estuary to facilitate fish passage to and from the ocean, regulation of stream flows, installation of fish ladders, and riparian habitat improvements on several tributaries.<sup>190</sup> SCWA conducts this watershed protection and management in cooperation with the U.S. Army Corps of Engineers, which operates two of the dams in the watershed, and the Mendocino County Russian River Flood Control and Water Conservation Improvement District.<sup>191</sup> The Watershed Planning and Restoration Sub-Charge was \$81.06 per acre-foot in 2012 and 2013.<sup>192</sup>

The MWD includes in its wholesale rates a “Water Stewardship Rate.”<sup>193</sup> According to MWD, the purpose of the rate is to “recover[] the cost of Metropolitan’s financial commitment to conservation, water recycling, groundwater clean up and other local resource management programs.”<sup>194</sup> MWD adopted the water stewardship rate in 2003.<sup>195</sup> It has increased the rate several times from its original twenty-three dollars per acre-foot to its current forty-one dollars per acre-foot.<sup>196</sup> The water

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188. *Water Supply*, SONOMA CNTY. WATER AGENCY, <http://www.scwa.ca.gov/water-supply> (last visited Aug. 1, 2014).

189. *The Biological Opinion: Frequently Asked Questions*, SONOMA CNTY. WATER AGENCY, <http://www.scwa.ca.gov/files/docs/projects/rrifr/RRIFR%20-%20BO%20FAQs%20-%20final%208-19-13.pdf> (last visited Aug. 1, 2014).

190. See generally U.S. ARMY CORPS OF ENGINEERS, SAN FRANCISCO DIST., BIOLOGICAL OPINION FOR WATER SUPPLY, FLOOD CONTROL, AND CHANNEL MAINTENANCE (2008), available at <http://www.scwa.ca.gov/files/docs/projects/rrifr/Signed-RussianRiverFinalBO9-24-08.pdf>.

191. See generally Memorandum of Understanding Among United States Army Corps of Engineers, National Marine Fisheries Service, and Sonoma County Water Agency (Dec. 24, 1997), available at <http://www.co.mendocino.ca.us/bos/meetings/MG27371/AS27379/AS27380/AI27475/DO27508/1.PDF>.

192. SONOMA CNTY. WATER AGENCY, SONOMA COUNTY WATER AGENCY RATES FOR WATER DELIVERIES IN FY 12–13 (2012), <http://www.scwa.ca.gov/files/docs/finance/1213/2012-2013-Water/18-Water.Rates.pdf>.

193. *Adopted Water Rates and Charges*, METRO. WATER DIST. OF S. CAL., [http://www.mwdh2o.com/mwdh2o/pages/finance/finance\\_03.html](http://www.mwdh2o.com/mwdh2o/pages/finance/finance_03.html) (last updated Apr. 19, 2012).

194. *Id.*

195. *Historical Water Rates*, METRO. WATER DIST. OF S. CAL., [http://www.mwdh2o.com/mwdh2o/pages/finance/finance\\_02.html](http://www.mwdh2o.com/mwdh2o/pages/finance/finance_02.html) (last updated Apr. 16, 2012).

196. *Id.*

stewardship rate is but one of fifteen component rates for MWD's wholesale water service.<sup>197</sup>

We believe that both types of water stewardship charges are consistent with Proposition 26's substantive standards and may be enacted as a fee rather than a tax. As described above, modern water service agencies manage their resources as a portfolio that includes imported water, local surface and groundwater, recycled water, recovered stormwater, acquisition of transferred water, and programs to encourage conservation and efficient use.<sup>198</sup> The costs of any project that increases the quantity or reliability of the agency's water supplies or decreases demand on the system may be properly charged to all customers. Water stewardship charges benefit all property and customers to which the water service is ultimately provided.

There are, of course, limits on the types and amount of water stewardship fees that an agency may charge. The fee must apply prospectively to mitigate the harm that the agency's water supply functions (and its customers' water use) may impose on other land and water users or the environment. As previously discussed, Proposition 26 requires that charges levied to remedy past environmental damages be enacted as a tax. The aggregate funds collected from the fee may not exceed the "reasonable costs" of administering the water stewardship programs funded by the fee.<sup>199</sup> The agency must explain how the fee benefits its customers by enhancing its system-wide water service and water management objectives.<sup>200</sup> And the agency may not use funds collected from the fee for other projects.<sup>201</sup> A water stewardship fee could not be used to fund recreational uses within the watershed, for example. But if an agency stays within these legal bounds, it may adopt a water stewardship fee as part of its overall water service portfolio.

