PPIC

Paying for Water

PPIC WATER POLICY CENTER

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SUCCESSFUL WATER MANAGEMENT REQUIRES ADEQUATE, RELIABLE FUNDING

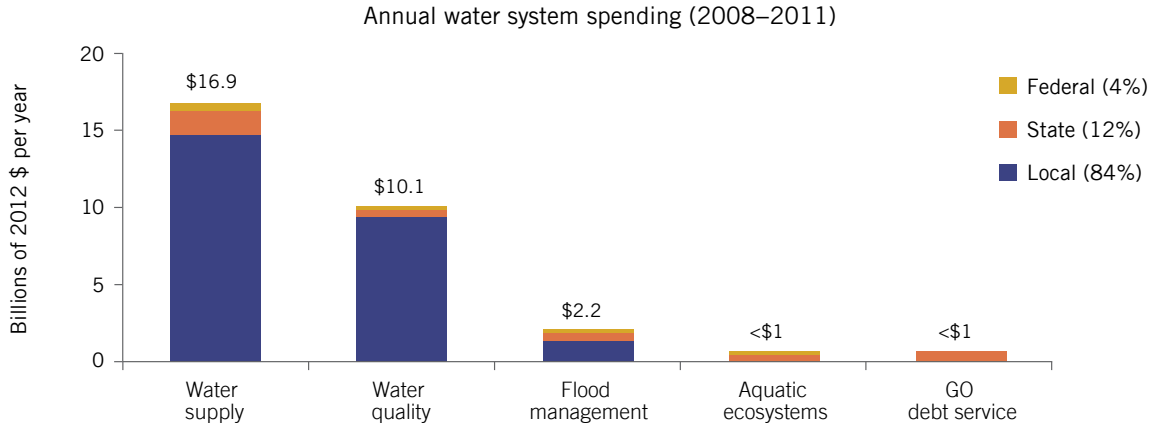
California's water system performs vital functions. It supplies water to cities and farms; prevents pollution of lakes, rivers, and coastlines; protects people and businesses from floods; and supports freshwater ecosystems. Numerous local, state, and federal agencies oversee this system and raise revenues from a variety of sources. Identifying funding gaps—and finding the best ways to fill them—are perennial concerns.

The funding source that has received the most public attention is state general obligation bonds—voter-approved debt reimbursed with General Fund taxes. Six such bonds were approved between 2000 and 2006, providing roughly $15 billion for water projects. In November 2014, voters approved Proposition 1, a $7.5 billion bond that extends this support.

State bonds are important, but they actually play a minor role in financing California water. Bonds provide at most $1 billion of the more than $30 billion in annual water-related spending. Local revenue, from water and sewer bills to taxes, provides the lion's share, 84 percent. The state contributes 12 percent and the federal government 4 percent.

California's urban water and sewer systems face challenges, but overall they are in reasonably good fiscal health. In contrast, other areas face critical gaps totaling $2–3 billion annually—a result of legal constraints on local funding, a shrinking federal contribution, and unreliable state support. In California's $2 trillion economy, this problem is manageable. But dealing with it requires a focused effort. Looking beyond bonds to fill current and potential funding gaps should be a top priority.

LOCAL UTILITIES RAISE MOST OF THE MONEY SPENT ON WATER IN CALIFORNIA



SOURCE: Ellen Hanak et al., *Paying for Water in California* (PPIC, 2014).

NOTES: The figure reports average spending for 2008–2011. State and local expenditures are net of grants from higher levels of government. The water quality category includes management of wastewater and approximately $500 million for polluted stormwater and other runoff.

CONSTITUTIONAL CHANGES HAVE HARMED LOCAL WATER FINANCE

Local finance is the lifeblood of California's water system. But a series of constitutional amendments—Propositions 13 (1978), 218 (1996), and 26 (2010)—have made raising funds for local water services more difficult than ever.

