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FEATURE ARTICLE

REALLOCATIONS AND THE 'TAKINGS' OF WATER

By Ryan S. Bezerra

With declining Delta smelt populations, discussion has increased about reallocating water to support the Delta's resources. The Delta Vision Blue Ribbon Task Force's Recommendation No. 7—"A revitalized Delta ecosystem will require reduced diversions—or changes in patterns and timing of those diversions, upstream . . . —at critical times" (Delta Vision Blue Ribbon Task Force report (2007) p. 13 (Delta Vision)—sounds, to many water users, like proposed state control of all Sacramento-San Joaquin Delta (Delta) watershed diversions and reservoirs.

Such proposals, if implemented, would trigger demands for compensation by affected water users. The "takings" clauses of the U.S. and California Constitutions would govern such demands. (This article refers to these two clauses collectively as the takings clause.) The takings clause's application to water rights, however, is relatively uncertain. Since the U.S. Supreme Court revived takings law in *Penn Central Transportation Company v. New York City* (1978) 438 U.S. 104, the Court's distinction between "regulatory takings" and "physical takings" has become talismanic at times—the government generally wins in regulatory taking cases, while property owners win in physical taking cases—but this distinction applies only uncomfortably to water rights. This article sketches: (1) why the distinction is difficult to apply to water rights; (2) how *Lingle v. Chevron U.S.A.* (2005) 544 U.S. 528, and the light it sheds on prior decisions, may improve the situation; (3) how California water decisions can be understood in that light; and (4) the implications for reallocations of water.

Physical/Regulatory Distinction's Utility Is Diminished Outside a Real Property Context

The takings clause does not distinguish among types of property, so it applies to regulation of all properties. (*See*, *City of Oakland v. Oakland Raiders* (1982) 32 Cal.3d 60, 66-68.) In 1978 in *Penn Central*, the Court held that height limitations for landmark properties were not a taking, stating that takings cases involve "essentially ad hoc factual inquiries" in which several factors are important, including "the extent to which the regulation has interfered with distinct investment-backed expectations . . . ." Four years later, in *Loretto v. Teleprompter Manhattan CATV Company* (1982) 458 U.S. 419, the Court held that a government's physical imposition on property, no matter how small, is a compensable taking. Spurred by *Loretto*, landowners often assert that regulations are physical takings. (*See*, *Tahoe-Sierra Preservation Council et al. v. Tahoe Regional Planning Agency et al.* (2002) 535 U.S. 302.)

Penn Central and most later takings decisions have concerned what might be termed "strictly" real property—colloquially, dirt. (*See, e.g., Dolan v. City of Tigard* (1994) 512 U.S. 374.) The disconnect between the takings clause's generality and the Court's tight focus on strictly real property has resulted in a general rule—the physical/regulatory distinction—that is difficult to apply to some other types of properties.

A hypothetical about patents demonstrates the point. Patents are property. (*Florida Prepaid Postsecondary Education Expense Bd. v. College Savings Bank et al.* (1999) 527 U.S. 627, 642.) A key element of the patentee's property is the exclusive right to use the patented concept. (35 U.S.C. § 271, subds. (a), (c).) Assume that a state decides to make and sell a product that utilizes a patent without the patentee's permission. The patentee cannot sue for patent infringement because the federal courts have exclusive jurisdiction over such claims and the Eleventh Amendment closes them to such claims against states. (*Florida Prepaid*, 527 U.S., at 647-648; 28 U.S.C. § 1338, subd. (a).)

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Although the patentee could not obtain infringement damages, takings compensation would be available. (*Florida Prepaid*, 527 U.S. at 644 fn. 9.) What sort of taking would have occurred? It could not have been a physical taking because the state did not seize the patent itself, but it also has not regulated the patent's use. The state merely has destroyed the patentee's market. While the state's action could not be either a physical or a regulatory taking, it still must be compensable. States should not be able to scour patent files in order to poach the best ideas.