The Sonoma County Watershed Planning and Restoration subcharge may also be justified on two other grounds. It is a regulatory fee designed to charge water users within the Russian River watershed for the harm that the impoundment and diversion of water (for their benefit) inflict on coho salmon—including flow alteration and reduction, degradation of habitat, and loss of spawning grounds and other

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197. *See Adopted Water Rates and Charges*, *supra* note 193. The Sonoma County Water Agency has similar surcharges on its wholesale water sales to fund conservation (\$32.85/af in 2012–2013) and recycled water and local supply programs (\$15.99/af). SONOMA CNTY. WATER AGENCY, SONOMA COUNTY WATER AGENCY RATES FOR WATER DELIVERIES IN FY 12–13 (2012), <http://www.scwa.ca.gov/files/docs/finance/1213/2012-2013-Water/18-Water.Rates.pdf>.

198. *See supra* Part II.D.

199. CAL. CONST. art. XIII C, § 1, cl. e; Tentative Determination and Proposed Statement of Decision on Rate Setting Challenges, *supra* note 113, at 58–60.

200. *See, e.g., Griffith v. Pajaro Valley Water Mgmt. Agency*, 163 Cal. Rptr. 3d 243 (Cal. Ct. App. 2013).

201. CAL. CONST. art. XIII C, § 1, cl. e.

habitat.<sup>202</sup> As such, the costs assigned to water consumers within SCWA's service area "bear a fair or reasonable relationship to [each customer's] burdens on, or benefits received from, the governmental activity"—that is, the federal, state, and local efforts to protect the coho salmon.<sup>203</sup> In addition, the charge may be fairly described as a regulatory mandate because it was adopted to comply with the reasonable and prudent alternatives of the Russian River biological opinion. Just as Proposition 26 allows an agency to charge its customers for the required costs of acquiring and treating water in accordance with the governing water rights and water quality laws, so too may the agency include in its water rates a charge for the costs of complying with the Endangered Species Act.

#### H. THE RELATIONSHIP BETWEEN ARTICLE X, SECTION 2 OF THE CALIFORNIA CONSTITUTION AND PROPOSITIONS 218 AND 26

Article X, section 2, of the California Constitution, enacted by initiative in 1928, is the foundation of California water rights and water administration.<sup>204</sup> It provides, in relevant part, that:

[B]ecause of the conditions prevailing in this State the general welfare requires that the water resources of the State be put to beneficial use to the fullest extent of which they are capable, and that the waste or unreasonable use or unreasonable method of use of water be prevented, and that the conservation of such waters is to be exercised with a view to the reasonable and beneficial use thereof in the interest of the people and for the public welfare. The right to water or to the use or flow of water in or from any natural stream or water course in this State is and shall be limited to such water as shall be reasonably required for the beneficial use to be served, and such right does not and shall not extend to the waste or unreasonable use or unreasonable method of use or unreasonable method of diversion of water.<sup>205</sup>

The California Supreme Court has held that

[R]easonable use of water depends on the circumstances of each case, [and] such an inquiry cannot be resolved *in vacuo* isolated from statewide considerations of transcendent importance. Paramount among these we see the ever increasing need for the conservation of water in this state, an inescapable reality of life quite apart from its express recognition in the 1928 amendment.<sup>206</sup>

These directives apply to all water rights—surface and groundwater—and to all agencies that regulate and manage the state's water resources.<sup>207</sup>

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202. *The Biological Opinion: Frequently Asked Questions*, *supra* note 189.

203. CAL. CONST. art. XIIC, § 1, cl. e.

204. MANAGING CALIFORNIA'S WATER, *supra* note 2, at 41.

205. CAL. CONST. art. X § 2.

206. *Joslin v. Marin Mun. Water Dist.* 429 P.2d 889, 894 (Cal. 1967).

207. *City of Barstow v. Mojave Water Agency*, 5 P.3d 853, 864 (Cal. 2000).

