

Successful water management requires adequate, reliable funding

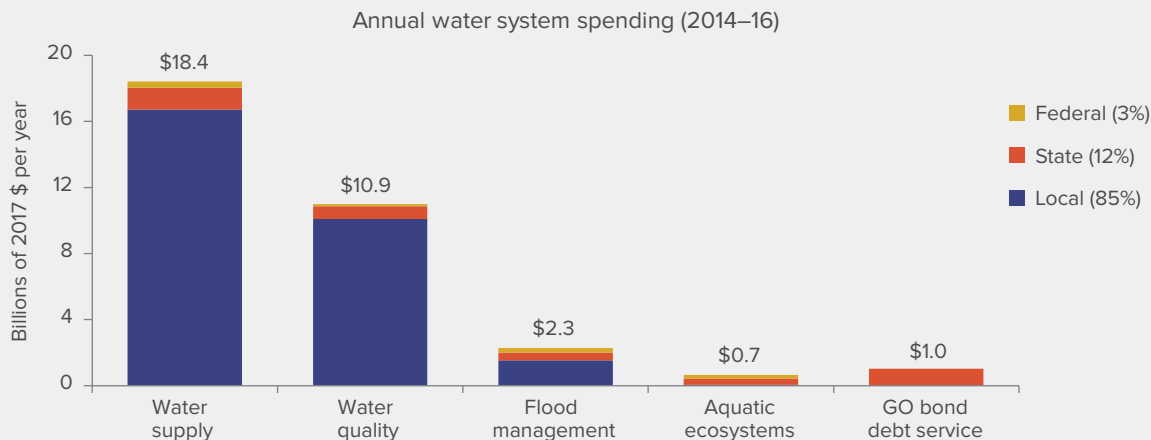
California’s water system supplies cities and farms; prevents pollution of lakes, rivers, and coastlines; protects people and businesses from floods; and supports ecosystems. Many local, state, and federal agencies oversee this system and raise revenues from a variety of sources. Identifying funding gaps and finding adequate and reliable ways to fill them are perennial concerns.

Most public attention has focused on state general obligation bonds—voter-approved debt reimbursed with General Fund taxes. Eight bonds approved between 2000 and 2018 set aside roughly \$24 billion for water projects. In November 2018, voters rejected Proposition 3—an \$8.9 billion water bond.

State bonds are important, but they play a relatively minor role in funding California’s water. Bonds typically provide less than \$1 billion of the more than \$33 billion in annual water-related spending. Local revenue—from water and sewer bills to taxes—provides 85 percent. The state contributes 12 percent and the federal government 3 percent.

California’s urban water and wastewater agencies face some fiscal challenges, including how to balance their checkbooks during droughts when they collect less revenue. But overall they are in reasonably good fiscal health. Other management 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 \$2.7 trillion economy, this problem is manageable. But dealing with it requires a focused effort and statewide leadership. Looking beyond bonds to fill gaps should be a top priority.

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



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

NOTES: The figure reports average spending for 2014–16. Local expenditures exclude grants from higher levels of government. The water quality category includes management of wastewater and approximately \$500 million for polluted stormwater and other runoff. GO bond debt service is repayment of state general obligation bonds.

Constitutional changes have disrupted 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 it harder to raise funds for local water services.

- **The changes have increased accountability, but with unintended consequences.**

Proposition 218’s rate-setting reforms improved transparency and accountability for local public agencies. But its simplistic cost-recovery requirement may inhibit sound local programs. The law specifies that rates cannot exceed the cost of providing a service. Some courts have ruled that conservation-oriented rates (called tiered or

budget-based rates) may violate the state constitution. This was a concern for utilities during the latest drought, as they struggled to adjust rates to promote conservation and stay fiscally sound.

- **Stricter voter requirements impede delivery of some essential water services.**

New local taxes for water programs must get two-thirds voter approval—a much higher hurdle than the simple majority required for local general taxes or state ballot measures. Before Proposition 218, elected governing boards could approve new fees and assessments for flood and stormwater management. Now this requires a majority of landowners or two-thirds of all local voters. A 2017 state law may have improved the situation for stormwater management, by defining it as part of the sewer system. If upheld by the courts, this puts stormwater on par with water, sewer, and trash collection services, which are not subject to direct voter approval of new fees.

Urban water and sewer systems are performing reasonably well

Urban utilities have generally been able to raise funds to replace aging infrastructure and to comply with new treatment requirements. Investments in conservation, water reuse, and local conveyance and storage since the 1990s have helped prepare cities for drought. But raising rates is unpopular, and some agencies—particularly smaller ones—have fallen behind on needed maintenance and investments.

- **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. Not so for low-income households. Proposition 218 restricts publicly owned utilities from providing “lifeline” discounts for more equitable pricing. These restrictions do not apply to privately owned water, energy, and telephone utilities, where lifeline rates are common.

- **Integrated water management is hard to fund locally, despite its benefits.**

Integrated water management involves agencies with different responsibilities collaborating to improve overall system performance. But Proposition 218’s cost-recovery requirements hinder water and wastewater agencies from sharing costs for activities that extend beyond their mandates. And financially weaker partners overseeing other programs have trouble contributing their share. Funding new programs for sustainable groundwater management will also be challenging.

California’s water system has multiple fiscal orphans

California is failing to adequately fund services that protect public health and safety and the environment, such as providing safe drinking water in small, low-income communities; managing floods; controlling stormwater and other polluted runoff; and managing freshwater ecosystems and headwater forests.

