LAO

The 2013-14 Budget:

Analysis of Governor's Proposition 39 Proposal

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Summary

Governor's Proposal. The Governor's 2013-14 budget includes a plan to implement the provisions of Proposition 39, which increases state corporate tax (CT) revenues and requires that half of these revenues for a five-year period be used for energy efficiency and alternative energy projects. The Governor proposes to count all associated revenues toward the Proposition 98 minimum guarantee for schools and community colleges. The Governor also proposes to designate all energy-related Proposition 39 funds to schools ($400.5 million) and community colleges ($49.5 million) in 2013-14 and for the following four years. The proposal provides this funding to the California Department of Education (CDE) and the California Community Colleges (CCC) Chancellor's Office to distribute on a per-student basis.

Proposal Raises Serious Concerns. The Governor's proposal to count all Proposition 39 revenues toward the Proposition 98 calculation is a significant departure from our longstanding view that revenues are to be excluded from the Proposition 98 calculation if the Legislature cannot use them for general purposes. In addition, the proposal excludes other eligible projects besides schools and community colleges (such as public hospitals) that potentially could achieve greater energy benefits. The proposed per-student allocation method also limits potential project benefits even among schools and community colleges. Further, the proposal does not coordinate Proposition 39 funding with the state's existing energy efficiency programs.

LAO Alternative. In view of the above concerns, we recommend the Legislature exclude from the Proposition 98 calculation all Proposition 39 revenues required to be used on energy-related projects and not count spending from these revenues as Proposition 98 expenditures. In addition, we recommend the Legislature direct the California Energy Commission (CEC) to administer a competitive grant process in which all public agencies, including schools and community colleges, could apply and receive funding based on identified facility needs. If the Legislature determined all Proposition 39 energy funding could be used for schools and community colleges, our basic approach of running a competitive grant program through CEC still could be used to better optimize benefits.

INTRODUCTION

The Governor's budget for 2013-14 includes a proposed plan to implement the provisions of Proposition 39. Passed by the voters in November 2012, this measure increases state CT revenues and requires for a five-year period, starting in 2013-14, that a portion of these revenues be used to improve energy efficiency and expand the use of alternative energy in public schools, colleges, universities, and other public buildings. In this brief, we (1) provide an overview of Proposition 39 and its requirements, (2) describe the Governor's proposed treatment of Proposition 39 revenues and the proposed allocation of such revenues, (3) raise many serious concerns with the Governor's approach, and (4) offer an alternative approach that addresses these concerns. (An education-focused version of this analysis is included in our report, *The 2013-14 Budget: Proposition 98 Education Analysis*.)

BACKGROUND

Existing State Energy Efficiency and Alternative Energy Programs. In general, energy efficiency refers to the installation of energy-efficient technologies or measures that are designed to reduce energy usage and eliminate energy losses in buildings. Thus, energy efficiency incentive programs aim to reduce energy usage while maintaining a comparable level of service, thereby saving energy consumers money on their utility bills. In comparison, alternative energy refers to energy that comes from "renewable" sources—meaning sources that are not finite and do not use up natural resources like more traditional forms of energy that rely on fossil fuels. Currently, California maintains over a dozen major programs that are intended to support the development of energy efficiency and alternative energy in the state. Over the past 10 to 15 years, the state has spent a combined total of roughly $15 billion on such efforts. (For a more detailed description of these programs, please see our recent report, *Energy Efficiency and Alternative Energy Programs*.)

Most Programs Maintained by CEC and California Public Utilities Commission (CPUC). The various energy efficiency and alternative energy programs are administered by multiple state departments, including CEC and CPUC. Energy efficiency upgrades and retrofits have been supported through programs at the CEC (such as Bright Schools and the Energy Conservation Program), as well as through programs directed by the CPUC and administered by the state's investor-owned utilities (IOUs). Funding from these programs have been allocated to various entities, including many schools and community college districts. In determining which specific projects to fund, the CEC and the IOUs provide energy audits to evaluate what types of upgrades would result in the most cost-effective energy savings. These programs also provide financing options for these upgrades.