Patents and Water Rights

California water rights are similar to patents in important ways. Like patents, the most economically potent California water right—the appropriative surface water right—now can be acquired only through a detailed regulatory process. (*See*, 37 C.F.R. §§ 1.1-1.997; Wat. Code, §§ 1200-1851.) Patents and appropriative water rights also are subject to important judge-made law – the doctrine of equivalents for patents, the public trust doctrine for water rights. (*See Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.* (2002) 535 U.S. 722 (doctrine of equivalents); *National Audubon Society v. Superior Court* (1983) 33 Cal.3d 419 (public trust).) (The doctrine of equivalents extends a patent's preclusive effect to ideas equivalent to the patent, but outside its written terms. (*Festo*, 535 U.S., 731-733.)) Most importantly, like patents, water rights have no *corpus*. (*Eddy v. Simpson* (1853) 3 Cal. 249, 252.) If property lacks a *corpus*, the physical/regulatory distinction fits it at best only uncomfortably. It therefore is unsurprising that courts have struggled to apply that distinction to water rights.

In *Tulare Lake Water Storage District v. U.S.* (Ct. Cl. 2001) 49 Fed. Cl. 313, the Court of Claims held that Central Valley Project (CVP) contractors had suffered compensable takings when federal resource agencies mandated Delta-pumping reductions to protect smelt and salmon, holding that the reductions were physical takings. The court did not distinguish water rights themselves from contracts with water-right holders, an omission which has triggered criticism (see *Klamath Irr. Dist. v. U.S.*. (Ct. Cl. 2005) 67 Fed. Cl. 504, 538). *Tulare Lake* nonetheless recognized a key aspect of the relationship between appropriative water rights and takings law: "[A] mere restriction on use . . . eviscerates the right itself since plaintiffs' sole entitlement is to the use of the water."

In *Allegretti v. County of Imperial* (2006) 138 Cal. App.4th 1261, 1271-1281, the Court of Appeal held that a county-issued permit's 12,000 acre-foot annual limitation on groundwater pumping on a landowner's property was neither a physical nor a regulatory taking. The court, however, contradicted itself. In discussing U.S. Supreme Court decisions, the court said:

> our highest court has found a physical taking where the government diverted water for its own consumptive use or decreased the amounts of water accessible by the owner of the water rights." In calling *Tulare Lake* flawed, however, the court said that, in that case, "the government's passive restriction, which required the water users to leave water in the stream, did not constitute a physical invasion . . . .

Casitas Municipal Water District v. U.S. (Ct. Cl. 2007) 76 Fed. Cl. 100, concerned a takings claim based on increased instream-flow requirements mandated by the National Marine Fisheries Service. The Court of Claims held that regulatory-taking rules applied, but also stated:

> [T]hat which defendant labels simply as a passive restriction on use in reality amounts to a transfer of value through which plaintiff's right of use is diminished and the public right of use is simultaneously enlarged.

The difficulties in these cases illustrate the need to reexamine the U.S. Supreme Court's decisions for guidance concerning how takings law applies to water rights.

Lingle Points the Way

The U.S. Supreme Court often has fractured in post-*Penn Central* takings cases. (*See, e.g., Palazzolo v. Rhode Island* (2001) 533 U.S. 606.) The Court's unanimous 2005 *Lingle* decision thus was remarkable. The Court held that the lower courts had erred in deciding that Hawaii's gasoline-pricing statutes effectuated a taking because they would not achieve the state's purpose of reducing prices. The Court described the strands of its recent takings jurisprudence and then stated:

> Each aims to identify regulatory actions that are functionally equivalent to the classic taking in which government directly appropriates private property or ousts the owner from his domain.

(544 U.S. at 539-540.)

