

Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Richard Doyle
City Attorney

SUBJECT: California Constitution Debt
Limit

DATE: August 21, 2009

SUPPLEMENTAL MEMO

BACKGROUND

In the course of the Request for Proposal process for a 20 to 25 year solar power purchase agreement for the Mabury and Central Service Yards, questions and concerns were raised about the "subject to appropriation" provision that was included in the exemplar agreement. This provision allows the City to cease making payments without penalty in any years in which the City Council does not appropriate sufficient funds to pay the expense of the agreement. The primary reason for including this provision was to address the California Constitution's requirement that, subject to certain exceptions, the City may not incur debt without first obtaining voter approval by a two-thirds majority. A secondary reason for including the provision was to provide the City with flexibility to cease purchasing power if there was no need for power at one or both of the yards.

The purpose of this memorandum is to explain the California Constitution's prohibition related to incurring debt and to provide ways to address it in the context of the solar power purchase agreement.

ANALYSIS

A. California Constitution --- Debt Limit.

The California Constitution includes two general constraints against borrowing to finance governmental activities without first obtaining voter approval. Article XVI, Section 18 applies to local governments (excluding redevelopment agencies) and Article XVI, Section 1¹ applies to the State. These Constitutional provisions are referred to as the Debt Limit.

¹ Article XVI, Section 1 provides in relevant part: "The Legislature shall not, in any manner create any debt or debts, liability or liabilities, which shall, singly or in the aggregate with any previous debts or liabilities, exceed the sum of three hundred thousand dollars (\$300,000), except in case of war to repel invasion or suppress insurrection...."

Article XVI, Section 18 provides in relevant part:

“a) No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose, except that with respect to any such public entity which is authorized to incur indebtedness for public school purposes....”

Both provisions have been in the California Constitution since the adoption of the 1879 Constitution. Their underlying purpose is to force government to operate within its means. In 1882, the California Supreme Court explained the purpose of the Constitutional Debt Limit as follows:

“...[E]ach year's income and revenue must pay each year's indebtedness and liability, **and that no indebtedness or liability incurred in any one year shall be paid out of the income or revenue of any future year.** The system previously prevailing in some of the municipalities of the State by which liabilities and indebtedness were incurred by them far in excess of their income and revenue for the year in which the same were contracted, thus creating a floating indebtedness which had to be paid out of the income and revenue of future years, and which, in turn, necessitated the carrying forward of other indebtedness, was a fruitful source of municipal extravagance. The evil consequences of that system had been felt by the people at home and witnessed elsewhere. It was to put a stop to all of that, that the constitutional provision in question was adopted.”²

In other words, unless an exception as described below applies, the City cannot be obligated under a contract to make a payment from its future revenues.

B. Exceptions.

Courts have recognized a number of exceptions to the Debt Limit. One court has noted that each exception “is fundamentally recognition that the transaction or legislation in question does not create a ‘debt’ owed by the governmental entity within the meaning of the debt limit provisions, but is instead a payment arrangement that falls outside of these provisions.”³

² The San Francisco Gas Co. v. Brickwedel, 62 Cal. 641, 642 (1882).

³ Taxpayers for Improving Public Safety v. Schwarzenegger, 172 Cal.App.4th 749, 762 (2009).

The exceptions are: (1) obligations imposed by law; (2) special funds exception; and (3) contingent obligations or pay as you go obligations.

1. Obligations Imposed by Law.

The Debt Limit does not apply where the underlying obligation is imposed by law. This exception has been applied to the payment of a county treasurer's salary that was set by State statute and to the construction of a court house because the county had a duty under state law to provide adequate quarters for the court. The reasoning for these decisions is that these liabilities are not those incurred by the local government by its actions or conduct.⁴

2. Special Fund.

If the obligation is to be paid solely from special funds, such as enterprise revenues, *with no recourse to the general fund*, then the Debt Limit does not apply. An example of this exception is the City's Airport Revenue bonds. The City's debt to bond owners is limited only to Airport revenues.

If the governmental entity is required to maintain the amount in the special fund through its taxing powers or its general fund, the special fund exception will not work.⁵ Similarly, if the special fund is a separate fund but the source of the funds is general fund money, then the special fund exception does not apply.

3. Contingent or Pay as You Go Obligations.

This exception is based on the premise that an amount payable upon a contingency is not a debt and does not become a debt until the contingency happens.⁶ It has been used to uphold multiyear contracts where the governmental entity agrees to pay amounts in succeeding years for leases of property, and purchases of goods or services to be exchanged in those succeeding years.⁷ For multiyear contracts, the Constitutional Debt Limit won't be triggered so long as the governmental entity is only obligated to make payment yearly for the goods, services or use of leased property received in that year.

⁴ Lewis v. Widber, 99 Cal. 412, 415 (1893) [treasurer's salary]; County of Los Angeles v. Byram, 36 Cal. 2d 694 (1951) [county courthouse].

⁵ Board of State Harbor Commissioners for San Francisco Harbor v. Dean, 118 Cal. App.2d 628 (1953) [revenue bonds to be repaid from revenue from harbor operations of harbor]; City of Oxnard v. Dale, 45 Cal.2d 729 (1955).

⁶ Doland v. Clark, 143 Cal.176 (1904).

