No. S224779

Exempt from Filing Fees
Government Code § 6103

IN THE SUPREME COURT
OF THE STATE OF CALIFORNIA

Citizens for Fair REU Rates, et al.
Plaintiffs and Appellant

vs.

City of Redding, et al.
Defendants and Respondents

OPENING BRIEF

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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ISSUES PRESENTED FOR REVIEW

1. 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))?
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?

INTRODUCTION

This case asks the Court to determine whether a budget transfer from the City of Redding's electric utility to its general fund re-legislated every two years without change since 2005 is a tax under Proposition 26.

Like most municipal electric providers in California, the City established its payment in lieu of taxes (PILOT) from its electric utility to its general fund in 1988 to approximate the 1 percent property tax its electric utility assets would bear if held by an investor-owned utility such as Pacific Gas & Electric.

Citizens for Fair REU Rates (Citizens)[1] argue Proposition 26, article XIII C, section 1, subd. (e) of the California Constitution now requires voter approval of the long-standing PILOT because its existence means the City's electricity rates necessarily exceed the cost-of-service limitation of Proposition 26's exception to its definition of "tax" for fees for government services. (Cal. Const., art. XIII C, § 1, subd. (e)(2).)[2] However, unlike Proposition 218, which it amends, Proposition 26 is not retroactive as to local government and does not displace earlier legislation that raises the cost of government services to achieve other social goals. As the City's PILOT from its electric utility to its general fund predates Proposition 26, it is not disturbed by that measure, but grandfathered by it.

Even were that not so, the trial court found as a matter of fact — and the record demonstrates — that the PILOT is not funded by rates on City electricity customers, but from the proceeds of wholesale transactions. The City's wholesale prices are not "imposed" on the sophisticated market participants who choose to

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[1] "Citizens" refers collectively to Citizens for Fair REU Rates, Fee Fighter, LLC and the individual plaintiffs and appellants in the two cases consolidated here.

[2] All further references to articles and sections of articles in this Brief are to the California Constitution.

buy power from Redding and those prices therefore are not subject to Proposition 26.

Even if Proposition 26 did apply here, the PILOT compensates the City's general fund for vital benefits and services the City provides to the electric utility — such as police and fire protection of utility assets and employees and use of City rights of away — so the general fund is not impoverished by the decision to municipalize electric service.

Finally, were the PILOT subject to Proposition 26, the City has not "imposed, extended or increased" it since the 2010 effective date of that measure and voter approval is therefore not yet required by article XIII C, section 2, subdivision (b).

For all these reasons, this Court should affirm the trial court's judgment.

STATEMENT OF THE CASE

I. TRIAL COURT PROCEEDINGS

Citizens for Fair REU Rates filed a petition for writ of mandate and complaint for declaratory and injunctive relief (Case No. 171377, "Rate Case"), alleging an increase in electric rates the City Council adopted December 7, 2010 constituted a tax requiring voter approval due to the continuing existence of the PILOT. (1 CT 2.) The City demurred, arguing the PILOT predated Proposition 26 and was therefore not subject to it. (1 CT 29.) The trial court denied the

demurrer. (2 CT 474.) The City then answered, denying all claims and contentions. (2 CT 486.) The City certified and lodged its 12-volume Administrative Record ("AR") of the information considered by the City Council when it adopted the PILOT and the challenged electric rates. (2 CT 496.)

Feefighter, LLC — a for-profit entity owned by counsel for Citizens — then filed a second lawsuit (Case No. 172960, "Budget Case") seeking declaratory and injunctive relief and damages, alleging the City's budget for Fiscal Years 2011–2012 and 2012–2013 illegally included revenues from the PILOT. (2 CT 498.) The City answered by general denial and certified and lodged two additional volumes as an addendum to the Administrative Record to include materials pertinent to the budget adoption. (2 CT 557 [Answer]; 3 CT 732 [Notice of Lodgment].)

