S224779

SUPREME COURT
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IN THE SUPREME COURT
OF THE STATE OF CALIFORNIA

Citizens for Fair REU Rates, et al.
Plaintiffs and Appellants,
vs.
City of Redding, et al.,
Defendants and Respondents.

ANSWER BRIEF ON THE MERITS

Review Of a Published Decision of the
Third Appellate District, Case No. C071906

Reversing a Judgment of the Superior Court of
the State of California for the County of Shasta,
Case No. 171377 (Consolidated with Case No. 172960)
Honorable William D. Gallagher, Judge Presiding

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2. Does the exception for "reasonable costs to the local government of providing the service or product" apply to the PILOT (Cal. Const., art. XIII C, § 1, subd. (1)(e)(2))?

3. Does the PILOT predate Proposition 26?

II. INTRODUCTION

On November 2, 2010 the voters of California approved Proposition 26, an initiative measure amending Article XIIIC of the California Constitution to address the phenomenon whereby the Legislature and local governments have disguised new taxes as "fees" to obtain more revenue from California taxpayers, circumventing the Constitutional rights of the citizenry to vote on new taxes. The findings and declaration of purpose reinforce the remedial intent of Proposition 26, noting that despite the enactment of Proposition 218 – which made the right to vote on special and general taxes a Constitutional right per Article XIIIC §2 – there had ben no abatement in exactions because the Legislature and local agencies had simply changed the labels on new "taxes" to call them "fees." Therefore, per the findings and declarations of Proposition 26 (emphasis added):

> (f) In order to ensure the effectiveness of these constitutional limitations, **this measure . . defines a "tax" for state and local purposes so that neither the Legislature nor local governments can circumvent these restrictions on increasing taxes by simply defining new or expanded taxes as "fees."** (Prop. 26, § 1, subds. (b), (c), (e), (f), reprinted at Historical Notes, 2B West's Ann. Cal. Codes (2013) foll. art. 13A, § 3, pp. 296-297).

Proposition 26 became effective the day after the election, December 3, 2010.

The focus and impact of Proposition 26 is in the paradigm shift it made in defining "taxes" and "fees," together with shifting the burden to the government to prove that an exaction truly is a "fee" as opposed to a disguised "tax." Under the prior construct of California law the Legislature and local agencies were free to create exactions imposed on the public and call them "fees," then place the burden on the tax-paying public to challenge the exaction in court, where the taxpayer would be required to carry the burden of proof and overcome a highly deferential standard of review favorable to the government (*Homebuilders Association of Tulare/Kings Counties, Inc. v. City of LeMoore* (2010) 185 Cal.App.4th 554, 562 (*Homebuilders*): "The plaintiff has the burden of proof with respect to all facts essential to its claim for relief and that burden remains" and 561: "Judicial review is limited to an examination of the proceedings before the City to determine whether its action was arbitrary, capricious, or entirely lacking in evidentiary support.") Proposition 26 reversed the analytic route the court must follow, by broadly defining "tax" in Article XIIC §1(e) as "any levy, charge, or exaction of any kind imposed by local government, except the following..." It is then incumbent on the local agency to carry the burden of proof,

by a preponderance of the evidence, that the exaction fits within one of the seven listed exceptions to the broad definition of "tax."

The dispute in this case concerns what Citizens For Fair REU Rates (hereinafter "Citizens") contend are artificially inflated electric rates, adopted as a 7.84% rate increase by the City of Redding (hereafter "City") when the City Council approved Resolution No. 2010-179 on December 7, 2010 (and therefore subject to Proposition 26) (4 AR 1041-1045). The gravamen of Citizens' claim is that the rates are a "tax" rather than a "fee" because the City increases and designs its rates to recover the amount of a planned transfer of rate revenues from the electric utility to the general fund which the City denominates as a "Payment In Lieu Of Taxes" or "PILOT." This portion of the rates is purported to be calculated so as to mimic the amount the City might pay in property taxes on its electric utility assets *if* the City were ever to pay such taxes (which it does not). The so-called PILOT amount of the rates approved in Resolution 2010-179 was about $5,968,220. There is no evidence in the record that this "PILOT" amount of the rate revenue was connected to any cost of service for electricity, and it is undisputed that City has no cost of service study or analysis for its rate increase. The funds transferred from the electric utility to the general fund are not restricted as to their use; like other proceeds of taxes, the City may and does spend the monies freely for any purpose deemed worthy.

Aside from the amount of the electric rates necessary to recover the PILOT amount of about $6 million (which repeats annually, and for purposes of this litigation *cumulatively*), Citizens have not challenged the remainder of the rates as to whether they are otherwise representative of the cost of service to provide electricity to the ratepayers. Thus, this action concerns what is in

essence the overcharging of electric rates, and the so-called "PILOT" is merely the metric of that overcharge.

One might think that – given these undisputed facts – there would be no difficulty or resistance to applying the remedial definition of "taxes" to the increased electric rates adopted by the City after Proposition 26 had become effective, but that would underestimate the tenacity and creativity of the City. The primary defense mounted by the City is that its history of overcharging ratepayers caused the PILOT calculation to acquire a life of its own, largely because the City has planned on exacting the amount of the PILOT in its biennial budget-making process to transfer it to the General Fund, and therefore this long-standing practice pre-existed the approval of Proposition 26 sufficient to give it a "grandfathered" status.

The logical and legal disconnect in the City's central defense is that the "PILOT" is nothing more than a standard line item notation in the City's budget indicating the City's intention to transfer that amount from the electric utility to the General Fund. It sits alongside thousands of other line items for transfers and expenditures in the City budget. Prior to this controversy it received no special treatment, nor was it ever independently processed as any sort of fee, charge, exaction, surcharge, or assessment cognizable under any statutory scheme for such matters. The mere fact that the City adopts its budgets by resolution does not confer a special status on the PILOT or a thousand other transfers, expenditures, collections, etc. contained within the budget. There is no basis whatsoever in California law to find that this metric for an interfund transfer has evolved into anything independently legally cognizable; the City has provided no legal authority for such a novel proposition, because there is none. To be more precise for the purposes of Proposition 26 analysis, it is

undisputed that the planned interfund transfer in the amount of the PILOT notated in the City budget is not itself a "fee" or "charge" as those terms are used in Article XIIIC §1(e) (See City Respondent's Brief from the proceedings below, at p. 19, fn. 15, and at p. 22 – acknowledging that the projected interfund transfer in the amount of the PILOT is not a "fee" or "charge" or "rate," and calling it a "cost funded by utility resources"). There is nothing to "grandfather" as to Proposition 26.

The City's other defenses argued in its opening brief melt away with only slight scrutiny: (•) that the City should be allowed to make a "modest profit"; (•) that the PILOT amount allegedly could have been paid from power sales; (•) that the City's rates are reasonable based on market comparison to other utilities in the state. These are addressed *post* only as may be needed to protect Citizens for rebuttal purposes. Citizens are mindful that, strictly speaking, none of the defenses referenced immediately above are permissible for briefing under the Court's April 29, 2015 order for briefing and argument to be limited to the 3 specific issues in the order.

III. STATEMENT OF THE CASE

A. STATEMENT OF FACTS

There is no dispute as to any of the material facts in this case. On November 2, 2010, the voters of the State of California approved Proposition 26, amending Article XIII C of the California Constitution to place significant limitations on the ability of local governments to raise, extend or impose charges for government services or products by further clarifying the definition of a local "tax" requiring approval by the electorate. In particular, Section

1(e)(2) provides that a charge is exempt from the voter approval requirements for taxes only if the charge for the government service or product "does not exceed the reasonable costs to the local government of providing the service or product" (2 CT 402-403). Also added to Article XIII C of the California Constitution was the provision placing the burden *on the local government* to prove "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" (2 CT 403).

