CASE NO. S150518

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

CALIFORNIA FARM BUREAU FEDERATION, et al.,

Plaintiffs and Appellants,

v.

CALIFORNIA STATE WATER RESOURCES CONTROL BOARD, et al.,

Defendants and Respondents.

NCWA PETITIONERS' OPENING BRIEF

After Decision by the
Court of Appeal, Third Appellate Dist., No. C050289

From Judgment
of the Sacramento County Superior Court, Case No. 03CS01776
The Honorable Raymond M. Cadei, Judge

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Statutes and Regulations

NCWA PETITIONERS' OPENING BRIEF

I.

INTRODUCTION

Petitioners and Plaintiffs Northern California Water Association, Central Valley Project Water Association, and over 200 other water right holders in California (collectively, "NCWA Petitioners") respectfully request that this Court reverse, in part, and affirm in part[1], the decision of the Third District Court of Appeal in this matter.

A. Issues Presented

The issues presented by NCWA Petitioners are:

1. Whether Water Code section 1525 et seq., requiring adoption of regulations establishing a regulatory fee structure to fund the State Water Resources Control Board's ("SWRCB") Division of Water Rights, is unconstitutional for the following reasons:

[1] NCWA Petitioners agree with the Third District Court of Appeal's determination that the regulations set forth in title 23, sections 1066 and 1073 of the California Code of Regulations result in an unconstitutional tax. NCWA Petitioners requested review of the Third District Court of Appeal's decision that the underlying statutory structure, Water Code section 1525 et seq., is valid.

a. As the State of California ("State") has all but conceded,[2] the statutory scheme does not permit the adoption of regulations that meet constitutional requirements;

b. Water rights are real property rights and, therefore, the statutory scheme results in imposition of an unconstitutional non-ad valorem tax on real property;

c. The statutory scheme permits imposition of an unlawful tax on the United States; and

d. The statutory scheme creates new federal law by permitting the pass-through of a regulatory fee imposed on the United State to contractors with the United States.

2. Whether the State has provided sufficient evidence to demonstrate that a minimum $100 fee bears a fair or reasonable relationship to the fee payers' burdens on or benefits from the regulatory program.

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[2] As the State argued in its Petition for Rehearing, Water Code section 1525 mandates the SWRCB to collect sufficient funds to recover the "entire cost" of the Water Right Program. (Petition for Rehearing, pp. 9-10.) Thus, and to the extent the SWRCB is prohibited from collecting "regulatory fees" from permittees and licensees for burdens created by or benefits bestowed upon others, it cannot craft lawful regulations. (*Id.* at pp. 16-18.)

B. This Court's Prior Consideration of These Issues

The issues presented here all revolve around the fundamental question of whether the fees authorized by Water Code section 1525 et seq. are, in fact, "taxes" adopted in violation of Proposition 13 of the California Constitution. This Court has considered the application of Proposition 13 to regulatory fees twice before, first in *Sinclair Paint Co. v. State Board of Equalization* (1997) 15 Cal.4th 866 ("*Sinclair*") and then in *Pennell v. City of San Jose* (1986) 42 Cal.3d 365 ("*Pennell*"). In *Sinclair*, this Court stated the test for determining whether a regulatory fee is proper: "[T]o show a fee is a regulatory fee and not a special tax, the government should prove (1) the estimated cost of the service or regulatory activity, and (2) the basis for determining the manner in which the costs are apportioned, so that charges allocated to a payer bear a fair or reasonable relationship to the payer's burdens on or benefits from the regulatory activity." (*Sinclair* at p. 878, citing *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control Dist.* (1988) 203 Cal.App.3d 1132, 1146.)

Here, the statutory fee system created by Water Code section 1525 et seq., fails this test because the State cannot, under any circumstances, prove the estimated cost of the service or regulatory activity and, therefore, cannot demonstrate that the fees authorized by Water Code section 1525 et seq. "do not exceed the reasonably

necessary expense of the regulatory effort." (*Sinclair*, *supra*, 15 Cal.4th at p. 879, citing *United Business Com. v. City of San Diego* (1979) 91 Cal.App.3d 156, 165.) This failure results because (1) the fees are charged for general government functions and not merely for regulatory activities; and (2) even if the fees are intended to pay the costs of regulatory activities, there is no connection between the fees charged and the estimated cost of the regulatory activities. Moreover, under the statutory framework, the State cannot, under any circumstances, develop a regulatory fee scheme that apportions the costs "so that charges allocated to a payer bear a fair or reasonable relationship to the payer's burdens on or benefits from the regulatory activity." (*Sinclair, supra,* 15 Cal.4th at p. 878.) Indeed, the State has admitted that, under the current statutory framework, it cannot develop a set of regulations that will pass the test for a valid regulatory fee.[3]

In addition to failing to meet the *Sinclair* test, the charges authorized by Water Code section 1525 are unconstitutional taxes because (1) they are imposed on the water right per se, taxing all aspects

[3] As the State argued in its Petition for Rehearing, Water Code section 1525 mandates the SWRCB to collect sufficient funds to recover the "entire cost" of the Water Right Program. (Petition for Rehearing, pp. 9-10.) Thus, and to the extent the SWRCB is prohibited from collecting "regulatory fees" from permittees and licensees for burdens created by or benefits bestowed upon others, it cannot craft lawful regulations. (*Id.* at pp. 16-18.)

of the right, without regard to the use to which the right is put, in violation of Proposition 13; and (2) they are imposed on the federal government and on contractors with the federal government, in violation of the Supremacy Clause. While *Pennell* discusses the imposition of regulatory fees on real property, neither *Pennell* nor *Sinclair* involved imposition of a charge as an incident of property ownership[4], as is the case here. Further, neither *Pennell* nor *Sinclair* addressed the imposition of regulatory fees or taxes on the federal government or on contractors with the federal government.

As described more fully herein, the charges authorized by Water Code section 1525 et seq. are unique and distinguishable from any regulatory fees previously upheld by this Court and the Courts of Appeal. The charges authorized by Water Code section 1525 et seq. do not meet constitutional requirements and, therefore, NCWA Petitioners respectfully request that this Court reverse the Third District Court of Appeal's decision and find Water Code section 1525 et seq., unconstitutional and invalid.

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[4] This Court also considered charges imposed on landlords in *Apartment Assn. of Los Angeles County, Inc. v. City of Los Angeles* (2001) 24 Cal.4th 830, in the context of Proposition 218. There, however, this Court held that the charge was imposed on the "business" activity of being a landlord, and not as an incident of property ownership. The same cannot be said here.

Regarding the imposition of the challenged charges on the water rights held by the federal government, and collected from those who contract with the federal government, this Court has not passed upon this issue. Indeed, no case has determined that a state can impose "fees" on federal contractors for costs associated with "regulating" the federal government. The only context in which this issue has been considered is where the various states *tax* federal contractors for their possessory interest in federal property. In this regard, the challenged charges are unprecedented.

II.

BACKGROUND

A. Water Code Section 1525 et seq.

In 2003, in an attempt to curb California's budget crisis, the Legislature passed a law to shift many state general funded programs to fee-based programs. The law, known as SB 1049, was passed in the Assembly and the Senate by simple majority (53%). (Stats. 2003, ch. 741; Appendix of Appellants California Farm Bureau Federation, et al. and Northern California Water Association, et al. ("AA") at p. 1988.) SB 1049 was signed by then Governor Gray Davis and took effect January 1, 2004. (*Ibid.*) The portion of SB 1049 relevant here is codified at Water Code section 1525 et seq.

Included in SB 1049 was a provision directing the SWRCB to impose fees to cover all costs incurred by the SWRCB's Division of Water Rights. (Wat. Code, § 1525(c).) The water right fee structure set out in SB 1049 has two basic parts. First, it establishes one-time charges for services rendered in response to specific applications, requests or petitions by water rights holders. (Wat. Code, § 1525(b).) Second, it establishes an "annual fee" levied upon, for all relevant purposes, "each person or entity who holds a permit or license to appropriate water." (Wat. Code, § 1525(a).)

