

Date of Hearing: April 1, 2024

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Timothy Grayson, Chair

AB 2457 (McCarty) – As Introduced February 13, 2024

SUBJECT: Sacramento Municipal Utility District: nonstock security

SUMMARY: Makes permanent a temporary Sacramento Municipal Utility District (SMUD) program allowing SMUD to acquire a nonstock security interest in a corporation or private company under specified circumstances.

Specifically, **this bill:**

- 1) Removes the January 1, 2025, sunset date for statutory provisions authorizing SMUD to operate a pilot program (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.
- 2) Removes the Pilot Program's three-acquisition cap, thereby allowing the SMUD board to make more than three nonstock security acquisitions.
- 3) Makes other assorted technical and conforming changes.

EXISTING LAW:

- 1) Authorizes local officials to invest a portion of local agencies' temporarily idle funds in a variety of financial instruments, including securities.
- 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.
- 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 dispel of the nonstock security when, in its judgment, it is in the best interests of SMUD to do so. (Gov. Code Section 12773).

FISCAL EFFECT: Unknown. This bill is keyed Nonfiscal by Legislative Counsel.

COMMENTS:**1) Purpose**

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) Overview: Securities and limits on local governments

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.

Limitations on state and local agencies' ability to make certain types of investments serve several purposes. Firstly, these limitations prevent corruption, self-dealing, and situations where government officials may face conflicts of interest in decisions made on behalf of residents. Secondly, they can safeguard public funds, particularly in scenarios where investments may perform poorly.

3) Overview: SMUD Pilot Program

AB 689 (McCarty), Chapter 230, Statutes of 2019, authorizes SMUD, 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:

- Preventing conflicts of interest.

- 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.
- Governing the approval process for these acquisitions.
- Ensuring the acquisition of nonstock securities does not unduly influence the amount paid for goods and services.

The primary motivation behind the Pilot Program is to provide SMUD with additional opportunities to monetize its intellectual value and achieve a greater return on investment in the products and services it helps develop. In this way, the Pilot Program treats SMUD akin to a university or start-up incubator, supporting private enterprises in growing and entering the market.

Prior to AB 689's passage, SMUD had reported collaborating with private companies through contractual arrangements to develop new energy products, services, and programs, such as rooftop solar, energy storage, or data analytics. However, SMUD noted that the compensation methods for these arrangements, such as direct payments or royalty agreements, imposed limitations on SMUD's return and, in many cases, were impracticable or infeasible.

As of the publication of this analysis, SMUD has only completed one Pilot Program acquisition: In 2022, SMUD acquired a warrant for 500,000 shares of common stock at an exercise price of \$4.296 per share. Further details about the ESS agreement are provided in Staff Comment #4.

4) **Details of the ESS acquisition.**

a) **Overview.**

ESS describes itself as a "long-duration energy storage company specializing in iron flow battery technology" whose batteries provide flexibility to grid operators and energy assurance for commercial and industry customers.

In 2022, SMUD and ESS entered into an agreement for ESS to supply up to 2 GWh of long-duration energy storage over the next four years. Under the agreement, ESS will set up facilities for battery system assembly, operations, and maintenance support, and expand workforce training through the Center of Excellence. At the time of the deal, ESS was described by one media outlet as the "largest-ever US flow battery purchase."¹

As part of the collaboration between SMUD and ESS, the latter entered into a stock warrant agreement with SMUD. Under this agreement, 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, 2030.²

b) **How does a stock warrant work?**

¹ <https://www.canarymedia.com/articles/energy-storage/ess-inks-largest-ever-us-flow-battery-purchase-with-sacramentos-utility>

² <https://www.sec.gov/Archives/edgar/data/1819438/000162828023005933/ghw-20221231.htm>

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, and 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.

SMUD's agreement with ESS is unique because, as noted in Comment #2, 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 2.7 of the SMUD-ESS warrant agreement directly addresses this tension, specifying that nothing stops SMUD from assigning or transferring the warrant to another party:

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.

5) Support

SMUD, along with a coalition of economic development groups and chambers of commerce, write in support of AB 2457. The coalition letter states:

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.

6) Next steps and suggested amendments

A key question for committee members is whether the details of the ESS acquisition justifies making the Pilot Program a permanent authority for SMUD without further legislative review, as the current version of AB 2457 allows. The ESS acquisition is the only data point thus far, and even this lone data point is incomplete since SMUD has not sold the ESS warrant to another investor. Moreover, to the extent that SMUD acquires other variations of nonstock securities as part of these agreements, the specifics of those agreements may need additional review.

Due to the above considerations, the committee recommends a 10-year sunset, which extends the program rather than making it permanent. Additional legislative oversight over this authority is warranted, and a 10-year extension will give SMUD additional time and flexibility to pursue these agreements and provide additional evidence of their impact. Specifically, the committee recommends adding the following subdivision to Section 12773 of the Public Utilities Code:

(f) This section shall remain in effect only until January 1, 2035, and as of that date is repealed.

REGISTERED SUPPORT / OPPOSITION:

Support

California Asian Pacific Chamber of Commerce
 California Electric Transportation Coalition
 California Municipal Utilities Association (CMUA)
 California Special Districts Association
 Elk Grove Chamber of Commerce
 Natomas Chamber of Commerce
 North Sacramento Chamber of Commerce
 Rancho Cordova Area Chamber of Commerce
 Sacramento Asian Pacific Chamber of Commerce
 Sacramento Black Chamber of Commerce
 Sacramento Hispanic Chamber of Commerce
 Sacramento Metropolitan Chamber of Commerce
 Sacramento Municipal Utility District
 Slavic-american Chamber of Commerce

Opposition

None on file.

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