

Date of Hearing: May 1, 2024

ASSEMBLY COMMITTEE ON LOCAL GOVERNMENT

Juan Carrillo, Chair

AB 2457 (McCarty) – As Amended April 3, 2024

SUBJECT: Sacramento Municipal Utility District: nonstock security.

SUMMARY: Extends the sunset date of the Sacramento Municipal Utility District's (SMUDs) existing nonstock security program and removes the limit on the number of acquisitions SMUD can make under this program. Specifically, **this bill:**

- 1) Extends the sunset date of SMUDs nonstock security program until January 1, 2035.
- 2) Deletes the program's limit of three acquisitions.
- 3) Authorizes the board of directors of SMUD to also hold nonstock security in a corporation or other private entity as full or partial consideration for providing that entity services or access to district facilities.
- 4) Makes numerous technical changes.
- 5) Finds and declares that a special statute is necessary and that a general statute cannot be made applicable because of the unique needs of SMUD regarding nonstock security interests in private entities with which the district partners to further its purposes.

EXISTING LAW:

- 1) Authorizes local officials to invest a portion of local agencies' temporarily idle funds in a variety of financial instruments, including securities [Government Code (GC) §§ 53600-53610]
- 2) Defines security to include a variety of tools including stocks and nonstock securities, such as certificates of deposit or certificates of interest or participation in any profit-sharing agreement (Corporations Code § 25019).
- 3) Prevents the Legislature from authorizing the state or local agencies from holding stock in a corporation, but provides limited exceptions for irrigation districts, public agencies that join together to process workers' compensation claims, unemployment compensation, tort liability, or insurance pooling arrangements (Section 6 of Article 16 of the California Constitution).
- 4) Authorizes, until January 1, 2025, SMUD to operate a pilot program under which the board of directors may hold nonstock security in a corporation or other private entity if acquired as part of procurement of goods or services from that entity, so long as no separate funding is expended solely for the nonstock security. The SMUD board of directors may sell or otherwise dispose of the nonstock security when, in its judgment, it is in the best interests of SMUD to do so. (GC § 12773).

FISCAL EFFECT: None.

COMMENTS:

- 1) **Bill Summary and Author's Statement.** This bill extends the sunset date of SMUDs existing nonstock security program until January 1, 2035, and removes the limit on the number of acquisitions SMUD can make under this program. SMUD is the sponsor of this bill.

According to the author, "SMUD has set a very ambitious goal to completely remove carbon emissions from its power supply by 2030 while keeping any rate increases below inflation. In order to achieve this goal and state-mandated clean energy targets, SMUD has been working with, and will continue to work with, innovative companies on technologies to fill gaps in the clean energy transition. Working with these companies and financially benefitting from it keeps SMUD rates low for its ratepayers. This means extending AB 689's authority will continue to help SMUD and the state reach its climate goals and benefit ratepayers."

- 2) **Local Governments and Securities.** A security is a term used to describe a variety of financial instruments, such as stocks, bonds, or other types of products that involve an investment of money with an expectation of a profit from the efforts of someone other than the investor. Generally, a company or government will issue a security to raise capital or funds. One prevalent type of security is the common stock, a type of equity security that represents ownership of the issuing company.

The California Constitution restricts a local agency's ability to directly own common stock. Article 16, Section 6 of the California Constitution explicitly prohibits the Legislature from authorizing the state or any political subdivision to subscribe for or become a stockholder in any corporation. However, there are limited exceptions, including provisions for irrigation districts, tort liability, and insurance pooling arrangements.

When investing, reinvesting, purchasing, acquiring, exchanging, selling, or managing public funds, state law outlines local agencies' investment objectives, also known as the prudent investor standard. The primary objective is to safeguard the principal of the funds under the local agency's control. The secondary objective is to meet the liquidity needs of the depositor. The final objective is to achieve a return on the funds under its control.

- 3) **AB 689 of 2019.** AB 689 (McCarty), Chapter 230, Statutes of 2019, authorized SMUD to operate a pilot project, until January 1, 2025, to hold nonstock securities in a corporation or other private entity if the utility acquires that security as part of a procurement of goods or services from that entity so long as it does not spend separate funding solely to acquire the security. SMUD can only make three acquisitions, and the value of any single acquisition cannot exceed 3% of SMUD's annual revenues.

Before finalizing an acquisition, the SMUD board must make findings demonstrating that the acquisition aligns with the district's purposes and is in the interest of its ratepayers. Additionally, SMUD is required to establish a policy outlining procedures, at a minimum, for:

- a) Preventing conflicts of interest.

- b) Specifying how much of an acquisition to accept in lieu of, or in addition to, other forms of compensation in order to ensure a reasonable return on investment.
 - c) Governing the approval process for these acquisitions.
 - d) Ensuring the acquisition of nonstock securities does not unduly influence the amount paid for goods and services.
- 4) **Warrants.** A stock warrant is an agreement between a company and a purchaser enabling the acquisition of shares at a predetermined price until a specified expiration date. Upon meeting the conditions outlined in the warrant agreement, the buyer gains the right to purchase the stocks at the agreed-upon "exercise price," irrespective of the stock's market value. The profitability of a stock warrant depends on whether it allows the investor to buy the stock below its current market price. A warrant is desirable for investors because they are not obligated to go through with the purchase.