The Legislature commanded the SWRCB to develop a fee schedule "so that the total amount of fees collected pursuant to this section equals that amount necessary to recover costs incurred in connection with the issuance, administration, review, monitoring, and enforcement of permits, licenses, certificates, and registrations to appropriate water, water leases, and orders approving changes in point of discharge, place of use, or purpose of use of treated wastewater." (Wat. Code, § 1525(c).) SB 1049 also directs the SWRCB to "set the amount of total revenue collected each year through the fees authorized by this section at an amount equal to the revenue levels set forth in the annual Budget Act for this activity." (Wat. Code, § 1525(d).) The SWRCB adopted the implementing regulations and the fee schedule through Resolution No. 2003-0077.

One-time fees for applications and petitions are paid directly to the SWRCB and annual fees are billed by and payable to the State Board of Equalization. (Wat. Code, §§ 1535, 1536.) Failure to pay the annual fee for a period of five years may result in the revocation of the water rights. (Wat. Code, §§ 1539, 1241.)

One of the many problems facing the monumental shift to a fee-based system is that the United States holds approximately 35% of all licensed and permitted diversions in California. (AA at pp. 1686-1687.) Notwithstanding the Legislature's prior recognition that the State could not impose fees on the United States, SB 1049 does so. (Compare former Wat. Code, § 1560 (2002) with current Wat. Code, § 1560(a).) Where the United States refuses to pay, or the SWRCB determines that the United States is *likely to refuse to pay*, the SWRCB was provided the authority to "allocate" the fees imposed on the United States to "persons or entities who have contracts for the delivery of water from the person or entity *on whom the fee was initially imposed.*" (Wat. Code, §§ 1540, 1560, emphasis added.) Thus, SB 1049 provided the SWRCB with the authority to collect the fees imposed on the United States from federal contractors. Moreover, the SWRCB regulations provided for such collection from only those federal contractors that receive water from the Central Valley Project ("CVP") and not from any other federal project. (See Cal. Code Regs, tit. 23, § 1073.)

B. Proposition 13

Proposition 13, set forth in the California Constitution, provides for limitations on real property tax rates, real property assessment limitations, and restrictions on state and local taxes. (Cal. Const., art. XIII A; *Sinclair, supra*, 15 Cal.4th at p. 872.) Specifically, article XIII A, section 3 provides:

> [A]ny changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no new ad valorem taxes on real property, or sales or transaction taxes on the sales of real property may be imposed. (Cal. Const., art. XIII A, § 3.)

Proposition 13 was, in effect, a "*legislative battering ram* which [was] used to tear through the exasperating tangle of the traditional legislative procedure and strike directly towards the desired end," tax relief. (*Amador Valley Joint Union High School Dist. v. State Bd. of Equalization* (1978) 22 Cal.3d 208, 228, emphasis in original.) Proposition 13 was structured in such a way as to ensure that the tax savings that resulted through the property tax rate and assessment limitations were not withdrawn or depleted by additional levies and exactions. (*Id.* at p. 231.) Nonetheless, an exception to Proposition 13's stringent limitations on government exactions has been created – the so-called "regulatory fee." Regulatory fees are imposed pursuant to

the police power and are valid only if the fees "do not exceed the reasonable cost of *providing services necessary to the activity for which the fee is charged* and *they are not levied for unrelated revenue purposes*." (*California Assn. of Professional Scientists v. Department of Fish & Game* (2000) 79 Cal.App.4th 935, 945 ("*CAPS*"), emphasis added.) The charges at issue in this case are not valid regulatory fees, but are instead taxes levied on the mere ownership of real property, levied for unrelated revenue purposes, and without connection to regulatory activities.

C. Background on Water Rights

The unprecedented nature of the charges at issue in this case results, in part, from the unique nature of the property being assessed – water rights. The SWRCB's actual role with regard to water rights is defined and limited by statute and is itself a natural extension of California water law. California recognizes a myriad of rights to water, making the California law of water rights, at best, complex. California law identifies two distinct categories of water: (1) water flowing in known and definite channels, otherwise known as "surface water" and (2) percolating water found underground known as "groundwater." The SWRCB has been delegated regulatory responsibilities only with regard to limited categories of surface water rights. Percolating groundwater is wholly outside of the SWRCB's jurisdiction (Wat. Code, §§1200, 1201)

and the SWRCB has taken no action to extend its "fee" structure on those who hold rights to percolating groundwater. (See Cal. Code Regs., tit. 23, § 1066 [requiring annual fees only for water right permits and licenses].)

California surface water law begins with the basic premise that one cannot take water from a stream without acquiring some type of water right. (Wat. Code, § 102.) While a water right is usufructuary in nature, once it is perfected it becomes a vested real property right. (*Ivanhoe Irr. Dist. v. All Parties* (1957) 47 Cal.2d 597, 623, revd. on other grounds, *Ivanhoe v. McCracken* (1958) 357 U.S. 275; *United States v. Gerlach Live Stock Co.* (1950) 339 U.S. 725, 752-754.) California's current system of water rights is a dual, or hybrid, system of water rights. (*People v. Shirokow* (1980) 26 Cal.3d 301, 307.) Under this dual system, both riparian and appropriative rights to surface water are recognized. (*Id.* at p. 307.)

The riparian doctrine essentially provides that a person owning land bordering a stream has the right to divert and use water on lands bordering the stream. (*City of Los Angeles v. Aitken* (1935) 10 Cal.App.2d 460.) All landowners bordering the stream are vested with a common ownership of the waters of the stream and in times of shortage, all riparians must share in the shortage proportionately. (*Prather v. Hoberg* (1944) 24 Cal.2d 549, 559-560.) The SWRCB has

taken no action to extend its "fee" structure on those who hold riparian rights. (See Cal. Code Regs., tit. 23, § 1066 [applying annual fees only to water right licenses and permits].)

California's gold rush and mining industry resulted in water being diverted from streams and used on non-riparian lands. The doctrine of prior appropriation is the legal recognition of the right to use water on non-riparian lands. (*Irwin v. Phillips* (1855) 5 Cal. 140.) Under the prior appropriation doctrine, one who actually diverts and beneficially uses water obtains the continued right to do so, so long as the water is surplus to the needs of riparians and earlier, or prior, appropriators. (Wat. Code, § 1240; *People v. Shirokow, supra*, 26 Cal.3d at p. 308.)

Appropriative rights are themselves divided into two general categories: pre-1914 appropriative rights; and permitted or licensed water rights. Prior to the enactment of the Water Commission Act in 1913, one could acquire the right to divert water by simply diverting and using water. (*Nevada County & Sacramento Canal Co. v. Kidd* (1869) 37 Cal. 282, 311.) These rights are commonly referred to as "pre-1914" appropriative rights. The SWRCB has taken no action to extend its "fee" structure on those who hold pre-1914 appropriative rights. (See Cal. Code Regs., tit. 23, § 1066(a) [requiring annual fees only for persons who hold a water right permit or license].)

The Water Commission Act of 1913 provided, among other things, for a more orderly method of appropriating surface water through an application process. Today, and since 1914, anyone seeking to obtain an appropriative water right is required to file an application with what is now known as the SWRCB. (*People v. Shirokow, supra*, 26 Cal.3d 301; Wat. Code, § 1225 et seq.) Upon approval of the application, the SWRCB issues a water right permit. (Wat. Code, § 1380 et seq.) Beneficial use of water perfected under this post-1914 statutory structure is confirmed with a license issued by the SWRCB. (Wat. Code, §§ 1605, 1610.) The license is, in essence, the title or deed to the water right, recorded in the county in which the diversion takes place. (Wat. Code, § 1650.) The SWRCB has placed the entire burden of its "fee" structure on this limited sub-set of permitted and licensed water rights.

Recognizing the need to put all waters of the State to reasonable and beneficial use to the fullest extent possible, the people of the State of California enacted article X, section 2 of the California Constitution, which provides, in pertinent part:

> It is hereby declared that because of the conditions prevailing in this State *the general welfare requires that the water resources of the State be put to beneficial use to the fullest extent of which they are capable*, and that the waste or unreasonable use or unreasonable method of use of water be prevented, and that the conservation of such waters is to be exercised

> with a view to the reasonable and beneficial use thereof in the interest of the people and for the public welfare. (Cal. Const., art. X, § 2, emphasis added.)