On December 7, 2010, little more than one month after the general election of November 2, 2010 approving Proposition 26, the City of Redding City Council adopted Resolution 2010-179, increasing the rates charged by the Redding Electric Utility ("REU") a total of 15.68% between January and December 2011 (4 AR 1041). This rate increase included an embedded "Payment In-Lieu of Taxes" ("PILOT") charge, a charge collected through REU rates and transferred to the City's general fund (3 CT 736). The PILOT charge is calculated using an amount based on 1% of the Redding Electric Utility fund's total fixed assets, and is meant to mimic the amount of property taxes the City would have to pay on REU's assets if the City had to do so (3 CT 736), (though, as explained below, it in fact does not). The calculation of the PILOT is made without any reference to the cost of operating the Redding Electric Utility.

The City first included an accounting of the transfer of the PILOT charge in its 1988-89 budget (5 AR 1134 – 6 AR 1540, Tab 173), though it should be noted that the PILOT was never (and has never been) approved or voted on as a separate and specifically

approved charge by the City (and see again City Respondent's Brief from the proceedings below, at p. 19, fn. 15, and at p. 22 – acknowledging that the projected interfund transfer in the amount of the PILOT is not a "fee" or "charge" or "rate," and calling it a "cost funded by utility resources"). Prior to this, between 1971 and 1988, the City moved money from its Electric Utility Fund to its General Fund via an "operating transfer", a transfer in a fixed amount established by the City budget (3 AR 640, Tab 111). As of the 1988-89 budget, the City replaced this fixed amount transfer with the transfer of a PILOT charge from REU to the City's General fund, calculating the PILOT using an amount based on 1% of the Redding Electric Utility fund's total fixed assets. As stated above, the calculation of the PILOT is meant to mimic the amount of property taxes the City would have to pay on REU's assets if the City had to pay such taxes (which it does not) (3 CT 736).

The manner in which the City calculates the PILOT charge has changed over the years. In the City's budget for fiscal year 1988-89, the method chosen for calculating the PILOT was to assess the value of REU's property and equipment and subtract estimated depreciation of equipment, furnishings and vehicles (2 AR 380, Tab 42); in the City's adoption of its 1991-92 budget, the City amended this calculation to include the value of capital construction works in progress but not completed (2 AR 416, Tab 59); in the City's adoption of its 2001-2003 budget, the calculation was amended to include a maximum 2 percent annual growth in accessed valuation (3 AR 693, Tab 126); in the most recent change to the PILOT calculation formula, the City states that the PILOT calculation was amended to include the value of joint-venture assets in which REU has a share (2 CT 530). Each adjustment of the formula for calculation of the PILOT charge has resulted in additional assets or

asset values being allowed for inclusion in the formula. As is apparent from the foregoing, the formula for calculation of the PILOT bears no relation to the actual cost of operating the utility – it is merely a calculation of 1% of the assets currently held by REU.

At this point it should be noted that in the City's Opening Brief, the City misrepresents the method by which the PILOT was and is calculated. The City states in its Opening Brief at page 8 that a 1999 review of its PILOT, conducted by the firm of R.W. Beck, Inc. (at Tab 119, 3 AR 663-665), indicated that the City was not using the method used by the State Board of Equalization when calculating property taxes for Independently Operated Utilities (IOUs) but then adjusted the PILOT to adopt the Board of Equalization methodology in its 2001-2003 budget. The City's Opening Brief then states incorrectly that the Board of Equalization method was to value assets using original, rather than depreciated, values, and cites the Beck report for this finding. In fact, the report correctly states "the State Board of Equalization uses the *depreciated* value when calculating property taxes for the IOUs", not the original value, and that at the time the City of Redding was not using this method (at 3 AR 664, 1st ¶, emphasis added) nor has the City ever adopted this method[1]. The report goes on to indicate that "if Redding were to deem it desirable to more closely approximate methodologies used for property tax assessment, then the Board of Equalization model for electric utility plant would be a good model" (at 3 AR 664, 1st ¶)

[1] See also Tab 3, 1 AR 12-117, Handbook Titled "The Appraisal of Public Utilities," from the Valuation Division of the Property Department of the California State Board of Equalization: "The original cost figure are trended to produce a trended historical cost or reproduction cost. The reproduction cost is depreciated by the use of percent good tables based on a present worth concept, while historical cost is depreciated on the basis of the straight line method required by the regulatory commission" (1 AR 64).

and to recommend that the City may want to "[m]odify the bases for In-Lieu of Tax calculations to be the depreciated or book value of assets; or for the power plant, the market value of the asset. This will more closely track methodologies used for property tax assessments, particularly those used by the California Franchise Tax Board for IOUs" (3 AR 665, 1st ¶).

Far from adjusting the PILOT to adopt the state's method, as the City's Opening Brief incorrectly claims, the City apparently rejected this recommendation, and expressed concerns with this approach in its Notes on the changes in Electric Utility In-Lieu Tax calculation methodology, referencing the Beck report and indicating that basing the in-lieu tax assessment on depreciated value to be more consistent with the State Franchise Tax Board "could lead to consideration of alternative methods of establishing valuation, such as income approach which is based on a projection of the future income expected to be derived from the asset" (Tab 121, 2 AR 668 at ¶ 5).

The City's Opening Brief is therefore incorrect in stating that the method used by the City to calculate its PILOT is that used by the California State Board of Equalization and Franchise Tax Board; the City's Opening Brief correctly states, however, that the method used by the City to calculate the PILOT is to use original, rather than depreciated, asset values. This method is clearly demonstrated in Attachment A to Resolution 2011-111, the City's Electric in-Lieu Computation worksheet (11 AR 2469, Tab 203), where the only depreciated assets listed are "Vehicle, Equipment. Furn." (line 2), amounting to approximately $8.6 million out of a total of $438,027,371 in "Appreciating assets" (line 14) – less than 2%. While this distinction seems to take us a bit into the weeds, it just goes to demonstrate the falseness of the City's claim that the City's

calculation of the PILOT mimics what the City would receive in tax revenue if the utility were privately owned, further illustrating the arbitrariness of the calculation and the absence of any connection to the actual cost of providing electric service to the City's ratepayers.

On December 16, 2008, the City adopted Resolution No. 2008-191, increasing REU rates (4 AR 821, Tab 144). This was the most recent increase prior to the December 7, 2010 increase that is the subject of this action. At the hearing on the Resolution, the City's Electric Utility Director, Mr. Hauser, in response to public questions about the PILOT, stated that it was correct that the calculation of the PILOT was not related to REU's cost of providing services (2 CT 388-389).

This admission by the City's Electric Utility Director that the PILOT is in no way a reflection of the calculation of any particular cost or expense incurred by REU to provide electric services to its customers is borne out by the events that occurred after the December 16, 2008 rate approval and increase, and which led up to the December 7, 2010 increase in the REU rates that is the subject of this action.

Between 2007 and 2011, the City constructed a Power Generation Plant, Power Plant Unit 6. This added $64,500,000 in assets to REU between FY 2007-08 and FY 2010-11 (City of Redding Capital Improvement Plan at 3 CT 648). At 1%, this amounted to a $645,000 increase in the PILOT charge over this period of time, with $356,008.60 of that amount added after the December 16, 2008 rate increase (City of Redding Capital Improvement Plan at 3 CT 648).

