TO: LOCAL AGENCY FORMATION COMMISSION
FOR LOS ANGELES COUNTY

FROM: LLOYD W. PELLMAN
County Counsel

RE: Commission Authority to Set Terms and Conditions Regarding Public Utilities

The Sub-Committee on Findings, Terms and Conditions (the "Sub-Committee") has requested our opinion as to the extent of the Commission's authority under the Cortese-Knox Local Government Reorganization Act of 1985 (the "Cortese-Knox Act")1 to set terms and conditions related to the continued provision of public utility services by the City of Los Angeles to any new city formed pursuant to the special reorganization proceedings.

As explained below, the Commission has discretionary authority to set terms and conditions that require the City of Los Angeles to continue to provide water, electrical power, waste water, and storm water services to any new cities formed pursuant to the proposed special reorganizations, and to further require the City of Los Angeles to charge utility customers in any of the new cities the same rates as customers within the remaining City of Los Angeles and to treat customers in any of the new cities on an equal footing with customers within the remaining City of Los Angeles.

1 As you know, the Cortese-Knox-Hertzberg Local Government Reorganization Act of 2000, which became effective January 1, 2001, is not applicable to the San Fernando Valley area and Harbor area proposals for special reorganization because those proposals were pending prior to the effective date. All references herein are to the former Government Code sections of the Cortese-Knox Act.

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Background

The City of Los Angeles currently provides residents and businesses within the City of Los Angeles with the following public utility services: (1) water and electrical power through the Department of Water and Power; and (2) wastewater and storm water service through the Bureau of Sanitation. The comprehensive fiscal analysis for each special reorganization proposal assumes that the City of Los Angeles will retain ownership of these systems and continue to provide these services to any new cities formed pursuant to the special reorganization proceedings.

The applicants have requested that the Commission consider creating a joint powers authority or utility district to own and control the utilities or that the new cities be given an undivided, proportional interest in these assets. While the Commission may consider the applicants' proposals, the Commission is not limited by those proposals and may consider other options.

We have previously advised the Commission that it does not have the authority to create a joint powers authority because a joint powers authority must be formed by at least two existing public entities, and the proposed cities have not yet been formed. (Cal. Gov. Code § 6502) Even if the applicants and the City of Los Angeles were to reach an agreement on the formation of a joint powers authority, only the city council of the proposed new city could enter into such an agreement.

We have also previously advised the Commission that it cannot initiate the formation of a utility district, and it does not currently have before it an application for the formation of a utility district. Depending on the type of district proposed, formation must be initiated by the public entities involved or it must be initiated by petition. For instance, pursuant to the Municipal Utility District Act, formation proceedings must be initiated by resolution of the public agencies involved or by petition signed by ten percent of the registered voters. (Cal. Pub. Util. Code §§ 11581, 11641) The applicants cannot comply with the first means of initiation because the proposed new cities have not been formed and the City of Los Angeles has not agreed to the formation of such a district. Neither have the applicants complied with the second means of initiation, because they have not submitted a petition signed by ten percent of the registered voters. Other types of districts would likely have similar initiation requirements.
With regard to the transfer of an undivided proportional interest in
the public utility assets, we have previously advised the Commission that while it
has the authority to transfer assets, the City of Los Angeles must receive
compensation for the transfer of those assets it holds in a proprietary capacity.
(See Cal. Gov. Code § 56844(a).)

This opinion addresses the issues of service provision and rates,
based on the assumption that ownership of the public utility assets will be retained
by the City of Los Angeles.

The Continued Provision of Utility Services

A municipal corporation, such as the City of Los Angeles, is
authorized by the California Constitution to "establish, purchase, and operate
public works to furnish its inhabitants with light, water, power, heat,
transportation, or means of communication." (Cal. Const., Art. XI, § 9(a)) A
municipal corporation may also "furnish those services outside of its boundaries,
except within another municipal corporation which furnishes the same service and
does not consent." (Id.) Cities may also regulate persons or corporations that
may "establish and operate works for supplying those services." (Cal. Const., Art.
XI, § 9(b))

Consistent with the above constitutional provisions, Public
Utilities Code section 10002 provides that: "[a]ny municipal corporation may
acquire, construct, own, operate, or lease any public utility." Public Utility Code
section 10101 establishes a municipal corporation's right to use public rights of
way for its public utilities:

There is granted to every municipal corporation of the State
the right to construct, operate and maintain water and gas
pipes, mains and conduits, electric light and power lines,
telephone and telegraph lines, sewers and sewer mains, all
with the necessary appurtenances, across, along, in, under,
or over any railway, canal, ditch, or flume which the route
of such works intersects, crosses, or runs along, in such
manner as to afford security for life and property.
When the right of way is located within another incorporated city, the municipal corporation and the city must first agree to "the location of the use and the terms and conditions to which the use shall be subject." (Cal. Pub. Util. Code § 10103)

The rights bestowed upon the municipal corporation are considered franchises:

[Public utility districts are municipal corporations within the intendment of [Public Utilities Code] section 10101 and . . . the rights obtained by a public utility under statutes similar to section 10101 have always been considered franchises by the courts of this state. The statutory grant does not give the public utility a proprietary right in the land but merely a limited right to use the streets to the extent necessary to furnish its services to the public. [Citations omitted.] A franchise is a special privilege conferred by the government on an individual or a corporation. [Citations omitted.] Where a franchise is not based on a contract, it is terminable at the will of the governmental entity.

(Kachadoorian v. Calwa County Water District, 96 Cal.App.3d 741, 746, 158 Cal.Rptr. 223 (1979)) A charter city, such as the City of Los Angeles, is a municipal corporation for the purposes of Public Utilities Code section 10101, et seq. (California Apartment Association v. City of Stockton, 80 Cal.App.4th 699, 704, 95 Cal.Rptr.2d 605 (2000))

It is well settled in California that a water company engaged in the distribution of water to the inhabitants of a community is under "a duty and obligation to supply the water in proper proportion to the persons composing the class for which the use was created." (Fellows v. City of Los Angeles, 151 Cal. 52, 59, 90 P. 137 (1907)) This duty and obligation arises from the utility's enjoyment of its franchise to use the public streets for its pipelines, and has been held to apply to a municipal corporation which acquires a water system within another community. (City of South Pasadena v. Pasadena Land and Water Co., 152 Cal. 579, 93 P. 490 (1908))
In *South Pasadena*, the question before the court was whether or not the City of Pasadena could acquire the private water company that had served portions of both Pasadena and the City of South Pasadena, and the legal relationship of the parties after such a sale. The court held that:

[T]he transferee would take the franchise and property pertaining to it subject to all the burdens of this nature, and, so long as it held it, would be obliged to continue the performance of the public service to which the property and franchise had been dedicated, or to allow others to do so in its behalf.

(*Id.,* at 587.) The California Constitution sets forth protection against abandonment of the public service obligations inherent in a franchise:

The Legislature shall not pass any laws permitting the leasing or alienation of any franchise, so as to relieve the franchise or property held thereunder from the liabilities of the lessor or grantor, lessee, or grantee, contracted or incurred in the operation, use, or enjoyment of such franchise or any of its privileges.

(*Cal. Const., Art. XX, § 4*)

This obligation to continue to provide the public services previously provided has also been described as a "trust" or a "servitude." In *South Pasadena*, the court held that after the acquisition of the water system, Pasadena would, with respect to the water previously used by South Pasadena, hold title to the water in trust for the beneficial use of the residents of South Pasadena:

Water which is . . . dedicated to the use of an outside community cannot be at the same time surplus water subject to sale to others. The sale is already, in effect, accomplished. The city of Pasadena, with respect to this part of the water, will hold title as a mere trustee, bound to apply it to the use of those beneficially interested.
In *East Bay Municipal Utility District v. Railroad Commission*, 194 Cal. 603, 229 P. 949 (1924), the court, in finding that the district had the authority to acquire a water system outside of the district, held that:

The petitioner has the power to acquire the works and system outside the district. If it should do so it would acquire such property subject to the burden of servitude of continuing the service and on no just principle could it continue to hold the property outside the district discharged thereof.

(Id., at 621; see also, *Durant v. City of Beverly Hills*, 39 Cal.App.2d 133, 102 P.2d 759 (1940) (when the city purchased a private water plant it assumed a trust to perform the contract and to meet the obligations of the private concern); and *County of Inyo v. Public Utilities Commission*, 26 Cal.3d 154, 161 Cal.Rptr. 172 (1980) (the City of Los Angeles, by purchasing certain water systems in Inyo County incurred an obligation to deal fairly with its customers in those communities and to provide them with reasonable service at reasonable rates).)

It is also well settled that a community or its inhabitants may sue to enforce their rights to continued utility service. (See *Fellows*, 151 Cal. at 59 and *South Pasadena*, 152 Cal. at 588.)