- **The changes have increased accountability, but with unintended consequences.** Proposition 218's rate-setting reforms have improved transparency and public accountability. At the same time, voter-approved measures have imposed overly simplistic cost-recovery requirements. These inhibit local agencies from investing in new supply, such as recycled water and conservation, and pollution control, such as stormwater capture and treatment.

- **Stricter voter requirements impede delivery of some essential water services.**
  For flood and stormwater management, a majority of landowners or a two-thirds majority of all local voters must now approve new fees and assessments—previously, these were approved by elected governing boards. In addition, new local taxes for water programs must now get two-thirds voter approval—a much higher hurdle than the simple majority required for local general taxes or state ballot measures. The new state water bond—widely considered to have passed by a landslide with a 67.1 percent approval vote—would barely have squeaked by under the rules governing local tax measures.

URBAN WATER AND SEWER SYSTEMS ARE PERFORMING REASONABLY WELL

Unlike flood and stormwater agencies, California's water supply and sewer utilities are exempt from Proposition 218's voting requirement. They have generally been able to get the funds needed to replace aging infrastructure and comply with new treatment requirements. Investments since the 1990s in conservation, water reuse, and local conveyance and storage were invaluable in preparing cities for the latest drought.

- **Utilities face looming legal uncertainties.**
  Proposition 218's cost-recovery requirement specifies that rates cannot exceed the cost of providing a service. Some courts have interpreted this requirement very narrowly, jeopardizing the implementation of important programs, such as conservation-oriented water rates and the development of recycled wastewater and other nontraditional sources of water.

- **Keeping water affordable for low-income households will be a challenge.**
  Water and sewer bills have been rising to keep pace with investment needs. For most Californians, these charges are a small share of income. For low-income households, however, affordability is a growing concern. Proposition 218 restricts the ability of water utilities to provide "lifeline" discounts to low-income households. Such discounts have helped make energy and telephone billing systems more equitable.

CALIFORNIA'S WATER SYSTEM HAS MULTIPLE FISCAL ORPHANS

California is failing to adequately fund five services that protect public health and safety and the environment: safe drinking water in small, disadvantaged communities; flood protection; control of stormwater and other polluted runoff; management of aquatic ecosystems; and integrated water management.

- **Safe water is unaffordable in some rural communities.**
  Providing safe drinking water is a special challenge in small, disadvantaged rural communities, where costs per household are high and local funding resources are scant.

- **Federal funding for flood projects has been inadequate.**
  Federal policy authorizes matching grants of up to 65 percent of project costs for flood protection. But this authorization is largely unfunded, leading to a large investment backlog. And federal contributions are shrinking because of budgetary restrictions. Voters in some communities have approved modest local cost shares, but it will be much harder to pass the larger charges needed to fill the gap.

- **Stormwater agencies have been hit hardest by constitutional changes.**
  Stormwater management once focused solely on draining streets after storms. Over the past two decades, mandates have expanded to prevent pollution of rivers, lakes, and beaches by limiting discharges and cleaning runoff before it enters waterways. It is especially hard to persuade local voters to approve funds for cleanup that mainly benefits downstream communities.

- **Most ecosystem management programs lack a reliable funding base.**
  Funding is usually straightforward for ecosystem investments that are a mandatory part of new projects. But most environmental problems result from past water- and land-use practices, and financial responsibility for fixing them is frequently disputed. Some communities have approved taxes to support their watersheds. However, this approach is limited by the requirement to have special taxes approved by two-thirds of the voters.

- **Integrated water management is hard to fund locally, despite its benefits.**
  Integrated water management involves collaboration among agencies with different responsibilities to improve overall system performance. Proposition 218's cost-recovery requirements make it hard for water and wastewater agencies to share the costs of activities that extend beyond their mandates, and financially weaker partners overseeing flood, stormwater, and ecosystem programs have trouble coming up with their share.

