



Proposition 50 Resources Bond: Funding Eligibility of Private Water Companies

ELIZABETH G. HILL • LEGISLATIVE ANALYST

The implementation of the Proposition 50 resources bond has raised the issue of whether *private* water companies should be eligible for these funds. We identify several legal, tax, and policy issues for legislative consideration in evaluating this issue. We recommend that the Legislature declare its policy position on this matter. Our review concludes that the broad public purpose of Proposition 50 bond funds would be served by including private entities as eligible recipients of such funds. ■

Acknowledgments

This report was prepared by Mark C. Newton. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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OVERVIEW

The Issue

Various state departments are currently reviewing whether *privately* owned water companies should be included as eligible grant recipients under Proposition 50 grant guidelines they are now developing. Proposition 50—an initiative bond measure—is a \$3.44 billion general obligation resources bond approved by the voters in November 2002. Unlike prior resources bond measures that generally restrict grant and loan funds to public agencies and nonprofit organizations, Proposition 50 is in most cases silent on the issue of public versus private eligibility. Rather, the measure typically provides funds for “water systems” or “water projects.”

Legislative Analyst’s Findings

We identify several legal, tax, and policy issues for legislative consideration. Based on our review, it appears that legal and tax-related concerns with allowing private water companies to receive bond funds can be addressed, making this issue largely a policy one. That is, *should* private water entities be eligible to receive bond funding? We conclude that the broad public purpose of Proposition 50 bond funds would be served by including private entities as eligible recipients of these funds. Whether the

Legislature decides to include or exclude private water companies from receiving bond funds, we recommend that in either case legislation be enacted to ensure the consistent implementation of its policy decision across the various state departments implementing Proposition 50.

BACKGROUND

Water Systems in the State

Drinking water is generally supplied to residents of the state through three types of water systems. These water systems are owned by public agencies (such as local water districts); private, not-for profit mutual water companies (entities whose shareholders are the landowners served by the water system); and private, for-profit corporations. There are about 8,700 water systems in the state that have at least 15 service connections and are subject to state oversight. As Figure 1 shows, about 23 percent of Californians receive their water from private water companies.

Figure 1
Water Systems in California^a

Ownership of System	Number of Systems Statewide	Percent of Population Served
Public Agency		
Local water agencies	About 8,130	About 76 percent
Privately Owned		
Private, for-profit water utilities ^b	About 170	About 23 percent
Private, not-for-profit, mutual water companies	About 400	Less than 1 percent
Total	About 8,700	

^a Excludes systems with fewer than 15 service connections and systems serving mobilehome parks which collectively serve about 2 percent of the state's population.

^b Regulated by the California Public Utilities Commission.

Regulation of Water Systems. The Department of Health Services (DHS) administers a safe drinking water regulatory program for all publicly and privately owned water systems, as long as the system has 15 or more service connections.

As regards the setting of rates, the California Public Utilities Commission (CPUC) does this for private, for-profit water utilities, while local government water systems and mutual water companies set their own rates.

Who Are the Private, For-Profit Water Utilities? There are about 170 privately owned, for-profit, CPUC-regulated water utilities in the state, of which about 75 percent are relatively small companies that serve fewer than 500 connections. Nine companies have more than 10,000 service connections. Practically every county in the state is served in part by a private water utility. As with the publicly owned systems, these privately owned water systems serve communities of varying economic resources.

What Proposition 50 Funds Are at Stake?

Of the \$3.44 billion of total authorized funds in Proposition 50, about \$1.4 billion is for purposes that could potentially be allocated to private water companies. The remainder of the \$3.44 billion is either for programs for which private companies are excluded from eligibility by the bond measure or for purposes that do not relate to the activities of private water companies (such as funding for the acquisition and restoration of coastal watersheds). The funding allocations for which private water companies are potentially eligible include:

- \$500 million to the Department of Water Resources (DWR) and the State Water Resources Control Board (SWRCB) for grants for various “integrated regional water management” projects. These projects can be for a wide variety of purposes (such as water conservation, water quality improvement, and flood control), but must be consistent with an adopted regional water management plan to be eligible for funding.
- \$435 million to DHS for safe drinking water loans and grants.
- \$180 million for water use efficiency projects in the CALFED Bay-Delta Program.
- \$100 million to DWR for grants for desalination projects and contamination treatment.
- \$100 million for water quality grants.
- \$50 million to DWR for grants for drinking water system water security.