Article X, section 2, expressly grants the legislature the power to pass laws in furtherance of its policies.<sup>208</sup> Pursuant to this authority, the legislature has enacted statutes to encourage conservation and efficient use, to create incentives to use recycled water, meter and report on water use, promote water transfers, and monitor and report on groundwater levels.<sup>209</sup> It has authorized counties and local agencies to conjunctively manage surface and groundwater supplies, and has required urban and agricultural water agencies to adopt best management practices to promote conservation and efficient use.<sup>210</sup> In addition, the legislature has granted public water agencies authority to use “allocation-based conservation water pricing,”<sup>211</sup> which it identified as “one effective means by which waste or unreasonable use of water can be prevented and water can be saved in the interest of the people and for the public welfare, within the contemplation of section 2 of article X of the California Constitution.”<sup>212</sup>

All of these programs require funding—usually from water rates or fees charged to their beneficiaries. For example, recycling facilities may be a component of a retail agency’s rate base because the reclaimed water contributes to the agency’s overall water supplies. Many agencies acquire water from willing sellers (both on long- and short-term bases), and the cost of this transferred water is included in the agency’s water rates. The costs of water use monitoring, conservation incentives, and conjunctive use programs also are commonly charged to the agencies’ customers as part of the costs of the agency’s water supply and management portfolio. Until the enactment of Propositions 218 and 26 (and the judicial decisions applying these laws to water service and water management), the general assignment of the costs of these programs to water consumers raised no significant constitutional questions. Indeed, as noted above, these programs were founded on the constitutional mandate of reasonable use.

Following the enactment of Propositions 218 and 26, however, both the relationship between the conservation and reasonable use directives of article X, section 2, and the authority of the state and local agencies to use fees to support efficient water use and management have become important open questions. In *Palmdale*, the court of appeal briefly considered one facet of this relationship, concluding that the tiered rate structure adopted by the district—though enacted pursuant to the allocation-based conservation water pricing authority of Water Code sections 370–374—nonetheless must comply with the procedural and

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208. CAL. CONST. art. X § 2.

209. CAL. WATER CODE §§ 460–465, 500–535, 1700–1745.11, 10920–10936 (West 2014).

210. *Id.* §§ 10608–08.64, 10610–56, 10750–83.2, 10800–53.

211. *Id.* §§ 370–374.

212. *Id.* § 370(a); *see supra* Box 2.

substantive standards of Proposition 218.<sup>213</sup> The court held that “California Constitution, article X, section 2 is not at odds with article XIID [that is, Proposition 218] so long as, for example, conservation is attained in a manner that ‘shall not exceed the proportional cost of the service attributable to the parcel.’”<sup>214</sup>

The *Palmdale* decision is not necessarily incorrect. The court did not hold that allocation-based conservation pricing is now unconstitutional. Rather, it struck down the tiered rate structure because the district failed to explain why the higher-tiered rates applied to irrigation users at volumetric consumption levels that were lower than those for residential and commercial users.<sup>215</sup> For the reasons described above, the absence of a cogent explanation for differential rates is a legitimate basis for invalidation under Proposition 218.

We are concerned, however, with the *Palmdale* court’s suggestion that the conservation and reasonable use mandates of article X, section 2 must conform to the general requirements of Proposition 218. Simply put, if the courts strictly apply the “cost of service” standards of Proposition 218, they risk undermining both the essential directives of article X, section 2 and many of the salutary features of contemporary California water policy.

Judicial insistence that public water agencies establish a tight fit between the aggregate costs and benefits of their water supply portfolios and how they allocate those costs and benefits to individual water users and property owners would place an impossible burden on the agencies. In particular, the molecular-level accounting standard articulated by the superior court in the *Capistrano* litigation—by which the city must prove that the water produced by its recycling program be physically available to all of its customers<sup>216</sup>—is both unduly burdensome as a matter of administrative law and unrealistic in the context of modern water resources management. So, too, would be a standard of judicial review that required water agencies to prove precisely how responsive different categories of demand are likely to be to pricing differentials embodied in a tiered-rate structure.

An exacting standard of judicial review of these types of decisions under Proposition 218 would also pose a risk of unintended consequences. For example, the *Capistrano* court’s invalidation of the recycled water charge to those customers and landowners who do not physically receive the recycled water may threaten the city’s ability to fund its recycled water program. This, in turn, may reduce the quantity

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213. *City of Palmdale v. Palmdale Water Dist.*, 131 Cal. Rptr. 3d 373, 381 (Cal. Ct. App. 2011).

214. *Id.*

215. *Id.* at 380–81.

216. Proposed *Capistrano* Decision, *supra* note 77, at 5.

and reliability of the city's water supplies for all of its customers; or it may increase the price of water to all customers if the city either needs to acquire additional imported water to make up for the deficiency or must extend its water delivery system to allow it to send recycled water molecules throughout its service area.

In other words, heightened judicial review under the auspices of Proposition 218 may insert the courts into areas beyond their technical competency. Moreover, to the extent that judicial applications of Proposition 218 make it impossible (or unnecessarily expensive) to fund water management programs that agencies have adopted pursuant to the statutes described above, the courts risk interfering with the legislature's prerogative to enact laws in furtherance of the water conservation and reasonable use mandates of article X, section 2.