Lingle thus reconciled its regulatory-takings and physical-takings cases as reflecting the same fundamental concern, but it begs the question of what actions are "functionally equivalent" to governmental usurpations of property. The Court's takings decisions concerning California water rights—*Dugan v. Rank* (1963) 372 U.S. 609, and *U.S. v. Gerlach Live Stock Co.* (1950) 339 U.S. 725—are not instructive because they concerned the impoundment, and delivery to others, of water covered by riparian rights and thus involved actual usurpations of property, not their "functional equivalents." Three decisions that did not involve strictly real property, however, are very useful here: (1) *International Paper Co. v. U.S.* (1931) 282 U.S. 399; (2) *Kaiser Aetna v. U.S.* (1979) 444 U.S. 164; and (3) *Ruckelshaus v. Monsanto Co.* (1984) 467 U.S. 986.

In *International Paper*, the Court held that the U.S. had taken a paper company's right to divert water from a hydroelectric company's canal. During World War I, the government requisitioned all of the electricity that the hydroelectric company could generate using the canal's full capacity, preventing the paper company from using any water. (282 U.S. at 405-407.) Justice Holmes wrote for the Court:

> The petitioner's right was to the use of the water; and when all the water that it used was . . . turned elsewhere by government requisition . . . it is hard to see what more the Government could do to take the use.

Justice Holmes, however, did *not* cite *Pennsylvania Coal v. Mahon* (1922) 260 U.S. 393, the seminal regulatory taking decision, even though he wrote the majority opinions in both cases. The implication is that the Court did not consider *International Paper* to involve the same analysis as *Pennsylvania Coal*.

In *Kaiser Aetna*, the Court held that the U.S. Army Corps of Engineers (Corps) committed a taking when it asserted the federal navigational servitude to compel public access to a private marina that a landowner built in a lagoon that was private property under state law. (444 U.S. at 166-169, 178-180.) The Court emphasized that the landowner had relied on the Corps' pre-project acquiescence by investing in, and building, the marina and stated that one key, but non-controlling, factor was that public use would destroy "one of the most essential sticks in the bundle of [property] rights," the right to exclude others.

In *Ruckelshaus*, the Court held that the Environmental Protection Agency's (EPA) disclosures of trade secrets submitted during the statutory pesticide-licensing process sometimes were takings and sometimes not. (467 U.S. at 1013-1014.) The Court analyzed only the impact on the submitter's investment-backed expectations, holding that: (1) before 1972 statutory amendments, a submitter could not have expected the EPA to keep the trade secrets confidential, so disclosing information submitted before 1972 could not be a taking; (2) 1972 amendments allowed a submitter to submit trade secrets that the EPA would keep confidential in some circumstances, so the information's disclosure could be a taking; and (3) 1978 amendments guaranteed that the EPA would keep submitted information confidential for only a limited time, so the EPA's later disclosure of it would not be a taking. *Ruckelshaus* held that a trade secret's disclosure implicated the right to exclude, even though a trade secret cannot be physically occupied. (467 U.S. at 1011-1012.)

Lingle's Functional Equivalent Standard

These cases establish four principles for applying *Lingle*'s "functionally equivalent" standard to property interests that have no *corpus*. First, courts should analyze how a regulation impacts the unique aspects of the relevant property interest. In *International Paper* and *Ruckelshaus*, the Court found takings where the government had frustrated the property interests' key elements—the use of water in *International Paper* and the right to exclude in *Ruckelshaus*. Second, *Ruckelshaus* indicates that, a key element of any property right—the right to exclude—can be invaded without a physical occupation. Third, *Kaiser Aetna* and *Ruckelshaus* indicate that, once the government has allowed a party to create an asset through its investments, the agency may not require that the asset be turned to public use without paying compensation, even where the agency cites a public right like the navigational servitude. These decisions refute the argument that any action taken under such a public right, like the navigational servitude or the public

trust, is not a taking. (Accord *National Audubon*, 33 Cal.3d at 444 fn 22.) Fourth, the importance of the government's interest is largely irrelevant. Few governmental interests can equal fighting a world war, but *International Paper* still required the government to pay compensation.