The policy, therefore, inherent in California water law, "is to utilize all water available; to *encourage* the impounding and distribution of storm and flood waters whenever it may be done without substantial damage to existing rights; and to *require the greatest number of beneficial uses that the water supply can yield.*" (Hutchins, The California Law of Water Rights (1956) at p. 11, emphasis added; AA at p. 1257.) Through the 1928 Constitutional Amendment and through the Water Code, the people and the Legislature have declared that the people of the State of California have a paramount interest in the use of all the water of the State and that interest includes the *maximization* of the use of water in the public interest. (See Hutchins, *supra*, at pp. 11-13; AA at pp. 1257-1259.) The reasonable beneficial use of water is a good thing to be encouraged; it is not a bad thing to be deterred. Those that hold water rights and divert water from California's rivers and streams are implementing the very policy embodied by the California Constitution and expressed by the Legislature. These diversions *collectively* supply nearly all of California with water for municipal and industrial uses, among others, and supply water to California's agricultural industry, the very backbone of the state's economy. Moreover, much of the water at issue is devoted to activities associated

with flood protection, navigation and flood control. This is particularly true with respect to the extensive rights associated with the CVP.

D. The United States Bureau of Reclamation, the Central Valley Project, and Central Valley Project Contracts

1. Operation of the Central Valley Project

The United States Bureau of Reclamation ("USBR"), a division of the Department of the Interior, holds permitted and licensed water rights for and operates the Central Valley Project. The USBR, in the operation of the CVP, diverts and stores water from various sources for a multitude of purposes pursuant to its appropriative water rights issued by the SWRCB. Indeed, the CVP serves many purposes, including to:

> [I]mprove navigation, regulat[e] the flow of the San Joaquin River and the Sacramento River, control[] floods, provid[e] for storage and for the delivery of the stored waters thereof, for the reclamation of arid and semiarid lands and lands of Indian reservations, and other beneficial uses, and for the generation and sale of electric energy. Act of August 26, 1937, Pub. L. No. 75-392, 50 Stat. 844, 850. To accomplish the project's purposes, CVP's construction includes a series of many dams, reservoirs, hydro-power generating stations, canals, electrical transmission lines, and other infrastructure. [*United States v. Gerlach Live Stock, supra*, 339 U.S. at p. 733.] (*Westlands Water District v. United States* (9th Cir. 2003) 337 F.3d 1092, 1095-1096.)

The USBR, in the administration of Reclamation law and for the operation of the CVP, is like any other applicant for water rights in California and can only obtain rights to divert and deliver water within the CVP through the application of relevant provisions of state law.

(*California v. United States* (1978) 438 U.S. 645.) Thus, the underlying water rights permits for the CVP were granted by the State of California in accordance with SWRCB Water Rights Decisions 893, 990 and 1020. The United States, pursuant to its permits and licenses for the CVP, is entitled to divert approximately 111 million acre-feet of water. (AA at pp. 1720.02-1720.03.) The USBR delivers water to many entities, for many purposes. However, it is undisputed that *only* 6.6 million acre-feet out of the over 111 million acre-feet that the USBR has under permit is under contract with the various public agencies and others who receive water from the USBR through the CVP. (AA at pp. 1594-1598; 1535:11; 1545:21.) This group of federal contractors receiving CVP water is comprised of various public agencies colloquially referred to as "CVP Contractors."[5] Less than 6 percent of all water diverted by the United States pursuant to these permits or licenses is available to the CVP Contractors. The remaining water diverted and stored pursuant to these permits and licenses is used by the USBR for hydroelectric, fish

[5] The group of public agencies identified as "federal contractors" and Petitioners and Plaintiffs herein includes the City of Roseville, El Dorado Irrigation District, Sacramento County Water Agency, City of Tracy, Contra Costa Water District, City of Fresno, County of Fresno, County of Tulare, Sacramento Municipal Utility District, Westlands Water District, County of Colusa, City of Redding, City of Shasta Lake, City of Coalinga, Panoche Water District, and the Placer County Water Agency, among others.

and wildlife and other purposes. (AA at pp. 1545:1-20, 1595, 1701, 1720.02.)

2. The SWRCB's Relationship to the CVP

The SWRCB, in the administration of the water rights for the CVP, regulates the United States as the "permit holder." The SWRCB does not regulate CVP Contractors. The Legislature expressly provided that "[t]he allocation of the fee or expense to these contractors does not affect ownership of any permit, license, or other water right, and does not vest any equitable title in the contractors." (Wat. Code, § 1540.) Thus, in the eyes of the Legislature, CVP Contractors have *no* property interest in the United States' CVP water rights, and cannot avail themselves of the SWRCB's regulatory process to protect their interest in the CVP water rights. They are "strangers" to those water rights with no more relation to them, from the regulatory perspective, than any other member of the public.

E. Proceedings Below

NCWA Petitioners filed a Verified Complaint for Declaratory and Preliminary and Permanent Injunctive Relief (Code Civ. Proc., §§ 1060, 526, 527); Taxpayers Injunctive Relief (Code Civ. Proc., § 526); Petition for Writ of Mandate (Code Civ. Proc., § 1085); and Validation Action (Code Civ. Proc., § 863) ("Complaint") on December 17, 2003, just two days after the SWRCB adopted Resolution

No. 2003-0077. (AA at p. 1.) Because the controversy involved the fees imposed on the water rights held by the United States, NCWA Petitioners named the United States as a real party in interest. The United States specially appeared, notifying the trial court that it had not waived its immunity for the purpose of the pending action. (AA at pp. 123-126.)

Subsequent to NCWA Petitioners' action, the State Board of Equalization issued water rights bills as required by SB 1049 and the implementing regulations. NCWA Petitioners, along with over 200 individual petitioners, filed a petition for reconsideration with the SWRCB, which was denied. (AA at p. 297.) The Complaint was amended to include all named petitioners and to add a challenge to the SWRCB's denial of the petition, along with a request for refund of all fees paid. (AA at p. 127.) NCWA Petitioners' case was consolidated with a similar action filed by the California Farm Bureau Federation. (AA at p. 360.)

A hearing on the merits was held on April 15, 2005. The trial court upheld the water right fees as "valid regulatory fees." The court further held that the fees did not violate the Supremacy Clause by imposing a tax on the United States because the statute provided that the fee "may be allocated to another party." (AA at p. 3358:15-25.) The

trial court also upheld the allocation of the fees both to and among the CVP Contractors.

Subsequent to the April 15, 2005 hearing, on April 28, 2005, the United States forwarded a letter and memorandum to the SWRCB, expressing the official position of the United States that the water right fees are illegal taxes imposed on the United States in violation of the United States Constitution. (AA at pp. 3152-3159.) On May 3, 2005, NCWA Petitioners provided the trial court with a copy of the letter and memorandum as part of NCWA Petitioners' Motion for Reconsideration. (AA at p. 3142.) The trial court granted NCWA Petitioners' motion, and reconsidered and affirmed its prior ruling, notwithstanding the official opinion of the United States on this issue. (AA at pp. 3368-3370.)

The Third District Court of Appeal reviewed this matter and concluded that while the statutory structure at issue was facially valid, the annual fee structure set forth in the SWRCB's regulations was unconstitutional as applied. NCWA Petitioners here do not seek review of the Court of Appeal's determination that the subject regulations are unconstitutional and support the Court of Appeal's decision in this regard. NCWA Petitioners challenge the Court of Appeal's determination that the challenged statutory structure is facially constitutional.

The Court of Appeal's Statement of the Case is itself detailed and is found at pages 3-26 of its Opinion.

III.

ARGUMENT

A. Standard of Review and Burden of Proof

Determining whether a charge is "fee" or a "tax" is a question of law and, as such, the court performs an independent review. (*Sinclair, supra*, 15 Cal.4th at p. 874.) In conducting an independent review, the court is not bound by the interpretation or construction that the courts below gave to the laws in question. (*St. Agnes Medical Center v. PacifiCare of California* (2003) 31 Cal.4th 1187, 1196.)

