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April 7, 2015

Hon. Tani Cantil-Sakauye, Chief Justice
Associate Justices of the Supreme Court
Supreme Court of California
350 McAllister St.
San Francisco, CA 94102

RECEIVED
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Re: ***Citizens for Fair REU Rates v. City of Redding*, 233 Cal.App.4th 402, Supreme Court Case No. S224779 (Petition for Review filed March 3, 2015); Letter in Support of Petition for Review**

Dear Chief Justice Cantil-Sakauye and Associate Justices:

We write on behalf of the League of California Cities ("the League") to urge this Court, as a matter of statewide importance, to grant the petition for review filed by the City of Redding in *Citizens for Fair REU Rates v. City of Redding* (2014) 233 Cal.App.4th 402 ("*Citizens*"). This decision has a broad and potentially costly impact on many California cities, as it could negatively affect municipal credit ratings and thereby increase cities' costs to obtain financing. Indeed, the credit rating agency, Fitch Ratings, has issued a statement that the "ruling could lead to increased financial pressure for California cities that transfer revenue from electricity utilities to general operating funds." (A copy of this February 11, 2015 press release by Fitch Ratings is attached as Exhibit A.) "Electric system transfers account for a significant amount of general fund inflows in a number of other California cities including Glendale, Lodi, Los Angeles, Pasadena and Riverside. Fitch believes a trend of similar legal actions could become a rating sensitivity in the coming years for those cities." Review is also necessary to secure uniformity of decision and to settle important questions of state law regarding the retroactive effect of 2010's Proposition 26 and its applicability to long-standing municipal budgetary practices.

Citizens holds that the City of Redding's 25-plus year practice of transferring certain money from its municipal electric utility fund to its general fund, by itself, constitutes a "tax" subject to the requirements of Proposition 26. This holding is absurd

on its face – Proposition 26 defines "tax" as meaning "any levy, charge, or exaction of any kind imposed by a local government except the following: [list of exceptions]." (Cal. Const. Art. XIII C, § 1, subd. (e).) Redding's (and other California cities') budgetary act of transferring sums from one fund to the other does not, by itself, constitute any such imposition and thus cannot be found, by itself, to be a tax. (Cf. *Great Oaks Water Company v. Santa Clara Valley Water District* (2015) __ Cal.App.4th __, 2015 WL 1403340, at p. *24 (budget actions reviewed under deferential arbitrary and capricious standard).) Yet the *Citizens* decision repeatedly refers to the interfund transfer itself as a tax that, in the court's view, must directly comply with Proposition 26.

Had *Citizens* employed the correct analytical methodology, it would have instead considered the extent to which the electricity rates Redding arguably "imposes" on its residents are "taxes." The decision recognizes that Proposition 26 excepts from the definition of tax any "charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of providing the service or product." (Cal. Const. Art. XIII C, § 1, subd. (e)(2); cf. Art. XIII A, § 3, subd. (b)(2) (substantially identical exception for State fees).) So Redding's utility rates could only be "taxes" if Redding directly charged its residents more than "the reasonable costs" Redding incurs in providing utility service.

This analytical mis-step in *Citizens* results in significant adverse consequences for not only Redding, but for any California city that operates a municipal utility. First, it allowed the court to apply Proposition 26 retroactively to Redding's pre-Proposition 26 utility rates. By focusing only on the annual budgetary transfer, *Citizens* justified retroactive application of Proposition 26 by holding that Redding makes a brand new budgetary decision each year and that Proposition 26 thus can be applied "prospectively" to each future budget cycle. Had the *Redding* decision instead focused on the City's electricity rates, it would have been compelled to find that Proposition 26 could not be applied retroactively to challenge electricity rates in existence when Proposition 26 was adopted in 2010 (even if those rates included some share of the general fund budget transfer). And Redding's rate increases after 2010 should not be subject to challenge under Proposition 26 so long as the amount of those increases were, themselves, justified by Redding's increased costs in providing services (and not by any increase in the general

fund budget transfer, which the Petition demonstrates Redding has not changed since 2005 [Petition at p. 3, citing Respondents' Brief at p. 43 and 3 CT 530].). As a result, *Citizens* contradicts other recent case law holding that Proposition 26 does not apply retroactively while claiming to follow it. (See *Brooktrails Township CSD v. Board of Supervisors* (2013) 218 Cal.App.4th 195, 205-207; cited in Opinion at p. 19, fn. 6.).)

