ENVIRONMENTAL
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BEFORE THE CALIFORNIA SENATE

COMMITTEE ON AGRICULTURE AND WATER RESOURCES

TESTIMONY OF ENVIRONMENTAL DEFENSE FUND

ON OPTIONS FOR FINANCING CALIFORNIA'S WATER PROJECTS

Presented by

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Fresno, California
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Senator McCorquodale and members of the Committee, my name is John Krautkraemer, and I am a Senior Attorney with the Environmental Defense Fund in its Oakland office. I thank you for the opportunity to testify at this hearing. As I stated in my testimony during the first hearing on this subject in January, the issues surrounding State Water Project financing are closely tied to issues of overall water management in the state, including protection of the environmental and economic resources of the San Francisco Bay/Delta estuary. We welcome your attention to this issue and hope to continue to work with you and with the various stakeholders as the dialogue moves forward.

I would also like to acknowledge the significant contribution of the California Research Bureau (CRB), and particularly Mr. O'Connor, for once again preparing an excellent background paper that helps to further refine and focus the issues which are the subject of this hearing.

At the outset, I think it is important to reiterate briefly the reasons for the current financial concerns facing the State Water Project and some of its agricultural contractors. This is important because in developing solutions to these problems it is necessary first to understand their genesis. It is also important because there is a certain amount of rhetoric one hears which seeks, incorrectly, to characterize these problems as recent, and

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as largely due to measures that have been taken to protect the Bay/Delta environment.

Contrary to this view, the repayment problems faced by some of the SWP's agricultural contractors are neither new, nor are they caused chiefly by improved environmental protections. Far more important are unrealistic past projections (beginning as early as the 1960s when project bonds were presented to the voters for approval) about how much it would cost to build the projects needed to meet full contract entitlements. Added to this is the fact that urban contractors' demands are increasing for water that they have contracted (and paid) for, but in the past have not taken. And it is not new demands for environmental water, but rather past failures adequately to account for and incorporate environmental needs into project planning, that have led to the need for recent measures (and proposed measures) to remedy the considerable environmental damage caused by the SWP.

It is important to remember that some of Kern County Water Agency's member agencies were expressing concern over their water bills beginning in the mid-1980s, when the operative standards for the Delta were those contained in D-1485. And the 100% reduction in State Water Project supplies that occurred in 1991 and is often cited as an example of the current crisis also preceded the additional measures that have since been invoked in the Delta to protect winter-run salmon and delta smelt. This shortage resulted

from a combination of drought conditions and unabated deliveries during the early years of the drought, not from actions taken to protect the environment.

Against this background, it is important to look for solutions that remedy the problem. Clearly, since a large part of the problem is the higher than projected costs of project construction, attempting to remedy the problem by building more projects that (at least some of) the contractors will not be able to pay for is **not** the solution.[1]

The California Research Bureau's background paper lays out a range of options that individually or in combination provide a solid basis for possible solutions to the current problems.[2] While we are not prepared at this early juncture to endorse any specific option, there are some general principles for SWP refinancing that we believe should guide further consideration.

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[1]It is noteworthy that the SWP's Delta water charge dropped significantly (from almost $20/af to less than $15/af) after the defeat of SB200, and the facilities it authorized, in 1982. See D. O'Connor, Background Brief on Financing of the State Water Project (California Research Bureau, January 1994) at p.37 (Fig. 3.B). It is likely that had those facilities been approved, the ability of some contractors to meet project obligations would have been strained even more.

[2]References in this testimony to "options" are those discussed in CRB's background paper, Financing the State Water Project: Options for Change (August 1994).

First, entitlements should be brought more closely in line with the current delivery capability of the project, either by invoking Article 18(b) of the contracts, or by legislation, or by some combination of the two. This entitlement level should then be capped, for example, by declaring the State Water Project complete as proposed in Option 6 (and in SB 1924).

Second, after entitlements are reduced and capped we favor market mechanisms over rationing to allocate these entitlements. This will help ensure that entitlements are distributed in the most economically efficient way. An "auction" approach such as that proposed in Option 3 should be given thorough consideration (and could be used for permanent reallocation, not just to address annual shortages). Another approach, which might help allay fears that urban contractors would out-bid agricultural contractors in an auction, would be to allocate remaining entitlements proportionately to existing entitlements, and then rely on voluntary trades to reallocate those entitlement.

Voluntary marketing of entitlements (both within and outside the SWP) should be facilitated, regardless of how remaining entitlements are initially allocated. Rules governing such trades should be developed to provide certainty and to protect all legitimate interests, including those of third-parties. However, neither DWR nor any its contractors should be allowed to disapprove economically and environmentally sound transfers.