- **State bonds have helped fill gaps, but they also have drawbacks.**
  Since 2000, state bonds have helped fund all five gap areas, and Proposition 1 extends some of that support. But bonds are not a reliable long-term funding source, and they generally don't cover operating costs. In addition, bonds are repaid from the state General Fund. During economic downturns, bond repayment can take funds from other important budget areas such as higher education and health and human services.

- **Other funding sources are needed to pay for fiscal orphans.**
  To close funding gaps, California needs a broader, more reliable mix of state and local funding sources, including new fees and taxes. Examples include parcel taxes, small surcharges on water and chemical use, and small increments to the sales tax. Such measures are already used in some California communities and in other states.

CALIFORNIA NEEDS TO GO BEYOND BONDS TO CLOSE FUNDING GAPS

Gap area	Annual gap ($ millions)	Onetime infusion from Prop 1 ($ millions)	Other long-term funding options
Safe drinking water in small rural systems	$30–$160	$260*	▪ Statewide surcharges on water, chemical use
Flood protection	$800–$1,000	$395	▪ Developer fees ▪ Property assessments ▪ Special state, local taxes
Stormwater management	$500–$800	$200	▪ Developer fees ▪ Property assessments ▪ Special state, local taxes ▪ Surcharges on water, chemical, or road use
Aquatic ecosystem management	$400–$700	$2,845**	▪ Special state, local taxes ▪ Surcharges on water use, hydro-power production
Integrated management	$200–$300	$510	▪ Special state, local taxes ▪ Surcharges on water use

SOURCES: Ellen Hanak et al., *Paying for Water in California* (PPIC, 2014) and bill text for AB 1471, the Water Quality, Supply, and Infrastructure Improvement Act of 2014.

* These funds are available for communities of all sizes. Another $260 million is available for small community wastewater systems.

** This includes the $1.495 billion earmarked for ecosystem investments and $1.35 billion from water storage project matching funds set aside for ecosystem benefits.

LOOKING AHEAD

California must fill a critical $2–3 billion annual funding gap across a number of essential functions: ensuring clean drinking water for all residents; protecting residents from flooding; keeping beaches, rivers, and lakes safe for recreation; safeguarding threatened aquatic ecosystems; and fostering integrated water management. Action is also needed to avoid funding problems for urban water and wastewater systems, given the uncertain legal status of financing these services.

Use new bond funds to fill real gaps. Proposition 1 will inject $7.5 billion into the water system. The legislature and state agencies should make sure these state funds are not simply substituting for local funds.

Look beyond bonds. One legislative priority should be to help local agencies raise needed funds. For example, the legislature could expand local funding authority and provide guidance to the courts on how their interpretations of Proposition 218 may affect water program financing. Another priority is to enact new state fees and taxes to boost funding for fiscal orphans.

Reduce water management costs. State and federal agencies need to coordinate their activities better to reduce regulatory inefficiency. Obtaining permits represents a major time and cost drain for environmental programs that are already strapped for funding. The legislature could ease the burden by authorizing regional permits in places where significant investments are needed.

Communicate water rate decisions more effectively. Utilities have been most successful when the public understands the reasons for rate increases. This is a special challenge during droughts, when customers are often unprepared for the rate increases needed to offset revenue losses from water shortages and water use restrictions. Utilities also must build strong administrative records of rate decisions to meet potential Proposition 218 court challenges.

Consider constitutional reforms. To solidify local funding bases for water services, voters may need to approve several constitutional changes that address the unintended consequences of previous amendments—while retaining transparency and accountability requirements. These might include revising Proposition 218's cost-recovery requirements, stipulating that flood and stormwater programs should be treated like water and wastewater programs, and lowering vote thresholds for special taxes to a simple majority, the same as general taxes.

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PPIC PUBLIC POLICY INSTITUTE OF CALIFORNIA

The PPIC Water Policy Center spurs innovative water management solutions that support a healthy economy, environment, and society—now and for future generations.

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