Second, by holding that Redding's entire general fund budget transfer is subject to Proposition 26, *Citizens* calls into doubt the ability of cities to sell electricity (and perhaps other utility commodities, such as water and natural gas) wholesale at market prices, effectively holding instead that, under Proposition 26, such cities may only sell electricity at actual cost. *Citizens* largely ignores that Redding's utility also generates electricity in excess of its customers' needs, which excess it sells on the open market to wholesalers, such as the former Enron. Of course, in adopting Proposition 26, the voters only sought to restrict the ability of local agencies to have taxes and fees "imposed" on those who have no practical alternatives to those services, and had no intent to regulate an agency's sale of any product on the open market to sophisticated market participants with alternative sources of supply. If left published and not reviewed, the *Citizens* decision will result in significant confusion and uncertainty for all publicly owned utilities in California that sell electricity (or other utility commodities) in the open market, and then transfer a portion of the proceeds of such sales to their general funds. As a letter in support of review from the Northern California Power Association demonstrates, essentially all public utilities sell power in the wholesale markets given their need to balance power supplies and demands in dynamic conditions.

As Justice Duarte correctly recognized in her dissent below, the result of the *Citizens* decision "is disruptive, uncertain, and chaotic and . . . is not compelled by Proposition 26 . . . ." (Dissent at p. 1.) The League has a strong interest in this Court's review of this decision.[1]

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[1] The League is an association of 474 California cities dedicated to protecting and restoring local control to provide for the public health, safety, and welfare of their residents and to enhance the quality of life for all Californians. The League is advised by its Legal Advocacy Committee, which comprises 24 city attorneys from all regions of the state. The Committee monitors litigation of concern to municipalities and identifies those cases that have statewide significance. The Committee has identified this case as having

BACKGROUND

Like many California cities, the City of Redding owns and operates a municipal utility (the Redding Electric Utility, or "the Utility"), which provides electric service for the City's residents and businesses. These customers pay the City's electric rates in exchange for this service. Redding's utility also generates excess electricity which it has long sold on the open market – at market prices – to wholesalers, such as the former Enron. (See, e.g., *Public Utilities Com'n of State of Cal. v. F.E.R.C.* (9th Cir. 2006) 462 F.3d 1027 [demonstrating Redding's participation with Enron in the wholesale market regulated by F.E.R.C.].)

Redding maintains an operating fund for the Utility, that includes income from its electric rates and from its sale of excess electricity on the open market, much of which is used to pay for the Utility's operating costs. And, like all cities, Redding has a "general fund," that includes its discretionary income from various sources, such as general taxes, and that is uses to pay for the costs of general municipal services. As *Citizens* acknowledges, some of Redding's general fund expenditures significantly benefit the Utility. (See Opinion, at pp. 21-22 ["Undoubtedly, Redding incurs costs to provide infrastructure and support to the Utility. For example, Redding police protect the Utility property and the Utility's workers. Redding's streets, used by the Utility in its operations, are built and maintained by Redding's general fund. Redding's fire department stands ready to respond if a Utility transformer sparks a fire, or a downed tree cuts a live utility line, endangering Redding's citizens."].)

Redding has long transferred certain sums from its Utility fund to its general fund. Since 1988, the amount of this transfer has been calculated based on the amount of the one percent ad valorem property taxes the Utility would otherwise pay if it were a private rather than a public utility. This transfer is referred to as a "payment in lieu of taxes" or "PILOT." Many of the League's member cities who operate utilities have similar PILOTs. (See Opinion, at p. 4, n. 2 ["PILOTs are not uncommon among California municipalities."].)

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such significance. The League previously filed an *amicus* brief in support of the City of Redding in the appellate proceedings below and also filed a letter with this Court on March 20, 2015 requesting depublication of the decision.

