SUPREME COURT COPY

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.

S 150518

SUPREME COURT
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Court of Appeal, Third Appellate District, Case No. C050289
Sacramento County Superior Court Case Nos. 03CS01776, 04CS00473
The Honorable Raymond Cadei, Judge

REPLY TO ANSWER TO PETITION FOR REVIEW

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REPLY TO ANSWER TO PETITION FOR REVIEW

Under California Rules of Court, Rule 8.500, the California State Board of Equalization (BOE) and the California State Water Resources Control Board (SWRCB) (SWRCB and BOE, collectively, the State) submit the following Reply to the Northern California Water Association, et al.'s (NCWA's) Answer to Respondents' Petition for Review.

I. NCWA doesn't answer the State's first issue regarding the Court of Appeal's corruption of the *Sinclair Paint* test.

NCWA's Answer never addresses the State's first issue: the Court of Appeal's corruption of the *Sinclair Paint* test through its consideration of the benefits received by water right holders who are not subject to the SWRCB's permitting and licensing authority. By statute, these water right holders do *not* pay the fees established by section 1525 of the Water Code. Instead, NCWA argues that the Court of Appeal invalidated California Code of Regulations, title 23, section 1066 because the "fee allocation is not justified by either the *fee payors'* benefits from *or* burdens on the regulatory program." (NCWA Answer, p. 4 [first italics added, second in original]; see *Sinclair Paint Co. v. State Bd. of Equalization et al.* (1997) 15 Cal.4th 866, 878 (*Sinclair Paint*) [setting out test].) NCWA misses the point.

The Court of Appeal compared *the fee payers* (the regulated community of permittees and licensees) to *the non-fee payers* (other water right holders who are not subject to the water right permit and license system but who benefit from that regulatory program). (Slip op., p. 36.) The second prong of the *Sinclair Paint* test

requires the state to show "the basis for determining the manner in which the costs are apportioned, so that charges allocated to a payor bear a fair or reasonable relationship to the payor's burdens on or benefits from the regulatory activity." (*Sinclair Paint, supra,* 15 Cal.4th at p. 878.) An agency would *never* be able to construct a fee system that places the cost of regulation on the regulated community if it must also -- at the same time -- take into consideration those who benefit from that regulation.

The SWRCB has argued from the beginning that it can impose the majority of the costs of the regulation on the permitted and licensed water right holders:

> [T]he use and diversion of water pursuant to water right permits and licenses issued by the Water Board is the very subject of the Water Board's water rights regulatory program. To find a valid regulatory fee, the court need only determine that the Legislature acted after finding a reasonable relationship between the fee and the need to which the feepayers' activities contribute."

(Appendix 2044:19-23 [Respondents' Brief on Appeal].) The fact that other water right holders, including permitted and licensed water right holders, "benefit" from this regulation when it protects their water rights, is the flip side, or the effect, of the regulation. If the SWRCB's primary job is the regulation of permittees and licensees and it imposes the fee to cover those costs, it does not matter that this regulation serves to "benefit" the public trust or anyone else. Isn't this benefit the reason for the regulation? By their nature, regulatory activities are undertaken pursuant to the government's police power, and "the police power is constitutional only if adopted to promote the health, safety, and welfare of the public as a whole." (*Mills v. County of Trinity* (1980) 108 Cal.App.3d 656, 661.)

The Court of Appeal faulted the SWRCB for failing to provide (irrelevant) evidence because of its corruption of the *Sinclair Paint* test. It invalidated section 1066 because the SWRCB "offered no breakdown of costs or other evidence to demonstrate that the services and benefits provided to the non-paying water right holders were de minimis." (Slip op., p. 41.) In other words, the SWRCB's showing that the regulatory effort devoted to regulating non-fee payers is de minimis is inadequate; the SWRCB must show that both the burdens imposed *and the benefits received* are de minimis.[1]

In addition to failing to address the Court of Appeal's corruption of the *Sinclair Paint* test, the rest of NCWA's argument (concerning the alleged lack of any evidence of the cost of regulatory program and alleged problems with the allocation among the fee payers themselves) is irrelevant. Worse, it misconstrues the Court of Appeal's decision.

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[1] The Court of Appeal states that "Indeed, it would be difficult to make the de minimis argument, given the evidence in the record regarding the role of the Division in *protecting* pre-1914 water rights and the allocation of Division resources." (Slip op., p. 41 [italics added].) But on the *same page* as the referenced figures showing the allocation of the program's resources, the SWRCB also estimated that it spent "approximately five percent of its resources protecting the water rights of parties who hold rights not subject to permit or license." (Appendix 2298.) Moreover, the trial court recognized that NCWA itself went so far as to claim that the SWRCB had *no* regulatory authority over water right holders who did not hold their rights pursuant to state-issued permits and licenses. (Reporter's Transcript Hearing on Writ of Mandamus (RT), p. 14:28 - p. 15:23 [italics added]; see Appendix 1199:2-3; 1200:9-10 [NCWA's brief asserting SWRCB has no authority over other types of water rights].)