- **State bonds help fill gaps, but they have drawbacks.**

Since 2000, state bonds have helped fill funding gaps. But bonds are not a reliable long-term source, and they generally don’t cover operating and maintenance costs. Bonds are repaid with interest from the state General Fund. During economic downturns, repayment can take funds from other important state programs.

- **Paying for water’s fiscal orphans requires other funding sources.**

California needs a broader, more reliable mix of state and local funding sources, including new fees and taxes. Some examples are parcel taxes, small surcharges on water and chemical use, and small increments to the sales tax. Such measures have been proposed at the state level, and some California communities and other states already employ them.

- **Some poor communities can’t afford safe water.**

Providing safe and reliable drinking water is a special challenge in small rural communities, where costs per household are high and local funding resources are scant. Common problems include nitrate from farm runoff and other groundwater contaminants, such as naturally occurring arsenic. These communities are also vulnerable to water shortages during droughts. State bonds and other programs support some infrastructure upgrades and consolidation with larger water systems. But more durable funding is needed—including for operations and maintenance. The cost of solving this problem is modest compared to other gap areas.

- Federal funding for flood projects has been inadequate.**
 Federal policy authorizes matching grants for flood protection projects—up to 65 percent of costs. But this is mostly unfunded, leading to a large investment backlog. Federal contributions are shrinking, and state bond funds have not come close to filling this gap. 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.
- Constitutional changes have hit stormwater agencies hardest.**
 Stormwater management once focused solely on draining streets after storms. Mandates have expanded to prevent pollution of rivers, lakes, and beaches by limiting discharges and cleaning runoff before it enters waterways. Even if courts uphold recent legislation that defines stormwater as part of the sewer system, it may be hard to raise funds for cleanup that mainly benefits downstream communities. Recent state bonds have only contributed modestly to this area.
- Most ecosystem management programs lack a reliable funding base.**
 Although recent state bonds devote some funds to ecosystems, these do not provide consistent ongoing support. Funding for mandatory ecosystem investments within new projects is usually straightforward. But most environmental problems result from past water- and land-use practices, and responsibility for fixing them is often disputed. Some communities have approved special taxes to support their watersheds, but the two-thirds voter requirement limits this approach.
- Protecting headwater forests requires increased investments.**
 Wildfire suppression consumes most spending by state and federal forest agencies—about \$2 billion a year, versus just \$100 million for forest management projects. Focusing on fire suppression prioritizes the treatment of symptoms rather than the causes of unhealthy forests. Headwater forest health will continue to decline without a strategy and funding to increase the pace and scale of management.

CALIFORNIA NEEDS TO GO BEYOND BONDS TO CLOSE FUNDING GAPS

| Gap area | Annual gap (\$ millions) | Onetime infusion from GO bonds passed since 2014 (\$ millions) | Other long-term funding options |
|--|--------------------------|--|--|
| Safe drinking water in small, poor communities | \$30–160 | Up to \$370 | <ul style="list-style-type: none"> Statewide surcharges on water, chemical use |
| Flood protection | \$800–1,000 | \$845 | <ul style="list-style-type: none"> Developer fees Property assessments Special state, local taxes |
| Stormwater management | \$500–800 | \$300 | <ul style="list-style-type: none"> Developer fees Property assessments Special state, local taxes Surcharges on water, chemical, or road use |
| Freshwater ecosystem management | \$400–700 | \$3,987 | <ul style="list-style-type: none"> Special state, local taxes Surcharges on water use, hydropower production |
| Integrated management | \$200–300 | \$860 | <ul style="list-style-type: none"> Special state, local taxes Surcharges on water use |

SOURCES: E. Hanak et al., *Paying for Water in California* (PPIC, 2014), and text for Proposition 1 (approved in November 2014) and Proposition 68 (June 2018).

NOTES: Most safe drinking water funds prioritize disadvantaged communities, but of all sizes. Another \$260 million for small community wastewater systems is available from these bonds. Freshwater ecosystem management funds include programs for aquatic habitat and watersheds, plus \$1.35 billion from Proposition 1 storage projects reserved for ecosystem benefits. Integrated management funds include integrated regional water management and sustainable groundwater management.

Looking ahead

California must fill critical funding gaps for essential functions: ensuring clean drinking water for all residents; protecting residents from flooding; keeping beaches, rivers, and lakes safe for recreation; safeguarding threatened freshwater

ecosystems; and improving headwater forest health. Action is also needed to avoid funding problems for urban water and wastewater systems, which face rising costs and legal uncertainties, and to encourage more integrated water management.

Use new bond funds to fill real gaps. Recent bonds have infused billions of dollars into the water system. The legislature and state agencies should make sure these state funds are going to programs and agencies that lack an adequate funding base—not simply substituting for local funds.

Look beyond bonds. One legislative priority is to help local agencies raise needed funds by expanding local funding authority and providing guidance to the courts on how their interpretations of Proposition 218 may affect water financing. Another priority is to enact new state fees and taxes to boost funding for fiscal orphans.

Adjust local water rates to cope with drought. Rate structure adjustments and drought surcharges are needed to reduce the fiscal effects of conservation and encourage continued urban investment in drought resilience. Utilities must effectively communicate the reasons for rate changes during drought. They must also build strong administrative records of ratemaking decisions to meet potential Proposition 218 court challenges.

Clarify constitutional requirements. To solidify local funding, voters may need to approve constitutional changes that address the unintended consequences of previous amendments—while retaining transparency and accountability requirements. These might include clarifying Proposition 218’s cost-recovery requirements (to allow for conservation and lifeline rates) and stipulating that flood programs should be treated like water and wastewater programs.

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