A significant change in the formula REU uses for calculating the PILOT amount occurred in the 2010 Fiscal Year, again after the 2008 rate increase and, most significantly, shortly before the 2010 rate approval and increase. As evidenced by Attachment A to

Resolution 2011-111, the City's Electric in-Lieu Computation worksheet (11 AR 2469, Tab 203), the City changed its concept of "assets" and changed its formula for the PILOT to include the City's share of assets actually owned by joint powers authorities of which the City is a member. The value of the City's share in joint-venture assets added for FYE 2010 is considerable – totaling $98,025,133, which, at 1%, accounted for a $980,251 increase in the PILOT charge (See line items 6 – 8, FYE 2010 at 11 AR 2469, Tab 203). This significant addition in REU assets of course translates into a significant increase in the PILOT to be transferred from REU into the City's General Fund – from $4,832,090 for FY 2008-09 (as indicated in the City's 2008 & 2009 Biennial Budget at 3 CT 671) to $6,055,950 for FY 2009-10 and $5,968,220 for FY 2010-11[2] (as indicated in the City's 2010 & 2011 Biennial Budget at 3 CT 677). Further demonstrating that the purported "Payment In Lieu of Taxes" does not actually mimic the amount the City would receive in property taxes if the utility were privately owned is the fact that two of these power generation joint ventures are not even located within the state of California, let alone the boundaries of the City of Redding. The "MSR" plant (valued at $54,580,050 – Tab 203, 11 AR 2469, at line 8) is located in New Mexico (1 RT 72-73, lines 25-9) and the Tank COTP (valued at $637,748 – Tab 203, 11 AR 2469, at line 7) is an electric line that runs from Tracy, California into Oregon. This practice flatly contradicts the approach taken in the California State Board of Equalization's Appraisal of Public Utilities handbook, which states that "California has no authority to levy a property tax against property located in other states" and that, though some public

[2] (the slight decrease from the $6,055,950 PILOT transfer in FY 2009-10 is due to depreciation of assets with no addition of major capital facilities in that fiscal year)

utilities have unitary tangible assets located outside of California, "[t]hese assets are not subject to California property tax, and their values must be excluded from the unitary value" (1 AR 52).

On December 7, 2010, the City Council held a public hearing to consider adopting increased electric rates that include the amount represented by the PILOT. Plaintiffs objected to approval of the increased rates on the grounds that inclusion of amounts for the PILOT violated Proposition 26 and would result in the imposition of an unlawful tax created without voter approval.

The City Council passed Resolution No. 2010-179, increasing REU rates by 7.84%, effective January 2011, and again by 7.84%, effective December 2011. Between the 2008 rate increase and this rate increase, the PILOT charge to be transferred from REU to the City's general fund grew by $1,136,130 due to the addition of the Power Generation Plant and REU's joint venture assets. Resolution No. 2010-179 acknowledges the role of the additional PILOT charge in the increased rates, stating on its face that one of the purposes for the increase is "to obtain funds necessary to maintain such intra-City transfers as authorized by law" (at §3, at 4 AR 1041, Tab 163, though Appellants dispute that this transfer is "authorized by law").

On June 22, 2011, the City Council adopted Resolution No. 2011-111, approving the City's 2012 & 2013 Budget (11 AR 2466-2469, Tab 203). This Resolution contained language, findings and pronouncements relating to electric utility rates and the PILOT charge that had never been included in any prior Budget Resolution. On its face, the extra language included in Resolution No. 2011-111 appeared to be a re-affirmation and approval of the incorporation of the PILOT charge in the REU rate increases previously adopted by Resolution No. 2010-179 and therefore, to protect Appellants' rights,

Appellants filed a second complaint, as indicated in the Procedural History, below.

B. PROCEDURAL HISTORY

On February 4, 2011, Appellants filed a Petition for Writ of Mandate and Complaint for Declaratory and Injunctive Relief (Shasta County Case No. 171377) against the City of Redding and Redding City Council on the grounds that Resolution 2010-179, increasing REU rates, was adopted by the City of Redding on December 7, 2010, in violation of Article XIII C of the California Constitution insofar as this increase included the PILOT charge, because the PILOT is a tax within the meaning of this Article (1 CT 2). On March 9, 2011, Respondents City and City Council of Redding demurred to all causes of action (1 CT 29). On June 6, 2011, the trial Court denied Respondents' demurrer, ordered Respondents to file a response and issued a briefing schedule (2 CT 474). The respondents answered on June 16, 2010, denying all claims and contentions (2 CT 486). On August 5, 2011, Respondents filed a Certification and Lodgment of Administrative Record for four volumes (Volume I-IV), pages 0001-1106 (2 CT 494, 2 CT 496).

On June 22, 2011, the City adopted Resolution No. 2011-111 approving the City's 2012 & 2013 Biennial Budget (2 CT 530). Contained in this Resolution was language relating to electric utility rates and the PILOT charge which appeared to be an attempt by Respondents to affirm, ratify, validate and re-approve the REU rate increase adopted in Resolution No. 2010-179, which was the subject of Plaintiff's initial Petition. In order to protect Plaintiff's rights, Plaintiff filed a second Complaint against Respondents on August 29, 2011, for Declaratory Relief and Refunds/Damages (Shasta County Case No. 172960), on the same grounds as the initial

Complaint, and seeking a refund of improperly collected fees on the grounds that the illegal tax constituted an unconstitutional taking under the 5th Amendment of the United States Constitution and Article I, §19 of the California Constitution, and on breach of contract and common count grounds. (Prior to the filing of Appellant's second Complaint, on June 20, 2011, Appellant Fee Fighter LLC submitted a Claim for refunds of the unlawful portion of the rates paid by 348 utility customers who had assigned their rights to Fee Fighter. No response was received after 45 days and, pursuant to Gov. Code §912.4, the claim was deemed rejected). On August 29, 2011, Appellants filed a Notice of Related Case with the first Petition, Case No. 171377 (2 CT 535). The Respondents Answered the Complaint on September 27, 2011, denying all claims and contentions (2 CT 557).

The first matter proceeded to trial on November 8, 2011, after briefing by both parties in accordance with the briefing schedule ordered by the Court (Appellants filed their opening brief on September 6, 2011 (2 CT 538); Respondents filed a response brief on October 5, 2011 (3 CT 607); Appellants filed a reply brief on October 21, 2011 (3 CT 686)). On December 21, 2011, the Court issued its Ruling After Judgment, denying Appellants' Petition.

On January 25, 2012, the Parties stipulated to consolidation of the actions, agreeing that the second trial would continue without briefing, and the court so ordered (3 CT 713 and 3 CT 716). On February 15, 2012, Respondents filed a second Certification and Notice of Lodgment of the Administrative Record for an additional ten volumes (Volume V – XIV), pages 1107-3241. The second matter proceeded to trial on April 30, 2012. The Court issued its Memorandum of Decision on June 22, 2012, again denying Appellant's Complaint (3 CT 724).

Appellants timely filed a Notice of Appeal in the consolidated cases on August 20, 2012 in the Third District Court of Appeals. After the initial briefing, the Court requested simultaneous supplemental briefs on five issues. Oral argument was heard on October 6, 2014, and pursuant to Respondent's request, the court ordered the parties to submit supplemental briefing as to whether the PILOT was created by the City's budget and therefore expired with the biannual budget passed by the City for Fiscal Years 2009-2011, or was a continuing appropriation intended by the City to be permanent. Supplemental briefing on this issue was completed on November 6, 2014, and the Court of Appeal issued its published decision on January 20, 2015, holding that the PILOT constitutes a ta under Proposition 26 unless Redding could prove the amount collected represents its reasonable costs to provide electric service and remanding the case for this factual determination.

Respondents petitioned this court for review on March 2, 2015, and review was granted on April 29, 2015.

IV. STANDARD OF REVIEW

There is no dispute as to the material facts necessary to the decision of this matter, and the issues to be resolved are substantive requirements affecting the Constitutional rights of the Plaintiffs. In such cases the Court on appeal must exercise independent judgment and conduct a de novo review of the matter before it.