Although the above-cited cases all address franchise obligations related to water systems, there is no apparent distinction between the obligations that arise from a franchise to provide water and franchises to provide electricity, gas, wastewater treatment or storm water service: "in taking over facilities serving another area, the district must, on principles of fairness and justice, continue the service which was furnished outside the district, where this can be done efficiently and economically." (*Sacramento Municipal Utility District v. Pacific Gas & Electric Co.*, 72 Cal.App.2d 638, 653, 165 P.2d 741 (1946) (regarding purchase of electrical utility system).)

Upon special reorganization, the new cities that may be created would own and control the local rights of way located within their territories. (Cal. Gov. Code § 57385) As set forth above, with control of the rights of way comes the power to bestow certain franchises for the use of those rights of way.
There are, of course, no cases directly dealing with a special reorganization and the continuation of utility services. All of the above cases deal with the acquisition by a municipally-owned utility of another community's utility system. However, the City of Los Angeles has provided utility services to the communities proposing special reorganization since their annexation to the City of Los Angeles at the start of the century. Assuming that the City of Los Angeles retains ownership of these public utilities, the City will own the utility systems of communities outside of its boundaries. Based thereon, the continued use of the rights of way in these new cities by the City of Los Angeles would likely constitute a franchise, and the City of Los Angeles would hold title to these public utility systems as a trustee for the beneficial interest of the communities that these systems were created to serve. Therefore, the City of Los Angeles would likely be under an obligation to continue to provide utility services to any new cities formed pursuant to the proposed special reorganizations, and any new cities or their inhabitants may be able to enforce that obligation in court.

**Utility Rates**

Article XII of the California Constitution vests the Legislature with plenary power over all public utilities and bestows upon the Public Utilities Commission ("PUC") rate-fixing authority over privately-owned public utilities and common carriers. The courts have interpreted Article XII as excluding municipally-owned utilities from PUC regulation. (*County of Inyo*, 26 Cal.3d at 166-167.) Although the Legislature has not done so, it does have the authority to make municipally-owned utilities subject to regulation by the PUC. (*Id.;* Cal. Const., Art. XII, § 5)

The Legislature has exercised its power over municipally-owned utilities by direct statutory regulation. (Cal. Pub. Util. Code § 10001, *et seq.;* see also, *California Apartment Association*, 80 Cal.App.4th at 708 ("The express and plenary power of the Legislature to grant regulatory authority to the PUC implies that the Legislature possesses that power and also may regulate directly by statute.").) The Legislature, however, has not regulated rates for municipally-owned utility service.

When a municipally-owned utility provides service outside of its boundaries, the rates must be reasonable, and may be judicially enjoined if they are unreasonable or discriminatory. (See *Durant*, 39 Cal.App.2d at 139; and *County of Inyo*, 26 Cal.3d at 159.) The California Supreme Court, however, has held that a municipally-owned utility could classify its customers as resident and
non-resident customers and charge higher rates for non-resident customers if there was a rational basis for the difference. (*Hansen v. City of Buenaventura*, 42 Cal.3d 1172, 233 Cal.Rptr. 22 (1986)) It has also been held that the utility rates of a municipally-owned utility need not be based purely on costs; that rather, the municipally-owned utility is entitled to a reasonable rate of return. (*Id.*, at 1176, 1183; see also *Howard Jarvis Taxpayers Assoc. v. City of Los Angeles*, 85 Cal.App.4th 79, 82, 101 Cal.Rptr.2d 905 (2000).) Since utility rates are basically commodity charges, they do not fall within the scope of Proposition 218, and therefore, are not subject to voter approval. (*Id.*, at 83.)

In addition to judicial recourse regarding unreasonable rates, any new cities formed pursuant to special reorganization may have regulatory authority over the utility rates charged within their boundaries. As stated above, the PUC does not regulate the rates of municipally-owned utilities, nor does the Legislature. The California Constitution provides that a city "may make and enforce within its limits all local, police, sanitary, and other ordinances and regulations not in conflict with general laws." (Cal. Const., Art. XI, § 7) With regard to local utilities, the Constitution also provides that:"[p]ersons or corporations may establish and operate works for supplying those services upon conditions and under regulations that the city may prescribe under its organic law." (Cal. Const., Art. XI, § 9) In the absence of any conflict with State law and the powers conferred upon the PUC, it would appear that a city could regulate the rates of a municipally-owned utility operating within its jurisdiction."

In *South Pasadena*, the court discussed this issue at length:

In the carrying on of the water service to the people of South Pasadena the city of Pasadena will not be acting in its political, public, or governmental capacity as an agent of the sovereign power equal in all respects to the city within which it operates. . . . South Pasadena, within its own limits, will be the sole representative of sovereignty in the fixing of rates, and in the supervision of the streets; and Pasadena will be subject thereto, as a private person.