Proposition 39 Raises Additional State Revenues and Designates Half for Energy Projects. Proposition 39 requires most multistate businesses to determine their California taxable income using a single sales factor method. (Previously, state law allowed such businesses to pick one of two different methods to determine the amount of taxable income associated with California and taxable by the state.) This change has the effect of increasing state CT revenue. For a five-year period (2013-14 through 2017-18), the proposition requires that half of the annual revenue raised from the measure—up to $550 million—be transferred to a new Clean Energy Job Creation Fund to support projects intended to improve energy efficiency and expand the use of alternative energy. Specifically, the measure requires that such funds maximize energy and job benefits by supporting (1) eligible projects at public schools, colleges, universities, and other public buildings and (2) public-private partnerships and workforce training related to energy efficiency and alternative energy. Proposition 39 also requires that funded programs be coordinated with the CEC and CPUC in order to avoid duplication and leverage existing energy efficiency and alternative energy efforts. In addition, the proposition states that the funding is to be appropriated only to agencies with established expertise in managing energy projects and programs.

Proposition 39 Affects School Funding by Raising Proposition 98 Minimum Guarantee. Proposition 98, passed by voters in 1988 and modified in 1990, requires a minimum level of state and local funding each year for school districts and community colleges. This funding level is commonly known as the Proposition 98 minimum guarantee. Though the Legislature can suspend the guarantee and fund at a lower level, it typically decides to provide funding equal to or greater than the guarantee. The Proposition 98 guarantee can grow with increases in state General Fund revenues (including those collected from state corporate income taxes). Accordingly, the revenues raised by Proposition 39 can affect the state's Proposition 98 funding requirements.

GOVERNOR'S PROPOSITION 39 BUDGET PROPOSAL

The Governor's budget for 2013-14 reflects an increase in state CT revenues resulting from the passage of Proposition 39 and proposes to allocate *all* of the proposition's energy-related funding to school districts and community college districts.

Counts All Proposition 39 Revenue to Proposition 98 Calculation. The administration projects that Proposition 39 will increase state revenue by $440 million in 2012-13 and $900 million in 2013-14. The Governor's budget plan includes all revenue raised by Proposition 39 in the Proposition 98 calculations, which has the effect of increasing the minimum guarantee by $426 million in 2012-13 and an additional $94 million (for a total increase of $520 million) in 2013-14. In both 2012-13 and 2013-14, the Governor proposes to fund Proposition 98 at his estimate of the minimum guarantee.

Designates All $450 Million for School and Community College Energy Efficiency Projects. The Governor proposes to allocate all Proposition 39 energy-related funding over the next five years exclusively to school districts and community college districts ($450 million in 2013-14 and an estimated $550 million annually for the next four years). For 2013-14, the Governor's budget proposes to provide school districts with $400.5 million and community college districts with $49.5 million. The Governor proposes to classify this spending as Proposition 98 expenditures that count toward meeting the minimum guarantee. The administration proposes to appropriate the funding for school districts to CDE and the funding for community colleges to the CCC Chancellor's Office. The budget also proposes to provide CDE with one permanent position ($109,000) to help implement and oversee the Proposition 39 program. The Governor proposes no additional positions for the CCC Chancellor's Office for the administration of Proposition 39.

Allocates Funds on Per-Student Basis. The administration's proposal would require that CDE and the Chancellor's Office allocate funding to districts on a per-student basis. In 2013-14, school districts and community college districts would receive $67 and $45 per student, respectively. The CDE and Chancellor's Office would issue guidelines for prioritizing the use of the funds. The administration notes that CDE and the Chancellor's Office could consult with CEC and CPUC in developing these guidelines. Upon project completion, school districts and community college districts would report their project expenditure information to CDE and the Chancellor's Office, respectively.

