FEATURE ARTICLE

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General Fund Payments as an Alternative to the Private Sale of Municipal Assets

Monetizing, or cashing out, the value of long-held water, sewer, or parking system assets, can seem like an irresistible financial solution for a borough. Business plans of financial and law firms are based on advising, and sometimes encouraging, such transactions. However, borough officials should carefully consider the pros and cons of signing away the most valuable assets a borough (or its municipal authority) will ever own.

Though water system privatization has occurred for decades, the number of PA municipalities considering the sale of public water systems, and more recently sewer systems, has increased considerably since Act 12 of 2016. It created new valuation and cost recovery options that enable regulated utilities to offer higher prices for municipal assets.

Basically, Act 12 created a process for a private utility to obtain a rate hike through the Public Utility Commission (PUC) that allows the purchase price to be spread over its customer base. Asset sales, or 40- to 50-year "concession" agreements, can result in significant cash offers that may lead to more liquidation of municipal assets.

Another reason for a borough to sell its utility system is to avoid costly or complex upgrades. The positive of freeing time and budgets from utility operations cannot be underestimated.

Aging infrastructure and stringent regulations were often cited by legislators for incentivizing private utilities to take over municipal assets.

The Downside of Selling

Selling a utility system can result in unexpected consequences. There are the high professional fees typically generated by this kind of complex transaction. There also is a legal debate as to the propriety of using a one-time windfall, financed by utility customers, to cover accrued general fund obligations.

One inevitable consequence is future rate hikes for the ratepayers. Private utilities typically seek increased rates every three years. These increases generally keep pace with inflation, resulting in about 10 percent more on a bill every three to four years. This should be weighed against any moderation in taxes.

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Loss of control over future system expansions, operations, and employment is another reason cited to turn down a purchase offer. The extent and timetable of lost municipal powers varies with the agreement. More lucrative expansion outside of the borough could foster sprawl and accelerate the flight of businesses (and assessed values). The cost of new township infrastructure would then be borne, at least in part, by borough residents.

Alternatives to Selling

A 2012 amendment to the Authorities Act prohibited gifts or loans of money from an authority to its municipality for "any purpose other than a service or project directly related to the mission or purpose of the Authority." Municipalities that relied on such annual payments were left with no choice but to sell the system outright.

This amendment has been interpreted to mean that an authority must receive value commensurate with payments made to the municipality. Implementing a "cooperation" agreement specifying the extent and value of services is a possibility (assuming legitimate values are assigned), though this does not typically result in relief to the general fund.

However, there is firm legal authority for a municipality to receive a "reasonable rate of return" (RRR) on assets it owns. This means a borough could pay itself a RRR from the annual operation of assets already owned. If the system is owned by an authority, a payment system can still be structured.

Additionally, a borough can be compensated for assets that are used by the authority in its operations. This could include sewage (or stormwater) transmission mains that were never conveyed to the authority, for example, or land or rights-of-way used, but not owned, by the authority. The borough can then lease those assets to the authority.

If the authority owns the entire system, options still exist.

The Authorities Act gives the incorporator the right to acquire any or all of its authority's "projects." This could include a particular asset, such as the water source (wells or reservoir), sewage treatment or water filtration plant, septage handling facilities, or other essential or revenue-producing portions of the overall system. Or, the entire system could simply be transferred (back) to the borough.

The biggest legal obstacle to acquiring authority assets is that the "obligations" (typically debt) associated with the transferred assets, must be assumed.

A borough could issue general obligation (GO) debt to retire the authority's revenue debt, which would then be "self-liquidating" from authority payments. The parties can also simply comply with the authority's existing borrowing documents.

Bond trustees and PennVest have consented to asset transfers without disturbing existing interest rates, provided the municipality guarantees the debt. This guaranty assures that the lenders are paid before the municipality.

Acquired assets can then be simultaneously leased back to the authority to preserve the PUC exemption. The revenues still belong to the authority, so liens securing authority debt are not disturbed. Also, bulk service agreements with neighboring municipalities do not have to be assigned.

Legal Limits on Payments

There are limits to what a borough can demand as general fund payments from utilities.

The Pennsylvania Supreme Court has held that a municipality can deposit utility revenues into its general fund if: (1) the source of the revenues is owned by the municipality, (2) these deposits equal an RRR commensurate with investor-owned utilities, and (3) the resulting rates paid by customers, after the lease payments, remain "reasonable" (again, compared to private utility rates).

A fair rental and user fee analysis that the borough can rely on in the event of a legal challenge is typically performed by an engineer or financial adviser. The result is a choice of possible payments and the rate impact from each.

This approach resulted in annual payments for at least two PA municipalities that produced annual, predictable revenue to the general fund. Also, the year-to-year lease did not have to anticipate every conceivable future scenario (unlike a 40-year investor lease). Local control of municipal assets was preserved, including local employment and expansion, and utility profits remained within the community.

The Authorities Act states that the incorporating municipality may at any time "specify the project or projects to be undertaken by the Authority." A borough could simply amend the authority's articles of incorporation to add a new "project" that is currently a drain on the borough's general fund.

Delegating specific responsibilities (e.g., stormwater management, floodwall, street maintenance, etc.) would mean the authority undertakes the new mission using system revenues rather than taxes.

There are two requirements to make this strategy work: (1) the Authorities Act must authorize the new project, and (2) the authority's loan documents must allow this use of the revenues.

The borough should consider issuing GO bonds, lending the proceeds to the authority to undertake utility projects. GO bond documents do not restrict system revenues, and the GO bond payments would come from the authority.

Surrendering ownership of essential public assets to private hands should be a last resort. Likewise, seeking a one-time cash infusion that benefits the current administration at the expense of future elected officials is politically questionable. Perhaps annual payments that reflect the historical value rendered by the borough to the entire region, including from its long-held utility assets, is a more appropriate solution.

About the author: *Jens Damgaard is a public finance lawyer with Eckert Seamans Cherin & Mellott, LLC in Harrisburg, with more than three decades of experience representing school districts, counties, municipalities, and municipal authorities in tax-exempt and structured financings for a variety of public projects. He also represents banks, underwriters, and trustees in connection with bond issues, loans, investment and derivative products, and credit issues.*

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