Similarly, continuing judicial applications of Proposition 218's cost-based allocation requirements to fees and charges that effectuate stormwater management and groundwater administration threaten to turn these regulatory fees into special taxes that require a two-thirds vote of the electorate. As discussed above, this would not only conflict with Proposition 26's more relevant and realistic standards, but would also jeopardize regulatory and resource management programs that are now vital components of water conservation and reasonable use as required by article X, section 2.

Thus, rather than asking whether article X, section 2 can be implemented in a manner that fits into the strictures of Proposition 218, the courts should seek to ensure that their interpretation of Proposition 218 does not undermine the essential purposes of article X, section 2 (see *infra* Box 4). An informed and nuanced understanding of modern water resources administration—and of the complexities of the charges, rates, and regulatory fees that both fund and effectuate these myriad programs—will help the courts come to a working accommodation of these important constitutional laws.

## BOX 4: CONSTITUTIONAL TENSIONS

One important case, *Brydon v. East Bay Municipal Utility District*, 29 Cal. Rptr. 2d 128 (Cal. Ct. App. 1994), has addressed the tensions between the constitutional mandate of reasonable use and the constitutional limits on taxes and fees. Although this decision predates Propositions 218 and 26, it nonetheless illustrates how the courts should evaluate the relationship between article X, section 2 and the newer constitutional requirements.

In response to water shortages caused by the 1986–1992 drought, the East Bay Municipal Utility District adopted a tiered-rate pricing structure for residential water service. The base rate was \$0.91 per unit and increased in three blocks based on each household’s consumption to a top rate of \$3.94 per unit. *Id.* at 130–32. Customers in the inland portions of the East Bay Municipal Utility District’s service area (which use relatively large amounts of water) sued, alleging that the tiered rate structure was a special tax that required approval of a two-thirds majority of the electorate under Proposition 13. *Id.* at 132–33. The California Court of Appeal rejected this claim. It held that:

The inclining block rate structure bears none of the indicia of taxation which [Proposition 13] purported to address. The rate structure was not designed to replace property tax monies lost in consequence of the enactment of [Proposition 13]. The rates were levied against water consumers in accordance with patterns of usage, and at no cost to taxpayers generally. The incremental rate was not compulsory to the extent that any consumer had the option of reducing his or her consumption. (*Id.* at 137.)

The court also addressed the interplay between article X, section 2 and Proposition 13:

[I]n the present context the constitutional mandate of water conservation . . . is at least as compelling as the objectives of [Proposition 13]. Indeed, even if [Proposition 13] is applicable to the instant rate structure . . . shifting the costs of environmental degradation from the general public to those most responsible is consistent with the objectives of Proposition 13. The inclining block rate structure is a reasonable reflection of the fact that it is in part the profligate usage of water which compels the initiation of regulated conservation measures including those public education programs designed to encourage conservation. (*Id.* at 136.)

In 1993, while the litigation was pending, the legislature amended the Water Code to allow public water agencies to “adopt and enforce a water conservation program to reduce the quantity of water used by [its customers] for the purpose of conserving the water supplies of the public entity.” CAL. WATER CODE § 375(a) (West 2014). It followed up in 2008 by adding sections 370–374 and expressly authorizing “allocation-based conservation water pricing” described in Box 2, *supra*.

For the reasons discussed in the text, the courts should interpret Propositions 218 and 26 in such a way as to effectuate the important reasonable use and conservation mandates of article X, section 2 and these more specific implementing statutes.

### III. RECOMMENDED POLICY RESPONSES AND LEGAL REFORMS

Propositions 218 and 26 were enacted for the purpose of limiting the ability of local agencies (and for Proposition 26, also the state) to use fees and other charges to raise revenues to pay for general government programs, rather than support the specific services for which the fee is charged. These laws also require greater transparency and accountability whenever governments increase rates and fees for such services. But the two constitutional amendments have also produced some unfortunate—

and likely unintended—consequences for the management of water services that are vital for California’s economy, environment, and society. To enable the state’s water suppliers and administrators to continue to provide clean, reliable, and environmentally responsible water services, the state’s voters should consider amending Propositions 218 and 26 to address these unanticipated (and undesirable) fiscal constraints. This Part outlines these proposed constitutional amendments. It begins, however, by describing other actions that water agencies, courts, and the legislature can take to help ensure that the strictures of Propositions 218 and 26 do not deter or prohibit sound water resources administration.