As explained by the Appellate court in its decision in this matter, in 1978, California voters adopted Proposition 13 (Cal. Const., art XIII A) to require that any "special taxes" for cities, counties, and special districts be approved by a vote of the qualified electorate (Art. XIII A, § 4). In 1996, voters adopted Proposition 218 (Articles XIII C and XIII D), with one of its aims being "to tighten the

two-thirds voter approval requirements for 'special taxes' and assessment imposed by Proposition 13." (*Brooktrails Township Community Services Dist. v. Board of Supervisors of Mendocino County* (2013) 218 CA 4th 195 at 197. To this end, Proposition 218 added article XIII C, §1 to require that new taxes imposed by a local government be subject to a vote of the electorate of either a majority for a "general tax" or two-thirds for a "special tax." The voters amended article XIII C in 2010 when they passed Proposition 26, further defining "tax" to include "any levy, charge, or exaction of any kind imposed by local government", with certain listed exceptions (Art. XIII C, § 1, amended by Prop. 26, as approved by voters, Gen. Elec., Nov. 2, 2010 (Proposition 26)).

The provisions of Proposition 218 relating to the construction of the voter approval requirements of Article XIIIC for special and general taxes are instructive as to the standard of review. Section 5 of Proposition 218, the Right to Vote on Taxes Act, stated that "[t]he provisions of this act shall be liberally construed to effectuate its purposes of limiting local government revenue and enhancing taxpayer consent" (Ballot Pamp., Gen. Elec. (Nov. 5, 1996), text of Prop. 218, §5, p. 109). The provisions of the Right to Vote on Taxes Act included those requiring voter approval of any special or general tax imposed by a local government – the provisions at issue here. In interpreting the provisions of Article XIIIC relating to special and general taxes in this matter, therefore, the court must liberally construe its provisions to effectuate its purposes of limiting local government revenue and enhancing taxpayer consent.

The California Supreme Court's decision in *Silicon Valley Taxpayers Assoc. v. Santa Clara County Open Space Authority* (2008) 44 Cal.4th 431, 444-450 [*Silicon Valley Taxpayers*], is also instructive in that it analyzes the scope of review for Article XIIID §4(f) – an

analogous provision enacted by the earlier (1996) Proposition 218 that places the "burden ... to demonstrate" constitutional compliance on the government in the context of "assessments." In rejecting arguments that traditional deferential review should be given to the government's decision-making on assessments, the Court stressed that the new rules created by the voter approved proposition create "substantive requirements" in "constitutional provisions of dignity at least equal to the constitutional separation of powers doctrine. ... Thus, a local agency acting in a legislative capacity has no authority to exercise its discretion in a way that violates constitutional provisions or undermines their effect. We must "'enforce the provisions of our Constitution and may not lightly disregard or blink at a clear constitutional mandate. [citations]'". Though Proposition 218 did not specify the quantum of proof that the government was required to "demonstrate," the Court found that the implication of constitutional rights required *independent, de novo review* of the local agency decision.[3]

It would appear that the drafters of Proposition 26 took note of the *Silicon Valley Taxpayers* 2008 decision and used extra care to specify that the government has the "burden of proof" by a "preponderance of the evidence" (Ca. Constitution Article XIIIC §1(e)). The constitutional requirements for compliance with Proposition 26 are no less "substantive" than those for Proposition 218. (Compare Prop 26, Article XIIIC §1(e)(2) – charge "which does not exceed the reasonable costs to the local government of providing the service of product," and Prop 218, Article XIIID §4(a) – assessment "which exceeds the reasonable cost of the proportional

[3] The Court overturned the Appeal Court decision according the agency decision deferential "substantial evidence" review.

special benefit conferred on that parcel.") Accordingly, the standard of review in this case should be no less.

In one of the few cases to date that has reached appellate review pertaining to Proposition 26, the plaintiff challenged an ordinance passed by the City of Santa Cruz establishing a residential rental inspection fee (*Griffith v. City of Santa Cruz* (2012) 207 Cal.App.4th 982). In that case the Court of Appeal for the 6th District also found the matter before it "subject to a *de novo* or independent standard of review" (*ibid.*, 207 Cal.App.4th at 990).

There should be no question in this case that the decision of the City of Redding in adopting increased electric rates is to be given no deference that otherwise might be accorded a municipal body, and this Court of Appeal should exercise its *independent judgment* and give *de novo* review in deciding the matter.

V. BURDEN OF PROOF, QUANTUM OF PROOF, AND MATTERS TO BE PROVEN BY THE CITY

Article XIIIC §1(e) begins with the statement that:

"(e) As used in this article, "tax" means any levy, charge, or exaction of any kind imposed by a local government, except the following:"

and then follows with 7 specific exceptions. In this case the exception pertinent to the REU rates is XIIIC §1(e)(2):

> "(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."

Article XIIIC §1 concludes, following the list of "exceptions," by stating the government's burden of proof as follows (emphasis added):

> The 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.**

This is a major departure from existing case law on fees and charges with respect to the burden of proof and the quantum of proof. Prior to approval of Prop 26, case law held that the government had only an initial *burden of production* of evidence to support its determination to approve the imposition of a fee or charge. "The plaintiff has the *burden of proof* with respect to all facts essential to its claim for relief" (*Homebuilders, supra,* 185 Cal.App.4th at 562 – action challenging housing development fees); "The plaintiff challenging a fee bears the burden of proof to establish a prima facie case showing that the fee is invalid" (*California Farm Bureau Federation v. State Water Resources Control Board* (2011) 51 Cal.4th 421, 436, and see fn. 2 at 428 (*California Farm*): case initiated before Prop 26 approved and none of the parties asserts that Prop 26 applies to the case). Now, however, the government must bear the actual *burden of proof* (synonymous with the term "burden of persuasion" – *ibid,* at 436, fn. 17), and "must present evidence sufficient to establish in the mind of the trier of fact or the court a requisite degree of belief (commonly proof by a preponderance of the evidence)" (*ibid.*at 436, citation to *Sargent Fletcher, Inc. v. Able Corp.* (2003) 110 Cal.App.4th 1658, 1667).

The quantum of proof required of the government under Article XIIIC §1 – proof by a *preponderance of the evidence* – is also unprecedented in the case law on challenges to quasi-legislatively adopted fees. The prior law as stated in *Homebuilders, supra,* 185 Cal.App.4th at 562, was that "judicial review is limited to an examination of the proceedings before the City to determine whether its action was *arbitrary, capricious,* or *entirely lacking in evidentiary support.*" Now, however, Article XIIIC §1 has explicitly replaced the former extremely deferential standard with the familiar *preponderance of the evidence* standard for the government to meet its burden.

The matters that the government must prove in this case begin with Article XIIIC §1(e)(2), requiring proof by preponderance of the evidence that the increased electric rate under Resolution No. 2010-179 "does not exceed the reasonable costs to the local government of providing the service or product" (electrical service). In this respect Plaintiffs have adequately alleged and presented the issue that the PILOT component of the electric rate is in excess of the reasonable cost of providing the service. The City must prove that the PILOT component of the rate pays for actual reasonable costs of providing electric service to its ratepayers.

The last paragraph of Article XIIIC §1, separated into its component parts, requires that the government prove three things:

(1) That the "levy, charge, or other exaction is not a tax";

(2) That the amount is "not more than necessary to cover the reasonable costs of governmental activity";

(3) 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 from the governmental activity."

