ANNUAL PAYMENTS AS AN ALTERNATIVE TO SELLING MUNICIPAL ASSETS

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It is no secret that many Pennsylvania municipalities are facing the consequences of a shrinking tax base and growing expenditures. Aging infrastructure, underfunded pension obligations, and rising costs for health care and social services mean local government deficits are on the rise.

No wonder that it is an annual struggle to balance the general fund budget. "Monetizing" or cashing out the value of long-held water, sewer or parking system assets can often seem like an irresistible solution. Business plans being conceived by financial and law firms are built around advising (and possibly encouraging) such transactions. However, government officials should carefully consider the pros and cons of signing away, for generations, what is likely the most valuable assets the municipality will ever own.

Though water system privatization has been occurring for decades, the number of Pennsylvania municipalities considering the sale of public water systems, and more recently sewer systems, has increased considerably since a state law was enacted in 2016 that makes it much easier for private utility companies to expand through municipal acquisitions. Act 12 of 2016 created new valuation and cost recovery options that enable utilities to offer higher prices for municipal assets.

Basically, Act 12 allows the buyer and seller to hire approved valuation experts to appraise the assets to be transferred. The average of the two appraisals is then used as a fair market value that can be incorporated into the private utility's rate base. The next time the utility seeks a rate hike with the PA Public Utility Commission (PUC), the new purchase price can be factored in and spread over the utility's much larger customer base (unless the parties agree in advance to freeze or phase in the higher rates over a specified period). Future improvements to the assets can be included in user rates as well, on a phased basis.

With higher offering prices on the table, asset sales or 40-50 year "concession" agreements can generate significant cash offers. Provided the municipality jumps through the proper hoops, this money is being used to pay down existing debt, shore up pension funds, or cover years of capital needs or budgetary shortfalls. When money is tight, a hefty cash payment is hard to turn down. Perhaps we are witnessing an epic liquidation of municipal assets in Pennsylvania.

Another reason to sell the local utility system is because it needs major upgrades, and the municipality is not willing to take on the cost or complexity of such a project. Also, freeing administration and employee time and costs devoted to utility operations and maintenance, should not be underestimated.

Aging infrastructure, in combination with increasingly stringent regulations, is most often cited by legislators for incentivizing private utilities to take over municipal assets. Annual, state budget impasses are unlikely to produce new grant programs. Assistance that does exist, comes in the form of loans that must be repaid in today's rising interest rate environment.

However, selling a utility system can result in some unexpected consequences. The high fees typically generated by such transactions can be a source of embarrassment or even litigation. The intended use of the lump-sum payment is also fertile ground for dispute. There is a debate within the legal community as to the propriety of using a one-time windfall, financed by utility customers within and outside the municipality, to cover accrued general fund obligations. Some say the utility customers should benefit from the payment, perhaps by escrowing the money as a rate stabilization fund. It gets more complicated, legally and logistically, when a municipal authority is involved.

One consequence that should not be unexpected is higher future rates for the local ratepayers, as well as of the private buyer's distant customers. Private utilities typically apply to the PUC for an increased rate tariff every three years. These increases generally keep pace with inflation in service costs, and result in an effective rate increase of about 3.0% to 3.5% per year. With increases occurring in three year increments, one can expect users to experience a 10% increase in rates every three to four years. This has to be weighed against moderations in taxes resulting from the sale price.

Loss of control is also cited as a reason to turn down a purchase. Once the asset is sold or leased to a third party, control over future system expansions, operations and employment are typically forfeited over the long term. The extent and timetable of lost control varies with the terms of the agreement or lease. For example, a private utility could enter into a lucrative agreement with private developers to extend service into a new suburban area, rather than a City's low-income or developable areas. This could foster sprawl and accelerate the relocation of businesses

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(and assessed values) out of the City. The cost of this new suburban infrastructure would then be borne, at least in part, by the City's residents.

Another lesson from the law of unintended consequence comes from a 2012 amendment to the Municipality Authorities Act (Section 5612(a.1)). That amendment prohibits gifts or loans of money from an Authority to its incorporating municipality for "any purpose other than a service or project directly related to the mission or purpose of the Authority…" Many municipalities have relied on such annual payments. The resulting deficits left municipalities with no choice but to sell the system outright.

The 2012 Authorities Act amendment is typically interpreted to mean that the Authority must receive value commensurate with payments to the municipality. It is often assumed that the municipality can only be reimbursed for actual expenditures made from, or allocated to, its general fund. A "cooperation" or similar agreement specifying the extent and value of the municipality's services is a possibility (assuming legitimate values assigned to services), though this does not typically result in material relief to the general fund. Value, and levels of compensation, can be created in other ways however.

There is legal authority for a municipality to receive a "reasonable rate of return" (RRR) on assets it owns, in the same way that investor-owned utilities are legally entitled to earn a profit annually from assets its shareholders own. If a system is already owned by the municipality, it is allowed to pay itself the RRR from annual operations. However, if it is owned by a municipal authority, a payment system can still be structured. The goal is to implement a process causing as little disruption as possible…to both the municipality and to the Authority.