Importantly, a stock warrant does not confer upon the warrant holder the same rights and privileges as a stockholder. A warrant holder cannot receive dividends and cannot vote as a shareholder. Instead, companies typically issue warrants to attract investors or incentivize third parties, such as SMUD, to engage in a strategic relationship or invest in the company's long-term viability.

- 5) **ESS Acquisition.** SMUD has completed one Pilot Program acquisition to date. As part of the collaboration between SMUD and ESS, self-described as a "long-duration energy storage" company, the two parties entered into a stock warrant agreement. In 2022, ESS issued a warrant for up to 500,000 shares of ESS common stock at an exercise price of \$4.296 a share, and the vesting of those shares will depend on the achievement of certain commercial milestones through December 31, 2030.¹ SMUD's agreement with ESS is unique because SMUD cannot legally exercise its right to purchase the shares. SMUD, barred by the California Constitution from owning stock of a private company, can only resell this warrant to another investor. Section 2.6 of the SMUD-ESS warrant agreement directly addresses this tension:

"The Company acknowledges that SMUD, a municipal utility district and political subdivision of the state California, is prohibited from subscribing for stock, or to becoming a stockholder in any corporation per Article XVI Section 6 of the California Constitution....Accordingly, the Company and SMUD agree that in no event shall SMUD be entitled to exercise any portion of this Warrant until such time as SMUD is entitled to hold stock securities without violating the Stock Prohibition and the Company shall not issue any Shares directly to SMUD. Nothing in this Section 2.7 shall limit SMUD's ability to assign and transfer this Warrant to another Holder pursuant to Sections 6.3 and 6.4 below or limit the ability of such subsequent Holder to exercise this Warrant."

- 6) **Policy Consideration.** AB 689 established the nonstock security program for SMUD and imposed a 5-year sunset date and an acquisition limit of three on the program. To date, SMUD has only completed one acquisition, and this bill would remove the acquisition

¹ <https://www.sec.gov/Archives/edgar/data/1819438/000162828023005933/ghw-20221231.htm>

limitation. While the sponsor has noted that future acquisitions are already in progress, is there enough information to determine whether the acquisition cap should be eliminated? The Committee may wish to consider if an acquisition cap should be reinstated until more information on SMUD's nonstock security program is available to the Legislature.

- 7) **Committee Amendment.** In order to respond to the policy consideration above, the Committee may wish to amend this bill as follows:

12773(d). ~~Any~~ **The authority described in subdivision (b) shall be limited to a total of six acquisitions.** Any profit or other gain earned by an acquisition shall be used to benefit the district's ratepayers.

- 8) **Arguments in Support.** SMUD, the sponsor of this bill, and a coalition of supporters proclaim that, "SMUD is the nation's sixth largest not-for-profit, community-owned electric utility, serving Sacramento country for over 75 years. SMUD has an aspirational goal to completely remove carbon from its portfolio by 2030. In order to meet SMUD's zero carbon goal, as well as the state's clean energy goals, substantial investment will be needed in new technologies, grid modernization, electric transportation, and related initiatives. New technological advances will be imperative to reaching their audacious goals, and SMUD will continue to partner with private sector companies to develop needed technologies. Monetization of SMUD's intellectual value that can be realized through a security interest in these companies is a prudent way for SMUD to help offset rate increases, bringing direct value back to our customers.

"AB 2457 will provide SMUD the ability to monetize its intellectual value and time spent with companies to help develop pioneering energy products, services, and programs that benefit SMUD customers, the Sacramento community, and the state. Given that SMUD will not pay for the nonstock equity and will not spend any money to exercise the nonstock equity, there is no additional risks or losses for SMUD if the company does not commercially succeed. There are only potential economic benefits if the partnering company succeeds. It is important to reiterate that SMUD will continue with these partnerships with or without this authority, as they need the innovative technologies and resources to meet their 2030 goal, as well as the state's clean energy goals.

"Allowing SMUD to participate in these deals helps promote the clean energy economy in California. Developing these new technologies with SMUD encourages these companies to build a presence here. This allows for compounding benefits from these arrangements, including new jobs and investment in the region.

"SMUD exercised this new authority by entering into an agreement with a long duration energy storage provider, and SMUD is currently negotiating an agreement in the medium and heavy duty zero emission vehicle space. SMUD has developed an extensive and public process for the acquisition review through SMUD's publicly-elected board of directors."

- 9) **Arguments in Opposition.** None on file.

10) **Double-Referral.** This bill was double-referred to the Assembly Banking and Finance Committee, where it passed on 8-0 vote on April 1, 2024.

REGISTERED SUPPORT / OPPOSITION:

Support

Sacramento Municipal Utility District [SPONSOR]
California Asian Pacific Chamber of Commerce
California Electric Transportation Coalition
California Municipal Utilities Association
California Special Districts Association
Elk Grove Chamber of Commerce
Natomas Chamber of Commerce
North Sacramento Chamber of Commerce
Rancho Cordova Chamber of Commerce
Sacramento Asian Pacific Chamber of Commerce
Sacramento Black Chamber of Commerce
Sacramento Hispanic Chamber of Commerce
Sacramento Metropolitan Chamber of Commerce
Slavic-American Chamber of Commerce

Opposition

None on file

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