In order to prove a charge is a "regulatory fee" and not a tax, the government must prove (1) the estimated cost of the regulatory activity, and (2) the basis for determining the manner in which the costs are apportioned, so that the charges allocated to a payer bear a fair or reasonable relationship to the payer's burdens on or benefits from the regulatory activity. (*Sinclair, supra*, 15 Cal.4th at p. 878; *CAPS, supra*, 79 Cal.App.4th at p. 945.)

Courts impose this burden upon the government because Proposition 13 was intended to provide for broad constitutional restrictions on "taxes." Regulatory fees are a judicially created exception to the otherwise broad constitutional restriction. Thus, "it

rightfully follows that the . . . agency which seeks to avoid this general rule should have the burden of establishing that it fits the exception." (*Beaumont Investors v. Beaumont-Cherry Valley Water District* (1985) 165 Cal.App.3d 227, 235.) Indeed, it is well established that it is the "solemn duty of the courts to jealously guard and effectuate the initiative process, it being one of the most precious rights of our democratic process." (*Beaumont* at p. 235, citing *Amador Valley Joint Union High School Dist. v. State Bd. of Equalization* (1978) 22 Cal.3d 208, 248, internal citations omitted.) The State has failed to meet its burden.

B. Water Code Section 1525, Subdivision (a), Is an Unconstitutional Tax on Real Property

"Each person or entity *who holds*[6] *a permit or license to appropriate water* . . . shall pay an annual fee according to a fee schedule adopted by the board." (Wat. Code, § 1525(a), emphasis added.) Article XIII A, section 3, of the California Constitution

[6] To the extent the term "holds" is ambiguous in the context of Water Code section 1525, subdivision (a), "hold" is defined as "|t|o possess in virtue of a lawful title; as in the expression, common in grants, 'to have and to hold'. . . ." (Black's Law Dictionary (6th ed. 1990) p. 730, col. 2.)

prohibits any new ad valorem taxes on real property.[7] Water rights, in California, are real property. The annual fees imposed on water rights are imposed *as an incident of property ownership* and were adopted in violation of article XIII A, section 3, of the California Constitution. Water Code section 1525, subdivision (a), is unconstitutional on its face.

It is black letter law that water rights are real property. "It has been the uniform holding of the courts that the appropriative right is real property." (Hutchins, The California Law of Water Rights, *supra*, at p.121, citing *Fudickar v. East River Irrigation District* (1895) 109 Cal. 29, 36-37, and *Schimmel v. Martin* (1923) 190 Cal. 429, 432, among others; see also *McDonald & Blackburn v. Bear River & Auburn Water & Min. Co.* (1859) 13 Cal. 220, 232 [water rights are "substantive and valuable property"]; *Kidd v. Laird* (1860) 15 Cal. 161, 179-180; *Stanislaus Water Co. v. Bachman* (1908) 152 Cal. 716, 725.); see also 4 Witkin, Summary of Cal. Law (10th ed. 2005) Real Property, § 3(6), at p. 217 [defining real property as "all freehold interests, together with such things closely associated with land as fixtures, growing crops and

[7] The State has argued below that the charges at issue do not violate this prohibition because the charges are not based upon the value of the property at issue. (Respondents' Brief at p. 29.) However, the California Constitution, article XIII, section 1, requires that all taxes on real property be ad valorem.

water." (Internal quotations omitted, emphasis added)]; Civ. Code, § 658 [defining "real or immovable property" as, among other things, "[t]hat which is incidental or appurtenant to land"[8]] .) Water rights are real property; they are not like building permits, they are not like business licenses, they are not like permits to emit pollution into the air, they are not like manufacturing paint containing lead that poisons children.

The California Constitution, in article XIII, section 11, entitled "Taxation of local government *real property*," specifically includes the right to use and divert water as part of real property: "Lands owned by a local government that are outside its boundaries, *including rights to use or divert water* from surface or underground sources and any other interests in lands, are taxable . . . ." (Emphasis added; see also *Stanislaus Water Co. v. Bachman, supra*, 152 Cal. 716, 725; see *Scott-Free River Expeditions, Inc. v. County of El Dorado* (1988) 203 Cal.App.3d 896, 904 ["Water is unquestionably a species of real property and the right to use such water, whether that right be riparian, appropriative, or any other such right, is a valuable property right upon

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[8] In California, a water right is considered appurtenant to the land for which it is appropriated. (*Inyo Consolidated Water Co. v. Jess* (1911) 161 Cal. 516, 520; *Tulare Irr. Dist. v. Lindsay-Strathmore Irr. Dist.* (1935) 3 Cal.2d 489, 546-547.)

which a possessory interest tax may be levied."]; *Jurupa Ditch Co. v. County of San Bernardino* (1967) 256 Cal.App.2d 35, 40 ["an appropriative right to take water from a stream is real property, is a fee simple interest and subject to taxation ...."]; *North Kern Water Storage Dist. v. County of Kern* (1960) 179 Cal.App.2d 268, 271 ["[a] water right is land" for the purposes of taxation and the California Constitution]; *San Francisco v. County of Alameda* (1936) 5 Cal.2d 243, 246-247 [riparian rights form an important element in the valuation of land for taxing purposes]; Hutchins, The California Law of Water Rights, *supra,* at p. 122 ["For purposes of taxation, appropriative water rights constitute land as that term is used in [former] art. XIII, sec. 1, of the State Constitution"] and 9 Witkin, Summary of Cal. Law (9th ed. 1989) Taxation, § 141, pp. 176-177 [right to divert water for nonriparian use is real property].) Water Code section 1525, subdivision (a), imposes a charge on real property, based solely upon the ownership of real property.

The Court of Appeal concluded that the usufructuary nature of water rights somehow affects its status as real property. (Opinion at pp. 35-36.) The fact that the right to water is "usufructuary" in nature, however, is not relevant to its status as real property for the purposes of the instant case. Indeed,

> [a]lthough there is no private property right in the corpus of the water while flowing in the stream, *the right to its use is classified as real property.* [Citations omitted.] The concept of an appropriative water right *is a real property interest* incidental and appurtenant to land. [Citations omitted.] (*Fullerton v. State Water Resources Control Board* (1979) 90 Cal.App.3d 590, 598, emphasis added.)[9]

The State has argued below that the "water rights fees are not based on the assessed value of the water rights" and are therefore not "ad valorem" property taxes. (Respondents' Brief at p. 29.) A tax on property is not valid simply because it is based on something other than the property's "value." Pursuant to Article XIII, section 1, all taxes on property *must*, by definition, be ad valorem.[10] (*City of Oakland v. Digre*

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[9] This is consistent with the position the State took approximately 25 years ago when it filed its Respondents' Brief in *Fullerton v. State Water Resources Control Board.* There the SWRCB argued, consistent with what is now over 140 years of legal precedent, that water rights were real property. (See AA at pp. 1799-1800.) The First District Court of Appeal agreed with the SWRCB's characterization of appropriative water rights as real property. (See *Fullerton v. State Water Resources Control Board, supra*, 90 Cal.App.3d at p. 600 ["[the SWRCB] contends that as the term 'appropriation' was not defined in the code, the Legislature left unchanged the meaning of the term, as it had consistently developed, *including its characterization as essentially a possessory right like other interests in real property.* We agree." (Emphasis added.)].)

[10] *Neilson v. City of California City* (2005) 133 Cal.App.4th 1296 ("*Neilson*") is inapposite. There, the Court held that a "local government" could impose a non-ad valorem tax, a "special tax," on real property if approved by two thirds of the electorate. (*Neilson* at p. 1308.) *Neilson* construed section 4 of article XIII A of the California Constitution in light of the later-adopted Proposition 218, contained in article XIII D, section 3.

(1988) 205 Cal.App.3d 99, 109-110.) Thus, regardless of whether the charges are imposed on the value or calculated by some other method, they are taxes imposed on real property in violation of Proposition 13.

Moreover, the annual fees at issue are not simply "associated" with a property right; they are imposed as an incident of ownership. The clear and unambiguous language of Water Code section 1525, subdivision (a) provides, "Each person or entity *who holds* a permit or license to appropriate water ... shall pay an annual fee according to a fee schedule established by the board." (Wat. Code, § 1525(a), emphasis added.) By virtue of holding the property right, that is, by simply owning property, one becomes subject to the charge.