Administration’s Direction on This Issue

The Governor has recently directed each department administering Proposition 50 bond funds to decide, on a department-by-department basis, whether or not to allow private water companies to be eligible for these funds. In this regard, DHS has developed draft guidelines for those Proposition 50 grant programs that it will administer. The draft guidelines make private entities eligible to apply for *all* grant programs, with the exception of a \$25 million grant pro-

gram for pilot and demonstration projects for the treatment or removal of specified contaminants.

The DWR has indicated that it plans to release draft solicitation packages which include the possible funding of partnerships between a local public agency and not-for-profit mutual water companies. This is consistent with DWR's past practice with earlier water bonds. These partnerships must compete for the bond funds and, if funds were awarded, the funds would be allocated directly to the local public agency. The DWR is currently reviewing whether or not to extend funding eligibility to private for-profit companies.

At this time, SWRCB has not indicated how it will proceed on this issue.

Legislation Has Been Introduced

Senate Bill 909 (Machado), introduced last year, would establish in state law a policy regarding the allocation of state bond funds to private water companies. As currently written, SB 909 would provide that CPUC-regulated water utilities and mutual water companies are eligible to receive grant funding from the sale of general obligation bonds, subject to various conditions. Some of the conditions would address the constitutional prohibition against gifts of public funds to private entities, discussed further below. Although this bill is currently in the Assembly Water Parks and Wildlife Committee, there has not been action on the bill since last June.

ISSUES FOR LEGISLATIVE CONSIDERATION

Legal Issues

Are Private Water Companies Eligible to Receive Proposition 50 Grant and Loan Funds?

The Legislative Counsel has released an opinion on this issue at the request of Senator Machado. Legislative Counsel concluded that private water systems are eligible for Proposition 50 funding unless specifically excluded from eligibility under the terms of a particular provision of the bond measure. We find that the funding allocations listed above (totaling about \$1.4 billion) are ones in which private water entities have not been specifically excluded from eligibility by the terms of the bond measure and are for purposes relating to private water companies' activities. In contrast, for example, Proposition 50 limits grants for coastal nonpoint source pollution to certain public entities, educational institutions, and nonprofit organizations, thereby excluding private water entities.

Public Benefit and the "Gift of Public Funds" Issue. Legislative Counsel also considered in the same opinion whether allocating Proposition 50 funds to private companies violates the state constitutional provision that precludes the Legislature from making a gift of public funds to a private person or corporate entity (Section 6 of Article XVI of the California Constitution). Legislative Counsel cited case law which held that the allocation of public funds to private entities would not result in an unlawful gift of public funds as long as the funds are expended for a public purpose. This "public purpose" requirement is reflected in the provisions of the bond measure and subsequent implementing legislation. Specifically, Proposition 50 provides that "it is the intent of the people that investment of public funds pursuant to [the bond measure] should result in public benefits." In addition, the Legislature enacted implementing legislation (Chapter 240, Statutes of 2003 [AB 1747, Committee on Budget])

requiring each state agency expending Proposition 50 funds to report to the Legislature on the intended public and environmental benefit associated with each allocation of those funds.

The concern has been raised that the public purpose requirement for state bond-funded projects would be violated if the benefit of low-interest loans or grants to private, for-profit water companies were to be passed on to company shareholders in the form of higher profits. Our review, however, finds that current CPUC ratemaking practice would prohibit such a shareholder benefit. Specifically, the CPUC has long-established rules that exclude the benefit of grants and government-financed low-interest loans from being included in a utility's "rate base" (essentially the value of its infrastructure, along with debt servicing costs) on which its allowable rate of return is calculated. (If the Legislature wishes, it could ensure that this practice continues by specifically codifying the exclusion of such funds from a utility's rate base.)

Tax-Exempt Status of the Bonds

Federal Requirement. Under federal tax rules, the tax-exempt status of a single state general obligation bond issue is lost if more than \$5 million or 5 percent of the bond issue's proceeds (whichever is less) is used to make *loans* for "private use" purposes. Currently, the State Treasurer typically issues bonds in the range of \$500 million to \$2 billion in a single issue, the proceeds of which are for multiple bond programs.