(*South Pasadena*, 152 Cal. at 592-593.) It should also be noted that the court concluded that the City of Pasadena would have recourse to the courts if South Pasadena set unreasonably low rates for services provided within its boundaries. (*Id.*)
South Pasadena was decided a few years prior to the adoption of the amendments to the Constitution which authorized cities to provide services to outside residents and bestowed the PUC's predecessor, the Railroad Commission, with authority to regulate privately owned public utilities. In dicta, however, the California Supreme Court has, as recently as 1980, indicated that the rationale in South Pasadena is still applicable: "[o]ur review of the amendment indicates that, rather than being ambiguous on the subject, it does not deal with the issue at all, and thus leaves in effect the prior law, as stated in South Pasadena, that the city where the customers reside has priority in establishing rates for service." (County of Inyo, 26 Cal.3d at 161 (commenting on dicta in City of Pasadena v. Railroad Commission, 183 Cal. 526, 192 P. 25 (1920) which the Supreme Court disapproved to the extent contrary with its opinion).) Since County of Inyo dealt with unincorporated communities, the court determined that the decision in South Pasadena could not be applied to the case before it. (Id.) The same holds true for the other rate cases discussed herein, namely Durant and Hansen, since each dealt with service provided to unincorporated areas.

Based on the above, regardless of whether or not the Commission sets terms and conditions regarding utility rates, it appears that any new city formed pursuant to the proposed special reorganizations would have sovereign authority to regulate utility rates, in the absence of direct regulation by the Legislature or the Legislature's extension of the PUC's jurisdiction to include municipally-owned utilities. In the alternative, the new cities and their inhabitants could also seek judicial determination of the reasonableness of any rates set by the City of Los Angeles.

The Commission's Authority Regarding Utility Service and Rates

The Legislature's authority to prescribe procedures for the formation of cities is set forth in Article XI, § 2(a) of the California Constitution. As set forth above, the Legislature also has plenary power over public utilities, including municipally-owned utilities. (Cal. Const., Art. XII; § 5; see also, California Apartment Association, 80 Cal.App.4th at 708.) Provisions within the Cortese-Knox Act address public utility issues, and with respect to those utilities regulated by the PUC, requires Commission interaction with the PUC prior to Commission decision-making that may affect privately owned public utilities. (Cal. Gov. Code §§ 56129 - 56131, 56832)
No provision of the Cortese-Knox Act expressly addresses issues related to municipally-owned utilities, however, the Commission is given broad authority to set terms and conditions regarding the provision of services by cities, counties and districts. Government Code section 56844 provides that a change of organization or reorganization may be made subject to, among other terms and conditions:

(j) The fixing and establishment of priorities of use, or right of use, of water, or capacity rights in any public improvements or facilities or of any other property, real or personal.

(r) The continuation or provision of any service provided at that time, or previously authorized to be provided by an official act of the local agency.

(t) The extension or continuation of any previously authorized charge, fee, assessment, or tax by the local agency or a successor local agency in the affected territory.

(v) Any other matters necessary or incidental to any of the terms and conditions specified in this section.

These provisions have not been interpreted by the courts; however, it would appear that they authorize the Commission to set terms and conditions regarding priorities of use, continuation of services and the continuation of any charge or fee for such use or service. Based thereon, the Commission could set terms and conditions that require the City of Los Angeles to continue to provide utility services to any new cities formed pursuant to the proposed special reorganizations, and to further require the City of Los Angeles to treat customers in any new cities on equal footing with customers within the remaining City of Los Angeles and charge the same rates as customers within the remaining City of Los Angeles. The Commission could not, however, require the City of Los Angeles to treat those customers in the new cities with greater priority than those customers within the remaining City of Los Angeles or require that they be charged lower rates or rates different from those currently authorized by the City of Los Angeles.
Conclusion

The Commission has discretionary authority to set terms and conditions that require the City of Los Angeles to continue to provide water, electrical power, waste water, and storm water services to any new cities formed pursuant to the proposed special reorganizations, and to further require the City of Los Angeles to charge utility customers in any of the new cities the same rates as customers within the remaining City of Los Angeles and to treat customers in any of the new cities on an equal footing with customers within the remaining City of Los Angeles.

In addition, the City of Los Angeles may be under an independent obligation to continue to provide utility services to any new cities formed pursuant to the proposed special reorganizations. The City of Los Angeles, to the extent it provides utility services within any new cities, may also be subject to rate regulation by the new cities. Any obligation to provide utility services may be enforceable in court, and the courts may also determine the reasonableness of utility rates.