#### A. AGENCY ACTIONS

As discussed above, public retail water agencies can and should improve the administrative records they develop to support proposed new fees and charges and changes to their rate structures. This will require greater clarity in the ratemaking process, including a simplified and accessible narrative explanation to inform the public and guide the courts on judicial review. Water agencies also must link fee and rate changes to the new projects and water management programs that they are designed to fund. In addition, they must provide cost-based justifications of rates and fees and explain why the allocation of these charges among customers complies with Proposition 218’s substantive standard. Proposition 26 is likely to require wholesale agencies to make similar changes to their ratemaking processes.

Water agencies should take advantage of the significant authority afforded by article X, section 2 of the California Constitution, sections 370–374 of the Water Code, and other laws to use fees, water rates, and rate structures to create incentives for water conservation and efficient use. As the legislature recognized when it enacted section 372, allocation-based tiered water pricing is an “effective means by which waste or unreasonable use of water can be prevented and water can be saved in the interest of the people and for the public welfare.”<sup>217</sup>

Water agencies must take seriously, however, the judicial warnings that they may not simply assert that tiered rates and water surcharges will deter waste and profligate use. Although ratemaking is not a precise science, and agencies should be afforded significant leeway in setting rates and fees that they believe will create incentives for conservation and efficient use, agencies must nonetheless explain how their water pricing decisions are likely to achieve the constitutional and statutory goals of promoting efficient water management and use.

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217. CAL. WATER CODE § 370(a) (West 2014).

Stormwater and groundwater management agencies can also enhance their ability to use fees and charges to pay for the costs of stormwater discharge, treatment, infiltration, and conjunctive use programs if they are able to integrate the programs funded by these fees into their (or another agency's) water supply system. Where stormwater is managed and recaptured as part of an agency's water supply portfolio—that is, replenishment of groundwater and reuse of treated stormwater discharges—the portion of the cost of the stormwater program attributable to that water supply function may be defined as a cost of water service. The same is true for groundwater extraction fees that protect against overdraft and help pay for the cost of imported water that is used to recharge the aquifer for the benefit of all groundwater users. It is appropriate to charge each user a fee based on actual pumping because that apportionment reflects both the costs that each user places on the aquifer and the individual benefits of groundwater replenishment.

Propositions 218 and 26 thus create incentives for combined stormwater/water supply agencies to account for their stormwater reuse just as they do for their imported water, local surface and groundwater supplies, and other water supply functions that constitute their rate bases. These laws also may create incentives for independent stormwater or groundwater management agencies to enter into a joint powers agreement (or perhaps to merge) with a water supply agency so that they can gain the same benefits of integrated, portfolio-based water management and financing.

#### B. THE ROLE OF THE COURTS

The courts can help to ensure that Propositions 218 and 26 do not impede prudent and creative administration of California's water resources systems by developing a more realistic understanding of integrated water portfolio management. Water service cannot be segmented by source of supply as in *Capistrano*, where the court focused on where the water molecules produced by the city's recycled water program flowed in relation to imported water and local groundwater supplies.<sup>218</sup> Rather, as practiced by modern water utilities, water service is an integrated and unified product.

Thus, the guiding principles for judicial review of system-wide fees or rates that fund specific water development, management, or conservation programs should be:

If the program augments the agency's water supply portfolio, reduces demand from freshwater sources, enhances water supply reliability, improves overall water quality, or enables the agency to comply with environmental and other regulatory requirements, then the costs of the

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218. Proposed *Capistrano* Decision, *supra* note 77, at 4.

program may be imposed on all of the agency's customers, not just on those customers who have direct access to the water produced or conserved by the program. The agency shall apportion the costs of the program based on the proportional cost of aggregate water service attributable to each customer.

This is essentially the standard of judicial review that the court of appeal applied in *Griffith*.<sup>219</sup> A similar standard would apply to judicial review of fees and charges for other types of water management actions that benefit all customers, such as conjunctive ground and surface water management, integration of stormwater and water supply operations, and demand reduction programs, including financial incentives for improvements in irrigation efficiency, low-water landscaping, plumbing improvements, and surcharges on excessive use (that is, higher tiers in tiered-rate systems). Consistent with article X, section 2, the courts should also give significant deference to water agency decisions designed to improve overall water management, encourage conservation and efficient use, and comply with environmental standards and other regulatory requirements.