These four principles may be crucial in takings cases involving California water rights, as the example of reservoir storage demonstrates. The State Water Resources Control Board (SWRCB) has broad discretion in issuing the initial permit (Wat. Code, §§ 1253, 1257), but, after the SWRCB issues the permit, the permittee's investments create the storage, which is valuable because it bridges the gap between wet and dry seasons. Because the permittee has an investment-backed expectation that it will control the storage that it created, the state generally cannot later order that the permittee devote that storage to public use—and thus infringe the permittee's rights to exclude others and to use the stored water—without paying compensation. This result is indicated by *International Paper*, *Kaiser Aetna* and *Ruckelshaus*, even though the state's order would not require a water user to open its reservoir to physical public use.

Economic Considerations Integrate Takings Law with State Water Law

California retains some ability to reallocate water resources, as decades of state water decisions indicate. Those decisions can be integrated with takings law by focusing on parties' investment-backed expectations. Two economic concepts are key here: opportunity costs and externalities. All economic transactions have opportunity costs because, once a transaction is completed, the affected resources cannot be devoted to other uses. (*See*, Tietenberg, *Environmental and Natural Resources Economics* (3rd ed. 1992) pp. 25-26.) A party's use of resources also may have impacts that it may not feel or that may not be apparent prospectively, which impacts economic theory identifies as externalities. (*See id.* at pp. 51-52.)

California decisions that have approved reallocations of water have addressed water uses' opportunity costs or externalities. In reviewing these decisions, it is important to remember that it is what courts do, not what they say, that counts because water decisions sometimes contain conflicting quotes. (*See*, *Brown v. Kelly Broadcasting Co.* (1989) 48 Cal.3d 711, 734-735.) For example, water users like this quote from *National Audubon*:

> Now that the economy and population centers of this state have developed in reliance upon appropriated water, it would be disingenuous to hold that such appropriations are . . . improper to the extent that they harm public trust uses . . . .

(33 Cal.3d at 446.) Environmental interests and the state prefer:

> The state . . . has the power to reconsider allocation decisions even though those decisions were made after due consideration of their effect on the public trust.

(*Id.* at p. 447.)

Rather than focusing on quotes, however, we should recognize that California public trust decisions address water uses' externalities. *National Audubon* involved obvious externalities: Los Angeles's diversions from Mono Lake's tributaries were damaging the lake's resources. In *Racanelli*, the court held that, while the SWRCB was required to set water quality standards to protect the Delta's beneficial uses, it could limit the CVP's and SWP's responsibility for maintaining those uses to those project's impacts. (*U.S. v. State Water Resources Control Bd.* (1986) 182 Cal.App.3d 82, 125-126, 129-130, 148-152.) In contrast, when the public trust was asserted to try to usurp the benefits of a water user's investments, the court denied the assertion. (*See Golden Feather Community Ass'n v. Thermalito Irr. Dist.* (1989) 209 Cal. App.3d 1276 (reservoir storage).)

Other trust cases help to segregate the trust's externality-control function from its other functions. In *State of California v. Superior Court (Fogerty)* (1981) 29 Cal.3d 240, 249, the Court stated that landowners could use properties subject to the trust in ways "are not incompatible" the trust—*i.e.*, that do not foist externalities onto trust interests—but that the trust also authorized the state to remove even compatible improvements on such properties *if the state pays just compensation.*

Focusing on case results also indicates that cases decided under what is now Article X, § 2, of the California Constitution have limited water uses' oppor-

tunity costs. That section seeks to limit opportunity costs almost explicitly:

> [B]ecause 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 . . . .

The California Supreme Court consequently has declared that, because water supplies are variable and so important in California, water's use triggers unique concerns about lost opportunities that even authorize courts, in some cases, to compel senior water users to change their operations to free up water for juniors. (*Gin S. Chow v. City of Santa Barbara* (1933) 217 Cal. 673, 701-702; *City of Lodi v. East Bay Municipal Utility District* (1936) 7 Cal.2d 316, 341.)