The Court of Appeal *upheld* the allocation of the fees *among* the permit and license holders who pay annual fees. (Slip op., p. 43; see p. 36 [describing challenges to allocation as (1) between types of water right holders and (2) among permittees and licensees].)[2] Nor did the court find "that the State's justification for apportioning fees based upon the size of the diversion was 'without factual support.'" (NCWA Answer, p. 15 fn. 7, citing slip op., p. 42.) Again, the court had no problem with the method for apportionment *among* the feepayers: its problem was the allocation of the majority of program costs to the permit and license holders, as opposed to other water right holders. (Slip op., pp. 40-42.)

Finally, the Court of Appeal also rejected plaintiffs' argument that the statute allowed the SWRCB to collect more than the estimated cost of the regulatory program. (Slip op., pp. 34-35.) It did *not* find that "Respondents failed to present any evidence about either the estimated or actual cost of the regulatory program." (NCWA Answer, p. 9.)

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[2] The Court of Appeal identified the allocation of fees between one-time filing fees and annual fees as a problem to underscore its conclusion that those who do not hold their water rights subject to the permit and license system do not pay annual permit and license fees. (Slip op., p. 40 ["holders of water rights representing 40 percent of California's water . . . subsidized the cost of processing certain applications and petitions"].) In any event, the argument that those who pay annual fees subsidize those who pay one-time fees ignores the fact that annual fees and one-time fees are two different ways of allocating costs among the same general category of persons: the permit and license holders. (See Wat. Code, § 1525, subd. (b)(3)-(5).) Similarly, a water right applicant will be paying an annual permit fee once the permit is approved.

II. NCWA agrees that the Court of Appeal applied a less deferential standard of review to the SWRCB's regulations but claims it was proper because this is a constitutional challenge.

NCWA claims Respondents "argue that the Court of Appeal should have jettisoned this venerable standard [i.e., that a question of law is "subject to independent review"] and deferred to the SWRCB's determination that the regulations [are constitutional]." (NCWA Answer, p. 12.) Again, NCWA misconstrues the State's position. The State would never contend that it has the right to determine the legal question of whether the regulations are constitutional. The State merely claims it has the right to make the quasi-legislative determination of how best to allocate the fees, and to have the factual determinations and policy judgments it made in deciding on that allocation reviewed in accordance with the deferential standard of review that applies to quasi-legislative actions.

NCWA's Answer illustrates the reason this case warrants the Court's review: to determine whether courts are authorized to substitute their own independent judgment for the quasi-legislative judgment of the regulatory agency in deciding how best to allocate costs among regulated parties. NCWA claims that because this is a constitutional challenge, the courts would be "hamstrung" if they had "to accept all of an agency's findings and 'policy determinations' as valid. . . ." (NCWA Answer, p. 14.) But NCWA ignores *20th Century Ins. Co. et al. v. Garamendi* (1994) 8 Cal.4th 216, which states that when a court is reviewing the findings and exercise of discretion of an administrative agency, it does not re-weigh these matters for itself simply because the ultimate issue is a legal one, even if it is a question of constitutional dimension. (*Id.*

at p. 278, fn. 13.)

Deference to quasi-legislative decisions is a fundamental aspect of the constitutional doctrine of separation of powers. (See *Western States Petroleum Assoc. v. Superior Court (California Air Resources Bd.)* (1995) 9 Cal.4th 559, 572 (*WSPA*).) For a court to review the evidence without any deference to the determinations made by the administrative agency as part of the rulemaking proceedings would make allocation of regulatory fees as much a judicial function as a legislative one. As this Court explained in *20th Century Ins. Co. v. Garamendi, supra,* 8 Cal.4th 216, such judicial encroachments on legislative and executive functions were abandoned long ago:

> To a greater or lesser degree, [the regulated industry's] discussion is animated by *Lochner v. New York* (1905) 198 U.S. 45 [49 L.Ed. 937, 25 S.Ct. 539], and its ancestors and progeny. That line, however, is long since dead. Contrary to what appears to be their belief, "[t]he day is gone when" courts could "use [] the Due Process Clause of the Fourteenth Amendment"—or any other provision of the United States Constitution—"to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought." (*Williamson v. Lee Optical Co.* (1955) 348 U.S. 483, 488.)

