



PHILIP ANGELIDES
Treasurer
State of California

March 17, 2004

The Honorable Arnold Schwarzenegger
Governor
State of California
State Capitol
Sacramento, CA 95814

Dear Governor Schwarzenegger:

It has come to my attention that the Department of Health Services (DHS), and possibly other departments within the Administration, may be proposing to extend to private water companies a variety of grant and loan programs funded through voter approved general obligation bonds, in particular, Proposition 50 of 2002, the Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002.

I urge you to halt these proposals immediately because of serious concerns regarding potential costs to taxpayers, inadequate assurance of public benefits, and inconsistencies with representations made to voters about potential uses of the bond funds. These concerns are explained in greater detail below.

Costs to Taxpayers

Traditionally the State issues its general obligation bonds on a tax-exempt basis, where the interest received by a bondholder is exempt from taxation by the State and the federal government. This allows the State to borrow at a significantly lower cost than that incurred by private companies.

The IRS has strict constraints on the amount of bond proceeds from any single issue of tax-exempt bonds that can be used to make loans for "private use" purposes, as any such loans to private water companies would be. These limits are the lesser of 5 percent of the amount of each bond issue, or a maximum of \$5 million per bond issue. Currently, the State issues its bonds in par amounts ranging from \$500 million to \$2 billion in order to meet the needs of multiple agencies and bond programs in the most timely and cost-effective manner. Thus, there is a very limited capacity for private use purposes, and it must be shared among multiple state programs participating in the bond sales. Any loans to private water companies that would cause the State to exceed this limit would require the State to issue taxable bonds, at significantly higher costs to the General Fund.



The difference in long-term interest rates between tax-exempt state general obligation bonds and taxable state general obligation bonds could vary significantly under different rating and market conditions. Presently, historically low interest rates in the bond markets result in this difference being between 1.00 and 2.00 percentage points (100 to 200 basis points). In higher interest rate environments, this spread is even greater. If even 10 percent of the \$3.4 billion in Proposition 50 bonds were issued on a taxable basis at the 2.00 percentage point spread it would result in estimated additional interest costs to the General Fund of \$125 million.

There are only two ways to mitigate this increased cost to California taxpayers. The first would be for the private water companies to obtain an allocation of private activity tax-exempt bonding authority from the California Debt Limit Allocation Committee, which I chair. CDLAC currently allocates the State's limited amount of private activity tax-exempt bonding authority granted by the federal government among such important purposes as affordable housing, student loans, and pollution control. These funds are consistently oversubscribed already. In my view, it is not feasible to consider redirecting any of this bonding authority to private water companies.

The only other way of mitigating the negative impact on taxpayers and the General Fund is to recover these higher interest costs through the interest rates charged on the loans to private water companies, thereby ensuring that the borrowers requiring the State to issue any taxable bonds bear the full costs of those bonds.

Public Benefit Considerations

Proposition 50 requires a public purpose to be achieved by the projects funded. This would appear to require that any savings due to state loan or grant funding provided to private water companies be passed on to benefit the companies' customers through lower rates, rather than passed on to company owners in the form of higher profits. In published statements, a spokesperson indicated that the PUC had not determined how it would deal with this potential situation. It is crucial that, before any program is approved to provide grants or loans to private water companies, the State assure itself that customers would receive the savings accruing from state funding.

Voter Intentions

The analysis of Proposition 50, provided to the voters by the Legislative Analyst (LAO Analysis) in the official voter guide, states that bond funds "...would be available for expenditures by various state agencies and for loans and grants to local agencies and nonprofit associations." The LAO's discussion of bond costs reflected expected tax-exempt interest rates (then at approximately 5.25 percent). In addition, when discussing the property tax-related impacts of the bonds, the LAO Analysis focuses on the fact that "...property owned by governmental entities, and by nonprofit organizations under specified conditions, is exempt from property taxation." The LAO concluded that Proposition 50 could reduce property tax revenues as a result.

The printed argument in favor of Proposition 50 indicated that it was supported by local water agencies, and listed several such municipal water districts. No private water company was referenced or included. Likewise, nothing in the text of the proposed law gave voters any indication that private water companies might be considered eligible for funding. Notably, there is a definition of "nonprofit organization" in the law, but no such definition for private water company.

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It is unclear to me how voters could be expected to conclude from the information provided to them that any entity other than a state agency, local water agency, or nonprofit organization would be able to receive the benefit of bond funding. Therefore, it is critical that the proposal to extend these benefits to private water companies be examined carefully for appropriateness and legality.

I urge you to halt any proposal to extend these bond-funded programs to private water companies. The State should take no further steps down this path until fully addressing these concerns: costs to taxpayers, public benefits, and consistency with voter intentions. My office is available to assist the Administration in its efforts to explore these matters fully.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Phil Angelides', with a long horizontal flourish extending to the right.

Phil Angelides
State Treasurer

cc: Hon. Bill Lockyer, Attorney General
Hon. Mike Machado, Chair, Senate Agriculture and Water Resources Committee
Hon. Joe Canciamilla, Chair, Assembly Water, Parks and Wildlife Committee
Donna Arduin, Director, Department of Finance
Kim Belshé, Secretary, Health and Human Services Agency
Mike Chrisman, Secretary, Resources Agency
Tom McCaffery and Rich Bayquen, Chief Deputy Directors, Department of Health Services
Lester A. Snow, Director, Department of Water Resources