Propositions 218 and 26 assign to the government the burden of proving that fees, charges, and rate structures are consistent with the law's substantive standards.<sup>220</sup> The *Palmdale* court held that the purpose of this provision of Proposition 218 was to grant the courts authority to apply a "more rigorous standard of review" than that used in other administrative law cases, and that courts must exercise "independent judgment" in determining whether fees, charges, and rate structures comply with Proposition 218.<sup>221</sup> This does not mean, however, that the court must micromanage water ratemaking decisions.

Questions about the need for a particular water management program and accompanying fee, charge, or water rate needed to fund it should remain the primary responsibility of the agencies. The proper role for the courts is to ensure that the agency's decision to impose a groundwater augmentation fee or recycled water charge, for example, is supported by substantial evidence in the administrative record. The courts should then exercise their "independent judgment" to determine whether such programs actually serve their stated purposes and benefit

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219. See generally *Griffith v. Pajaro Valley Water Mgmt. Agency*, 163 Cal. Rptr. 3d 243 (Cal. Ct. App. 2013).

220. CAL. CONST. art. XIID, § 4, cl. f.

221. *City of Palmdale v. Palmdale Water Dist.*, 131 Cal. Rptr. 3d 373, 378 (Cal. Ct. App. 2011). The *Palmdale* court based this decision on the California Supreme Court's interpretation of another section of Proposition 218 that assigns the burden of proving compliance with the standards governing assessments. See generally CAL. CONST. art. XIID, § 4, cl. f. The court held that this section requires the courts to use their "independent judgment" and review agency assessments with a higher level of scrutiny than they do other types of administrative and local governmental decisions. *Silicon Valley Taxpayers Ass'n v. Santa Clara Cnty. Open Space Auth.*, 187 P.3d 37, 49 (Cal. 2008).

all customers—including those that do not themselves use the blended water in question—by enhancing water supply reliability or lowering system-wide water rates. But the courts should not require agencies to demonstrate a precise fit between ends and means—that is, by requiring the agency to prove that each customer will incur the exact same benefits and costs from such programs. Any such higher level of judicial scrutiny would insert the courts into questions of water management that go well beyond their relative expertise and would place a burden of proof on the agencies that they could not meet in most cases, as there are always differences in the costs and benefits of water services that vary even among similarly situated parcels and customers.

The courts should also carefully consider the relationship between Propositions 218 and 26, especially as applied to stormwater discharge fees, groundwater extraction charges, and other regulatory fees. For the reasons discussed in detail above, we urge the courts to interpret Proposition 26 as displacing the substantive standards of Proposition 218 in cases of conflict between the two. Finally, the courts should interpret both of these revenue provisions of the California Constitution in light of article X, section 2 (the section of the constitution that most specifically addresses water use and water resources management). The courts must ensure that their interpretations of Propositions 218 and 26 do not undermine the essential water conservation and reasonable use directives of their constitutional counterpart.

### C. LEGISLATIVE RESPONSES

The legislature can play a constructive role in clarifying the requirements of Propositions 218 and 26 for water management and regulation, as it did with the Proposition 218 Omnibus Implementation Act of 1997.<sup>222</sup> Although most of this statute addresses assessments, section 53756 authorizes public retail water agencies (along with wastewater, sewer, and refuse collection agencies) to “adopt a schedule of fees or charges authorizing automatic adjustments that pass through increases in wholesale charges for water” if the agency complies with four relatively simple criteria.<sup>223</sup> This “pass-through” exemption to the procedural and substantive standards of Proposition 218 has become an important feature of ratemaking.

To address the challenges presented by Propositions 218 and 26 for water service rates and rate structures, stormwater and runoff management funding, and groundwater extraction fees, the legislature could articulate several unifying principles of water resources

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222. CAL. GOV'T CODE §§ 53750–53756 (West 2014).

223. *Id.* § 53756.

management, regulation, and funding policy that would guide agencies and reviewing courts. These principles should include:

1. Clarification that water development projects (including imported water, acquisitions of transferred water, recycled water, desalinated water, and stormwater capture), conjunctive surface and ground water management projects, conservation and efficiency incentive programs, and environmental and regulatory compliance benefit all parcels and customers served by local public water agencies. Therefore, the costs of such projects and programs may be assigned to all parcels and customers within the service area, consistent with Proposition 218.

2. A declaration that fees and charges designed to regulate a use of land, water, or other resources for the purpose of creating financial incentives for conservation or more efficient use, or for the purpose of ensuring that each property or resource user subject to the fee pays for the external costs of the regulated activity, are exempt from Proposition 218's substantive standards as long as the fee or charge complies with the substantive standards of Proposition 26.