(*20th Century Ins. Co. v. Garamendi*, *supra*, 8 Cal.4th at p. 278.) Fee payers are entitled to challenge the validity of the SWRCB's regulations, but only by challenging the rulemaking decisions that set the regulations in place, not by asking the courts to substitute their judgment for that of the administrative agency.

The fact that the issues are of constitutional dimension does not change the standard of review. As in any case, the SWRCB's interpretation of constitutional

and statutory law should be reviewed under the "independent judgment" standard of review. (See *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 11, fn. 4.) However, this standard does not permit the court to second-guess the SWRCB's findings of fact and policy considerations.

This court already rejected -- in *20th Century Ins. Co. v. Garamendi* -- the position that whenever a regulation is challenged on constitutional grounds the "independent judgment" standard of review applies. The court recognized that *any* regulation can be challenged on constitutional grounds. Thus, to apply the independent judgment standard of review because the case involves constitutional issues would create an exception that swallows the rule:

> The [claimants] may be understood to argue that the independent-judgment-on-the-evidence standard is applicable . . . on the ground that the regulations in question implicate the United States and/or California Constitutions. *An argument of this sort would allow the rule of arbitrary-or-capricious review to be swallowed up by a purported "exception."* That is because *all* regulations involve the federal and/or state charters, at least to some degree.

(*Id.*, 8 Cal.4th at p. 279, fn. 13 [italics added].) Part of the agency's normal rulemaking function is to make findings of fact. Consequently, both the *process* of finding the facts and the *findings themselves* must be considered "quasi-legislative" and given deference accordingly. (*Id.*, 8 Cal.4th at pp. 278-279.) It does not matter that the agency's findings may have a bearing on constitutional issues.

The Supreme Court's reasoning in *20th Century Ins. Co. v. Garamendi* applies with full force in the context of regulatory fees. Any action challenging a tax or

fee regulations can assert constitutional issues such as substantive due process and equal protection. And any fee regulation can be challenged under Proposition 13. Thus, to accept the position that the presence of constitutional issues requires the "independent judgment" standard of review would mean that *every* challenge to a tax or fee regulation could be drafted in a way that requires the court to second-guess the agency's quasi-legislative rulemaking decision.

There is no question here that plaintiffs challenged the quasi-legislative rulemaking decisions of the SWRCB. Both NCWA and the Farm Bureau challenged the allocation established by the regulations themselves: "The parties agreed to bifurcate the factual issues involved with the individual [NCWA Petitioners] and proceed on the question of whether the statutes and regulations at issue are unconstitutional or unlawful and whether the [SWRCB] otherwise abused its discretion in adopting the regulations." (Appendix 3379:13-18.) "In this matter, plaintiffs/petitioners have mounted a broad-based challenge to the system of fees respondent enacted pursuant to Water Code section 1525." (Appendix 3393:16-17.) Both NCWA and the Farm Bureau present a purely facial challenge to the regulations.

It makes no difference that this is a suit for refund under a Proposition 13 challenge. Where a suit for refund relies on a challenge to a quasi-legislative decision, the courts consistently apply the "abuse of discretion" standard of review. In *Wallace Berrie & Co. v. State Bd. of Equalization* (1985) 40 Cal.3d 60, the Supreme Court considered a facial challenge to a regulation in the context of a suit for refund of sales taxes. The court held that because the plaintiff challenged "the validity of the

regulation itself, the proper standard of review is whether [the regulation] is arbitrary, capricious, or without rational basis." (*Id.*, 40 Cal.3d at pp. 65-66.)

Other refund cases follow the same approach. (See, e.g., *Aerospace Corporation v. State Bd. of Equalization* (1990) 218 Cal.App.3d 1300 [sales tax regulation found invalid under "arbitrary and capricious" standard of review because inconsistent with relevant law]; *General Business Systems, Inc. v. State Bd. of Equalization* (1984) 162 Cal.App.3d 50, 54-55 [regulation challenged as extending sales tax law beyond Legislature's intent; "arbitrary and capricious" standard of review held to apply]; *Henry's Restaurants of Pomona, Inc. v. State Bd. of Equalization* (1973) 30 Cal.App.3d 1009, 1020-1021 [suit for refund of sales taxes based on constitutional grounds; court affirmed validity of statute and regulation under "arbitrary and capricious" standard of review]; see also, *Yahama Corp. of America v. State Bd. of Equalization, supra,* 19 Cal.4th at pp. 7-8 [in suit for refund, agency's "annotations" analyzing tax consequences of various transactions do not constitute quasi-legislative decisions and are not entitled to the same deference as formal regulations].)