The first of the above items would appear to be a general catchall that requires demonstration that the charge not only meets one of the seven exceptions to the all-inclusive definition of a "tax" in XIIIC §1(e), but also satisfies any other requirements of current law that might cause a "fee" to be considered a "tax". In this case, for example, the PILOT component of the increased electric rate is collected for "general revenue purposes" – a fact which makes it a "tax" (*Weisblat v. City of San Diego* (2009) 176 Cal.App.4th 1022, 1043 (*Weisblat*); *Sinclair Paint Co. v. Bd. of Equalization* (1997) 15 Cal.4th 866, 874 (*Sinclair Paint*); Gov. Code §50076). Notwithstanding the futility of the City disputing the "general revenue" nature of the PILOT component of the electric rates, the City is Constitutionally required to prove this is not the case.

The second item is a standard requirement from case and statutory law that distinguishes a "fee" from a "tax" (*Sinclair Paint, supra*, 15 Cal.4th 866, at 876; see Gov. Code §50076, excluding from the term "special tax" any fee "which **does not exceed the reasonable cost of providing the service** or regulatory activity **for which the fee is charged** and which is not levied for general revenue purposes" (emphasis added)). However, this provision would seem to overlap the "exception" of Article XIIIC §1(e)(2) that the charge "does not exceed the reasonable costs to the local government of providing the service or product," and nothing new would be required.

The third item is a standard case law requirement for fees that it be shown 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 from the governmental activity" (*Beaumont Investors v. Beaumont-Cherry Valley Water Dist.* (1985) 165 Cal.App.3d 227, 234-235 (*Beaumont Investors); Building Industry Association v.*

City of Patterson (2009) 171 Cal.App.4th 886, 898-899 (*Building Industry*).

This "reasonable relationship" test is independent of whether or not excessive or general revenues are produced by the "fee." If the "fee" is not reasonably related to the burdens, costs, or benefits connecting the fee payor and the government service, the "fee" is a tax. In the present case, Plaintiffs allege that there is no connection or relationship at all between the PILOT component of the increased electric rates and any costs, burdens or benefits of electric service to REU ratepayers. The burden is on the City to prove that such a "reasonable relationship" exists.

Finally, though this consideration perhaps should come before or concurrently with all of the above, Plaintiffs submit that the threshold decision of whether Proposition 26 is or is not applicable to a fee or charge in the first instance, regardless of the argument made for exclusion, is itself an issue on which the government is required to bear the burden of proof. If the matter before the Court is "**any levy, charge, or exaction of any kind imposed by a local government**", then XIIIC §1(e) makes it a **"tax"** unless the government proves that the **"levy, charge, or other exaction is not a tax"** per the explicit requirements of the last paragraph of Article XIIIC §1. To approach the question otherwise would potentially vitiate the purpose of Proposition 26, as stated in its findings and declaration of purpose (put before the voters along with the operative text of the initiative), and invite more of the creative mischief by which:

> "local governments have disguised new taxes as 'fees' in order to extract even more revenue from California tax payers" to circumvent constitutional voting requirements. ... 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. This measure protects taxpayers by limiting the methods by which local governments exact revenue from taxpayers without their consent." (Ballot Pamp., Gen. Elec. (Nov. 2, 2010) text of Prop. 26, § 1, p. 114, reprinted in Historical Notes, 2A West's Ann. Cal. Const. (2013 supp.) foll. art. XIII C, § 3, pp. 141–142.)

In the present case, the City argues that Proposition 26 has no application to the increased electric rates that incorporate an amount to cover the PILOT that is transferred to the general fund, because the City has in past years – before approval of Proposition 26 – made budgetary allocations for the PILOT, and therefore (though there is a logical disconnect here) Proposition 26 has no application to a legal challenge to increased electric rates incorporating the amount of the PILOT which are adopted by the City after the approval of Proposition 26. Without addressing the City's argument on its merits or the lack thereof, it should be clear that the adoption of the City's increased electric rates on December 7, 2010 – after the approval and effective date of Proposition 26 – make the judicial review of those rates subject to Proposition 26 and its procedural provisions. Thus the burden is on the City to prove that the portion of the newly increased electric rates challenged by Plaintiffs as unlawful was somehow "grandfathered" due to City budgetary allocations and inter-fund transfers that preexisted Proposition 26.

VI. LEGAL DISCUSSION

Much of the Opening Brief by the City strays into issues which the City had raised in the proceedings below, were rejected by the Court of Appeal, and are outside the scope of the three issues which this Court directed us to brief and argue. As explained above, Citizens will rebut the City's arguments insofar as they may

indirectly bear on the issues, if at all, mindful that this court has directed us to specifically limit our briefing and argument to the three issues in the court's April 29, 2015 Order.

For each of the three questions posed by the court, a direct answer by Citizens is provided below. Further illumination of the issue may also be found in the legal discussion that follows *post*.

A. Is a payment in lieu of taxes (PILOT) transferred from the city utility to the city general fund a "tax" under Proposition 26 (Cal. Const., art. XIII C, § 1, subd. (1)(e))?

ANSWER: Though generally an interfund transfer between City departments is not *per se* a "charge" to anyone and therefore not intrinsically a "tax" under Proposition 26, when (as here) the PILOT amount is imposed as part of an electric rate increase to collect the PILOT funds in addition to the rate revenues needed to support the cost of service by the utility, then the triggering event is the City approval of the artificially inflated electric rate increase that includes the amount necessary to collect the PILOT, and the transfer of the PILOT (tax monies) to the City general fund is simply part of the same taxing mechanism.

Citizens have consistently argued in the trial court and on appeal that that the imposition of a "tax" occurred when the Redding City Council approved Resolution 2010-179 on December 7, 2010, increasing electric rates by 7.84%, but embedded or blended into this rate increase was the PILOT in the amount of $5,968,220, or roughly 6% to 7% of the new rates. The rate increase is a levy/charge/exaction and therefore unquestionably (unless proven otherwise by the City) a "tax" under Art. XIIIC §1(e).

The transfer of the PILOT amount from the electric utility to the general fund would occur after the rate increase and collection of sufficient funds to make the transfer in the amount of the PILOT as planned. If the imposition of the inflated rates has been found to be a "tax" then the funds collected and transmitted for the PILOT naturally would also be "taxes." In this sense the PILOT transfer of funds from the electric utility to the general fund is "fruit of the poisonous tree" – with the "poisonous tree" being the collection of electric rates in excess of the "reasonable costs to the local government of providing the service or product." (Cal. Const., art. XIII C, § 1(e)(2)) and the PILOT the "poisonous fruit."

Further, if the utility rates are considered to be so connected with the inter-fund PILOT transfer that they were effectively one transaction, or a "pass-through," then they should stand or fall together depending upon whether the City could meet its burden to prove that the electric rates do not collect more "reasonable costs to the local government of providing the service or product." (Cal. Const., art. XIII C, § 1(e)(2) – see discussion below.) That was the analysis followed in *Howard Jarvis Taxpayers Association v. City of Roseville* (2002) 97 Cal.App.4th 637, 647 (*Roseville*) and in *Howard Jarvis Taxpayer's Association v. City of Fresno* (2005) 127 Cal.App.4th 914, 918, 926 (*Fresno*).

In the *Roseville* case, the City (general fund) charged an "in-lieu franchise fee" to the water, sewer, and refuse utilities of the City, with the amount set at a flat 4% of the yearly budgets of each utility; that cost was passed on to consumers as a "blended component of the rates charged by those utilities irrespective of the amount consumed." In the *Fresno* case, the City (general fund) collected a "fee in-lieu of property taxes" from all of its utilities at a rate of 1% of the assessed value of fixed assets of the utility department or

division; the amount paid by each utility was passed through to its customers and "blended" into the user fees. In both the *Roseville* case and the *Fresno* case the Courts of Appeal considered together the intra-city charge to the utility and the pass through to the rate payer being charged for a property-related service, and in both cases brought under Proposition 218 the plaintiffs prevailed because the charge passed through to rate payers was in excess of and bore no relation to the cost of the utility services.

