Senate Natural Resources and Water Committee Hearing

"Beyond Bonds: Options for Funding Public Benefits of Water Related Investments"

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Madame Chair and Honorable Committee Members,

Thank you for the opportunity to address you today. I will focus my remarks on the findings and recommendations on water sector finance from our new study, *Managing California's Water: From Conflict to Reconciliation.* In this study, we take a look at the weaknesses of California's current funding system and propose ways to address funding gaps.

<u>Context: state and federal funding</u>

Over the past decade, California has come to rely on state general obligation (GO) bonds to support the water sector. In real terms (2008$), California voters approved over $32 billion in state GO bonds since 1970 for this sector; over two-thirds of this total ($23 billion) was approved since 2000. Bond financing emerged as the state's budget woes have made it increasingly difficult to support water sector activities with general fund tax dollars, a situation that is unlikely to turn around anytime soon. And although California's water utilities were able to benefit from large temporary increases in federal stimulus funding, federal taxpayer dollars are also likely to be severely limited in the future given federal budget woes.

GO bonds have enabled California to fund a variety of activities, including water and wastewater investments, environmental management, flood protection, and even basic operations of state government. But they are an unstable source of revenue. And because they are repaid with general fund revenues, they impose tradeoffs with other sectors, like education, that do not have the funding options available to the water sector. To fund the water system, California should be relying much more heavily on fees levied on water users rather than general tax dollars. Such fees can provide more reliable funding, while providing the right incentives to water system users to reduce risky and environmentally harmful practices.

Weaknesses of the current system: a mixed picture

If we take a quick look across the various components of the water system, it's clear that the parts of the system that already rely on user finance are in the best shape.

- Water and wastewater utilities – which deliver water to the state's residents and businesses and treat their wastewater discharges – account for the largest expenditures within the water sector, and they are primarily funded by their ratepayers. Overall, California's water and wastewater utilities have been investing at higher rates than estimated needs. They are generally able to raise rates when justified, and their rates are in the range considered affordable. Although these utilities certainly benefit from the availability of bond funding, bonds are supporting activities they could finance through water rates.
- In contrast, we found serious funding concerns in the area of flood protection. Historically flood protection has relied on a substantial federal cost share (often 65%), and relatively limited local contributions (typically only 10 to 15%). But federal contributions have not kept pace with funding needs. These needs also far surpass the amounts available from state GO bonds (including the roughly $5 billion available since 2006). This is an area where greater local cost shares will be necessary.
- Another major problem area is environmental management. There are considerable unmet needs to improve flows, habitat, and water quality. California has largely been relying on bond funds to support environmental management and the underlying science needed to better identify management actions. A more stable source of funding is needed, supported by those who use water and discharge pollutants into the system.

- Finally, state planning and management functions are facing a financial crisis. California used to rely on general fund revenues to support these actions, but state budget woes have made this difficult. Since 2001, bonds have funded at least one-quarter, and sometimes more than half of the Department of Water Resource's operational expenses in most years.

What we propose: a system supported by water users

To fill the gaps in water finance, we propose a system that relies more fully on user-generated funds. Currently water system beneficiaries aren't paying the full cost of the system, and state and federal tax revenues will be an inadequate and unreliable source for the foreseeable future. The basic idea is that those who divert water, discharge pollutants into water bodies, or develop land in ways that increase flood risk contribute to a more sustainable, safer system. We propose four categories of fees:

- A public goods charge on water use: a volumetric charge on all surface and groundwater users, to fund the public goods aspects of water management (ecosystem management, administration, research and development) and to incentivize regional water supply reliability projects and integrated water management (something now supported by state GO bonds). Parallels in other sectors include the public benefit charge in the energy sector, in place since 1996, and the fuel tax, in place since the 1920s. In the water sector, some regional agencies, including the Metropolitan Water District of Southern California and the Sonoma County Water Agency, already levy such fees.
- Special mitigation fees: Regulatory fees are appropriate to directly support environmental mitigation of some actions. This includes surcharges on chemicals that are contaminating the state's waterways and fees to support environmental mitigation of the state's many dams and the retirement of those dams whose economic benefits have ceased to outweigh the environmental damage they cause. Parallels exist in numerous areas, including charges for hazardous waste disposal (e-waste, oil, lead paint) and mine site restoration.

- Water quality permit fees: In addition to the current policy of funding the costs of administration, these fees should fund the costs of environmental mitigation from pollutant discharges.
- Regional and local risk-based flood management fees: To address California's growing flood risk, greater regional and local contributions will be needed, and these should be assessed based on the benefits of flood protection investments to individual properties. Such risk-based assessments are already being used by some local agencies, including the Sacramento Area Flood Control Agency.

Many of these fees will require legislative approval, and the recent passage of Proposition 26 makes it likely that a two-thirds vote of the legislature will be required for at least some of them. Increasing local contributions to flood protection will also be a challenge given Proposition 218 requirements that either a majority of local landowners or two-thirds majority of the public approve any new flood assessments. But Californians really don't have a choice if they want to secure a safe and reliable water supply and flood management system for the decades to come. In this sector, we are lucky to have some viable alternatives to taxpayer support. What we now need is the courage to implement new policies.