The trial court ruled for the City on the Rate Case after bench trial. (3 CT 709.) The court concluded the December 2010 electric rate increase neither created nor altered the PILOT and Proposition 26 does not apply retroactively to the PILOT and therefore did not invalidate the December 2010 rate increase. (3 CT 711.)

The court then consolidated the two cases for all purposes. (3 CT 719.) As the parties agreed, they did not file additional briefs for the Budget Case, which was tried on the briefing in the Rate Case, although the court heard additional argument. (3 CT 720 [¶¶ 4–5].)

The court then issued judgment for the City in both cases on July 13, 2012. (3 CT 750.) In a second detailed and considered Memorandum of Decision, the trial court concluded that Proposition 26 does not apply retroactively to the PILOT, which the City Council first adopted in 1988. (3 CT 736, 739 [last ¶].) The trial court also concluded the PILOT is a cost of service for the City's electric utility not displaced by Proposition 26 and that was not funded from the challenged electric rates. (3 CT 737 [lines 2–3]; 741–742.) Citizens timely appealed on August 20, 2012. (3 CT 760.)

II. APPELLATE COURT PROCEEDINGS

After the parties fully briefed the case in the Third District Court of Appeals, that court invited simultaneous supplemental briefs on five questions. The parties filed the requested supplemental briefs and the Court heard oral argument.

After argument, the City filed an Application for Leave to File Supplemental Brief and Proposed Supplemental Brief to address issues raised at argument not previously briefed. The court granted this request and the parties submitted supplemental briefing addressing whether the City Council's adoption in June 2011 of a two-year budget that maintained the pre-existing PILOT constituted new legislation subject to Proposition 26 or the continuation of earlier legislation grandfathered by it.

On January 20, 2015, the Court of Appeal issued its published decision, holding the PILOT to be a tax subject to Proposition 26 and remanding for determination whether it was cost-justified. (*Citizens for Fair REU Rates v. City of Redding* (2015) 182 Cal.Rptr.3d 722.) Justice Duarte dissented. (*Id.* at p. 738.) The City sought rehearing to clarify the opinion and to correct factual errors. The Court of Appeal denied rehearing in an order incorporating minor changes.

This Court granted the City's Petition for Review.

STATEMENT OF FACTS

From 1971 to 1988, the City implemented an operating transfer from its electric utility to its general fund — i.e., a transfer in an amount established by the City budget, as distinguished from a PILOT, which is calculated like a property tax as a percentage of the value of utility assets. (II AR Tab 37, p. 358 ("In-lieu Tax Analysis"); II AR Tab 42, pp. 379–380 ("In-Lieu Analysis"); III AR Tab 111, p. 640 (1st ¶).) The transfer was intended to compensate the City's general fund for benefits and services the City provides the utility, and for which a private utility would pay property taxes and a franchise fee (a fee in the nature of rent for use of public rights-of-way), in addition to services that would not ordinarily be provided to a private utility, such as billing and finance. (II AR Tab 37, p. 358 ("In-lieu Tax Analysis"); I AR Tab 5, p.133; III AR Tab 119, p. 663 (2d whole ¶).) Its effect was to leave the City's general fund on the

footing it would have if the community had not elected to municipalize electric service.

In 1987, the City's Finance Department determined that operating transfers undervalued City benefits to the electric utility. (I AR Tab 4, pp. 119–124 (Finance Director's memo).) Finance Department staff examined similar programs in 34 cities that operated municipal utilities (i.e., essentially all municipal utilities in California) and requested a legal opinion of respected outside counsel. (I AR Tab 4, p. 119 (Finance Director's memo); I AR Tab 5, p. 135 [staff notes of other cities' practices].) Martin McDonough of McDonough, Holland & Allen opined that PILOTs were lawful, and that City power rates including a PILOT would almost certainly be considered reasonable because those rates were (and are) lower than comparable private utility rates. (I AR Tab 5, p. 133.) Redding's electric rates continue to be among the lowest in California. (IV AR Tab 166, pp. 1074, 1080–1085.)