In November 2010, the state electorate adopted Proposition 26. Proposition 26 amended Article XIII C of the California Constitution by adding a definition of "tax" as meaning "any levy, charge, or exaction of any kind imposed by a local government" with a list of seven exceptions, including "(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 local government of providing the service or product." (Cal. Const. Art. XIII C, § 1, subd. (e)(2).)

In December 2010, Redding adopted a resolution increasing its electric utility rates by just over 15 percent, with half of the increase effective in January 2011 and the remaining half effective in December 2011. According to Redding, the purpose of the increase was to cover significant increases in costs of generating electricity over recent years, during which Redding had previously deferred rate increases. (See Redding's Petition for Review at pp. 6-7, citing (III AR Tab 140, pp. 797-800; IV AR Tab 159, p. 1031; IV AR Tab 163, p. 1041).

Plaintiffs filed two actions challenging Redding's December 2010 rate increases as well as its adoption of a biennial budget in June 2011, which were subsequently consolidated. The trial court entered judgment for the City, and plaintiffs appealed.

In *Citizens*, the Third District held that "the PILOT constitutes a tax under Proposition 26 for which Redding must secure voter approval unless it proves the amount collected is necessary to cover the reasonable costs to the city to provide electric service." (Opinion at p. 3, as modified Feb. 19, 2015.) And it further held that Redding may not make this budgetary transfer unless it can prove at trial that "the PILOT does not exceed reasonable costs . . . ." (Opinion, at p. 4, see also, p. 22, as modified Feb. 19, 2015 [holding "Proposition 26 would nonetheless require the PILOT to either reflect the city's reasonable cost of providing electric service or be approved by voters."].)

GROUNDS FOR REVIEW

I. The Opinion effectively applied Proposition 26 retroactively to Redding's actual utility rates in conflict with *Brooktrails.*

Redding's only action that can fairly be characterized as a potential "tax" subject to Proposition 26 is its actual act of charging its residents for electric service. It is only this act that potentially falls with Proposition 26's definition of "tax" as including "any levy, charge, or exaction of any kind imposed by a local government." (Cal. Const. Art. XIII C, § 1, subd. (e).) But this charge would not be found a tax if it falls within the exception in subdivision (e)(2) as a "charge imposed for a specific government service or product . . . which does not exceed the reasonable costs to the local government of providing the service or product." (*Id.*, at subd. (e)(2).)

Under this proper analysis, the PILOT itself cannot be found to be *directly* subject to Proposition 26. Such a budgetary transfer from the Utility fund to the City's general fund does not, by itself, fall within the definition of a "tax." At most, the existence of the PILOT transfer from the Utility fund to the City's general fund might be considered as evidence that the City's utility rates themselves might exceed the Utility's reasonable costs—but only to the extent that the amount of such a PILOT transfer is funded by the utility rates (as opposed to the Utility's other revenues, such as income from sale of excess electricity in the wholesale market), and even then, only to the extent that any amount of the PILOT funded by the rates exceeds the general fund's reasonable costs of providing various services to the Utility, including police, fire, public works, street maintenance, and other services.

But because Proposition 26 does not apply retroactively, Redding (and the trial court) should not have to engage in this type of complex historical factual analysis for the 25-plus year old PILOT transfer. To the extent that any portion of Redding's 2010 electric rates funded any portion of the PILOT, those rates should be found to be grandfathered under and not subject to Proposition 26. And likewise, Redding should be able to justify its post-Proposition 26 rate increases by demonstrating that such increases are the direct result of increases in the Utility's reasonable costs of providing service and not to any increases in the amount of the PILOT itself. (See Redding's Petition for

Review at p. 7, citing IV AR Tab 163, p. 1041 ["The 2010 rate increases did not change the PILOT in any way."].) To construe Proposition 26 otherwise is to allow it to terminate pre-2010 fees when they are increased or renewed. Although Proposition 218 imposes such a rule as to property related fees under Article XIII D (Cal. Const., art. XIII D, § 6, subd. (d)), Proposition 26 adds nothing comparable to Article XIII C, in issue here. These two articles are *in pari materia*, and this difference in language requires a difference in meaning.