In that regard, the State's reliance on *Pennell, supra*, 42 Cal.3d 365, for the proposition that fees may be "associated" with a property right is inapposite. (See Respondents' Brief at p. 29.) In *Pennell*, landlords were charged a per-unit fee for all rental units owned. The fees in *Pennell* were not imposed on real property as an incident of ownership. Instead, they were imposed on a business activity – renting apartments. (*Id.* at p. 375, fn. 10 accord *Apartment Assn. of Los Angeles County, Inc. v. City of Los Angeles, supra*, 24 Cal.4th at p. 838.) The annual charges at issue here are imposed not on a business activity, but solely because one owns real property, and the funds collected are used for the various purposes of the Division of Water Rights, including

regulating persons not subject to the annual charges and subsidizing the costs of processing new water right applications, among other things. The annual charges are unlawful taxes imposed on real property.

C. The Annual Fees Authorized by Water Code Section 1525, Subdivision (a), Are Not Valid Regulatory Fees

It is important to note, in the first instance, that the question of the value or importance of the SWRCB's Division of Water Rights is not before this Court. Neither is the question of whether and to what extent the Division should be properly funded; indeed, it should. The question before this Court is whether the Legislature can solve its "funding crisis" through "charges" that attempt to avoid Proposition 13's required two-thirds supermajority voting requirements.

While *Sinclair* sets out what appears to be a relatively straightforward test for determining whether a charge is a "tax" or a "regulatory fee," the question of whether the activities of government can be reduced to simple distinct "regulatory" programs for which a "regulatory fee" can be charged is a more difficult question.

According to *Sinclair*, the State bears the burden of demonstrating (1) the estimated cost of the service or regulatory activity, and (2) the basis for determining the manner in which the costs are apportioned, so that the charges allocated to a payer bear a fair or reasonable relationship to the payer's burdens on or benefits from the

regulatory activity. (*Sinclair, supra*, 15 Cal.4th at p. 878, citing *San Diego Gas & Electric Co. v. San Diego County Air Pollution Control Dist., supra*, 203 Cal.App.3d at p. 1146.) The State has failed to satisfy this burden and, indeed, it cannot do so.

1. The State Cannot Impose "Fees" to Cover All the Costs Associated with Overseeing California's Water Resource

Each statute adopted by the Legislature, and codified in the various California Codes, pertains to some type of "regulation." The Legislature enacts laws which are implemented through various rules and regulations by state and local agencies to both encourage and discourage conduct by private persons and businesses alike. It is incomprehensible that Proposition 13 can be read and interpreted to allow any government activity that can be classified as "regulatory" to be funded through "regulatory fees" outside of Proposition 13's protections. Because *all* government activities can, at some level, be characterized as regulatory, all government activity would, under this rubric, elude Proposition 13. "Otherwise, virtually all of what are now considered taxes could be transmitted into [regulatory] fees by the simple expedient of dividing what are generally known as taxes into

constituent parts, e.g., a police fee."[11] (*Novato Fire Protection District v. United States* (1999) 181 F.3d 1135, 1139, citations, quotations omitted.)

The State argues that so long as there is a "reasonable relationship between the fee and the need to which the fee payor's activities contribute," a fee can be charged. (Respondents' Brief on Appeal at p. 33.) The ownership of property, however, can arguably be "reasonably related" to the need for a whole host of governmental regulation, including zoning enforcement, community policing, education, the need for flood protection, and the demand for water supplies, among others. Yet, no court has extended the regulatory fee concept to these general, core, governmental services, as an incident of property ownership. (See *City of Oakland v. Digre, supra*, 205 Cal.App.3d at pp. 108-109.) Not surprisingly, the State's methodology for determining whether a charge falls outside of Proposition 13 can be used to validate a fee for any governmental agency or program. Every

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[11] The Superior Court expressed some concern about the reach of the "regulatory fee" concept, explaining "the appellate cases all face incidents [sic] where there are non-regulatory aspects to the programs involved . . . the classic one is *Sinclair*, where I understand from *Sinclair* that a big chunk of money was being used for health programs for children . . . how is that regulatory? * * * That is certainly not [sic] regulatory activity, health care for children." (AA at p. 3285.)

governmental program or regulation "benefits" someone and/or exists because someone or something "contributed" to the need. The analysis cannot be so superficial.[12]

A fundamental threshold question is whether the "regulation" for which a "fee" is being charged can, in fact, be funded through regulatory fees. (See, e.g., *Sinclair, supra*, 15 Cal.4th at p. 879 ["In our view, shifting the costs of providing evaluation, screening, and medically necessary follow-up services for potential child victims of lead poisoning from the public to those persons deemed responsible for that poisoning is likewise a reasonable police power decision."].) With

[12] In the official California Voters Pamphlet, Proposition 13 opponents argued that the initiative would "[require] new taxes to preserve critical services . . . ," would "[reduce] drastically police patrol services and fire protection . . . ," and would "[slash] current local funding for parks, beaches, museums, libraries, and paramedic programs." (See Motion Requesting Judicial Notice (granted by Opinion at p. 2, fn. 1) at Exh. A, pp. 58-59.) Arguments against Proposition 13 similarly predicted the need to "double" the current income tax or sales tax to make up the shortfall. (*Id.* at p. 59.) The legislative history of this enactment cannot be read in such a way as to permit the imposition of "fees" on the ownership of real property to make up for the tax revenue lost through Proposition 13.

regard to the ongoing activities[13] of the Division of Water Rights, the State cannot impose regulatory fees.

The role of the SWRCB's Division of Water Rights is not a simple "regulatory program" where one can identify those who place a "burden" on or "benefit" from the Division's activities. Indeed, the very concept of water rights in California, and the entire State's reliance on this resource, transcends the simple concept of "regulation" and certainly removes this case from the types of fee schemes previously passed upon by this and other courts.

The SWRCB, created in 1967, has duties framed not only by the Water Code, but also by the 1928 amendment to the California Constitution, which is the foundation upon which modern day California water law operates. Thus, the SWRCB is a "statewide agency," whose functions "partake of both constitutional and statutory characteristics." (*Bank of America v. State Water Resources Control Bd.* (1974) 42 Cal.App.3d 198, 206.) The SWRCB, in addition to administering the State's water right permitting and licensing system, has other major responsibilities including protecting the public trust,

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[13] The State can properly charge applicants for new water rights with the cost of processing those applications. (See Wat. Code, § 1525(b).) Here, however, the SWRCB is charging existing water right holders increased fees to pay the cost of processing new water right applications. (Opinion at p. 40.) In any event, charging ongoing "annual" fees is a distinct question.

administering statutory adjudications and acting as a court reference. (See *National Audubon Society v. Superior Court* (1983) 33 Cal.3d 419; Wat. Code, §§ 2000, 2500 et seq.) Indeed, the Superior Court recognized that the SWRCB "does engage in activities that appear to be of a general planning or environmental protection nature, such as Bay-Delta planning and protection of public trust resources ...." (AA at p. 3362:26-28; accord Opinion at p. 40.)

Of course, the California Constitution defines the public interest as it relates to the beneficial use of waters of the State. (Cal. Const., art. X, § 2.) The California Constitution expressly provides that the *general welfare* requires that the waters of the State be put to beneficial use to the fullest extent to which they are capable. (*Ibid.*) The Water Code provides that the "people of the State have a paramount interest in the use of all the water of the State . . . ." (Wat. Code, § 104; see also Wat. Code, § 100.) The Water Code's provisions related to water rights further provide:

> This division is hereby declared to be in furtherance of the policy contained in Section 2 of Article X of the California Constitution and in all respects for the welfare and benefit of the people of the state, for the improvement of their prosperity and their living conditions, and the board ... shall be regarded as performing a governmental function in carrying out the provisions of this division. (Wat. Code, § 1050.)