SERIOUS CONCERNS WITH GOVERNOR'S PROPOSAL

In reviewing the Governor's proposed treatment of Proposition 39 revenues and proposed expenditure of such revenues, we identified many serious concerns that merit legislative consideration. Figure 1 summarizes these concerns, which we discuss in more detail below.

Questionable Treatment of Proposition 39 Revenues

Varies Significantly From Our Longstanding View of Proposition 98. The Governor applies all revenue raised by Proposition 39—including the revenue required to be spent on energy-related projects—toward the Proposition 98 calculation. This is a serious departure from our longstanding view of how revenues are to be treated for the purposes of Proposition 98, which we have developed over many years with guidance from Legislative Counsel. It also is directly contrary to what the voters were told in the official voter guide as to how the revenues would be treated. Based on our view, revenues are to be excluded from the Proposition 98 calculation if the Legislature cannot use them for general purposes—typically due to restrictions created by a voter-approved initiative or constitutional amendment. The voter guide reflected this longstanding interpretation by indicating that funds required to be used for energy-related projects would be excluded from the Proposition 98 calculation. Had the Governor used

Figure 1

LAO Concerns With Governor's Proposition 39 Proposal

✓ **Questionable Treatment of Proposition 39 Revenues**
- Varies from our longstanding view of Proposition 98.
- Could lead to greater manipulation of the minimum guarantee.

✓ **Governor's Proposed Allocation Method Limits Benefits**
- Excludes many eligible projects.
- Fails to account for energy consumption differences.
- Fails to sufficiently leverage existing programs and experience.
- Does not account for significant past investments in K-14 facilities.
- May not guarantee return on investment.
- Allocates funding inefficiently.

the approach described in the voter guide, the minimum guarantee would be roughly $260 million lower in 2013-14 than the amount specified in his budget proposal. (This approach would have no effect on the calculation of the 2012-13 minimum guarantee.)

Could Lead to Greater Manipulation of the Minimum Guarantee. The Governor's approach assumes that all tax revenues deposited directly into the General Fund must be included in the Proposition 98 calculation, whereas any tax revenues deposited directly into a special fund must be excluded from the calculation. This approach easily could result in greater manipulation of the Proposition 98 minimum guarantee. The state could, for example, require that all sales tax revenues be deposited directly into a special fund rather than the General Fund, thereby excluding the revenues from the Proposition 98 calculation. These types of accounting shifts could undermine the meaningfulness of the guarantee and render it effectively useless in setting a minimum funding requirement for schools and community colleges. By focusing on allowable uses of funds, not whether the funds were deposited into this or that account, our view would prevent such manipulation. Under our view, revenues are excluded from the Proposition 98 calculation only if they are clearly removed from the Legislature's control (typically by constitutional or voter-approved action).

Governor's Proposed Allocation Method Limits Benefits

Excludes Many Eligible Projects. By dedicating all of the Proposition 39 energy-related funding over the five-year period to school districts and community college districts, the Governor's approach excludes consideration of other eligible projects that potentially could achieve a greater level of energy benefits. For example, large public hospitals that operate 24 hours a day, 7 days a week generally have a relatively large energy load. In contrast, schools are typically open for only part of the day and generally either closed or partially closed in the summer months.

Fails to Account for Energy Consumption Differences. A building's energy consumption is largely affected by the climate in which it is located. For example, facilities located in cold climates will use more energy for heating, while facilities located in temperate climates generally use less energy for heating and cooling. These climate differences significantly impact what types of energy efficiency retrofits and upgrades will be most effective at reducing a particular facility's energy consumption. All other factors being equal, conducting an energy efficiency upgrade on a facility that requires relatively more energy (versus a facility that uses less energy) will result in greater energy benefits. In addition, the size, design, and age of a facility affects its energy consumption. By providing funding to every school district and community college district on a per-student basis, the Governor's proposal ignores these important factors and effectively limits the potential energy benefits that otherwise could be achieved with the Proposition 39 funding.