In the present case the PILOT amount transferred from the electric utility to the general fund also is passed through to ratepayers and is blended into the overall rates. It should be noted that the formal legal connection between the rates and the PILOT inter-fund transfer amount is established by the Resolution adopting new / increased electric rates, while the budget entries anticipating a transfer of the PILOT amount from the electric utility to the general fund have no specific directive as to how the funds are to be obtained. In particular, Resolution No. 2010-179, which is the subject of this action, contains the standard provision in ¶3 thereof:

> "That the purposes for the imposition of the increases and other changes are as follows: [(1) –(5)] and **(6) to obtain funds necessary to maintain such intra-city transfers as authorized by law."** (emphasis added)

The "intra-city transfers" referenced in the Resolution above are directed to the PILOT amount which the City transfers from the electric utility rate revenues to the general fund. There is no dispute on that point. And perhaps to remove any doubt the City's follow-up electric rate Resolution 2013-015 (for which Citizens have requested judicial notice) contains this identical reference to "intra-city transfers" followed by an explanatory parenthetical reference to its budget Resolution 2011-111 that sets out an extensive discussion of the PILOT and its history.

Of importance is the fact that the increased rates are legally authorized and directed to fund the "intra-city transfer" – which clarifies that rates (not, as suggested by City, wholesale power sales revenues, etc.) are used to provide the necessary funds. The budgetary references to the PILOT, on the other hand, do not compel or even describe any action to obtain the funds necessary for the "intra-city transfers" beyond the transfer itself. Thus, even if Resolution 2010-179 and the budgetary references to the PILOT are considered together, it is the Resolution that creates the operative linkage between the two.

It also is the rate resolution that constitutes the legally cognizable act for the statute of limitations per Cal. Pub. Util. Code §10004.5 to commence, and – in this case – to determine whether a "tax" under Cal. Const., art. XIII C, § 1(e) was imposed after the effective date of Proposition 26. Clearly the City's Resolution 2010-179 adopted December 7, 2010 came after the November 3, 2010 effective date of Proposition 26. Despite the strenuous efforts of City to characterize this action as a challenge to budgetary approvals of the past, the Resolution 2010-179 adoption date of December 7, 2010 is the operative date for analysis. There is no issue of "retroactivity" of Proposition 26 to be examined.

The primary issues were recognized by City as they were first creating the PILOT as a revenue enhancing program back in 1988. In a legal analysis prepared by Martin McDonough of McDonough Holland & Allen dated October 16, 1987, Mr. McDonough observed that (3 AR 633):

> "There does not appear to be any prohibition against transfers of public money from one fund to another, in the absence of special provisions in the governing statute, bond indenture, or

> the like, and thus the issue appears to be whether the rate which produces the surplus revenues for transfer to the general fund is reasonable, rather than the legality of the transfer."

The City anticipated and did apply the PILOT for departments – like the electric utility – operated as "enterprise funds." The City's budget describes "enterprise funds" as (9 AR 1994):

> "Enterprise funds are established to account for operations that are financed and operated similar to a private business. The intent of the City is to match costs associated with the enterprise operation with the revenues generated."

When the City studied creation of the PILOT the Finance Director, Linda Downing, observed in a memo to the City Manager dated January 7, 1988, that implementation of the PILOT would raise various amounts from a list of enterprise funds (including the electric utility), and that (1 AR 177):

> "The adoption of in-lieu payments would force rates to be increases for the above mentioned funds, the magnitude of these rate increases is unknown at this time."

Thus the mechanism of the "PILOT" from its inception in 1988 through today is quite simple: After the City decides on what the amount of the PILOT should be, then that amount of the PILOT necessarily requires an increase of the rates of the enterprise fund – which otherwise matches costs with revenues-- in order to obtain surplus revenues for subsequent transfer to the general fund. The electric rate increase (Resolution 2010-179 in this case) imposes the amount of the PILOT required to generate the surplus revenues the City desires for transfer to the general fund, and the actual money transferred in the amount of the PILOT is in the nature unlawful taxes.

B. Does the exception for "reasonable costs to the local government of providing the service or product" apply to the PILOT (Cal. Const., art. XIII C, § 1, subd. (1)(e)(2))?

ANSWER: The City is required to comply with Proposition 26 and prove that the PILOT amount imposed by the electric rate increase and subsequently transferred to the general fund is not in excess of the "reasonable costs to the local government of providing the service or product." (Cal. Const., art. XIII C, § 1(e)(2)

In this case the City is, by virtue of the approval of Resolution No. 2010-179, imposing electric rates increased for (*inter alia*) the express purpose of funding an inter-fund transfer in the amount of the PILOT, and is required to prove that the collection of the PILOT amount in the rates does not "exceed the reasonable costs of providing the service or product." Much like the defendant cities in both *Roseville, supra,* and *Fresno, supra,* the City of Redding professes that its general governmental activities and infrastructure provide some kind of economic support for the electric utility that justifies the PILOT, but in the record before us the City utterly fails to produce any evidence of the specifics of what that support really is and what its dollar value may be. It is admitted by City that it did not do a "cost of service" report or analysis that might answer that question. But there is little reason for the City to study what it already knows and what is patent from the record: the exaction from rate payers of the PILOT amount and inter-fund transfer paid for by increased electric rates is general revenue to the City for a variety of public services and has no connection to identifiable costs.

The City's vague argument that it incurs costs in other departments of its general services that offset the PILOT is problematic even if there were any identifiable costs. That is because

going back to at least 1988 the City has operated its departments and their respective budgets using a "cost-allocation plan" that tracks support costs incurred between the different departments and adjusts their budgets to compensate for the costs one department may incur for the benefit of another. Much if not all of the economic support the electric utility receives from other departments has already been accounted for and compensated under the cost-allocation plan. For the utility to exact money as a PILOT from ratepayers and transfer it to other departments for these same costs would be double payment.

This issue was recognized at the very beginning by the City's Director of Finance, Linda Downing, who in a memo dated January 7, 1988 described it as a "fairness question" and potential "double whammy" to collect the PILOT to pay for support costs of departments while also operating a cost allocation plan on top of it (1 AR 178).

The City has the burden in this matter to demonstrate a genuine cost basis for its electric rate collections, and specifically the amount designated for an inter-fund transfer in the amount of the PILOT. The record has no such evidence. Under case law and Proposition 26 (Cal. Const., art. XIII C, § 1(e)(2)), this exaction must be found to be a "tax" (*County of Fresno v. Malmstrom* (1979) 94 Cal.App.3d 974, 983–984; *Apartment Assn of Los Angeles County, Inc. v. City of Los Angeles* (2001) 24 Cal.4th 830, 843).

Perhaps because of the absence of any evidence of cost justification the City has resorted to several arguments attempting to circumvent the issue altogether. These arguments involve: (a) reasonableness of rates determined by market comparison, (b) the

purported availability of revenues that could have paid the PILOT, and (c) allowance for a "modest profit." None of these arguments have merit, nor do they absolve the City of its constitutional duty to charge electric ratepayers no more than the reasonable cost to provide them with electricity.