In administering the State's water right permitting system, therefore, the SWRCB is implementing the constitutional and statutory mandate that all waters of the State be put to maximum beneficial use. In complying with this mandate, then, *all* actions of the SWRCB are required to be in the interest of all the people of the State – and there is no particularized burden, sufficient to justify millions of dollars in "fees," created solely by those holding the underlying "rights" to divert water, nor do those who hold water rights necessarily recognize a particular "benefit." Instead, the burdens on the Division are created by *all* Californians, and the benefits accrue to the same – not to the myriad of local public, state, and federal agencies, among others, who divert water for their use. Thus, the annual fees are neither imposed to regulate a burden directly caused by the payer, nor paid in return for a benefit directed to the fee payer. As such, they are taxes and were adopted in violation of Proposition 13. (*Leslie's Pool Mart, Inc. v. Dept. of Food and Agriculture* (1990) 223 Cal.App.3d 1524, 1544; *Mills v. County of Trinity* (1980) 108 Cal.App.3d 656, 660.)

For example, the United States "holds" the water rights for the Central Valley Project, which was constructed and operates for a multitude of purposes, including flood protection, improved navigation, salinity control, and storage and stabilization of the water supply. (See e.g., Wat. Code, § 11207.) The CVP also provides power for people in

and out of the State through the Western Area Power Authority, the federal agency authorized to sell power generated by the CVP. (AA at p. 1701.) The CVP provides recreational opportunities for all Californians and dedicates substantial quantities of water for environmental purposes. (See generally, AA at pp. 1731-1736, "Central Valley Project General Overview," printed from the USBR's website at http://www.usbr.gov/dataweb/html/cvp.html.)

Like the federally-owned CVP, California's State Water Project ("SWP") provides flood protection, stabilizes the state's water supply, and provides recreational opportunities and water for the environment. (*Central Delta Water Agency v. State Water Resources Control Board* (2004) 124 Cal.App.4th 245, 264; Wat. Code, § 12930 et seq.) The California Department of Water Resources "holds" the water rights for the SWP. Thus, both the CVP and SWP operate and divert water for all of these purposes pursuant to water rights administered by the SWRCB.

CVP Contractors and many receiving water from the SWP, as well as many water right holders, are public agencies who, in carrying out the constitutional mandate to maximize beneficial uses of water, deliver water to all Californians for municipal, industrial, irrigation and recreational uses, among others. Yet, notwithstanding the obvious public need created by Californians generally, the Legislature has imposed the costs associated with all of the SWRCB Division's

activities on a small subclass.[14] In dealing with the State's water right permits and licenses, the SWRCB's activities are, in large part, for general, core governmental purposes and the cost of such activities should be "borne by the State." (See *Pennell, supra*, 42 Cal.3d at p. 372; see also, *United States v. City of Huntington* (4th Cir. 1993) 999 F.2d 71, 73 ["[f]ire and flood protection ... are core government services."].) It is hard to imagine something more essential and more a core governmental purpose than providing water to homes, industries and farms.

The City of Oakland attempted a similar end-run around Proposition 13 in 1988 when it attempted to impose a flat fee on all real property within the City to support fire, police and park services, among other things. (*City of Oakland v. Digre, supra*, 205 Cal.App.3d at p. 102.) The City argued that each parcel required municipal services, including police and fire protection, and therefore "benefits from such services." (*Id.* at p. 107.) The City also argued that the property was

[14] Section 1525, subdivision (c), provides that the SWRCB shall set the fees authorized by Section 1525 so that the total amount collected equals the amount necessary to fund all the activities of the Division of Water Rights. (State's Petition for Rehearing, p. 9 ["section 1525 . . . authorized the SWRCB to impose fees to cover the entire cost of the water right program"], p.16 [section 1525(c) "is very broad, and includes essentially *all* water right regulatory activities" (emphasis in original)], p.17 ["the 'activity" [referred to in subsection (d)(3)] reflects the entire cost of the program"].)

more "valuable" as a result of these services. (*Ibid.*) Not surprisingly, this annual fee on real property, partially funding police and fire services, was held an unconstitutional property tax. (*Id.* at p. 109.) Notably, the court drew distinctions between "'essential' services such as police and fire protection" and "'elective' services." (*Id.* at p. 108; see also *Novato Fire Protection Dist. v. United States, supra*, 181 F.3d 1135; and *United States v. City of Huntington, supra*, 999 F.2d 71.)

The SWRCB's assertion that the fees are proper because the fee payer's use of water alone creates the "need" for the regulatory program is fundamentally flawed and ignores the California Constitution and the Water Code. (AA at pp. 1720-1752.) In particular, the SWRCB fails to recognize the constitutional and statutory provisions declaring that it is the public's need for water that creates the need for the allocation and administration of water by the SWRCB and it is the public generally that benefits from the water rights program. (Cal. Const., art. X, § 2; Wat. Code, § 1050.) While water right holders, or fee payers, undertake activities to meet the public needs, they do not create the obligation to meet that need which is, in fact, mandated by the Constitution.

Unlike all other regulatory fee cases where the regulation seeks to limit the regulated activity for the protection of the public, here, by constitutional mandate, the activity must be maximized for the public benefit. (Cal. Const., art. X, § 2.) Thus, the suggestion that the fees at

issue are "regulatory" based upon the reasoning in *Sinclair, supra,* 15 Cal.4th 866, in that they "deter" future conduct, is wholly inapplicable.[15] Again, of note is that most of the Petitioners in this action are local public agencies that provide water service to the public. In that regard, it is the public's need for water that creates the "burden" on the regulatory program and not the water right holders. This further demonstrates the public nature of water use and reinforces that the annual fees are imposed for the support of government. (See *Novato Fire Protection District v. United States, supra,* 181 F.3d at pp. 1139-1140 [charges for essential governmental services are taxes].). In that regard, the present case is distinguishable from all other regulatory fee cases concerning regulatory programs that respond to harmful activities undertaken by a special class of persons.

Through Water Code section 1525, the Legislature seeks to impose *all* the costs of providing these services, for which the burden is created by and the benefit accrues to all Californians, on a small subset of those supplying water to all Californians. The SWRCB has implemented the Legislature's command by imposing annual fees on owners of real property to fund those general governmental services. In

[15] The State's argument in this case that those that simply divert water are doing "harm" is not supported anywhere in the record and is wrong, as a matter of law. (AA at p. 1710:1-8; Opinion at p. 42.)

doing so, both the Legislature and the SWRCB have transmuted into fees what should be paid by the State and has, in effect, "contrive[d] to tax ... through gerrymandering." (*Novato Fire Protection Dist. v. United States, supra*, 181 F.3d at p. 1140; *United States v. City of Huntington, supra*, 999 F.2d at p. 73.) As such, the charges are *not* valid regulatory fees but are, instead, taxes adopted in violation of Articles XIII and XIII A of the California Constitution.

2. The State Has Failed to Meet Its Burden of Demonstrating the Estimated Cost of the Regulatory Program

Assuming, *arguendo*, the SWRCB's water rights program is not entirely a core governmental function that the State should pay for, the State has failed to demonstrate that the fees will not exceed the cost of the regulatory program. Indeed, as the State has acknowledged, it cannot make this demonstration. (State's Petition for Rehearing at pp. 12-15.)

Water Code section 1525(c) enumerates the activities for which the SWRCB is required to recover fees. The SWRCB has acknowledged that the activities enumerated in Water Code section 1525(c) are all the activities of the water right program. (Petition for Rehearing at pp. 9, 16 and 17.) Water Code section 1525(d) requires the SWRCB to "set the amount of total revenue collected each year through the fees authorized by this section at an amount equal to the

revenue levels set forth in the annual Budget Act for this activity." (Wat. Code, § 1525(d)(3).) The problem with this structure, and the reason the statute creates an unconstitutional tax, is that there is no relationship between the cost of the regulatory program and the amount set forth in the Budget Act. The State has made this clear (Petition for Rehearing at pp. 12-15) and, therefore, there is no way for the State to ensure that the amount set forth in the Budget Act is equal to the cost of the regulatory program.

3. The Annual Charges Pay for All Activities of the Division of Water Rights and Do Not Bear Any Relationship to the Benefit from or Burden on the Regulatory Program

Assuming *arguendo* that the Division performs only regulatory functions and, therefore, the entire budget of the Division covers only regulatory activities, the charges developed by the SWRCB are nonetheless invalid because the annual fees are not reasonably related to those regulatory functions. Instead, the annual fees merely spread the cost of a wide variety of functions and subsidize certain activities altogether, without regard to the burden imposed by, or benefit conferred upon, any fee payor or class of fee payor.