For a court to exempt a suit for refund under Proposition 13 from the "abuse of discretion" standard of judicial review would mean that quasi-legislative decisions are treated differently in the area of fees than in the area of taxes, or any other area of the law. Regulations regarding taxes and fees are entitled to as much deference as any other kind of regulation. The Court of Appeal's decision would deprive them of that deference.

Reviewing the regulations without any regard to their dignity as quasi-legislative decisions would elevate fee payers to the status of a "protected class," or treat the tax restrictions imposed by Proposition 13 like a "fundamental right." But a party's reliance on Proposition 13 to challenge a regulatory fee does not call for heightened constitutional scrutiny. Proposition 13 is merely one part of the California Constitution, and it does not override constitutional principles of separation of powers.

III. The State has not "conflated" federal and state law.

The Court of Appeal conflated federal and state law when it found that the state could impose fees only to the extent of the value of the property interest held by the contractors. (Slip op., pp. 47, 50.) Such a fee would not be a regulatory fee.

Federal law provides that the tax or fee must not be assessed on the federal government's use or interest, but on the *contractor's use or interest.* The water right fees are not a tax on the value of the federal property, or even the value of the contractor's property.

The permits and licenses held for the Central Valley Project (CVP) are held to support contract deliveries. The United States Bureau of Reclamation (Bureau) diverts, stores and delivers water under contract for the benefit of the Bureau contractors. (E.g., Appendix 2722 [example of contract provided by NCWA petitioners].) The fees are based on a fair allocation of the cost of the regulatory program that enables the contractors to take delivery of water under those permits and licenses.

Therefore, in the face of the United States' refusal to pay, the SWRCB chose the statutory option of allocating the fees to the federal contractors. (Wat. Code, §§ 1540, 1560, subd. (b)(2).) The SWRCB determined that the annual fees (subject to a discount of 50 percent for permits for hydropower)[3] could be allocated to the federal contractors based on the benefits they received from the regulation: i.e., their "contractual interest" is equal to the discounted face value of the federal permits and licenses related to their contracts. (Cal. Code Regs., tit. 23, § 1073; *id.*, § 1071, subd. (a)(2); see Appendix 2223:15 - 2226:5 [explaining the fee calculation]; 2549 [issue paper explaining fee calculation and exploring alternatives]; 2307 [explaining the discount].) This *is* their "segregated"[4] interest.

The SWRCB could choose to place the regulatory fee on either the United States or the contractor. A direct regulatory relationship with the Bureau's contractors is unnecessary to uphold the fees as valid regulatory fees. (*Sinclair, supra*, 15 Cal.4th at p. 877 [no need for regulatory relationship with paint producers to impose regulatory fees to support mitigation of the effects of their past activities]; *Kern County Farm Bureau v. County of Kern* (1993) 19 Cal.App.4th 1416 [no requirement that assessment be applied only to the landfill operator]; Appendix 2817-2819 [86 Ops.

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[3] Under federal reclamation law, power generation is incidental. Power is used to support project water deliveries, and "surplus" power in excess of that needed for deliveries is used to repay the cost of the project. (43 U.S.C. § 522; see *Burley Irr. Dist. v. Ickes* (D.C. Cir. 1940) 116 F.2d 529, 530-531.)

[4] It should be noted also that the contractors do not pay the one-time filing fees related to the Bureau's permits and licenses.

Cal.Atty. Gen. 176 (2003) providing that city may shift burden of annual business license fee to cover costs in processing license application and inspection of vendor's premises from the individual swap meet vendor to the swap meet operator].)

CONCLUSION

For the foregoing reasons, and for the reasons stated in Respondents' Petition for Review, the State urges this Court to grant its Petition for Review.

Dated: March 22, 2007

Respectfully submitted,

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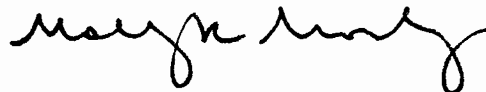

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CERTIFICATION OF WORD COUNT

The text of the State's Reply to NCWA's Answer to Respondents' Petition for Review consists of 3,441 words according to the word processing program used to prepare the brief.

Dated: March 22, 2007

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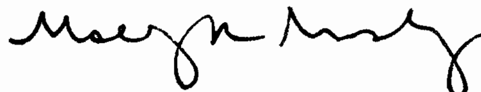

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DECLARATION OF SERVICE BY OVERNIGHT COURIER AND HAND-DELIVERY

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No.: **S 150518**

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I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on March 23, 2007, at Sacramento, California.

D. Burgess
Declarant

Signature