California courts therefore have limited water uses under Article X, § 2, where those uses involved opportunity costs that substantially exceeded any resulting benefits. (*See, Peabody v. City of Vallejo* (1935) 2 Cal.2d 351; *Joslin v. Marin Municipal Water Dist.* (1967) 67 Cal.2d 132.) Even in closer cases, the courts have indicated that state action was necessary to make water available for many water users during critical times (*People ex rel. State Water Resources Control Board v. Forni* (1976) 54 Cal.App.3d 743, 750-751), or to avoid the irretrievable dedication of water to unproductive use. (*Imperial Irr. Dist. v. State Water Resources Control Bd.* (1991) 225 Cal.App.3d 548, 553, 570.) If there is a reasonable relationship between a water use's opportunity costs and its benefits, then Article X, § 2, is satisfied. No case has authorized reallocations of water simply to satisfy revised state policy preferences. The state's authority to control a water use's opportunity costs does not include the authority to recapture the lost opportunity itself. In *City of Barstow v. Mojave Water Agency* (2000) 23 Cal.4th 1224, the California Supreme Court thus held that a public need—the need to fix an overdrafted groundwater basin—did not justify dispensing with existing water-right priorities.

When examined together with U.S. Supreme Court takings decisions involving interests that are not strictly real property, California water decisions can be understood as allowing the state to control water uses' opportunity costs and externalities, but not to reprioritize uses according to the state's evolving preferences. Because water is a variable resource declared to be uniquely important by the California Constitution, the exercise of state power to require a water user to address its activities' impacts, or to control those activities' costs by maintaining a reasonable relationship between them and those activities' benefits, should be within a water user's expectations. On the other hand, the state's substantial rescission of its approval of the use, or its usurpation of the benefits of the water user's investments, would not be within a water user's expectations because the state's initial approval encouraged those investments. The state must pay compensation to recapture the opportunities it lost when it approved a water use, which it can do because—unlike private entities—it has the power of eminent domain. While the state has that extraordinary power, it does not have the even more extraordinary power to use the public trust doctrine or Article X, § 2, to recapture lost opportunities for free. Moreover, non-takings doctrines like federal preemption may limit further the state's power to reallocate water and any reallocations themselves would have to comply with Article X, § 2. (*See, California v. U.S.* (1990) 495 U.S. 490; *National Audubon*, 33 Cal.3d at 443.)

Economic Considerations Explain Recent Decisions Concerning Takings and Suggest Reallocation Proposals' Consequences

Under this article's analysis, recent cases that have struggled with the physical/regulatory distinction make sense. While *Tulare Lake*'s insight about takings law and appropriative water rights—if you take the use, you take the right—is valid, the decision still may be criticized for not accounting for the plaintiffs' reliance on contracts based on diversions that have been subject to reconsideration since they were permitted. (*See, State Water Resources Control Bd. Cases* (2006) 136 Cal.App.4th 674, 691-712.) *Allegretti* is best understood as a pre-project permitting case similar to many cases in which courts have denied takings compensation for permit conditions. (*See, e.g., Penn Central*, 438 U.S. at 128-138.) *Casitas* only concerned the selection of regulatory-taking or physical-taking rules, not whether compensation was due.

As for future disputes about reallocating water, the economics-based analysis indicated by *Lingle*, *International Paper*, *Kaiser Aetna* and *Ruckelshaus* suggests that an agency may not define "good" conditions—like water quality objectives or streamflow

standards—and then order that water-right holders implement them without compensation unless the agency proves that their water uses cause the impacts that the conditions are intended to address. Otherwise, the agency would not be addressing those uses' opportunity costs under Article X, § 2, or their externalities under the public trust doctrine. For example, the state may be unable to impose, without paying compensation, new limits on Delta-watershed diversions to enhance Delta aquatic conditions where those diversions have been stable for decades (Delta Vision, pp. 36-37), because the Delta's problems are not opportunity costs or externalities of those diversions.

If it would be expensive to compensate water users for reallocating their supplies, that result still would simply implement the takings clause. As Justice Holmes stated in *Pennsylvania Coal:*

> [A] strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change.

(260 U.S. at 416.)

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