Fails to Sufficiently Leverage Existing Programs and Experience. As previously indicated, Proposition 39 requires that monies from the Clean Energy Job Creation Fund be used in a manner that leverages existing energy efficiency efforts and expertise. The Governor's approach, however, would not take advantage of the state's existing knowledge and administrative infrastructure regarding energy efficiency. For example, many of the state's energy efficiency programs include some evaluation of a facility's energy usage (such as from the energy audits that are provided through CEC and the IOUs) to ensure that the most cost-effective energy savings are funded. In addition, because the proposed budget would appropriate the funding to CDE and the Chancellor's Office, the Governor's proposal might not meet Proposition 39's requirement that monies from the Clean Energy Job Creation Fund be appropriated only to agencies with established expertise in managing energy projects and programs. As a result of not coordinating Proposition 39 funding with the state's other energy efficiency activities and not appropriating the funding to agencies with established expertise, the Governor's approach makes comparing effectiveness across programs and evaluating the relative benefits of projects from a statewide basis difficult. (As we discussed in our recent report on energy efficiency and alternative energy programs, it is important for the state to have a comprehensive strategy for meeting its energy efficiency and alternative energy objectives.)

Does Not Account for Significant Past Investments in K-14 Facilities. Since 2002, voters have approved about $29 billion in state bonds and about $71 billion in local bonds for school facilities. Nearly all of the state bonds (and likely most of the local bonds) relate to new construction and modernization, with about $100 million of the state bonds specifically dedicated to green schools. During the same time, voters have approved about $3 billion in state bonds and about $24 billion in local bonds for facility improvements at the state's community colleges. In addition, many schools and community colleges have received funding from the energy efficiency programs administered by CEC and the state's IOUs. As a result of the decade-long $127 billion investment in K-14 facilities, as well as these other energy-specific programs, many school and community college buildings throughout the state have been newly built or modernized. As the state's building codes incorporate a large number of energy efficiency provisions, many of these facilities are already very energy efficient. The Governor's proposal, however, does not take into account the above state and local investments in energy-efficient facilities when allocating the Proposition 39 funds.

May Not Guarantee Return on Investment. Proposition 39 requires that the total benefits of each project be greater than total costs over time. For energy efficiency projects, it can take several years before enough energy savings accumulate to offset the upfront investment. For example, replacing an outdated heating and cooling system with an energy-efficient model would likely require a significant upfront investment and take several years for the project's savings to outweigh this investment. Under the Governor's proposal, it is unclear what requirements would be put in place to ensure that facilities upgraded with Proposition 39 funds remain in use long enough for the benefits to outweigh the costs. This is a particular concern for the nearly half of school districts with declining enrollment. Given the corresponding reductions in need for space, these districts might close or sell facilities that had been improved with Proposition 39 funds prior to a project's benefits outweighing its costs.

Allocates Funding Inefficiently. By distributing funding to districts on an annual, per-student basis, the Governor's approach likely would result in some school districts lacking enough funding to implement major energy-efficiency improvements in the first year of the program. For example, under the proposal, a small school district having 100 students would receive $6,700 in Proposition 39 funds in 2013-14. Such a small sum is unlikely to be sufficient to undertake comprehensive improvements for a facility. Given that the state has many small school districts (about 10 percent of districts have fewer than 100 students), this problem would be notable. To mitigate this concern, the Governor indicates that districts could carry over funding throughout the program's five-year life to increase the total resources available for a project. This approach, however, would result in funds potentially remaining idle for several years instead of being used in a way that would immediately begin to achieve benefits.

LAO ALTERNATIVE

In view of the above concerns, we recommend an alternative treatment of Proposition 39 revenues for purposes of calculating the Proposition 98 minimum guarantee. In addition, we outline a specific set of recommendations that would help maximize the potential benefits of this new funding.