⁷ See City of Los Angeles v. Offner, 19 Cal. 2d 483 (1942) [construction of an incinerator, paid by lease payments with option to purchase by city at end of term]; Dean v. Kuchel, 35 Cal.2d 444 (1950) [construction of state building(s), paid by lease payments with title passing to State at end of term]; McBean v. Fresno, 112 Cal.159 (1896) [multi-year contract for sewer hauling services].

C. Application to Solar Power Purchase Agreement (“Solar PPA”).

1. Subject to Appropriation Provision (nonappropriation provision).

Traditionally, the City’s multiyear service agreements include a provision to allow the City to terminate the agreement without penalty in the event that the City Council does not appropriate funds for the payment of the expense of the agreement following the first year of the agreement. No debt is created when the contract is signed since each year’s payment is subject to the appropriation of funds in subsequent fiscal years. This provision satisfies the Debt Limit and gives the City the most flexibility in budgeting for future expenses.

2. Appropriation Provision Providing for Precedence for Solar Power.

In response to an inquiry submitted by one prospective proposer, the “subject to appropriation” language in the exemplar agreement included in the RFP was modified so that the City would be obligated to pay the expense of the Solar PPA if any funds had been appropriated to pay for the electrical costs of the Central Service Yard/Mabury Yard. This was to address the concern of the solar companies that the City would use the subject to appropriation language to terminate its payment obligation and to switch to a cheaper electrical power source in order to save money. To further deal with the proposer’s concern that the City would stop paying and seek a more favorable PPA contract, the subject to appropriations language was modified so that if the agreement was terminated for failure to appropriate, then the City would promise not to enter into another Solar PPA for these sites for a 3 year period.

The above approach was not accepted by the proposers. However, it is similar to the one taken by the California State University System (“CalState”) for Solar PPAs entered into for the Sacramento and San Bernardino campuses. In both agreements, one of Calstate’s grounds for termination without penalty is a “...‘budget non-appropriation event,’ in which the Budget Act of any year covered in this Agreement does not appropriate funds for the procurement of any utility services” for the applicable campus. CalState also agreed to use best efforts to seek appropriation for utility services.

3. Pay as You Go.

Another approach that could be taken would be to include language in the contract that obligates the City to appropriate funds for the expense of the contract so long as the City receives beneficial use of the electrical power produced by the system. In the event that the system or the facility at which it was located was to be damaged or destroyed, the City would be relieved of its obligation to pay for power while the system is nonoperational. To the extent that

under these circumstances, the system were able to provide partial power to the facility, the agreement could have provisions obligating the City to make partial payment. This concept is consistent with the "pay as you go" exception that has been approved by the California courts, in that the City would only be obligated to pay the solar company in the course of a fiscal year to the extent that the electrical power to be provided under the contract could be used on site.

To the extent that the facility and the solar power system were operational and the City had the beneficial use of the power produced, the City would not be able to terminate the agreement without any obligation. Accordingly, the City's flexibility would be constrained in the event that the City wanted to take the facility out of service as the City would still have the obligation to pay for the power produced at the facility.

4. Termination for Convenience.

One solar provider has recommended that the nonappropriation provision be eliminated and, if the City failed to appropriate sufficient funds that the City's rights and obligations under the agreement should be addressed in the termination for convenience provision. A termination for convenience provision would permit the City to terminate the agreement for no cause. However, the City would be obligated to pay the solar provider per a formula or schedule specified in the contract. The purpose of these provisions is to make the provider whole for the lost revenues and tax credits that the provider would have received over the agreement's term.

If the Solar PPA was not drafted in compliance with the pay as you go exception so that it is clear the City is only obligated to pay the solar provider for the power received in each year of the agreement, a court would most likely view the termination for convenience provision under these circumstances as the City's agreement at the start of the agreement to incur debt. Under these circumstances, the amount that would be payable to the solar provider under the Termination for Convenience provision would need to be appropriated as of the City's execution of the Solar PPA.

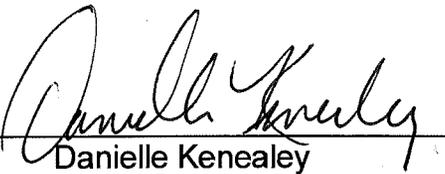
5. Non-Applicable Exceptions.

The obligation imposed by law and the special fund exceptions are not applicable to the Solar PPA for the Central Service and the Mabury Yards as there is no legal obligation to provide electricity at the City's facilities via solar power and the source of payment would be from the City's general revenues. San Francisco, through its Public Utility Commission, recently entered into a power purchase agreement in which no provision for the failure to appropriate funds was included since the source of the payments to the power provider was limited to the PUC's power revenues.

CONCLUSION

The California Constitution prohibits the City from entering into an agreement under which the City incurs an obligation that is payable from future revenues, unless the agreement is subject to termination if the City Council does not appropriate funds for the future years of the agreement's term or one of the exceptions to the Constitution's Debt Limit applies. In the case of a Solar PPA for the Central Service and Mabury Yards, the agreement could be structured so that the City is relieved from the obligation to pay in the event the City failed to appropriate funds for electrical power. Alternatively, the agreement could be structured so that the City's obligation to pay is contingent on the City's continued ability to be able to use the electrical power produced by the system on site.

RICHARD DOYLE
City Attorney

By 
Danielle Kenealey
Chief Deputy City Attorney

cc: Debra Figone