Had the Opinion properly focused on the application of Proposition 26 to Redding's legislatively-adopted electric rates, it should have found that those rates are grandfathered to the extent that they continue to fund any portion of the PILOT that they already funded pre-Proposition 26. But instead, the Opinion found that the PILOT itself was somehow a "tax" that was itself subject to Proposition 26. It then engaged in a convoluted analysis unsupported by citation to authority to find that, because the PILOT was part of an annual budget process and had not previously been established by ordinance, it could be challenged anew prospectively each year, explaining:

> "Each budget is a discretionary legislative act made by each city council. [Citation omitted.] The broad legislative discretion with which a city council is imbued stands in contrast to a tax or fee fixed by ordinance. In this case, each PILOT transfer represented a readoption in the discretion of each city council. Indeed, the record shows changes to the method of calculating the PILOT were made in 1992, 2002, and 2005. Consequently, the PILOT cannot be deemed to be grandfathered-in as preceding the 2010 adoption of Proposition 26." (Opinion, p. 18.)

The Opinion's finding that Proposition 26 can be applied to future PILOT's merely because the PILOT was not previously established by ordinance arbitrarily elevates form over substance. Redding has consistently made the PILOT transfers for over 25 years with only three minor adjustments during that period—analysis of the retroactivity issue should not turn on whether the PILOT was adopted by ordinance, resolution, or consistent budgetary practice. More fundamentally, however, this finding side-steps the legislative nature of Redding's electric rates themselves and essentially allows for a retroactive application of Proposition 26 to those rates.

II. The Opinion suggests cities cannot sell electricity and other utility commodities in wholesale markets at market prices.

Citizens creates significant confusion and uncertainty by holding that the entire amount of the PILOT transfer itself—rather than just the Utility's electricity rates actually charged to Redding's residents—must be limited to the Utility's service costs. As explained above, in addition to providing electric service to Redding's residents, the Utility also generates additional electricity for sale in the open market to other wholesalers. Proposition 26 does not regulate such sales as "taxes"—they do not involve any "imposition" of a "levy, charge, or exaction" subject to Article XIII C, section 1, subdivision (e)—and Redding (and all other California cities) should be free to sell on the wholesale market at market rates rather than actual costs. (*Ponderosa Homes, Inc. v. City of San Ramon* (1994) 23 Cal.App.4th 1761, 1770 [construing "impose" under Mitigate Fee Act to involve use of "force" or "authority"].) To the extent that any portion of (or the entire amount of) such a PILOT is funded by "profit" to a municipal utility from such sales, there is no reason for any court to mandate that a city must prove that the entire amount of the PILOT does not exceed actual costs of serving customers who provide other revenues to the utility via retail rates.

Citizens appears to assumes that the PILOT is funded directly and solely from Redding's utility rates, and ignores the possibility that it can be funded from proceeds from Redding's sale of extra electricity on the wholesale market. However, on this point, the Petition argues the trial court found that the amount of Redding's PILOT could be funded three times over from the Utility's revenues from its sale of electricity to wholesale customers. (See Redding's Petition for Review at pp. 19-20, citing 3 CT 741 [trial court Memorandum of Decision]; compare Opinion at pp. 21-22 [describing this as a conclusion of law].) This fact alone suggests that the entire amount of the PILOT merely reflects a transfer of some of the profit of such sales to the City's general fund, and there was thus no reason for the court below to interpret Proposition 26 to mandate that the City prove that the PILOT (as opposed to the Utility's electricity rates) does not exceed its actual costs. But *Citizens* virtually ignores this critical fact, aside from brief references to it. (*Citizens* at pp. 15 [briefly acknowledging "Redding's insistence it could cover the PILOT costs with non-retail income"], 22-23 [confusingly stating that "[t]he possibility that non-rate revenues exceed the PILOT does not satisfy Proposition 26's

requirement that Redding demonstrate the collected tax reflects the reasonable costs of providing electric service."].)