(1) The constitutional mandate of Proposition 26 requires that rates be no more than the reasonable *cost to provide the service*, not the reasonable *cost as compared to the marketplace.*

The City claims, and the trial judge appears to have agreed, that the electric rates charged by the City must be adjudged "reasonable" because they are purportedly lower than those paid by others in California. Citizens disagree with the factual assertion that the City's rates are "reasonable" in the marketplace, and might point to Redding's nearest neighbor City of Shasta Lake that is similarly situated and has substantially lower rates, but Citizens decline the invitation to engage an irrelevant debate. Proposition 26 (Cal. Const., art. XIII C, § 1(e)(2)) mandates rates limited to the reasonable *cost to provide the service*, irrespective of where those rates might stand in the marketplace. The Court of Appeal addressed this issue as follows:

> We disagree with Redding's assertion, in its supplemental brief, that the PILOT comports with Proposition 26 because Redding's electric rates are lower than those paid by others in California. Even if Redding's rates were the lowest in California, Proposition 26 would nonetheless require the PILOT to either reflect the city's reasonable cost of providing electric service or be approved by two-thirds of voters. An unconstitutional tax is not rendered lawful simply by being bundled with otherwise reasonable utility rates.

Though no one would want to see high electric rates in the City, it is instructive to recognize that the constitutional standard

also protects the City's utility if, despite the most efficient and lawful practices, circumstances beyond the City's control cause the City's rates to rise to a level far higher than what might generally be considered "reasonable" for the marketplace in California. In that event, if "marketplace reasonableness" were to be substituted for the constitutional standard of *reasonable cost to provide the service*, the City's electric utility would have to shut down – an absurd result. And in the opposite hypothetical – closer to what prevails today on the facts – if the City's costs to provide electric service are lower than the statewide average, the City is not then given license to gouge its rate payers by exacting for the general fund any margin between its relatively low cost to deliver the electric service and a price that might be considered average or "reasonable" in the marketplace.

Constitutional provisions are to be construed by the courts "liberally and practically; where possible they avoid a literalism that effects absurd, arbitrary, or unintended results" (*Richmond v. Shasta Community Services District* (2004) 32 Cal.4th 409, 419). In the instant case Citizens submit that the plain meaning of the provisions of Cal. Const., art. XIII C, § 1(e)(2) compel the City to confine its rates to the amount necessary to defray the reasonable costs the City actually incurs to deliver the electric service to its rate payers. Resorting to marketplace comparisons to determine a constitutional standard for "reasonable" rates when the provisions of Proposition 26 are clearly tied to the local agency costs of service is erroneous and leads only to mischief, or corruption, or both.

(2) The purported availability of other revenues that allegedly were high enough to pay for the PILOT is irrelevant, disconnected from the total cost/revenue balance of operating the utility, and is not a part of the mechanism of the exaction that constitutes an unlawful tax.

The City argued in the trial court and continues the tack through appeal that its non-rate revenues from wholesale sales of power were much more than the amount of the PILOT, which – the City argues – makes it impossible to discern what funds were used to pay the PILOT amount in the transfer to the general fund. [1] This argument is irrelevant because the gravamen of the harm to Citizens is that the electric **rates** exacted from them are significantly higher than the reasonable cost of delivering the electric service. If Citizens and other Redding ratepayers are forced to pay unlawfully high electric rates, they would gain no comfort from the City's use of non-rate revenues to fund the PILOT transfer from the electric utility to the general fund. [2] Secondly, the existence of non-rate revenues generated by the electric utility is meaningless when taken out of context of the total revenue/cost balance of the utility as a whole. The electric utility is an "enterprise fund" department of the City, which means that – in accordance with the City's budgetary policies – "the intent of the City is to match costs with the enterprise operation with the revenues generated" (9 AR 1994, description of fund types from City 2010-11 biennial budget.) By this policy the non-rate revenues should be roughly balanced out by equivalent costs in utility operations or investments. [3] There is no evidence, and the City doesn't attempt the argument, that the non-rate revenues were actually used to fund the PILOT transfer, nor did those funds substitute for the rate revenue exacted for that purpose. There is no connection to the mechanism of the unlawful exaction here. And if there was an unexpected windfall to the utility from its wholesale power sales, why was that not used to relieve the rate payers from some or all of the increase in their rates? If the City indeed had "extra money" from non-rate revenues that it did not

apply as prescribed by law that only compounds the violation already committed.

(3) The City erroneously clings to the notion that it is entitled to operate the electric utility at a "modest profit," relying on case law and concepts that pre-date Proposition 26 (see City Opening Brief at pp. 45-46).

To begin with, there is no way to know the difference between utility profits that are "modest" versus those that are "immodest" – qualifications by City that belie this concept as being a legal anachronism following the voter's approval of Proposition 26 in November of 2010. City still relies on *Hansen v. City of San Buenaventura* (1986) 42 Cal.3d 1172, for authority to exact rate revenues at some level greater than the cost of service, resulting in the collection of "profits" which the City sees as free money that it may apply as it deems appropriate to other municipal uses (*i.e.*, transfer to the general fund) not necessarily related to the electric utility. We are now almost 30 years removed from the *Hansen* decision, and in that interim the California Constitution as it relates to the exaction of fees and charges has been changed substantially, first by Proposition 218 in 1996 and next by Proposition 26 in 2010. The Court of Appeal in *Roseville*, 97 Cal.App.4th at 649, noted that Roseville's reliance on the *Hansen* decision as part of its justification for a flat 4% in-lieu franchise charge to 3 utilities' annual budgets was "problematic." In its disposition of the *Roseville* case the Court of Appeal did not give shelter to the franchise charges as permissible "profits" (also referred to as a "reasonable rate of return"), but found that the charges violated Proposition 218.

Citizens submit that the constitutional constraints today, from both Propositions 218 and 26 and the progression of case law

jurisprudence based on them, have eliminated the leeway that local agencies might have had at one time to exact fees and charges that result in "profits." This is not to say that municipal utilities are forbidden from maintaining reserves, collecting for planned system betterments, providing for contingencies and liability, etc. However, it should be clear beyond that cavil that today charges cannot be exacted for purposes unrelated to the function of the municipal enterprise, and there is no allowance for "free money" to be collected and sent to the general fund for the City to spend as unrestricted general revenue.

C. Does the PILOT predate Proposition 26?

ANSWER: The pilot has existed only as a budgetary item since about 1988, but it is itself not an "exaction" or "fee" and therefore has never had any relevant existence in relation to Proposition 26.

The PILOT as a budgetary transfer of funds from the electric utility fund to the general fund of the City has been a practice of the City since roughly 1988, but this does not address the question of whether the PILOT is a cognizable fee, charge or exaction that predates Proposition 26 so that it might be "grandfathered" as a charge to continue to be exacted from Redding's rate payers. The City admits that the PILOT itself is not a "fee," or "charge," or "exaction." (See City Respondents' Brief in the Court of Appeal below, filed April 27, 2013, at p. 19, fn. 15, and at p. 22) The only fees, charges or exactions for electric rates that would come within the purview of Const., art. XIII C, § 1(e) would be the electric rate resolutions adopted by the City from time-to-time to adjust/increase the rates in the City. These are adopted per the guidelines and

requirements of Redding Municipal Code §14.22.170 (emphasis added):

14.22.170 - Rate establishment.

A. The city council shall by **resolution** establish electrical utility rates for all electrical utility subscribers. In the establishment of rates, the city council may provide different rates for various categories of use, quantities of power used, and types of service furnished. In fixing and establishing electrical utility rates for service within the corporate limits of the city, the council shall be guided by the standards set out in this section.

B. Electrical utility rates shall be sufficient to discharge and pay all the costs of operation and maintenance of the electrical utility department and the electrical utility system, including reasonable provision for general administrative services, and to discharge and pay all costs in connection with additions and betterments to the electrical utility system, and to provide for the amortization of all depreciation and obsolescence within the system, and to discharge and pay any and all bonded indebtedness incurred in the construction or extension of the electrical utility system, including principal and interest thereof, and to establish and maintain a reasonable reserve fund to provide for unforeseen contingencies and the acquisition of facilities in newly annexed areas as well as extensions and betterments of the existing system. **Electrical utility rates shall not be charged in excess of the amounts necessary to raise the costs, expenses and appropriate reserves set out in this section.**

C. Copies of any resolution adopted by the city council pursuant to this section shall be maintained in the offices of the city clerk and the finance director for inspection by the public and shall be made available to any person or persons upon request.