Exclude Energy-Related Funding From Proposition 98 Minimum Guarantee. Consistent with our view of how revenues are to be treated for the purposes of calculating the minimum guarantee, we recommend the Legislature exclude from the Proposition 98 calculation all Proposition 39 revenues required to be used on energy-related projects. Based on the administration's revenue estimates, this approach would reduce the minimum guarantee by roughly $260 million. In addition, we recommend the Legislature reclassify the $450 million to be spent on energy-related projects as a non-Proposition 98 expenditure (though the state still could choose to spend these monies on schools and community colleges).

Alternative Increases Proposition 98 Operational Support by $190 Million. As Figure 2 shows, adopting our recommended approach would result in $190 million in additional operational Proposition 98 support for schools and community colleges. This amount is the net effect of two factors. On the one hand, by excluding some Proposition 39 revenue from the Proposition 98 calculation, the minimum guarantee falls by $260 million in 2013-14. On the other hand, by not using Proposition 98 funding for school energy projects, spending falls by $450 million relative to the Governor's budget plan. Thus, maintaining spending at the revised minimum guarantee would result in an additional $190 million in operational funding. Under this approach, the $450 million still needs to be used for energy-related projects, and it could be used for schools and community colleges to the extent the basic provisions of Proposition 39

Figure 2

Fiscal Effects of LAO Approach

(In Millions)

	Governor	LAO	Difference
Proposition 98 Funding:			
Operational funding for schools and community colleges	$55,750	$55,940	$190
Energy project funding, only schools and community colleges	450	—	-450
Subtotals, Proposition 98	($56,200)	($55,940)	(-$260)
Non-Proposition 98 Funding:			
Energy project funding, all allowable projects including schools and community colleges	—	$450	$450
Total Spending	**$56,200**	**$56,390**	**$190**

are met. From the state's perspective, this approach increases total state costs by $190 million and, thus, could result in reduced spending on non-Proposition 98 General Fund programs.

Process for Allocating Funding Should Maximize Benefits. In order to ensure that the state meets the requirements of Proposition 39 and maximizes energy and job benefits, we recommend the Legislature adopt a different approach than that proposed by the Governor. Specifically, we recommend that it:

- ***Designate CEC as Lead Agency for Proposition 39 Energy Funds.*** We recommend the Legislature designate the CEC (whose primary responsibility is energy planning) as the lead agency for administering—in consultation with the CPUC and other experienced entities—the clean energy funds authorized in Proposition 39. This would help ensure that the relative benefits of each project can be considered from a statewide perspective.

- ***Use Competitive Grant Process Open to All Public Agencies.*** We also recommend that the Legislature direct CEC to develop and implement a competitive grant process in which *all* public agencies could apply for Proposition 39 funding on a project-by-project basis. In order to ensure that the state maximizes energy benefits, this competitive process should consider and weigh all factors that affect energy consumption. The CEC could create a tiered system that categorizes facilities based on a high-, medium-, and low-energy intensity or need. Based on that categorization, funding should be provided to facilities with the greatest relative need in coordination with other existing energy efficiency programs.

- ***Require Applicants to Provide Certain Energy-Related Information.*** In order to qualify for grant funding and assist CEC in evaluating potential projects, we recommend that applicants first have an energy audit to identify the cost-effective energy efficiency upgrades that could be made, similar to the types of audits currently provided through CEC and the IOUs. As part of the application, facilities should also provide information regarding the climate zone, size, design, and age of a building.

We recognize that there may be legislative interest to allocate all or a portion of the Proposition 39 energy funding to specifically support energy efficiency projects at schools and community colleges. To the extent that the Legislature chooses to prioritize such projects, we believe that our recommended process would be a more effective approach in meeting the goals of Proposition 39 than allocating funds to school districts and community college districts on a per-student basis as proposed by the Governor.

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