3. Reiteration that "allocation-based conservation water pricing," as authorized by sections 370–374 of the California Water Code, is an important means of encouraging the efficient use of water consistent with the prohibition of waste and reasonable use mandate of article X, section 2, of the California Constitution. This would be accompanied by a legislative statement of policy that the courts therefore should give substantial deference to a water agency's decision to adopt tiered rates, unit fees, conservation charges, and other economic incentives that encourage conservation and efficient use. Because these fees, charges, and rate structures benefit all parcels and customers served by the agency, they may be applied to all parcels as long as the fees, charges, and rates do not discriminate among parcels or customers based on type of water use or other factors not related to cost of service.

4. Authorization for local water agencies to use revenues from upper rate tiers to support water conservation programs. As the legislature has done for the Irvine Ranch Water District and the Santa Margarita Water District (see *supra* Box 2), this should include authority to capture and treat polluted runoff that results from overwatering.

5. A declaration that water agencies, water regulators, and the courts should interpret and implement Propositions 218 and 26 consistent with the water conservation and reasonable use mandates of article X, section 2.

These legislative determinations would not be binding on the courts because Propositions 218 and 26 were enacted as constitutional amendments, and the California Supreme Court has made it clear that the judiciary has final authority to interpret and ensure the proper implementation of their terms.<sup>224</sup> Nevertheless, the legislature's

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224. *Silicon Valley*, 187 P.3d at 50.

interpretation of the law should carry significant weight with the courts. This is especially true for the clarifications and declarations just listed because each of them addresses the sound management of California's water resources and article X, section 2 of the Constitution expressly grants the legislature authority to pass laws to implement its reasonable use mandates.<sup>225</sup>

#### D. CONSTITUTIONAL CHANGES

Several of the interpretations and reforms that we recommend may not be consistent with the terms of Propositions 218 and 26. One example is our interpretation of Proposition 26 as not changing the law governing regulatory fees that apply prospectively to deter harmful activities (such as excessive groundwater pumping that contributes to overdraft) or that force land and water users to pay for the negative externalities of their activities. Another is our suggestion that these types of regulatory fees should be governed only by the substantive standards of Proposition 26. Even a court that agrees with our conclusion that Proposition 218 is ill-suited to regulatory fees—and that this interpretation better harmonizes the two propositions—might be reluctant to construe one provision of the constitution as taking precedence over another without clear guidance from the electorate, which has final authority over these aspects of California's constitutional law.

It therefore may be preferable—even necessary—to ask the voters to amend the constitution to correct the problems created by Propositions 218 and 26 for effective water resources management. Indeed, it is doubtful that anyone involved in the sequential enactment of these two initiatives—the drafters, sponsors, or the voters—carefully thought through the consequences of these laws for programs such as tiered water pricing, water recycling, stormwater discharge fees, conjunctive surface and groundwater management, or lifeline rates for low-income households. Nor is it likely that any of these groups

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225. CAL. CONST. art. X, § 2. The legislature may also want to consider making two other changes to protect the solvency of water agencies in the face of Proposition 218 challenges. First, it would also be useful for the legislature to enact a statute of limitation on lawsuits brought to challenge increases in rates, fees, and other charges under Propositions 218 and 26. The 120-day statute of limitations for judicial challenges to water and sewer connection fees and capacity charges in California Government Code section 66022 could serve as a model. Second, it would be useful for the legislature to extend to all public agencies providing water services the provisions in the California Water Code section 31007 that require county water districts (a particular type of special district) to establish fees and charges at rates sufficient to cover their costs. In *Mission Springs Water District v. Verjil*, the California Court of Appeal held that the local electorate “does not have the power . . . by initiative . . . [to] set water rates so low that they [are] inadequate to pay [the water district’s] costs.” 160 Cal. Rptr. 3d 524, 546 (Cal. Ct. App. 2013).

considered the interplay between Propositions 218 and 26 and article X, section 2.

The following package of amendments would be consistent with the conclusions of our analysis:<sup>226</sup>

1. Amend Proposition 218 to allow public water agencies to adopt fees, charges, and rates that fund water acquisition, water development, and water resources management programs that benefit their customers by increasing water supplies, reducing demand, or otherwise enhancing the reliability of water service—even though not all customers may receive or have access to the water that is physically produced or saved by these programs.

2. Amend Proposition 26 to state clearly that prospective regulatory fees enacted to deter land and water use activities that harm other resource users or the environment, or that compel land and water users to internalize the external costs of their actions, may be enacted as fees (rather than taxes).