The City Council adopted PILOTs benefitting its general fund from water, sewer, solid waste, and electric utilities in the Fiscal Year 1988–1989 budget.[3] (II AR Tab 28, p. 319 (last ¶) [City Manager's budget report]; III AR Tab 111, p. 640 (1st ¶) [City Attorney's

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[3] The City's fiscal year, like that of most local governments, is July 1 to June 30. Unspecified "years" referenced in this brief and in the record are fiscal years.

memo].) Initially, the PILOT was calculated by assessing the value of the electric utility's property and equipment, subtracting estimated depreciation, and multiplying the result by the 1 percent property tax rate permitted by Proposition 13. (II AR Tab 42, p. 380 (2d ¶).) Upon adoption of the 1991–1992 budget, the City Council amended the PILOT to include the value of construction in progress. (II AR Tab 70, pp. 446–447 ("Assumption 3"); II AR Tab 72, p. 450 (last ¶).)

Following adoption of Proposition 218 in November 1996, the City retained an independent rate-making consultant to compare the PILOT to the cost of the services for which it was charged. (III AR Tab 119, pp. 663–665 (R.W. Beck memo).) That study concluded the PILOT fairly compensated the City for services to the utility — such as billing and finance and for use of public rights-of-way. (III AR Tab 119, p. 663 (8th & 10th bullets).) It noted the PILOT represented approximately 5 percent of electric utility revenues, "well within the range of similar transfers in California." (III AR Tab 119, p. 663 (10th bullet).) The study noted the State Board of Equalization assessed multi-county utility property for property taxation using original, rather than the depreciated, asset values; but the City's PILOT then did not. (III AR Tab 119, p. 664 (1st ¶).) Upon adoption of the 2001–2003 budget, the City Council adjusted the PILOT to adopt that methodology, including a 2 percent cap on annual growth in assessed valuation (the ceiling imposed by Proposition 13,

art. XIII A, § 2, subd. (b)). (III AR Tab 126, pp. 693–694 (carry-over ¶); III AR Tab 134, p. 738 (1st ¶, last sentence).)

The City last amended the PILOT in 2005 to include the electric utility's share of assets held by joint powers agencies ("JPAs").[4] (2 CT 530 (last ¶); see also City's Apr. 18, 2014 Motion for Judicial Notice in support of Respondent's Brief to the District Court of Appeal, Exh. D (PILOT Calculation for FYs ending 2006 and 2007).)[5]

City staff calculates the PILOT with each budget according to the formula adopted by the City Council. (E.g., III AR Tab 126, pp. 693–694 [2001–2003 budget summary] (carry-over ¶); XIII AR Tab 205, p. 2896 [2011–2013 budget].) Because the formula relies on estimates, the PILOT is "trued up" upon the adoption of budgets in odd-numbered years to correct estimates for the previous biennium. (E.g., XIII AR Tab 205, p. 2971 (last ¶).)

The City increased electric rates in 2008 to compensate for change in the Western Hydroelectric contract, fluctuations in the natural gas market and a dry year for hydroelectric power, which produces the cheapest power available to the electric utility. (III AR

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[4] Such agencies are formed pursuant to Government Code sections 6500 et seq.

[5] The Court of Appeal denied all the parties' motions for judicial notice in a footnote in its opinion. (233 Cal.Rptr.3d at p. 725, fn. 3.)