In October of 2008, the Assistant City Attorney for Redding, Barry DeWalt (now the City Attorney), authored a legal memorandum on the issue of whether there are any "legal

constraints to the City Council's establishment of electric utility rates which would provide a source of revenue in excess of the costs, expenses and reserves necessary to provide services to the public?" (3 AR 793-796). In his memorandum Mr. DeWalt opines that the electric utility may recover the payment-in-lieu of property tax as a charge from the City that would qualify as a **cost or expense** under RMC §14.22.170 (3 AR 795).

Consequently, the PILOT can at best (for the City) be characterized as a "cost" item for the electric utility that it may recover through the rates as with all other costs of the enterprise. Citizens deny that the PILOT is a legitimate "cost" item for the utility, but for the sake of answering the immediate question of whether the PILOT is "grandfathered" as a fee, charge, or exaction following the approval of Proposition 26 the answer is clear: it does not.

In summary then, the answer to this Court's question is that the City had an historical practice dating back to roughly 1988 of making budgetary transfers from the electric utility to the general fund in the amount of the PILOT, but the PILOT itself would not be a fee, charge or exaction that would survive in the electric rates and be "grandfathered" under the new constraints of Proposition 26, effective November 3, 2010.

V. ADDITIONAL MATTERS RAISED BY CITY AS TO THE "REASONABLENESS" OF THE PILOT.

A. On each occasion that the City considers and adopts a resolution for new or increased electric rates, including the adoption of increased rates on Dec. 7, 2010 in Resolution No. 2010-179, the newly adopted rate resolution reflects the City's judgment

that the rates do not exceed the "reasonable costs to the local government of providing the service or product" (per Cal. Const., art. XIII C, § 1(e)(2)).

City argues that it has no continuing or future duty to determine whether or not the amount of the PILOT is equivalent to costs incurred by the City. Having gotten away with exacting the PILOT amount in the rates once, the City believes it can add that amount into the rates forever, without question. This position could not be more irresponsible in flouting what is a constitutionally imposed duty to assure ratepayers that they are not being charged more than the reasonable cost of service. The rate increases approved by the City in Resolution No. 2010-179 cannot be upheld when there is no evidence in the record (much less a "preponderance of the evidence") to support their validity.

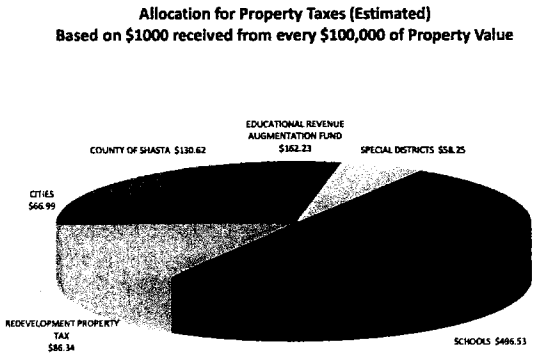
When there is a legal requirement that fees or rates meet a certain legal standard, then each time the rates come up before the legislative body and there are proposed modifications to only parts of the rate measure, the approval of the modified rate measure triggers the duty of the City to ensure that the entire rate measure is in compliance with legal standards, even as to those parts not changed.

This was one of the findings in *Barratt American, Inc. v. City of Rancho Cucamonga* (2005) 37 Cal. 4th 685, 704, where the City of Rancho Cucamonga had re-approved a comprehensive fee schedule but had only modified some of the fees. The City's re-enactment of the fee resolution was held to reflect the City's judgment that all of the fees were compliant with the law limiting their recovery to the estimated reasonable cost of services, including fees that were unchanged in the fee schedule.

In the present matter the City's adoption of Resolution 2010-179 reflected its judgment that the electric rates do not recover more than "the reasonable costs to the local government of providing the service or product" per Cal. Const., art. XIII C, § 1(e)(2), notwithstanding that the rates included the amount of the PILOT that was also a part of the total charge in previous fee resolutions. The City was not absolved of its duty to assess the propriety of collecting the PILOT amount just because it may have collected the PILOT amount from past fee enactments.

B. The City's exaction of the PILOT amount is not remotely comparable to the small amount of property tax funds the City would receive if the utility were privately owned.

City argues repeatedly that it must collect the PILOT electric rates so that it may receive the same revenue equivalent to what it would get in property taxes if the utility were privately owned. This is an egregious misrepresentation. Not only does the City inflate its "PILOT" with gimmicks that increase the assessable values (see details in Statement of Facts, *supra*), when the City collects its own PILOT it keeps 100%, whereas a privately owned utility would send its check to the State and the City would only receive about 6% of that amount coming back (*2014 Property Tax Distribution*, available at http://www.co.shasta.ca.us/docs/Auditor/docs/2014-property-tax-distribution; last accessed June 29, 2015).



The carving up of property tax revenues is dramatic and is easily verified at the website for the County Auditor/Controller. For every $100 the City exacts for itself as a PILOT, a private utility would send out a check for the same amount but the City would only get $6.

VI. CONCLUSION

Municipal electric utilities such as the one in Redding hold great promise for electric ratepayers all over the State of California, but they also carry great risks. The great promise lies in the fact that a municipal utility can operate more efficiently at lower rates, leverage the advantages of municipal financing, and in theory be more responsive to the local rate payers than a giant investor-owned utility. The risks stem from the fact that the utility generates such a large amount of cash and cash flow (in Redding the electric utility budget is larger than all of the rest of the City's departmental budgets combined), and the utility operations are extraordinarily complex; the electric utility budget becomes a temptation for abuse by municipal managers, and utility operations require management at skill levels the City may not be able to adequately provide. When municipal utilities abide by the law and function well they are

among the greatest assets offered to ratepayers and the citizens of these cities. When they stray from the law, the harmful consequences for ratepayers and citizens can be dramatic.

Redding's abuse of the rate setting process by collecting the PILOT amount in the electric rates is indefensible. At the end of the day, their argument is no more than a plea that they have done it before so why not let them continue, and the familiar entreaty that they need the money. However, consider that the falsely inflated rates (even if moderate in comparison to metropolitan areas of the state) are often too much for a significant number of their ratepayers on low or fixed incomes to keep up. Onerous late fees for late payments and disconnections follow. Falsely inflated electric rates are the worst kind of unlawful tax because they hurt the most vulnerable in our society.

Proposition 26 must be enforced in this matter, and the record before the Court makes plain that relief should be given to Citizens. Scrupulous enforcement of the law in this case will help this electric utility fulfill its promise rather than its risks.

Respectfully submitted,

MCNEILL LAW OFFICES

Dated: July 1, 2015

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CERTIFICATE OF WORD COUNT

(California Rules of Court, Rule 8.504(d)(1))

The text of this brief, exclusive of cover page, tables and attachments, consists of 12,216 words, as counted by the word processing program that was used to generate this brief.

Respectfully submitted,

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PROOF OF SERVICE

I am employed in Shasta County; I am over the age of 18 years and am not a party to the within action; my business address is MCNEILL LAW OFFICES, 280 Hemsted Drive, Suite E, Redding, California 96002; on this date I served:

ANSWER BRIEF ON THE MERITS

X **BY FIRST CLASS MAIL:** The envelope was mailed with postage thereon fully prepaid in a sealed envelope and addressed as follows:

SEE ATTACHED LIST

X I hereby certify that the document(s) listed above was/were produced on paper purchased as recycled.
X I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed on July 1, 2015 at Redding, California.

Jennifer Dugan

SERVICE LIST

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California Supreme Court Case No. S224779
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