Here, in developing the fee schedule mandated by SB 1049, the SWRCB's primary concern was that the funding source was relatively stable. (AA at p. 1683.) The SWRCB did not take into account the actual costs associated with any of its activities.

As discussed previously, there are many types of water rights in California, including percolating groundwater, pre-1914 rights, riparian rights, permitted rights, and licensed rights. The SWRCB has identified the percentage of water rights held by each type of right. (AA at p. 1687.) Specifically, according to the SWRCB, 38% of all surface water rights are pre-1914 or riparian, 22% of all water rights are held by the USBR, and 40% of all water rights are held by permit and license holders. (*Ibid*; Opinion at pp. 42-43.) The SWRCB asserts "jurisdiction" over pre-1914 appropriative water rights and riparian water rights to the extent the SWRCB enforces the constitutional provisions prohibiting waste and unreasonable use. (AA at pp. 1696 and 1556:4-7.) According to the SWRCB, the Division's activities cover all of these rights. Yet, of those holding water rights, only permit and license holders are charged the annual fees. (Wat. Code, § 1525(a); Cal. Code Regs, tit. 23, § 1066.)

Even if annual fees would otherwise be proper, the annual fees mandated by Water Code section 1525 are improper because a fairly limited subclass of the regulated community is being charged for the burdens created by and benefits received by a much larger class. There is simply no basis for imposing the entire burden of a regulatory activity on a subclass of the regulated community. (*Sinclair, supra*, 15 Cal.4th at p. 878.) The annual fees, therefore, are not imposed to "assure that

the persons responsible pay their fair share of the cost of government." (*Sinclair, supra*, 15 Cal.4th at p. 879, internal quotations omitted.) They are, therefore, taxes adopted in violation of Proposition 13.

Moreover, while Water Code section 1525 purports to assess fees against the United States for its share of water rights, in fact, Water Code sections 1540 and 1560 merely permit the fees imposed on the United States to be "collected" from a group of public agencies that, according to the SWRCB, do not even hold water rights, nor may they avail themselves of the SWRCB's regulatory program. (Wat. Code, §§ 1540, 1560; AA at p. 1591; AA at pp. 1563-1565.) Third parties are paying for the regulation of the United States, which does not further the purpose of making those responsible pay their "fair share." (*Sinclair, supra*, 15 Cal.4th at p. 879.) Because the fees are not reasonably related to the fee payers' burdens on or benefits from the regulatory program, they are not valid regulatory fees.

D. The Statute Is Unconstitutional on Its Face Because of Its Treatment of Charges Imposed on the Federal Government

Since *McCulloch v. Maryland* (1819) 17 U.S. (4 Wheat.) 316, it has been axiomatic that the United States is immune from taxation by any state. Where the tax is imposed directly on the United States, the burden is on the taxing authority to show that the United States is not immune from the tax. (See *Jefferson County v. United States* (5th Cir. 1947) 164 F.2d 184.)

Every well-grounded doubt on the subject should be resolved in favor of the immunity. (*Austin v. Board of Aldermen* (1869) 74 U.S. (7 Wall.) 694.

1. A Tax[16] Imposed on the Property of the United States Violates the Supremacy Clause

The statute on its face imposes a fee upon the United States. Water Code section 1525 imposes the annual fee on "[e]ach person or entity who holds a permit or license to appropriate water . . . ." Moreover, Water Code section 1540 provides: "If the board determines that the person or entity *on whom a fee or expense is imposed* will not pay the fee or expense based on the fact that the fee payor has sovereign immunity . . . the [SWRCB] may allocate the fee or expense . . . to persons or entities who have contracts for the delivery of water from the person or entity on *whom the fee or expense was initially imposed.*" (Wat. Code, § 1540, emphasis added).

In order to avoid Proposition 13, the SWRCB characterizes the fee as a "regulatory" fee. Such fees are imposed to reimburse the agency for "expense[s] imposed upon it by the business *sought to be regulated.*"

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[16] While California courts have issued many decisions under Proposition 13 concerning the state-law distinction between "fees" and "taxes," that distinction is irrelevant for purposes of deciding whether the United States is immune from the impost. Whether the impost is characterized as a "user fee" or "charge for benefits conferred" or a "tax," the impact is the same on the United States. (See *United States v. Anderson Cottonwood Irrigation Dist.* (D. Cal. 1937) 19 F.Supp. 740.) Because of this impact, the United States is immune from the impost no matter how the assessment is characterized by California.

(*United Business Comm. v. City of San Diego* (1979) 91 Cal.App.3d 156 at p. 166, emphasis added.) Here, however, according to the SWRCB, federal contractors have no property interest in the water rights of the United States and have no greater relationship to the regulatory program for which the fees are charged than any member of the general public. (See AA at pp. 1591 and 1563:3-1566:24.[17]) The SWRCB simply has no regulatory authority over the federal contractors. (See Background, *ante*, at ¶ II.D.2.) There is no logic behind the pass-through of a regulatory fee to a non-regulated entity. To the extent a regulatory fee is intended to affect the behavior of the regulated entity, that effect will be lost if the regulated entity is not responsible for paying the fee and, instead, the fee is passed on to a party that has no control over the regulated activity and has no regulatory relationship with the SWRCB. To impose the fee directly on the federal contractors would obviate the SWRCB's regulatory fee justification and would necessarily cause the fee to be recognized as a tax that runs afoul of Proposition 13. (See *Leslie's Pool Mart, Inc. v. Dept. of Food & Agriculture, supra*, 223 Cal.App.3d at p. 1595.) Thus, if the fees charged

[17] In order to forestall any claim that by payment of the fees a federal contractor obtains an interest in the water rights of the United States, Water Code section 1540 proclaims: "The allocation of the fee or expense to these contractors does not effect ownership of any permit, license, or other water right, and does not vest any equitable title in the contractors."

are indeed regulatory, they must, in violation of the Supremacy Clause, be charged against the interest of the United States.

The trial court and the Court of Appeal relied on the language of Water Code section 1560(a)[18] to justify their view that the statutory scheme is not facially in violation of federal law. If the fee payer will not pay the fee because of sovereign immunity, Water Code sections 1560(b)(2) and 1540 permit the SWRCB to allocate the federal fee "to persons or entities who have contracts for the delivery of water from the person or entity on whom the fee was initially imposed . . . ." Because the federal government is immune from the fee under federal law, there should be no fee to be allocated to the federal contractors. The statutory scheme blithely ignores this problem and magically allows the SWRCB to charge the non-existent federal fee to persons and entities that have no relation to the regulatory scheme. This is legislative sophistry which cannot pass constitutional muster. If Water Code section 1560(a) is to be taken seriously, there can be no fee to allocate, and section 1540 is a nullity. In attempting to resurrect a fee that cannot exist under federal law, section 1540 itself violates the Supremacy Clause.

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[18] "The fees and expenses established under this chapter . . . apply to the United States and to Indian Tribes, to the extent authorized under federal or tribal law." (Wat. Code, § 1560(a).)

2. The Charge Cannot Be Passed Through Because Federal Contractors Have No Possessory Interest in the Water Rights

Not only does "allocating" the regulatory fee on non-regulated parties run afoul of Proposition 13, but such a "pass-through" does not cure the violation of the Supremacy Clause. While it is not a violation of the Supremacy Clause to impose a *tax* on federal contractors' possessory interest in federal projects (see, e.g., *United States v. County of Fresno* (1977) 429 U.S. 452 ("*County of Fresno*"), the Supremacy Clause is violated where, as here, the federal contractor has no interest in the property being taxed. (See, e.g., *United States v. Nye County* (9th Cir. 1991) 938 F.2d 1040 ("*Nye County*"); *United States v. Hawkins County* (6th Cir. 1988) 859 F.2d 20 ("*Hawkins County*").