Tab 140, pp. 797–798 (carry-over ¶ & 1st whole ¶ on p. 798); IV AR Tab 142, p. 816 (2d & 3d ¶s); IV AR Tab 166, pp. 1067–1068.) At the time, the City was concerned that it not raise rates too quickly (which can cause significant economic dislocations that academics refer to as "rate shock"[6]), and decided to raise rates to recover the full cost of service incrementally over several years, using cash reserves in the interim.[7] (III AR Tab 140, pp. 797–800 (staff report recommending rate increases over time); IV AR Tab 159, p. 1031 (2010 staff report to same effect).) Although several "wet" years might have allowed an eventual rate decrease, it did not rain — as we now know all too well. (See IV AR Tab 142, p. 816 (2d ¶).) Instead, the utility's cash reserves declined and staff warned the City Council in December 2010 that a failure to raise raises would harm the utility's credit rating and increase its borrowing costs. (IV AR Tab 165, p. 1060 ("Public Hearing"); IV AR Tab 166, p. 1077–1078.) Staff also recommended rate increases to reflect both escalating costs to purchase power and the City's covenants with bondholders

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[6] E.g., Edison Electric Institute, Rate Shock Mitigation (June 2007) available (as of May 25, 2015) at: <http://www.eei.org/whatwedo/PublicPolicyAdvocacy/StateRegulation/Documents/rate_shock_mitigation.pdf>.

[7] It is for this reason that rate-stabilization reserves are a common feature of utility cost-of-service analyses.

obligating it to maintain rates and cash reserves sufficient to ensure repayment of debt. (IV AR Tab 158, p. 1028 ("Public Hearing"); IV AR Tab 159, pp. 1031–1033 (staff report recommending rate increases).)

Accordingly, the City Council adopted Resolution No. 2010-179 in December 2010 to increase electric rates by 7.84 percent effective January 2011 and by another 7.84 percent effective December 2011. (IV AR Tab 163, pp. 1041–1042.)

Those increases did not change the PILOT or affect it in any way. (IV AR Tab 163, p. 1041.) Nor were those rate increases necessary to fund the PILOT, which was included — as had been the City's consistent practice since first adopting it in 1988 — in the 2009–2011 budget. The December 2010 electric rate increases were instead driven by the other costs noted above. Furthermore, the City's electric utility receives revenue from wholesale customers (and other non-rate sources) in three to four times the amount of the PILOT. (IV AR Tab 145, p. 831 (wholesale revenues and PILOT amounts);[8] IV AR Tab 149, p. 873 (PILOT amount).)

In June 2011, the City Council adopted Resolution No. 2011-111 to approve a budget for Fiscal Years 2012 and 2013

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[8] Duplication of the AR obscured much of page 831. A legible copy is attached to this Brief as Attachment 1 pursuant to California Rules of Court rules 8.520(b) & (h), and 8.204(d).

which reflected revenues from the PILOT. (XI AR Tab 203, p. 2466 (6th"whereas" clause).[9]

STANDARD OF REVIEW

An appellate court considers legal issues:

> de novo to the extent that the [lower] court decided questions of law concerning the construction of constitutional provisions and not turning on any disputed facts. [An appellate court] review[s] the [trial] court's factual findings under the substantial evidence standard.

(*Schmeer v. County of Los Angeles* (2013) 213 Cal.App.4th 1310, 1316 (*Schmeer*) [construing Proposition 26]; internal citations omitted.) Here, the record is not in dispute; the parties do, however, dispute the inferences to be drawn from it. While the City asserts some deference to the trial court's reading of the record is appropriate, even if this Court reviews the administrative record de novo, the trial court's well-reasoned conclusions survive review.

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[9] This Resolution is attached as Attachment 2 for the Court's convenience pursuant to California Rules of Court, rules 8.520(b) & (h), 8.204, subdivision (d).

> In reviewing the trial court's ruling on a writ of mandate (Code Civ. Proc., § 1085), the appellate court is ordinarily confined to an inquiry as to whether the findings and judgment of the trial court are supported by substantial evidence. However, the appellate court may make its own determination when the case involves resolution of questions of law where the facts are undisputed.

(*Saathoff v. City of San Diego* (1995) 35 Cal.App.4th 697, 700 [internal citations omitted].)