The Issue. In light of these tax rules, concern has been raised as to whether the federal tax-exempt status of a Proposition 50 bond issue could be jeopardized by making loans to private

water companies. The fiscal consequence to the state of losing the tax-exempt status on a bond issue is higher debt servicing costs due to higher interest costs. The magnitude of this fiscal impact is uncertain as it would depend on the size of the bond issue. In addition, the fiscal impact is uncertain as the difference in long-term interest rates between tax-exempt state general obligation bonds and taxable state general obligation bonds can vary significantly depending on rating and market conditions.

The Solution. We think that if the proceeds of Proposition 50 bond issues were used to make loans to private water companies, the bond issues can be structured to avoid the loss of tax-exempt status by living within the allowable levels of lending to private companies. We think that this should be easy to do for a couple of reasons. First, we note that the vast majority of the Proposition 50 bond funds that could potentially be allocated to private water companies are for *grants*, not loans. In fact, of the roughly \$1.4 billion that we have identified as funds that could potentially be allocated to private water companies, only about \$90 million is for loans. Specifically, this \$90 million is for loans administered by DHS under the federally supported Safe Drinking Water State Revolving Fund (SRF) Loan Program. (This amount is based on DHS' estimates of how it plans to allocate \$435 million in Proposition 50 funds for safe drinking water purposes among various grant and loan programs.) Therefore, by the terms of the bond measure, only a relatively small portion of the bond proceeds *could* be used to make loans to private water companies.

Second, based on past practice, it seems likely that of the \$90 million for loans, only a small amount would be made to private compa-

nies. Specifically, the state has made loans to private water companies for several years under the SRF Loan Program. Since this program's inception in 1998, only about \$2 million (less than 1 percent) of the SRF loans—totaling about \$264 million to date—have been made to private water companies.

Policy Issue

The legal and tax-related issues discussed above appear to present no significant barriers to allowing the allocation of Proposition 50 grant and loan funds to private water companies, in cases where the bond measure does not specifically exclude such eligibility. Accordingly, the major issue for legislative consideration is a policy one. We think that there is a benefit from having a consistent state policy on the issue of allocating bond funds to private water companies, and that this policy should be guided by legislative direction.

We think that the Legislature's evaluation of this policy issue should be framed in the context of the intended public purpose of the bond measure. Proposition 50's broadly stated public purpose is, among other things, to "provide a safe, clean, affordable, and sufficient water supply to meet the needs of California residents, farms, and businesses." Thus, it should be asked whether excluding private water companies from Proposition 50 bond funding eligibility furthers or constrains this public purpose. We think that a policy of including private water companies would further this broad public purpose.

A policy of including private water companies as eligible recipients of bond funds would

be consistent with federal policy direction. For example, Congress and the United States Environmental Protection Agency (U.S. EPA) both viewed providing financial assistance to private water companies as serving a public purpose when the federal Safe Drinking Water Act was reauthorized in 1996. This act created a national safe drinking water loan revolving fund, and private water utilities were specifically included as eligible loan recipients. According to U.S. EPA, which supported the policy change to include private entities in the loan program, such a policy recognized the fact that a significant number of water systems are small and privately owned and in need of assistance to bring them up to regulatory standards. As discussed previously, the California landscape mirrors the federal one, with a significant amount of the state's population being served by private water companies, the majority of which are small.

To the extent the Legislature wishes to include private water companies as eligible recipients of the bond funds, there may be a concern whether the funds would be reaching the communities that would find it relatively difficult to otherwise pay for water system improvements through increased rates. However, as noted above, economically disadvantaged communities in the state are served by both public agency and privately owned systems. Therefore, the Legislature could ensure that this concern is addressed by enacting legislation that targets Proposition 50 bond funding to water systems (whether publicly or privately owned) that serve economically disadvantaged communities.

CONCLUSION

The implementation of Proposition 50 has raised the policy issue of whether to include private water companies as eligible recipients of the bond funds in order to further the broad public purpose of the bond measure. There has been a similar policy discussion at the federal level regarding federal programs providing

financial assistance to water systems. We recommend that the Legislature declare its policy position on this matter. In our view, the broad public purpose of Proposition 50 would be furthered by including private water companies as eligible funding recipients.