3. Amend Proposition 218 to exempt these types of regulatory fees from its substantive standards, as they would be governed exclusively by the substantive standards of Proposition 26.

4. Amend Proposition 218 to incorporate the provisions of Government Code section 53756 by stating that public water agencies may adopt schedules of fees, charges, or rates that automatically “pass through increases in wholesale charges for water, sewage treatment, or wastewater treatment” without being subject to their procedural and substantive standards.

5. Amend Proposition 218 to exempt “water lifeline rates”—that is, subsidized rates for low-income customers—from the cost of service-based standards of that law.

6. Amend Proposition 218 to add stormwater discharge fees to the list of charges (currently, sewer, water, and refuse collection services) that are exempt from voter approval requirements.<sup>227</sup>

7. Amend Propositions 218 and 26 to state that, although the burden remains on the public water agency to prove that it has complied with their substantive standards, the reviewing courts must defer to the agency’s determination of the need for, amount, and allocation of a rate or fee, and uphold the charge if there is substantial evidence in the administrative ratemaking record to support the agency’s decision.

8. Amend Propositions 218 and 26 to state that public water agencies and reviewing courts shall interpret their provisions in a

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226. For the reasons described in *PAYING FOR WATER*, we also recommend that the voters amend Proposition 13 to allow local special taxes enacted for the purpose of funding water supply, water service, water management, stormwater management, and ecosystem improvement and management to be enacted by a simple majority vote of the electorate. *See generally* *PAYING FOR WATER*, *supra* note 1. This would be consistent with the voter threshold for the passage of local general taxes and all fiscal measures that appear on statewide ballots.

227. This change would not be needed if our second and third proposed constitutional amendments, which would exempt stormwater fees from Proposition 218 altogether, were enacted.

manner that is consistent with and promotes the water conservation and reasonable use directives of article X, section 2. This should include, but not be limited to, a statement that tiered rates and fees adopted to promote conservation and efficient use are constitutional, even if they are not strictly apportioned among property owners and water users on the basis of cost of service.

9. Finally, as discussed above, the central purpose of Propositions 218 and 26 was to ensure that the funds collected from water service rates, water management charges, and regulatory fees are not used for unrelated programs or activities. Thus, we also recommend that both laws be amended to state that neither the legislature nor local governments have authority to divert the proceeds of these fees and charges to purposes other than the programs that are the sources of the fees and charges. This would reinforce Proposition 218's declaration that "[n]o fee or charge may be imposed for general governmental services . . . where the service is available to the public at large in substantially the same manner as it is to property owners,"<sup>228</sup> as well as Proposition 26's directive that fees and charges not exceed the amount "necessary to cover the reasonable costs of the governmental activity" and that they "bear a fair or reasonable relationship to the payor's burdens on, or benefits received from, the governmental activity."<sup>229</sup>

#### CONCLUSION

The amendments to the California Constitution that began with Proposition 13 in 1978 and continued with Propositions 218 and 26 have fundamentally changed water ratemaking, management, financing, and regulation. These laws were responses to accumulating voter frustration with the rising costs of land ownership and utility service, as well as with state and local government decisions that some members of the public perceived as opaque, unaccountable, and unjustified. Although these laws have enhanced the transparency and accountability of governmental decisionmaking, the substantive standards of Propositions 218 and 26 have placed serious constraints on the ability of the state and local governments to raise funds for essential water supply, watershed protection, groundwater management, and pollution control programs—at least through the use of water rates, fees, and other charges.

We have taken a close look at many of these constraints on ratemaking, water management, and land and water use regulation. We have also considered the interactions among Propositions 218 and 26, as well as the effects of these newer laws on some of the most important statutory and constitutional directives that govern the use and management of California's water resources—most notably, the reasonable use mandates of article X, section 2. Based on our analysis, we have offered a variety of recommendations for water administrators,

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228. CAL. CONST. art. XIII D, § 6, cl. b, pt. 5.

229. *Id.* art. XIII A, § 3, cl. d; *id.* art. XIII C, § 1, cl. d.

legislators, judges, and the voting public to address some of the constraints and misunderstandings of these important initiatives. We hope that some of our legal analyses and recommendations may serve as a guide to constructive policy reforms that will assist the state and its diverse array of public water agencies in fulfilling their water service and stewardship obligations in an accountable, responsible, and reliable manner. At the very least, we hope that the attention that we may bring to these topics will facilitate a better understanding of the ambiguities and problematic features of Propositions 218 and 26, and will engender a much-needed public debate about the efficacy and wisdom of these laws for the future administration of California's most vital water systems.

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