"'[T]he court's decision to grant or deny [declaratory] relief will not be disturbed on appeal unless it be clearly shown ... that the discretion was abused.'" (*Pellegrini v. Weiss* (2008) 165 Cal.App.4th 515, 529; *Osseous Technologies of America, Inc. v. DiscoveryOrtho Partners LLC* (2010) 191 Cal.App.4th 357, 364.)

The trial court determined Proposition 26 did not apply to the PILOT, and therefore did not reach burdens of proof under that measure. (3 CT 739 (last sentence).) Similarly, the Court of Appeal noted only in passing that — under the final unnumbered paragraph of article XIII C, section 1, subdivision (e) — the local government bears the burden to prove by a preponderance of the evidence that a charge is not a tax. (182 Cal.Rptr.3d at p. 729.) This, duty, however, arises only when the plaintiff establishes a prima facie case that the revenue measure in question falls outside one of Proposition 26's

exemptions. (*California Building Industry Association v. State Water Resources Control Board* (2015) 235 Cal.App.4th 1430, 186 Cal.Rptr.3d 212, 227 [construing Prop. 26 as applied to State] (*CBIA v. SWRCB*).)

To the extent Citizens would assign the City the burden to produce an administrative record containing evidence to sustain its legislative acts to adopt the December 2010 power rates and its 2011–2013 budget, the City accepts the burden. The City denies that Citizens have established a prima facie case that the PILOT is a tax under Proposition 26 and therefore, asserts that the burden of persuasion remains on Citizens. (*CBIA v. SWRCB, supra.*) However, even if the City did bear the burden to prove any disputed facts by a preponderance of the record evidence, it can do so on this record.

To the extent Citizens would assign the City some burden as to questions of law, the City demurs. Proposition 26 states as to burdens of proof under that measure:

> 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.

(Art. XIII C, § 1, subd. (e) [final unnumbered ¶].)

What can it mean to bear the burden to prove that a charge is not a tax? A burden of proof is assigned with respect to disputed facts and assists a court in deciding issues as to which the evidence is in equipoise. (Evid. Code § 110 [defining "burden of producing evidence"]; Evid. Code § 115 [defining "burden of proof"].) The Court, however, needs no tie-breaking device for questions of law; it determines those independently. (See generally, *Crocker National Bank v. City and County of San Francisco* (1989) 49 Cal.3d 881, 888 [Mosk, J., discussing appellate standards of review of questions of fact, law, and mixed questions of fact and law].) Accordingly, Citizens and the City are on equal footing in this Court as to the meaning of Proposition 26 and other legal issues.

In any event, the City bore its burden to produce a record to support its December 2010 power rates and its 2011–2013 budget; Citizens failed to bear its burden to establish a prima facie case that the PILOT is a tax but, even if it had, the preponderance of the evidence in this record supports the City's legislative acts and demonstrates the trial court correctly applied the law.

LEGAL DISCUSSION

I. THE PILOT PREDATES PROPOSITION 26

A. The PILOT Is Preexisting Legislation

The trial court found that the PILOT had been a component of Redding Electric Utility's budget for over 20 years when Proposition 26 was adopted in November 2010. (3 CT 736, 739). The trial court also found the December 2010 rate increase did not affect the PILOT, which was funded by earlier rates. (3 CT 736–737.) The record supports these findings, as demonstrated above. The City Council adopted the PILOT in 1988, refined it in 1992, 2002 and 2005, and has implemented it without change since. (2 CT 530.)

The City Council's 1988 adoption of the PILOT by a budget resolution was a legislative act. Accordingly, Redding Electric Utility's duty to make the PILOT transfer is a lawful cost of its service, just as is its compliance with 2006's AB 32 — the State's landmark greenhouse gas law. As the Court of Appeal explained:

> [T]here is a limited role for the judiciary to play in determining whether a legislative enactment, including a budgetary enactment, is within the authority of the legislative body and whether it violates any constitutional provisions.

(*Scott v. Common Council* (1996) 44 Cal.App.4th 684, 698 [mandating council fund city attorney positions required by city charter].) Thus,