If the municipality owns something that the Authority currently uses for its operations, it is appropriate for the municipality to be compensated. This could include sewage (or storm water) transmission mains that were never conveyed to the Authority. It could include land or rights-of way used, but not owned, by the Authority. The municipality can then lease those assets to the Authority for a fair annual rental payment.

If the Authority currently owns all of the assets required to render service, options still exist. The Authorities Act gives the incorporating municipality 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, an entire system could be transferred.The higher the value of the transferred assets, the lower the RRR percentage would be for a desired payment amount (making it more defensible).

The biggest obstacle to the municipality acquiring Authority assets is that it must assume the "obligations" (typically debt) associated with the assets to be transferred. The municipality could issue its own general obligation debt to retire the Authority's revenue debt, which would then be "self-liquidating" (excluded from statutory debt limits) from the Authority payments. The parties can also simply comply with the existing loan or bond documents governing the transfer of assets. Bond trustees and the Pennsylvania Infrastructure Investment Authority (PennVest), have consented to asset transfers without disturbing favorable interest rates on existing debt, provided the municipality guarantees such debt. The guaranty assures that the lenders are paid before the municipality.

The assets can then be leased back simultaneously to the Authority. This preserves the exemption from PUC rate oversight (the Authority continues to set user rates), the lien of the existing loan documents continues to encumber the Authority revenues, and agreements with bulk service customers or neighboring municipalities do not have to be assigned. Again, the goal is to minimize disruption, and litigation.

Another option would be for the Authority to pay the municipality for a product or service that is produced by the transferred asset. For example, a municipality acquiring only the sewage treatment plant could charge the Authority for bulk sewage treatment services. As owner of the water source, the municipality could sell bulk treated or raw water to the Authority, for distribution in the lines retained by it. The bulk rates charged by the municipality to the Authority would not trigger PUC involvement on its own, because the Authority continues to set the user rates paid by customers. In any case, the municipality could avoid using its own personnel by contracting with the Authority, under a management or operating agreement, to run the facility on its behalf. The bulk rates are then calculated to cover operating expenses of the Authority,and applicable debt service, and the remaining profit is retained by the municipality.

There are limits to what a municipality can demand as annual lease payments or profits. 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-

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owned utilities, and (3) the resulting rates paid by customers, after the lease payments, remain "reasonable" (again, compared to private utility rates). This entitlement is based on United States Constitutional principles unlikely to be overturned.

There is no readily obtainable data for reasonable returns and utility rates. For that reason, a fair annual rental value and user fee analysis requires a professional study and opinion that can be relied on in the event of threatened legal challenges by customers or surrounding municipalities.This written study must include an appraisal of the subject assets (similar to what is done in connection with an asset sale) to determine percentage returns represented by a range of possible payments. It must include the cost of likely, future capital expenditures and resulting new debt service. The analysis looks at revenues freed up by expiring debt service, and inflation in costs of operation. The result is a selection of potential returns and payments, and the resulting rate impact from each.

This approach, used by at least two Pennsylvania cities, resulted in annual payments in lieu of a one-time cash infusion. These arrangements had the following, benefits:

- It gave those municipalities annual, predictable revenue for its general fund.
- The municipalities avoided the long-term temptations and potential mismanagement that could result from investing and managing one-time cash payments.
- The year-to-year lease did not have to anticipate every conceivable, future expenditure scenario. This arrangement was more flexible and can be amended from time to time as circumstances change, unlike a private investor that needs a firm (and profitable) contract to support its borrowing to pay a lump sum.
- Local control of the assets was retained, including local employment, and sensitivity to the municipality's ongoing needs was preserved.
- The utility profits remain within the community, not paid to private shareholders.
- The Authority remained subject to Authorities Act standards and judicial oversight on rates.

There exists another potential strategy to relieve a municipality's general fund budget. Section 5607(c) of the Authorities Act states that the municipality organizing an Authority may at any time "specify the project or projects to be undertaken by the Authority." Rather than receive revenues from the Authority, the municipality could amend the Authority's Articles of Incorporation to add a new "project" that is currently a drain on the municipality's general fund.

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Delegating responsibilities typically paid from taxes (e.g. stormwater management, floodwall or street maintenance, etc.) would mean the Authority undertakes the new mission using its existing revenues rather than the municipality's taxes. There are two requirements to make this strategy work: (1) the Authority must have the lawful power under the Authorities Act to undertake the delegated project, and (2) the Authority must not be prevented by creditor documents from using its utility revenues for that purpose. Often a trust indenture securing Authority bonds will restrict the use of utility revenues to only that system (including making the bond payments). One way to plan for this is to have the municipality issue general obligation bonds, and lend the proceeds to the Authority, to undertake the utility related projects. Documents securing GO bonds would not restrict system revenues even if the bond proceeds are used for the Authority run system. The bond payments would then be included in the Authority lease payments to the municipality.

Reasonable people can argue whether it is appropriate for utility revenues to subsidize a general fund budget. Yet, literature currently distributed by Pennsylvania state agencies and governor's office suggest the sale or lease of municipal assets as a way to avoid or escape distressed status. At least one City has done just that. Municipal utility and parking revenues are the few available sources of enterprise revenues, including from regional sources, that can stabilize a general fund and address the flight of property values due to increased taxes.

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

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