In *Nye County, supra*, 938 F.2d 1040, the Ninth Circuit struck down a tax on federal contractors based upon the following reasoning:

> Here, the property belongs to the United States. Arcata has no leasehold interest in it, but merely has the privilege, terminable at the will of the government, to use the property at the time and place and in the manner directed by the United States. Nye County makes no attempt to segregate and tax any possessory interest Arcata may have in the property, or Arcata's beneficial use of the property. Nye County simply taxes Arcata as if it were the owner of the property. The tax effectively lays "an *ad valorem* general property tax on property owned by the United States." (*Id.* at p. 1043, quoting *United States v. Colorado* (10th Cir. 1980) 627 F.2d 217, 221.)

In the proceedings below, the State primarily relied upon *United States v. County of Fresno, supra*, 429 U.S. 452, to support the collection of

the entire fee imposed on the United States' property from federal contractors. In *County of Fresno*, the State of California *taxed federal employees* "on their possessory interests in housing owned and supplied to them by the Federal Government as part of their compensation." (*Id.* at p. 453.) California's Revenue and Taxation Code authorized the County to impose an annual use or property *tax* on possessory interests on tax-exempt land. (*Id.* at p. 455) The *tax* was based on each *employee's* possession of, claim to, or right to the possession of land or improvements in non-taxable publicly owned *real property*. (*Id.* at pp. 455-456, and fn. 3) Importantly, *County of Fresno* was not a case involving federal contractors at all. Moreover, the Court in *County of Fresno* recognized that the "legal incidence of the tax involved . . . falls neither on the Federal Government *nor on federal property*." (*Id.* at p. 464, internal quotes omitted.) The opposite is true here. The charge is imposed against the water rights held by the United States, not on any possessory interest of federal contractors. (Wat. Code, § 1525(a).) Simply collecting these charges from third parties does nothing to cure the constitutional deficiency inherent in Water Code section 1525(a).

Moreover, federal cases decided after *County of Fresno* have clarified the constitutional doctrine of immunity in the context of taxing federal contractors in light of what it saw as "confusing precedents." (*United States v. New Mexico* (1982) 455 U.S. 720, 733.) In doing so, the

Court unequivocally affirmed the one constant: "a State may not, consistent with the Supremacy Clause, U.S. Const., Art. VI, cl.2, lay a tax directly on the United States." (*United States v. New Mexico, supra*, 455 U.S. at p. 733.) In this regard, the analytical focus turned from looking at the economic incidence of the charge in question to determining whether the charge was levied on the property of the United States. This distinction, between taxes imposed on federal property and those levied upon isolated possessory interests in federal property, was further discussed in *Nye County, supra*, 938 F.2d 1040. There, the court compared those taxes that survived, as in *County of Fresno* and *United States v. New Mexico*, where a private property interest in federal property was isolated, and those that perished, as in *United States v. Colorado, supra*, 627 F.2d 217 and *Hawkins County, supra*, 859 F.2d 20, where the states imposed taxes on the federal contractors measured by the value of the property held by the United States. (*Nye County, supra*, 938 F.2d 1040.) Indeed, one of the problems in *United States v. Colorado* was that the federal contractor "held no leasehold interest in the government property," which prohibited the imposition of the tax on the federal contractor. (*Nye County, supra*, 938 F.2d at p. 1042.)

The water right fees here are virtually indistinguishable from the charges that perished in *United States v. Colorado* and *United States v. Nye County*. Here, as in *Nye County*, the statute, under which the State seeks to impose its charge against the CVP Contractors, charges the users "in the

same amount and to the same extent as though the [CVP Contractors] were the owner of the property. Here, the property belongs to the United States . . . [the State] makes no attempt to segregate and tax any possessory interest [the CVP Contractors] may have in the property." (*Nye County, supra*, 938 F.2d at p. 1043.) The State simply charges the CVP Contractors as if they were "the owner of the property." (*Ibid.*) Water Code section 1525(a) "effectively lays an *ad valorem* general property tax on property owned by the United States." (*Ibid.*, quotations, citations omitted.)

It is perhaps possible that the California Legislature could have imposed a valid, non-discriminatory user fee upon the federal contractors. Perhaps this is what they intended but, just like the Tennessee Legislature, this is not what was enacted:

> Whether or not the Tennessee legislature had in mind a tax on beneficial use, it unquestionably did not describe one when it enacted the statute in question. Since [the contractor] has been determined not to have a real property interest in the facility, Tennessee's attempt to tax [the contractor] resulted in what was, in reality, a tax upon the United States itself. (*Hawkins County, supra*, 859 F.2d at p. 24.)

In the instant case, the Court of Appeal concluded that the charges were improper only because they were not limited to the federal contractors' interest in the federal property. (Opinion at p. 50.) This conclusion, however, is too limited and ignores that (1) a tax on federal property cannot simply be imposed on a third party without a waiver of immunity; (2) a regulatory fee cannot be passed through to a non-regulated

entity; and (3) the charge is being imposed directly on the federal property, rather than the federal contractors' interest in that property

Finally, Water Code sections 1560 and 1540 also run afoul of another aspect of the Supremacy Clause: discrimination against federal contractors. "It remains true, of course, that state taxes on contractors are constitutionally invalid if they discriminate against the Federal Government, or substantially interfere with its activities." [Citations omitted.] (*United States v. New Mexico, supra*, 455 U.S. at p. 735, fn. 11.) Here, Water Code sections 1560 and 1540 apply *only* to federal contractors. No other user of water derived from any other water right is required by statute to pay the fee. No contractor other than the federal contractor is *statutorily* required to pay the fee. As such, the statute on its face discriminates against federal contractors and thereby violates the Supremacy Clause.

E. The State Has Failed to Demonstrate that the $100 Minimum Fee Is Reasonably Related to the Payer's Burdens on or Benefits from the Regulatory Program

The Court of Appeal held "although the SWRCB did not offer evidence of the actual cost of billing the annual fees, we cannot say a $100 minimum annual fee was an unreasonable estimate of that cost." (Opinion at p. 43.) As noted, the State has the burden of proving the estimated cost of the regulatory program. (*Sinclair, supra*, 15 Cal.4th at p. 878.) The Court of Appeal found that the State had failed to provide

any evidence of the cost of the regulatory program. (Opinion at pp. 35, n. 21, and 43.) Without providing any evidence of the cost of the regulatory program, it is not possible for the State to meet its burden of showing the estimated costs of the program, and there can be no demonstration that the fees do not exceed that estimated cost. The Court of Appeal's conclusion, therefore, that the $100 fee is not unreasonable is not supported by evidence and is contrary to law.

IV.

CONCLUSION

For the foregoing reasons, NCWA Petitioners respectfully request this Court reverse the Court of Appeal's decision, in part, and find Water Code sections 1525, 1540, and 1560 unconstitutional and invalid.

Respectfully submitted,

SOMACH, SIMMONS & DUNN
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DATED: June 11, 2007

By _____
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WORD COUNT CERTIFICATION

(California Rules of Court, Rule 28.1(d))

The text of NCWA Petitioners' Opening Brief consists of 11,931 words according to the "word count" feature of the Word processing program utilized in creating this document.

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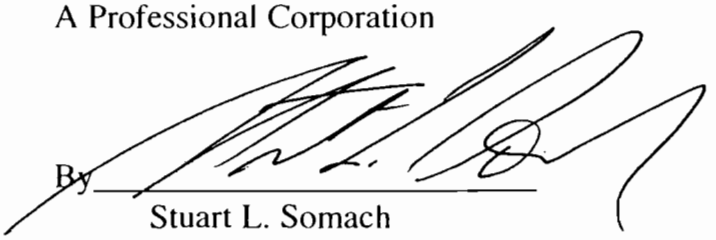

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PROOF OF SERVICE

I am employed in the County of Sacramento; my business address is 813 Sixth Street, Third Floor, Sacramento, California; I am over the age of 18 years and not a party to the foregoing action.

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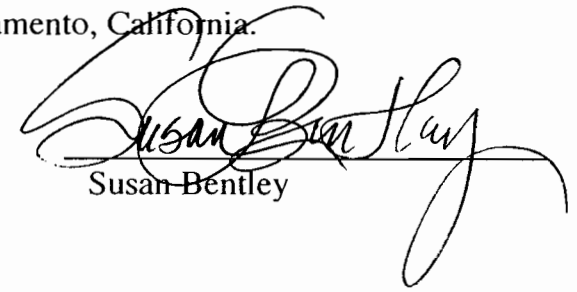

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