Third, payment for water should be linked more closely to deliveries. Indeed, the large fixed costs that must be borne by contractors regardless of how much water they take is the root cause of current repayment problems. The steps outlined in the first two points (reducing entitlements and reallocating through market mechanisms) should go a long way toward achieving this objective. However, there may be remaining costs that will need to be distributed among contractors. If so, these costs should be tied to actual deliveries. Of course, the corollary to this point is that contractors should get the water they pay for. Specifically, any refinancing plan should ensure that if urban contractors are to bear additional costs, they should also receive a concomitant priority to water supplies when shortages occur.

Fourth, those who benefit from any new project should pay their full proportionate share of the incremental (marginal) costs of that project.[3] This would have at least two benefits: (1) it would allow all water supply augmentation or demand reduction strategies to "compete" on an economically level playing field, and would facilitate least cost planning; and (2) it would reduce the potential for one group of water users to obtain a "free ride" at the expense of others. It would also likely favor local agency planning and funding of projects over state planning and funding,

[3]Declaring the SWP complete would help achieve this objective, since the costs of any new projects would no longer be averaged with previous SWP costs.

since each agency would be in the best position to evaluate what "mix" of options (including at what cost) best fits its supply and reliability needs.

Indeed, proposals for the state to engage in further planning and facility construction (with or without declaring the current SWP complete) raise some thorny issues.[4] Proposals for a Delta facility are a case in point. Presumably, any such facility, if it increases the export potential of the SWP, would potentially benefit any water user south of the Delta. It is also apparent that any facility would be quite expensive. Under these circumstances, it is not at all clear how agricultural contractors, who are already facing repayment difficulties, would be able to pay their share of any such facility, assuming the state adheres to a "user pay" principle. On the other hand, if would be inconsistent with this principle for urban contractors to bear the full (or disproportionate) costs of any such facility. Clearly, any refinancing option that contemplates continued state funding of new projects needs to address this issue.

In addition to determining how to allocate entitlements and payment obligations among contractors, any refinancing plan must also take into account how to meet environmental needs. We emphatically reject the position (discussed in relation to Option 13) that the environment should bear a greater share of project

[4]See, e.g., Option 7 and SB 1924.

costs because of supposed enhancements or benefits provided by the SWP. Indeed, this position is hardly credible considering the serious environmental damage that the project has caused, particularly in the San Francisco Bay/Delta estuary. Any accurate and full accounting would surely conclude that the environment has suffered a net loss since the construction and operation of the SWP.

However, in the interests of developing solutions to SWP financing problems that benefit all interests, there may be an opportunity to shift some costs away from project contractors to some type of "environmental fund", provided that the environment receives guaranteed and dependable water supplies in return. Such a "debt-for-nature" approach would be similar to Option 14, and would shift some of the repayment obligation of the SWP to the larger public in exchange for transferring project entitlements to the environment. These entitlements would be treated on an equal basis with entitlements for agricultural and urban contractors and would help guarantee certainty of environmental supplies.

A key issue would be how to finance a program for acquiring environmental water. Given the state's current fiscal situation it is unrealistic to assume that the general fund, or a bond measure, could be the sole basis for funding environmental acquisitions. Rather, some type of user fee approach, which ties funding for environmental needs more closely to water use, and is

used to create a state environmental restoration fund analogous to the restoration fund created in the Central Valley Project Improvement Act is also needed. Nor is there any reason to limit the contributors to such a fund to SWP contractors; logically all water users who contribute to the environmental problems associated with water development, including those of the Bay/Delta estuary, should bear a share of the costs associated with mitigating those impacts (accounting, of course, for the existing contribution of CVP contractors under the CVPIA).

The chief advantage of a restoration fund approach is that it will facilitate voluntary transfers of water to help meet environmental needs and thereby greatly lower the costs of achieving improved environmental protection. This market-like approach would target lower valued uses of water to meet environmental needs, rather than spreading reductions among higher valued agricultural or urban uses. A second advantage to such a program is that it provides a way to spread responsibility for meeting Bay/Delta and other environmental obligations among a wide range of water users, rather than just the customers of the state and federal projects.[5]

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[5]Some portion of such a water use charge could also be used to fund state water planning under the options discussed in CRB's paper that would segregate DWR's planning and SWP management functions and limit SWP contractor costs to the latter. Segregating the state's planning function from management of the SWP has considerable merit and should be thoroughly explored.

In conclusion, I would again thank the Committee for its invitation to testify today. EDF believes that discussions over how to reform SWP financing present a significant opportunity to move beyond the gridlock that has unfortunately characterized water management in this state in recent times. We reiterate our willingness to work with you and with the various interests to fashion a new approach to State Water Project financing that is mutually beneficial to all affected interests.

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