Citizens thus improperly implies that a municipal utility cannot charge market rates for selling electricity (and perhaps other utility commodities such as water and natural gas) to other wholesalers, or at least that it cannot transfer any component of "profit" from such sales to the municipality's general fund. But to the extent that Redding or any other California city has chosen to invest in such a utility, there is no reason that the city's general fund should not recover some modest return on that investment, at least where that return is funded from independent sources other than the municipal utility's electricity rates arguably "imposed" on its customers. (Cf. *Hansen v. City of San Buenaventura* (1986) 42 Cal.3d 1172 [City could earn rate of return on extra-territorial service without its rates constituting taxes under Prop. 13].) And it is certainly to the benefit of a city's residents that the city be able to utilize some of these proceeds to fund critical public services.

If left published and not reviewed, the *Citizens* decision thus will likely result in significant and costly confusion and litigation regarding the extent of a municipal utility's ability to sell at market rates to wholesale customers and undermine the analysis Proposition 26 requires as to the revenue measures within its reach.

On the grounds explained above, as well as all of the remaining grounds set forth in Redding's Petition for Review, the League respectfully urges this Court to grant review of the *Citizens* decision to provide guidance on these pressing questions for lower courts, cities, public utilities, and the Californians they serve.

Very truly yours,

JARVIS, FAY, DOPORTO & GIBSON, LLP

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EXHIBIT A

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Ruling May Endanger Key Revenue Source for Some CA Cities

Fitch Ratings-New York-11 February 2015: A recent appellate court ruling could lead to increased financial pressure for California cities that transfer revenue from electricity utilities to general operating funds, Fitch Ratings says. We believe this decision could lead to similar lawsuits in other locations.

The court ruled that the city of Redding's electric system payments in lieu of taxes (PILOTs) constitute a tax and, therefore, require two-thirds voter approval to remain in place. If the decision from this court stands or if the case is upheld by the state Supreme Court, it would remove an important income stream from the city of Redding's general fund. In fiscal 2014, the electric fund PILOT accounted for 7.8% of general fund revenues and transfers in. Electric system transfers account for a significant amount of general fund inflows in a number of other California, cities including Glendale, Lodi, Los Angeles, Pasadena and Riverside. Fitch believes a trend of similar legal actions could become a rating sensitivity in the coming years for those cities.

The appellate court decision would require two-thirds voter approval under Proposition 26 for the PILOTs to remain in place unless Redding can demonstrate that the transfers recover costs associated with providing electric service.

Momentum to limit utility transfers for general government purposes has been building for decades. Proposition 218 (passed in 1996) required new fees or taxes levied by local governments to receive two-thirds voter approval but excluded electric and gas rates. Proposition 218 and a subsequent ruling by the California Supreme Court in 2006 (Bighorn Desert-View Water Agency v. Verjil) successfully limited utility transfers not related to cost recovery. Proposition 26, passed in 2010, more broadly defines taxes with fewer exclusions.

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DECLARATION OF SERVICE

I, the undersigned, declare as follows:

I am a citizen of the United States and employed in the County of Alameda; I am over the age of eighteen years and not a party to the within entitled action; my business address is Jarvis, Fay, Doporto & Gibson, LLP, 492 Ninth Street, Oakland, California 94607.

On April 7, 2015, I served the within

LETTER SUPPORTING REVIEW

on the parties in this action, by placing a true copy thereof in a sealed envelope, each envelope addressed as follows:

William P. McNeill McNeill Law Offices 280 Hemsted Drive, Suite E Redding, CA 96002	*Attorneys for Plaintiff and Appellant CITIZENS FOR FAIR REU RATES*
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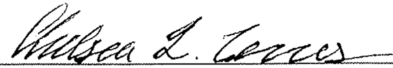
California Court of Appeals Third Appellate District 914 Capitol Mall, 4th Floor Sacramento, CA 95814-4719	

I caused each such envelope, with postage thereon fully prepaid, to be placed in the United States mail to be mailed by First Class mail at Oakland, California.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct. Executed on April 7, 2015, at Oakland, California.



Chelsea Torres